European Chamber
中国欧盟商会

Not Now, Maybe Later: Shanghai as an International Financial Centre

Executive Summary

In 2009, China's State Council announced ambitious plans for Shanghai to become a fully-fledged international financial centre by 2020.

With this deadline imminent, the European Chamber surveyed 26 executives from its Banking and Securities Working Group to gain a better understanding of Shanghai's progress. Their responses indicate issues such as a lack of transparent regulations, worrisome government interventions and various restrictions on business development that are likely to prevent this ambitious plan coming to fruition.

42 per cent of respondents believe that Shanghai will become a global financial centre in the near future. This optimism makes sense in light of Shanghai's financial leadership within China and leaps forward in measures such as the *Global Financial Centres Index*.

International financial centres should have transparent regulatory and legal frameworks and be favourable to foreign entities and investment. The survey reveals significant hurdles in both regards.

85 per cent of respondents identify regulatory hurdles as one of the largest impediments to growing their business in China. 88 per cent of respondents believe Shanghai's market to be overly regulated compared to international financial centres such as London and New York.

Regulatory constraints make it difficult for banks to fund their operations; for example, forthcoming limits on intragroup exposure will create headaches for three-quarters of respondents, severely limiting their ability to receive funds from European headquarters. Regulations related to liquidity ratios require the calculation of long-term debt as a current liability, contradicting international practice and unfairly reducing the liquidity ratio of foreign banks. Branches of foreign banks are still unable to issue onshore bonds, a problem cited by nearly half of the banking executives polled. 42 per cent of executives also point to inflow and outflow quotas as further compounding funding issues.

The issue of licencing is particularly salient, constituting a handicap to growing business for nearly half of respondents and raising suspicions of subjectivity and political influence in the approval process. Around three quarters of respondents, rate licencing in Shanghai as more difficult compared to other international financial centres; such frustrations can explain why 23 per cent of respondents find it difficult to open a business in the first place.

The strain of these regulations is intensified by a high degree of uncertainty. The majority of respondents express that Shanghai's enforcement of regulations is less specific, less transparent and less consistent compared to other financial centres. 69 per cent identify this opaqueness as a main

factor that will hold Shanghai back from international financial centre status. Despite clear improvement in coordination between China's various financial regulators, there is still much progress to be made in coordination between regulators' headquarters and branches.

Arbitrary government interventions may also hinder Shanghai from achieving its goal, as more than half of executives state. Not a single respondent believes that securities are accurately priced in China, and only 12 per cent believe that corporate credit in China is accurately priced. Disuse of the bankruptcy mechanism, only just overhauled in March 2019, has contributed to this gross mispricing of risk. This year's market opening to foreign rating agencies will hopefully prove an overdue step forward on this issue.

For 46 per cent of respondents, Shanghai's financial infrastructure still lacks an adequate amount of auxiliary service providers. A strong financial ecosystem will be bolstered by the European Commission's recognition of the Shanghai Clearinghouse as a qualifying central counterparty, a decision that must be preceded by Chinese authorities' recognitions of foreign central counterparties.

Over a third of survey respondents also expressed that data and cybersecurity issues may hold Shanghai back. As critical information infrastructure operators, some banks may be greatly affected by requirements to conduct security assessments for cross-border transfers.

A second tenet of an international financial centre is, as the name suggests, a high level of internationalisation. 73 per cent of executives believe that to truly be an international financial centre, the market share of foreign banks should exceed five percent. China's current foreign market share stands at 1.29%. High-level executives will also be vital to expand the footprint of foreign banks in Shanghai, and assigning foreign talents will go a long way in this growth. Yet recent revisions to the Individual Income Tax law will remove the tax-free benefits that make it feasible for such executives to bring their expertise to China.

Lastly, internationalisation of the *renminbi* (RMB) will be a key determinant of Shanghai's strength as a centre for global financial activities. Yet use of the RMB remains fairly low worldwide. Capital controls and RMB inconvertibility are identified by 88 per cent and 62 per cent of respondents, respectively, as major factors holding Shanghai back from its goal.

The European Chamber considers the removal of capital controls and full RMB convertibility essential for Shanghai to become an international financial centre, but recognises the potential negative repercussions if such changes were undertaken immediately, such as mass capital outflows. China should move towards full reform of these two aspects in a well-planned, phased and sensitive approach to avoid major damage to its own and the global economy. In the meantime, it can progress in the right direction of becoming an international financial centre by improving regulatory transparency and further internalisation of the Shanghai financial ecosystem. The European Chamber hopes the following recommendations may guide policymakers towards this goal.

Key Recommendations

1. Progress towards full convertibility of RMB.
2. Implement calculated and incremental reforms aimed at eventual removal of capital controls.
3. Improve the specificity, transparency and consistency in the enforcement of regulations.
4. End arbitrary, government-backed interventions in the stock market.
5. Lift various restrictions on business conduct.
6. Make it easier for subsidiaries and branches of foreign banks to issue RMB-denominated bonds for funding purposes.
7. Exempt foreign banks from the 25 per cent limit on intragroup exposure.
8. Remove the net of long-term borrowings from current liabilities for overseas branches when calculating liquidity ratios, in order to compare assets and liabilities in the same tenor and ensure equal treatment for Chinese and foreign banks.
9. Allow for the development of the Shanghai Clearinghouse as a qualifying central counterparty and provide for an equivalent system of recognition of foreign central counterparties.
10. Further improve coordination both among regulators and between central regulators and their Shanghai municipal branches.
11. Maintain reasonable, tax-free benefits for foreigners to improve talent acquisition and increase the number of foreign financial services companies operating in Shanghai.

Introduction

In April 2009, China's State Council put forward a proposal to develop Shanghai into an international financial centre with the release of its *Opinions of China's State Council on Expediting Shanghai's Development of Modern Services and Advanced Manufacturing and Building Shanghai into an International Financial Center and International Shipping Center* (Guo Fa [2009] No. 19).[1] With a 2020 deadline set for this ambitious task, the plan was announced after the worst of the global financial crisis had already been resolved, with the aim of promoting more sustainable economic growth and safeguarding China's national financial security.

The European Chamber notes several important advances in Shanghai's financial infrastructure – most notably the stock and bond connects, such as the London-Shanghai Stock Connect;[2] local reforms such as the 100 Measures;[3] and allowing foreign rating agencies into the local market. The international financial community welcomed these reforms, with the weight of China A-shares being increased in

[1] *Opinions on Shanghai Increasing the Pace of Development of a Modern Services Sector and the Creation of a Modern Manufacturing Industry, an International Financial Centre and an International Shipping Centre,* State Council, 29th April 2009, viewed 23rd October 2019, <http://www.gov.cn/zwgk/2009-04/29/content_1299428.htm>

[2] Ren, Daniel, *London-Shanghai stock connect goes live, allowing foreign firms to list their shares in mainland China for the first time, South China Morning Post,* 17th June 2019, viewed 23rd October 2019, <https://www.scmp.com/business/companies/article/3014809/london-shanghai-stock-connect-goes-live-allowing-foreign-firms>

[3] *100 Full-text Articles on Further Opening Up Shanghai: 5 Aspects, 20 Tasks, 100 Initiatives, The Paper,* 10th July 2018, viewed 13th October 2019, <https://www.thepaper.cn/newsDetail_forward_2252033>

the MSCI series of indices,[4] and Chinese corporate bonds being included in the Bloomberg Barclays family of indices.[5]

Yet there remains a sizeable gap between ambition and reality. For example, despite significant announcements to lift market equity caps for the banking and securities industries in 2018, international financial institutions still struggle to enter the market as licences are issued on a case-by-case basis and are based on high minimum requirements. Capital market reforms and internationalisation of the *renminbi* (RMB) are also still in a nascent stage of development.

With the 2020 deadline imminent, the European Chamber polled 26 executives from its Banking and Securities Working Group to gain an understanding of how close Shanghai is to becoming an international financial centre. The following report is based on this survey, as well as one-on-one interviews to supplement the data.

Will Shanghai become an international financial centre in the near future?
Around 42 per cent of respondents do see Shanghai becoming an international financial centre in the near future. That said, about 31 per cent say that Shanghai will not achieve this status and 27 per cent are uncertain about the city's future as an international financial centre in the short term (Figure 1).

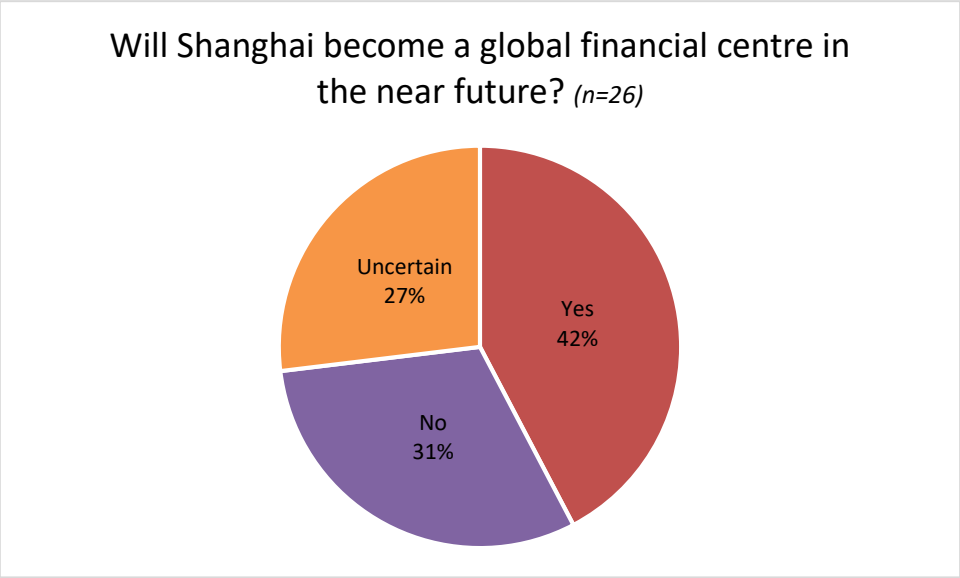

Figure 1

This optimism is perhaps best understood in the context of Shanghai already being the undisputed

[4] *MSCI Will Increase the Weight of China A Shares in MSCI Indexes*, MSCI Press Release, 28th February 2019, viewed 12th October 2019, <https://www.msci.com/documents/10199/238444/China_A_Further_Weight_Increase_PR_Eng.pdf/43f3ee8b-5182-68d4-a758-2968b4206e54>

[5] *Bloomberg Confirms China Inclusion in the Bloomberg Barclays Global Aggregate Indices*, *Bloomberg*, 30th January 2019, viewed 12th October 2019, <https://www.bloomberg.com/company/press/bloomberg-confirms-china-inclusion-bloomberg-barclays-global-aggregate-indices/>

financial centre of Mainland China. The city boasts the nation's largest stock exchange with a total market capitalisation of adjusted United States dollars (USD) 4.65 trillion as of September 2019.[6] It is somewhat behind New York's USD 22.9 trillion, but leads London's USD 4.59 trillion, Frankfurt's USD 1.93 trillion, and Paris' USD 2.9 trillion.

A total of 1,537 financial institutions are based in Shanghai, with nearly 30 per cent established by foreign companies.[7] By comparison, Shenzhen, one of China's fastest growing cities and an inspiring example of economic entrepreneurial spirit boosted by foreign investment, had just 465 financial institutions at the end of 2018.[8]

Internationally, Shanghai's clout as a financial centre has also grown in tandem with the importance—and opening up—of China's financial markets. The *Global Financial Centres Index* (*GFCI*) *26*, a biannual index issued by Long Finance, measures cities based on their attractiveness to financial services professionals. In September 2019, it ranked Shanghai fifth,[9] trailing behind New York, London, Hong Kong and Singapore. To put this ranking in the context of the April 2009 plan, in May 2009, the fifth iteration of the *GFCI* did not identify Shanghai in the top 25 cities.[10] Just six months later, Shanghai had earned tenth place.[11]

What are the attributes of an international financial centre?

The first step in analysing Shanghai's progress towards its goal is to categorise what makes an international financial centre, as there are various definitions. The European Chamber has identified key criteria from multiple sources to create the following definition:

International financial centres are strategically located financial hubs that have in place transparent regulatory and legal frameworks that are favourable to foreign entities and investment, a large concentration of prominent financial entities, world-class infrastructure and telecommunications, and a stable economy and political environment.

The survey findings indicate a multitude of issues related to regulations and the presence of foreign investment. As per the above definition and considering the city's undeniably advanced physical and technological infrastructure, the European Chamber considers these two aspects as the most important to the short-term realisation of Shanghai ambitions. The rest of the report will use these

[6] *China Market Capitalization: Shanghai Stock Exchange: Stocks,* CEIC, October 2019, viewed 19th October 2019,<https://www.ceicdata.com/en/china/shanghai-stock-exchange-market-capitalization/market-capitalization-shanghai-stock-exchange-stocks>

[7] *Shanghai aims to be global financial center by 2020*, *Global Times*, 22nd January 2019, viewed 19th October 2019, <http://www.globaltimes.cn/content/1136699.shtml>

[8] Zhou Mo, *China's financial sector can play bigger role in Shenzhen's tech hub*, *China Daily*, 22nd November 2019, viewed 25th November 2019, <https://www.chinadailyhk.com/articles/149/244/7/1574357022757.html>

[9] *Global Financial Centers Index 26*, Long Finance, September 2019, viewed 18th October 2019, <https://www.longfinance.net/programmes/financial-centre-futures/global-financial-centres-index/gfci-26-explore-data/gfci-26-rank/>

[10] Mainelli, Michael, *Global Financial Centers Index 5*, Long Finance, May 2009, viewed 18th October 2019, <https://www.longfinance.net/media/documents/GFCI_-_Finance_Dublin_2009_v1.1.pdf>

[11] *Global Financial Centers Index 25,* Long Finance, March 2019, viewed 22nd October 2019, <https://www.longfinance.net/media/documents/GFCI_25_Report.pdf>

two factors to best frame the perspectives of foreign banking executives in regards to Shanghai's status as an international financial centre.

China's economic slowdown is a notable but lesser concern for respondents, as just 27 per cent of those polled still consider it to be a constraint on their business (Figure 2). This statistic aligns with previous European Chamber findings. In the *Business Confidence Survey 2019*, the slowdown was ranked by 27 per cent of member companies as the top challenge to future business in China, up eight percentage points compared to the previous year.

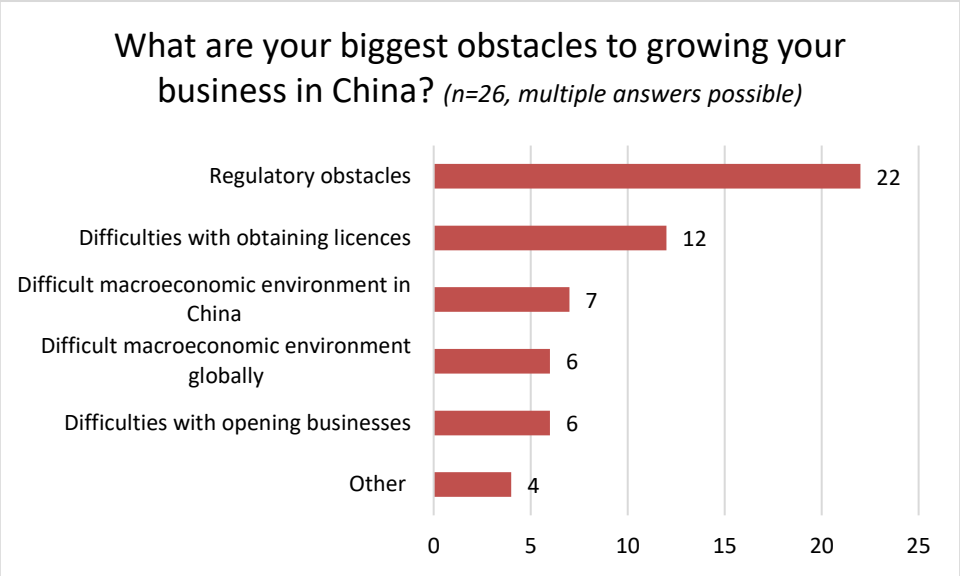

Figure 2

Factor One: Transparent regulatory and legal frameworks

Improved market access for foreign companies is not about market opening alone; it also requires regulatory reform. Survey respondents agreed almost unanimously (88 per cent) that compared to other international financial centres such as London or New York, Shanghai's financial market is overly regulated (Figure 3).

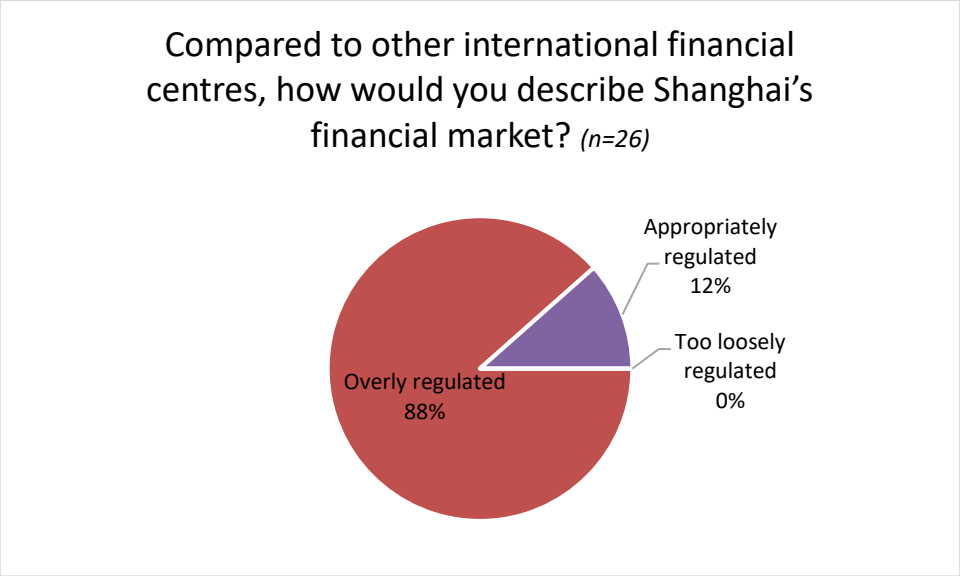

Figure 3

Suffocating rules

In a series of one-on-one interviews, European banking executives highlighted the staggering number of periodic reports that must be filed with various regulators – around 100 every month. These reports require significant amounts of data and thus significantly increase banks' costs and compliance requirements.

According to the European Chamber's *Business Confidence Survey 2019*, the slow pace of regulatory reform translated into missed business opportunities for more than half of Chamber members. More than ten per cent of those affected said these missed opportunities were worth more than a quarter of their annual revenue in China.

Moreover, 85 per cent of respondents in this present survey stated that regulatory obstacles are one of the largest impediments to growing their business in China (Figure 2). These constraints may be why the total market share of foreign banks is woefully small at 1.29 per cent.[12] This figure seems to be decreasing year-on-year, with foreign banks' total market share having stood at 1.6 per cent in 2014.[13]

Funding frustrations

In terms of funding banks' operations, the development of both wholly foreign-owned locally

[12] *China Banking Regulatory Commission 2016 Annual Report, China Banking Regulatory Commission,* 2016, pp. 46-47, viewed 22nd October 2019, <http://www.cbrc.gov.cn/chinese/files/2018/529E627CE8324461BD37CE152929E9BE.pdf>

[13] *Opening up China's Banking Industry: Developments, Effects and Policies, Financial Supervision Studies*, CBIRC, 2018, viewed 22nd July 2019, <http://zlf.rs.gdinfo.net/article/read.aspx?id=676559652>

incorporated banks and branches of foreign banks has been severely limited by numerous regulatory constraints. By far the greatest concern for polled executives is the forthcoming limits on intragroup exposure to 25 per cent of first-tier net capital, as per the China Banking and Insurance Regulatory Commission's (CBIRC) *Measures for the Administration of Large Risk Exposures for Commercial Banks* (*Risk Exposure Measures*).[14] For 73 per cent of respondents, these limits are among their biggest obstacles to funding their bank's operations as, once enacted, they would severely limit their ability to receive funds from European headquarters (Figure 4).

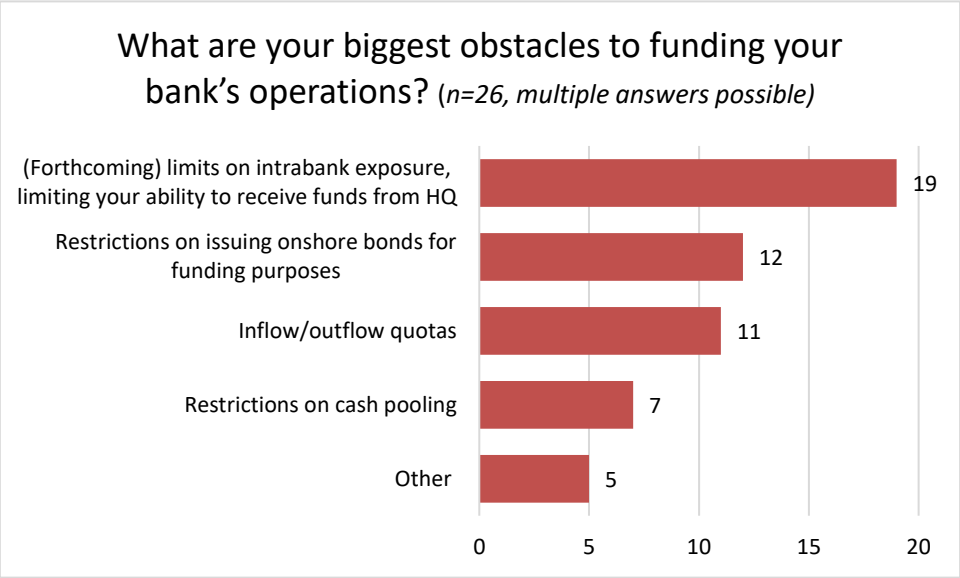

Figure 4

Regulations related to liquidity ratios also prove troublesome for foreign banks. The net amount of long-term borrowings of foreign banks in China from overseas bank group entities is treated as a current liability, despite the National Development Reform Commission's (NDRC's) classification of long-term borrowings under its long-term foreign debt quota. Liquidity ratios, an important metric used to determine the ability to pay off current debt obligations, rely on the accurate calculation of current liabilities; however, using the Chinese practice of including long-term debt as a current liability, foreign banks' liquidity ratio is unfairly reduced.

Considering the international practice of comparing assets and liabilities in the same tenor, the current classification in China does not facilitate fair calculation of liquidity for foreign banks. The purpose of a liquidity ratio is to ensure a bank's ability to pay short-term debt obligations; it is therefore essential that the classification of net, long-term borrowings gives a ratio that captures actual solvency. In the absence of large retail customer deposits, foreign banks—especially smaller branches—rely on overseas intragroup funding, which includes long-term borrowing.

[14] *Measures for the Administration of Large Risk Exposures for Commercial Banks*, CBIRC, 24th April 2018, viewed 26th September 2019, <http://www.cbrc.gov.cn/chinese/newShouDoc/338115BD0E6C43AAA979221670632DC5.html>

The issuance of RMB-denominated onshore bonds causes problems for 46 per cent of polled executives (Figure 4). While locally-incorporated foreign banks are legally allowed to issue debt securities and onshore asset-backed securities in the Chinese interbank bond market for funding purposes—as long as they can meet regulatory requirements and receive pre-approval from the CBIRC and the People's Bank of China (PBOC)[15&16]—it is currently still impossible for foreign banks' branches to do so. More foreign investment in RMB-denominated bond markets would help balance pressure on capital flows in and out of China. It would also increase scrutiny on credit quality and demand more transparency of financial records, helping establish wider differentiation between stronger and weaker borrowers. Furthermore, it could improve liquidity in onshore bonds.

For 42 per cent of polled executives, so-called inflow/outflow quotas, i.e. quotas requiring a corresponding inflow of funds for every outflow, adds difficulty to funding a bank's operations (Figure 4). It is an encouraging sign that just last month, the State Administration of Foreign Exchange announced the removal of quotas on the Qualified Foreign Institutional Investor (QFII) and RMB Qualified Foreign Institutional Investor schemes (RQFII), to boost capital inflows.[17] The European Chamber hopes for swift implementation of these reforms.

Hard to get off the ground

The difficulties associated with opening banking businesses such as branches, subsidiaries or Sino-foreign joint ventures is highlighted by 23 per cent of polled executives (Figure 2). Licencing issues alone prove a major roadblock for operations, with 73 per cent of respondents reporting that the process for receiving licences was more difficult in Shanghai compared to other international financial centres such as London and New York (Figure 5). This is also listed as one of the biggest obstacles to growing business in China for 46 per cent of respondents. One additional regulatory burden compared to other financial markets is that a bank needs to be invited by the National Association of Financial Market Institutional Investors to apply for a licence.

[15] *Foreign Bank Regulations*, CBIRC and the PBOC, 11th December 2006, viewed 26th June 2018, <www.cbrc.gov.cn/chinese/home/docView/2855.html>

[16] *National Bond Market Issuance Regulations for Financial Bonds*, CBIRC and PBOC, 1st June 2005, viewed 26th June 2019, <http://www.chinabond.com.cn/Info/843356>

[17] *China to scrap quotas that cap foreign financial investments*, *Reuters*, 10th September 2019, viewed 18th October 2019, <https://www.reuters.com/article/us-china-economy-investment/china-to-scrap-quotas-on-qfii-rqfii-foreign-investment-schemes-idUSKCN1VV0WJ>

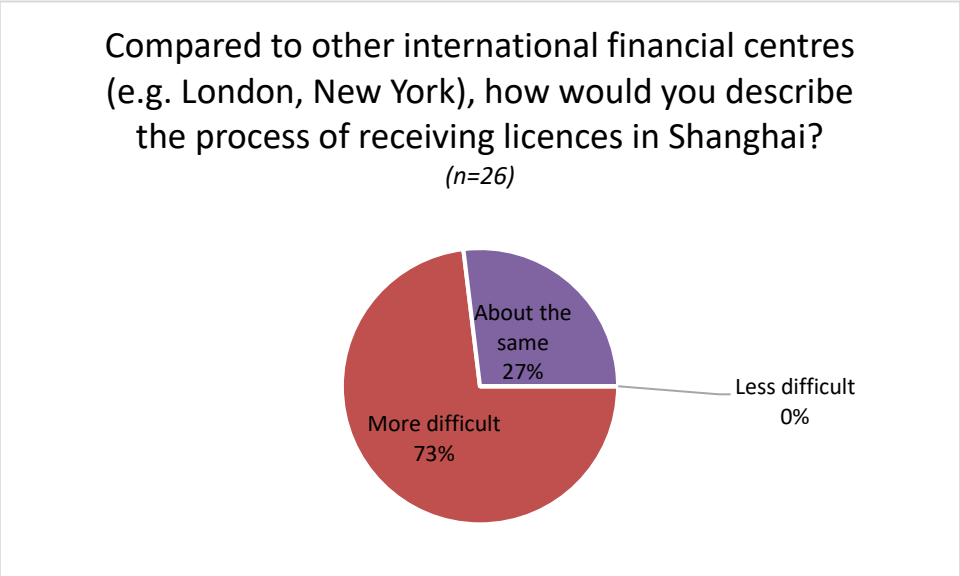

Figure 5

Submitting a licence application is complicated by the fact that there are only some objective criteria for licences being awarded, while a lot of the process is non-transparent. The 'criteria' are essentially only guidelines, giving regulators a lot of leeway and raising suspicion that the process may be influenced by matters of political expediency. One interviewed senior executive noted that "you cannot set your strategy as you are essentially flying in fog." European banks are looking to increase their capital expenditure, yet they are entirely dependent upon the goodwill of the regulator to grant them licences.

Uncertainty and confusion

Problems associated with burdensome regulations are compounded by the uncertainty and opaqueness that surrounds them. The majority of respondents believe the enforcement of regulations in Shanghai to be worse or less specific, transparent and consistent compared to other major financial centres (Figure 6).

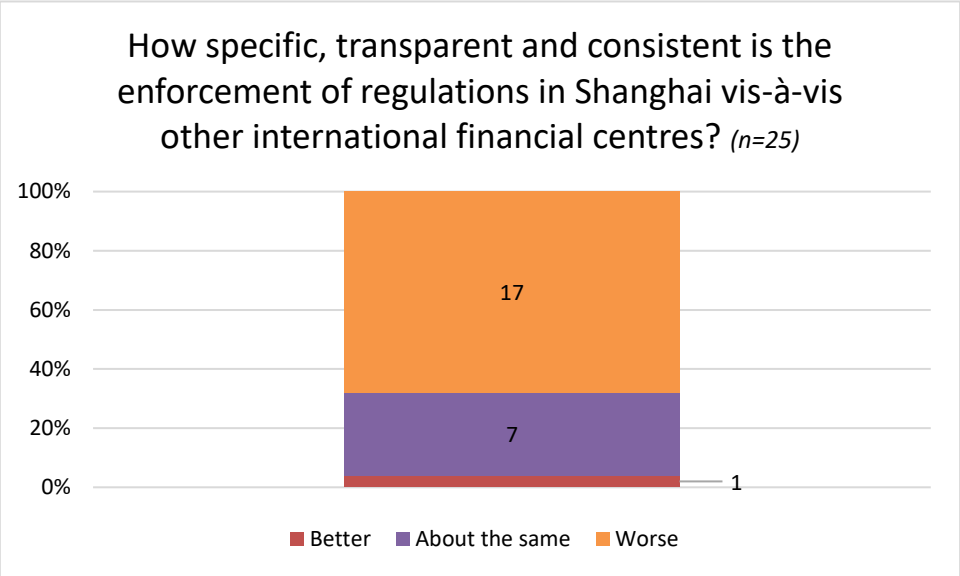

Figure 6

About 69 per cent anticipate that the limited transparency and reliability of regulatory, administrative and judicial matters will hold Shanghai back from becoming an international financial centre (Figure 7). This represents one of the survey's most significant findings, that being able to trust in judgements and decisions is a key foundation upon which financial services are built.

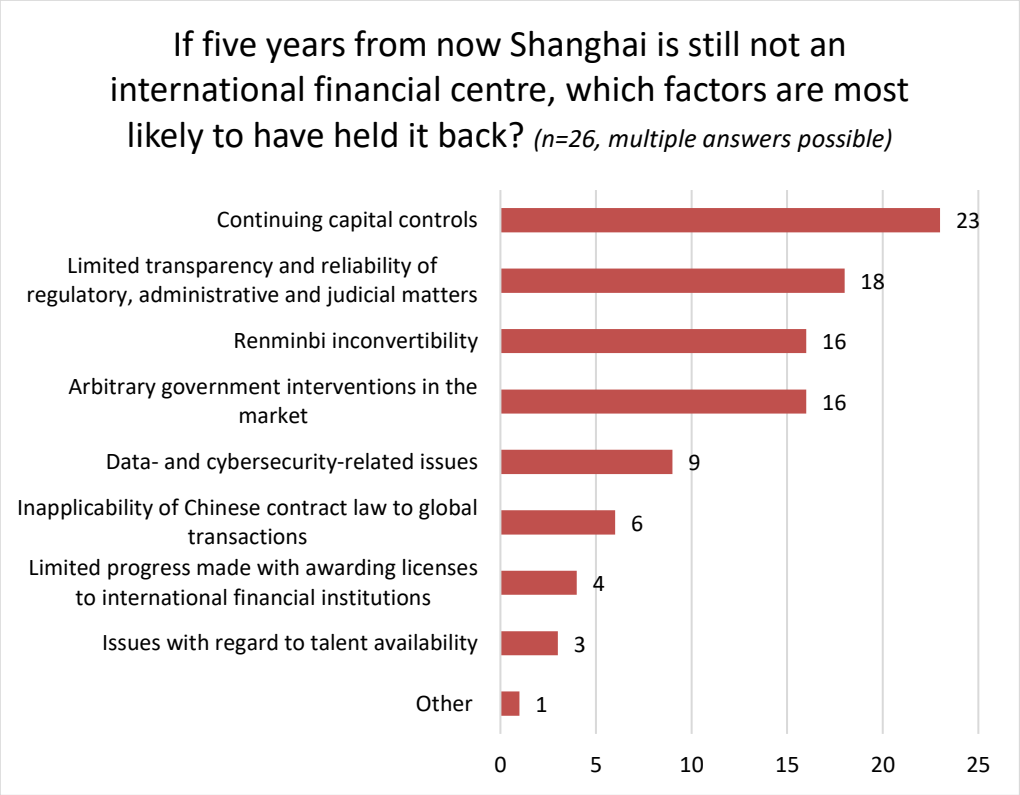

Figure 7

The European Chamber is pleased to note some improvement in coordination among the various financial regulators, as identified by over half of survey respondents (Figure 8). Yet executives remain divided over whether there has been any improvement in coordination between regulators' provincial branches and national headquarters. This is important as well-coordinated regulatory reform efforts will be a pivotal part of Shanghai's success.

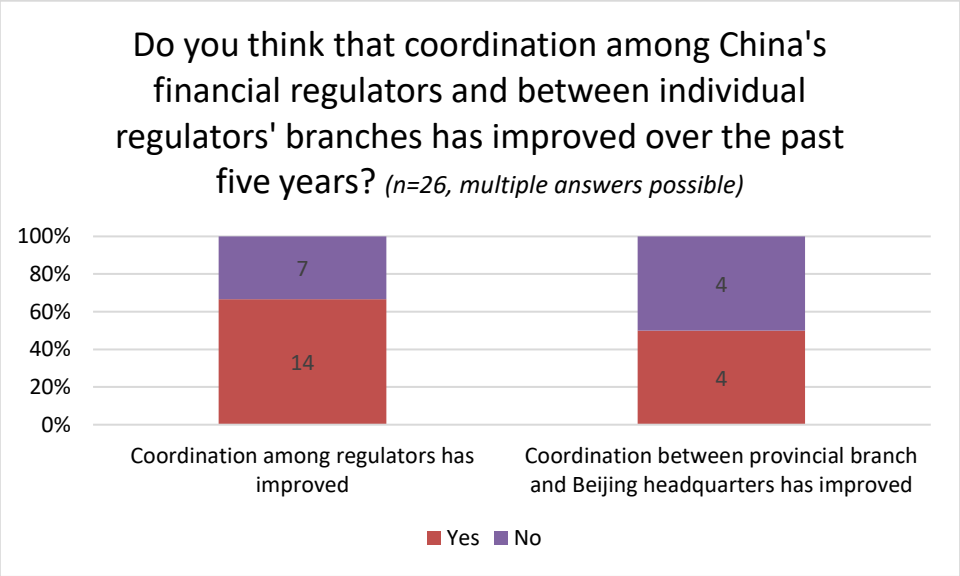

Figure 8

Leave it be

More than half of executives pointed to the significant problems that a continuation of arbitrary government interventions in China's financial markets pose for its development (Figure 7). Nearly all interviewees recalled the wild stock market gyrations that occurred over the course of 2015 and 2016, and the negative effect that the intervention of various Chinese regulators had on investor confidence.

Similarly, 58 per cent of polled executives report uncertainty over China's stock markets and equity pricing; not a single respondent believed that securities are accurately priced in Shanghai (Figure 9). To boost Shanghai's ability to develop into an international marketplace for financial services, regulators should put full trust in markets and cease intervening.

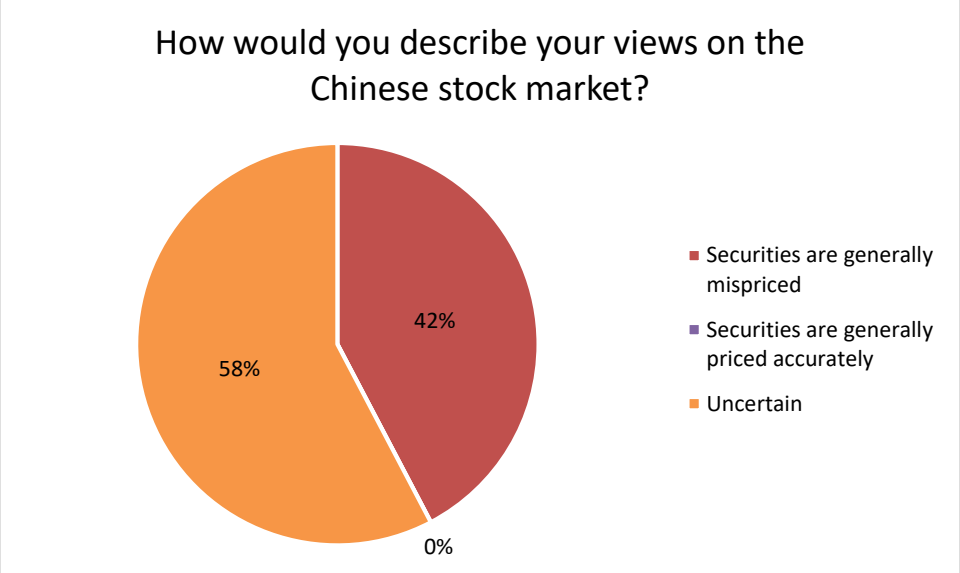

Figure 9

In March 2019, it was announced that China's 2007 Bankruptcy Law would be overhauled.[18] Up until now, the bankruptcy mechanism has rarely been invoked, which has led to a great mispricing of risk in China's financial markets.[19] This is backed up by 52 per cent of polled executives who report being uncertain whether corporate credit is generally priced accurately in China (Figure 10). Indeed, the quality and reliability of credit ratings in China has long been a point of concern for international observers,[20] with the January 2019 market opening to foreign rating agencies an overdue step in improving the overall quality of China's financial services sector. [21]

[18] *China Moves Closer to Overhaul of Bankruptcy Law, Caixin Global*, 29th March 2019, viewed 15th April 2019, <https://www.caixinglobal.com/2019-03-29/china-moves-closer-to-overhaul-of-bankruptcy-law-101398784.html>

[19] For example, the Bank for International Settlements (BIS) defines 'zombie firms' as "firms that are unable to cover debt servicing costs from current profits over an extended period", Banerjee, Ryan Niladri and Boris Hofmann, *The rise of zombie firms: causes and consequences, BIS Quarterly Review*, 23rd September 2018, viewed 26th June 2019, <https://www.bis.org/publ/qtrpdf/r_qt1809g.htm>

[20] Jacquet, Kate, *Understanding China's Bond Ratings*, *The Diplomat*, 27th June 2019, viewed 18th October 2019, <https://thediplomat.com/2019/06/understanding-chinas-bond-ratings/>

[21] *China picks S&P Global as first foreign bond rating agency, Nikkei Asian Review,* 28th January 2019, viewed 15th April 2019, <https://asia.nikkei.com/Business/Markets/China-picks-S-P-Global-as-first-foreign-bond-rating-agency>

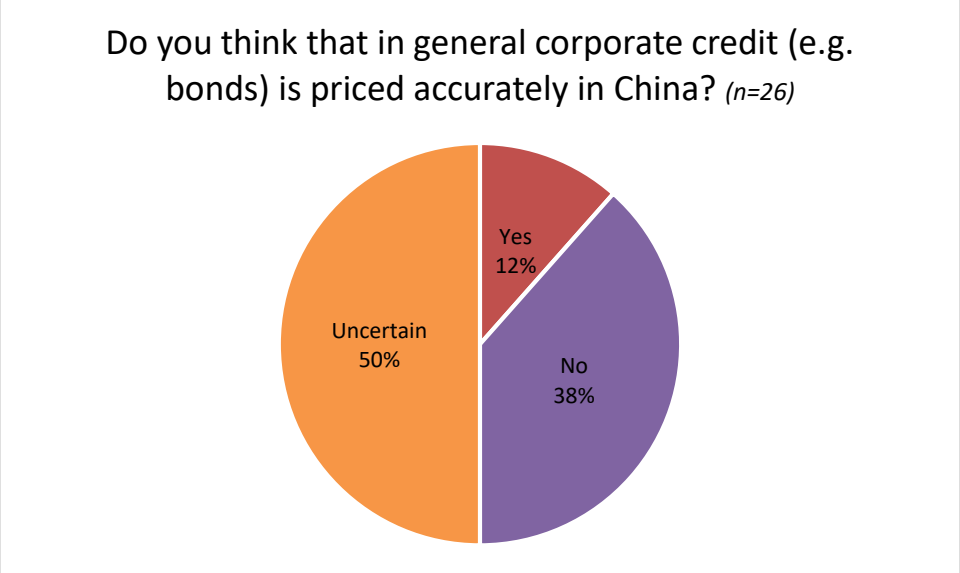

Figure 10

Clearing the way

China's financial sector has arrived at a point where it is increasingly necessary for the authorities to take a systemic approach to regulation, which will require improvements to Shanghai's financial infrastructure if it is to consider itself a world-class financial centre. As to the current state of this infrastructure, although most respondents are optimistic, there is still a significant percentage, 46 per cent, that believe Shanghai lacks enough auxiliary service providers such as lawyers, rating agencies and to offer a sufficiently diversified and well-functioning financial market ecosystem (Figure 11).

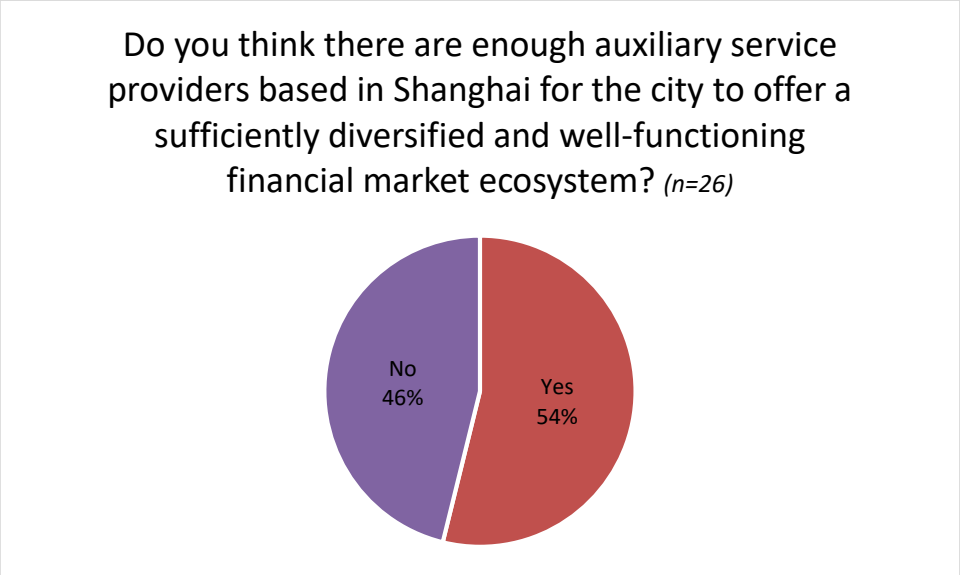

Figure 11

Further development of the Shanghai Clearinghouse will be important for the internationalisation of Shanghai as a financial centre. International recognition of the Shanghai Clearinghouse as a qualifying central counterparty (QCCP) would aide European banks in China with dealing in derivatives. That said, 46 per cent of European banking executives report being uncertain about how their business is being impacted by Shanghai's lack of progress in this respect (Figure 12).

Figure 12

The European Chamber understands that a dedicated team at the PBOC is trying to ensure that the Shanghai Clearinghouse is recognised internationally as a QCCP, i.e. an entity that has a licence to function as a central counterparty (CCP) and that has the permission to clear transactions in financial products.[22] For the European Commission to adopt an equivalence decision for Chinese CCPs, which would enable the European Securities and Markets Authority to recognise the Shanghai Clearinghouse as a QCCP, Chinese authorities need to first provide for an equivalent system of recognition of foreign CCPs.[23] For further information, please see the European Chamber's *Banking and Securities Position Paper 2019/2020*.

Data- and cybersecurity-related issues

About 35 per cent of survey respondents highlighted the significance of data- and cybersecurity-related issues for Shanghai's development as an international financial centre (Figure 7). While not as prominent as other issues, European banks have raised ongoing concerns with Chinese regulators mandating the moving of data and computing capacity, such as servers, onshore, as per overarching

[22] *Capital requirements for bank exposures to central counterparties*, Bank for International Settlements, July 2012, viewed 26th June 2019, <http://www.bis.org/publ/bcbs227.pdf>

[23] *Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties and Trade Repositories, European Parliament and European Council,* 4th July 2012, viewed 11th April 2019, <https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1564396424381&uri=CELEX:02012R0648-20190617>

pieces of legislation like the Cybersecurity Law. This requires critical information infrastructure operators— among which some banks may be found—to keep the personal information and important data they collect in China within the country, and to carry out a security assessment where cross-border transfers are warranted by their business needs.

In general, data concerns weigh heavily on the minds of foreign businesses across all sectors. According to the *Business Confidence Survey 2019*, 35 per cent of European firms believe the Cybersecurity Law will negatively impact their business, with the ratio for the financial services sector reaching 44 per cent.

China's Internet restrictions also contribute significantly to cyber-related unease in a way that is particularly disruptive for branches of foreign entities – more than half of respondents in the *Business Confidence Survey 2019* report that these restrictions cause difficulties in data and document exchanges with headquarters, partners and customers.

These regulatory issues create an environment that is particularly burdensome for foreign entities operating in China, and is proving a major obstacle to Shanghai's ambitions to become an international financial centre.

Factor 2: Favourable to foreign entities and investment

The European Chamber believes that 'internationalisation' must involve a significant amount of foreign participation. When asked what the minimum level of market share of foreign banks should be in the Chinese banking system for Shanghai to truly be an international financial centre, 43 per cent of polled executives stated that between five and ten per cent would be the minimum, while 30 per cent were of the opinion that it should be at least ten per cent (Figure 13).

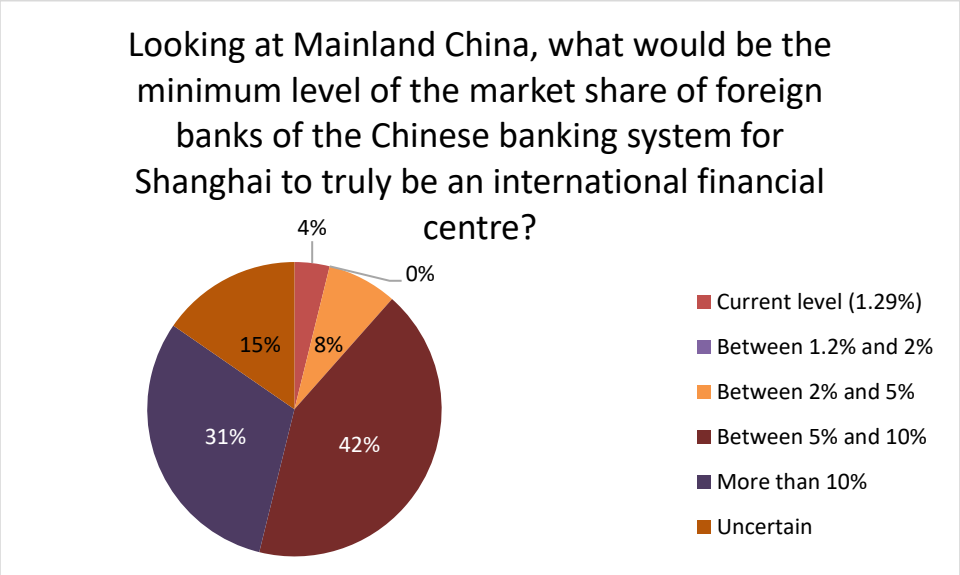

Figure 13

It is therefore highly problematic for Shanghai's aspirations that the entire foreign market share of the banking sector in China stood has declined year on year to 1.29 percent. By contrast, the market share of foreign banks is 21.6 per cent in New York,[24] and 12 per cent in Germany.[25]

Without a larger footprint of international banks and other financial services companies in the city, Shanghai could only rise to the status of a very large Mainland Chinese financial centre, and not the rival to international centres like London, New York, Frankfurt or Paris that it aspires to become. As previously detailed, this will entail improving operating conditions for foreign banks in the Chinese market.

High-level executive talent is particularly vital for the financial services industry. Similarly, the potential for international banks to expand their footprint relies to an extent on their ability to have foreign talent accept assignments in China, and certain recent regulatory changes will make this more challenging in the future.

Potential assignees require stable support for family members to relocate to China, and to help overcome difficulties of geographical distance, as well as language and cultural barriers. Historically, such personnel have been able to enjoy reasonable non-cash benefits exempt from individual income tax, if provided by the employer and supported by *fapiaos* (e.g. relocation support, return-home flights, housing support and children's education support).[26]

According to a circular released last year,[27]such benefits will become fully subject to individual income tax as of 1st January 2022. The European Chamber expects that when this change comes into effect, a heavy cost pressure will have to be absorbed by both European financial institutions and foreign banking executives in China. This will likely lead to less cross-border assignments of foreign financial talent to Shanghai, talent that contributes expertise and international best practices to the development of the financial industry in the city.

Another aspect that will determine Shanghai's level of competitiveness is the internationalisation of

[24] Nolle, Daniel E., 2013, *Foreign-owned banks: (way) underestimated — and volatile — participants in the U.S. banking market*, *The Journal of Financial Perspectives*, vol. 1, no. 1, pp. 1-15, viewed 18th October 2019, <https://www.ey.com/Publication/vwLUAssets/ey-foreign-owned-banks-way-underestimated-and-volatile-participants-in-the-us-banking-market/$FILE/ey-foreign-owned-banks-way-underestimated-and-volatile-participants-in-the-us-banking-market.pdf>

[25] Cull, Robert Cull, Peria, Maria Soledad Martinez and Verrier, Jeanne, *Bank Ownership: Trends and Implications*, International Monetary Fund, 22nd March 2017, viewed 19th October 2019, <https://www.imf.org/en/Publications/WP/Issues/2017/03/22/Bank-Ownership-Trends-and-Implications-44753>

[26] *China - Income Tax*, KMPG, 1st August 2019, viewed 20th October 2019, <https://home.kpmg/xx/en/home/insights/2011/12/china-income-tax.html>

[27] Notice on the Convergence of Preferential Policies after the Revision of the Individual Income Tax Law, State Administration of Taxation, 27th December 2018, viewed 30th April 2019, <http://www.chinatax.gov.cn/n810341/n810755/c3978994/content.html>

the RMB. The currency's international strength is specifically mentioned in the April 2009 plan, but a decade later RMB use outside of China (excluding Hong Kong) remains limited. RMB inconvertibility along with strict capital controls that are in place hinder its widespread adoption worldwide. When asked to identify what factor would hold Shanghai back from becoming an international financial centre, 88 per cent of survey respondents pointed to the continuation of capital controls (Figure 7), and 62 per cent highlighted the continued inconvertibility of the Chinese currency. Indeed, RMB internationalisation, a process widely considered to have kicked-off in 2009 with pilot projects for cross-border RMB settlement,[28] has stalled in recent years.

The PBOC responded to the last global financial crisis by reiterating their intent to boost the RMB as a competitor to the dollar. Yet today, despite being the eighth most traded currency, the RMB only accounts for four per cent of foreign exchange trades, paling in comparison to the US dollar's 88 per cent.[29] Offshore RMB debt is now 50 per cent less than it was in 2015,[30] and while offshore RMB pools saw the biggest increase between 2010 and 2015, they halved over the next two years.[31] The opening of investment inflows through such measures as QFII and RQFII quota relaxations, without a corresponding relaxation on outflows, further weakens the offshore liquidity of the market.[32]

A removal of capital controls and full convertibility of the RMB at this time could result in mass capital outflows, leading to negative repercussions for both the Chinese and world economies. Yet both factors are necessary for the true internationalisation of a financial centre. The European Chamber therefore recommends that China, in the absence of immediate complete reforms, focus more on adopting the other attributes of international financial centres—namely transparent regulatory and legal framework as well as favourability to foreign investment and business—in order to nudge Shanghai in the right direction of its goal.

Conclusion

Shanghai has not met its goal of becoming and international financial centre by 2020. Nevertheless, European banking executives remain optimistic about the more general progress made in reforming Shanghai's financial services industry, as seen in improvements to cross-regulator and intra-regulator communication and optimism over the state of the financial ecosystem.

The European business community hopes to see such progress accelerated and expanded. To accomplish this, China's financial regulators need to be aware of the issues holding the city back.

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[28] *Economic Watch: Yuan internationalization making steady progress*, *Xinhua*, 8th December 2018, viewed 18th October 2019, <http://www.xinhuanet.com/english/2018-12/12/c_137668404.htm>

[29] Areddy, James T., *China Is Pitting the Yuan Against the Dollar. So Far, It's Not Going to Plan*, *The Wall Street Journal*, 16th September 2019, viewed 20th October 2019, <https://www.wsj.com/articles/china-is-pitting-the-yuan-against-the-dollar-so-far-its-not-going-to-plan-11568649663>

[30] Lockett, Hudson and Szalay, Eva, *Why the renminbi's challenge to the dollar has faded*, *Financial Times*, 15th October 2019, viewed 18th October 2019, <https://www.ft.com/content/ba410544-ecba-11e9-ad1e-4367d8281195>

[31] Winsdor, Callan and Halperin, David, *RMB Internationalisation: Where to Next?*, Reserve Bank of Australia, 20th September 2018, viewed 18th October 2019, <https://www.rba.gov.au/publications/bulletin/2018/sep/rmb-internationalisation-where-to-next.html>

[32] *Track RMB internationalization on the Bloomberg Terminal*, *Bloomberg*, viewed 18th October 2019, <https://data.bloomberglp.com/professional/sites/10/RMB-Internationalization.pdf>

First, regulatory transparency needs to be greatly increased. The quality and reliability of regulatory, administrative and judicial matters remains the main issue holding Shanghai back from achieving its stated goal.

Second, Shanghai's financial ecosystem needs to become more internationalised. The government has made a lot of strides with that by, for example, allowing the first foreign rating agency into the market, yet more needs to happen, particularly to encourage more foreign presence in the market.

Finally, the full removal of capital controls and full convertibility of the RMB will ultimately gauge whether Shanghai has attained the distinction of being an international financial centre. However, considering the unfeasibility of this change at the moment, the European Chamber urges more attention to the first two points to guide Shanghai in the right direction, even if it cannot yet fully achieve its goal.

In many respects Shanghai has the foundations to become an international financial centre eventually, but complete success will be predicated on fundamental, structural reforms of the current financial ecosystem. This progress can only be triggered at a central level, and must be done in a well-planned, phased and sensitive approach to avoid systemic risks that would result in broader collateral damage for the global economy. Shanghai's position as an economic powerhouse and forerunner for reforms places it in a good position to advocate for the central reforms that national ministries will have to undertake in order to enact change.

The recommendations below are intended to be taken in a constructive manner, to provide pointers to both local and central level government authorities on what exactly should be done to allow Shanghai to fulfil its ambitions of becoming an international financial centre.

Key Recommendations

1. Progress towards full convertibility of RMB.
2. Implement calculated and incremental reforms aimed at eventual removal of capital controls.
3. Improve the specificity, transparency and consistency in the enforcement of regulations.
4. End arbitrary, government-backed interventions in the stock market.
5. Lift various restrictions on business conduct.
6. Make it easier for subsidiaries and branches of foreign banks to issue RMB-denominated bonds for funding purposes.
7. Exempt foreign banks from the 25 per cent limit on intragroup exposure.
8. Remove the net of long-term borrowings from current liabilities for overseas branches when calculating liquidity ratios, in order to compare assets and liabilities in the same tenor and ensure equal treatment for Chinese and foreign banks.
9. Allow for the development of the Shanghai Clearinghouse as a qualifying central counterparty and provide for an equivalent system of recognition of foreign central counterparties.

10. Further improve coordination both among regulators and between central regulators and their Shanghai municipal branches.
11. Maintain reasonable, tax-free benefits for foreigners to improve talent acquisition and increase the number of foreign financial services companies operating in Shanghai.

Abbreviations

CBIRC	China Banking and Insurance Regulatory Commission
CCP	Central counterparty
GFCI	Global Financial Centres Index
NDRC	National Development and Reform Commission
PBOC	People's Bank of China
QCCP	Qualifying central counterparty
QFII	Qualified Foreign Institutional Investor
RMB	Renminbi
RQFII	RMB Qualified Foreign Institutional Investor
USD	United States dollars

Appendix—Figures

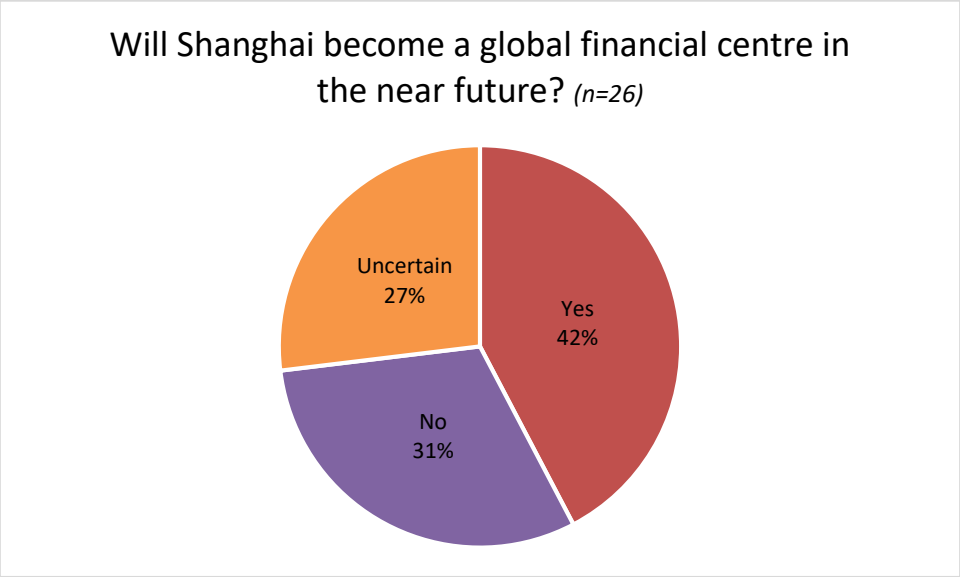

Figure 1

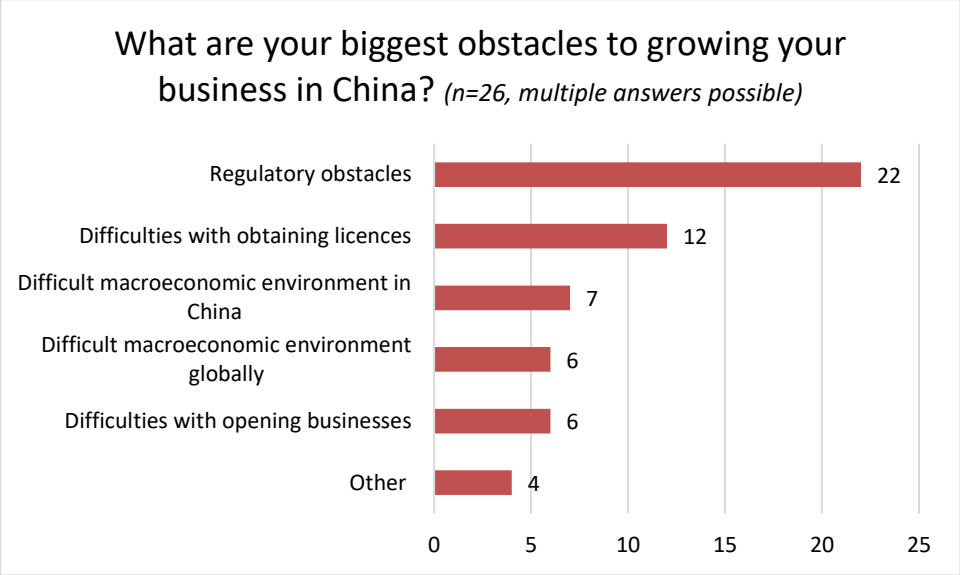

Figure 2

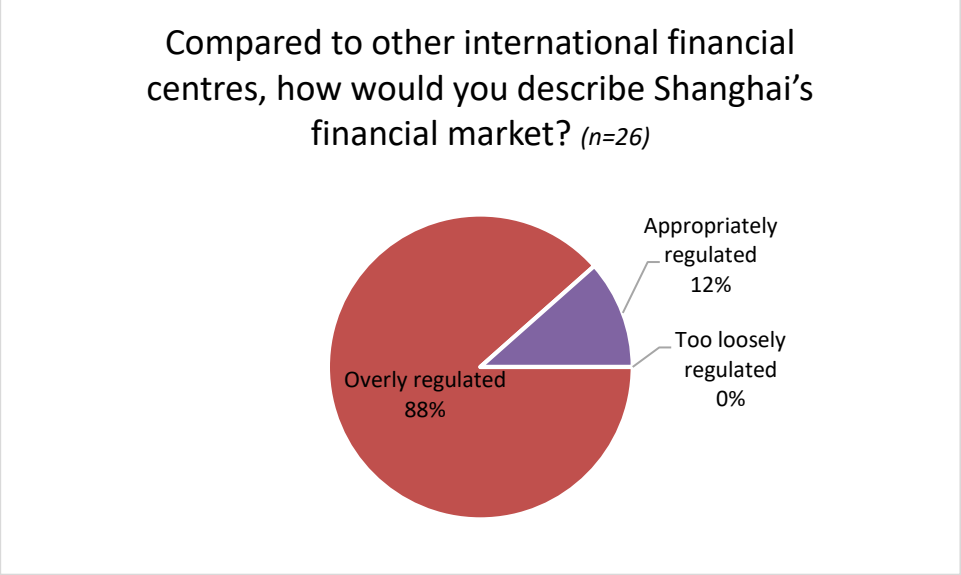

Figure 3

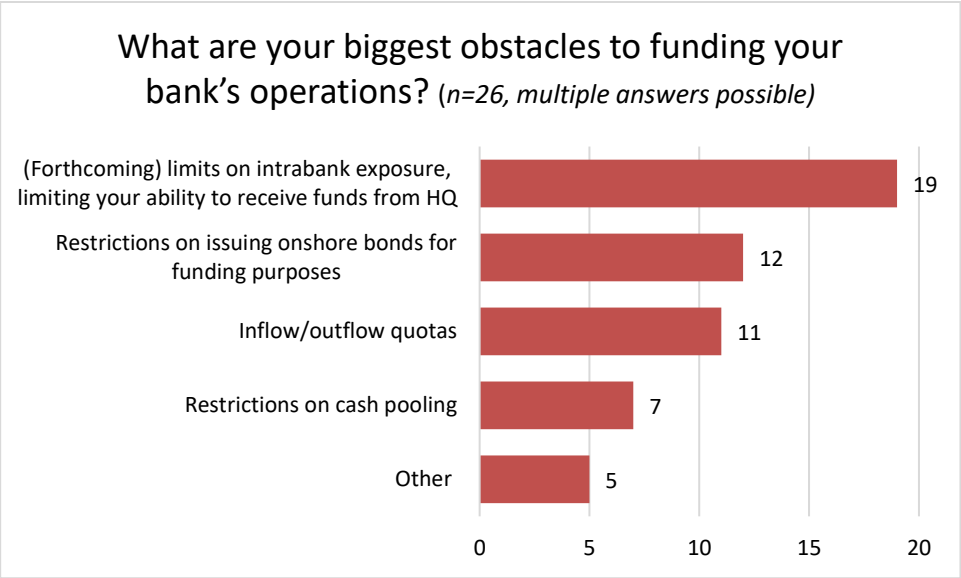

Figure 4

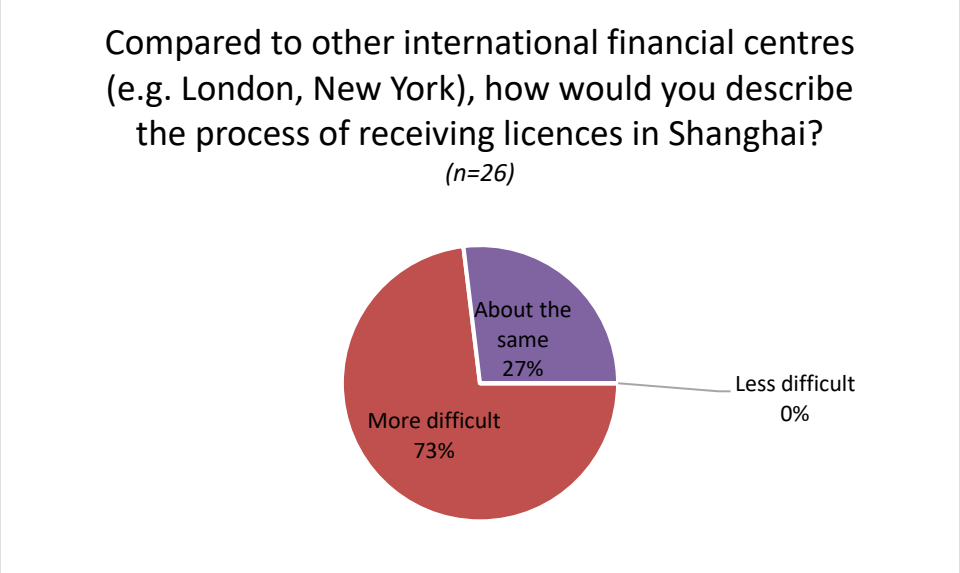

Figure 5

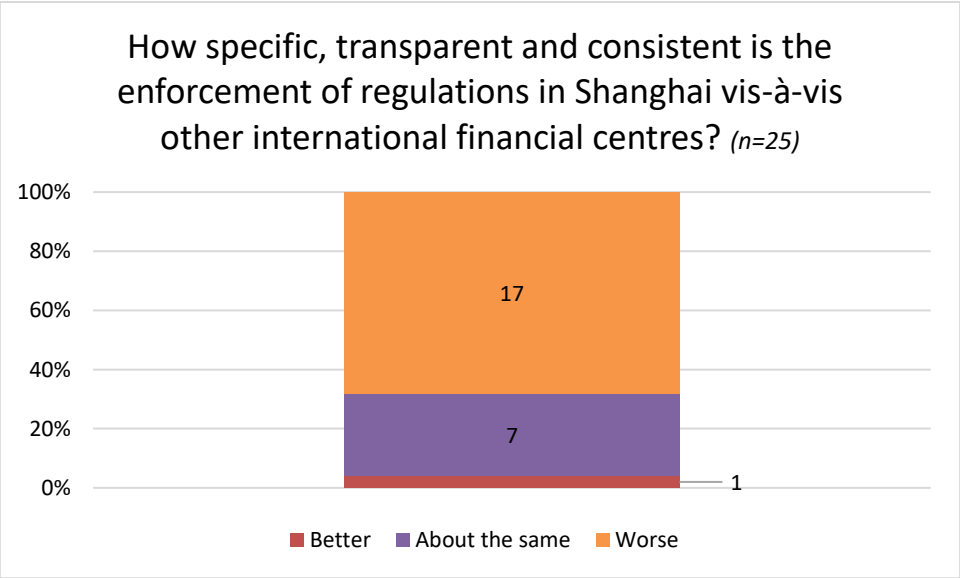

Figure 6

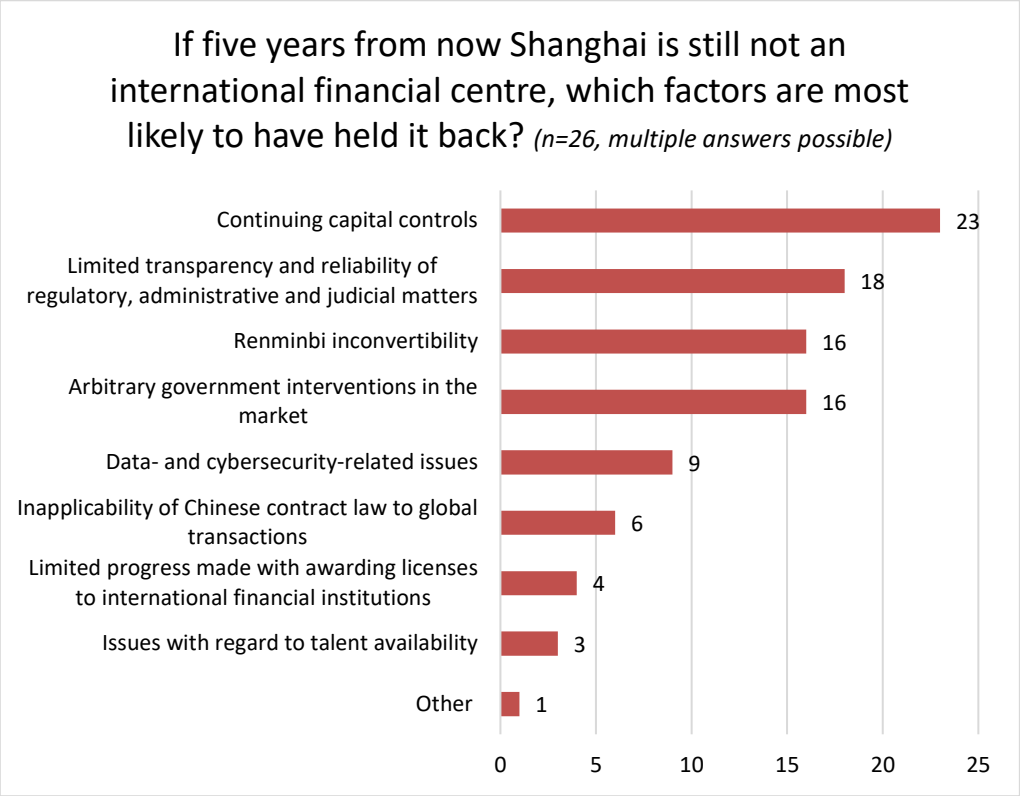

Figure 7

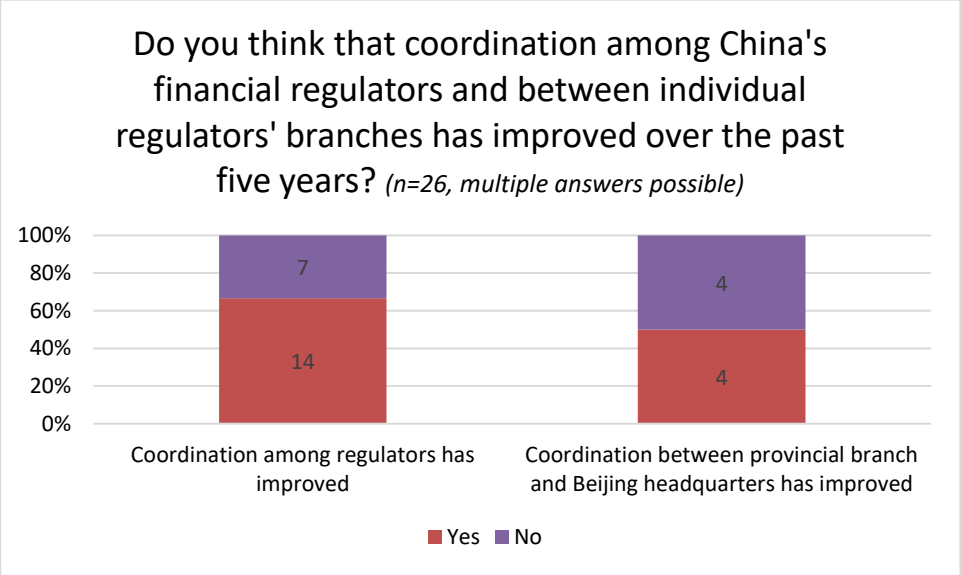

Figure 8

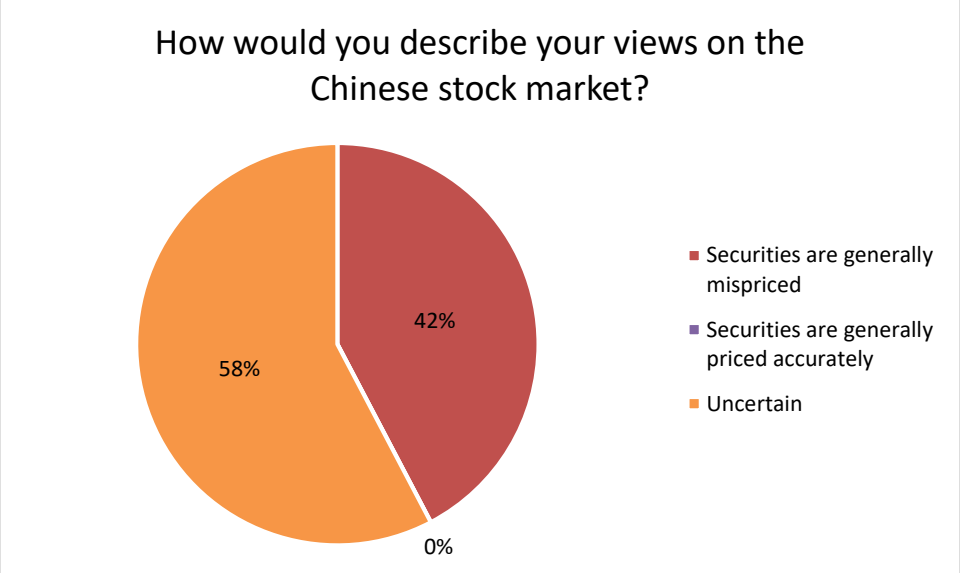

Figure 9

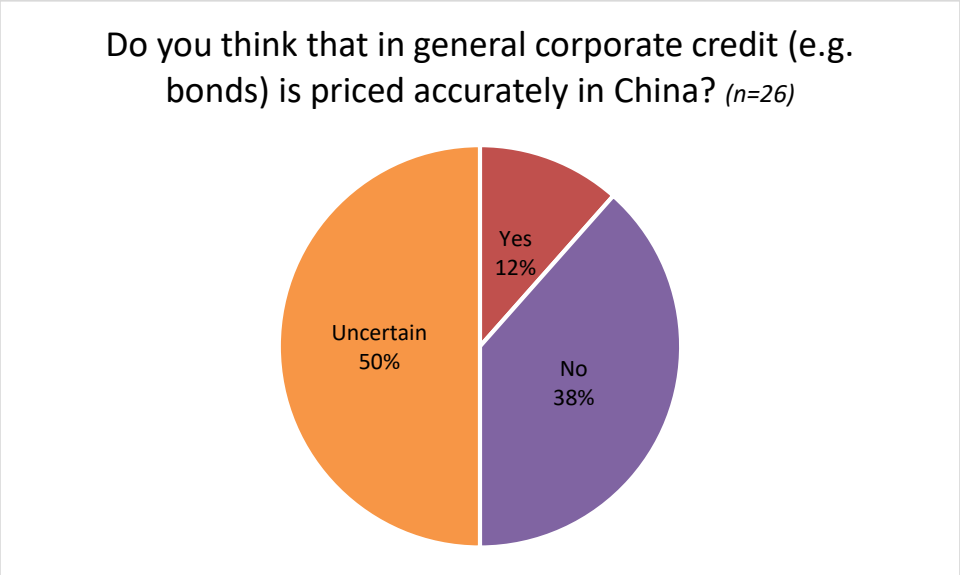

Figure 10

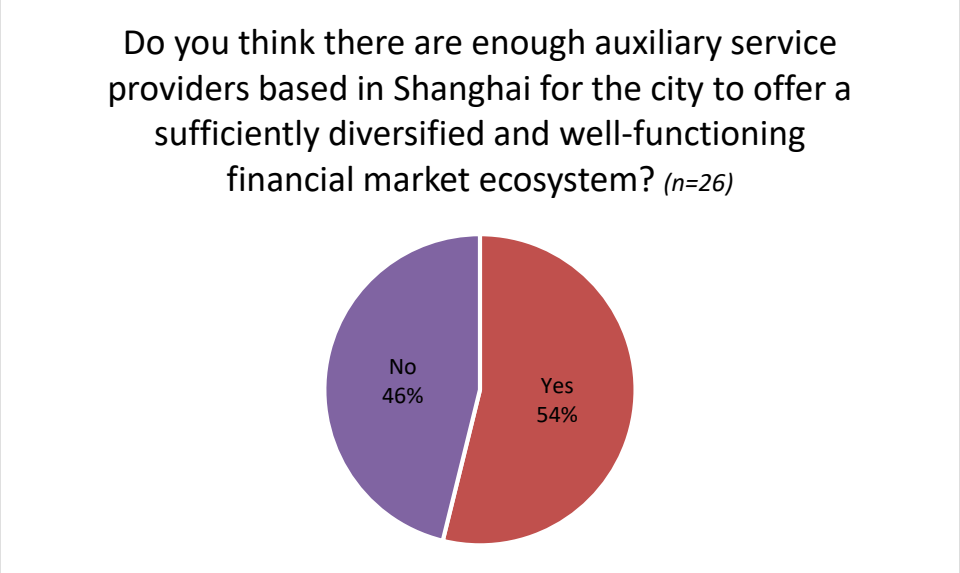

Figure 11

Figure 12

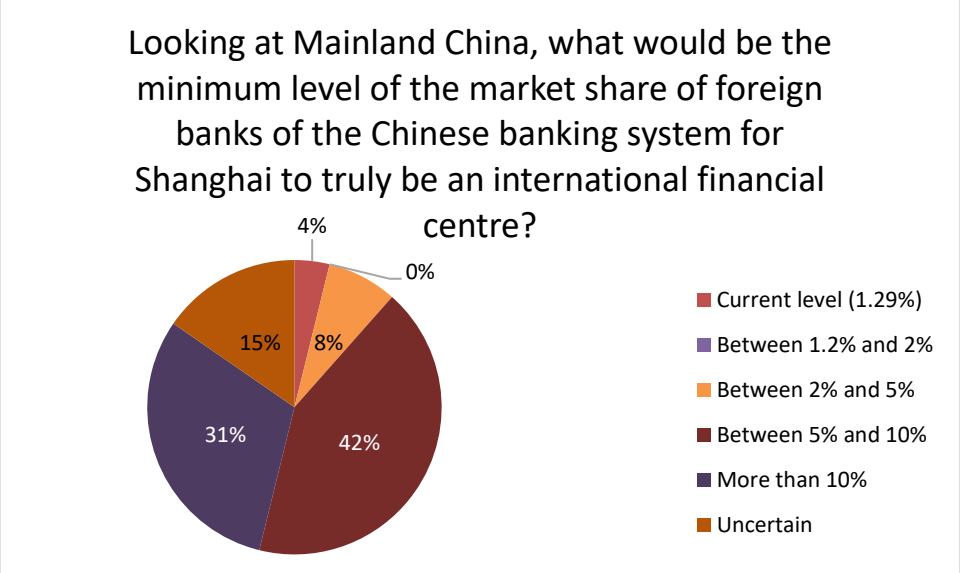
Looking at Mainland China, what would be the minimum level of the market share of foreign banks of the Chinese banking system for Shanghai to truly be an international financial centre?
4%
0%
8%
42%
31%
15%
Current level (1.29%)
Between 1.2% and 2%
Between 2% and 5%
Between 5% and 10%
More than 10%
Uncertain

Figure 13