

The China / Ireland connection: New opportunities for fund managers

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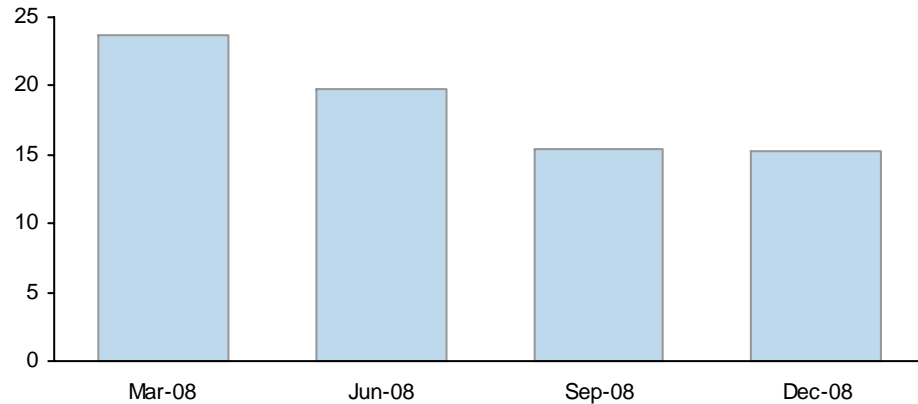


Update:
China Qualified Foreign Institutional Investor

An update on QFII Investment in China

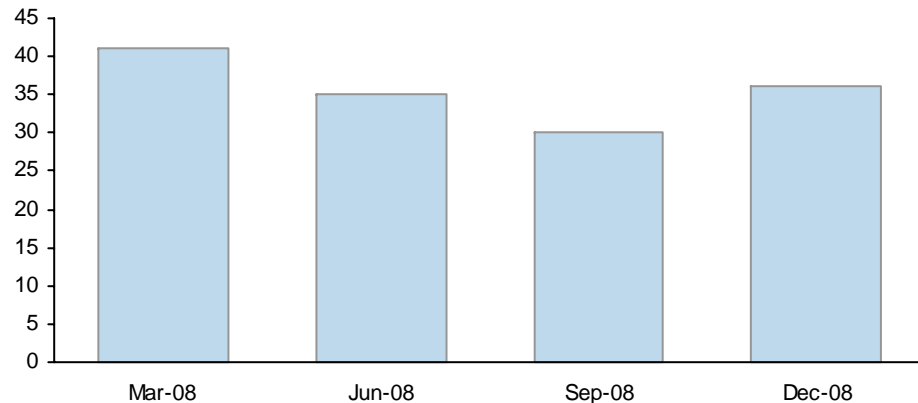
Total Market Capitalisation

(RMB in Trillions)



Total QFII Investment

(RMB in Billions)



- 9% GDP growth in 2008, forecasted to slow in 2009 although conditions in the global economy are improving and signs of greenshoots are emerging in China.
- Shanghai Composite Index is up to 28.35% and Shenzhen Component Index up to 36.97% in the 1Q09
- QFII share of A-share market had increased from 0.18 to 0.24% over the past six months
- Greater diversification from equity asset class to include fixed income and money market fund for more balanced QFII investment ⁽¹⁾

(1) Source: Wind info. Quarterly QFII investment is derived from quarterly report of listed companies, which is the aggregation of the amount listed in the Top 10 shareholders of listed companies under QFIIs.

New Market Participants

New MoU signed: Institutional investors from Ireland, Dubai, Russia and Austria can now apply for QFII license.

New Market Entrants

No.	Name	Quota (mn)	License Approval Date
1.	Mirae Asset Investment Management Co. Ltd.	150	25/07/2008
2.	ACE INA International Holdings, Ltd.	150	05/08/2008
3.	Caisse de dépôt et placement du Québec	200	22/08/2008
4.	President and Fellows of Harvard College	200	22/08/2008
5.	Samsung Investment Trust Management Co. Ltd.	150	25/08/2008
6.	AllianceBernstein Ltd.	50	28/08/2008
7.	Oversea-Chinese Banking Corporation Ltd.	150	28/08/2008
8.	First State Investment Management (UK) Ltd.	Pending	11/09/2008
9.	DAIWA Asset Management Co.	Pending	11/09/2008
10.	Shell Asset Management Co. B.V	Pending	12/09/2008
11.	T. Rowe Price International, Inc.	110	12/09/2008
12.	Société Générale Asset Management SA	Pending	14/10/2008
13.	Credit Suisse	Pending	14/10/2008
14.	UOB Asset Management Ltd.	Pending	28/11/2008
15.	Allianz Global Investors Luxembourg S.A.	Pending	16/12/2008
16.	ABU Dhabi Investment Authority	Pending	03/12/2008
17.	Capital International, Inc.	Pending	18/12/2008
18.	Mitsubishi UFJ Securities Co. Ltd.	Pending	29/12/2008
19.	Hanwha Investment Trust Management Co. Ltd.	Pending	05/02/2009
20.	Emerging Markets Management, L.L.C.	Pending	10/02/2009
21.	DWS Investment S.A.	Pending	24/02/2009

- 21 QFII licenses approved since July 2008
- Predominately Buy Side Investors/Asset Managers
- CSRC is approving an average of 3–4 QFII's a month
- Moving forward QFII approvals will speed up given appreciating pressure on the Yuan has subsided, time to market is reduced to approximate nine months

Source: License approved name and approval date are sourced from CSRC website; while quota amount is not publicly available, and is sourced from the market.

What's New in China QFII

Account Structure

- The Lehman's collapse exposed the risk of holding assets in a single account in the name of the QFII at the CSD level
- Two recent developments 1) QFII's can open a separate 'nominee' account at the CSD level to hold client assets, 2) possible to apply for a 'special account' by setting up a master feeder structure, this will permit monthly liquidity of US\$50 million per month without approval and lock-up period is reduced to three months from one year
- With monthly liquidity available under special account structure, we expect to see more pension funds, e.g. ERISA, to enter China A-share market

QFII Application Process Update

- Regulators concern over a number of QFII who had not been able to fully utilise QFII quota approved due to market difficulty, preference for direct investor and fund manager investing existing funds

Tax and Other Considerations

- Tax: Interest and Dividend tax of 10% commenced in January 2009 and first quarterly collection to take place in March 2009. It is anticipated Capital Gains tax may be introduced and QFII's have already started to withhold tax in preparation for the rollout
- QFII can participant in more liquid interbank bond market by purchasing a structured bond product through their local broker – this would allow for more balance portfolio investment
- A group can apply for two QFII licenses under the same investor type category, e.g. a fund manager can apply for two QFII licenses (CSRC had in the past had required the two license to be from different QFII category, e.g. bank and fund manager)
- Delegation of QFII quota within a group is possible – CSRC had recently approved a second QFII license for a financial group where the QFII quota of second license is shared between multiple entities within a group

Source: Discussion with clients, Shanghai Stock Exchange and regulators.

Market Outlook in 2009/2010

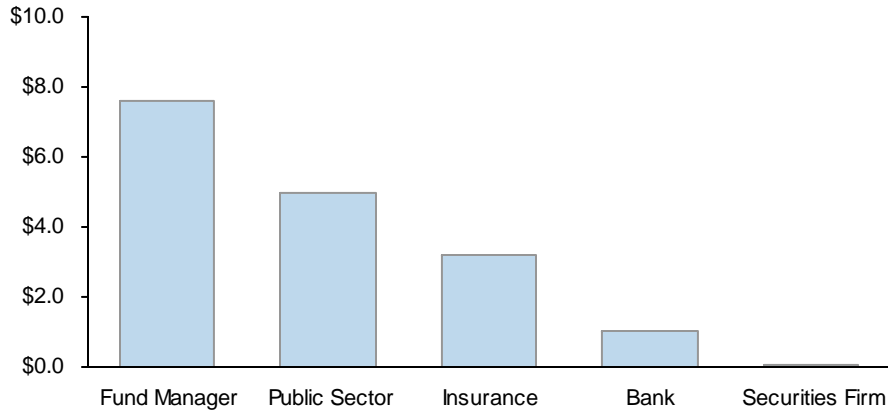
	Market Development	Impact
Trading	<ul style="list-style-type: none"> Trading Platform – Institutional investors to trade on the new block trading system while retail investor will continue to use existing trading platform 	<ul style="list-style-type: none"> Improved trading platform for institutional investors
Settlement	<ul style="list-style-type: none"> DVP T+1 – Postponed due to the implementation of a new block trading system in the market 	<ul style="list-style-type: none"> Eliminate broker and settlement risk inherent under the current T+0/T+1 settlement cycle
Securities Lending	<ul style="list-style-type: none"> Authorities will introduce under a three phased approach resulting in a central counterparty model in 2011, after which QFII may be allowed to participate in securities borrowing and lending 	<ul style="list-style-type: none"> Improves market liquidity and enhances market efficiency
Capital Market Developments	<ul style="list-style-type: none"> Stock index futures – postponed till 2010 First China Depository Receipts (CDR) to be listed in 2010 on Shanghai Stock Exchange (SSE) Introduction of bond forward contracts on SSE 	<ul style="list-style-type: none"> QFII may have more wider range of investment opportunities to include derivative products in China market
Other Planned Market Initiatives	<ul style="list-style-type: none"> SSE to establish a new International Board to allow Chinese companies listed overseas to list on International Board in USD; B-share market may be merged into the International Board Private equity funds listed on SSE Availability of bond repo market 	<ul style="list-style-type: none"> Offers more investment opportunities and choices for long term investor in the market
QDII	<ul style="list-style-type: none"> QDII demand has slowed given the poor performance of existing funds in the past but anticipate conditions to improve leading into 2010 	<ul style="list-style-type: none"> MOU with Ireland and Luxembourg to allow funds domiciled in these jurisdictions to be marketed in China

Update:
Qualified Domestic Institutional Investor Scheme

QDII Investment in China

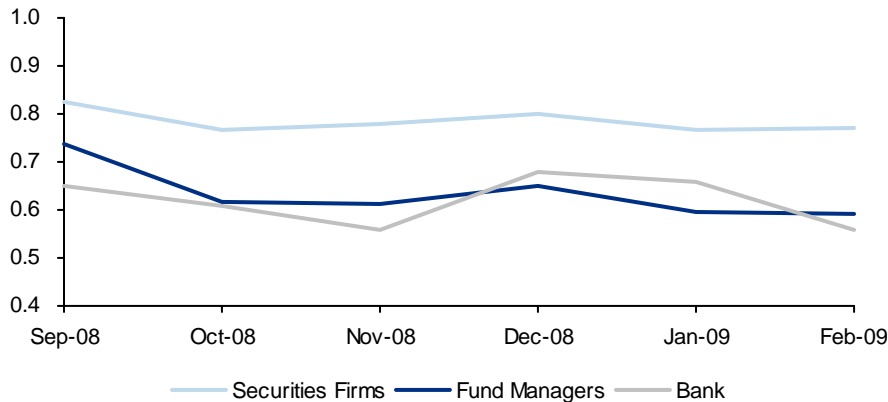
Estimated Total QDII Size in China ⁽¹⁾

(US\$ in Billions)



NAV of QDII Segments ⁽²⁾

QDII NAV Average



- Fund Manager segment is the largest QDII segment with US\$7.6 billion AUM followed by the public sector, insurance, banks and securities firms. We expect the fund manager QDII segment will continue to grow to be the dominant QDII segment in China
- Based upon NAV trends, securities firms' QDII performed relatively better at 0.77; average NAVs of QDII launched by fund managers and banks are 0.59 and 0.56 respectively
- The "CICC Great China Securities" QDII fund, launched by CICC in February 2008, was the only QDII launched by a securities firm in 2008. We believe securities firms' QDII performed relatively better as the majority of securities fund products may hold up to 100% cash as a defensive strategy

(1) Public sector QDII exclude direct investment made by public sector institutions not under QDII scheme, e.g. CIC investment into Blackstone.

(2) NAV of insurance and public sector QDII are not publicly available in China.

What's New in China QDII

Approval of QDII Funds

- All three regulators in China, i.e. CBRC, CSRC and CIRC, have not been approving QDII mutual funds/investment in the past nine months
- The last QDII fund approved was the Bocom Schroders global value selected fund launched by Bocom Schroders Fund Management Co., Ltd on 22 August 2008. The QDII fund raised US\$75 million
- CSRC has indicated that they are unlikely to approve new QDII mutual fund unless the first four funds, which had an average NAV of 0.42, recover to about 0.60–0.70. This will require existing QDII funds to return 100% from current levels before new funds will be approved
- Regulators have held frequent meetings with market participants to review the effectiveness of the QDII scheme. There were two meetings held in Beijing and Shanghai by CSRC and SAFE in March
- With more MOUs signed with CBRC, funds registered in the US, Korea, Australia, Ireland, Luxembourg, HK, UK, Japan and Singapore can now be distributed through Chinese banks

New Regulatory Development

- Launch of Separately Managed Account (SMA) QFII scheme by CSRC (see Appendix for further details)
 - Only applicable to fund managers with QDII and SMA license; a total of 27 fund managers qualify
 - Can be offered to both high net-worth individuals and institutional investors, minimum fund size is RMB50 million (or US\$7.4 million)
 - No application process – only filing with CSRC
 - Fund managers with un-used QDII quota would not need to re-apply for QDII quota
- Bank-owned JV fund managers have been most active in pursuing SMA QDII mandates as banks can refer clients to JV fund managers, e.g. ICBC Credit Suisse and Bocom Schroders
- CIRC, the insurance regulator, has approved the first QDII investment mandate for insurance companies to use overseas third-party fund managers for a QDII investment in an insurance company in China
- CIRC has approved investment into corporate bonds under QDII scheme

Source: Discussion with clients and regulators.

What's New in China QDII (Cont'd)

Other Considerations

- Domestic investors have been gradually switching from bond funds to equity funds as bond return had declined dramatically from the high of 8–10% in 2008 to 0.1% in March 2009
- A gradual recovery of domestic A-share funds raised; recent average fund size had increased to US\$200–300 million from the low of US\$50–100 million in mid-2008; we expect the average fund size to reach US\$500 million by end 2009
- Investors in the 27 new funds launched in China in 1Q09 totalling US\$7 billion AUM are more risk-averse
 - 12 new funds were bond and money market funds, comprising 27.5% of new funds
 - Four new funds were balanced fund, comprising 25% of total new funds
 - Four new funds were broadly diversified index fund or principal protected fund, comprising 25.5% of total new funds
 - Seven new funds were equity funds, comprising 22% of total new funds
- Fund managers have been actively building up managing investment of corporate annuity programs (corporate pension), total AUM of corporate annuity programs in China increased 20% in the fourth quarter in 2008 and reached US\$6.4 billion at the end of 2008
- CSRC has allowed fund management companies to set up subsidiaries in Hong Kong to expand international business. We have seen fund managers using their Hong Kong subsidiary to provide investment advisory services to overseas QFII investors and set up A-share and H-share China funds offshore
- Insurance companies with typically 80% investment in fixed income securities are under pressure with falling bond yields and have been looking at investing in PE funds with longer duration to match liability
- National Development and Reform Commission (NDRC) issued a new regulation to allow setup of PE companies and fund in Tianjin, a first foreign JV PE companies was established in March between Robeco N.V. and Tianjin Economic Development Authority (TEDA)

Source: Discussion with clients and regulators.

Market Outlook in 2009/10

	Market Development	Impact/Opportunity
Outflows from China	<ul style="list-style-type: none"> • Institutional investors under pressure to generate return from fixed income portfolios in China may tap into the Separately Management Account (SMA) QDII scheme to diversify into fixed income securities in overseas markets, e.g. corporate bond issued by Chinese companies in Hong Kong • Launch of QDII scheme by Trust companies • PE fund setup in Tianjin to be approved to invest into PE fund overseas with approval from the State Administration of Foreign Exchange (SAFE), this will not be under the current QDII scheme • CIRC to approve insurance companies to issue investment-linked products under QDII scheme • Gradual approval of QDII mutual fund in 2010 	<ul style="list-style-type: none"> • Foreign fund managers acting as sub-advisors to outflows from China • Outflows fund would require custody and fund services
Fund Product Development	<ul style="list-style-type: none"> • Launch of index fund initiative by Shanghai Stock Exchange, e.g. NASDAQ index fund • Gradual market segmentation, fund managers to offer differentiated products in the market, e.g. small and mid-cap A-share fund, socially responsible investment (SRI) fund etc. • CSRC to allow 'umbrella' fund where a fund may be comprised of several sub-funds, e.g. equity, fixed income and principal protected • Tianjin PE fund regulation issued by NDRC will be rolled out nationwide 	<ul style="list-style-type: none"> • Potential product-level partnership opportunity for foreign fund companies and exchanges to offer product expertise through partnership with Chinese fund managers
Distribution of Funds	<ul style="list-style-type: none"> • Foreign banks to be able to distribute local mutual funds 	<ul style="list-style-type: none"> • New fund distribution channel

Source: Discussion with clients, Shanghai Stock Exchange and regulators.

Partnership Opportunities for Foreign Institutions in China

Recent market developments in China fund industry have created several unique partnership opportunities in China.

	Description	Impact/Opportunity
<p>Mirroring A-share Funds</p>	<ul style="list-style-type: none"> • With several fund managers eager to expand into investment advisory business for overseas investor investing into A-share market, there is an opportunity now to form partnership with domestic fund managers to jointly develop and launch A-share fund both overseas and in China • For example, a foreign fund manager could jointly develop an A-share ETF product where the A-share ETF product could be launched in London using QFII license quota and the domestic fund manager will then launch the A-share ETF in China using its domestic fund license 	<ul style="list-style-type: none"> • Maximise the scale of fund between both China and overseas market • Create visibility and access for Chinese fund managers and overseas fund manager in reciprocal markets
<p>Product Specific JV in Hong Kong</p>	<ul style="list-style-type: none"> • With increasing numbers of domestic fund managers setting up subsidiaries in Hong Kong, there is now an opportunity to form partnerships or JV with Hong Kong subsidiaries for specific product, e.g. launching Greater China ETF funds that will cover both A-share and other H-share and HK equity markets 	<ul style="list-style-type: none"> • Quicker partnership – JV in HK would not require approval from mainland's regulators
<p>Referral Programs for Separately Management Accounts (SMA)</p>	<ul style="list-style-type: none"> • There are significant numbers of fund managers in China that are not bank-backed JV, hence, they may not have banks that will refer clients to them on SMA discretionary mandates • Overseas fund managers can potentially form alliances with selected non-bank backed fund managers to jointly target SMA mandates where overseas fund managers could directly target institutional clients in China and work with domestic fund managers to implement SMA mandates 	<ul style="list-style-type: none"> • Quicker partnership – unlike mutual fund QDII, SMA sub-advisory would not require prior approval from CSRC
<p>Setup of PE Funds in Tianjin</p>	<ul style="list-style-type: none"> • National Development and Reform Commission (NDRC) issued new PE fund regulation in Tianjin • Overseas fund managers can work with Chinese partners, which could be public sector institutions (e.g. municipal governments) or securities firms with PE investment license to setup PE funds in Tianjin where a portion of the PE funds can be collected in China and invest into overseas project or PE funds 	<ul style="list-style-type: none"> • Be able to capture a new form of investment outflows from China

Concluding Remarks – The China/Ireland Connection

- Economic activity is picking up, driven by extensive fiscal programs and government sponsored stimulus packages
- QFII licence approvals are anticipated to speed up this year given the appreciating pressure on the RMB has subsided
- Establishing an open ended dedicated China fund for investment in A shares will qualify for special account structure and flexibility of monthly liquidity
- QDII demand has slowed given the poor performance of existing funds in the past but as market conditions improve we expect to see a return to the market by key players
- Unique opportunities exist for Irish domiciled funds to invest into China via the QFII scheme; likewise the gateway is open to distribute existing products onshore in China via the QDII scheme

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Citi's Jervis Smith, Global Head of Client Executive for Global Transaction Services
will be speaking at next week's IFIA Conference in Dublin on Wednesday 27 May 2009

Questions

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