

Shanghai Pilot Free Trade Zone (FTZ) and what it means for China's Financial Industry + Qianhai District and Wenzhou Financial Reform

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A look at our report methodology and purpose

- Findings based on
 - Secondary research - internal knowledge, government institutions, media and financial institutions' reports.
- Report purpose:
 - Introduce the policies and schedules for these three test beds with some examples
 - Figure out the problems and bottlenecks of these three types of reform
 - Identify potential solutions for problems
 - Compare and contrast among these three regions and identify the differences



Section 1: The Shanghai Pilot FTZ

Section 2: Qianhai District

Section 3: Wenzhou Financial Reform

Section 4: Comparison

The Shanghai Free Trade Zone (FTZ) – Background

Intent of the Shanghai Pilot FTZ is to test regulatory and economic reform

- Authorized by the State council and opened on Sep. 29th 2013
- Comprised of three physical existing regions in the eastern part of Shanghai:
 - Yangshan Harbor Free Trade Zone
 - Waigaoqiao Free Trade Zone
 - Pudong Airport Free Trade Zone
- The total FTZ area covers 28 square kilometers
- The FTZ allows for not only free flow of goods, but of human talent and financial capital

The Shanghai Free Trade Zone (FTZ) – Objectives

Reforms in the Shanghai FTZ will / might (?) make it similar to Hong Kong, and then could be rolled out to the rest of China

- Objectives of new FTZ is to eventually help Shanghai to be the next:
 - International financial center
 - High-end service industries center
 - International trading center
 - Logistics / shipping center
- Test bed for further nation-wide reforms
- Potential helps China to successfully join TPP (Trans-Pacific Partnership Agreement)

The Shanghai Free Trade Zone (FTZ) – Industries

The Shanghai FTZ is focused on six major industries:

1. Financial services
 - Banking
 - Medical insurance
 - Financial leasing
2. Shipping services
3. Business services
4. Professional services
5. Cultural
6. Social services

The Shanghai FTZ – Negative items management system

The “Negative items” management system is one of the FTZ’s most unique characteristics and the key management mechanism

- ‘Negative items management system’:
 - Items / business on the list cannot be done
 - Items / business not on the list can without restrictions (supposedly)
- Old principle: ‘Positive items management system’ -> companies could not do anything not on the list
- The ‘Negative items management system’ could open up financial innovation and offer significant opportunity for foreign investors / firms
- Example:
 - Investment banks are currently on the list -> restricted
 - Commercial banks not on list -> open -> 10 banks including 2 foreign are entering currently
- Items on the negative list might just be partially restricted, not fully

The Shanghai Free Trade Zone (FTZ) – Key Reforms

There will be many areas of reform across multiple industries, but the most relevant financial service reforms are:

1. Better access for foreign institutions -> qualified foreign financial institutions to set up wholly-owned banks in the Shanghai FTZ
2. Market access in payments -> foreign third-party payment institutions may be allowed to apply for operating licenses
3. Foreign-owned credit rating firms
4. Financial leasing companies to set up branches in the FTZ
5. Freer trade of CNY (capital account / FX)
6. Gradually give foreign investors access to commodity futures market
7. Tax relief, appeared initially, eventually eliminated

The Shanghai Free Trade Zone (FTZ) – Problems

While there are significant positives about and around the Shanghai FTZ, there could be problems:

1. Competition with Hong Kong – what are the cities' roles?
2. Control CNY between FTZ and non-FTZ areas – how? Restrictions?
3. Competition from other cities applying for FTZ

The Shanghai Free Trade Zone (FTZ) – Future

Successful reform implementation in the Shanghai FTZ could set the stage for nationwide economic reform

- Too early to say that Shanghai will take HK's place -> likely 10+ years out
- CNY cross-border between FTZ and non-FTZ will be strict -> unlikely for someone to walk out of FTZ with a RMB stuffed suitcase
- National economic policies will likely be along the lines of Shanghai Pilot FTZ -> proving first in a test-bed



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Qianhai District – Background

Qianhai Special Economic District in Shenzhen was originally thought to be the new “the special district” for reforms

- Located in west Shenzhen; area of 14.92 square kilometers
- In August 2010, the Chinese state council approved the plan to develop Qianhai into a modern service center
- In March 2013, the National Development and Reform Commission released the ‘Industrial access catalog for Qianhai’, which specified six major industries to be developed
- Figures in August, 2013 showed that there are more than 1,300 firms set-up in Qianhai District, including 21% of which are foreign

Qianhai District – Objectives / Industries

Initial idea was to make Qianhai a global center for:

- Financial / commodity markets trading
- Supply chain management
- Global wealth management industry

With a focus on 6 industries:

1. Financial
2. Modern logistics
3. IT service
4. Applied scientific service
5. Professional service
6. Public service

Qianhai District – Preferential policies / HK Investment

Some financial industry policies are related to introducing HK investment into Qianhai

1. Drive cross-border CNY exchange and loans; CNY bonds in HK
2. Develop the PE industry in the region
3. Increase the number of foreign-funded equities investment funds
4. Lower entrance threshold for HK financial firms under the Closer Economic Partnership Arrangement (CEPA) framework
5. Encourage foreign and local financial institutions to set up multinational, national managerial or operational HQs in Qianhai

But...

1. Tax reduction policies are less likely to be implemented as the government wants tax policy consistent between special zones
2. Loosen employment and visa restrictions to encourage foreign talent to enter the zone

Qianhai District – Problems

The future of Qianhai is unclear now that the Shanghai FTZ has been setup; also HK does somewhat see Qianhai as a potential threat to Hong Kong's positioning as a relatively freer market.

Challenges for Qianhai

1. Unclear long term government plans for Qianhai
2. Lack of cooperation from HK government and companies
3. Relatively weak policies and implementation on the introduction of high-end talent



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Wenzhou – Background

Wenzhou is very wealthy, but has large SME financing issues so government has targeted Wenzhou for SME finance reform

- Large number of wealthy people, many of them are SME owners
- SME financing difficult in Wenzhou, so shadow financing is popular
- High number and profile defaults in Wenzhou
- Wenzhou identified as test-bed for SME financing innovation
- In March, 2012, the state council decided to try SME financial reform in Wenzhou. Rationale:
 - Huge financing demands from Wenzhou merchants and firms
 - Highly developed, largely illegal private lending market
- In November, 2013, Wenzhou government officially released the detailed rules and regulations for Wenzhou Financial Reform Test Field, including 12 basic principles

Wenzhou – 12 Basic Principles

The guiding principles are mainly related to SME financing problems and financial innovation; a few of the key reforms:

- Standardize the development of private lending market.
- Accelerate the development of new financial institutions such as micro-loan companies to support SMEs
- Develop professional asset management institutions
- Start the trail for local individual investors to invest directly to foreign markets, and the currency used is CNY
- Develop local equity and debt markets
- Strengthening local financial risk management practices

Wenzhou – Wenzhou Private Lending Service Center

An example of reform: Wenzhou Private Lending Service Center

- The center was set up in April, 2012 by the Wenzhou government, to serve as a platform for private borrowing and lending.
- This platform provides an important alternative channel for firms and individuals to finance at a lower cost compared non-bank lending.
- In the one year since the center was setup, the total transaction volume is CNY513mn through nearly 1,500 separate loan transactions.
- Other intermediary agencies similar to this center will be setup in the future to further support such transactions.

Wenzhou – Challenges

Wenzhou was never meant to be a ‘special economic zone’, but is still behind on reform and economic recovery

1. Policies have not been executed very effectively in the implementation stage
2. Market demand is still bigger than supply - CNY500mn has been lent, but there is a estimated demand of nearly CNY1tn
3. SME credit risk is still a challenge – not very good measurement or assessment of credit ratings



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Comparison – Direction of Reforms

The largest difference for Shanghai, Qianhai and Wenzhou is the direction and purpose of reforms:



Comparison – Scope

In addition to different focuses, each zone will have a different geographical scope both now and in the future:



Comparison – Recommendations

Shanghai

- Worth entering regardless of future FTZ plans -> low upfront costs and potentially higher costs and more restricted later

Qianhai

- Previously was very attractive for tax efficiency; now not applicable
- Future reforms around free trade of CNY could be attractive for wealth management firms

Wenzhou

- Generally less relevant for foreign firms and investors
- Wenzhou reforms encourage overseas investment -> opportunity for foreign financial services providers

Comparison – Overall Comments

- Generally, all of the currently published regulations for Qianhai and the Shanghai FTZ are vague -> real reforms / details will come later
- Our feeling is that details are vague for everyone; just because Citi is going in doesn't mean that they know something special
- China has a history of using zones as precursors for real reform -> Shenzhen used to be a sleepy town...

Questions and Answers

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