China

By Heather McLean

China is the word on trembling lips across the world. This enormous market is opening up and expanding, getting online and learning how to take advantage of its mass and its closeted economy, to make money on an ever-grander scale. From the eFX perspective the country has just started making tentative inroads. The Chinese government has a strong grip on the country's finances and information circulation. It is learning to relax that hold and to allow electronic trading to take place, yet this is just the beginning of that process; for eFX to really be able to take off in China, the government needs to place more trust in people and systems.

China has come a long way in eFX over the past four years. Hosan Chan, the manager at Fortune Free Holding, says that in 1994, the central bank, which is the People's Bank of China, and the State Administration of Foreign Exchange (SAFE) clamped down on all margin trading activity in China. She says that is because many investors lost a lot of money on the market due to poorly judged risk management.

As most of these investors were state owned banks, organisations or enterprises, the central bank and SAFE acted quickly. Chan says FX then disappeared from the Chinese market. However, she states that the situation has greatly improved in more recent times. Chan claims all the evidence is indicating that after over 10 years in exile, FX has come back to the Chinese market, sneaking in the back door and making itself known gradually.

"A lot of major market makers and brokers have been promoting their activities in mainland China in FX," Chan comments. "Most of the investors are individuals, because SAFE has strict regulation for wiring out foreign currencies. The potential market has attracted a lot of international FX organisations to open their business here. Now there are four commercial banks that have licences to open derivatives businesses. As a result of this, we are seeing an optimistic, very bright future for FX in China."

Increasing importance of China in FX market

The country's FX reserves grew in the fourth quarter of last year to hit $1.528 trillion, up by a healthy $94.6 billion from the third quarter, the central bank stated. That amounts to a rise of 43.3% for the same period in 2006. Altogether for 2007, China's FX reserves rose by $461.9 billion.

Additionally, the latest BIS survey reported that the renminbi saw its market share rise from 0.1% in 2004 to 0.5% in April 2007, with China as a market centre registering a market share (0.2%) for the first time on $9 billion a day.

In 2007, Singapore joined the UK and Switzerland as one of the top three major financial centres by gaining market share, while the US and Japan dropped down the list as they lost market share. Hong Kong's share of the market rose to 4.4% in 2007, from 4.2% in 2004, and the Hong Kong dollar's percentage share of turnover rose from 1.9% to 2.8% in that period. This, the BIS survey concludes, is a reflection of the increasing importance of China in the foreign exchange market.

Customers everywhere are becoming increasingly aware of the FX market, says Todd Crosland, CEO at InterbankFX. He comments: "It seems with recent economic concerns in the US, people are not only hearing about a looming recession but also how the US Dollar is dropping against its counterparts. We feel FX will be very important in the days to come as investors become more and more familiar with it. And as their concerns with the US economy increase, investors will seek out other forms of investment that will provide returns.

"Forex in China is equally important, but the situation is a bit different," Crosland continues. "The stock market in China has been booming recently, with a surprising amount of everyday citizens trading the stock market themselves. There will be a lot of hype once the Chinese government allows the Yuan to be traded, and this hype will attract many of these individual stock

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traders over to Forex, because, as they say, the grass is always greener on the other side."

Growing Investor confidence

Like most emerging markets, China seems to have been unaffected by the worst of the US sub prime lending fallout, and there is a growing confidence in the robustness of this market. If this confidence is maintained then it can be assumed that foreign investor interest will continue, leading to further growth in the FX market, with a proportionate increase in eFX, comments Rob Close, President and CEO at CLS Bank International.

Close continues: "We may also see Chinese investors beginning to look abroad, driving further FX growth. In the medium term market liberalisation, which has many other facets than just allowing faster renminbi appreciation, will further drive growth. We believe this growth would be assisted by the renminbi becoming in the medium term a CLS currency, and we are having discussions in relation to this.

"The cost of execution and demand for greater efficiency will also help fuel growth in the use of electronic platforms [in China]," states Close. "Key platforms already exist in China, which is probably already exceeding predicted global market growth of around 20% in platform based trading. The caveat is that if we continue to see the volatility experienced over the last few months, then these growth figures can be doubled. A proportionate increase in the Chinese market is to be expected."

As of 11 December 2006, the protective period for Chinese banks following China's entry into the World Trade Organisation came to an end, so China's financial industry opened fully. This has meant that more banks are increasing investment in technology and management resources to be more competitive, both onshore and offshore.

Importance of Hong Kong

While there are differences in technology and infrastructure between mainland China and Hong Kong, those are a moot point given that eFX is designed to be traded at any time, from anywhere, at least in theory.

K.C. Lam, director and head of Asian FX sales at CME Group, states: "Hong Kong has always prided itself as the gateway to China, and has benefited tremendously from the growth and trading going via Hong Kong to the rest of the world. The Hong Kong economy has a free and friendly business environment with excellent infrastructure, and absence of FX and capital controls. It also has a good pool of talent in the FX and e-commerce arena that will be very helpful in maintaining

Hong Kong's lead in the utilisation of FX e-commerce. CME Group has had an office in Hong Kong since 2006."

Lam adds: "Infrastructure in Hong Kong and major cities in China is generally very good. Other cities in China lag behind, although there has been a major investment in infrastructure that will only help to improve the environment for electronic FX trading."

Yet Crosland points to the enormous class divide that resides in China, making Forex most readily available to residents of the Eastern Tier-1 cities such as Beijing, Shanghai, Tianjin and Chongqing. Crosland continues: "The lack of technology in rural areas, though, is not the only hindrance to trading Forex online; there's also the fundamental fact that they are extremely poor and can barely feed themselves, let alone dabble in a market like this. As far as the larger cities are concerned, since technological advances are mostly dependant on the brokers, [for instance those companies with adequate servers, software, and the like,] a client only needs a computer and basic internet connection [in order to trade]."

Network Buildout

There is a large difference between the technological infrastructure of mainland China and Hong Kong, Chan agrees. She comments: "We had a wide application of broadband in 2000, and then eFX came to individual investors in China. However, the broadband from China to overseas is narrow capacity, and there is very strict surveillance of what is sent out online. On top of that, the data transfer is not steady, so data loss and going offline occurs often. Yet in July this year, China and America will be working together to build a high speed broadband network, which will greatly impact online trading. We will still have the worry of the National Security Bureau, however, as this organisation can interfere or block any website."

The network build out that Chan refers to is a deal between Verizon and five major Asian telecoms companies - China Telecom, China Unicom, China Netcom, Korea Telecom and Taiwan's Chunghwa Telecom – to increase the current capacity of China's broadband networks by 60 times.

eFX is becoming increasing important for China as the country moves rapidly to integrate itself to the rest of the world. CME Group has noted increasing liberation of trade policies and a more flexible regulatory environment, conducive for the flow of trades and investment, in the country.

Yet regulation is a big issue in mainland and offshore China, for both its restrictions and also its looseness. On the loose side, the bulk of FX regulations in China are fuzzy at best, Crosland claims. He says the majority of lines are simply not clearly drawn out.

"Although I doubt this ambiguity is deliberate, it nevertheless leaves investors and organisations open to trying new things, to push the semi-existent boundaries, thus spurring additional growth," Crosland states. "But that's not to say the regulatory bodies are passive and don't play a role, either. Yet the market is growing

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so fast and attracting such a myriad of new investors, I feel, to some extent, that it is the investor and organisations shaping the regulations; investors spur the speed of growth, and inspire market evolution, whereas a regulatory body is slower to adjust."

Regulation lost in translation

Regulation is literally getting lost in translation in mainland China. Whereas in Hong Kong there are clear guidelines in getting approvals, in China, providers are sometimes left trying to interpret and reinterpret the state and national level guidelines. This occurs because the translation of regulation from Mandarin into English is often not done by agencies that have an understanding of the market they are writing about, which is one of the reasons that eFX regulation in China is so vague.

Most of the banks that have got the capability to operate in China tend to be foreign players. These banks, states Richard Koh, Director/Regional Head of eSales - Asia at Standard Chartered, get regulation translated by professional departments and businesses which may not be well versed in the language of trading, technology and financial markets. This means many interpretations have either lost their meaning or been over interpreted, so the translator creates a hurdle even higher than the regulation requires.

In terms of regulation, the Chinese government has committed itself to greater FX flexibility, which involves both the pace of liberalising and rationalising capital controls, such as relaxing administrative constraints on FX transacting, and the optimal degree of flexibility in the exchange rate. With the development of various hedging instruments, China is increasing the options of FX trading for both buy side and sell side. This in turn will hasten the use of electronic FX trading, as this is a more efficient way to scale in country as large as China.

Yet, the advance of eFX remains a challenge in China due to the regulatory requirement for strict documentation supporting each trade on a pre trade basis.

Regulators impose a stringent need for documentary evidence in order to prove a trade can be achieved. In other words, trades, other than those done by banks, cannot be done for speculative reasons; it must be for a genuine trade reason, Koh says.

"Because of the need for pre trade documentary proof, trading is severely challenged," Koh says. "If you are on the phone, you have to say you will send an email or fax the document over, then ask 'Are you staring at it?', 'Are you happy with it?', get verbal confirmation, and then do the trade. It becomes very awkward if you were to require pre trade documentary proof and then go online to do an actual execution. It's two separate, disparate processes rather than one single phone call."

Yet this also explains the lack of multibank platforms on Chinese soil. Koh continues: "If a trader goes online and prefers a multibank platform to a single bank platform, we are presented with another challenge because how would you do a pre trade documentary proof? You have to send a document to five banks before you decide which price you want to take? This is why most of the multi bank platforms do not try very hard to operate in China as it is operationally very cumbersome in order to achieve this requirement for pre trade documentary proof."

The solution to this issue, Koh claims, would be for the Chinese government to emulate those in Taiwan and Thailand, and even in Korea to a large extent. The regulators in those countries have understood that e-trading makes the process of pre trade contracts

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cumbersome, so they allow trades up to a certain size followed by documentary proof sent at the end of the trading day.

Chan states the regulatory environment for FX trading in China is still intangible, but that she can see that the government is preparing the way for a more open market. "The government needs to build up a good environment for the domestic banks to have a good share of this market before it is open," she explains. "However, the charge for FX trades in domestic banks is very high, so most buyers are not willing to trade with them. If there is open policy for the banks, they are going to have great market margin."

SAFE

One organisation working to improve the FX situation in China is SAFE. SAFE works from a regulatory, policy and risk management perspective in China, with responsibility for managing and monitoring foreign exchange transactions under capital accounts, including inward and outward remittance and payments. It is responsible for managing the foreign exchange reserves of the country in accordance to the rules and regulations set by the Chinese government, Lam says.

SAFE has many functions covering the Chinese FX market. SAFE is tasked with designing and implementing the balance of payments (BOP) statistical system in conformity with international standards, developing and enforcing the BOP statistical reporting system, and collecting relevant data to compile the BOP statement; it is analyzing the BOP and foreign exchange positions, providing policy proposals with the aim of achieving an equilibrium BOP position, and conducting feasibility studies on the convertibility of the renminbi under capital account; drafting rules and regulations governing foreign exchange market activities, overseeing the market conduct and operations, and promoting the development of the foreign exchange market.

SAFE is also involved with analyzing and forecasting the foreign exchange supply and demand positions and providing the People's Bank of China (PBC) with propositions and references for the formulation of exchange rate policy; promulgating regulatory measures governing foreign exchange transactions under current account and supervising the transactions accordingly; monitoring and regulating the foreign exchange account operations both in China and abroad; supervising and monitoring foreign exchange transactions under capital account, including inward and outward remittance and payments; managing foreign exchange reserves of the country in accordance with relevant rules and regulations; drafting foreign exchange administration rules, examining the domestic entities' compliance with foreign exchange administration rules and regulations, and penalizing institutions engaging in illegal practices; participating in relevant international financial activities; and performing other duties and responsibilities assigned by the State Council and the PBC.

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Yet despite this massive remit, Chan says SAFE does still not have clear regulation laid out for E-Forex. However, she adds that it does not forbid citizens in investing in foreign countries, but each citizen can only transfer $50,000 in one year. "This allowance greatly limits the development of eFX," she claims.

Retail FX potential

It seems obvious that China is on the cusp of bigger and better things. So much so that retail FX provider, Interbank FX, decided in late 2007 to open a satellite office in Beijing. The company is currently focusing a lot of energy and manpower in that region and anticipates the number of new Chinese accounts to quickly surpass the number of new US accounts it has, where most of its business in conducted.

Retail is thought by many to represent the greatest potential market for eFX, through retail brokerages and aggregators, as evident by the same segment in Japan where households make up a large proportion of retail FX players, Koh claims. However, he adds that comparing China to the Japanese market, as far as retail FX is concerned, is not a like for like comparison. This is due to the inherent carry-trades in the latter, which is not present in the former; in fact, Koh says conventional wisdom dictates to hold on to CNY due to its relative undervaluation.

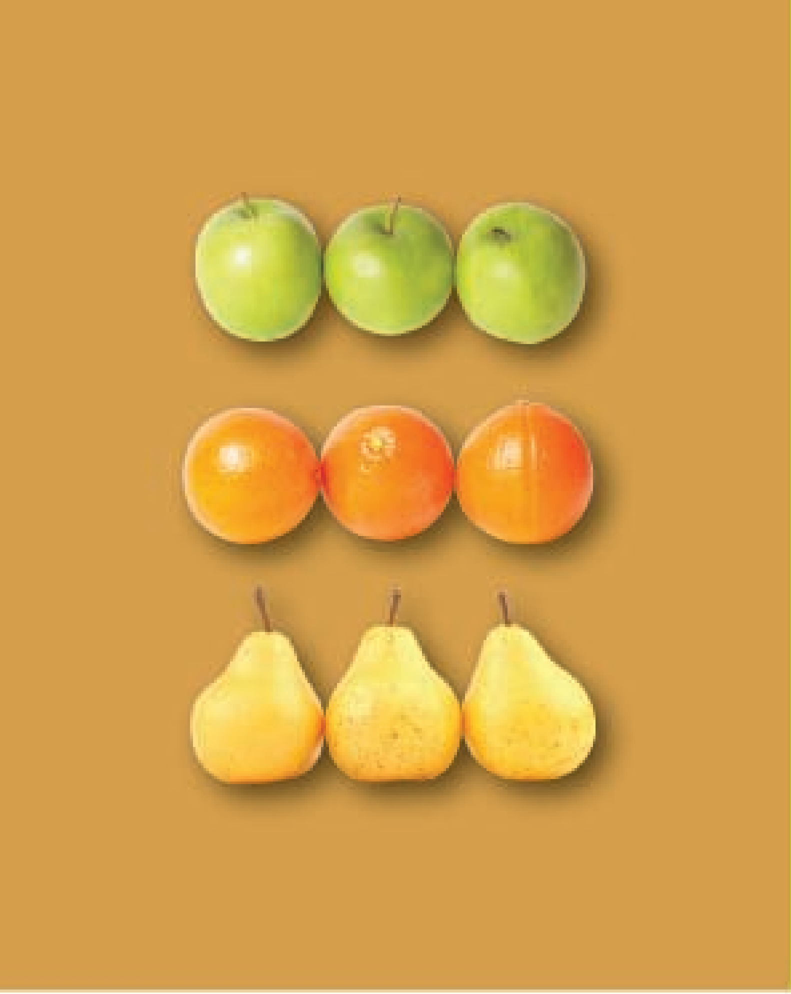
"Whereas in China, everyone knows that the CNY is undervalued so keeping your currency in your home country where the interest rate is actually higher, compared to the Yen, makes sense," Koh states. "This means eFX is not that popular in China right now. However, everyone in China likes dealing in shares which means the market is still vibrant."

So retail FX in China is at an early stage; while some offshore retail platforms are making inroads into the country, the market is far from realising its full potential. However, Lam says: "Mid to long term, this is going to be one huge market, rivalling the size of the retail market of Japan."

Lam continues that FX futures is important for the Chinese retail market. "Currently, there is not a futures FX market available for retail in China. Yet FX futures is ideally suited for retail FX trading as they are very liquid, with easy access and execution, fully disclosed pricing and a level playing field for all market participants, with the safety and security of a regulated FX environment. Most retail customers trading FX in a cash market will end up paying a pip or more of the price on every trade."

Pushing FX delivery through e-channels

In China, other than the big four local banks, the middle tier banks largely have insufficient liquidity so they source liquidity from offshore banks, Koh comments. He says most of these offshore liquidity providers have in the last couple of years been consistent and successful in pushing FX delivery through electronic channels.

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Local banks in China do around 70% of all FX transactions electronically, Koh states: "Banks have largely converted to eFX for non strategic – read, non market moving trades of less than $15 million to $20 million - since 2006, with the proliferation of e-platforms from foreign liquidity providers and state driven initiatives, such as CFETS. For trades that may move the market, deals are done largely over the telephone still."

The investment and asset management community in China is likely to embrace the benefits of e-trading, states Lam. He says increased awareness and training will be key in propagating the benefits of e-trading to the local investment and asset management community.

Local corporates are a lot slower in catching on to eFX, Koh comments, primarily due to their preference for US dollar accounting for international trade, which therefore requires only USD/CNY trades that are still not very widely available due to regulatory restrictions.

Chinese corporates' response to developments in treasury technology and the use of online FX trading platforms offered by banks and portals is still in the early stages of development, Lam says. In the interbank arena last year, CFETS launched cash trading in five currency pairs against the reminbi, utilising a new trading platform customised to support the reminbi.

Participants on the platform include the 300 CFET member banks as well as 20 large banks, many of which are large global institutions. This adoption will eventually filter down to corporates, says Lam, who adds that although there are some larger corporates already using treasury technology offered by banks, it is still not pervasive.

Demand for currency derivatives

Lam continues: "However, we believe the treasury technology uptake and online FX trading will be greatly improve when CFETS starts to offer currency derivative hedging for its members."

As early as 2001, the CSRC and SAFE enacted regulations permitting Chinese corporations to trade foreign derivatives products to hedge corporate risks. Lam says his company is seeing this demand increasing as the users in China become more sophisticated in the way they manage risks.

"There is also greater awareness amongst investors," Lam continues. "Recently, the Shanghai Futures Exchange (SFE), was given regulatory approval to launch gold futures. Recent combined volume turnover of the nation's three commodity futures exchanges totaled 40.97 trillion yuan in 2007, up 95% from the year before."

CME has entered into an agreement with the China Foreign Exchange Trade System (CFETS) to which CFETS will become a 'super clearing' member of CME, providing CFETS members (which include all of the major Chinese banks in China) with access to CME Group FX and interest rate futures markets.

This agreement and proposal is currently being reviewed by CFTC, says Lam. "This agreement will promote the infrastructure building of China's FX market and the further opening of China's financial markets," Lam states. "The agreement will be an important step in the development of China's FX market. It will help financial institutions in terms of price discovery and risk management of their exposures in these markets."

The demand for currency derivatives as hedging instruments is quite high in China, and is partially dependent on the health of the US economy. Take for instance the recent economic stimulus package recently passed by the US Congress; according to Crosland that money usually comes in the form of Treasury Bonds sold to foreign countries. “Estimates say China owns 10% of our [the US] debt,” Crosland elaborates. “China will be happy to loan us more as our economy struggles and their economy booms, as a good portion of the money lent to us goes straight back to China soil in the form of purchased goods.”

Close says it is likely that the continued economic growth and related international investment will drive the growth in currency derivatives in the Chinese market. As the renminbi remains a non-convertible currency, derivatives are playing an increasing role for those wishing to invest in China, and in hedging in particular, he claims.

A key example is the growing use of non-deliverable forwards which are used by corporations and fund managers as their preferred hedging tool for shorter dated hedging, generally with 90 day tenors, Close continues. He says several major fund managers have indicated to CLS Bank International that as much as 20% of their daily and quarterly volumes are traded as NDFs rather than outright.

Close says: “CLS is supporting this growth in NDFs by extending its service to process and settle these instruments,” he comments. “We are delivering automation in an environment where little automation exists, facilitating more convergence and standardisation, bringing increased efficiency and delivering significant ticket cost reductions. NDFs have traditionally been associated with manual processes, long-form confirmations, and lack of standardisation. These factors contribute to expensive processing costs for NDFs, estimated at $20 per trade or more, a multiple of the cost to process an FX spot or forward trade.”

Future eFX prospects

On the future for eFX in China, Lam says the regulatory environment has become more flexible. He adds: “Moreover, as a result of greater awareness of various risk management and hedging tools available in the market, the future prospects for FX e-commerce are only going to improve.”

While Chan is enthusiastic. She says: “eFX has huge market potential in China. The economics of China has developed for 26 years and accumulated substantive wealth. Most of that wealth was saved, but when saving does not satisfy value increment expectations, people seek other tools of investment. Now most of that money is going to the stock market. With the development of regulation for FX, I believe the growth of eFX in China will be explosive.”