HKEX
香港交易所

October 2021

Research Report

MSCI China A 50 Connect (USD) Index Futures: A new offshore risk management tool for broad-based equity exposure to China

CONTENTS

Page

Chief China Economist's Office
Hong Kong Exchanges and Clearing Limited

18 October 2021

SUMMARY

Hong Kong Exchanges and Clearing Limited (HKEX) launched USD-denominated, cash-settled MSCI China A 50 Connect (USD) Index Futures on its subsidiary, the Hong Kong Futures Exchange, on 18 October 2021. The MSCI China A 50 Connect (USD) Index Futures is the first officially recognised offshore market risk management tool for Stock Connect-eligible A-shares.

With China being an increasingly important driver of global economic and financial activities, the inclusion of China A-shares into global benchmark indices and continued capital market liberalisation initiatives implemented by Mainland China authorities now offer significant investment opportunities for global investors to gain exposure to the world's second largest economy. However, the offshore market still lacks diversified risk management tools against broad China A-share exposures. Market participants regard this as a constraint for their deeper and broader participation into onshore equity markets.

The new contract aims to meet increasing risk management demand from international investors for broad-based equity exposure to Mainland China. It also complements HKEX's China-related products and services, including Stock Connect, structured products, exchange traded funds (ETFs) and derivatives, allowing investors to consolidate China exposure in one venue.

The launch of this new contract is a key step forward in further advancing HKEX's plans to build an offshore Mainland China equity derivatives suite in Hong Kong, and represents another significant development in building the breadth, depth and attractiveness of Hong Kong's vibrant financial markets. It also demonstrates Mainland authorities' strong commitment to deepen China's A-share market, broaden A-share market's investor base, support cross-border capital flows, and drive the two-way opening-up of China's onshore capital markets.

While China has become the world's second largest economy, China's capital markets have also been growing fast with increased breadth and depth. Further developing and opening up China's capital markets are being placed at a critical position to support China's long-term economic and strategic goals, as expressed through a number of high-profile national strategic initiatives over the past few years. With capital markets across the Mainland and Hong Kong being linked via different schemes to access different markets and products, Hong Kong has been playing and will continue to play a unique role in connecting China and the world as the main gateway to the onshore markets.

Hong Kong, being a leading offshore Renminbi (RMB) hub in the world, is poised to be the desirable place to facilitate the internationalisation of RMB assets including China A-shares. Furthermore, the strategic positioning of Hong Kong as stated in the 14th Five-Year Plan allows Hong Kong to continue to play important roles through various cross-border capital market initiatives. Together with its robust fundraising, investment and risk management infrastructures accessible to market participants worldwide, the introduction of MSCI China A 50 Connect (USD) Index Futures will further strengthen Hong Kong's function as an offshore RMB hub, as well as an international asset management and risk management centre. Looking forward, Hong Kong is well positioned to continue enriching the variety of investment product lines, broadening the investor base in Hong Kong, and developing itself as Asia's premier derivatives hub.

The past few decades have seen China's labour and goods reshaping the world against the macro backdrop of globalisation and global economic integration, particularly after China's entry into the World Trade Organisation and becoming "the world's factory". In the coming decades, we expect China's capital markets, together with offshore capital markets in Hong Kong being linked to onshore capital markets, to reshape the global financial landscape in many different ways.

1. STRATEGIC VALUE AND POTENTIAL MACRO IMPLICATIONS: A NEW RISK MANAGEMENT TOOL FOR STOCK CONNECT-ELIGIBLE A-SHARES

With China being an increasingly important driver of global economic and financial activities, the inclusion of China A-shares into global benchmark indices and continued capital market liberalisation initiatives implemented by Mainland Chinese authorities are now offering global investors exposure to significant investment opportunities in the world's second largest economy[1]. However, the offshore market still lacks diversified risk management tools against broad China A-share exposures. Market participants regard this as a constraint for their deeper and broader participation into the onshore equity markets.

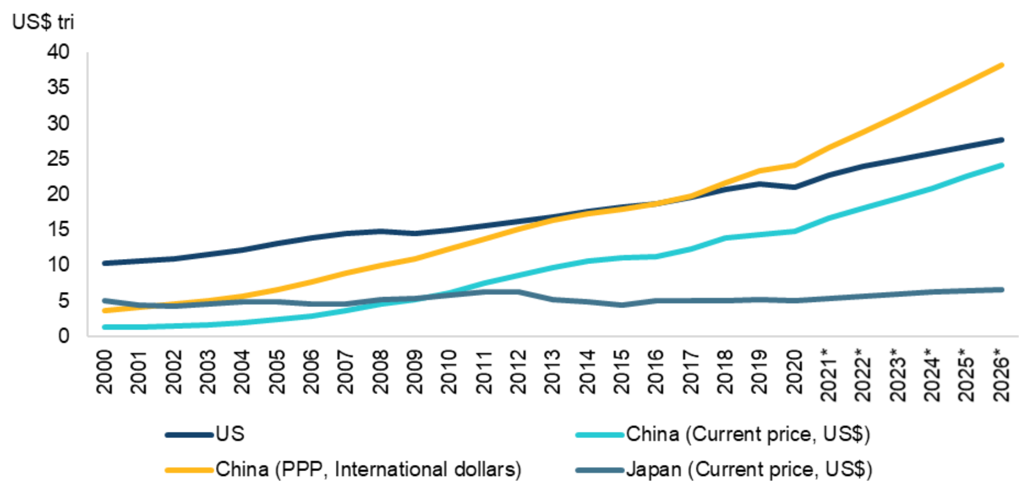
The introduction of MSCI China A 50 Connect (USD) Index Futures, as the first officially recognised offshore market risk management tool for Stock Connect eligible A-shares, has offered strategic values together with macro implications in various aspects.

1.1 Bring the world closer to the world's second largest economy

The global economic landscape has undergone dramatic shifts over the past few decades along with the rise of the Chinese economy. Alongside its resilient economic growth amidst the turbulent global environment over the years, underpinned by highly diversified and fast-evolving economic fundamentals, China has continued with liberalisation and structural reforms for its capital markets. These reforms offer international investors valuable opportunities to get exposure to and reap possible benefits from the economic growth of China, the strategic significance of which could hardly be overlooked.

According to the International Monetary Fund (IMF), China overtook Japan to become the world's second largest economy in 2010 in terms of gross domestic product (GDP) in nominal terms (see Figure 1). China's GDP outstripped that of the United States (US) in 2017 and is estimated to account for about 20% of total global output by 2026 in purchasing power parity (PPP) terms (see Figure 2). Based on projections released by the Centre for Economics and Business Research (CEBR) in December 2020, China will overtake US to become the world's largest economy around 2030 by GDP in nominal terms (see Figure 3).

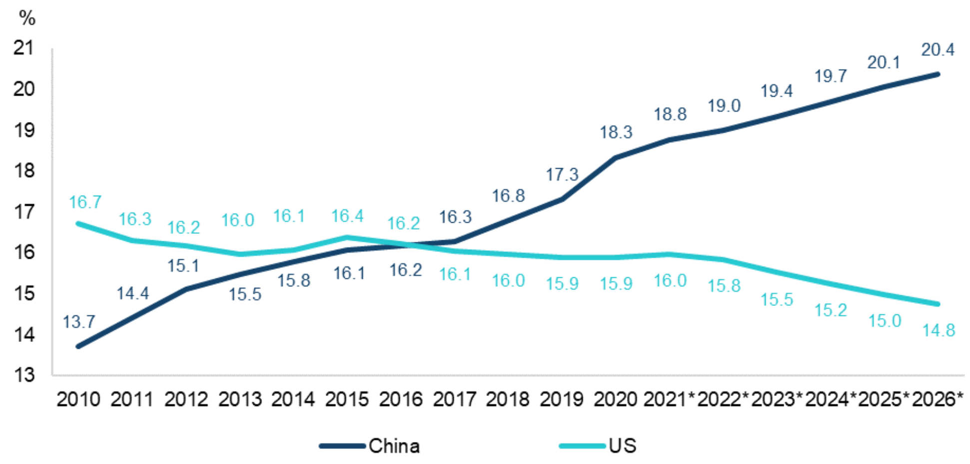
Figure 1. GDP of major economies — Actual and forecast (2000 – 2026)



* Figures for 2021 to 2026 are forecast figures.
Source: IMF, *World Economic Outlook*, April 2021.

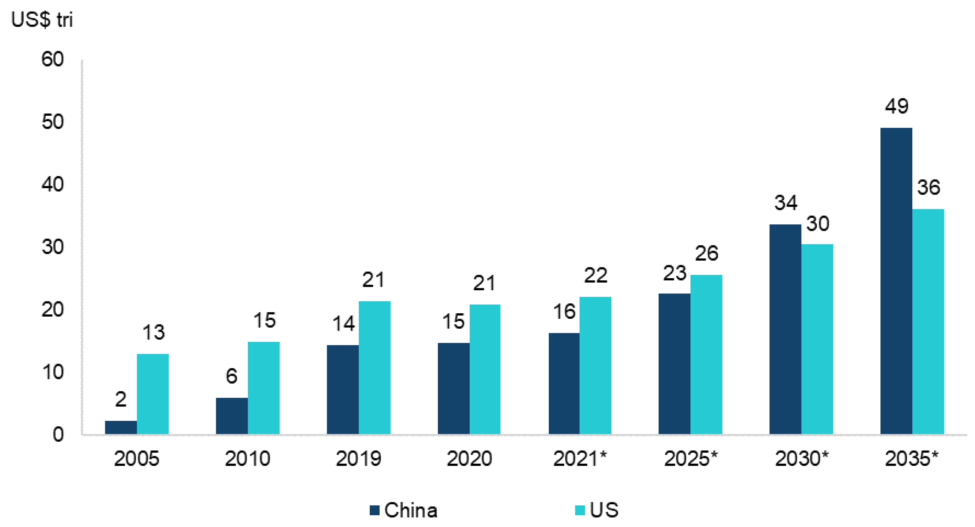
[1] Source: International Monetary Fund, *World Economic Outlook*, April 2021.

Figure 2. Shares of global GDP (in PPP terms): China and US — Actual and forecast (2010 – 2026)



* Figures for 2021 to 2026 are forecast figures.
Source: IMF, *World Economic Outlook*, April 2021.

Figure 3. China and US GDP in nominal terms — Actual and forecast (2005 – 2035)



* Figures for 2021 to 2035 are forecast figures.
Source: CEBR's *World Economic League Table 2021*, December 2020.

As a result of China's economic growth and opening up, many economies around the world are more exposed to the Chinese economy through increasing international trade and cross-border investments. Such exposure also gives rise to growing global demand for Renminbi (RMB) assets, especially after RMB's inclusion into IMF's Special Drawing Rights currency basket since 2016.

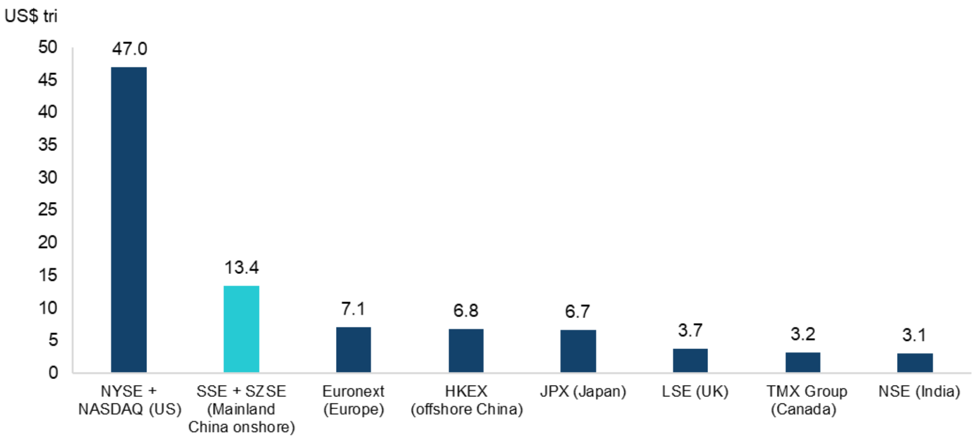
Further developing and opening up China's capital markets are being placed at a critical position to support China's long-term economic and strategic goals, as expressed through a number of high-profile national strategic initiatives over the past few years. In December 2018, the positioning and strategic significance of China's capital market in the new era were made clear for the first time in China's annual Central Economic Work Conference. To support China's economic transformation, the Conference stressed that the capital market will play a vital role in the functioning and operating of the financial system, and through deepened reforms, the goal is to establish a standard, transparent, open, dynamic and resilient capital market[2]. Released in March 2021, the national 14th Five-Year Plan re-emphasised the importance of implementing capital market liberalisation reform, building a sound multi-tiered capital market, broadening the institutional investor base, and increasing the share of direct financing to support economic development, especially the share of equity financing[3].

China's capital market reforms have continued and even accelerated over the past few years[4], leading to structural changes in aspects such as corporate fundamentals, regulatory frameworks, investor education, market accessibility, market microstructure, information disclosure, etc. The past few years have also seen targeted policies to make the capital market a more important source of financing than bank loans. The introduction of a new set of asset management regulations in April 2018 that aimed to curb the growth of the shadow banking industry is also an example of mainland authorities' continued efforts in such areas[5].

Against increasing challenges and uncertainties in the global macro backdrop, Mainland authorities have been emphasising the importance of economic rebalancing and further boosting total factor productivity, as expressed in the 14th Five-Year Plan and the dual circulation strategy[6], for which efficient allocation of capital and other resources is crucial. A vibrant capital market is indispensable for achieving efficient market-driven allocation of production factor resources.

With China being an increasingly important driver of global economic activities, China's capital markets have been growing fast. In respect of the equity market, the combined market value of onshore stocks listed on the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchanges (SZSE) has become the second largest in the world (see Figure 4).

Figure 4. Top ten exchanges by market value of listed stocks (Jun 2021)



Note: The chart presents the top 10 WFE member exchanges by market value of listed stocks, where figures of exchanges in the same country/region are combined.

Source: World Federation of Exchanges (WFE).

2 Source: "Strong leadership of the CPC Central Committee has charted the course for capital market reform and development" (〈黨中央堅強領導為資本市場改革發展指明方向〉), *Xinhuanet*, 7 January 2021.

3 Source: *Outline of the 14th Five-Year Plan for National Economic and Social Development of the People's Republic of China and the Vision for 2035* (《中華人民共和國國民經濟和社會發展第十四個五年規劃和 2035 年遠景目標綱要》), released by the State Council, 21 March 2021.

4 See "Capital market reform continue to deepen" (〈資本市場基礎制度改革將不斷深化〉), *Xinhuanet*, 19 May 2020.

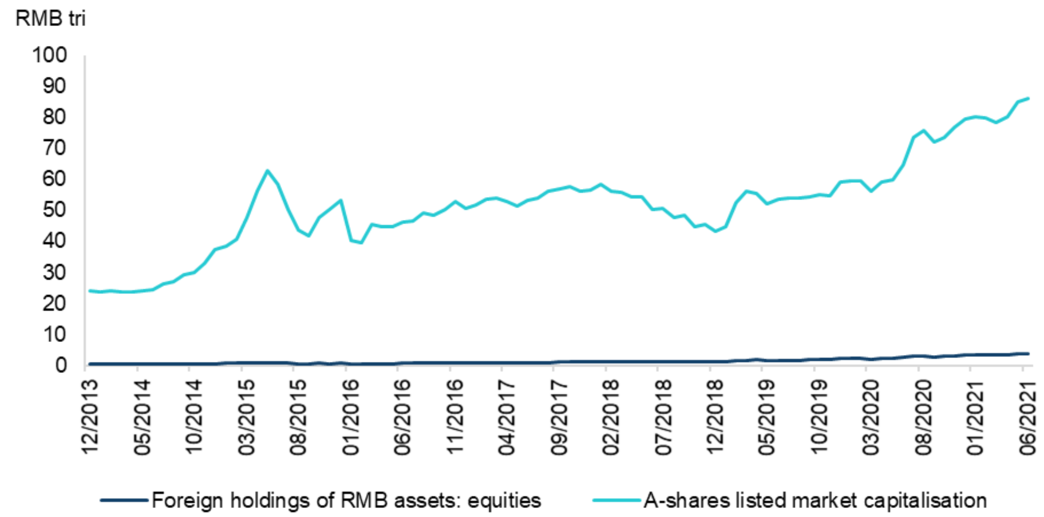
5 Source: "Guiding Opinions of the People's Bank of China, the China Banking and Insurance Regulatory Commission, the China Securities Regulatory Commission, and the State Administration of Foreign Exchange on Regulating the Asset Management Business of Financial Institutions" (〈中國人民銀行、中國銀行保險監督管理委員會、中國證券監督管理委員會、國家外匯管理局聯合發佈《關於規範金融機構資產管理業務的指導意見》〉), released by the State Administration of Foreign Exchange (SAFE), 27 April 2018.

6 This is an economic development strategy first put forward by the Standing Committee of the Political Bureau of the Communist Party of China Central Committee Meeting (中共中央政治局常務委員會會議) held in May 2020.

At the same time, international investors have an increasing motive to reassess the position of Chinese assets in their global portfolios. Under a typical asset allocation framework, investors assess potential investment opportunities in an asset class from two aspects: the expected return and the benefits from diversification. This approach should also apply to China A-shares as an asset class. From practical and operational perspectives, in considering the inclusion of China A-shares into their portfolios, investors will also consider factors like the pros and cons of various access channels, sources of risk and return (including differentiated sector compositions), macroeconomic-related drivers, style factors and other idiosyncratic drivers of China A-shares that may influence their investment decision[7].

While China A-shares are now among the largest, most liquid, and strategically important asset class with unique diversification features[8], foreign holdings in A-shares are still low relative the size of the A-share market (see Figure 5), not to say to the size of China's economy. This may be due to various constraints, such as the ease of trading, market accessibility-related issues, the lack of familiarity with unique local market mechanisms, insufficient sell-side research coverage and limited access to diversified risk management tools.

Figure 5. Foreign holdings of onshore equities vs A-shares listed market capitalisation (Dec 2013 – Jun 2021)



Source: People's Bank of China (PBoC), Wind.

Over the years, the offshore market has lacked a broad-based risk management tool for China A-share exposure, thus constraining foreign participation into the onshore equity market. With the introduction of the MSCI China A 50 Connect (USD) Index Futures, the offshore market now has an officially recognised risk management tool for broad-based equity exposure to China. This new contract also complements Hong Kong Exchanges and Clearing Limited (HKEX)'s China-related products and services, including Stock Connect, structured products, exchange traded funds (ETFs) and derivatives, enabling investors to manage their China exposure in one venue.

1.2 A further step in China's continuing capital market opening-up process

China's commitment and continued moves to open up its onshore capital market are in line with its long-term economic and strategic goals. This offers access to stable pools of global

7 Source: Zhen Wei, "China A shares inclusion into MSCI indices: the journey and impact", *Mutual Market Connectivity and Hong Kong Market Innovations for New-economy Financing*, The Commercial Press (H.K.) Ltd, October 2019.

8 Source: Bridgewater, "Balancing Chinese assets offers a rare opportunity for investors", April 2019.

institutional investment to deepen the onshore capital market, attract long-term capital inflows to support China's economic development and transformation, and support RMB internationalisation with increasing two-way capital flows.

Over the years, China's ongoing opening up of its capital markets has improved market accessibility of Chinese assets through multiple channels, raising global interest in RMB assets, including China A-shares. Meanwhile, A-share exposure is increasingly being incorporated into large global benchmark indices, which further drives global allocation and portfolio flows into China's onshore equity markets.

Different access channels to the A-share market now include the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) schemes[9], Shanghai-Hong Kong Stock Connect (SH-HK Stock Connect) and Shenzhen-Hong Kong Stock Connect (SZ-HK Stock Connect) schemes, Mainland-Hong Kong Mutual Recognition of Funds scheme, ETF Cross-listing scheme, and the Cross-boundary Wealth Management Connect Scheme in the Guangdong-Hong Kong-Macao Greater Bay Area (Wealth Management Connect) (see Table 1).

Table 1. Different channels to access onshore equity market

Scheme	QFII/RQFII	Stock Connect	Mutual Recognition of Funds	ETF Cross-listing	Wealth Management Connect
Launch date	• QFII: Dec 2002 • RQFII: Dec 2011	• SH-HK Connect: Nov 2014 • SZ-HK Connect: Dec 2016	Jul 2015	• SH-HK Scheme: Oct 2020 • SZ-HK Scheme: Jun 2021	Sep 2021
Quota limit	No quota limit	• No aggregate quota • Daily quota limit for Northbound: RMB 52 bil[10] • Daily quota limit for Southbound: RMB 42 bil[11]	RMB 300 bil aggregate quota for in and out fund flows each way	• Hong Kong "feeder" ETF: no quota limit • Mainland "feeder" ETF: subject to Qualified Domestic Institutional Investor (QDII) quota limit	• RMB150 bil aggregate quota in each Northbound and Southbound leg • RMB1 mil quota limit for individual investors
Eligible products	Cash equities including primary offering and secondary trading, China depository receipts (CDRs), asset-backed securities (ABS), warrants, margin trading, equity index futures,	Eligible listed stocks on HKEX SSE and SZSE[12]	General equity funds, mixed funds, unlisted index funds and physical index-tracking ETFs	2 SZ ETFs 1 SH ETFs 3 HK ETFs[13]	• Northbound: low- to medium-risk products distributed by Mainland banks, including public fixed income and equity wealth management products and public securities

9 The QFII scheme offers foreign investor's direct access to China's capital market. The RQFII scheme allows for the use of RMB funds raised in eligible locations outside of Mainland China to invest in the domestic securities market. New regulations were announced in September 2020 by Mainland regulators to unify the two schemes.

10 Daily quota limit applies to each of the Shanghai Connect and the Shenzhen Connect, effective from 1 May 2018.

11 Daily quota limit applies to each of the Shanghai Connect and the Shenzhen Connect, effective from 1 May 2018.

12 Number of eligible stocks under Stock Connect as of 31 August 2021 are: 523 HKEX-listed stocks, 588 SSE-listed stocks and 851 SZSE listed stocks. (Source: HKEX.)

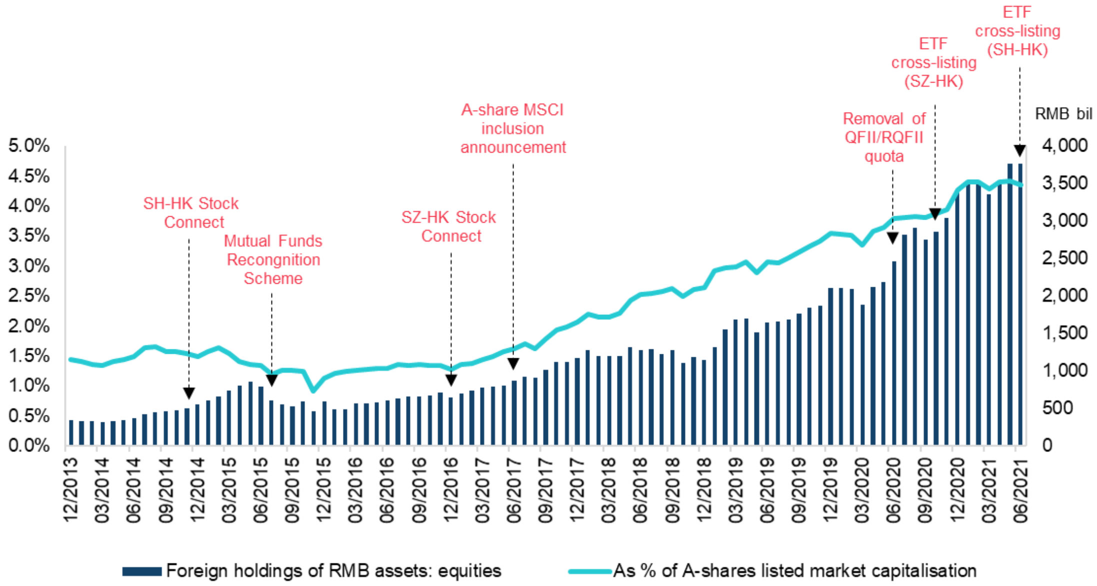
13 Number of eligible ETFs as of 31 August 2021. (Source: HKEX announcements.)

Table 1. Different channels to access onshore equity market					
Scheme	**QFII/RQFII**	**Stock Connect**	**Mutual Recognition of Funds**	**ETF Cross-listing**	**Wealth Management Connect**
	securities investment funds and other equity-related products approved by CSRC				investment funds • Southbound: low- to medium-risk and non-complex products distributed by and deposits at Hong Kong banks
Regulatory approval	PBoC, CSRC, SAFE	No requirement	CSRC, SFC	CSRC, SFC	CBIRC, CSRC, SFC, HKMA

Source: Websites of PBoC, SAFE, China Banking and Insurance Regulatory Commission (CBIRC), China Securities Regulatory Commission (CSRC), Hong Kong Monetary Authority (HKMA), Securities and Futures Commission (SFC) and HKEX.

With such unprecedented access to the large and liquid A-share market, international investors' holdings of A-shares have been growing at a fast pace after the inclusion of China A-shares into key global benchmark indices, albeit from a low base (see Figure 6).

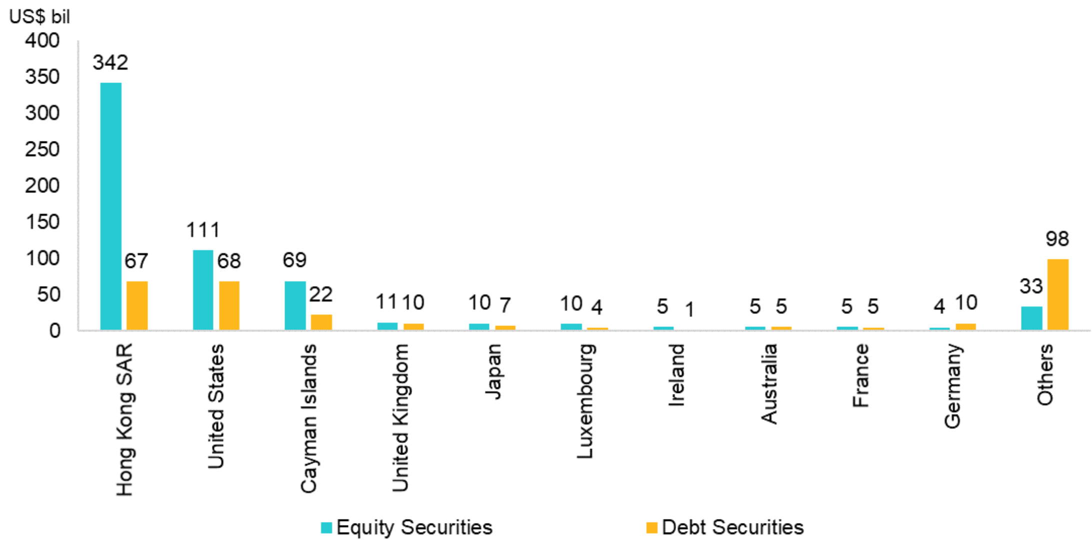
Figure 6. Foreign holdings of onshore A-shares (Dec 2013 – Jun 2021)



Source: PBoC, Wind.

As seen from the various Mainland-Hong Kong connectivity schemes listed in Table 1, Hong Kong plays an important role in facilitating China's financial opening. These connectivity schemes enable access to multiple market and product segments in the Mainland and Hong Kong markets, reflecting Hong Kong's unique role in connecting China and the world. Hong Kong, as world's leading fundraising hub, also plays an important role in fuelling the expansion of Chinese enterprises over the years. Moreover, in supporting two-way cross-border capital flows, Hong Kong has become the largest destination of China's external portfolio investment (see Figure 7). Being a leading offshore RMB hub in the world, Hong Kong is well positioned to facilitate the internationalisation of RMB assets including China A-shares.

Figure 7. China's external portfolio investment assets by country/region (end of 2020)



Source: SAFE.

Amid COVID-19 disruptions since 2020 and the lingering geopolitical tensions in global macro backdrop, China's financial opening has continued and even accelerated. Examples of China's major steps in financial market opening include the removal of QFII/RQFII quota in May 2020 and the measures for enhanced administration of QFIIs and RQFIIs announced in September 2020 that further streamline the application and review procedures and to expand the investment scope to cover more sophisticated products from onshore markets[14]. The QFII enhancement measures were widely recognised by international market participants as a key milestone reflecting mainland authorities' commitments towards opening up China's capital markets. In July 2020, the service of Master Special Segregated Accounts (MSPSA) was launched as an enhancement to support Stock Connect, aiming to address the market demand for more efficient pre-trading checking and to provide additional benefit and convenience for institutional investors and market participants[15]. This is another example of various initiatives and enhancement measures to improve international investors' accessibility to China A-shares.

The launch of MSCI China A 50 Connect (USD) Index Futures is another step forward in supporting China's continued capital market liberalisation and opening-up process. It demonstrates the mainland authorities' strong commitments to deepen China's A-share market, broaden the A-share market investor base, and support cross-border capital flows and the two-way opening up of China's onshore capital markets.

1.3 Further facilitate foreign participation in China A-share market through Stock Connect

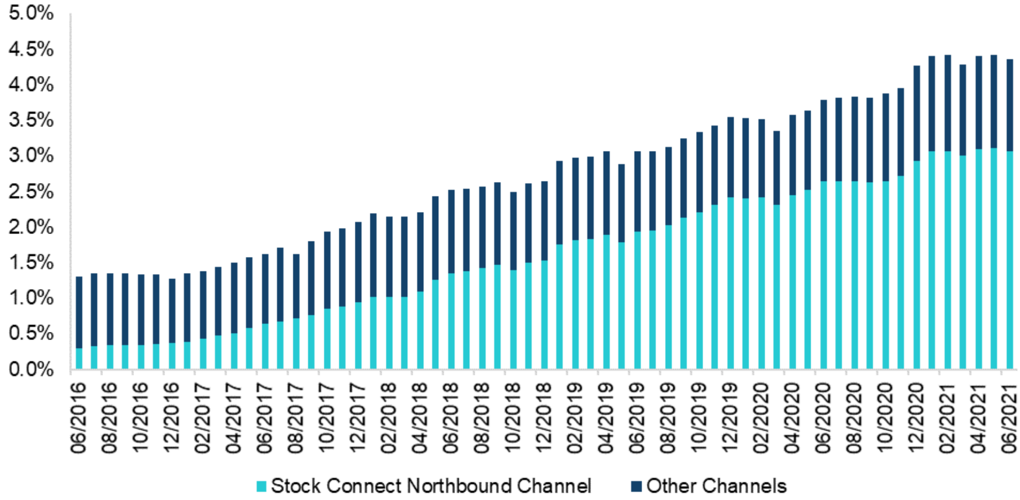
Since the launch of SH-HK Stock Connect in 2014 and the SZ-HK Stock Connect in 2016, the Stock Connect scheme has proven itself to be a robust channel for foreign investors to access the A-share market — foreign holdings of China A-shares through this channel have increased steadily, demonstrating that Stock Connect has become one of the main channels for international investor to invest in China A-shares (see Figure 8).

---

14 Accordingly, the regulatory regime of the QFII and RQFII schemes have been unified. See *CSRC, PBOC and SAFE release the Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors* (中國證監會、中國人民銀行、國家外匯管理局發佈《合格境外機構投資者和人民幣合格境外機構投資者境內證券期貨投資管理辦法》), news release on the CSRC's website, 25 September 2020. The new regulatory measures have become effective since 1 November 2020.

15 Source: "HKEX to launch master SPSA service on 10 July", news release on the HKEX's website, 9 July 2020.

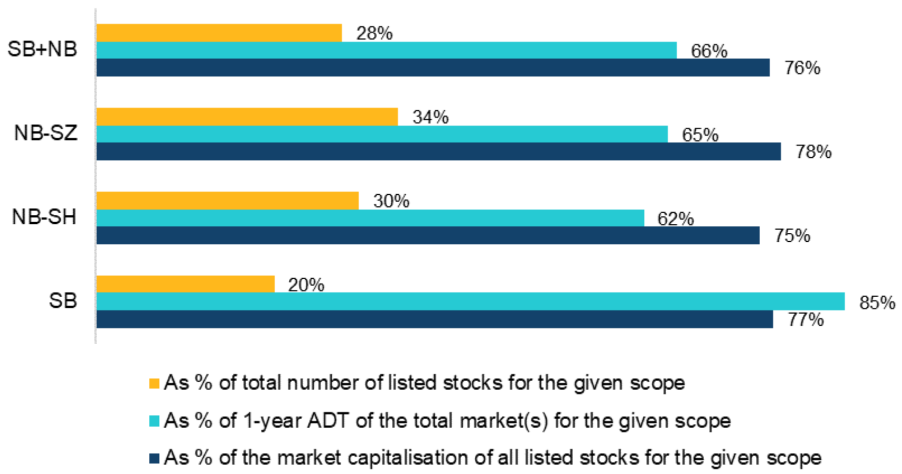
Figure 8. Foreign holdings as % of China A-shares listed market capitalisation through Stock Connect compared to other channels (Jun 2016 – Jun 2021)



Source: HKEX, Wind, PBoC.

As of 31 August 2021, the Stock Connect scheme covered 1,962 eligible stocks (worth US$14.7 trillion) listed in the Hong Kong and Mainland markets, which accounted for 28% of the combined total number of the stocks listed in the markets, 66% of 1-year average daily turnover value (ADT) and 76% of the combined total listed market capitalisation of the markets[16] (see Figure 9). As of 31 August 2021, 474 Stock Connect eligible China A-shares have been included in the MSCI All Country World Index (MSCI AC World), MSCI Emerging Markets Index (MSCI EM), MSCI AC Asia ex-Japan Index (MSCI AeJ) and MSCI China Index (MSCI China)[17].

Figure 9. Market shares of eligible stocks in the Stock Connect universe (31 Aug 2021)



Note: SB refers to Southbound Stock Connect; NB refers to Northbound Stock Connect; NB-SZ refers to Northbound under SZ-HK Stock Connect; NB-SH refers to Northbound under SH-HK Stock Connect; data for calculation of 1-year ADT covers one year period before 31 August 2021.

Source: HKEX, Wind.

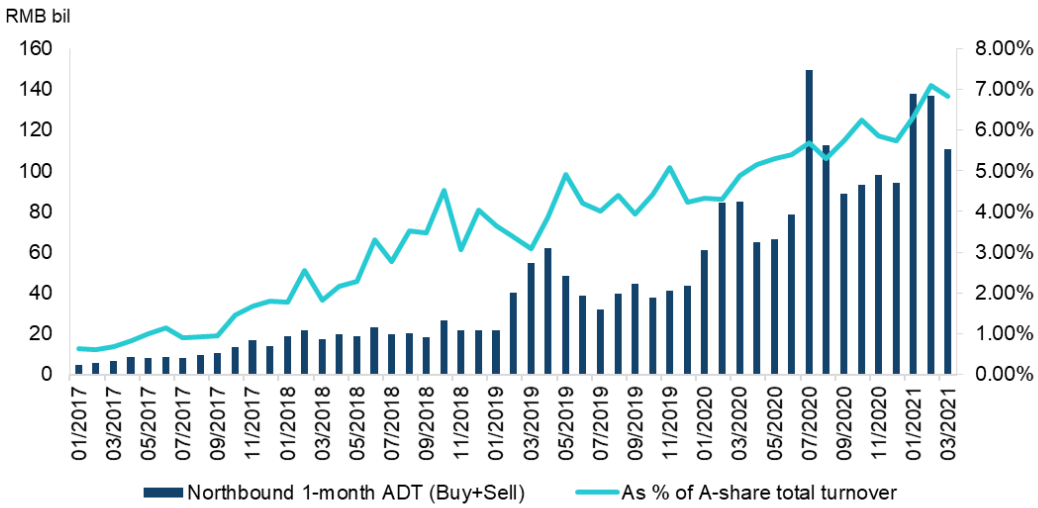
16 Source: HKEX, Wind.

17 Source: MSCI.

Alongside, the Northbound investor base is expanding at a rapid pace — the number of Special Segregated Accounts (SPSA)[18] opened at the Hong Kong Securities Clearing Company Limited (HKSCC) grew by almost 7 times to 13,366 by 31 July 2021[19], up from less than 1,700 in June 2017, indicating growing interest from international investors to invest in China A-shares.

International investors' increasing reliance on Stock Connect is also demonstrated through the steady growth in Northbound trading and holding values. The Northbound trading value in terms of 1-month ADT reached RMB 137 billion in July 2021, compared to RMB 4.7 billion in January 2017 (see Figure 10). The Northbound holding value of China A-shares reached RMB 2.48 trillion by the end of August 2021, compared to RMB 138 billion as at the end of June 2016 (see Figure 11). The sector breakdown of China A-shares held by Northbound investors showed that the holdings were diversified across different sectors, indicating global investors' aggregate interest in gaining relatively broad sector exposures to the Chinese economy (see Figure 12).

Figure 10. Northbound ADT and as percentage of China A-shares total turnover (Jan 2017 – Mar 2021)



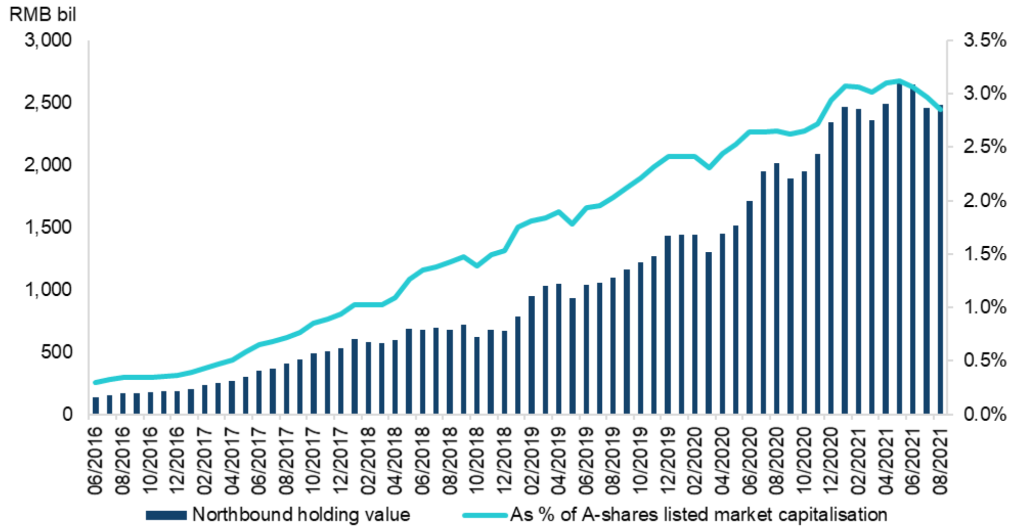
Source: HKEX, SSE, SZSE.

---

18 SPSA service is a mechanism to facilitate investors who maintain Stock Connect eligible stocks with custodians but want to sell their Stock Connect eligible stocks without having to pre-deliver the securities from their custodians to their executing brokers.

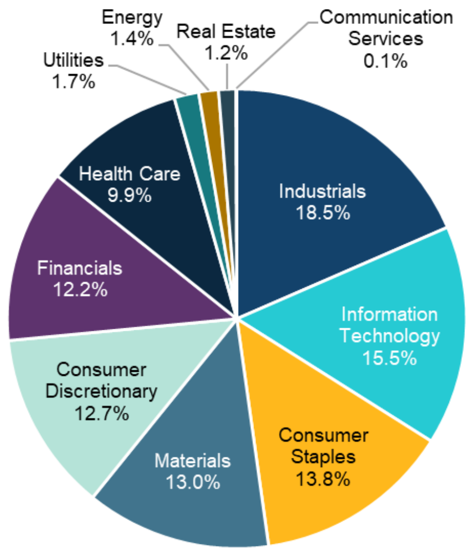
19 Source: HKEX.

Figure 11. Northbound holding value and as percentage of A-shares listed market capitalisation (Jun 2016 – Aug 2021)



Source: HKEX, Wind.

Figure 12. Northbound holding value breakdown by sector (31 Aug 2021)



Source: Wind.

As illustrated above, Stock Connect has established itself as one of the primary channels to access China A-shares and the MSCI China A 50 Connect Index covers the core large-cap stocks accessible through Stock Connect. Hence, the introduction of MSCI China A 50 Connect (USD) Index Futures, could potentially further facilitate international investors' participation in the A-share market through Stock Connect, and could further boost capital flows into onshore capital markets.

1.4 A further step in supporting A-shares' inclusion in MSCI benchmarks

The journey of A-shares' inclusion into MSCI indices, started in June 2017 when MSCI announced that it would include China A-shares in the MSCI Emerging Markets Index and the MSCI All Country World Index. As announced, this inclusion decision gained broad support from international institutional investors with whom MSCI consulted during June 2014 to June 2017. With an initial inclusion factor (IF) at 5%, MSCI added 222 China A-share large-cap stocks in 2018, representing on a pro forma basis approximately 0.73% of the weight of the MSCI Emerging Markets Index[20].

Having conducted an extensive global consultation with a large number of international institutional investors worldwide, on 28 February 2019, MSCI announced that it would raise the inclusion factor for China A-shares from 5% to 20%, and successfully implemented this between May 2019 and November 2019. As a result, 253 large-cap and 168 mid-cap China A-shares, including 27 A-shares listed on ChiNext of the SZSE, were added at 20% inclusion factor. According to investor feedback received through the consultation process, the robustness of the Stock Connect scheme and the strong commitment by the Chinese regulators to continue to improve market accessibility are the critical factors that has won the support of international institutional investors[21].

Subsequent to the successful implementation of final phase of the 20% partial inclusion of China A-shares in MSCI indices, MSCI reiterated a number of concerns from investors that need to be resolved ahead of consideration of further inclusion, including[22]:

- **Access to hedging and derivatives:** the lack of listed futures and other derivatives products may make investors' ability to implement and manage the risk of increasing the weight of China A-shares in the MSCI indices less efficient.
- **Short settlement cycle of China A-shares:** the short settlement cycle of China A-shares presents operational risk and tracking challenges, especially for those based outside Asian time zones. It becomes a larger risk as the A share weight and number of securities grows.
- **Trading holidays of Stock Connect:** the consultation feedback also indicates that investors are concerned with the misalignment between onshore China and Stock Connect holidays.
- **Availability of omnibus trading mechanism in Stock Connect[23]:** Many large fund managers and broker dealers have highlighted the pressing need for a well-functioning omnibus mechanism, i.e., the ability to place a single order on behalf of multiple client accounts is critical to facilitate best execution and lower operational risk to international institutional investors.

While certain onshore index futures and options have become available, such as CSI 300 Index futures and options, SSE 50 Index futures and options, and CSI 500 Index futures, the available offshore futures do not include a broad-based risk management tool. The launch of MSCI China A 50 Connect (USD) Index Futures could fulfil one of the four criteria from MSCI for potentially raising the inclusion factor for China A-shares.

Looking forward, international investors may consider making a greater allocation to China A-shares along with the expectedly increasing weights of China A-shares in MSCI indices. As a reference experience, in the first decade since Korea (1992 – 2002) and Taiwan (1996 – 2006) stocks were added to the MSCI indices, foreign ownership of local stocks rose from 4% to 12% for Korea, and from 9% to 23% for Taiwan[24].

---

[20] Source: "Results of MSCI 2017 market classification review", MSCI, 20 June 2017.

[21] Source: "MSCI will increase the weight of China A shares in MSCI indexes", MSCI, 28 February 2019.

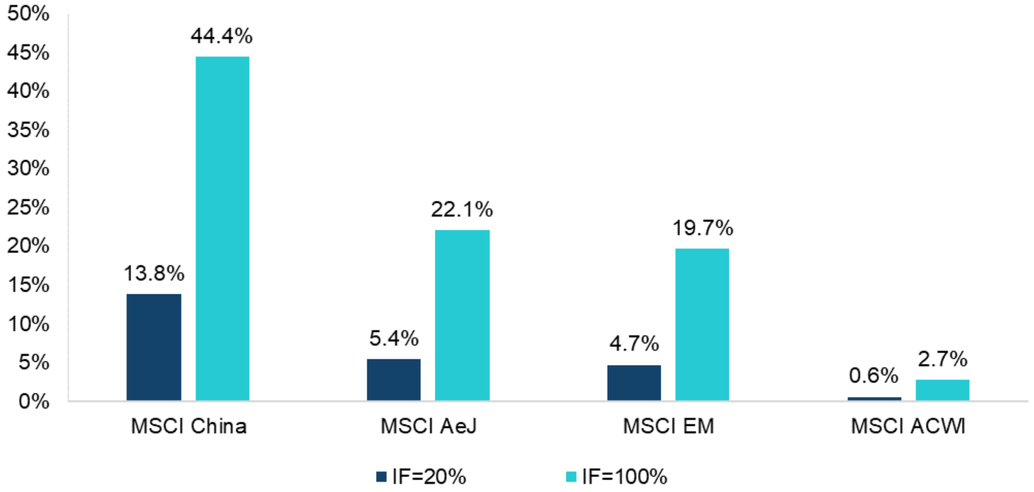
[22] Source: "MSCI completes the successful implementation of final phase of the 20% partial inclusion of China A shares in MSCI Indexes", MSCI, 26 November 2019.

[23] Master SPSA (MSPSA) was launched on 10 July 2020 as an enhancement to the existing SPSA service to allow pre-trade checking to be conducted at a fund manager, or aggregate level, to help increase their operational efficiencies while maintaining the same post-trade settlement processes at the individual SPSA level for consistency.

[24] Source: "Catching an accelerating Northbound train to A shares", Goldman Sachs, June 2021.

According to MSCI, as of 31 August 2021, the MSCI indices included 474 China A-shares, comprising 247 large-cap and 227 mid-cap stocks. The weight of China A-shares in the MSCI ACWI and MSCI EM Index reach 0.6% and 4.7%, respectively. On a pro-forma basis, China A-shares will potentially represent 44.4%, 22.1%, 19.7%, and 2.7% of MSCI China, MSCI AeJ, MSCI EM, and MSCI ACWI with a 100% inclusion factor (see Figure 13).

Figure 13. China A-shares' weight in MSCI indices — current and projection



Note: Data as of 31 August 2021, with 474 China A-shares included; pro-forma calculation based on current prices as of 31 August 2021, assuming the same set of 474 China A-shares included.

Source: MSCI.

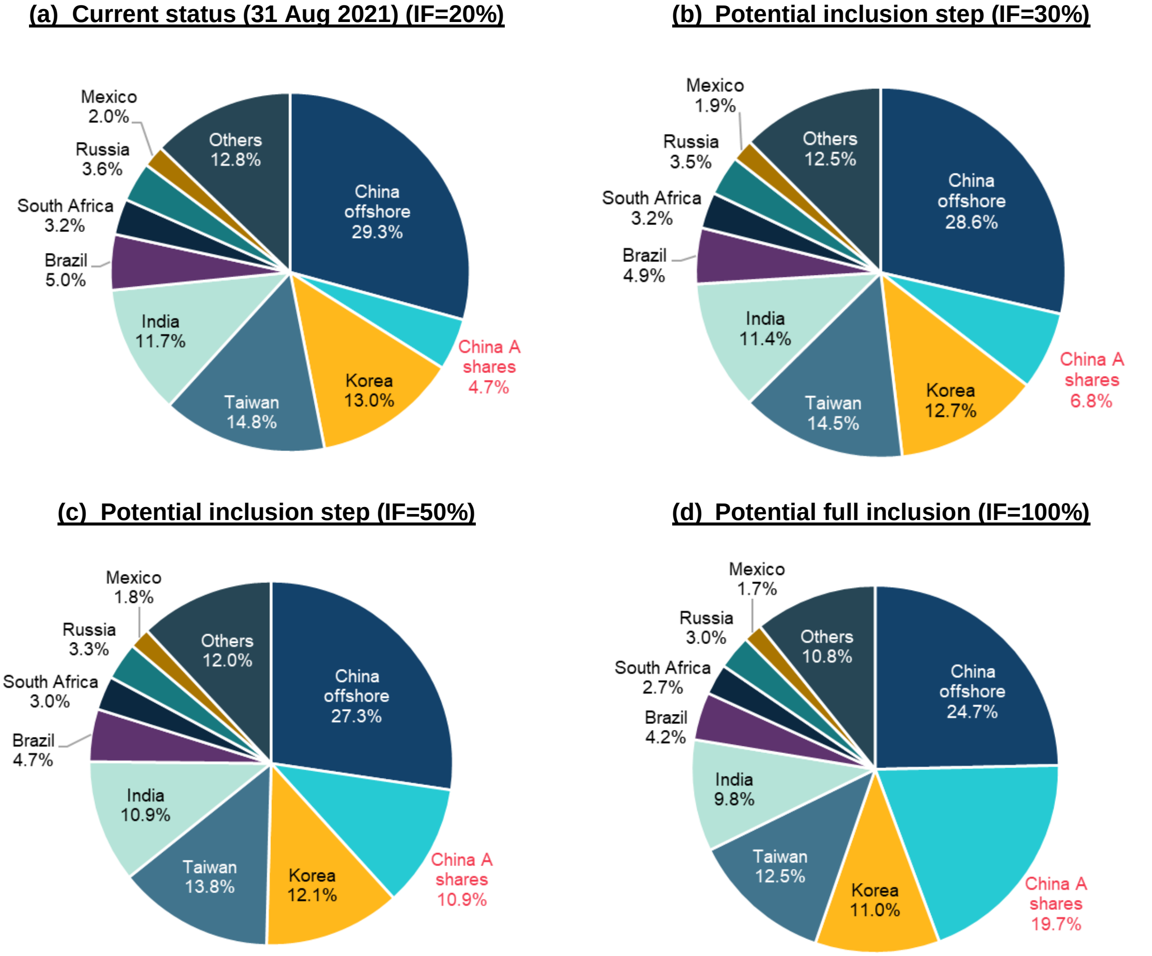
The increasing importance of China in global investment portfolios is well evidenced by the country's market capitalisation weight in the MSCI indices. With 474 China A-shares and 256 offshore-listed Chinese stocks[25] included, Chinese stocks' weight in MSCI EM Index has increased from 18% in December 2009 to 34% in August 2021[26].

Assuming a phased approach for MSCI's inclusion of China A-shares, China A-shares and offshore-listed Chinese stocks combined could potentially account for more than 44% in the MSCI EM Index by country weight in terms of market capitalisation as of 31 August 2021 (see Figure 14). Foreign investment into China A-shares could be significant in the coming years if, as expected, passive index-tracking funds and actively managed funds use these indices as benchmarks for their investments.

[25] Including H shares, B shares, red chips, Mainland private enterprises listed in Hong Kong and other foreign listings (e.g. ADRs) of Chinese stocks. Source: MSCI.

[26] Source: MSCI.

Figure 14. A potential roadmap of China A-shares' inclusion into MSCI EM Index



Note: "China offshore" refers to H shares, B shares, red chips, Mainland private enterprises listed in Hong Kong and other foreign listings (e.g. ADRs) of Chinese stocks. Assuming 474 China A-shares included, at prices as of 31 August 2021.

Source: MSCI, data as of 31 August 2021.

Given the above global trend of improved accessibility to China A-shares and increasing representation of China A-shares in global benchmark indices, well-established offshore A-share derivatives trading and hedging mechanisms will become more and more important for addressing international investors' growing need for a broad range of risk management tools.

2. MSCI CHINA A 50 CONNECT INDEX: A BENCHMARK FOR A-SHARE INVESTMENT THROUGH STOCK CONNECT

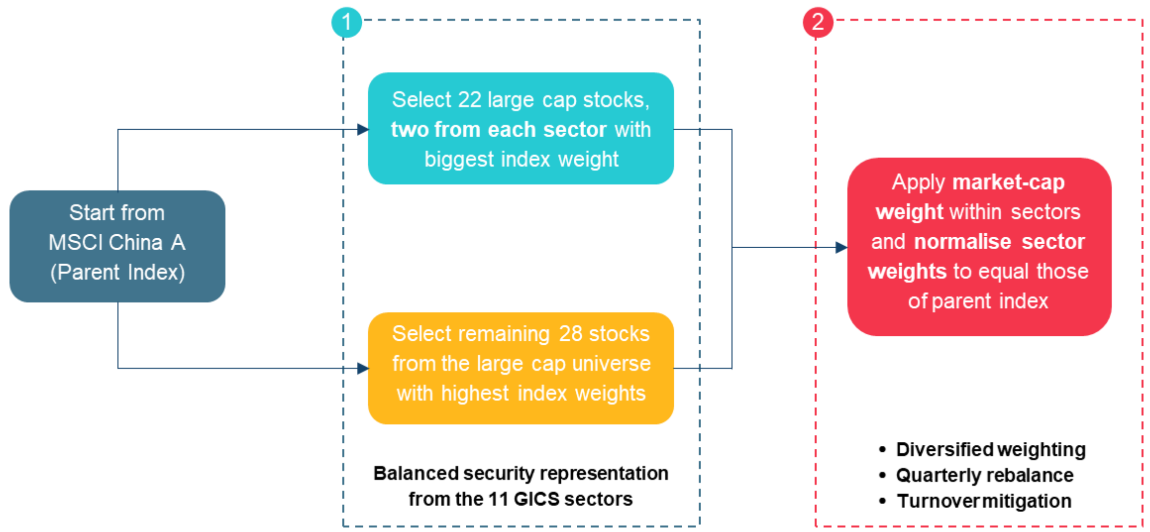
2.1 Sector-balanced exposure to China A-shares

There are different China-dedicated equity benchmarks carrying different flavours of sector coverage, index weighting and inclusion methodology. MSCI's methodology used to construct the MSCI China A 50 Connect Index, was designed to achieve balanced exposure to China A-share large-cap stocks.

The MSCI China A Index[27], being the parent index for the MSCI China A 50 Connect Index, captures large and mid-cap representation across China A-shares listed on the SSE and SZSE. The index only covers stocks accessible through Stock Connect. According to MSCI, the MSCI China A 50 Connect Index is then constructed by applying the following steps[28].

First, the two largest securities from each Global Industry Classification Standard (GICS®) sector are selected from the large cap segment of the MSCI China A Index by index weight. Second, the remaining securities are selected from the parent index by index weight until the total security count reaches 50. Finally, the selected securities are weighted based on the free-float market cap weights of the parent index and reflecting the sector weight allocation of the parent index (see Figure 15).

Figure 15. MSCI China A 50 Connect Index methodology



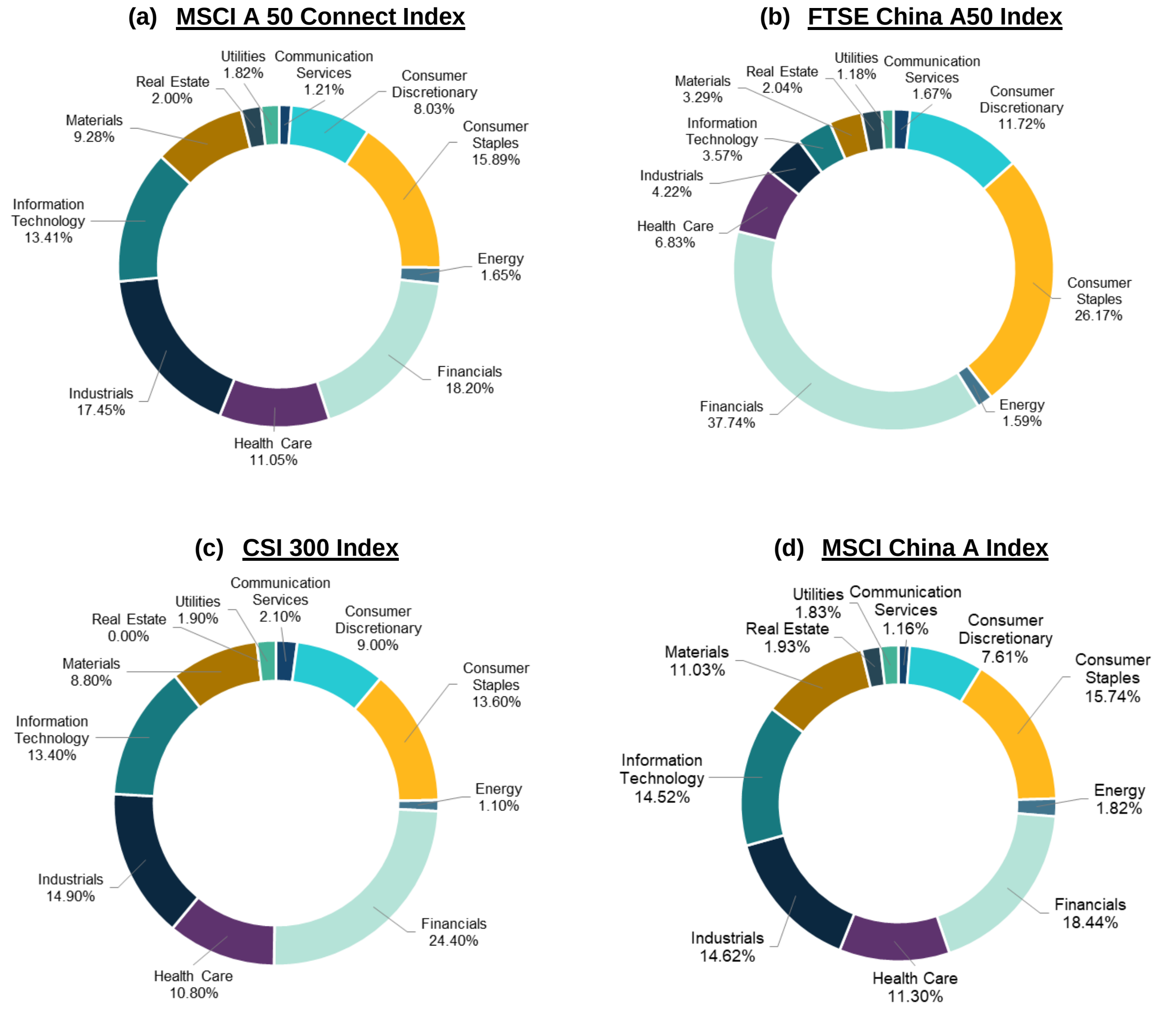
Source: MSCI.

Such index methodology for MSCI China A 50 Connect Index enables it to serve as a proxy for market opportunities to reflect broad diversification across the Chinese economy. As observed from Figure 16, MSCI A 50 Connect Index is considered to have a balanced sector composition that reflects the sector composition in the Chinese economy. Therefore, the index would be able to provide a more balanced sector exposure to China A-shares, avoiding overweighting of specific sectors such as financials and consumer staples.

[27] See Factsheet on MSCI China A Index, available on MSCI's website.

[28] Source: MSCI China A 50 Connect Index Methodology, MSCI.

Figure 16. Sector weight comparison for selected onshore and offshore A-share indices (30 Jul 2021)



Source: MSCI, CSI, FTSE Russell.

2.2 Highly correlated to MSCI China A Index for managing market risk

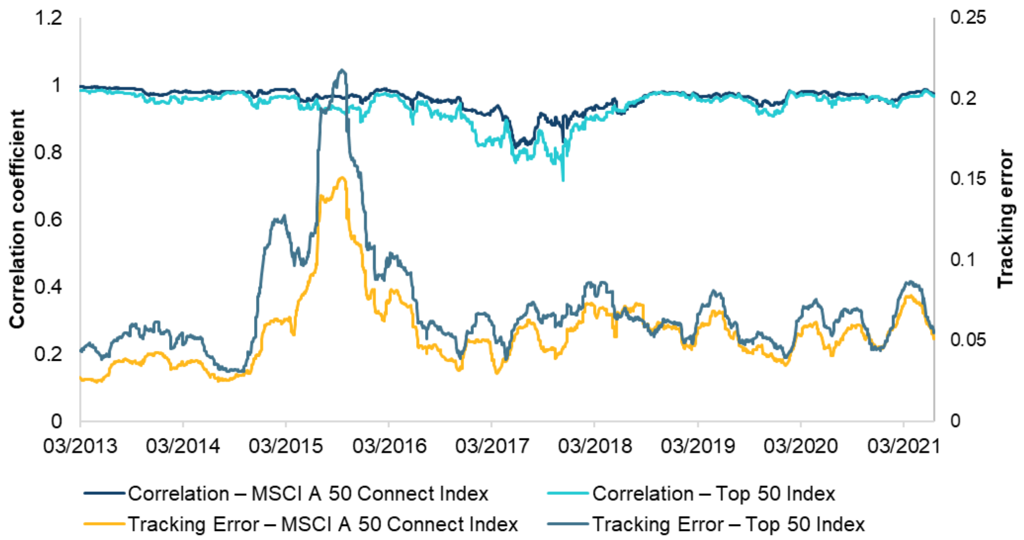
Subject to investors' different investment targets, risk management framework and other operational practices in implementing their China A-share investment strategies, the ability to isolate market system risk (beta risk) could be critical when investors implement different allocation approaches to China A-shares. By comparing market-tracking characteristics such as correlation and tracking error for indices constructed using different methodologies, investors can assess the efficiency and effectiveness of different risk management tools for managing market risks.

To examine the market tracking characteristics of the MSCI China A 50 Connect Index, related analyses were performed on the index against its parent index, MSCI China A Index. On a three-month rolling basis, the MSCI China A 50 Connect Index had consistently shown higher correlation with, and lower tracking error, to the MSCI China A Index, compared with index constructed by simply selecting the 50 largest stocks from the benchmark index (referred to as the Top 50 Index in the analysis) (see Figure 17)[29]. Upon backtesting with historical data, the

[29] Source: Zhen Wei and Shuo Xu, "A sector-balanced approach to China A mega-cap exposure", published on MSCI's website, 27 August 2021.

MSCI China A 50 Connect Index also shows high correlation with the CSI 300 Index, one of the main onshore equity benchmarks (see Table 2).

Figure 17. Three-month rolling correlation with, and tracking error versus the MSCI China A Index (Mar 2013 – Jun 2021)



Source: MSCI analysis.

Table 2. Index correlation of selected onshore and offshore A share indices (Jan 2021 – Jul 2021)

	MSCI A 50 Connect Index	MSCI China A Index	CSI 300 Index	FTSE China A50 Index
MSCI China A50 Connect Index	1.00	0.97	0.97	0.96
MSCI China A Index		1.00	0.99	0.94
CSI 300 Index			1.00	0.95
FTSE China A50 Index				1.00

Source: Bloomberg, MSCI.

With an underlying index that is highly correlated to key China A-share indices, MSCI China A 50 Connect (USD) Index Futures can be an effective risk management tool for managing market risk for different investors with different investment strategies towards China A-shares.

3. HKEX MSCI CHINA A 50 CONNECT (USD) INDEX FUTURES: PRODUCT DESIGN AND APPLICATIONS

By definition, equity index futures are derivative instruments that give investors exposure to price movements on an underlying equity index. Investors therefore can take positions against the movements of a basket of equities without trading individual stocks. Futures trading plays an important role as it helps investors navigate market risk and uncertainties. Futures exchange offers a centralised marketplace where market participants can trade the futures with improved capital efficiency and increased equity exposure through margining mechanism.

In general, equity index futures can be used for a number of purposes such as expressing directional views, hedging, portfolio diversification, and spread trading. In other cases, some investors use equity index futures as a leading indicator of market sentiment.

Bearing the key technical and practical (operational) advantages of futures trading, the HKEX MSCI China A 50 Connect (USD) Index Futures are expected to address offshore investors' needs for managing their A-share exposure in the following ways:

- **Navigate risk and uncertainties:** Take advantage of the sector-balanced proximity to China's A-share market and capture China-related opportunities in real-time.

- **Trade and hedge China exposure in one marketplace:** The MSCI China A 50 Connect (USD) Index Futures complement HKEX's China-related products and services, including Stock Connect, structured products, ETFs and derivatives, enabling investors to manage their China exposure in one venue.

- **Truly global:** The MSCI China A 50 Connect (USD) Index Futures are quanto futures which are denominated and cash settled in US dollars. Trading hours of the futures cover the Asian, European and the US time zones.

- **Market transparency and price discovery efficiency:** The on-exchange standardised futures contract provides orderly, transparent and efficient markets, where collective expression of market participants' opinions on the market can be offered with screen pricing supported by market makers / liquidity providers with daily marking to the market.

- **Capital efficiency:** The contract is traded on a margin basis, with the margin being only a fraction of the contract value, making futures trading capital efficient.

- **Enhanced market exposure:** The availability of margin mechanism offers increased equity exposure comparing to long-only approaches.

- **Low transaction cost:** There will be trading fee waiver for all accounts from 18 October 2021 to 30 June 2022 (both dates inclusive).

- **Low counterparty risk:** The HKFE Clearing Corporation Limited, an HKEX subsidiary, acts as a central counterparty to every trade executed through HKEX. The counterparty risk is therefore minimal.

As an investment and hedging tool, equity index futures could potentially serve a broad investor base. Potential users who could benefit from the use of HKEX MSCI China A 50 Connect (USD) Index Futures would include:

- **High-net-worth investors and active fund managers:** The product could help these investors implement a core dedicated China A allocation via country long/short strategies as part of investors' asset allocation plans or refine the size exposure in an existing portfolio.

- **Arbitrageurs:** They could make use of the product to seek profits on potential pricing discrepancies and market dislocation opportunities concerning the A-share market.

- **Index fund managers:** Adopting passive index-tracking strategies, they could use the product to benefit from broad-based sector diversification in A-shares.

- **ETF managers and index futures-based ETF managers:** They could use the product as the underlying investment vehicle to replicate physical A-share index portfolio with lower capital cost and transaction cost, and securitise their cash balances to reduce cash drag on their portfolios.

- **Hedgers:** They could manage the systematic risk of the China A-share market by using the product to create a fully-hedged position when a portfolio is not fully positively or negatively correlated with the underlying index.

4. CONCLUSION AND OUTLOOK

Equity index futures play an important role in managing portfolio exposures and facilitating the price discovery of the underlying market. Efficient price discovery and risk management will develop with liquidity as investors begin to adopt new futures products. As trading volume tends to flow to markets where there are well-designed products meeting market needs, efficient use of capital, competitive transaction cost and versatile trading and settlement facilities, HKEX stands to meet all of these needs in one marketplace, creating the potential for a deep and vibrant ecosystem to be built step-by-step over the long run.

Over the years, the offshore market has lacked a broad-based risk management tool for A-share exposure, thus constraining global participation in onshore equity markets. The introduction of MSCI China A 50 Connect (USD) Index Futures offers a new risk management tool for diversified China portfolios, provides sector-balanced exposure to China's A-share market, and allows for trading and hedging China exposure in one marketplace by further complementing HKEX's China-related products and services. It is a key step forward in further advancing HKEX's plans to build an offshore Mainland China equity derivatives suite in Hong Kong.

The launch of this new contract, together with continued enhancements in Stock Connect and ongoing index inclusion progress of China A-shares, could potentially further attract international long-term funds to allocate to A-shares, deepen the reform and opening of the onshore equity index futures market, and promote the coordinated development of onshore and offshore A-share index futures markets.

With capital markets across Mainland and Hong Kong being linked via different schemes to access different markets and products, Hong Kong has been playing and will continue to play a unique role in connecting China and the world as the main gateway to the onshore markets.

Hong Kong, being a leading offshore RMB hub in the world, is poised to be the desirable place to facilitate the internationalisation of RMB assets including China A-shares. Furthermore, the strategic positioning of Hong Kong as stated in the 14th Five-Year Plan allows Hong Kong to play important roles through various cross-border capital market initiatives. Together with its robust fundraising, investment and risk management infrastructure accessible to market participants worldwide, the introduction of the MSCI China A 50 Connect (USD) Index Futures will further strengthen Hong Kong's function as an offshore RMB hub, as well as an international asset management and risk management centre. Looking forward, Hong Kong is well positioned to continue enriching the variety of investment product lines, broadening the investor base in Hong Kong, and developing itself as Asia's premier derivatives hub.

The past few decades have seen China's labour and goods reshaping the world against the macro backdrop of globalisation and global economic integration, particularly after China's entry into the World Trade Organisation and becoming "the world's factory". With the further development and opening-up of China's capital markets being placed at a critical position to support China's long-term economic and strategic goals, in the coming decades, we expect China's capital markets, together with the offshore capital markets in Hong Kong being linked to onshore capital markets, to reshape the global financial landscape in many different ways.

APPENDIX. HKEX MSCI CHINA A 50 CONNECT (USD) INDEX FUTURES CONTRACT SPECIFICATIONS

Feature	Details
Underlying Index	MSCI China A 50 Connect Index
HKATS Code	MCA
Trading Currency	USD
Underlying Index Currency	CNH
Contract Multiplier	USD 25
Minimum Fluctuation	0.20 index point
Contract Months	Spot month, next calendar month and the following 4 quarterly months
Pre-Market Opening Period (Hong Kong Time)	8:45 am – 9:00 am
Trading Hours (Hong Kong Time)	9:00 am – 4:30 pm (day trading session); 5:15 pm – 3:00 am (after-hours trading session)
Trading Hours on Last Trading Day	9:00 am – 3:00 pm
Last Trading Day (LTD)	The third Friday of the contract month. If it is not a Hong Kong business day or it falls on a Mainland China public holiday, the LTD shall be the preceding Hong Kong business day which is also a business day in Mainland China
Final Settlement Price	The average of quotations of the MSCI China A 50 Connect Index on LTD, taken at: (i) 15 second intervals during the last two hours of trading on the Shanghai Stock Exchange and Shenzhen Stock Exchange before the end of the continuous trading sessions, and (ii) the closing index value, rounded up to the nearest 2 decimal places if the figure in the third decimal place is 5 or above and rounded down to the nearest 2 decimal places if it is below 5
Exchange Fee	USD 1.0
Settlement Fee	USD 1.0
Commission Levy[30]	USD 0.07
Large Open Position	500 open contracts in any one contract month
Position Limit	28,000 net contracts long or short for all contract months combined
Eligibility for US Persons	Commodity Futures Trading Commission (CFTC) certified

30 The Commission Levy is collected in the trading currency equivalent to HKD 0.54 at the exchange rate determined by Hong Kong Futures Exchange from time to time. There will be Commission Levy exemption for the first six months of trading from launch date.

Hong Kong Exchanges and Clearing Limited

8/F, Two Exchange Square
8 Connaught Place
Central, Hong Kong

hkexgroup.com | hkex.com.hk

info@hkex.com.hk
T +852 2522 1122
F +852 2295 3106