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Assessing the role of Chinese finance in developing London's financial centre post Brexit: a guide for policymakers

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1.0 Executive summary

The competitiveness of London's financial centre is shaped by the UK's current adoption of EU regulations. The future development of London's financial services sector is unknown as Britain's relationship with Europe changes following the vote to leave the EU in the 2016 referendum. This uncertainty arises because even if Theresa May's Withdrawal Agreement is adopted, the UK will then have to choose whether to converge, seek equivalence with or diverge from EU regulations for financial services.

Research by Professor Sarah Hall (University of Nottingham) argues that the implications of these regulatory decisions will impact London's financial services sector's relationship with financial markets globally. Her research focuses on how London's role as the largest western financial centre for financial transactions denominated in China's currency, the renminbi, could be adversely affected following changes in the regulatory alignment between the UK and the EU following Brexit.

Key findings

The research found that

- London's regulatory environment and historic enthusiasm for facilitating innovation in financial markets was central to it becoming the financial centres of choice for Chinese policymakers seeking to internationalise the Chinese currency (Renminbi) from the mid 2000s onwards
- There is considerable competition between European financial centres, notably Frankfurt, Paris and Luxembourg as well as London to attract Chinese financial markets. This reflects the appetite of these cities to develop their financial markets which is also clear in ongoing changes in the UK's relationship with Europe
- London's long term success as a leading western centre for Chinese currency internationalisation will rely on the ability of policymakers to achieve a favourable regulatory environment whilst also maintain the reputation of London as a global financial centre
- There are opportunities for London to develop news types of Chinese financial markets. This includes those related to green finance and the Belt and Road initiative. Ensuring that these opportunities are included in decisions about the future regulatory relationship between the UK and the EU for financial services will be an

important factor in determining the extent to which London can continue its leading role within Chinese financial markets.

Policy implications

This research leads to the following guidelines for policymakers working to support the development of London as an international financial centre after Brexit

- Decisions made concerning the future regulatory alignment between the UK and the EU for financial services need to examine their implications for global financial markets, beyond Europe, that make an important contribution to the competitiveness of London as a financial centre
- Regulatory liberalisation relative to the EU may make London a more attractive location for Chinese financial transactions.
- London has locational advantages vis-à-vis European financial centres for attracting Chinese finance that need to be protected following Brexit that focus on the close and longstanding relationship between British policymakers and their Chinese counterparts.
- However, any reputational damage to London as the result of deregulation is likely to negatively impact on the attractiveness of London for Chinese financial markets

2.0 The growth of Chinese finance in London's financial district

Prior to 2004, RMB denominated trading was not allowed outside China and the RMB had virtually no international influence. Subsequently, the Chinese monetary and financial authorities have pursued a carefully managed policy of internationalisation such that the RMB is now the fifth most-used currency globally for international payments and was selected to join the International Monetary Fund's basked of global reserve currencies in November 2015 (IMF 2015).

In order to understand how London has risen to become the leading western offshore RMB centre and the possibilities for future growth in this area following Brexit, it is important to situate London within the wider geographies of RMB internationalisation. It is not easy to give a precise start date for RMB internationalisation as it has unfolded incrementally through a series of policy changes initiated by the political and financial authorities in Beijing (Chen and Cheung 2011; Walter and Howie 2012). However, the early 2000s marked an important period of financial policy liberalisation (SWIFT 2011), building on the broader internationalisation of the Chinese economy (see Yeung and Liu 2008). For example, in 2006, the study group within the People's Bank of China published a report entitled 'The timing, path and strategies of RMB internationalization' that gave significant impetus to currency internationalisation (PBOC study group 2006). This report argued that currency internationalisation could enhance the competitiveness of the Chinese economy. Moreover, the financial crisis of 2008 provided additional motivation for the Chinese government to support RMB internationalisation as it sought to reduce China's reliance on the US dollar in trade relationships (Walter and Howie 2012; Zhang 2009).

Building on these early developments, RMB internationalisation can be broken down into three phases, following the initial period of policy liberalisation in the early 2000s (see figure 1). Each of these phases involved the development of distinctive geographies of RMB internationalisation associated with processes of territorialisation. These financial geographies have been shaped significantly by regulatory and broader state intervention by financial authorities in Beijing in order to address particular limitations associated with the wider RMB internationalisation project.

Figure 1 Monetary form, geographical reach and policy basis of RMB internationalisation

Policy liberalisation

- 2002 Qualified Foreign Insitutional Investors (QFII) can buy and sell RMB shares in China
- 2004 Personal RMB business banking permtted in Honk Kong and Macau

Regionalisation

RMB trade money

- 2007 debt capital market for RMB denominated bonds (dim sum bonds) launched in Hong Kong
- 2008 Currency swap agreement between China and South Korea
- 2009 RMB cross border trade settlement with Hong Kong, Macau and ASEAN countries

Internationalisation

RMB investment money

- 2010 RMB trade settlement with any corporate globally
- 2010 Investment in China interbank bonds
- 2011 Renminbi Qualified Foreign Institutional Investor Scheme (RQFII) can invest in mainland China

Network of offshore RMB centres

Diversification of RMB monetary forms

- Development of dim sum bond market beyond Hong Kong (London, 2012)
- 2013 London given initial RMB quota of 80bn RMB
- 2014 China Construction Bank named as RMB clearing bank in London

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Source: adapted from Swift 2011 using author’s research

As figure one shows, following initial policy liberalisation, internationalisation focused on the RMB as a form of regional trade money through a gradual expansion in the ways in which the RMB could be used to settle trade (ASIFMA 2014). The Chinese monetary authorities used a number of initiatives to facilitate this. Most notably, in July 2009 a pilot RMB cross border trade settlement program was launched. This program allowed importers in Shanghai and four selected cities in Guangdong (Guangzhou, Shenzhen, Zhuhai and Dongguan) to settle cross-border trades with Hong Kong, Macau and ASEAN countries in RMB. Up until this point, trade was typically settled in US dollars or Euros, leading to significant transaction and hedging costs for Chinese firms when dealing in foreign currencies. The scheme was expanded in July 2010 to allow settlement in RMB for firms operating in a much broader range of locations in China (including Beijing and twelve provinces) with any country globally, thereby marking a significant geographical expansion of RMB internationalisation beyond south east Asia. Following this, the proportion of China's trade settled in RMB has grown from 7% in 2011 to 14% in 2013 (ASIFMA 2014).

Whilst trade money was the primary focus of the initial stages RMB internationalisation, by the late 2000s, the early stages of the next phase of RMB internationalisation were being developed. This focused on internationalisation based around the RMB as a form of investment money - an initiative that was aimed at overcoming some of the problems that were emerging following the growing use of RMB in global trade. In particular, concerns were emerging that companies trading with China were converting their RMB back into their domestic currency and hence not reinvesting in mainland China (HSBC 2013). In response, a number of policy changes were made. Of particular importance is the RMB Qualified Foreign Institutional Investor Program (RQFII) that was announced in 2011. This program allowed licensed investors to use RMB held offshore to invest in China, through the Shanghai and Shenzhen stock exchanges, in financial products including shares, bonds, securities and stock index futures. Initially, all investments into the Chinese mainland through this scheme had to be made through funds based in Hong Kong. However, from 2013 onwards the geography of this was expanded, initially permitting investment through Singapore based funds. In 2014, further internationalisation occurred when London was given an RQFII quota of RMB80bn.

It is at this stage that the distinctive spatial footprint of RMB internationalisation begins to emerge as the Chinese financial authorities have sought to facilitate RMB internationalisation whilst managing a gradual process of capital account liberalisation and maintaining control of exchange rates (He and McCauley 2010). These twin policy objectives have resulted in a distinctive geography of regulatory reform based around a separation between onshore RMB markets (using the currency designation CNY) and offshore markets (understood as those outside of mainland China) including Hong Kong (with the currency designation CNH). Interest and exchange rate controls remain in onshore RMB markets whilst these have been liberalised in offshore RMB markets (ASIFMA 2014). This distinction echoes Palan's (2006, xix) argument that offshore financial space is constructed through processes of re-regulation as it 'becomes an embedded dimension of contemporary statehood'. In the case of RMB internationalisation, offshore financial space is organised through a small number of offshore financial centres. Echoing the use of Hong Kong as an experimental site for the reform and internationalisation of the Chinese economy more generally (Chen and Cheung 2011), Hong Kong became the first such centre in mid 2010 (Walter and Howie 2012). Since then, a small number of other financial centres including Singapore, Taiwan and London have developed significant RMB financial markets (Standard Chartered 2014). These offshore RMB centres can be defined as a financial centre “outside [mainland] China that conducts a wide variety of financial services denominated in RMB” (ASIFMA 2014, 20) that connects with onshore financial services in mainland China (Subacchi and Huang 2012) (see table 1)

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Table 1 Attributes of leading offshore RMB centres Source: Adapted from ASIFMA 2014 using author's research

Financial services activity	**Hong Kong**	**Singapore**	**Taiwan**	**London**
RMB deposits (RMB bn)	827	172	123	15
Clearing Bank	BOC HK	ICBC SG	BOC TW	China Construction Bank
RQFII quota (RMB bn), (date of initial allocation)	270 (2011)	50 (2013)	100 (proposed)	80 (2014)
RMB services	Retail and commercial banking Foreign Exchange Primary and secondary RMB securities market RMB trade facilitation	Retail and commercial banking Foreign Exchange Broad financial market products RMB trade facilitation	Retail and commercial banking Limited financial market products RMB trade facilitation	Foreign exchange Limited financial market product Limited retail and commercial banking
Key advantages	Gateway to mainland Chinese markets Strong existing financial centre infrastructure	ASEAN financial hub Strong existing financial centre infrastructure Hub for regional treasury and commodity traders Strong asset management market with wide investor pool	Strong trade links Large deposit base with need to cross border remittances	European time zone World's leading foreign exchang centre Strong existing financial infrastructure
Focus markets	Greater China regional treasury centre	South Asia Regional Trade Centre Commodities centre Private banking	Domestic/Cross-strait RMB usage	Global treasury centre, global foreign exchange trading, asset management

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Pilot schemes and new product development
Dim sum bond market

As table 1 shows, in addition to holding an RQFII quota, these centres host a designated RMB clearing bank, hold sizable (although varying) RMB deposits and have seen the development of a range of RMB markets. These centres are supported by a number of offshore financial RMB hubs (such as Paris and Frankfurt) that access mainland China through the offshore RMB centres (Subacchi and Huang 2012). Hong Kong remains the largest offshore RMB Centre and has been the most widely studied to date (see Fung and Yau 2012).

However, the case of the development of London as an offshore RMB centre raises important questions about how and why it became the first western such centre and the implications of this for the possible future trajectories of RMB internationalisation and understandings of IFCs more generally.

3.0 Explaining the importance of London within RMB internationalisation

Table 2 specifies three sets of institutions that account for why London was identified by the Chinese monetary authorities as the location for the first western offshore RMB centre and how this was supported by both the state and private sector in London. First, London specific conventions, understood as the socio-cultural norms that structure and shape what counts as desirable and legitimate financial activity in the City were instrumental for both Chinese monetary authorities and policy makers and the private sector financial services community in the UK. In particular, the relationship between the temporal and geographical specificity of these conventions as they operated in the late 2000s in the wake of the 2007-8 financial crisis and the trajectory of RMB internationalisation needs to be understood.

Beginning with the creation of new financial markets and products that are clearly necessary if RMB finance is to be developed in London, following the 2007-8 crisis there was a concern within both practitioner and policy making circles concerning the potential for the crisis to threaten London's position as a, if not, the leading IFC (Hall, 2009). As Table 2 shows, these concerns meant that London's financial sector community, with the support of the UK Government, was particularly open to experimentation and the associated development of new forms of financial markets 'in an effort to maintain it's position as the leading international financial centre globally' (Financial journalist, China specialist, London, February 2015). This is also reflected in comments from senior managers in leading investment banks made at the time

> 'HSBC is fully committed and uniquely positioned to support the internationalisation of the RMB for the benefit of China and the global economy. This initiative reinforces London as a leading global financial centre' (Spencer Lake - Co-Head of Global Markets, HSBC, cited City of London/Bourse Consult 2014).

Table 2: Factors accounting for the identification of London as the first western offshore RMB centre

Institutional form	Specific attribute	Indicative example from research interviews
City specific conventions	Propensity for financial market innovation	"There was definitely a period in the 2010s when the City [of London] needed to think about new markets to try to cement its position as the leading financial centre – there was interest in carbon markets for example but RMB finance was also definitely identified as an option which had strong Government support" (Capital markets lawyer, London, March 2015)
	International outlook	"London is an *international* centre in ways that places like New York and even Singapore aren't really. You can see this in its pre-eminence in foreign exchange trading, but in less clear measures like its outlook, the international origin of the financial institutions here and the backgrounds of the people working here. That makes it an obvious destination for RMB markets" (Vice president, Chinese commercial bank, London, June 2015)
	Relational proximity between China and the UK	"London has particular advantages that make it the obvious choice for an RMB hub in Europe. It is obviously the leading financial centre in the region, but its location makes working with Beijing easier, it has close links with Hong Kong and Beijing that can be drawn upon to build successful RMB markets and it has the specific experience of developing offshore [euro-dollar] markets" (Banking Associate, Chinese commercial banks, Beijing December 2014)
External economies of scale available to financial institutions in London	Market Liquidity and associated labour market expertise	"The depth of the market in London and the associated expertise in developing new markets, from financiers and lawyers makes London an obvious choice (to develop RMB markets) compared to other centres" (Bank vice president, Chinese Commercial bank, London, February 2015)

Regulatory environment	Comparatively deregulated, flexible financial milieu	“The development of the euro dollar market in London [in the 1960s] demonstrates that the City is prepared to use favourable regulation to stimulate new markets and that is certainly attractive to the Chinese monetary authorities” (Financial journalist, China desk, London, March 2015)

Source: Author’s fieldwork

This is related to the second set of conventions that were important in London's development as an offshore RMB centre, which can be summarised as its 'genuine and deep international disposition' as a junior Chinese banker put it to me in April 2015. This reflects the fact that London, in contrast to New York, has always relied on *international* financial services for its development, given the relatively small size of its potential domestic market (Kynaston 2012). In particular, as Table 2 shows, the British Government was vital in facilitating this because under Prime Minister David Cameron, it was prepared to overlook concerns over China's human rights record in order to facilitate economic, and particularly financial, links with China in order to secure economic development through the continued dominance of London as an IFC (*The Guardian* 2015). Indeed, the Chancellor of the Exchequer at the time, George Osborne, has been described as a Sinophile who was particularly keen to develop bilateral economic agreements with China (*Financial Times 2015b*).

The third set of conventions that are important in the identification of London as the chosen location for the first western offshore RMB centre lies in its close relational proximity with both Hong Kong (the first offshore RMB centre) and monetary authorities in Beijing, as shown in table 2. These connections are important because 'they afforded a degree of comfort for financial regulators in Beijing that they understood how London worked and would respond to their requests and at least an understanding of how Chinese finance might operate within London's finance community through the close colonial based relations with Hong Kong', as a capital markets lawyer working on RMB bonds put it in March 2015. This builds on the wider importance of this relational proximity for Chinese financial geographies more generally. For example, Lai (2011) has argued that London served as a preferred 'learning partner' for the restructuring of the Chinese banking system because of the close personal and social networks between senior policymakers in Beijing and their UK counterparts.

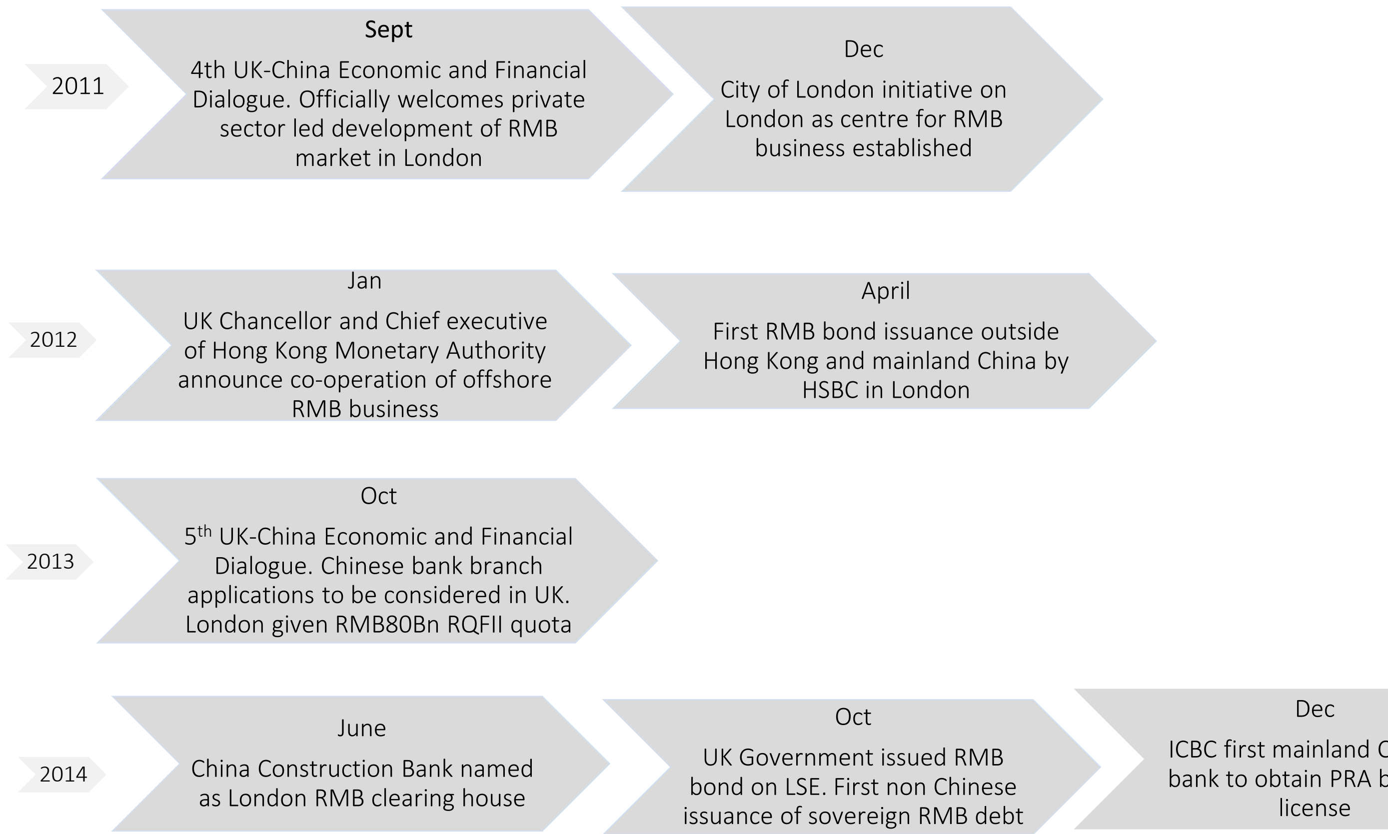
However, whilst these conventions within London and the role of state and policymaker support for them from both Beijing and the UK clearly played an important role in the legitimation of London as the first western offshore RMB centre, as Table 2 shows, it is important to note that more standard institutional attributes identified in the literature on the success of London as an IFC and the external economies of scale that is offers were also important. In this respect, London's time zone, facilitating 24 hour trading with overseas counterparts, its historic reliance on foreign exchange markets and its deep and dense pool of highly skilled labour have all been identified in the policy literature surrounding RMB internationalisation, echoing the considerable literature in geography that has developed to explain London's continued importance as an international financial centre (Clifford Chance 2012; Thrift 1994; see also table 1.) For example the importance of time zones in determining the location and relative success of offshore RMB centres is reflected in the announcement made by the Bank of China in Hong Kong in August 2014 that from 1 October 2014 it would extend the hours it offered RMB clearing services in Hong Kong in order to cover the time zones of Europe and America as well as Asia (Bank of China 2014).

Finally, the third dimension of London's institutional landscape that was important in facilitating its initial development as an offshore RMB centre was its approach to regulation, and particularly the use of regulatory changes to facilitate the development of offshore markets historically through the development Eurodollar markets in the 1960s and 70s (Subacchi and Huang 2012). Crucial to the development of Euro bond markets in London was the combination of regulatory change and the ways in which financial institutions sought to work within this changing environment whilst also shaping it in ways most advantageous to their own ends (in other words, remaking the territorial qualities of London's financial district at the time (Burn 1999; Schenk 1999). There are clear differences between the Euro-dollar markets and offshore RMB centres, not least the far more interventionist role played by the Chinese state in the latter compared with the US government in the former, such that financial authorities in London are *responding* to regulations made at a distance, rather than shaping the process themselves as was the case in Eurodollar markets (Subacchi 2014). However, the existence of euro-dollar markets in London was taken as evidence of London's ability and willingness to make regulatory changes to develop offshore markets, reflecting its wider expertise in foreign exchange markets as shown in Table 2.

Taken together, these institutional dimensions of London's financial district explain *why* it was selected as the first offshore RMB centre.

In order to understand *how* London has developed its RMB business it is necessary to focus on the political appetite to develop London as an offshore RMB centre in the mid 2000s. The most important mechanism here are the annual UK-China Economic and Financial Dialogues which have taken place primarily at the level of deputy prime minister annual since 2007. The significance of these dialogues is two fold. At one level, they serve as a platform to announce key regulatory changes, predominately from Beijing but also from the UK's monetary authorities, that have facilitated the development of RMB markets in London. However, at another level, they also serve an important discursive role in the careful performance of close economic and financial relations between the UK and China that are used by both sides to demonstrate their commitment to the place of London within RMB internationalisation. The fifth and sixth dialogues are particularly important because these meetings signalled a marked acceleration in the pace and scale of London's development as an offshore RMB centre (see figure 2).

Figure 2 Timeline of London's development as an offshore RMB centre



Source: adapted from Ying (2013: 12-13) using author's research

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The fifth UK-China Economic and financial dialogue was held in Beijing in October 2013 between the Chinese Vice Premier Ma Kai and the UK's Chancellor of the Exchequer George Osborne. At this meeting, a joint commitment was made to facilitate liquidity of RMB in London building on the currency swap arrangement in 2013 between the Bank of England and the People's Bank of China.[1] It was also announced that UK institutions would be given licenses within the RQFII (Renminbi Qualified Foreign Institutional Investor) scheme before the end of 2013 with an initial UK quota of RMB 80billion issued to London in October 2013. This is significant within the wider project of RMB internationalisation and the place of London within it because the scheme allows foreign investors to invest offshore RMB raised in designated financial centres into Chinese securities for the first time and London was the first such centre outside greater China to be issued with a quota.

The UK's monetary authorities sought to respond to this demonstration of Beijing's commitment to London through their own regulatory changes. Most notably, it was agreed that the Bank of England would agree to consider applications from Chinese Banks to open branches rather than subsidiaries in the UK. Up until this point, the development of Chinese banks in London was characterised by a cautious approach, following the 2007-8 financial crisis, with only subsidiaries permitted to open with their associated higher capital and liquidity requirements. However, this met with significant concern from the Chinese banking industry, echoing research that has demonstrated how firms from emerging markets such as China seek out internationalisation opportunities in part to overcome regulatory constraints in their home market (Luo and Tung 2007). For example, in a letter to HM Treasury in 2012 the Association of Foreign Banks argued that 'they [Chinese banks] are finding it increasingly difficult to operate in the UK under the current regulatory environment'. This changed in June 2014 when it was announced that Industrial and Commercial Bank of China would be given a full banking licence in London by the end of 2014. The Chinese bank ICBC welcomed this in their annual report arguing that

> 'The most welcome [outcome of the Fifth Dialogue] was the announcement in October by the Chancellor of the Exchequer that the Prudential Regulation Authority will allow our Chinese banks to establish branches in London as soon as the regulatory details have been agreed. This is something for which we have campaigned for some time. In ICBC (London) plc, as a locally constituted subsidiary, we are constrained in our lending by the amount of our local capital.' (ICBC London 2013, 5).

Building on these developments, at the sixth dialogue held in London in September 2014, it was recognised that 'the London RMB market […] is at the forefront of RMB business among

[1] See the combined policy outcomes of the 5th China-UK Economic and Finance dialogue available from https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/250003/UK_Chinese_EFD_outcomes_paper.pdf.

European countries'.[2] This position was reflected in a number of important announcements concerning regulatory changes aimed at enhancing London's role in RMB internationalisation. Most notably in June 2014 China Construction Bank was named as the renminbi clearing bank in London. As in previous meetings, the importance of this announcement from Beijing was reflected in regulatory changes made in London in order to take advantage of Beijing's continued commitment to London. For example, it was agreed that the Financial Conduct Authority's Approved Persons Regime for asset management and other regulated activity (a *de facto* register of financiers who are eligible to offer financial advice in the UK) did not include a nationality restriction and hence, Chinese finance professionals would be welcome in the City. Meanwhile, in terms of bonds, it was announced that China Construction Bank intended to issue an RMB bond in London and the UK government announced its intention to issue a RMB denominated bond in London. As a result of these changes, London has rapidly risen to being widely recognised as the leading western offshore RMB centre. For example, by the end of 2013, 62% of all RMB trading conducted outside China and Hong Kong took place in London and the City handles nearly 30% of all RMB foreign exchange trading (FSTIB 2014).

The commitment of the UK Government under David Cameron and George Osborne to support London's development as an offshore RMB centre is further demonstrated by the UK government becoming the first western country to issue debt in RMB when it raised 3bn RMB in 2014 in what was the largest ever RMB bond (Moore and Noble 2014). Whilst the issuance itself is comparatively small, it is symbolically important for RMB internationalisation generally but also for demonstrating the UK Government's commitment to developing London as an offshore RMB centre. It is also was indicative of the diversification of investor origins within RMB bond markets with 57% of investors being Asian and 43% European (Li 2014).

4.0 Future prospects for Chinese finance in London as UK-EU relations change

The analysis above demonstrates that over a relatively short period of time from the mid 2000s onwards, London has developed a market leading position as the leading western offshore RMB centre. Figures show that 37% of renminbi foreign exchange transactions beyond mainland China now take place in the UK. Moreover, average daily trading volumes increased 50% between quarter four of 2017 and quarter four of 2018 to £76.6. billion (City of London/People's Bank of China representative office for Europe 2019). Indeed, as figure 3 shows, there is now a cluster of Chinese financial related institutions operating within the City of London.

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[2] See the combined policy outcomes of the 6th China-UK Economic and Finance dialogue available from https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/354137/UK-China_policy_outcomes.pdf,

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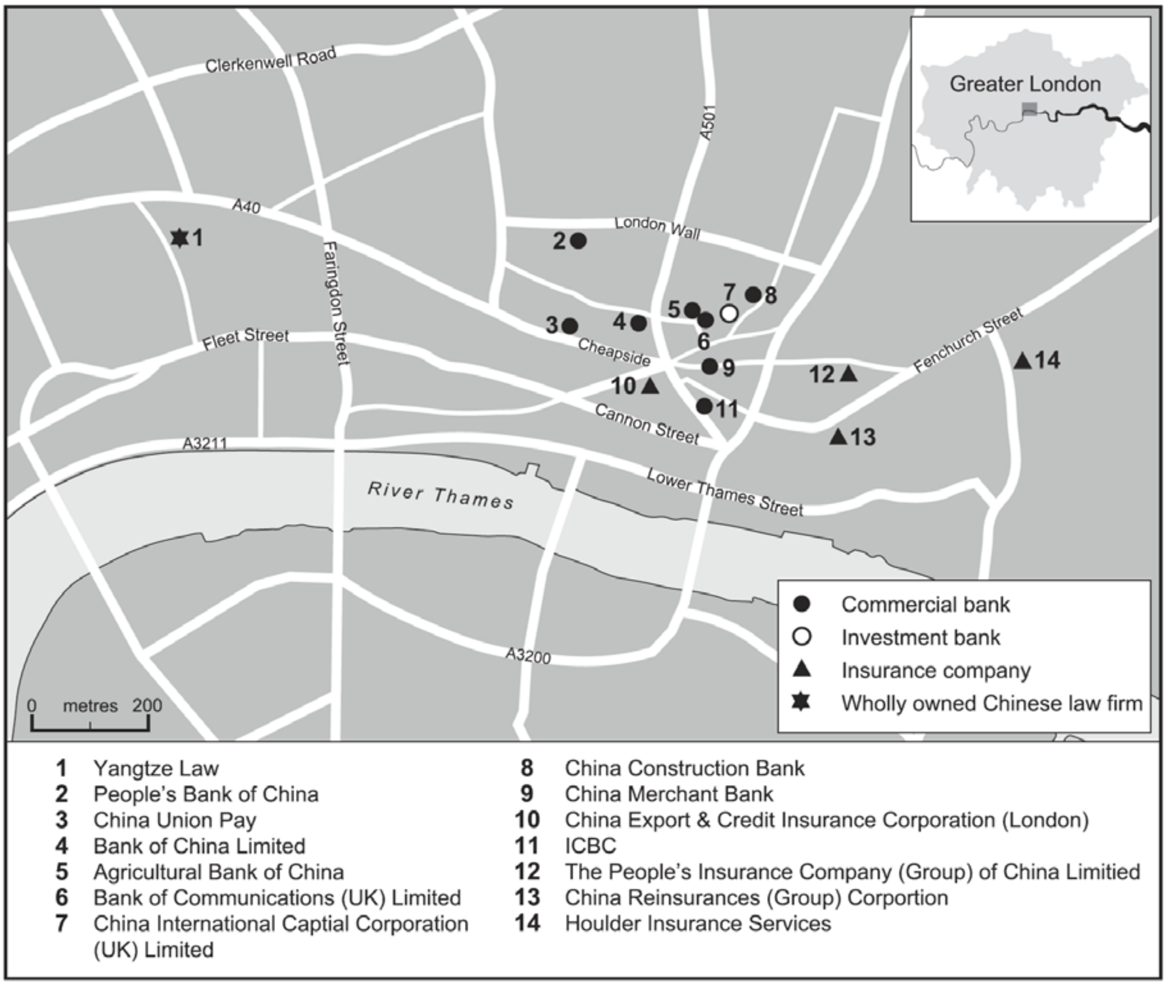

Location of leading Chinese financial institutions operation in London (Source: Hall 2018)

The development of this cluster has relied on the strong commitment of policymakers and regulators in both Beijing and London in order to make regulatory changes to facilitate the entry of Chinese financial institutions. These regulatory changes have operated alongside the strong international reputation London has for the development of new financial markets, particularly those relating to foreign exchange trading.

However, significant concerns exist surrounding the on going development of London's RMB activities. The most high profile of these has been how the Brexit vote in the UK's referendum on EU membership in June 2015 may affect China's commitment to London as its western offshore centre of choice (South China Morning Post, 2016). Meanwhile, there are indications that the new Prime Minister installed after this vote, Theresa May, is less concerned with fostering relations with China in the name of economic development than her predecessor (BBC 2016). Moreover, prior to the 2015 referendum there was evidence that

London's development as an offshore RMB centre was not without its problems. For example, within Europe it was facing competition from a number of centres, particularly Luxembourg (Strauss 2014); the much heralded Chinese bank branches had not been fully integrated into London's financial district (Hall 2015) and the RQFII quota remained significantly under utilised (SWIFT 2014). These developments clearly remind us that the process of RMB internationalisation, and the development of offshore RMB centres within this, is not straightforward or necessarily linear in nature. However, they also signal the continued role of inter-state relations in shaping this process in ways that echo the wider arguments made in this paper. It will, therefore, be important for policymakers to work to raise the profile of Chiense financial markets within London if these are to remain an area of comparative strength as the function and regulatory setting of London's financial district changes as the UK prepares to leave the EU.

Further reading

This research was funded through a British Academy Fellowship held at the University of Nottingham. Further information about the research can be found here

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