China Economic Monitor

Q3 2018

kpmg.com/cn

Contents

Note: Unless otherwise stated, data used in this report is from Chinese government agencies such as the National Bureau of Statistics (NBS), the People's Bank of China (PBOC), the Ministry of Commerce (MOFCOM) and the General Administration of Customs (GACC).

Executive Summary

In the first half of 2018, China's economic growth remained solid, with GDP up 6.8% YOY, the same as in Q1. However, due to financial de-leveraging and the escalation of the US-China trade tension, China's economic growth is expected to slow in the second half of the year.

On the domestic front, the de-leveraging of financial risks has shown great results. Growth of macro leverage ratio has slowed significantly, and the leverage of the corporate sector has declined. Meanwhile, off-balance sheet financing has also dropped sharply. However, tightened financial supervision has also had an impact on economic growth. One result is the constant slowdown of fixed asset investment, especially the sharp decline in infrastructure investment growth. The continued strengthening of financial supervision and regulation of local government debt have impacted the funding source of infrastructure investment. In the short term, it is expected to bring downward pressure on economic growth, but in the long run, it is a necessary step to curb local government debt and prevent systemic financial risks.

In order to alleviate the liquidity pressure and mitigate the impact of US-China trade frictions, the People's Bank of China (PBoC) has implemented two rounds of targeted cuts on required reserve ratios (RRR) since April, in a move to ensure "reasonably ample liquidity". At the end of June and early July, the Monetary Policy Committee of the PBoC and the Financial Stability and Development Committee of the State Council also proposed to "control the pace and intensity of structural de-leveraging" and "control the pace and intensity of supervision work". It suggests the government will be more cautious on the pace of the financial regulation and try to strike a delicate balance between de-leveraging and maintaining necessary economic growth.

On the external front, US-China trade frictions continue to escalate. On June 15, U.S. President Trump announced a 25% tariff on $50 billion worth of Chinese imports. Among which, tariffs on $34 billion of imports has been levied since 6 July and tariffs on the remaining $16 billion have been effective since 23 August. After China's reciprocal measures, on July 10, Trump ordered the Office of the US Trade Representative to study a 10% tariff on an additional $200 billion of Chinese imports. U.S.-China trade conflict is risking a further escalation.

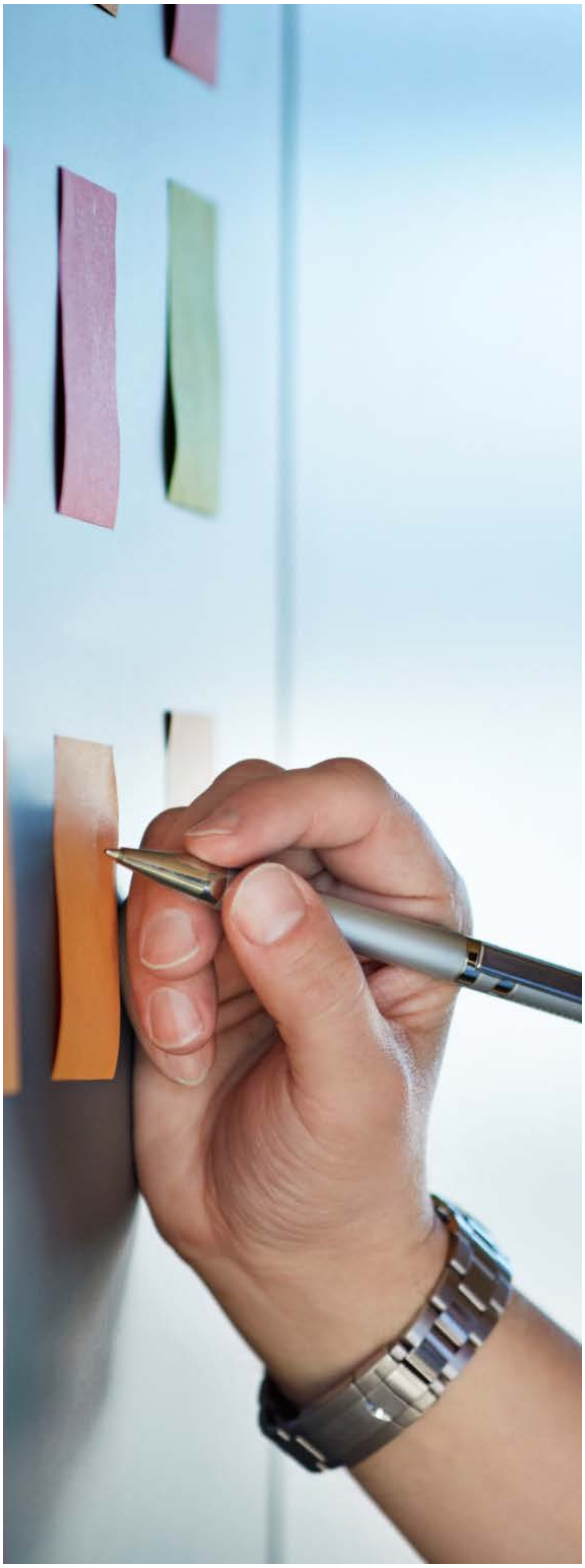
Although the US-China trade tension will negatively affect China's export industry and investment in related sectors, we believe its overall impact on the Chinese economy is still manageable. The dependence of China's economy on external demand has been significantly reduced. In 2017, domestic demand contributed more than 90% of China's economic growth. In the first half of 2018, domestic demand's contribution to overall growth was close to 110% (net exports pulled down 10% of economic growth), highlighting the leading role of domestic demand in driving economic growth.

More importantly, the push of supply-side structural reform has increased the resilience of the Chinese economy. In the first half of 2018, China's high-tech and equipment manufacturing industry continued to show fast growth, and industrial capacity utilization rate increased steadily. With the upgrading of the industrial structure, the service industry and high-end manufacturing will give new impetus to overall economic development. In the meantime, the recovery of private investment and relatively stable consumption will also provide support to the economy.

On July 23, China's State Council executive meeting announced that fiscal and monetary policy will be further fine-tuned to boost the real economy, to stimulate social vitality and to promote stable and effective investment growth. Heightened US-China trade frictions have increased the uncertainty of the external environment and set a certain downward pressure on the development of Chinese economy. The State Council executive meeting stated that it would adjust the macroeconomic policies in response to changes to make sure the economy fluctuates within a reasonable range. The meeting had a positive effect on coordinating the current fiscal and financial policies and promoting the joint support of the PBoC and Finance Ministry in the development of the real economy. It should be noted that together with the introduction of policy fine-tuning, this meeting also emphasized the need to "maintain macroeconomic policy stability" without using extreme stimulus measures. However, the meeting still largely focused on stimulating growth through increasing investment, while consumption has not been given its deserved attention.

In sum, although China's economic growth faces challenges in the second half of 2018, we are still optimistic with the economy's overall stability. We expect the government to reach the growth target of around 6.5%.

Special topic: The EU General Data Protection Regulation (GDPR)



With the rapid development of the Internet and the Internet of Things, traces of individual's activities remain as data on the Internet. It makes people's life more convenient and efficient, but it also imposes significant security risks of data leakage. Gemalto's research shows that technology, government, retail, and finance are the sectors that are more vulnerable to data breaches.

The GDPR officially came into force on 25 May, 2018. The GDPR aims to regulate and strengthen the data privacy of European citizens by emphasizing the transparency, security and accountability of data controllers. The new regulation, which is often called the most stringent regulation governing data privacy, has a broad impact and represents a new era in data protection.

- A wide range of applications: As long as the company provides goods or services to individuals within the EU, or collects and processes personal data, it should comply with GDPR, regardless of whether the company has branches in the EU.

- Enhanced data subjects rights: GDPR further defines the scope of personal data and provides many rights to the data subject (individual).

- Stricter obligations for data controllers and data processors: GDPR imposes more specific obligations on data controllers[1] and data processors in processing personal data, requiring an internal accountability mechanism.

- Significant penalties for non-compliance: non-compliance will result in a penalty of up to 20 million euros or 4% of annual global turnover, whichever is higher.

KPMG believes that the effective development of GDPR compliance can help companies gain customers' trust, raise brand image, advance internal data management, strengthen information security, and improve the businesses' competitive advantage. In an era where personal information has become a key asset and business driver, only a well developed personal data protection strategy can enable companies to remain competitive. In recent years, China has also improved its legislation on information security. Even if a Chinese company does not currently conduct businesses in the EU, it can also benchmark with GDPR and establish a comprehensive personal information protection system, in order to adapt to future development trends and comply with international standards requirements.

[1]GDPR defines controller as the person that determines the purposes and means of processing personal data.

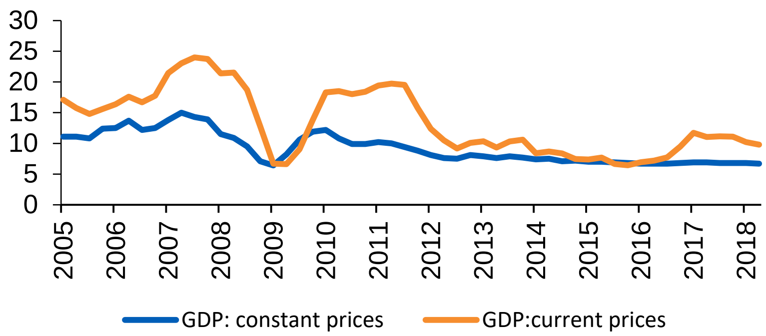
1

Economic Outlook

Overall economic growth remained stable while momentum of industrial output weakened

China's GDP increased by 6.7% YOY in the second quarter of 2018, and by 6.8% in the first half of the year. This performance was 0.1 percentage point less than the annual growth rate for 2017. The second quarter's nominal growth rate was 9.8%, down by 0.4 percentage point and 1.3 percentage point respectively comparing to the first quarter of 2018 and to the whole year of 2017. The nominal GDP growth rate is usually correlated with corporate profits. A slowdown indicates corporate profits have either increased or dropped.

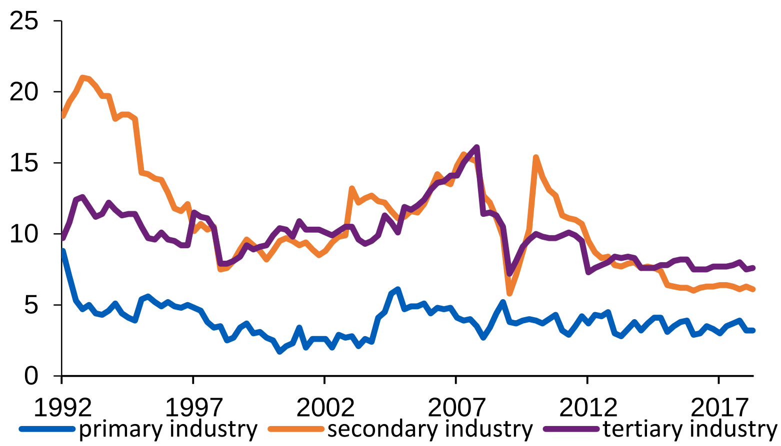
Fig. 1 GDP growth rate: quarterly YOY (%)



Source: Wind, KPMG analysis

From an industry perspective, the growth of the tertiary service industry retained its leading position, with an increase of 7.8% and 7.6% respectively in the second quarter and first half of 2018: both were higher than the GDP growth during the same period. In the first half of 2018, the service industry contributed 60.5% to GDP growth, which was 1.8% higher YOY. The growth of the secondary (manufacturing) sector has slowed down to 6.1% in the first half of 2018, a slight drop of 0.2 percentage points from the first quarter.

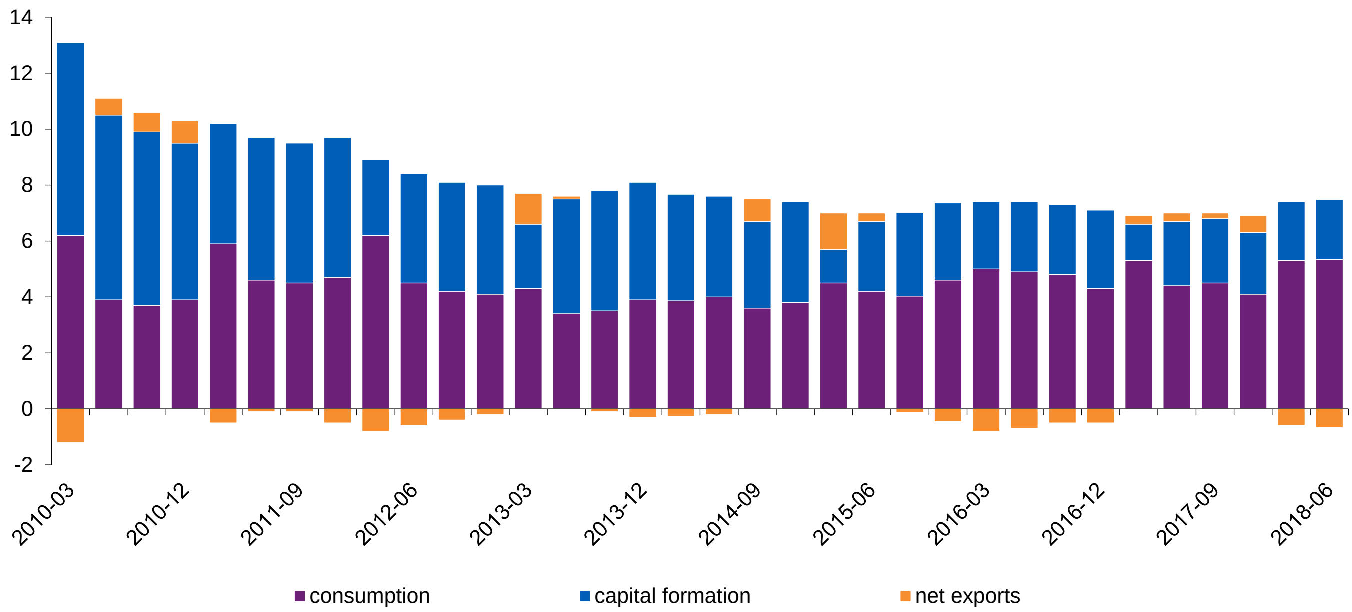
Fig.2 Growth rate of three industries: accumulated YOY (%)



Source: Wind, KPMG analysis

On the demand side, economic growth was mainly underpinned by domestic demand, with consumption being the major driver. In the first half of 2018, domestic consumption pushed GDP growth up by 5.3%, contributing to 78.5% of economic growth; external demand's contribution to GDP growth continued to be negative, pulling the GDP growth down[2] and representing a drag on GDP growth this quarter.

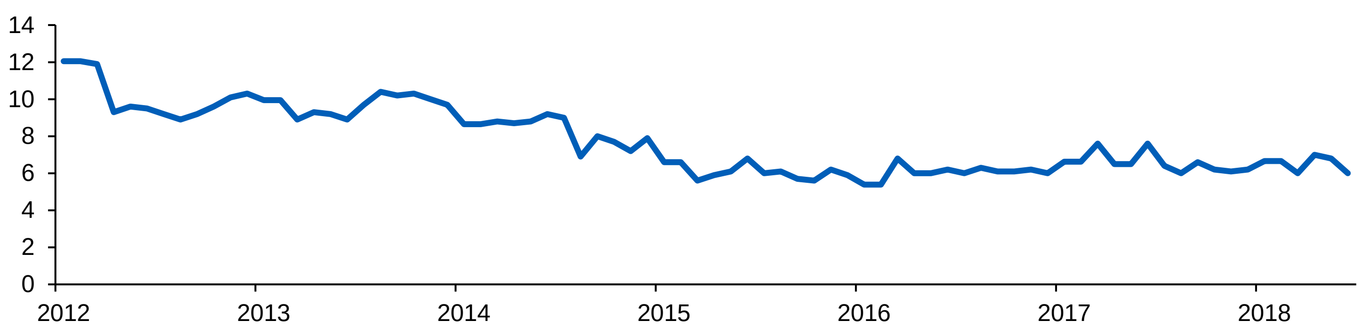
Fig.3 Sectors driving GDP growth: accumulated (%)



Source: Wind, KPMG analysis

In the first half of 2018, the growth momentum of industrial output slowed. Industrial added value above designated size[3] increased by 6.7% YOY, a slight drop by 0.1 percentage point from Q1. In June, the national purchasing manager index (PMI) fell slightly by 0.4 percentage point to 51.5, indicating that manufacturing activity has become less robust, although it is still in expansion. We expect industrial production growth will continue to fall into a moderate range in the second half of 2018.

Fig. 4 Above-scale industrial value added: MoM (%)

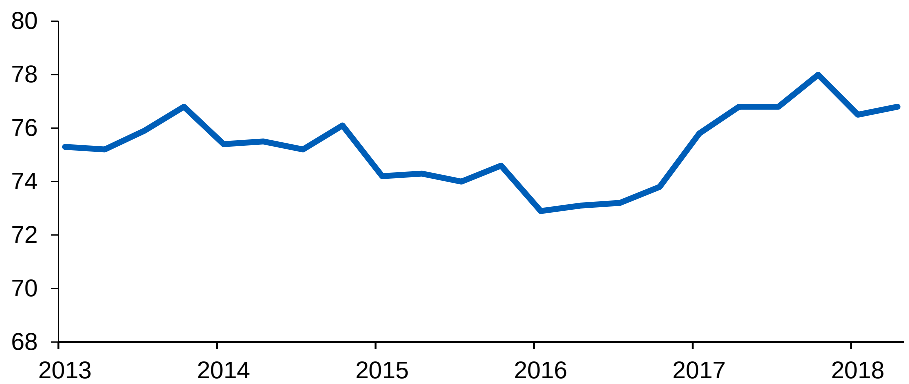


Source: Wind, KPMG analysis

[2]The drag on GDP growth has widened from -0.6 percentage points in Q1 to -0.7 percentage points in the first half year.
[3] Above designated size refers to all the enterprises with the annual sales revenue of over RMB 20 million.

Although the overall growth of industrial output has slowed down, the conversion of old and new 'kinetic energy' (which means the transition from the traditional economy to the new economy) continues to accelerate. The added value of high-tech industries and equipment manufacturing industry increased by 11.6% and 9.2% respectively, which was faster than the above-scale industries by 4.9 and 2.5 percentage point respectively in the first half of 2018. Meanwhile, the industrial capacity utilization rate continued to increase, signaling the positive results of supply-side structural reforms. In the first half of 2018, national capacity utilization for the industrial sector rose to 76.7%, which was 0.2 and 0.3 percentage point higher than that of the first quarter and a year earlier.

Fig.5 Industrial capacity utilization change (%)

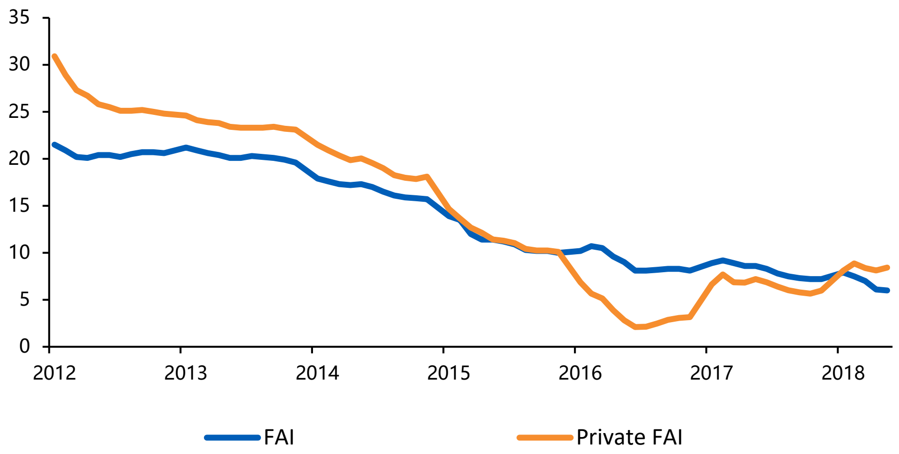


Source: Wind, KPMG analysis

Manufacturing investment growth improved but infrastructure investment still under pressure

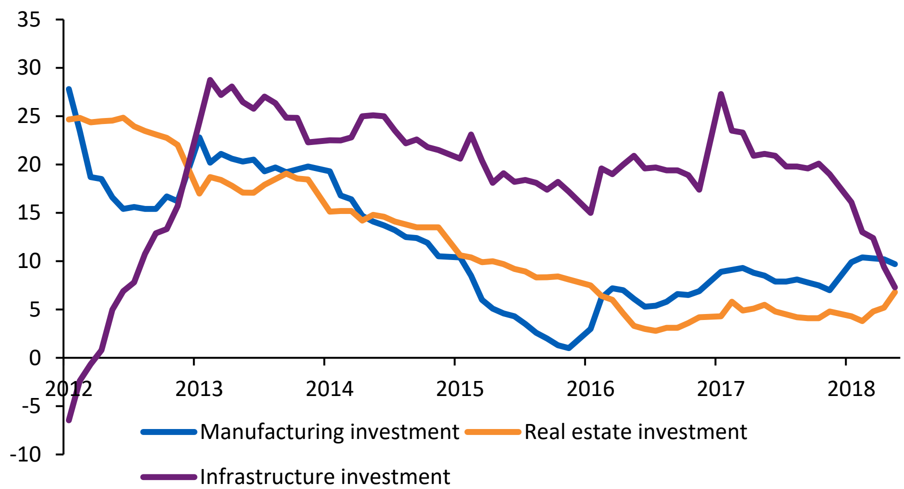
The growth rate of fixed asset investment (FAI) continued to fall, with a YOY increase of 6.0% in the first half of 2018. The cumulative growth rate was the lowest since 2000. However, recovery has been seen in private investment. It increased by 8.4% YOY in the first half of 2018, putting a stop to the stagnation of the past two years.

Fig.6 Fixed asset investment: accumulated (%)



Source: Wind, KPMG analysis

Fig.7 Fixed assets investment by sector: accumulated (%)



Source: Wind, KPMG analysis

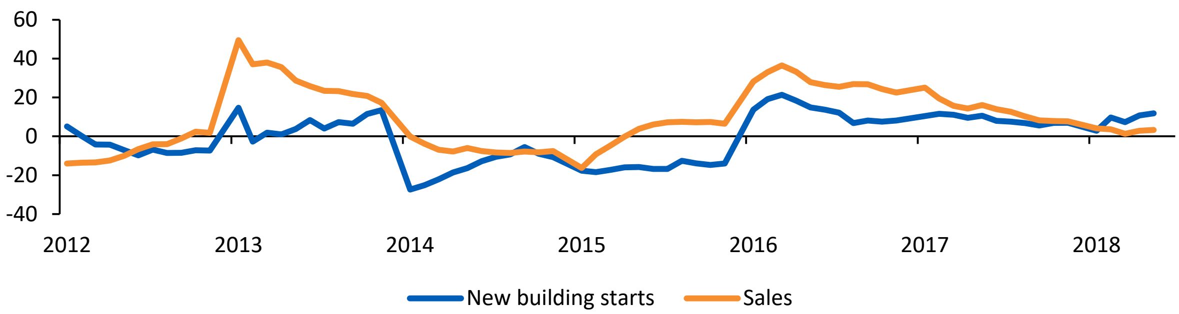
Despite the overall weak economic growth, manufacturing investment data was more positive. Its cumulative growth rate was 6.8% in the first half of 2018, its fastest rate of growth since February 2016. The growth momentum is expected to continue as private investment recovers.

However, the growth of infrastructure investment (excluding electricity) continued to fall. It increased by 7.3% in the first half of 2018, suggesting a 5.7 percentage point decline from Q1 and marking a six-year low. The central government-led measures to de-leverage, manage local government debt and regulate local government financing vehicles have also placed downward pressure on infrastructure investment. On March 28, the Ministry of Finance issued the 'Notice on the Issues concerning Regulating the Investment and Financing Behaviors of Financial Enterprises for Local Governments and State-owned Enterprises' (Ministry of Finance 2018 No. 23[4]). No. 23 targets the supervision of funding sources, while the two previously released official documents, No. 50[5] and No. 87[6] focus on regulating local governments and financing platforms.

On April 2, President Xi Jinping proposed the concept of "structural de-leveraging" at the first meeting of the Central Finance and Economic Affairs Committee. Xi was quoted as calling for forward structural de-leveraging, developing targeted measures to deal with risks in different markets, and urging local governments and enterprises, especially state-owned enterprises (SOEs) to reduce their leverage as soon as possible in order to achieve a stable and gradual decline in the macro leverage ratio. The speech signalled the upcoming focus on local governments and SOEs' debt problems. We expect to see an ongoing decline in the growth of infrastructure investment as the de-leveraging campaign progresses.

Real estate investment continues its fast-growing momentum. The growth in the first half of 2018 reached 9.7%, a 0.7 percentage point slight drop from Q1. The new round of rebound in investment growth owes to the land price surge since the second half of 2017, which was pushed up by a pick up in real estate developers' land acquisition. On the other hand, real estate sales remained sluggish: the floor space of commercial buildings sold in the first half of 2018 saw a YOY growth of 3.3%, a significant decline compared to 16.1% growth a year earlier. We expect that the expansion of real estate investment in the second half of 2018 will cool down.

Fig.8 New housing construction and sales (size): accumulated (%)



Source: Wind, KPMG analysis

[4] See: http://jrs.mof.gov.cn/zhengwuxinxi/zhengcefabu/201803/t20180330_2857297.html
[5] On April 26, 2017, the six ministries and commissions jointly issued the "Notice on Further Regulating the Local Government's Debt Financing Behaviour" (Ministry of Finance [2017] No. 50), requiring local governments to clean up the illegal guarantees, strengthen the management of the financing platform, and regulate PPP and government-funded funds to establish and improve local government debt financing mechanisms. See：http://yss.mof.gov.cn/zhuantilanmu/dfzgl/zcfg/201705/t20170503_2592801.html
[6] On May 28, 2017, the Ministry of Finance issued the "Notice on Resolutely Stopping Locally Infringement of Financing in the Name of Government Purchase Service" (Ministry of Finance [2017] No. 87). The new rules focus on regulating the procedures of government purchases. See：http://yss.mof.gov.cn/zhengwuxinxi/zhengceguizhang/201706/t20170602_2614514.html

Premier Li Keqiang chaired the State Council executive meeting on July 23, which provides guidance for the development of macroeconomic policy in the second half of 2018. The key takeaways in the meeting were:

Fiscal and financial policies should work together to boost support for the real economy

- "Proactive fiscal policy to be more active": the government will focus on introducing steeper tax cuts, expanding the R&D tax deduction, accelerating tax rebates, and stepping up the pace of issuing special local government bonds.
- "Prudent monetary policy to be neither too tight nor too loose": maintain sufficient social financing and liquidity, ensure ample capital flow into the real economy, and support the financing of small and micro businesses.

Stimulate market demand and promote steady investment growth

- A number of projects in fields such as transportation, gasoline and natural gas, and telecommunication, will be promoted to attract private investors.
- The demand for capital for projects that are under construction should be fully met, and local governments should support and encourage financial institutions in ensuring reasonable financing for ongoing projects.
- Match development goal with market demand, and promote the construction and storage of a number of flagship projects.

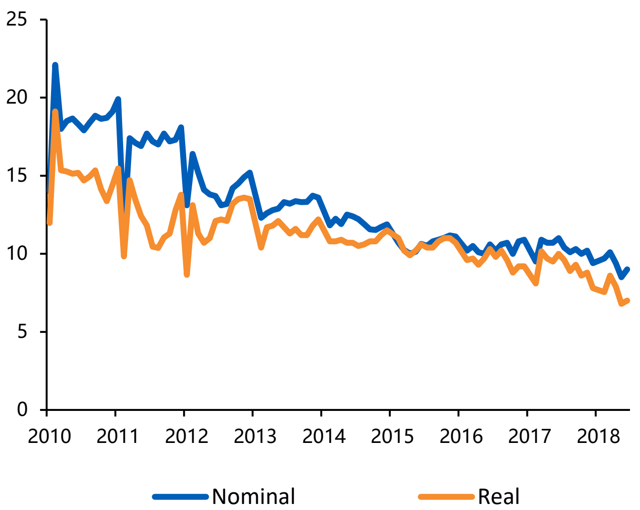
Heightened US-China trade frictions increased the uncertainty of the external environment and created downward pressure on the Chinese economy. The State Council executive meeting stated that it would 'pre-tune and fine-tune' the macroeconomic policies in response to changes to ensure the economy fluctuates within a reasonable range. The meeting is significant in terms of promoting the coordination of fiscal and financial policies as well as enhancing the cooperation between PBoC and the Finance Ministry. It worth mentioning that the meeting emphasized "maintaining stable macroeconomic policy" rather than adopting strong stimulus policies.

The meeting introduced tax cuts and investment as the key measures to stimulate domestic demand, but consumption-related measures were given relatively less attention.

Per capita consumption expenditure growth rebounded

In the first half of 2018, the total retail sales of consumer goods increased by 9.4% YOY, a 0.4 percentage point drop from Q1. The real retail sales of consumer goods, excluding the price factor, increased by 7.7% in the first half of 2018 YOY.

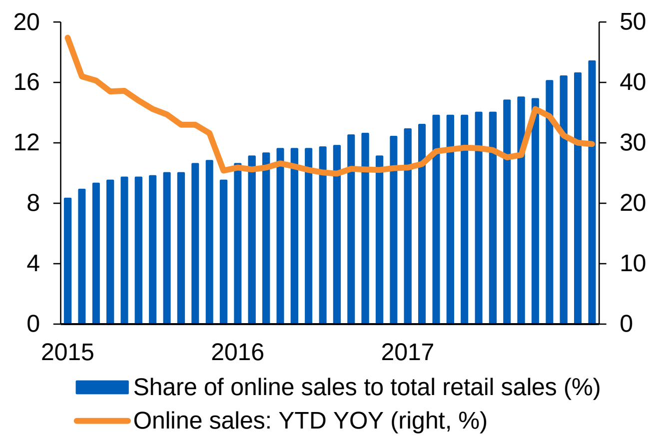
Fig.9 Total retail sales of consumer goods: monthly YOY (%)



Source: Wind, KPMG analysis

Online consumption continues to perform well. In the first half of 2018, the online retail sales of physical goods increased by 29.8% YOY. Although the growth dropped slightly from Q1's 34.4%, it was still significantly higher than the overall consumption growth. The share of online retail sales of physical goods in total retail sales of consumer goods reached a new high of 17.4%, suggesting an increase of 1.3 percentage point over Q1.

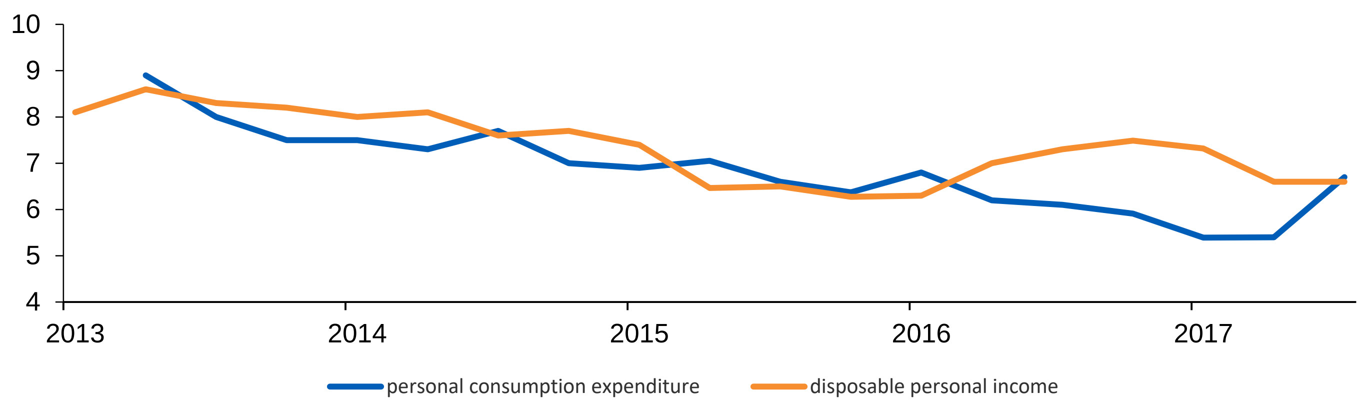
Fig.10 Online and offline consumption of physical goods



Source: Wind, KPMG analysis

In the first half of 2018, the growth of per capita real disposable income remained stable with an increase of 6.6% YOY, which was the same as in Q1. Steady personal income growth provides solid support for consumption growth. At the same time, per capita household consumption expenditure in the first half of 2018 increased by 6.7%, which was not only higher than Q1's 5.4%, but also marked the fastest growth since the end of 2016. The growth of per capita household consumption expenditure reflects the rapid growth of China's service sector, as it is included in the service sector indicator.

Fig.11 National residents' per capita disposable income and per capita consumption expenditure growth rate: accumulated (%)

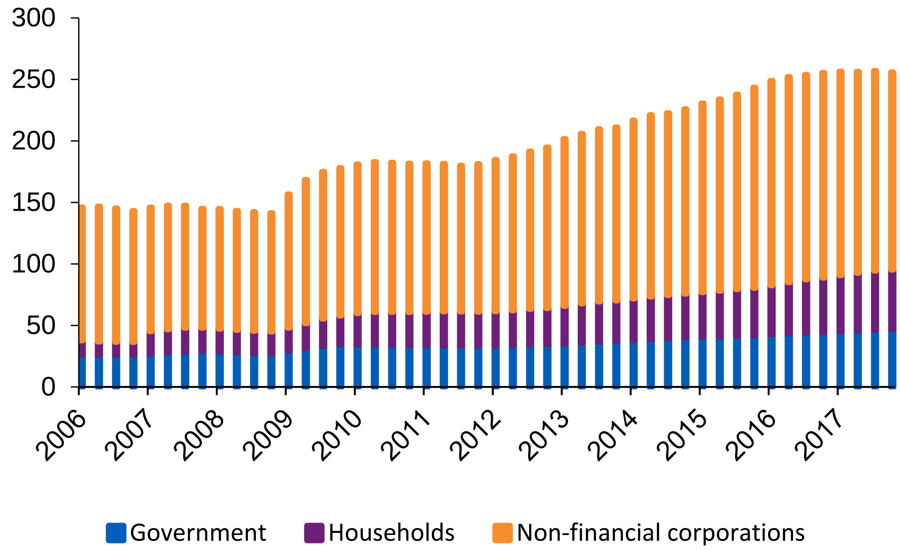


Source: Wind, KPMG analysis

Financial de-leveraging taking a toll on growth and off-balance sheet financing falling sharply

With effective implementation of supply-side structural reforms and a stable and neutral monetary policy, China's macro leverage growth has significantly slowed. According to the Bank for International Settlements (BIS), the leverage ratio of China's non-financial sector increased by only 0.4 percentage point to 255.7% in 2017. Of which, the non-financial corporate sector leverage ratio was 160.3%, down 6.1 percentage point from 2017.

Fig.12 Key economic sectors' leverage ratio (%)

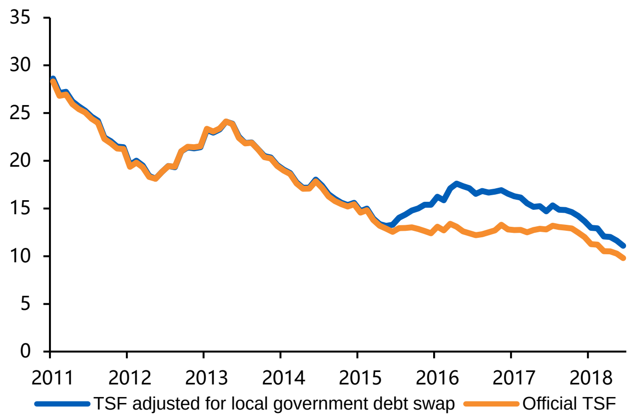


Source: BIS, KPMG analysis

The financial sector's de-leveraging has achieved remarkable results. The problem of capital idling in the financial system and the rapid growth of non-standard financing has been effectively contained. From January to May, depository institutions' claims on other financial institutions only grew by 2% YOY, which was significantly lower than the growth in previous two years (growth rate in 2016 and 2017 was 66% and 24% respectively).

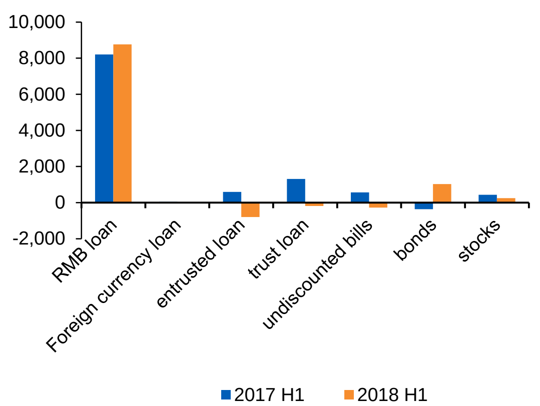
In Q2, total social financing (TSF) was RMB 3.52 trillion, a decrease of more than RMB 700 billion YOY. The growth of TSF stock has been declining for 11 consecutive months. The growth rate dropped to single digits at the end of June (9.8% YOY). The growth of broad TSF stock (adjusted by local debt) fell to a record low of 11.1%, a decrease of 3.6 percentage point YOY. Judging from the financing structure, the scale of off-balance sheet non-standard financing continued to shrink. In Q2, off-balance sheet financing represented by entrusted loans, trust loans and undiscounted bills decreased by RMB 1.13 trillion, serving as the main drag on the TSF growth.

Fig.13 Social financing: accumulated, YOY (%)



Source: Wind, KPMG analysis

Fig.14 New TSF composition (RMB billion)



Source: Wind, KPMG analysis

The sharp decline of TSF put downward pressure on the economy. In order to lessen the pressure of de-leveraging on domestic liquidity, to minimize the impact of recent trade frictions on aggregate demand and asset prices, and to better manage market expectations, China's monetary policy has undergone some minor adjustments while maintaining its overall stability and neutrality:

- January 25, the "Notice of the People's Bank of China on Targeted Required Reserve Ratio (RRR) Reduction for Inclusive Finance[7]" (released on September 30, 2017) was officially enforced. The RRR cut is expected to cover all large and medium-sized commercial banks, about 90% of city commercial banks and about 95% of rural agricultural banks, releasing between RMB 300 billion to RMB 380 billion in liquidity.

- April 17, the central bank announced a targeted 1 percentage point reduction (taking effect on April 25). About RMB900 billion ($143 billion) of outstanding medium-term lending facility loans will be repaid on the day of the cut and another RMB400 billion will be unleashed to support small businesses, increase funds stability in the banking system, and optimize the liquidity structure[8].

- June 1, the central bank announced the expansion of the guarantee scope of its medium-term lending facilities (MLF) in order to help with the financing needs of small businesses and green economy, and to promote the healthy development of the credit market[9].

- June 24, the central bank announced a new round of targeted RRR cut of 0.5 percentage point (effective on July 5). It is expected to unlock about RMB 700 billion of liquidity to further promote the market-based legalization of debt for equity swaps and support smaller companies[10].

- June 27, the central bank monetary policy committee's quarterly meeting changed the expression of liquidity from "reasonably stable" to "reasonably ample" and proposed to "control the intensity and pace of the structural de-leveraging" in order to "stabilize market expectations".

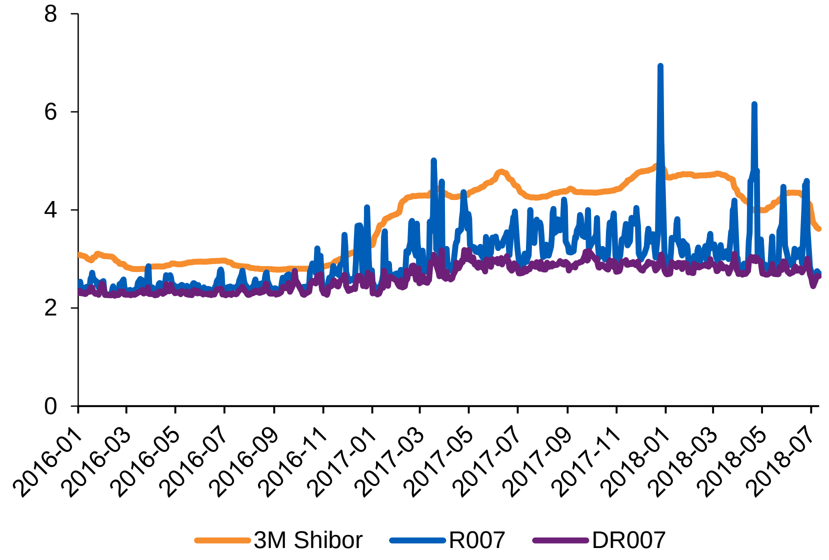
- July 2, state council financial stability development committee's meeting proposed to "control the pace and intensity of supervision work".

The current liquidity in the interbank market is relatively abundant. The 7-day pledge repo rate (DR007), the interbank 7-day pledge repurchase rate (R007) and the Shanghai interbank 3-month offered rate (3M Shibor) both fell significantly from the year high and remained relatively low since 2017.

---

[7] See: http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3393332/index.html
[8] See: http://www.pbc.gov.cn/zhengcehuobisi/125207/125213/125434/125798/3522107/index.html.
[9] Previously, MLF operations accepted treasury bonds, central bank bills, CDB and policy financial bonds, local government bonds, and AAA corporate credit bonds as collateral. The newly added collaterals mainly includes: First, small, green and "three rural" financial bonds not lower than AA; second, AA+, AA corporate credit bonds, including corporate bonds, medium-term notes, short-term financing vouchers, etc.; third is high-quality small and micro enterprise loans and green loans. See: http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3549913/index.html
[10] See: http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3564334/index.html

Fig.15 Interbank market interest rates (%)



Source: Wind, KPMG analysis

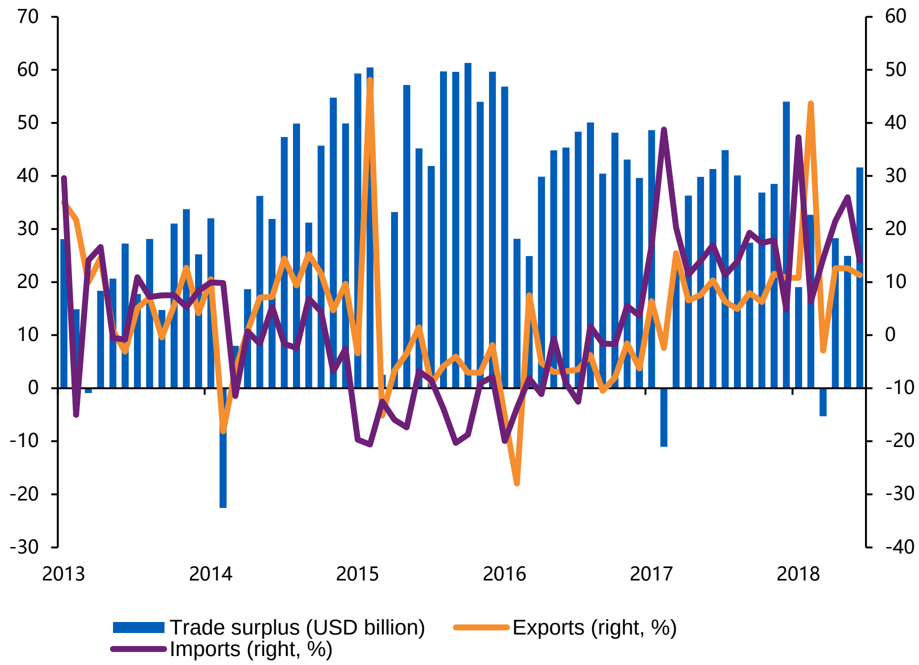
The monetary policy easing should help with improving corporate finance. However, the tightened financial regulatory has banned a large number of non-standard credit platforms. M2 and TSF data will not see significant change in this year as regulations on corporate financing remain tight.

During Q2, the consumer price index (CPI) continued to maintain a moderate increase. In June, it increased by 1.9% YOY, a slight decrease of 0.2 percentage points from last quarter. Pork price fell by 12.8% YOY and became the main drag on CPI. The producer price index (PPI) rebounded with the 4.7% YOY growth in June. The growth largely owes to the recent increase in raw material prices. As prices of industrial products such as coal and steel fall, the growth of PPI will also gradually slow down. In general, current inflation is relatively low with an insignificant upward pressure. It will not form a constraint on monetary policy.

Export performance and RMB expected to weaken

In Q2, exports and imports increased by 12.1% and 20.4% respectively, pushing trade surplus up to USD 94.82 billion. The total amount was significantly larger than that of Q1 (USD 46.46 billion), but decreased by 19.3% YOY. The growth of exports in Q2 exceeded expectation for two reasons: the sustained recovery of the world economy, and some exporters pushing shipping schedules forward to avoid proposed US tariffs. The negative impact of trade tensions on China's exports will be more visible going forward.

Fig.16 Import and export activities



Source: Wind, KPMG analysis

Since mid-April, the RMB has weakened against the US dollar. The exchange rate of the US dollar against the RMB (USD/CNY) increased from 6.2764 on April 17 to 6.6838 on July 16, a depreciation of 6.1% in three months. A strengthening US dollar is a key factor behind the RMB's depreciation. Driven by sound US economic growth and rounds of interest hikes announced by the Federal Reserve, the US dollar exchange rate index has risen by 5.2% since mid-April, putting downward pressure on the RMB exchange rate. On the other hand, the RMB has generally held its own against other significant currencies. As of July 6, 2018, the CFETS RMB exchange rate index was 95.07, lower than the mid-May high of 97.88, but still higher than 94.85 at the beginning of the year. The US economy's growing momentum will likely to cause US dollar to further appreciate: China's central bank will likely to intervene with policy tools to stabilize the market if RMB tumbles significantly. At the end of June, China's official foreign exchange reserves stood at USD 3.11 trillion, an increase of USD 1.506 billion from the previous month, ending two months of negative growth.

Fig.17 USD index and RMB exchange rate

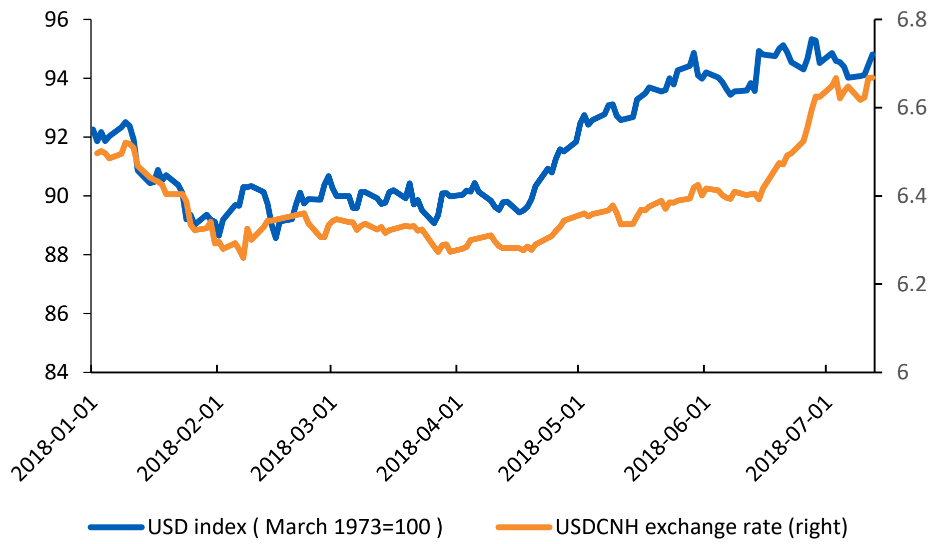
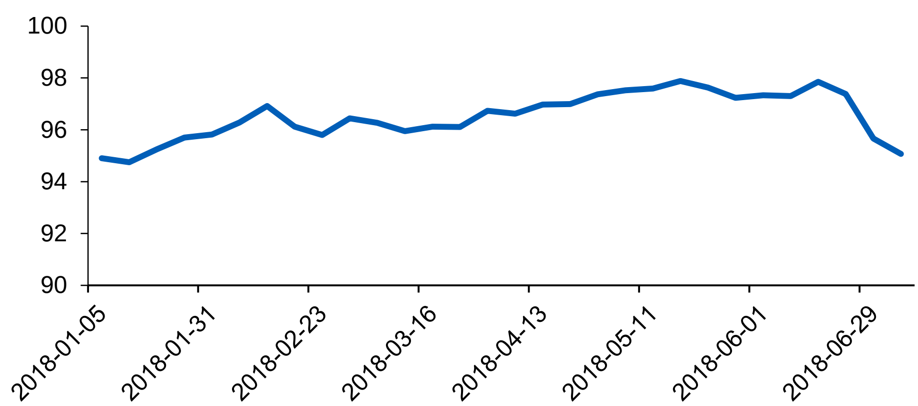
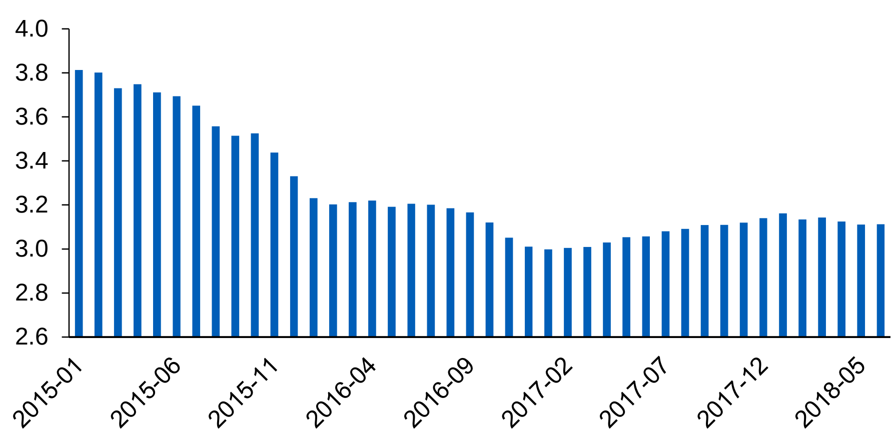


Fig.18 CFETS exchange rate index



Source: Wind, KPMG analysis

Fig.19 Official foreign exchange reserves (USD trillions)



Source: Wind, KPMG analysis

2

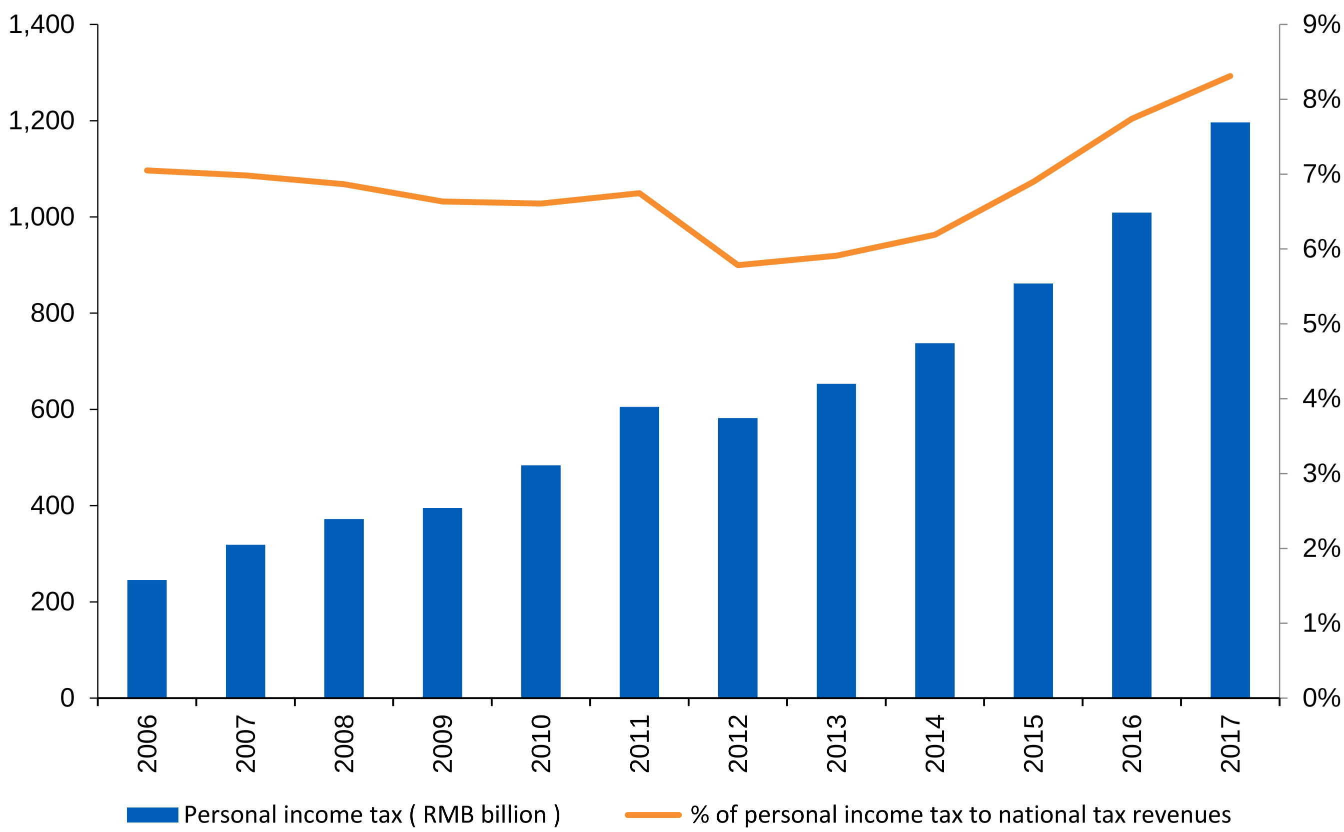
Policy Review

Individual income tax law facing significant reforms[11]

On June 19, the "Amendment to the Individual Income Tax (IIT) Laws of the People's Republic of China (Draft)" was submitted to the Third Session of the Standing Committee of the 13th National People's Congress. On June 29, the draft was open to public comments for a month. The proposed reform generated significant public attention and over 130,000 opinions were collected on the NPC website during the one-month window. According to the draft, new IIT Laws will come into effect on January 1, 2019. The monthly IIT threshold will be raised to RMB 5000 from October 1 to December 31, 2018 before the official enforcement[12].

China's IIT Laws was first promulgated in 1980. The monthly tax threshold was set at RMB 800 while average monthly income was only RMB 63.5[13]. In the following 38 years, IIT Laws have undergone six major reforms and the level of income at which taxes start to be levied was raised three times, in 2006, 2008, and 2011. The data below shows that in 2017, the national individual income tax revenue was RMB 1.197 trillion, an increase of 18.6% YOY, representing 8% of total national tax revenue for two consecutive years.

Fig.20 Individual income tax: 2006-2017



Source: Wind, KPMG analysis

[11] For more information, please refer to "PRC Individual income tax reform – Release of the proposed amendments, KPMG China Tax Alert, Issue 14, June 2018 https://home.kpmg.com/cn/zh/home/insights/2018/06/china-tax-alert-14.html

[12] In the writing of the report, the new individual income tax laws have passed the legislation on 31 August, 2018 and will come into force on 1 January, 2019. The passing of the laws was much faster than expected and highlighted its importance viewed by the government.

[13] 1980 Statistics on National Economic and Social Development, National Bureau of Statistics, April 1981.

Key amendments

1 Tax residence rule

The draft draws on international practice and introduces the concept of resident and non-resident (usually referring to foreign nationals) for tax purposes. It also intents to modify China's personal tax residence rule to a 183-day test from the existing one-year test.

2 Consolidating income with similar nature for taxation

The Draft grouped 4 categories of earned income, including income from salary and wages, income from provision of independent personal services, income from author's remuneration and income from royalties, into the category of "Comprehensive Income", and one set of progressive tax rates will apply for determining the IIT. Tax residents will be taxed on an annual basis while non-residents will still be taxed on monthly basis or as and when taxable income arises.

At the same time, income earned from the business activities of self-employed people will be reclassified as "Income from Operations", and income from contractual or leasing operations to enterprises and institutions will be incorporated into Comprehensive Income or Income from Operations depending on the nature of the income.

Income from operations, interest income, dividends, income from property leasing, income from transfer of asset, incidental income and other income will still be taxed separately at the rate prescribed for that category of income.

3 Adjusting Income Tax Brackets

Comprehensive income tax rate and some of the tax brackets will be adjusted.

Table 1 Comprehensive income tax rate comparison

Tax Rate（%）	Annual taxable income (RMB)	
	Current IIT Laws (2011)	Draft Amendment (2018)
3	<18,000	<36,000
10	18,000 to 54,000	36,000 to 144,000
20	54,000 to 108,000	144,000 to 300,000
25	108,000 to 420,000	300,000 to 420,000
30	420,000 to 660,000	420,000 to 660,000
35	660,000 to 960,000	660,000 to 960,000
45	> 960,000	>960,000

Note: The annual taxable income used in the Individual Income Tax Laws (2011 Amendment) is calculated by multiplying monthly taxable income by 12 months.
Source: "Personal Income Tax Laws of the People's Republic of China (2011 Amendment)", 2018 "Improvement of the Individual Income Tax Laws of the People's Republic of China (Draft for Review)", KPMG Analysis

Income from business operations will still be subject to progressive tax rates from 5% to 35% with appropriate adjustments to be made to each tax bracket, together with an increase of the lower band for the 35% tax bracket from RMB 100,000 to RMB 500,000.

4 Raising personal deduction on Comprehensive Income

The Draft proposes to raise the personal deduction amount for Comprehensive Income to RMB 5,000 per month (i.e. RMB 60,000 per year). If introduced, the new personal deduction will apply to all, and the current step-up in personal deduction (i.e. RMB1,300 per month) for foreign nationals will no longer apply.

5 Allowing itemised deductions for specific expenditures

In addition to the current deductible items, e.g. basic pension insurance, basic medical insurance, unemployment insurance, housing fund, the Draft has set up additional deduction for specific expenditures which are closely related to people's lives, such as expenditures on dependent children's education, continuing education, serious illness medical treatment, housing mortgage interest and rental.

6 Introducing general anti avoidance rule (GAAR) for individuals

The Draft makes reference to the general anti avoidance rules under the PRC Corporate Income Tax Law, and signalled the intent to introduce similar rules to empower the tax authorities to assess tax on individuals who are involved in transactions such as, asset transfers which are not at arm's length, tax avoidance by use of offshore tax haven, deriving inappropriate tax benefits through unreasonable commercial arrangements. Where tax is assessed, late payment surcharge would also be collected accordingly.

Important points:

1. Reducing tax burden reasonably

- Working class: The IIT reform is intended to reduce the tax burden of the working class, deepen reform of the income distribution system by raising the IIT threshold, aggregating income of a similar nature, and introducing additional special deductible expenses. This would further expand domestic demand and stimulate consumption to ease the downward pressure on the national economy.
- National tax treatment principle: The Draft indicated that the new IIT regime would no longer retain the existing additional personal deduction currently enjoyed by foreign nationals, which begs the question whether the existing tax exemption treatment of certain fringe benefits received by foreign employees will likely be revoked by the new IIT regime,
- Focus on people's livelihoods: The new reform introduces the concept of itemized deductions in respect of expenditures such as children's tuition and housing rental and mortgage payments. The changes take into account the actual burden of taxpayers, and help to ease the pressure on buyers and renters.

2. Safeguarding the integrity of the National Tax Base

The IIT reform will revise existing regulations that are not consistent with international practice to promote IIT reform, close current loopholes and protect the integrity of the national tax base.

- Introducing "tax residence" concept: The Draft introduces the concept of resident and non-resident, and modifies China's personal tax residence rule from the existing one-year test to a 183-day test. It will directly impact the taxation basis and employment arrangements of expatriates, overseas Chinese and residents from Hong Kong, Macao and Taiwan in China.
- General anti-avoidance rule: General anti-avoidance rules are a feature of many jurisdictions' tax legislation, and China has already concluded anti-tax avoidance agreements with 103 countries and jurisdictions. Since the implementation of the Common Reporting Standards ("CRS")[14], China has concluded bilateral Competent Authority Agreements and activated bilateral exchange relationships with 76 countries and jurisdictions. Introducing an anti-avoidance rule for individual income tax signals China's approach towards compliance and utilizes the automatic exchange of financial account information under CRS to increase enforcement of IIT obligations.

[14] CRS was developed in response to the G20 request and approved by the OECD Council on 15 July, 2014. It calls on jurisdictions to obtain information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis. (*Source*：OECD)

Tax collection and administration system improvements: new challenges

The Draft proposals will inevitably bring new requirements and challenges. However, the Ministry of Finance is silent on details of the proposed itemized deductions and the corresponding procedures to supplement the implementation and ongoing administration, which will be closely followed by the public throughout the IIT reform process. In particular it is not yet clear how companies may need to change how they withhold taxes from salary payments to their employees and how they will need to calculate individual income taxes on an annual basis going forward.

The release of the proposed amendments to PRC IIT Law marks an important step forward on the IIT reform. The imminent reform, coupled with the strengthened tax collection and administration system in China, will undoubtedly elevate the importance of individual income tax compliance. With that in mind, enterprises and individual taxpayers should pay close attention to the IIT reform. Thorough understanding of the changes and timely adjustments to the firms' current internal personnel policy, salary structure, and standardized IIT management process will help businesses benefit from new tax incentives while avoiding unnecessary costs.

China further opening up its financial sector

On April 10th, President Xi Jinping delivered a keynote speech entitled "Openness for Greater Prosperity, Innovation for a Better Future" when attending the opening ceremony of the 2018 Annual Boao Asia Forum and announced China's next new initiative to further open up. His pledge to widen access to China's financial market has drawn wide attention worldwide. China's Central Bank Governor Yi Gang further laid out a clearer timetable for opening at the Forum. The new governor outlined three principles China will follow in expanding financial openness: First, the financial sector should abide by pre-establishment national treatment[15] and the negative list system; second, the opening of the financial industry must be coordinated with reform of the exchange rate mechanism and the capital account convertibility process; third, equal emphasis should be placed on financial risks. Governor Yi Gang also stressed that the level of opening should be matched to regulatory capacity.[16] The opening-up measures for banking, insurance, securities will be released in the second quarter.

Fig.21 Financial sector opening-up measures since Q2

April

- China will widen market access for foreign insurance firms and foreign banks.
- China will raise foreign ownership limits to 51% in securities and fund management. The cap will be entirely lifted in three years.

May

- Daily quotas for stock connect schemes linking mainland and Hong Kong markets will be quadrupled. The daily northbound quotas under the Shanghai and Shenzhen stock connect schemes will be boosted to RMB 52 billion, up from RMB 13 billion at present. Daily southbound quotas under the schemes will be adjusted to RMB 42 billion from the original RMB 10.5 billion.

June

- Allow qualified foreign institutional investors to operate insurance agencies and loss-adjustment businesses.
- QFII, RQFII reform. The 20% monthly repatriation limit for QFII will be scrapped; the requirements for a three-month capital lock-up period for QFII and RQFII redemptions will be removed.
- Remove foreign ownership limits in securities and fund management. Level the playing-field for foreign investors*.
- Limits will be removed on foreign ownership in Chinese commercial banks' newly established asset investment companies.

July

The equity cap on foreign investments in life insurance and futures companies is raised to 51%.The cap will be entirely lifted in three years.

Within the year

- The requirement that foreign insurance companies have a representative office in China for two consecutive years prior to establishing a foreign invested insurer will be repealed.
- Allow foreign banks to set up branches and subsidiaries in the country.
- Limits will be removed from the foreign ownership in Chinese commercial banks' newly founded asset management subsidiaries.
- London-Shanghai Stock Link is planned to start within this year.

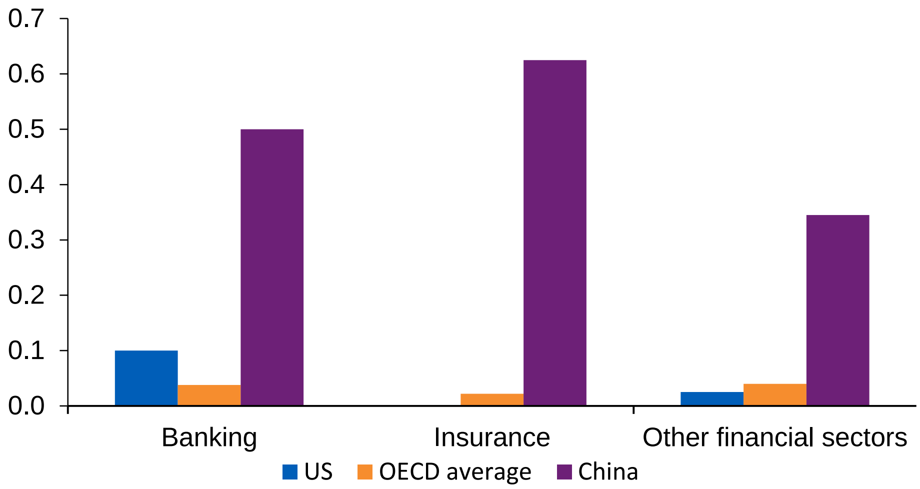
Note: asterisk (*) means the proposal is still waiting for public comment. "Within the Year" section is based on Central Bank Governor Yi Gang's keynote speech at Boao Forum for Asia.
Source: KPMG Analysis, based on publicly available information

[15] Pre-establishment national treatment means to provide national treatment for foreign capital during the entry stage, which means the capital importing country should provide foreign capital treatment that is no less than domestic capital in the pre-establishment stage. (*Source*: China Daily)
[16] Yi Gang announced at Boao Forum for Asia the specific measures and timetable for further opening up of the financial industry, the People's Bank of China's website, April 2018

Opportunities and Challenges

China has achieved a great deal since the beginning of opening up and reforms. For example, China's weighted average tariffs have fallen sharply from 14.67% in 2000 to 3.54% in 2016, close to that of developed countries. But the barriers remain high for foreign investments to enter China's financial markets. According to OECD's FDI Restrictiveness Index[17], China's indices in banking, insurance, and other financial sector are 0.5, 0.63 and 0.35 respectively, all are higher than OECD averages. There is ample room for China's financial sector to further open up.

Fig.22 OECD FDI Restrictiveness Index [13]

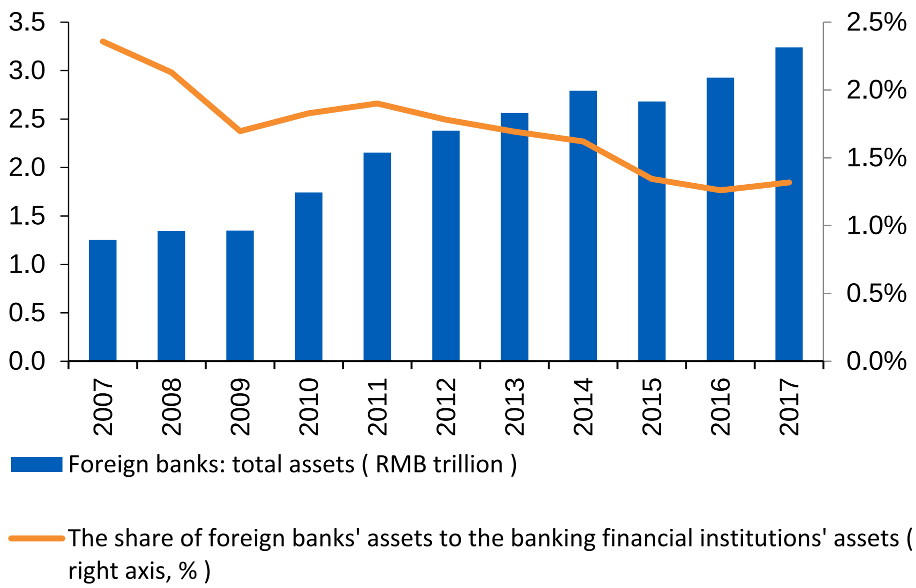


Source: OECD FDI Restrictiveness Index, KPMG Analysis

Taking the banking industry for example, at the end of 2017, there were 39 foreign banks and 1013 foreign bank - affiliated business institutions operating in China. The total assets owned by foreign banks grew from the original RMB 1.25 trillion to RMB 3.24 trillion at the end of 2017, representing an average 10% compound annual growth rate. However, the share of foreign bank assets in total domestic banking assets has been declining year on year. The share dropped to 1.3% at the end of 2017, a nearly 50% decrease since 2007. In contrast, at the end of 2017, foreign banks accounted for more than 14% of total banking assets in Germany and close to 48% in the US. While the underdevelopment of foreign banks in China can be partly attributed to their reduced appetite for international expansion since the 2008 financial crisis, the further opening up of the financial sector can be expected to boost the prospects of foreign banks in China.

[17] OECD FDI Regulatory Restrictiveness Index: restrictions are evaluated on a 0 (open) to 1 (closed) scale, OECD Stat.

Fig.23 Foreign banks total assets 2007-2017



Source: Wind, KPMG analysis

2018 saw China's financial sector being propelled by the opening up policies. Chinese financial institutions and China's financial regulations are being vastly improved in the process. The opening up presents both opportunities and challenges for both domestic and foreign financial institutions, as well as for China's financial regulatory system . Domestic financial institutions need to focus on enhancing their own competitiveness, while effectively attracting overseas investment and technology; foreign financial institutions should consider how to smoothly enter the Chinese market and quickly adapt to China's financial regulatory environment; China's financial regulators should carefully plan ways to mitigate financial risks to further promote a healthy market.

China unveiling plans to deepen reform and opening ups in Free Trade Zones

On September 29, 2013, China's first pilot program on Free Trade Zones (FTZs) - Shanghai FTZ was officially established. To date, the program has experienced three expansions: in 2015, Tianjin, Fujian and Guangdong were approved as the second batch of FTZs; in 2016, the third batch of seven FTZs was announced; in 2018, the 40th anniversary of China's reform and opening up, Hainan became China's 12th FTZ and the first free trade port.

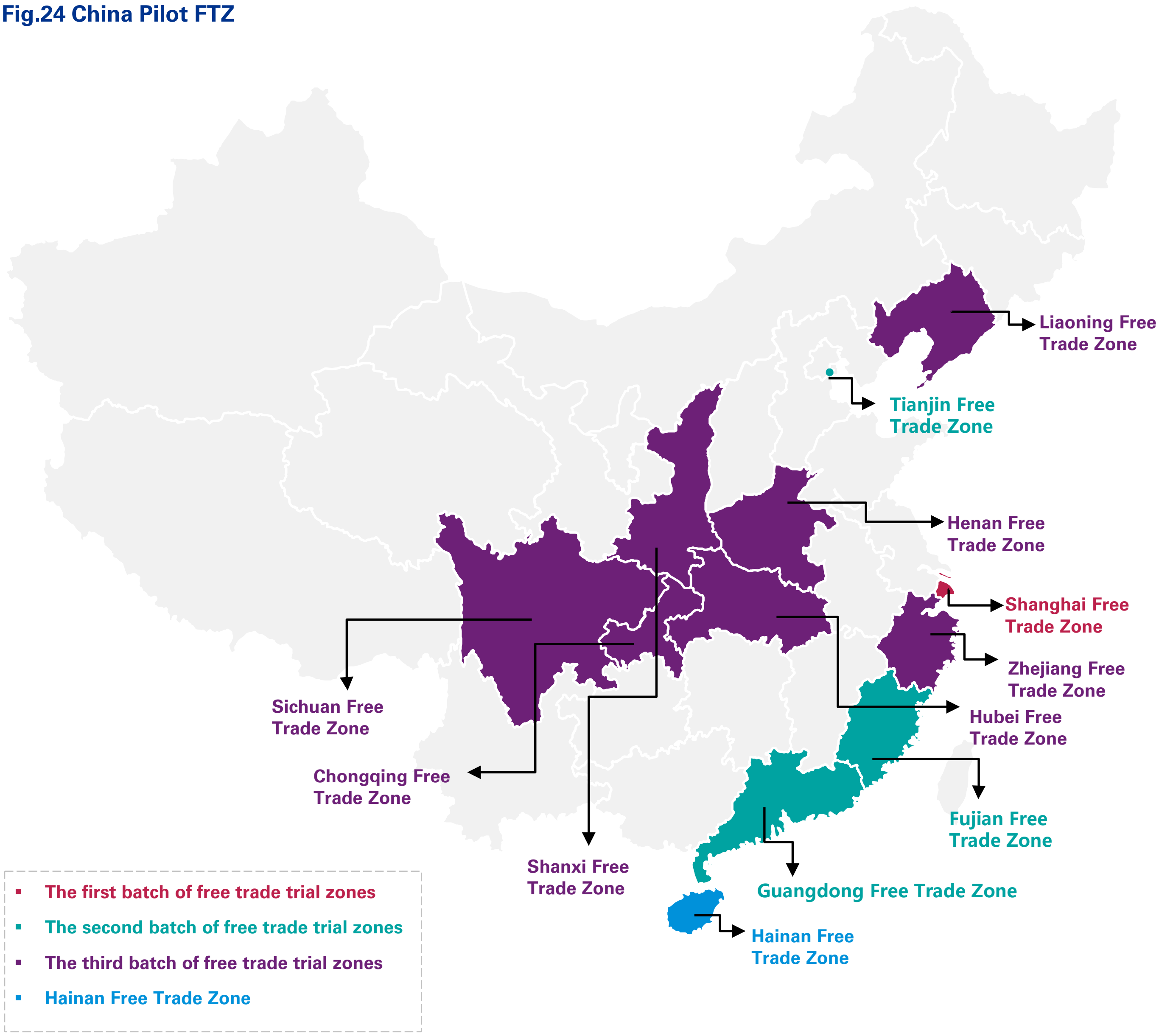
At the same time, greater autonomy has been promised to existing FTZs. On May 24th, the "Development of China (Guangdong), (Tianjin), (Fujian) Pilot FTZ Reform and Opening-up Plan" was released. The three provinces and municipalities have tailor made their own work plans. On June 21, the newly released "China (Shanghai) Pilot FTZ's Opinions on Expanding the Opening of the Financial Services Industry and New Advantages of Opening up" issued new preferential policies to attract foreign financial institutions. The new rules will widen the opening-up of banking, insurance and securities markets within the FTZ. The upgraded FTZ will compliment the advancing of a series of regional development strategies such as the Belt and Road Initiative, Beijing-Tianjin-Hebei Integration Plan, Guangdong-Hong Kong-Macau Greater Bay Area, Yangtze Economic Belt, Western Development, Northeast Area Revitalization Plan, and Rise of Central China Plan etc.

Table 2 Fast Facts of China's FTZs

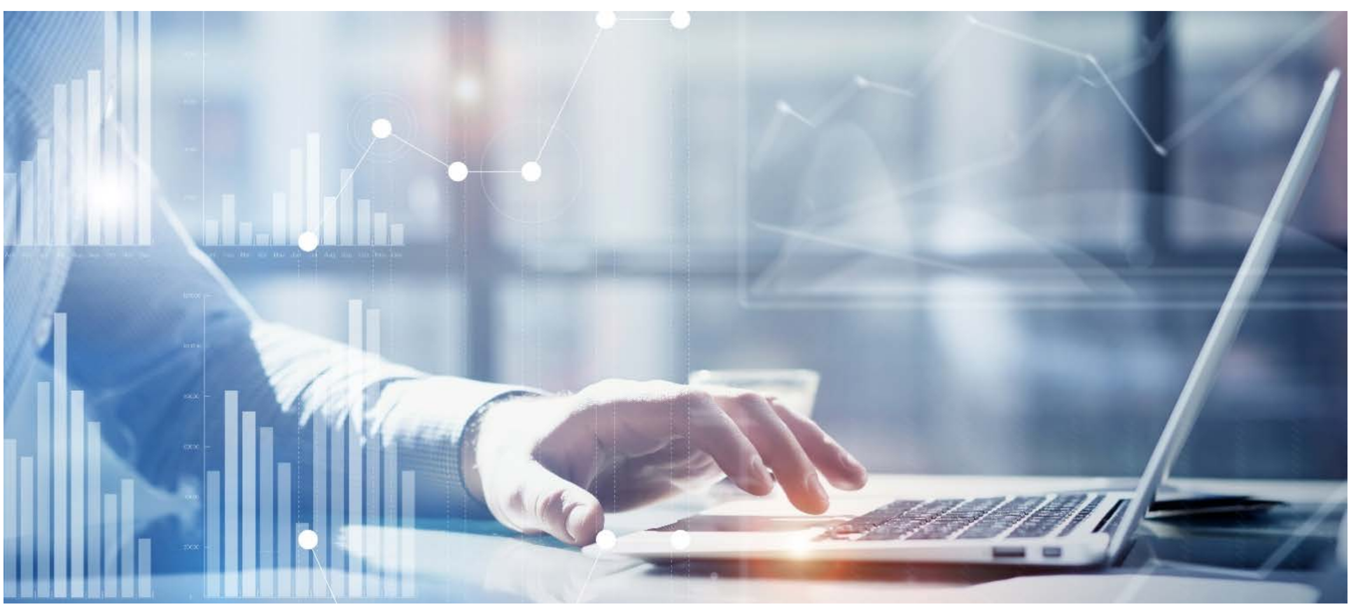
Year	FTZs	Strategic positioning
2013	Shanghai	Strengthening cooperation with the Shanghai International Financial Center and Science and Technology Innovation Center; serving as a hub for the Belt and Road Initiative and the Yangtze River Economic Belt.
2015	Guangdong	A leader in China's new round of opening up and reforms, a demonstration area for in-depth cooperation between Guangdong, Hong Kong and Macao.
2015	Tianjin	A high standard platform showcasing the opening up of the Beijing-Tianjin-Hebei Region; serving as a hub for the Belt and Road Initiative.
2015	Fujian	A demonstration area for in-depth cooperation among Taiwan and Mainland; a core area of the 21st Century Maritime Silk Road, promoting cooperation among and opening up of countries along the 21st Century Maritime Silk Road.
2017	Liaoning	A new engine to lift the overall competitiveness and openness of China's 'Old Northeast Industrial Bases'.
2017	Zhejiang	An important demonstration area for the opening up of Eastern coastal region; a world's leading area for the liberalization of commodities; and a resource allocation base with international influence.
2017	Henan	A modern comprehensive transportation hub serving the construction of the Belt and Road; a testing ground for comprehensive reform and opening-up; and a demonstration area for economic opening up in inland China.
2017	Hubei	Accommodating industrial transfer from costal areas to Central China; a testing ground for comprehensive reform and opening-up in inland China
2017	Chongqing	An important hub connecting Belt and Road with Yangtze River Economic Belt; a strategic anchor of the Western Development Strategy.
2017	Sichuan	A leading area for the opening-up of Western region and inland China.
2017	Shaanxi	An important anchor for economic cooperation and cultural exchanges along the Belt and Road.
2018	Hainan	A free trade trial zone and steady promotion of the construction of a free trade port; the ecological civilization experimental area; International tourism and shopping center; a major national strategic logistics zone; complement the implementation of national development strategies such as Marine Superpower, Belt and Road, and Civil-military integration.

Source: Wind, KPMG analysis

Fig.24 China Pilot FTZ



Source: Wind, KPMG analysis



The 2018 negative list of foreign investment marking greater market access

On June 28, the National Development and Reform Commission and the Ministry of Commerce jointly issued the 2018 edition of the "Special Administrative Measures for Access of Foreign Investment" (2018 Foreign Investment Negative List). It went into effect on July 28, 2018. The new list relaxes or removes restrictions or prohibitions on foreign investment in 22 industries that span manufacturing to services. The number of items on the list has been reduced from 63 to 48. The list enables market access in manufacturing, widened the openness of the service sector, and lowered barriers to market access for agriculture and energy. [18]

Table3 Facts of Negative List

Agriculture	1. No restriction on foreign shareholdings in companies engaged in selection and cultivation of new varieties of crops and production of seeds. For wheat and corn, foreign investors can own up to an 66% interest. 2. No restriction on foreign shareholdings in companies engaged in the purchase and wholesaling of rice, wheat and corn.
Energy industry	3. No restriction on foreign shareholdings in companies engaged in exploration and exploitation of rare and special coals. 4. No restriction on foreign shareholdings in companies engaged in exploration and exploitation of graphite. 5. No restriction on foreign shareholdings in companies engaged in the separation and smelting of rare earth and smelting of tungsten. 6. No restriction on foreign shareholdings in companies engaged in the construction and management of power grids. 7. No restriction on foreign shareholdings in gas stations.
Manufacturing	8. No restriction on foreign shareholding in companies engaged in the manufacturing of special purpose motor vehicles and new energy automobiles. No restriction on foreign shareholdings in companies engaged in the manufacturing of commercial vehicles in 2020. No restriction on foreign shareholdings in companies engaged in the manufacturing of passenger cars in 2022. 9. No restriction on foreign shareholdings in companies engaged in the design, manufacturing and maintenance of ships(including subsections). 10. No restriction on foreign shareholdings in companies engaged in the design, manufacturing and maintenance of aircraft for trunk lines and regional aircrafts; design and manufacturing of helicopters of three tons or more; manufacturing of ground-effect and water-effect aircrafts; design and manufacturing of unmanned aircrafts and aerostats. 11. No restriction on foreign shareholdings in companies engaged in the design, manufacturing and maintenance of utility aircrafts. 12. The manufacturing of arms and ammunition is not listed in the 2018 Negative List.
Service industry	13. No restriction on foreign shareholding in companies engaged in railway passenger transport. 14. No restriction on foreign shareholding in companies engaged in international marine transport. 15. No restriction on foreign shareholding in companies engaged in mapping. 16. No restriction on foreign shareholding in companies engaged in the construction and operation of network of trunk railway lines and power grid. 17. The investment in business premises for internet-access services is not longer prohibited.
Financial industry	18. 20% restriction on the foreign shareholding (as a single investor) in Chinese banks and the 25% limit for aggregated foreign ownership has been lifted. 19. The restriction on foreign shareholdings in domestically funded commercial banks has been lifted. Limits on foreign ownership in security companies, fund management companies, futures companies and life insurance companies has been increased to 51%. All caps on foreign shareholdings in financial sectors will be abolished in 2021.

Source: Freshfields Bruckhaus Deringer, KPMG Analysis

[18] Press conference of the National Development and Reform Commission to the reporter's question on the 2018 version of the special management measures for foreign investment access (negative list), National Development and Reform Commission, July 2018.

On June 30, “Pilot FTZ Special Administrative Measures for Access of Foreign Investment” (2018 FTZ Negative List) was released and came into effect in July 30. The FTZ list reduced the number of special administrative measures from 95 to 45, and is applicable to all pilot FTZs, but with restrictions lifted in three additional areas.

Table 4 Three restrictions canceled in the FTZ “Negative List”

Oil and gas extraction	No restriction on foreign holdings in the prospecting and exploitation of crude oil and natural gas (including coal bed methane, oil shale, oil sands, shale gas, etc.).
Nuclear fuel and nuclear radiation processing industry	No prohibition on foreign investment in the smelting and processing of radioactive minerals, and the production of nuclear fuel.
Cultural and Entertainment	No restriction on foreign holdings in performance brokerage agencies.

Source: KPMG Analysis, based on publicly available sources

The 2018 Negative List further broadens market access, injects more vitality into the development of the Chinese economy and promotes high quality opening up. Openness in the manufacturing sector is the highlight of the national list. It opens new doors to foreign investment in the high-tech and high-end manufacturing sector, including new energy companies, aircraft design and manufacturing, ship design and manufacturing.

On April 27th, Guidance Opinions Concerning Standardization of Asset Management Operations by Financial Institutions (aka New Regulations for Asset Management) were officially introduced. Compared to the first draft in 2017, revisions were made in areas such as relaxed restrictions on closed private equity products grading, some asset management products (AMPs) can be valued using an amortized cost method, and the grace period is extended to 2020. Despite the changes, the regulators' objectives remain unchanged: it will aim to establish standardised AMP leverage, uniform asset management operations within the same business category, and level market access and supervision. It also vows to eliminate regulator arbitrage. The ultimate goal is to establish sound institutions for the healthy development of the asset management market.

The content of new asset management regulations

The New Asset Management Regulations stipulate that AMPs include, but are not limited to, non-principal guaranteed wealth management products (WMPs) in the form of RMB or foreign currencies, fund trusts, AMPs issued by securities companies, securities subsidiaries, fund management companies and their subsidiaries, futures companies and their subsidiaries, insurance asset management institutions, and financial asset investment companies. Asset securitization businesses carried out under rules promulgated by the financial management authorities and the pension products issued under rules promulgated by the Human Resources and Social Security Department are exceptions. Private equity investment funds shall be subject to the special laws and administrative regulations of the private equity investment funds. Those activities that are not clearly defined in the private investment funds special laws and administrative regulations are subject to the new asset management rules. Rules on venture capital and government-funded industrial investment funds will be drafted separately.

The major financial institutions covered by the New Asset Management Regulations include:

- ✓ Banks
- ✓ Trusts
- ✓ Securities companies, securities company subsidiaries
- ✓ Fund management companies and their subsidiaries
- ✓ Futures companies and their subsidiaries
- ✓ Insurance asset management agencies
- ✓ Financial asset investment companies
- ✓ Private equity investment funds

Key points in the new rules include :

Eliminate implicit guarantees and promote net asset value management	Asset management businesses are defined as off-balance sheet financing of financial institutions. Financial institutions cannot offer implicit guarantees of the principal.
Strict standardization of investment in non-standard assets	AMPs must abide by the relevant quotas and liquidity requirements of financial regulators.
Removal of multi-tier nesting	AMPs can only have maximum two layers. Reinvested products are prohibited from investing in any other AMPs except for funds.
Prohibit the management of AMPs on a pooling basis with maturity mismatch	Each AMP should be separately managed, accounted and audited; closed AMPs' maturity period should be no less than 90 days.
Standardized leverage ratio	140% on open public offerings; 200% on closed public offerings and private equity products; 140% on graded private equity products.

During the grace period, new AMPs issued by financial institutions should comply with new regulations; financial institutions are allowed to issue old products during the transition, but are required to strictly control the volume and are expected to shrink it in a gradual manner. Financial institutions are prohibited to issue or republish AMPs that violate new rules when the grace period is over.

Background of New Asset Management Regulations

Asset management business has seen rapid growth in China's financial sector in recent years. From 2014 to 2017, the average annual compound growth rate of asset management business reached 31%, of which private equity funds grew at an average annual rate of 73%. At the end of 2017, excluding cross-holding factors, the total size of the AMP business has reached nearly RMB 100 billion. The share of trust in AMP business has dropped from 30% to 22%, while the proportion of private equity fund management products has doubled to 11%. The share of other institutions' products remain unchanged.

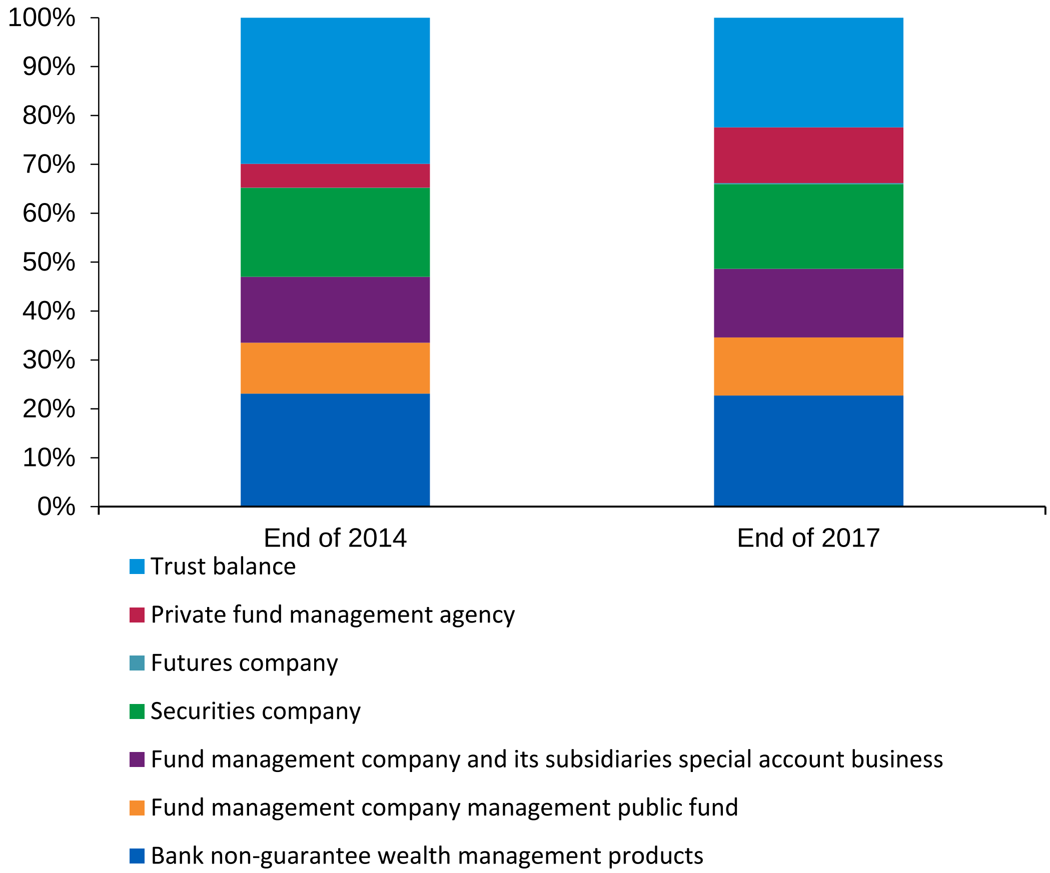
Table 5 Overview of financial institutions 'asset management business, 2014-2017

Categories of AMPs (RMB trillion)	2014 Year-end	2015 Year-end	2016 Year-end	2017 Year-end	CAGR 2014-2017
Bank non-principal guaranteed WMPs[19]	10.09	17.43	23.11	22.17	30%
Fund management company public fund	4.54	8.40	9.16	11.60	37%
Fund management company and its subsidiaries' special account business	5.88	12.60	16.89	13.74	33%
Securities company	7.95	11.89	17.58	16.88	29%
Futures company	0.01	0.10	0.28	0.25	170%
Private fund management agency	2.13	5.21	7.89	11.10	73%
Trust balance	13.04	14.69	17.46	21.91	19%
Total	43.64	70.33	92.37	97.64	31%

Source: Wind, China Banking Industry Market Report, KPMG Analysis

[19] According to the New Asset Management Regulations, bank WMPs regulated by this document are bank non-principal-guaranteed WMPs including but not limited to RMB or foreign currency.

Fig.25 Institutional assets proportion: 2014 and 2017



Source: Wind, China Banking Industry Market Report, KPMG Analysis

Asset management business has played a positive role in meeting the needs of Chinese citizens' wealth management, enhancing the profitability of financial institutions, optimizing the structure of social financing, and supporting the real economy. However, due to the inconsistencies in its guiding rules and standards, the AMP market has been beset by problems such as regulatory arbitrage[20], multi-layered nesting, uncontrolled risks, fund pools with liquidity risks, bad debt write-offs, and implicit guarantees. The unsupervised shadow banking businesses that are independent from the financial system have interfered with macroeconomic adjustments and control, increased the cost of social financing, affected the functionalities of financial services in real economy, and intensified the cross-industry and cross-market risks.[21]

New Asset Management Regulations, serving as the overarching guidelines of the AMP market, aims to strictly control risks, serve the real economy to better invest and finance, and guide funds toward the real economy. It also focuses on supervising all AMPs issued by various financial institutions, setting unified standards for the industry, and accelerating the industry transitioning. The publication of new rules shows that the supervision framework guiding the overall asset management market is taking shape.

Impact on the Industry

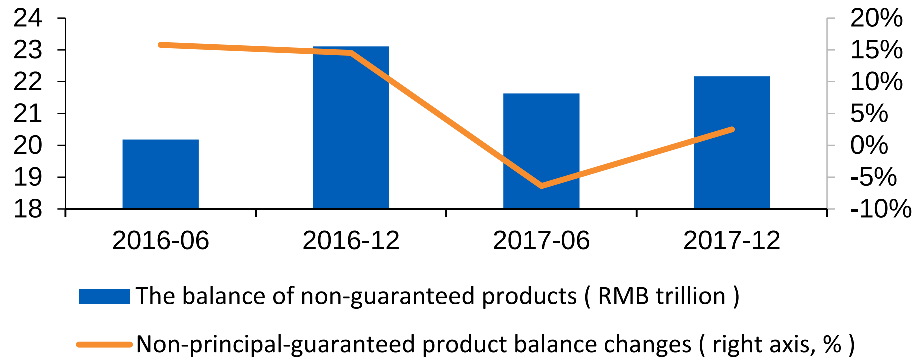
Non-principal guaranteed WMPs accounted for the most significant share of the asset management market, at 23%. The promulgation of the new rules has had a considerable impact on banks' asset management business by targeting the market chaos that has built up over the past years.

---

[20] Regulatory arbitrage is a practice whereby firms capitalize on loopholes in regulatory systems in order to circumvent unfavourable regulation.(*Source*: Investopedia)
[21] Press conference on the "Guiding Opinions on Regulating Asset Management Business of Financial Institutions", PBoC, April 2018.

In fact, since the beginning of 2017, the former China Banking Regulatory Commission has carried out a series of actions aimed at restoring order to the banking industry. One key move was to regulate the banks' off-balance sheet WMP businesses and rectify issues such as fund idling and regulatory arbitrage. From the end of 2016 to June 2017, the size of banks' WMP business showed a certain degree of decline. It took off again in the second half of 2017, but was still lower than at the end of 2016. According to the latest data, the balance of non-principal guaranteed WMPs in May 2018 was RMB 22.28 trillion, but fell to RMB 21 trillion in June[22], suggesting a YOY decrease. To summarize, the size of the off-balance sheet WMP business has been declining since the the new rules were issued.

Fig.26 Size change of non-principal guaranteed WMPs over time



Source: Wind, China Banking Market Report, China Banking Insurance Regulatory Commission, KPMG Analysis

KPMG Observations

The New Asset Management Regulations grant financial institutions a 2.5 year grace period. Financial institutions, especially banks, should try to adopt the net asset value management of AMPs as soon as possible, reduce the stock in an orderly fashion, and prepare for new issuances.

On the technical side, personnel training and system upgrades are required to meet the requirements of the new valuation method under the new rules, to avoid unnecessary investment losses and non-compliance risks. Banks should provide detailed product information for investors to better understand the financial risks associated with these products.

[22] Press conference on "Regulations on the Supervision and Management of Asset Management Business of Commercial Banks (Draft for Public Comments)",China Banking Regulatory Commission, July 2018.

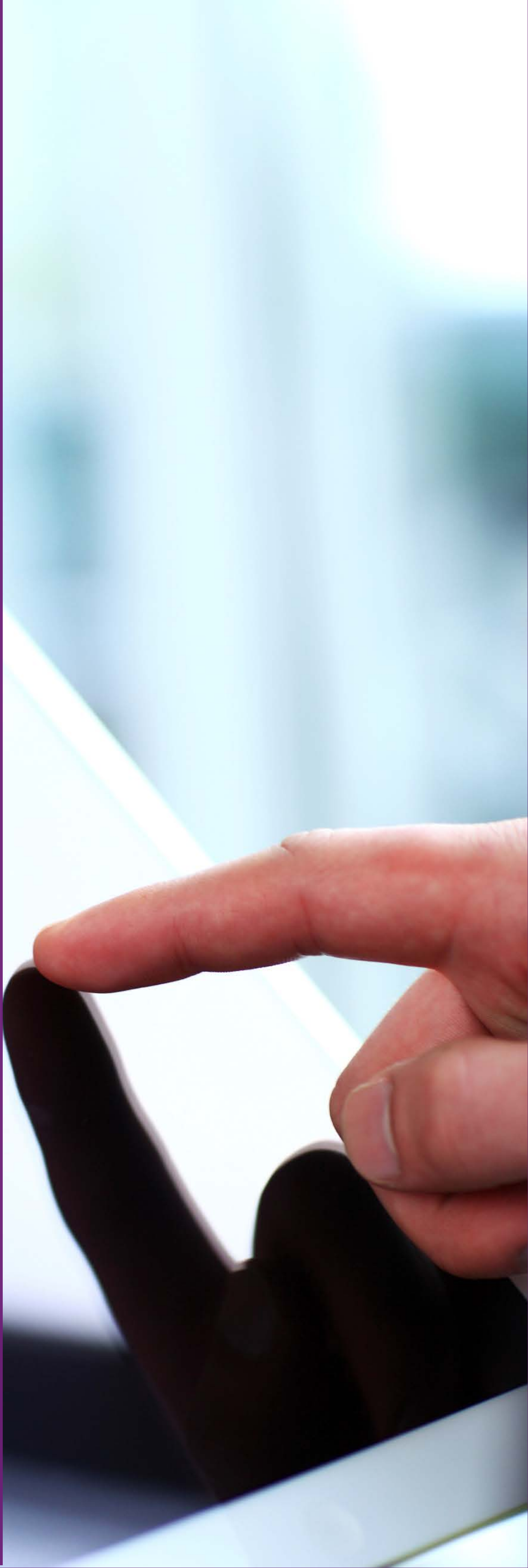
On July 20, the central bank issued the “Notice on Further Clarifying the Guiding Opinions on Asset Management Business of Financial Institutions (aka Implementation Notice) ” . On the same day, the China Banking Regulatory Commission and the China Securities Regulatory Commission separately published the drafts of “Measures for the Supervision and Administration of Commercial Banks’ Financial Management Businesses” , “Administrative Measures for the Private Equity Asset Management Business of Securities and Futures Operating Agencies” and “Regulations on the Operation and Management of Private Equity Asset Management Plans of Securities and Futures Operating Agencies” for public comments.

The Implementation Notice has more relaxed regulations such as allowing eligible public AMPs to invest in non-standard assets and allowing financial institutions to issue old products to invest in new assets during the grace period.

From the new guidelines released in April to the issuance of detailed draft of regulations in July, the regulatory authorities have further clarified the requirements and phases to implement the new regulations. The efforts are conducive to reducing market uncertainty and promoting stable growth. However, it is worth noting that the primary focus on getting rid of implicit guarantees, eliminating multi-level nesting, and containing bad debt write-offs remains unchanged. The current regulatory focus in the AMP market is strict supervision and risk prevention, while also paying attention to fine-tuning.

3

Special Topic: The EU General Data Protection Regulation



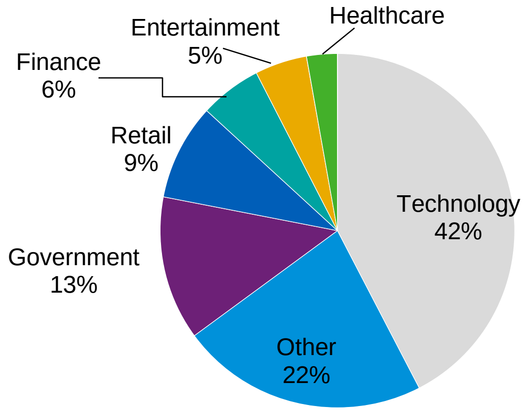
The General Data Protection Regulation (GDPR) was approved by the European Parliament in April 2016. On May 25, 2018, when the two-year transition period expired, GDPR officially came into force, superseding the Data Protection Directive 95/46/EC (DPD) which had been in place since 1995.

GDPR is considered the most stringent data privacy regulations to date in terms of its wide application, data complexity, and severe penalties. GDPR aims to regulate and enhance European citizens' rights to personal data by improving the transparency, security and accountability of data controllers. A significant regulatory milestone, it heralds a new era of data protection.

1. The Background of GDPR

With the rapid development of the internet and the Internet of Things, traces of individual's daily activities are stored as data on the Internet. Large-scale data breaches may occur if data processing or storage activities are mishandled. Examples include the 2017 Equifax and 2018 Facebook data leakages. According to Gemalto's 2017 Data Accidental Disclosure Statistics Report[23], there were 1,765 incidences of data breach and more than 2.6 billion compromised data records in 2017, of which 147 million were from Equifax, a US credit bureau.
Gemalto's research from 2013 to 2017 showed that of the total 9.7 billion data breaches, industries with the highest risk were technology, government, retail and finance.

Fig.27 Distribution of data leakage by industry 2013-2017



Source: Gemalto-Breach Level Index （7.3.2017） KPMG Analysis

Box 1: Facebook data breach

In March 2018, New York Times and The Guardian published detailed reports on the Facebook-Cambridge Analytica data scandal. Aleksandr Kogan, a data scientist at Cambridge University, developed an app called "this is your digital life" for Cambridge Analytica (CA), a British political consulting firm. CA arranged an informed consent process for research in which several hundred thousand Facebook users would agree to complete a survey only for academic use. However, Facebook's design allowed the app to not only collect the personal information of people who agreed to take the survey, but also the personal information of all the people in those users' social networks. In this way, CA acquired data from 87 million Facebook users (including approximately 2.7 million European users). During the 2016 US Presidential Election, the data was allegedly used to influence voter opinion on behalf of politicians who hired CA.

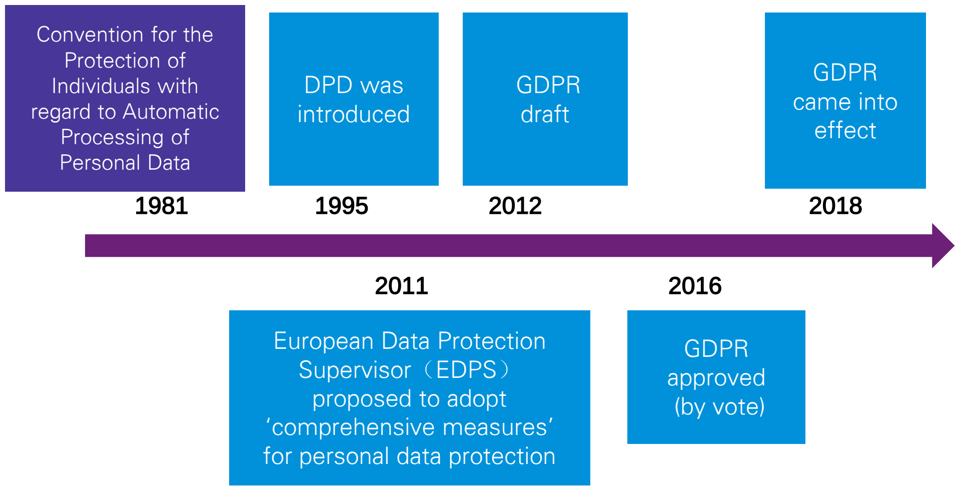
Facebook was aware of CA's data theft in 2015 but apparently failed to take any effective actions to stop it. Because the timing of the breaches, Facebook was not liable for penalties under GDPR: if GDPR penalties had been applicable, Facebook would have faced fines of up to $1.63 billion (4% of the company' global turnover). However, the company still faces EU investigations and a serious trust crisis.

Sources: The Guardian, KPMG analysis

EU has been a forerunner in legislation on data protection and cross-border information flows. The European Parliament passed the Convention on the Protection of Automatic Data Processing in 1981, the first legally binding international convention that covers data usage, privacy protection and data exchange[24]. In 1995, the EU issued DPD to set the basic standards for personal data protection that applied to all member countries. However, much has changed in the world of information in the 21st century. The development of personal data has experienced both exponential growth and diversification. DPD's protections regarding personal data became insufficient and outdated, and security breaches occurred with regularity. The EU started setting out plans for data protection reforms in order to make Europe fit for the digital age. Agreement was reached almost four years later, in 2016, for the new regulations to come into force in May 2018.

[23] 2017 The Year of Internal Threats and Accidental Data Breaches', Gemalto, April, 2018
[24] Data protection: EU experience worth learning, Beijing News, December 2017

Fig.28 EU's efforts on the legislation of personal data protection

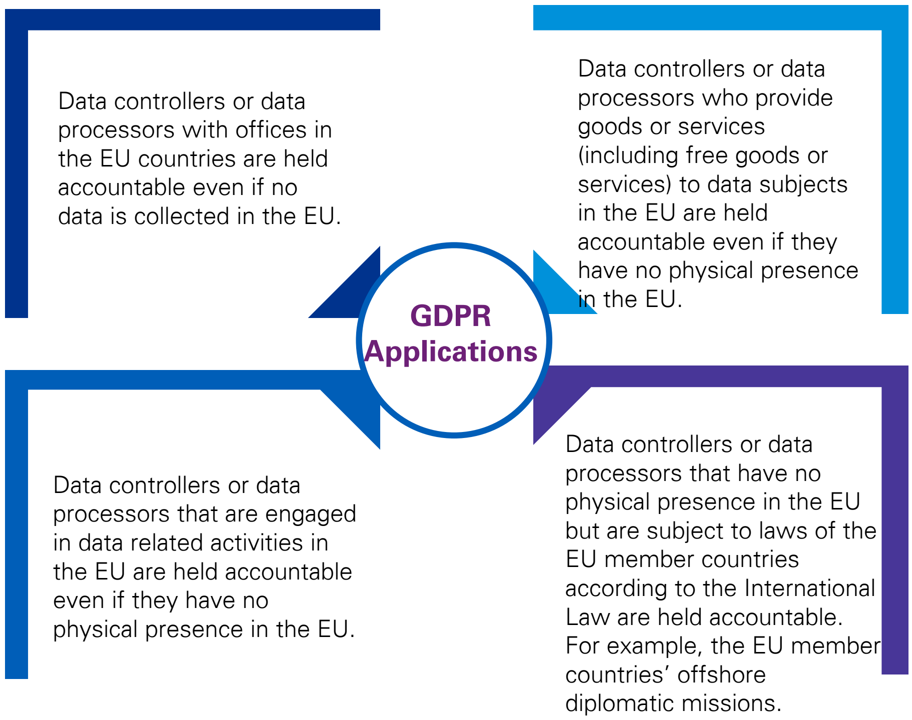


Source: KPMG Analysis

2. Key content of the regulation

2.1 A wide range of applications

Unlike DPD, each member country needs to have similar laws for GDPR implementation. GDPR is binding across all EU member states and is more widely applicable.



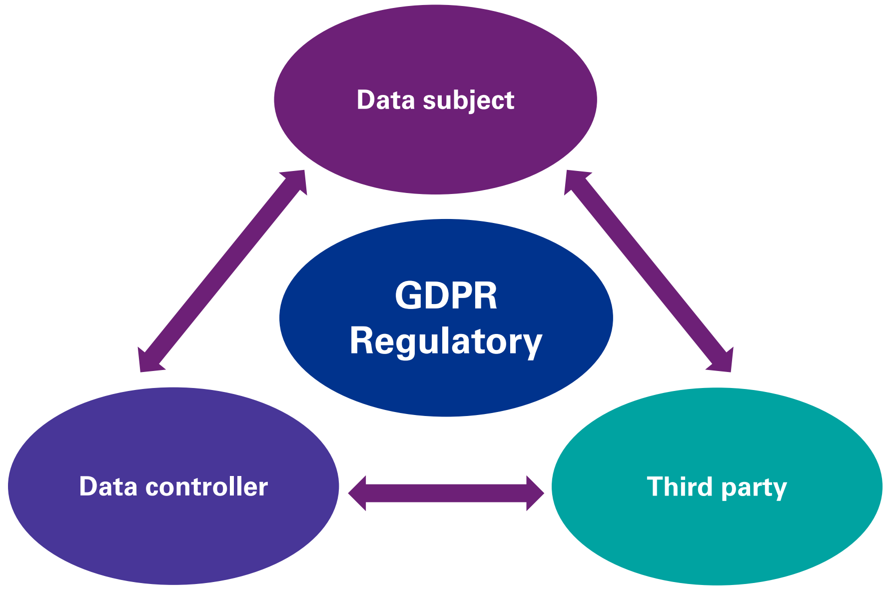
Companies should comply with GDPR if they use personal data of persons in the EU to provide services, to sell goods, or to monitor their behaviour, even if those companies don't have an office in the EU.

GDPR will affect Chinese companies that are planning to go global or have global development strategies. The affected firms span industries including financial institutions (international Chinese banks, financial leasing companies, insurance companies, etc.), internet firms, cross-border e-commerce, industrial manufacturing, household appliances, smart homes, and transportation (i.e. aviation).

2.2 GDPR holds several parties accountable

The GDPR regulations cover any data related behavior, including data collection, storage, utilization, and transmission. Rights and obligations of various parties including data subjects (individuals), data controllers and processors, third-party agencies and data regulators are intertwined within the GDPR framework.

Fig.29 Parties that GDPR holds accountable



Source: KPMG Analysis

2.3 Enhanced data subject rights

GDPR defines personal data as any information relating to an identified or identifiable natural person ('data subject') ; an identifiable natural person is one who can be identified, directly or indirectly. Compared to DPD, GDPR added to the existing definition of data subject rights the right to be forgotten and the right to data portability, and further expanded the scope of the right to access and the right to object.

1. Right of Access
   Data controllers are required to provide data subjects a copy of their processed personal data upon request within one month (the period can be extended to two months in case of large dataset). Electronic requests for data copy shall be provided in commonly used electronic form. The first request for a copy shall be free.
2. Right to Object
   Individuals have the right to object to the processing of their personal data in certain circumstances, such as data processing in cases of direct marketing, science and historical research or statistics.
3. Right to be Forgotten
   The individuals have the right to have data processors erase personal data, stop disclosing the data to others, and inform third-party organizations to refrain from processing data and erase it.
4. Right to Data Portability
   On top of accessing personal data, individuals may request to transfer the data from one data controller to another.

2.4 More stringent requirements on data controllers and processors

While protecting the legitimate rights and interests of the individuals, GDPR imposes strict requirements on data controllers and processors for personal data processing activities, and requires them to establish a well-established accountability mechanism.

1, Data processing activity records
GDPR requires companies or organizations that meet the following conditions to keep records of their data processing activities:
a. More than 250 employees;
b. Less than 250 employees, but are engaged in dealing with sensitive data, or the data processing activities may pose risks to data subject rights.

2, Data Protection Officer (DPO)
DPO must be appointed if the core activities of the data controllers or processors involve regular, systematic monitoring of data subjects on a large scale.

3, Data protection impact assessment
Data controllers should conduct a data protection impact assessment of data processing activities when there is a high risk of data breach. The assessment should be undertaken in consultation with the DPO. If a high risk is identified without effective measures to mitigate, controllers must consult the regulatory body before starting the data processing.

4, Notification of data disclosure
Should a personal data breach occur, data processor needs to immediately report to controller. The controller must notify the supervising authority of the breach within 72 hours of becoming aware of the event. The controller must also notify impacted individuals of any possible risks without undue delay.

5, Security measures
The GDPR also stipulates that data controllers and processors should take appropriate security measures, such as adequate IT security measures that include personal data masking and encryption, data recovery capabilities, and an effective system to conduct periodic tests and evaluation.

2.5 Substantial Penalties

GDPR will enforce two tiers of fines when noncompliance is identified :

1. Fines up to €10 million or 2% of the global annual turnover, whichever is higher. For instance, for noncompliance with data breach obligations.

2. Penalties of up to 4% of global turnover of the previous financial year or€20 million, whichever is higher. For example, for noncompliance of the basic principles of data processing (e.g. personal consent), illegal transfer of personal data to third countries or international organizations, or refusing to obey the orders of the regulatory agencies.

3. The far-reaching impacts of GDPR on companies

With the official enforcement of GDPR on May 25, the top priority for EU companies and international firms with European businesses is to establish a set of compliance measures to mitigate the risk of paying penalties. However, according to a survey[25] conducted by KPMG and the Legal 500, more than half of the surveyed global companies (54%) are not confident in responding to GDPR. The implementation of GDPR poses both opportunities and challenges for global companies. The two-year transition period was relatively short in terms of the size of the preparation work required for compliance. The size and unpredictability of personal data calls for improved equipment, IT technology and expertise. More importantly, awareness of personal data protection at the employee level is still low. According to the survey, less than 10% of respondents believe their employees are fully aware of the data protection obligations under GDPR. Enterprises should be more proactive with GDPR compliance. The compliance with GDPR will bring benefits to companies, such as increased customer trust, improved brand image and reputation, improved internal data management and information security management, and enhanced competitive advantages. In the era of big data, a strategy that aims to improve personal data protection could make a company more competitive in the market.

Box 2: The potential impact of GDPR

GDPR's stringent data protection is controversial. It is predicted that by 2025, the digital economy with represent half of the global economy. Data is becoming a core source of competitive advantage for companies, especially IT firms today. Will the implementation of GDPR hinder the development of the digital economy on the global stage? [26]

GDPR stated in its guidelines that it will inherit DPD's efforts in promoting the free flow of personal data while protecting individual rights. However, the enhanced individual rights and strict restrictions on data controllers and processors over data usage have increased barriers to the free flow of information. How GDPR could strike the balance between personal data protection and free information flows remains to be seen.

[25] General Data Protection Regulation (GDPR) study in collaboration with Legal 500, KPMG，https://home.kpmg.com/xx/en/home/insights/2018/05/the-general-counsels-guide-to-gdpr.html

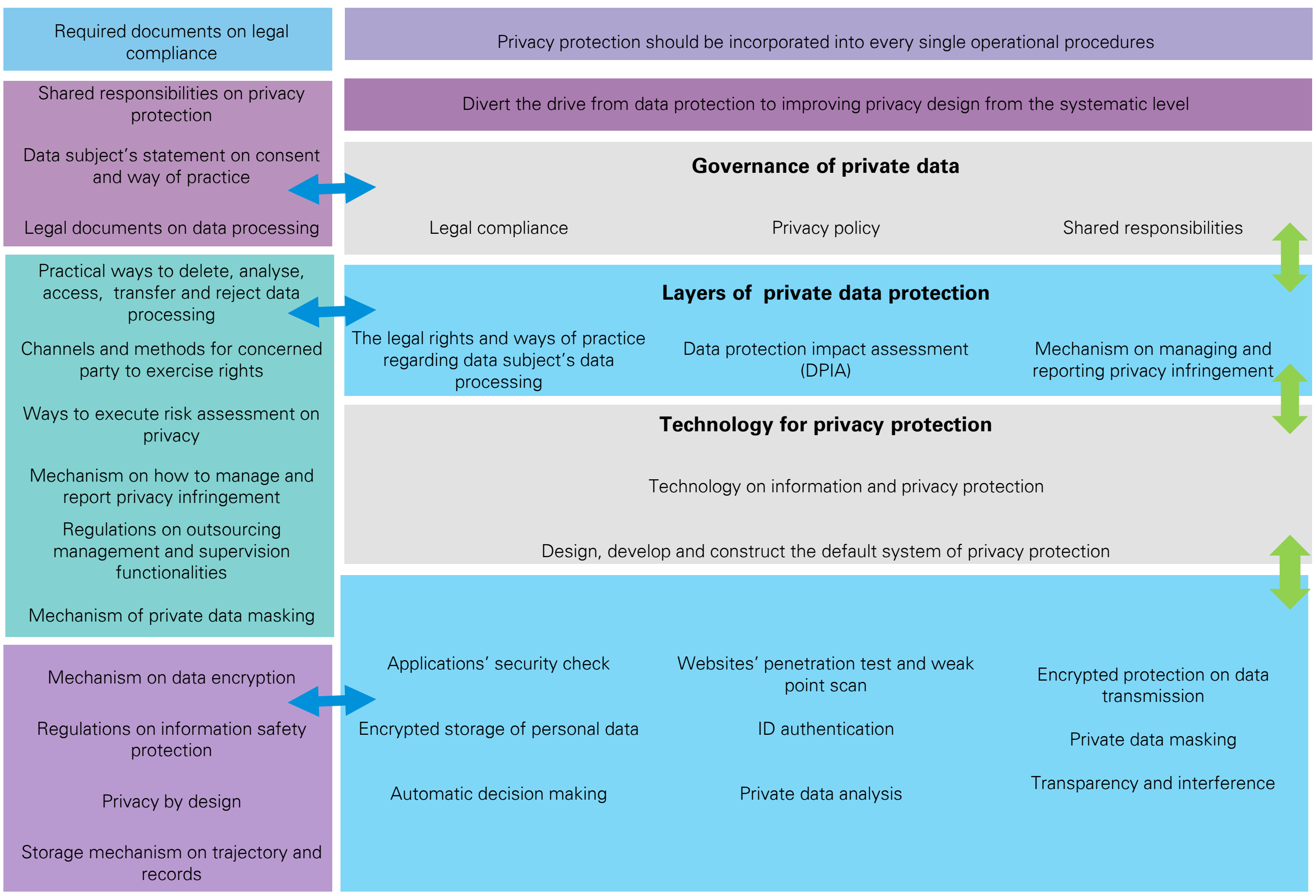
[26] White Paper on Digital Economy, Tencent Institute and Institute of Electronic Science and Technology Information, Ministry of Industry and Information Technology, March 2017

4. Recommendations on establishing an effective personal data protection system[27]

1. **Establish an efficient personal information inventory method.** Efficient inventory would enable companies to have better knowledge of its processed personal data to conduct targeted data risk assessment in order to comply with GDPR's regulations on personal information processing.
2. **Improve system's privacy design in response to the new data subject rights.** The only way to quickly respond to (within one month) data subject's request on data access, data erasure as well as data portability is to take into account of improving privacy design and technology in system upgrade.
3. **Establish a personal data risk assessment and control system.** KPMG's survey[28] of customer sensitivity to data privacy shows that people have fundamentally different expectations over the types of data privacy they enjoy. Companies should establish a system that incorporates individual preferences over data risk and control, and classifies personal information inventory accordingly.

STEP 1 Analyze individuals data types and sensitivity levels	**STEP 2** Investigate internal and external procedures of data processing	**STEP 3** Identify potential weak points that may trigger internet hacks	**STEP 4** Decide the types of security technology to adopt

From the aspects of legal compliance, information security and personal data processing compliance, a personal data protection management framework should be established as shown below:



[27] Ready for GDPR?, KPMG，https://home.kpmg.com/xx/en/home/insights/2017/07/ready-for-gdpr.html
[28] Crossing the Line，KPMG，https://home.kpmg.com/xx/en/home/insights/2016/11/crossing-the-line.html

4. **Noncompliant incidence management.** Only a robust incidence management processes will enable the companies to report a breach to the regulators within the 72 hour timeframe.
5. **Third party diligence and contracts.** To include explicit privacy clauses in contracts, a retention period and the right to audit. To conduct periodic system examination of the third party. According to the KPMG & Legal 500 survey, the vast majority of companies worldwide did not examine the risks posed by third parties as their supply chain. Only 10% of the respondents examined the compliance of their third parties to GDPR standards.
6. **Personnel training.** Staff should be well aware of the impact of GDPR and have a shift of awareness on the importance of data protection. High risk areas like HR and marketing should have focused training.
7. **Evaluate the feasibility to set up a DPO.** DPO's main responsibilities include serving as a communication channel among the company, regulators and consumers, and making sure the company's GDPR compliance over personal information protection. Companies should ensure DPO's independence in performing the duties[29]。

KPMG can provide companies with a set of GDPR compliance related services, including advisory services over compliance, realization of data subject rights system, data masking, and personnel training etc.:

Fig30. List of services that KPMG offers on GDPR

Some GDPR clauses remain ambiguous. For example, the definition of "reasonable" as the standard is not completely clear. How could companies achieve GDPR compliance without an official interpretation of the GDPR and legal precedents; is there a standard system to measure companies' information security system and ensure they are up to par? KPMG believes adopting well-known frameworks such as ISO/IEC 27001 or Cyber Essentials will help with implementing proper information protection measures. KPMG has summarized some standards for ISO/IEC information protection, in Table 6[30].

---

[29] KPMG : Chinese enterprises may consider setting up a DPO, China Trade News, May 2018
[30] KPMG: In response to GDPR, Taiwan's high-tech industry is making a move after customer request, iThome Security, March 2018

Table 6 ISO/IEC Partial Certification Standards

ISO/IEC certification standard	Content
ISO/IEC 29151	Relevant risk and impact assessment requirements on identifiable personal information protection
ISO/IEC 29134	Guide on Privacy Impact Assessment
ISO/IEC 27001 edition	Requirements on Information Security Management System
ISO/IEC 27002 edition	Operational Specifications on Information Security Control
ISO/IEC 27017	Information Security Control Specifications on Cloud Services
ISO/IEC 27035 edition	Incident Management

Source: ISO, KPMG analysis

In addition to GDPR issued by the EU, the US, Australia, Singapore, the United Kingdom and other countries and regions [31] also have detailed regulations on data breaches, especially on personal information leakage, for example, the Security Disclosure Notice Act of California from 2002 and Australia's 1988 Privacy Act, etc. At present, China's legislative framework on personal information is composed of "Internet Security Law of the People's Republic of China" and the "Information Security Technology - Personal Information Security Specification" issued by the National Information Security Standardization Technical Committee (GB/T 35273-2017). Recent revisions of the relevant regulations pushed China's legislation on personal information protection towards the EU's GDPR standards. For example, China passed the "Network Security Law of the People's Republic of China" in 2016, the same year as GDPR was adopted in the EU. The National Information Security Standardization Technical Committee of China also issued the "Guidelines for Cyber Security Practices - EU GDPR Concerns" when GDPR entered into force, in which suggestions are provided regarding the application of GDPR. In the long run, Chinese companies will need to establish a personal information protection system in reference to GDPR regulations regardless of whether their businesses involves the EU. GDPR compliance will help Chinese companies to be more competitive in facing the development of data security supervision in the future as well as in the international market.

[31] China Information and Communication Research Institute: International Experience regarding Data Breach Notification System, China Information Security, April 2018

Appendix: Key indicators

	Indicator	Unit	2016	2017	2018					
			Annual	Annual	January	February	March	April	May	June
Economic activity	GDP	Trillion RMB	74.4	82.7	19.9			22.0		
		% YOY	6.7	6.9	6.8			6.7		
	Industrial production	% YOY	6.0	6.6	15.4	-2.1	6.0	7.0	6.8	6.0
	Industrial profit	% YOY YTD	8.5	21.0	16.1		11.6	15.0	16.5	17.2
	Retail sales	% YOY	10.4	10.2	9.7		10.1	9.4	8.5	9.0
	Fixed asset investment	% YOY YTD	8.1	7.2	7.9		7.5	7.0	6.1	6.0
	Property starts	% YOY YTD	8.1	7.0	2.9		9.7	7.3	10.8	11.8
	Property sales	% YOY YTD	22.5	7.7	4.1		3.6	1.3	2.9	3.3
	Land purchases	% YOY YTD	-3.4	15.8	-1.2		0.5	-2.1	2.1	7.2
	Manufacturing PMI	Index	50.3	51.6	51.3	50.3	51.5	51.4	51.9	51.5
International trade and investments	Exports	% YOY	-7.7	7.9	10.6	43.5	-3.0	12.1	12.1	11.2
	Imports	% YOY	-5.5	16.1	37.3	6.4	14.5	21.7	26.0	14.1
	Trade balance	USD billion	509.7	419.6	18.7	32.4	-5.5	27.4	24.1	41.5
	Foreign direct investment (FDI)	USD billion	126.0	131.0	12.1	9.0	13.5	9.1	9.1	15.7
	Outbound direct investment (ODI)	USD billion	170.1	120.1	10.8	6.0	8.7	10.1	12.3	9.3
Financial market	RMB exchange rate	USD/RMB	6.64	6.75	6.44	6.32	6.32	6.30	6.38	6.46
	RMB real effective exchange rate	Index	124.4	120.6	122.6	127.6	125.9	126.3	127.2	126.4
	Shanghai Composite Index (Period end)	Index	3104	3307	3480.8	3259.4	3168.9	3082.2	3095.5	2847.4
	Money supply (M2)	% YOY	11.3	8.1	8.6	8.8	8.2	8.3	8.3	8.0
	Stock of Total Social Financing (TSF)	% YOY	12.8	12.0	11.3	11.2	10.5	10.5	10.3	9.8
	New TSF	RMB billion	17802	19440	3055	1165	1349	1582	764	1182
	New bank loans	RMB billion	12646	13523	2900	839	1120	1180	1150	1840
	Shibor (overnight)	%	2.07	2.63	2.65	2.59	2.61	2.65	2.61	2.57
Price	Consumer price index (CPI)	% YOY	2.0	1.6	1.5	2.9	2.1	1.8	1.8	1.9
	Produce price index (PPI)	% YOY	-1.4	6.3	4.3	3.7	3.1	3.4	4.1	4.7
	Crude oil (WTI)	USD/barrel	43.5	50.9	63.7	62.2	62.8	66.3	69.8	67.3
	Steel (rebar)	RMB/ ton	2476	3878	4052	4104	3956	3858	4065	4097
	Housing price index (70 cities)	% YOY	6.4	8.5	5.4	5.8	5.5	5.3	5.4	5.8

Source: KPMG analysis

Contact Us

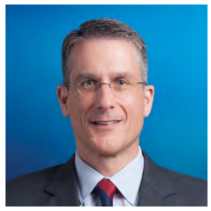
Jacky Zou
Senior Partner, Northern Region
KPMG China
+86 (10) 85087038
jacky.zou@kpmg.com

William Gong
Senior Partner, Eastern & Western Region, KPMG China
+86 (21) 22122999
william.gong@kpmg.com

Ronald Sze
Senior Partner, Southern Region
KPMG China
+86 (20) 38138810
ronald.sze@kpmg.com

Andrew Weir
Senior Partner, Hong Kong
KPMG China
+852 28267243
andrew.weir@kpmg.com

Raymond Ng
Head of Markets
KPMG China
+86 (10) 85087067
raymond.kk.ng@kpmg.com



Thomas Stanley
COO of Markets
KPMG China
+86 (21) 22123884
thomas.stanley@kpmg.com

Kevin Kang
Chief Economist
KPMG China
+86 (10) 85087198
k.kang@kpmg.com

For GDPR and cyber security risk consulting services, please contact:

Henry Shek
Partner, IT Advisory
KPMG China
+852 2522 6022
henry.shek@kpmg.com

Richard Zhang
Partner, IT Advisory
KPMG China
+86(21)22122888
richard.zhang@kpmg.com

- Thanks to Wayne Li, Wei Wang, Lorna Meng, Amon Yang, Abby Zheng, Lynne Li (Design) for their contributions to this report.

kpmg.com/cn/socialmedia

For a list of KPMG China offices, please scan the QR code or visit our website: https://home.kpmg.com/cn/en/home/about/offices.html.

Publication number: EN-GCP18-0003

Publication date: August 2018