

Economic Watch

China

Hong Kong, July 17, 2012
Economic Analysis

Asia

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As RMB internationalization advances, new headwinds call for policy steps

This note is an update of our seminal report on China's RMB Cross-Border Settlement program issued last year ([Origins, Mechanics, and Opportunities](#)). In addition to assessing progress in deepening cross-border settlements and the offshore RMB market, we flag a number of policy suggestions for advancing the process of RMB internationalization.

- **Since its inception in 2009, China's program of RMB cross-border trade settlement has been successful in raising the profile of the RMB in international transactions.**

In Q2 2012, cross-border trade transactions settled in RMB amounted to 10.9% of China's trade, up from almost zero when the program began. At the same time, the offshore RMB (CNH) market has expanded rapidly across a number of financial products, including spot FX, deliverable forwards, swaps, deposits and CDs, as well as bond and other structured products. Issuance of RMB-denominated "Dim Sum" bonds in particular has grown rapidly.

- **Despite the overall success, however, RMB internationalization has recently encountered headwinds.**

After increasing steadily through mid-2011, the share of cross-border trade settled in RMB has slowed more recently, and RMB deposits in Hong Kong have fallen. These headwinds are largely due to weaker appreciation expectations. The slowdown, however, masks two underlying trends. First, RMB trade settlements, which were previously undertaken primarily by Chinese importers, have broadened to Chinese exporters, resulting in a 60/40 split respectively (from 80/20 through the first half of 2011). Second, the geographical distribution of RMB trade settlements has expanded. These are healthy developments for the continued expansion of the use of the currency in international trade over the longer term.

- **Growth of the market is being facilitated by policy initiatives.**

Due to the lack of full convertibility, and in contrast to the development of the world's existing reserve currencies which developed as part of a market-driven process, internationalization of the RMB is still very much a policy-driven process. In addition to the expansion of the original pilot program to all enterprises and regions, positive steps have been taken to allow greater remittance of offshore RMB for use in the Mainland. Also, offshore liquidity has been enhanced through new bilateral currency swap agreements with more trading partner countries. In Hong Kong an RMB liquidity facility has been introduced between banks and the HKMA, and regulations have been relaxed to accelerate the growth of the RMB market.

- **Maintaining growth momentum of the offshore RMB market will require further supporting measures.**

In our view, these measures should address the following areas: i) more favorable treatment of transactions denominated in RMB (e.g., preferential tax treatment); ii) allowing direct trading of the RMB against other currencies to reduce transactions costs; (iii) further developing the RMB market in Hong Kong and expanding the pool of offshore RMB liquidity; and iv) broadening RMB investment channels to the Mainland.

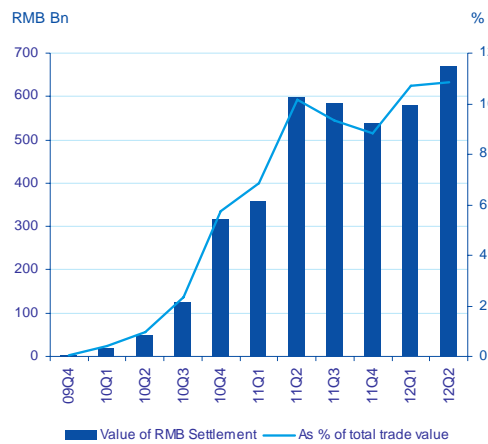
RMB-denominated cross-border trade slows on weaker appreciation expectations

After increasing sharply through mid-2011, the share of cross-border trade settled in RMB has more recently slowed (Chart 1). This has occurred despite an expansion over the past year in the domestic scope of the existing pilot program for RMB settlements, from 80% of domestic importers and exports (spread over 20 municipalities/provinces) to all of them. In the meantime, Hong Kong continues to enjoy a position as the premier RMB business center, with around 80% of total RMB invoiced trades being settled through Hong Kong's banking system.

The slowdown in the overall volume of RMB trade settlements, however, masks two important underlying trends. First, the balance of RMB trade settlements between domestic importers and exporters has become more even. In particular, whereas around 80% of RMB trade settlements in 2010 were due to activities of domestic importers (remitting RMB for payment to offshore companies), that share had fallen to around 60% in 2011. The reason for this shift, and the key factor for the overall stagnation in the growth of RMB-denominated trade flows, is most likely due to weaker RMB appreciation expectations, in part owing to China's narrowing current account surplus (Charts 2 and 3). This has deterred offshore exporters from accepting payment in RMB and, at the same time, has increased the incentives for offshore importers to pay in RMB.

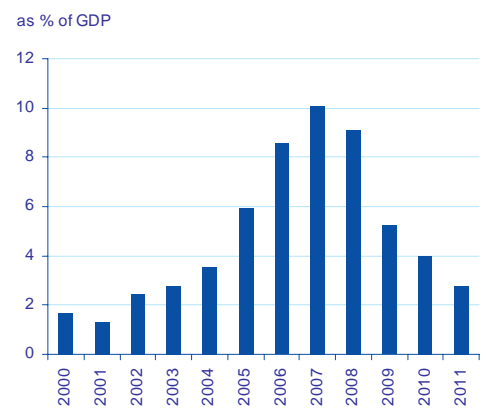
A second trend is a broadening of the geographical distribution of RMB trade settlements (Chart 4) In particular, the cumulative share of RMB cross-border trade settlements with companies outside of Hong Kong increased from around 25% at end-2010 to around 36% as of end-2011. This implies that the RMB as an invoicing currency may be gradually gaining acceptance.

Chart 1
The growth of RMB trade settlements has slowed



Source: CEIC and BBVA Research

Chart 2
China's current account surplus has narrowed



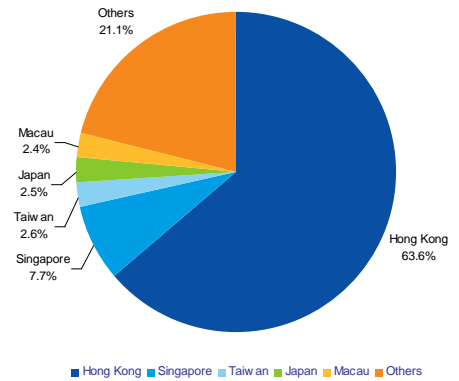
Source: CEIC and BBVA Research

Chart 3
Appreciation expectations have diminished



Source: Bloomberg and BBVA Research

Chart 4
Geographical distribution of RMB settled trades (as of end-January 2012)



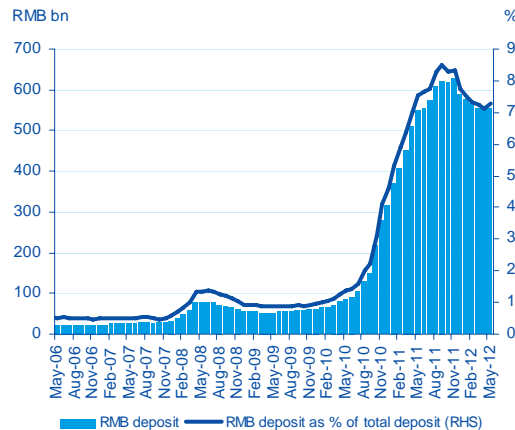
Source: PBoC and BBVA Research

Offshore RMB businesses continues to expand

Despite some flattening in the growth of RMB trade settlements, offshore RMB business continues to expand given the increasing attractiveness of RMB investment opportunities. As the “designated” premier offshore RMB center, Hong Kong has been a particular beneficiary of this business. At the same time, however, the offshore market has expanded in a number of financial centers, including Singapore, London, and Tokyo among others, each of which may develop its own particular segments and market niches (see below).

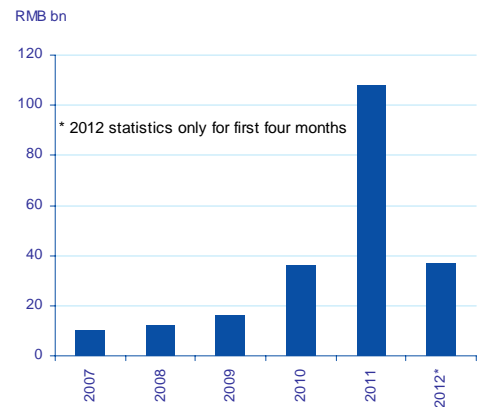
A growing pool of offshore RMB liquidity has fueled the growth of the “CNH” offshore market along side the traditional onshore CNY market. Market growth had been led by an increase in RMB deposits in Hong Kong, which peaked at RMB 627 billion in November 2011, equivalent to around 10% of Hong Kong’s total deposit base (Chart 5), before declining in recent months due to lower appreciation expectations. To date, the CNH market encompasses a range of financial products including spot FX, deliverable forwards, swaps, deposits and CDs, as well as bonds, and other structured products.

Chart 5
RMB deposits in Hong Kong rose rapidly through mid-2011, but have since diminished



Source: CEIC and BBVA Research

Chart 6
The Issuances of Dim Sum Bonds



Source: Bloomberg and BBVA Research

Despite a recent decline in RMB deposits in Hong Kong, the offshore RMB bond market (the so-called “Dim Sum” market) has continued to thrive, especially following efforts by the authorities to permit a more regular inflow of RMB funds for FDI purposes in the Mainland. As an example of the growing popularity of the instruments, a number of Dim Sum bonds and RMB-denominated notes are now listed on the Luxembourg stock exchange. In 2011 total issuance of Dim Sum bonds rose to RMB 108 billion, triple the figure of the previous year. At the same time, the composition of Dim Sum bond issuers has become more diversified (Chart 6). More recently, however, new issuance has slowed down due to lower appreciation expectations as well as the deteriorating global environment and heightened risk aversion.

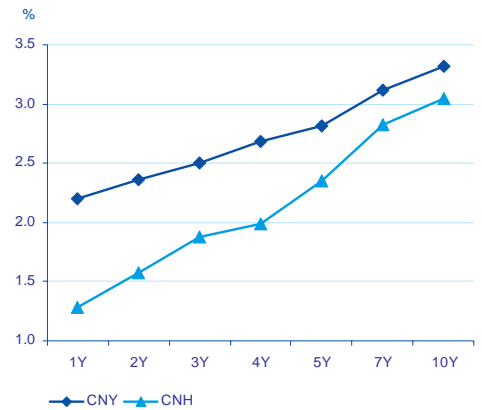
In addition to bonds, other forms of RMB-denominated assets available in Hong Kong have expanded (Chart 7). In April 2011, the first RMB-denominated IPO outside the Mainland was issued on Hong Kong’s stock exchange (Hui Xian Real Estate Investment Trust, for RMB 10.5 billion). However, demand for the new issue was disappointing, and the market remains very small. Of greater significance is an expansion in the offshore RMB loan market. According to the HKMA, offshore RMB loans in Hong Kong increased to RMB 42 billion in Q1 2012 from less than RMB 2 billion at end-2010. Most of the funds being raised in the offshore loan market are for FDI into the Mainland. Given that the Hong Kong market still has an RMB funding cost advantage (Chart 8), there may be further potential for the loan market to expand.

Chart 7
Offshore RMB-denominated assets



Source: CEIC and BBVA Research

Chart 8
The yield curve in offshore market is below its onshore counterpart



Source: Bloomberg and BBVA Research

Increasing competition for RMB business among leading financial centers

Offshore RMB business has attracted the attention of a number of financial centers other than Hong Kong. Despite Hong Kong’s existing advantages (such as the large share of transshipment through its borders, economic integration with China, and policy initiatives by the Chinese authorities to promote its financial system as the premier offshore RMB trading center), other financial centers are competing for market share, especially London, Singapore and even Taipei. For the time being, London has a relative advantage as an alternative to Hong Kong given its role as a leading center for currency activity; among other things, London enjoys a time zone advantage, enabling it to serve settlements and trading demand in Europe and America. By end-2011, RMB deposits in London had risen to RMB 36 billion, albeit still well below Hong Kong. Singapore also has potential to expand its RMB business via its

proximity to other ASEAN countries and its strong financial infrastructure. Finally, Taiwan is well placed to develop an offshore RMB market to serve its large local demand. (See our working paper [RMB Internationalization: What is in it for Taiwan?](#)). Taiwan's economic ties with China, including in trade and FDI (being strengthened through the Economic Cooperation Framework Agreement in place since 2010), make it a natural candidate to expand RMB business.

With a number of financial centers now vying for a place as a prominent offshore RMB center, an emerging issue is the kind of relationship that may develop among them. We would expect Hong Kong to retain an edge over other competitors due to its proximity and special relationship with the Mainland. Moreover, Hong Kong has a "first-mover" advantage, given the development of its offshore RMB market and its associated market depth and financial infrastructure. Rather than losing out to competitors, we believe it is more likely that Hong Kong will develop as "the center of offshore RMB centers", and in so doing, act as a "wholesale" player in products and services for other offshore RMB business hubs as they, in turn, provide services for their local clients.

That said, other offshore RMB centers may well give Hong Kong a run for its money by establishing unique advantages of their own and competing in niche markets. Singapore, for example, recently announced plans to list, quote, trade, clear and settle securities denominated in RMB. In particular, the Singapore exchange (SGX) would provide issuers with the option to offer 'dual currency' trading to enable investors to trade such securities in either RMB or Singapore dollars. The SGX is also expected to become the world's first exchange to offer the clearing of OTC FX forwards for RMB.

RMB is gradually gaining international acceptance

The RMB has also made further advances toward becoming an eventual reserve currency, although the process will take time. Several central banks have recently expressed an interest in holding RMB to diversify their foreign reserves. In this regard, a number of them, including in Hong Kong, Japan, South Korea and Malaysia have sought to invest in China's domestic bond market. At the same time, discussions have begun about the possibility of including the RMB in the basket of the IMF's Special Drawing Rights (SDR). Although the RMB's inclusion in the SDR is still a long way off - among other things, to qualify the RMB would need to be fully convertible - the discussions themselves are evidence of the growing acceptance of the currency in the international financial world.

As another sign of the expanding use of the RMB, the Taiwanese authorities' in early July announced that domestic companies can now issue RMB bonds directly in overseas markets, rather than through their offshore subsidiaries.

RMB internationalization is a policy-driven process

In contrast to the development of the world's existing reserve currencies which evolved as part of a market-driven process, internationalization of the RMB is still very much a policy-driven process. This is mainly due to the lack of full convertibility of the RMB.

Beyond expanding the domestic scope of the original trade settlement Pilot Program, the thrust of the authorities' efforts is to facilitate repatriation of offshore funds to the Mainland in order to enhance the attractiveness of holding RMB. The authorities are also improving the institutional capacity for RMB internationalization through bilateral currency swap agreements with an increasing number of countries and advancing with the direct trading of the RMB against other currencies.

With respect to enhancing the attractiveness of offshore RMB, the authorities have progressively facilitated flows between the onshore and offshore markets by relaxing capital account restrictions. Such initiatives include: i) allowing RMB denominated FDI and OFDI (March 2012); ii) launching and expansion of an "RQFII program" to permit RMB-denominated investment into China's securities markets; and iii) opening the domestic inter-bank bond market to specific foreign institutional investors including a number of central banks. Although

most of these initiatives are still subject to limitations and quotas, they have helped to enhance the liquidity of the offshore RMB market and broaden the investment use of the offshore RMB (Table 1).

China's government has also sought to lay an institutional foundation for RMB internationalization through the establishment of bilateral currency swap agreements with trading partner countries, totaling 17 at present (Table 2). Since the beginning of 2011, China has signed such agreements with 9 countries worth RMB 355.7 billion (about US\$56 billion). In addition, China has renewed and expanded its swap agreements with Hong Kong and South Korea to RMB 400 billion and RMB 360 billion respectively. (The PBoC has acknowledged that some of the swap lines have been utilized, although it has not revealed any figures.)

Lastly, the expanding ability to trade RMB directly against other currencies has, at the margin, facilitated the use of the RMB in bilateral trade flows. Rather than opening new channels per se for RMB trade settlement, allowing direct trading against other currencies has reduced spreads and fees, and thereby reduced the cost of transacting in RMB. In 2011, a number of pilot regions were established to enable direct foreign exchange trading between the RMB and other currencies (Table 3). Significantly, China and Japan have agreed to launch direct trading of the RMB and Yen, effective from June 2012, which is expected to further increase the usage of the RMB in the Sino-Japan bilateral trade.

Development of the offshore RMB business is, of course, subject to financial regulations of the Hong Kong authorities. In this regard, a number of steps have been taken so far this year to ease restrictions to facilitate growth of the market:

- *RMB net open position limits (NOP)*: the NOP was increased from 10% to 20% in January 2012, and then made more flexible in May. (The NOP set limits on the difference between on-balance RMB assets and liabilities) The new flexibility allows banks to set their own internal RMB NOP limits above 20% in consultation with the HKMA, "appropriate for the scale and nature of their business."
- *RMB liquidity limits (RMB risk management limit)*: in June 2012 the "RMB liquidity limit" was replaced with a more flexible "RMB liquidity ratio" of 25% calculated on the same basis as the statutory liquidity ratio, which expands the range of permissible assets that can be held against the liquidity requirement. Previously, banks were required to hold at least 25% of their RMB deposits as cash (held in their settlement account balance with the RMB Clearing Bank).
- *RMB liquidity facility*: in June 2012 the HKMA introduced a facility to provide RMB liquidity to banks, by drawing on the swap arrangement with the PBoC. The facility is intended alleviate possible short-term RMB liquidity shortages, and "to support the continuous deepening of the RMB capital market in Hong Kong and to reinforce Hong Kong's role as the global hub for offshore RMB business." Under the facility, banks can borrow RMB on a one-week basis from the HKMA against eligible collateral.

However, RMB internationalization has encountered headwinds

After a stellar take-off in the past couple of years, the further development of the offshore RMB market and RMB internationalization have encountered headwinds. As noted above, the most apparent is a decline of RMB deposits in Hong Kong over the past 5-6 months.

A number of factors might explain the decline, all relating to reduced appreciation expectations of the currency. First, a more even balance in RMB-related trade flows has slowed the pace of RMB outflows to the offshore market. The latest statistics show that the ratio of RMB trade value in exports to that in imports declined to 1:1.7 in 2011 from 1:5.5 in 2010. As such, we estimate that around RMB 540 billion flowed out to the offshore market in 2011 through the trade settlement channel, representing a 13% increase over the previous year even though the total value of RMB settled trade transactions over the same time tripled over the same time period.

Second, the rise of other offshore RMB hubs may have diverted deposit in Hong Kong. As discussed above, London accumulated deposits amounting to RMB 37 billion as of end-2011. Furthermore, more RMB-denominated investment instruments emerged outside Hong Kong, including the first Dim Sum bond issued in London last year.

Third, the gradual easing of capital account restrictions is enabling offshore RMB to flow back to the mainland more easily. Some of these channels are exclusive to Hong Kong, such as RQFII.

Such channels have led to competition among Hong Kong's banks for RMB liquidity, resulting in higher yields on RMB deposit instruments, although they are still below onshore interest rates. To alleviate such pressures, the HKMA has taken steps to allow banks to tap its currency swap line with the PBoC so as to perform the role of the lender of last resort in the offshore RMB market.

Policies to advance RMB internationalization amidst the headwinds

Weaker appreciation expectations for the RMB have brought new challenges to the internationalization of the currency. This places a premium on the authorities' policy initiatives to sustain the momentum of RMB internationalization. The following steps would be useful:

- *Preferential treatment for using the RMB as an invoicing currency in cross-border trade transactions and investment.* For example, certain imports denominated in RMB could be subject to favorable tax treatment. Procedures to simplify settling trade in RMB and integrating RMB clearing mechanisms would also be useful.
- *Direct trading of RMB against other currencies, especially with ASEAN trading partners, South Korea and Taiwan.* This would expand the market further by reducing currency conversion costs. The authorities could also establish more bilateral currency swap lines in order to ensure sufficient RMB liquidity in the direct trading currency markets.
- *Further develop the RMB market in Hong Kong and expand the pool of offshore RMB liquidity.* In this respect, over time the authorities can increase the limit on individuals' day-to-day RMB conversion and other RMB limits and quotas. However, in the current environment of reduced appreciation expectations and falling RMB deposits, now may not be the right time to increase conversion limits as it could accelerate the outflow of RMB deposits.
- *Broaden RMB investment channels.* Facilitating the flow of RMB to the mainland remains a key element to enhance the attractiveness of holding RMB offshore. The authorities may need to relax part of restrictions under capital account as well as increase the existing quotas imposed on some relevant pilot programs. For example, the RQFII quota can be increased and more China's onshore enterprises should be allowed to issue dim sum bonds in the offshore market.
- *Expand the possibilities of outward RMB investment from China.* The authorities could introduce an "RQDII" scheme, allowing qualified institutional investors in China to invest offshore using RMB-denominated funds, with the ultimate assets held in either RMB or another currency. In either case, such a move would increase the offshore pool of RMB liquidity.

Table 1. Policy initiatives to advance RMB internationalization

| Date | Policy Initiatives |
|-----------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 2011 Jan | PBoC released the "Administrative Measures for the Pilot RMB Settlement of Outward Direct Investment (ODI)", which is a guideline for the financial institutions to conduct cross-border settlement of ODI in RMB. |
| 2011 Apr | Hui Xian ,a real estate investment trust (REIT) has raised RMB 10.48 bn and become the first RMB IPO outside mainland China. |
| 2011 Jul | The CME Group announced to launch new RMB futures contracts at the PBoC benchmark spot daily fixing rate. The CME also announced to allow investors to use RMB as collateral for trading futures since 2012. |
| 2011 Aug | The Vice Premier Li Keqiang visited Hong Kong and announced several measures to further enhances the role of the city as an offshore RMB center. New measures include expanding the pilot RMB trade settlement scheme to nationwide for the selected enterprises, allow foreign investors to buy mainland securities under RQFII program and support FDI with RMB legally obtained overseas back to mainland China etc. |
| 2011 Oct | Measures to allow RMB funds raised legitimately overseas to make foreign direct investments back to the mainland was promulgated under certain restrictions, aiming to promote the utilization of RMB in cross border trade and investment. |
| 2011 Dec | Measures to allow RMB Qualified Foreign Institutional Investors (RQFII) of fund management and securities companies to invest in domestic securities under certain quota were approved. |
| 2012 Mar | The pilot RMB trade settlement scheme was further expanded to all the import and export enterprises. |
| | A pilot program to allow foreign central banks, Hong Kong and Macau clearing banks and trade settlement banks to invest offshore RMB in the onshore interbank bond market, facilitating the yuan's repatriation mechanism. |
| 2012 Apr | Quotas for the RQFII investment was increased by RMB 50 billion. The qualified institutions were allowed to use the quota to issue RMB A-share ETF products listed in the HKEX. |
| 2012 June | HKMA unveiled a program for banks to tap into its swap line with the PBoC if they are in need of RMB liquidity. Moreover, HKMA relaxed limit regulation for RMB liquidity for banks. |
| 2012 July | China's authorities pledged to undertake new initiatives to encourage third-parties to conduct RMB trade settlement and investment through Hong Kong. Moreover, new preferential treatment will be applied to the offshore RMB long-term investment in domestic capital market, although the relevant details have not yet been released |

Table 2. Bilateral currency swap agreements between China and trading partners

| | Total Size | Effective Date | Expiration Date |
|-------------------|------------------------------|----------------|-----------------|
| China-Korea | 180 bn RMB/38 Tr Won | Dec-08 | Dec-11 |
| renewed | 360 bn RMB/64 Tr Won | Oct-11 | Oct-14 |
| China-Hong Kong | 200 bn RMB/227 bn HKD | Jan-09 | Jan-12 |
| renewed | 400 bn RMB/490 bn HKD | Nov-11 | Nov-14 |
| China-Malaysia | 80 bn RMB/40 bn MYR | Feb-09 | Feb-12 |
| renewed | 180 bn RMB/90 bn MYR | Feb-12 | Feb-15 |
| China- Belarus | 20 bn RMB/8 tr BYB | Mar-09 | Mar-12 |
| China-Indonesia | 100 bn RMB/ 175 tr Rupiah | Mar-09 | Mar-12 |
| China-Argentina | 70 bn RMB/ Equal Amount Peso | Mar-09 | Mar-12 |
| China-Iceland | 3.5 bn RMB/66 bn ISK | Jun-10 | Jun-13 |
| China-Singapore | 150 bn RMB/30 bn SGD | Jul-10 | Jul-13 |
| China-New Zealand | 25 bn RMB | Apr-11 | Apr-14 |
| China-Uzbekistan | 0.7 bn RMB | Apr-11 | Apr-14 |
| Mongolia | 5 bn RMB | May-11 | May-14 |
| expanded | 10 bn RMB | Mar-12 | May-14 |
| Kazakhstan | 7 bn RMB | Jun-11 | Jun-14 |
| Thailand | 70 bn RMB/ 320 bn THB | Dec-11 | Dec-14 |
| Pakistan | 10 bn RMB/140 bn PKR | Dec-11 | Dec-14 |
| UAE | 35 bn RMB/20 bn AED | Jan-12 | Jan-15 |
| Turkey | 10 bn RMB/3 bn TRY | Feb-12 | Feb-15 |
| Australia | 200 bn RMB/30 bn AUD | Mar-12 | Mar-15 |

Table 3 Direct currency trade between China and other countries

| Date | Province | Country | Currency | Details |
|----------|------------|------------|------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 2011 Jun | Yunnan | Laos | Lao Kip (LAK) | Direct exchange between RMB/LAK was provided by the Fudian bank in Kunming, capital of Yunnan province. |
| 2011 Jun | Xinjiang | Kazakhstan | Kazakhstan Tenge (KZT) | Direct exchange between RMB/KZT was provided by the BOC in Xinjiang province. |
| 2011 Jun | Guangxi | Vietnam | Vietnamese Dong (VND) | The China-ASEAN RMB clearance and settlement center was established by ICBC in Nanning, with a pilot program for direct exchange between RMB/VND. |
| 2011 Jul | Shandong | Korea | Korea Won (KRW) | Direct exchange between RMB/KRW was provided by selected banks to qualified clients in Qingdao. |
| 2011 Dec | Yunnan | Thailand | Thai Baht (THB) | Exchange between RMB/THB started to be offered by selected banks from Yunnan province in the interbank market, after the currency swap line was signed earlier between China and Thailand. Direct exchange between the two currencies was also provided. |
| 2012 Jun | Nationwide | Japan | Japanese Yen (JPY) | China and Japan announced to begin direct trading of RMB/JPY in Shanghai and Tokyo since June 2012. The JPY will thus become the second major currency (after the USD) to have a direct exchange rate against the yuan in the onshore market of China. |

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