China's Bond Connect: a new diversification

Overview and background

In the past decades, China's economy and government have been pushing ahead to further liberalize the Chinese financial sector, especially in terms of current trade tensions with the U.S.

China has been actively developing its capital markets and further opening-up to foreign investors aiming to connect Chinese capital markets with the rest of the world. Historically, China's influence in global bond markets has not been matched by its market size. Tight controls on forex conversion and cross-border capital flows have excluded the full participation of foreign investors. However, another milestone in the long-term liberalization process of the Chinese bond markets is marked by the launch of a mutual market access scheme, the Bond Connect Scheme (**Bond Connect**), between mainland China and Hong Kong in July 2017. Bond Connect, showing China's determination to gradually open up its market, holds significant opportunities for international market participants at an operational level by allowing overseas investors to invest in the Chinese onshore bond market in a much simplier and easier fashion than previous schemes established over the past years.

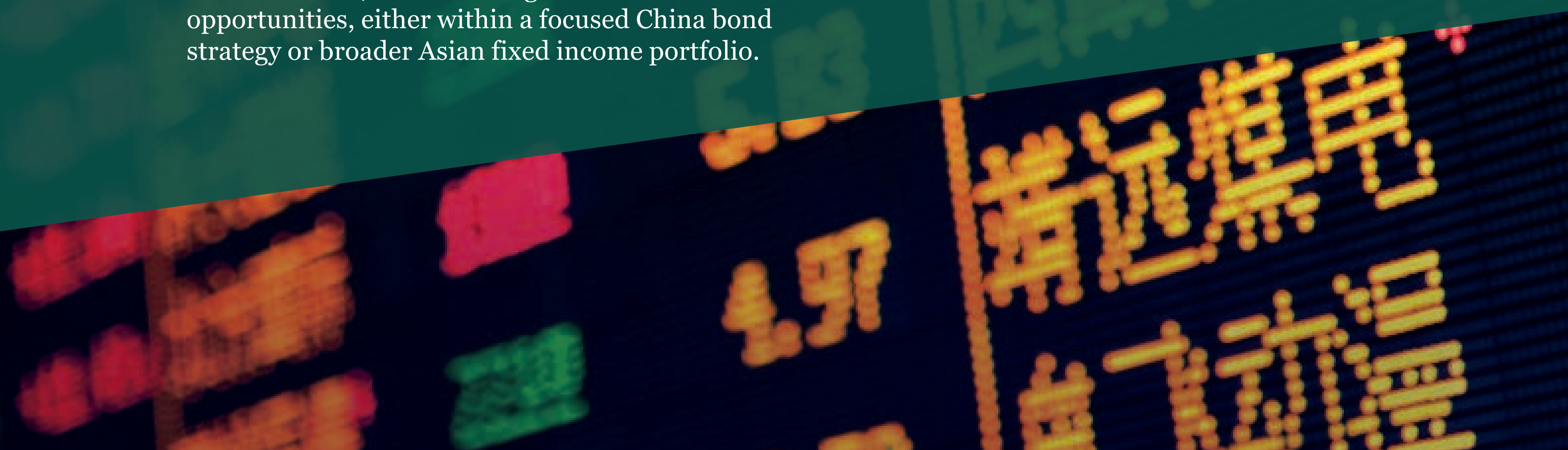
Bond Connect is designed to use familiar trading interfaces of established electronic platforms eliminating the requirement to register on the mainland. Hence, Bond Connect exemplifies one of the most accessible programmes to date, offering greater safeguards and cost effectiveness while allowing a more convenient access to the Chinese domestic bond market. We believe, given recent renminbi stabilization, investors should prepare for the continued evolution of Chinese debt markets by seeking access to Bond Connect. Indeed, Bond Connect may widen the appeal of China bonds, given greater currency stability and improved prospects for wider index inclusion of onshore bonds, while offering new diversification opportunities, either within a focused China bond strategy or broader Asian fixed income portfolio.

Scope of Bond Connect

Hence, Bond Connect is a mutual access scheme that allows non-PRC investors to access the mainland China bond markets (**Northbound Trading**) and will permit PRC investors to access the Hong Kong bond market (**Southbound Trading**) through market infrastructure linkages between mainland China and Hong Kong. Currently, only Northbound Trading is operational, allowing overseas investors to invest in bonds issued on the China Interbank Bond Market (**CIBM**) via mutual access trading, custody and settlement arrangements. Southbound Trading, whereby PRC investors will be able to invest in overseas bonds markets and therefore a form of outbound investment, will start at a later date, which is going to be determined by the PRC authorities in the event they feel 'conditions are ripe'. The delay in making Southbound Trading operational may be due to well-documented concerns about capital flight from China which has led to a raft of restrictions being imposed by various Chinese authorities on outbound investments by Chinese companies since the end of 2016.

Moreover, Bond Connect has fewer restrictions. Unlike previous schemes, there is no quota requirement, no minimum holding period, no repatriation restriction and no need for investors to identify the intended investment amount.

Despite speculations concerning "parallel trading" not being permitted under Bond Connect, meaning that foreign investors that already access the onshore bond market through Qualified Foreign Institutional Investors (**QFII**), RMB Qualfiied Foreign Instituional Investors (**RQFII**) and/or Foreign Institutional Investors (**FII**) routes may not be able to trade under Bond Connect, it becomes evident that this is not the case.



Prior to the launch of Bond Connect, foreign investors were required to go through an onerous process of submitting a qualification application, opening an account, applying for a RMB quota and finding a clearing agent with international settlement capacity. Now, Bond Connect allows investors to register, trade and settle using existing onshore infrastructure in China. Before trading on the CIBM, investors need to register as eligible foreign investors with the PBOC Shanghai Head Office first. No other formal approvals are required once registration is completed.

When it comes to rating agencies, it becomes clear that the rating environment is likely to change in the near future. Following the launch of Bond Connect, rating agencies have been given the 'green light' to rate Chinese domestic issuers and issues.

RDVP

Furthermore, Bond Connect has also fully implemented a new settlement system known as real-time delivery-versus-payment or RDVP. The process ensures that payment and delivery happen simultaneously; hence, it enables international investors to join the scheme and seek investment opportunities in China Interbank Bond Market.

Panda bond guidelines

Bond Connect has been a breakthrough for the Panda bond market. Falling yields in China and rising yields in e.g. the dollar market have seen the two markets converge further, making onshore China a less expensive borrowing option. However, the idiosyncratic nature of the Panda market and its convoluted rules mean we are now in a place where one company has issued the vast majority of outstanding bonds.

Panda bonds, which by their nature show China becoming more open to the world, could be another way in which China makes a symbolic concession to the White House. Panda bonds might be the best choice for foreign investors who seek exposure to yuan assets but are concerned about credit risk.

For certain foreign issuers, new guidelines concerning Panda bonds have made the issuance process simpler and more in line with international bond market practice. Like Bond Connect, the guidelines are intented to internationalize China's domestic bond market by aligning such market with the international bond market to attract international issuers to the Panda bond market. The guidelines codification of eligibility criteria and issuance requiremenets provide significant certainty for international issuers looking to tap the Panda bond market. For example, the German carmaker Daimler returned to the Panda market, pricing a dual-trancher, one and three year private placement bonds with coupons of 5.18% and 5.3%.

ABS market

The Chinese bond market is now the second largest in the world (only the U.S. market is larger), with an estimated US$12 trillion (June 2018). The ABS market has seen quick and diverse development in the past decade and has facilitated the development of Chinese capital market significantly. Through Bond Connect, overseas investors can invest in asset-backed medium term notes programmes backed by assets of Chinese companies.

Conclusion

In conclusion, the Bond Connect as a major financial development offers great opportunities to the savvy investor for several reasons, including the massive size of China's bond market, the huge potential for market growth, the diversity of issuers and the prospect that a more open market may lead to the inclusion of Chinese debt offering in global bond indices. Reasons for an involvement in China's onshore bond market are not only manifested in its sheer size and higher yields. There are also other unique features presented by this market. If managed properly, we believe China's onshore bonds provide global investors a potentially attractive option to diversify portfolio risks and enhance risk-adjusted returns. Low correlations with bonds in other markets offer global investors a market to diversify investment risks and reduce portfolio volatility.

The opening of the Mainland's bond market is conducive to improving the interest of foreign investors in RMB bonds, attracting overseas funds to Mainland's capital market, and promoting international and diversified development of the Mainland's financial market.

For further information please see our previous alerts on this topic:

- Investing in asset-backed notes through the Bond Connect scheme: a new channel to access the Chinese debt capital markets
- In black-and-white-letter law: China issues new Panda bond rules

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