A Closer Look at Bond Connect

Expert Insights from Asset Servicing Live Webcast Series

BNY Mellon hosted a live audio webcast, A Closer Look at Bond Connect in July. Magdalene Tay from BNY Mellon and industry experts from Bloomberg reviewed the scheme after passing its one year mark from its launch. They shared insights on the impending global bond indices Inclusion, the challenges and opportunities for foreign investors.

Since its launch on July 3, 2017, the Bond Connect scheme has drawn interest from offshore investors seeking to participate in the China Interbank Bond Market (CIBM) – the world's third-largest bond market with value over US$10 trillion[1]. Today, more than 300 foreign investors have registered and participated in the CIBM through Bond Connect and that number is expected to rise. China's onshore bond market has been growing at 20% year-on-year[2] with foreign holdings increasing among two of the most popular types: China government (72%) and policy bank bonds (26%)[3].

For investors, one notable development around the scheme has been the accelerated inclusion of China into major global bond indices. In March this year, it was announced that one of the most widely-used fixed income benchmarks, the Bloomberg Barclays Global Aggregate Index, would gradually phase in Chinese RMB-denominated government and policy bank securities over a 20-month period from April 2019[4].

Once added, RMB will be the fourth largest currency component (5.7%) of the Index. Currently, USD stands at the largest (41%), EUR at second (24%), followed by JPY (16%)[5]. Three other Bloomberg indices that will include China are the Asia Pacific Aggregate, Emerging Markets Local Government and the Emerging Markets Local Government with China Capped[6].

Post our webcast, three significant moves were announced to enhance the Bond Connect scheme, which have the potential to encourage participation and more maturity across the debt markets.

1. Implementation of delivery: On August 24, China implemented a true delivery-versus-payment (DVP) settlement system for transactions through Bond Connect. Under this settlement, payment for bonds is due at the time of delivery, which effectively reduces settlement risk.
2. Block trade allocation: On August 31, Bond Connect launched the service of block trade allocations, which allows foreign investors to allocate block trades across accounts prior to the trades[7]. With the pre-trade allocations function going live effective September 3, traders can execute a single block trade (in one electronic request) and allocate specific percentages or absolute amounts of the trade to maximum 30 individual accounts. The block trade facility is available on the TradeWeb platform.
3. Taxation: The State Council of People's Republic of China announced that coupon interest income received by foreign institutional investors in China bond market will temporarily be exempted from corporate income tax (CIT) and value added tax (VAT) for three years[8].

Similar to the impact of Stock Connect being included into MSCI indices[9], the Bond Connect could help to draw meaningful inflows to the onshore market in the long term. As more global investors include Chinese bonds to their portfolios, it will be especially important to watch the transformation this will bring to key bond indices and the overall debt market in China.

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[1] Figure mentioned during webcast introduction
[2] https://www.bnymellon.com/apac/en/_locale-assets/pdf/our-thinking/untying-chinas-gordian-knot.pdf
[3] Presentation: BNY Mellon slide 8
[4] https://www.bloomberg.com/company/announcements/bloomberg-add-china-bloomberg-barclays-global-aggregate-indices/
[5] Presentation: Bloomberg slide 18
[6] Presentation: Bloomberg slide 12
[7] http://www.chinabondconnect.com/documents/News2018-08-30EN-Allocation.pdf
[8] https://www.bloomberg.com/news/articles/2018-08-30/china-plans-tax-cuts-for-foreign-bond-investors-to-aid-growth
[9] https://www.bnymellon.com/apac/en/_locale-assets/pdf/our-thinking/stock-connect-charting-a-future-course.pdf

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