



Untying China's Gordian Knot

New Horizons: Up close with the China Bond Market

“

The evolution of China's credit market in the past fifteen years has been truly game changing, akin to unlocking the markets with a series of measured steps which will ultimately result in greater capital inflows. The direct CIBM scheme is China's Gordian Knot moment.

”

Mathew Kathayanat
Director APAC Product Management
BNY Mellon

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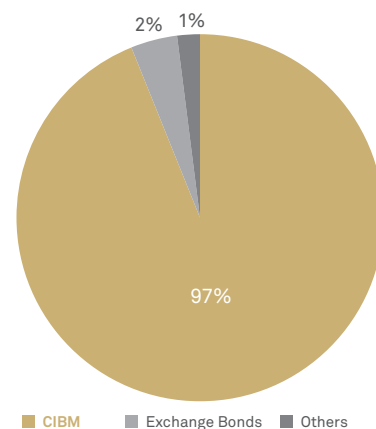
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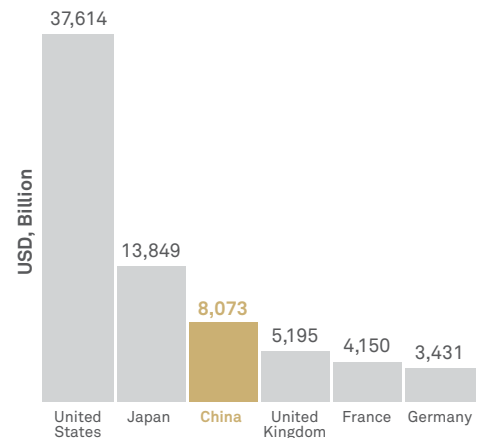
Earlier last year, China's Central Bank, the People's Bank of China (PBOC), introduced the direct route for foreign investors to access the China Interbank Bond Market (CIBM). CIBM accounts for over 90% of the onshore bond market in China (See Figure 1) and this provides foreign investors access to the third largest bond market in the world after the United States and Japan. (See Figure 2)

Figure 1:
Onshore Bond Market in China



Source: China Central Depository & Clearing Co., Ltd (www.chinabond.com.cn); data as of December 2016

Figure 2:
Domestic Debt Market Size by Country



Source: World Federation of Exchanges; data as of December 2016



ABOUT CIBM



CIBM REPRESENTS OVER
90%
OF THE ONSHORE
BOND MARKET ¹



CHINA ONSHORE
BOND MARKET HAS
BEEN GROWING
20%
YOY ²



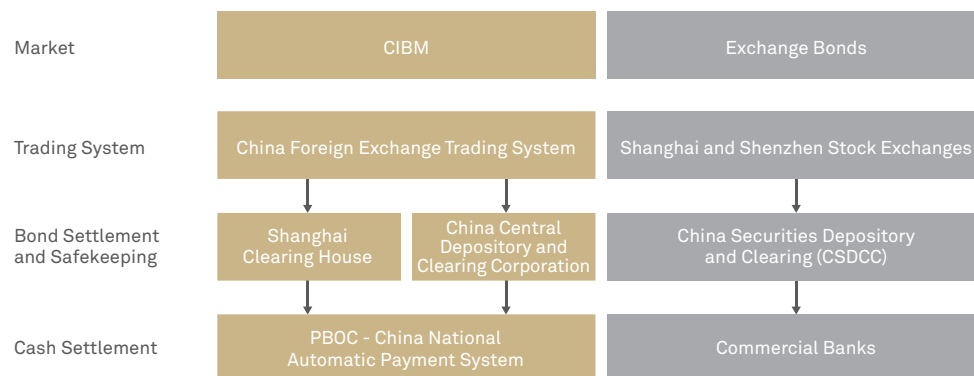
CHINA IS THE
3rd
LARGEST BOND MARKET
IN THE WORLD ³

Please see endnotes on last page

The Lure of China's Bond Market

The onshore bond market is predominantly made up of the CIBM and the exchange bond market.¹ The CIBM is the over-the counter (OTC) market and is regulated by the PBOC. The exchange bond market refers to bonds listed and traded on the two main stock exchanges, the Shanghai and Shenzhen Stock Exchanges. Figure 3 below illustrates the China bond market structure.

Figure 3: China Onshore Bond Market Structure

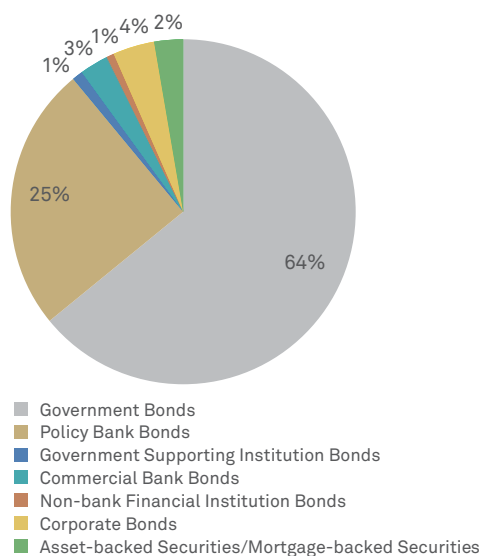


Source: China Central Depository & Clearing Co., Ltd (www.chinabond.com.cn)

Government bonds and policy bank bonds which are issued in CIBM represent 89% of CIBM distribution volume. Corporate bonds with 4% CIBM distribution volume is a rapidly growing market in recent years (See Figure 4). As of January 2017, policy bank bonds constitute over 30% of the total trading volume in the China interbank market, followed by certificate of deposit (See Figure 5).

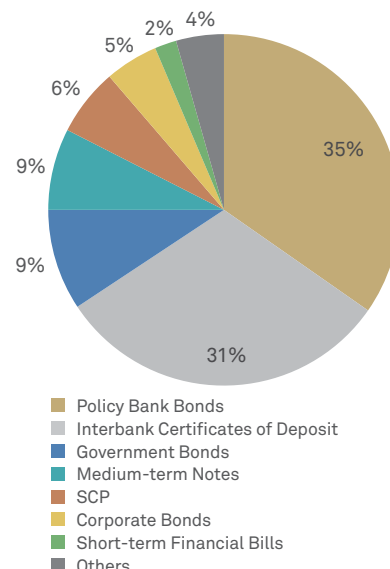
The size and dynamics of CIBM offer opportunities for global investors to diversify their investment portfolios. "It is a market very much sought after by fund managers who are interested to increase their China allocation by accessing onshore RMB fixed income securities and at the same time benefit from the relatively higher yield which they are producing." says Stéphane Karolczuk, Partner and Head of the Hong Kong office at Arendt & Medernach.*

Figure 4: CIBM Distribution Volume



Source: China Central Depository & Clearing Co., Ltd (www.chinabond.com.cn); data as of December 2016

Figure 5: CIBM Trading Volume



Source: Market overview report, January 2017 from China Foreign Exchange Trade System (www.chinamoney.com.cn)

* Please note that current or past performance of any investment is not indicative, nor a guarantee, of future results.

ABOUT CIBM



7,165

TOTAL NUMBER OF BONDS
TRADED ON CIBM AS OF
2 FEBRUARY 2017¹



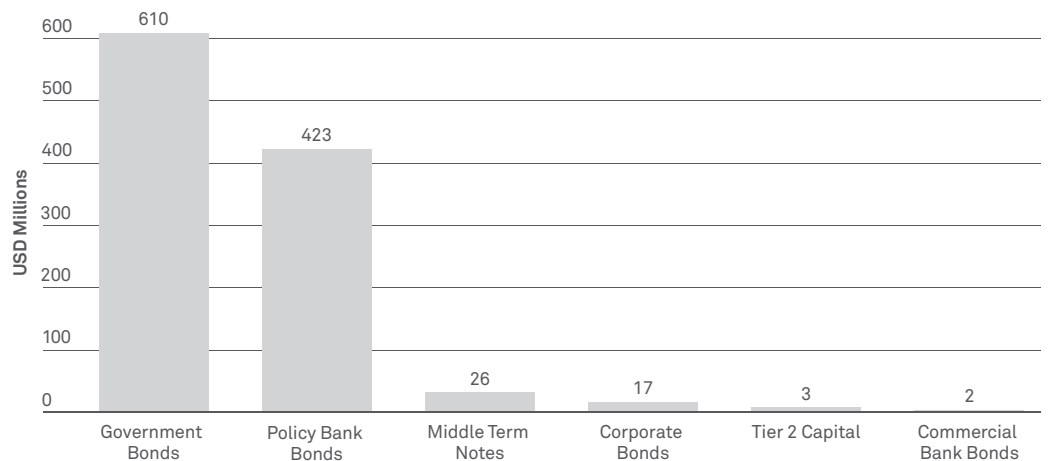
FOREIGN INVESTORS VIA
CIBM DIRECT ACCESS
NOW ALLOWED TO TRADE
ONSHORE FX DERIVATIVES



REGISTRATION ONLY
SCHEME BY PBOC OFFERS
QUICK ENTRY TO CIBM

Please see endnotes on last page

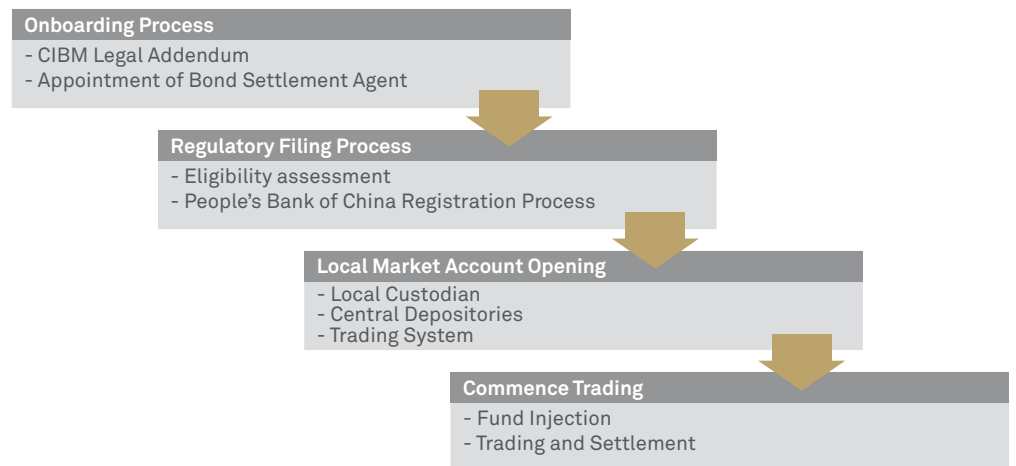
Figure 6: Interbank bonds held by Foreign Investors



Source: China Central Depository & Clearing Co., Ltd (www.chinabond.com.cn); data as of March 2017

“The relative ease of access to CIBM can be an important factor for global investors when considering to include China onshore bonds in their investment portfolio.” says Magdalene Tay, APAC Custody Product Manager for Asset Servicing at BNY Mellon.

Figure 7: CIBM Direct Route - Access Process



The Door Swings Open

The foreign ownership in CIBM is small, representing less than 2% of the outstanding value (See Figure 8). One of the key reasons is due to the restricted access for foreign investors.

In 2010, the PBOC started to allow foreign institutional investors namely foreign central banks, RMB clearing and settlement banks, and sovereign wealth funds to invest in CIBM. In 2011, CIBM was further made available to Qualified Foreign Institutional Investors (QFII) and subsequently Renminbi Qualified Foreign Institutional Investors (RQFII) in 2013.

In February 2016, the Chinese government, in an effort to liberalize the capital market, further widened the scope of foreign investors to all foreign institutional investors including commercial banks, insurance companies, asset managers, pension funds and broker-dealers, to CIBM via the direct access route.

ABOUT CIBM



ON MARCH 1, 2017,
BLOOMBERG LAUNCHED

2

NEW HYBRID BOND
INDICES THAT INCLUDE
CHINA ONSHORE BONDS.
THIS IS IN ADDITION TO
THE **GLOBAL INDICES**
UNDER THE BLOOMBERG
BARCLAYS BENCHMARK
BOND INDEX

OVER 50% RATED

AAA

BY DAGONG GLOBAL
CREDIT RATING CO., LTD ^{1*}

Please see endnotes on last page

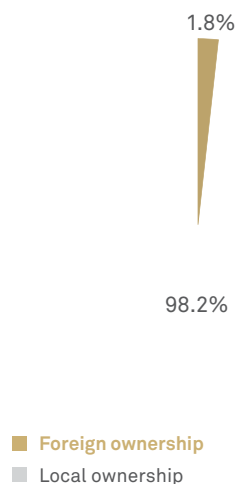
* Refers to percentage of rated bonds.
Ratings are issued by domestic
Chinese credit rating agencies and
not all bonds are rated.

“This new direct route to the China interbank bonds market provides fund managers new opportunities, in particular, the ability to access onshore RMB fixed income securities in a manner which, practically, is much more flexible than the existing QFII and RQFII quota systems.” Stéphane Karolczuk says. Figure 9 illustrates the different types of foreign investors registered with the PBOC since the inauguration of CIBM direct route.

The direct access route simplifies and expedites the entry process which entails only registration with the PBOC. There is no individual and aggregate investment limits. In addition, there is no foreign exchange restriction such as lock-up and repatriation.

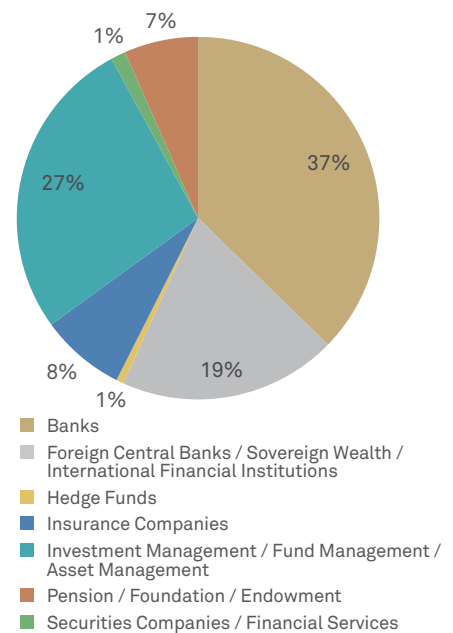
The expansion of onshore bond market has gained foreign regulatory support. “Indeed, Luxembourg Undertakings for Collective Investment in Transferable Securities (UCITS) funds have over the years been authorized to take advantage of the various China access channels introduced by the Chinese authorities. UCITS may access this market through QFII, RQFII, Stock Connect, CIBM direct, and perhaps tomorrow the Bond Connect”, says Stéphane Karolczuk. The Commission de Surveillance du Secteur Financier (CSSF) has now allowed UCITS managers to have direct access to CIBM.⁴

Figure 8:
CIBM: Foreign vs Local Ownership



Source: China Central Depository & Clearing Co., Ltd (www.chinabond.com.cn); data as of October 2016

Figure 9:
Category of Foreign Investors in CIBM



Source: The People's Bank of China; data as of March 2017

Figure 10: Investment Channels to CIBM



Source:

^A China Securities Regulatory Commission (www.csrc.gov)

^B Safe Administrative Foreign Exchange (www.safe.gov.cn)

^C China Foreign Exchange Trading System

WHAT'S NEXT



EXPANSION OF
SETTLEMENT CYCLE TO

TD+2/3⁵



EVALUATION OF
CENTRAL SECURITIES
DEPOSITORIES TO ACT AS
WITHOLDING TAX AGENT
FOR COUPON PAYMENT⁶



BOND CONNECT
LINK EXPECTED BY
END OF 2017⁷



EXPECTED INCLUSION IN
CITI FIXED INCOME INDICES
IN FEBRUARY 2018¹⁰

Please see endnotes on last page

Potential Opportunities

In August 2016, PBOC had approved the World Bank to issue Special Drawing Rights (SDR) denominated bond in the CIBM with a total size equivalent to USD 2.8 billion⁸. This marked another step by the Chinese government to internationalize the capital market.

On 1 March 2017, Bloomberg launched the new indices, 'Global Aggregate + China Index' and 'Emerging Market Local Currency Government + China Index' covering China onshore bond securities⁹.

The recent announcements have brought the China bond market closer to inclusion in global indices. China and Hong Kong are also currently discussing "Bond Connect", following the successful launch of the Stock Connect. This initiative would make Chinese bonds more accessible to international investors.

"The direct access route can prove relatively easy and quick as it requires registration only with the PBOC", says Magdalene Tay, BNY Mellon. (See Figure 11)

Figure 11: QFII, RQFII and Direct Route Comparison

	QFII / RQFII	Direct Route
Pre-Investment Approval	Yes	No
Investment Quota	Yes	No
Investment Scope	- Listed securities - CIBM - Securities investment funds - Index futures	CIBM
Approximate Access Timeframe (if all documents are in order, and subject to variation)	Several months (depending on case by case)	3 - 4 weeks
Injection and Lock-Up Period	Yes	No
Repatriation Restriction	No, except QFIIs (subject to monthly limit)	No

In the registration form, the applicant has to indicate the anticipated investment size in CIBM. Additionally, the international investor has to inject 50% of the anticipated investment size registered with PBOC within 9 months from the date on which the registration is completed. Otherwise, the international investor has to re-file the anticipated investment size with PBOC.

With the anticipated inclusion of China's bonds in the global indices, BNY Mellon Asset Servicing APAC estimates foreign investment in CIBM may reach as high as 7% by 2020.

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Endnotes

¹ Source: China Central Depository & Clearing Co., Ltd (www.chinabond.com.cn)

² Source: Bank for International Settlements, data captured in Q2 of each year ending June 2016

³ Source: World Federation of Exchanges, data as of December 2016

⁴ Source: Arendt article on 23 November, 2016 titled "The China Interbank Bond Market: UCITS able to access the CIBM without QFII or RQFII quotas"

⁵ Source: China Central Depository & Clearing CO, Ltd

⁶ Source: The People's Bank of China meeting with CIBM bond settlement agents on 20 October 2016

⁷ Source: Financial Times Article on 15 March, 2017 titled "China-Hong Kong Bond Connect link to open by year-end"

⁸ Source: The World Bank article on 12 August, 2016 titled "World Bank Approved as the First SDR Bond Issuer in China (www.worldbank.org/en/news/pressrelease/2016/08/12/world-bank-approved-as-the-first-sdr-bond-issuer-in-china)

⁹ Source: Bloomberg article on 1 March, 2017 titled "Bloomberg Launches New Fixed Income Indices Covering China Bonds (www.bloomberg.com/company/announcements/china-new-fixed-income-indices/)

¹⁰ Source: Reuters Article on March 7, 2017 titled "Update 2 – Citi to add China bonds to its government bond indexes from Feb 2018" (www.reuters.com/article/china-bonds-investment-idUSL3N1GK3D0)

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