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Investment Facilities of Mainland Bond Market Continue to Improve and Degree of Openness Is Expected to Deepen

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Since the launch of Bond Connect, channels for foreign investors to enter the Mainland bond market have been further broadened. Currently, foreign investors can enter the Mainland bond market through QFII, RQFII, CIBM and Bond Connect. Improvement of investment facilities has prompted international investors to keep increasing their holdings of RMB bonds, and the Mainland bond market has become an important market for foreign central banks and institutional investors to allocate their assets. In March, Bloomberg announced the addition of Chinese RMB-denominated government and policy bank securities to the Bloomberg Barclays Global Aggregate Index starting next April. Increasing level of internationalization of Mainland bond market has attracted more overseas investors.

To meet the demand of overseas institutions for RMB bonds, the Chinese government has continuously reformed the bond market since the beginning of this year, including opening the domestic credit rating business to foreign ownership, loosening the relevant provisions of QFII and RQFII, clarifying the tax rules for investing in RMB bonds, and fully implementing a delivery versus payment (DVP) settlement system for transactions through Bond Connect. These supporting policies remove some of the trading barriers and policy uncertainties in accessing the Mainland bond market and help enhance the attraction of the Chinese bond market for foreign investors, thus deepening the degree of openness of the Mainland bond market.

Allocation by overseas institutions in China’s bond market

1. Proportion of foreign investors in the Mainland bond market sets record high

In recent years, the Mainland bond market has developed rapidly and has achieved positive results in terms of breadth and depth. As of July 2018, current outstanding balance of the Mainland bond market registers 80.5 trillion yuan, the third largest bond market in the world. Nowadays, foreign investors can carry out cash bonds in the exchange market and conduct various financial transactions such as cash bonds, bond lending, bond forwards, interest rate swaps (IRS), and forward interest rate agreements in the inter-bank bond market.

Meanwhile, the degree of openness of the Mainland bond market has also deepened. According to the People’s Bank of China, more than 1000 overseas investors have been allowed to enter the interbank bond market. Foreign investors have increased their holdings of Chinese bonds for 17 consecutive months. By the end of July this year, foreign holdings of the RMB bonds increased to 1612.3 billion yuan. The proportion of overseas institutions in the Mainland bond market reached a record high of 2.24%, up 0.39 percentage points since the beginning of the year, while the proportion of overseas institutions in Mainland government bond market further rose to 7.67%, up 2.7 percentage points.

2. Government bonds are most popular among international investors

In regards of investment structure, government bonds are most attractive to foreign investors. In terms of absolute scale, by the end of July this year, foreign holdings of government bonds, policy bank securities, negotiable certificates of deposit (NCDs) and corporate bonds amounted to 1 trillion yuan, 330 billion yuan, 200 billion yuan and less than 100 billion yuan, respectively. In terms of increases, foreign institutions have increased their net holdings of government bonds by about 38 billion yuan per month since the second half of last year. Monthly net increase of NCDs (15.4 billion yuan) is less than half of that of government bonds, while the monthly net increase of securities bonds is less, with only about 1 billion yuan. In terms of proportion, foreign institutions increased their holdings of RMB bonds by 398.4 billion yuan in the first half of this year, accounting for 10% of the total increase of RMB bonds. The increase of foreign holdings of RMB government bonds was 308.8 billion yuan, accounting for 81% of the total increase of RMB government bonds. Overseas institutions have clearly become main buyers of Chinese government bonds.

3. Bond Connect is running smoothly and trading is more active

Since its launch in July 2017, more and more foreign institutions have tapped into the Mainland bond market through Bond Connect. As of July 31st, a total of 400 overseas institutions have participated in the market through Bond Connect. In addition, bond trading is more active. Total volume of transactions in the first seven months of this year reached 537.48 billion yuan. Trade volume in June and July both exceeded 100 billion yuan, recording 130.9 billion yuan and 115.5 billion yuan respectively, significantly higher than the monthly average volume of 54.2 billion yuan in the first quarter.

Despite trade frictions and the soft RMB this year, the continual opening up of the capital market and the demand for asset diversification have attracted more foreign investors to the Mainland bond market.

Investment facilities continue to improve and help deepen the degree of openness

1. Clarifying the tax policy for overseas institutions investing in the Mainland bond market

China's cabinet announced in late August that foreign investors would be exempt from enterprise or value added taxes on interest income earned in the domestic bond market for three years.

Previously, China's tax provisions on foreign institutions entering the Chinese bond market were relatively obscure. In terms of income tax, the Mainland currently levies income tax on interest income other than government debt at a rate of 10%, while capital gains are exempt. As for value added tax (VAT), the Mainland policy does not explicitly state that overseas institutions is exempt from VAT, so the market presupposes a 6% VAT on bond coupons of non-government bonds. In the process of investment by overseas institutions, custodian banks of overseas institutions will deduct these taxes directly for collection by the tax authorities. However, no tax authority in the past has collected such taxes on foreign investment in the Mainland bond market, and how to handle these historical withholding taxes is not clear. The obscure tax policy makes foreign investors more cautious when entering the mainland bond market. In order to avoid tax problems and compliance risks, foreign institutions prefer government bonds.

The uncertainty of tax policy apparently affects the investment willingness and asset allocation of foreign investors, thus to a certain extent affecting the liquidity of the Mainland bond market.

The State Council meeting made it clear that no tax will be levied on overseas institutions in the next three years, eliminating most of the tax uncertainties and facilitating the investment of overseas institutions. Exemption of interest income tax for overseas institutions will also greatly increase their investment returns and may make their investment structure more balanced. In the past, only investment in government bonds was exempt from tax. Under the new policy, taxes of all types of bonds were exempt, which may result in higher yields on policy bank securities and NCDs, thus prompting foreign institutions to increase allocation to these bonds.

To sum up, a clear tax policy helps attract foreign institutions into the Mainland bond market. Diversification of investors and the balance of investment structure will be conducive to the long-term development of the Mainland bond market. Yet the issue of historical withholding tax and the tax policy after the three-year period remain to be solved.

2. DVP settlement has been fully implemented in Bond Connect

Recently, Hong Kong Monetary Authority (HKMA) announced that Delivery versus Payment (DVP) settlement has been fully implemented in Bond Connect. With the adoption of DVP settlement, foreign investors were no longer required to pre-fund their onshore brokers before the bond is delivered. This increases settlement efficiency and reduces settlement risks, affording greater convenience to international investors and boosting foreign investment into the Mainland bond market.

3. Relaxing major restrictions on QFII and RQFII schemes

In June, the People’s Bank of China (PBOC) and the State Administration for Foreign Exchange (SAFE) eased restrictions on QFII and RQFII schemes. The key changes are as follows. Firstly, the monthly 20% repatriation limit imposed on the QFII scheme will be removed, allowing overseas investors to remit funds according to their own investment situation. Secondly, the lock-up restrictions applicable to the investment principal under both QFII and RQFII schemes will be removed, facilitating the flow of capital and attracting more overseas investors. Thirdly, QFIIs and RQFIIs will be allowed to enter onshore forex hedging transactions to hedge currency risks according to their investing needs in the Mainland.

Since the majorities under QFII and RQFII schemes are long-term institutional investors and restrictions on total quota remain in place, relaxation of QFII and RQFII rules may not lead to frequent cross-border capital flows, and the impact on market stability and the RMB’s exchange rate is limited. Moreover, the simplification of foreign fund management will help enhance the recognition of the Mainland market and stimulate the enthusiasm of foreign investors. Diversification of investors will also make pricing of the Mainland bond market more reasonable.

4. Opening up onshore credit rating business to foreign ownership

At the end of March, China opened up its domestic credit rating business to foreign ownership. As a result, international credit rating agencies such as Moody's, S&P Global, and Fitch can establish a self-run ratings business in China instead of working with a Chinese partner.

At present, about 90% of foreign holdings are concentrated in government bonds and policy bank securities, and there is little demand for credit bonds. This is due to the mismatch of the Mainland rating system with the international standards. The Mainland ratings are 6-7 notches higher than international ratings on average, resulting in lower international recognition of the Mainland rating system. In addition, many foreign investors face certain restrictions on their investment targets and cannot invest in credit bonds without international rating.

Introduction of overseas rating agencies into the Mainland rating market will help promote the convergence of domestic and foreign rating standards and enhance the credibility of the Mainland credit rating agencies and the comparability of rating results. In the long run, the entry of foreign ownership will further improve the management mechanism of domestic credit rating business, enhance the confidence of foreign investors in the Mainland credit rating, and further deepen the openness of the Mainland bond market.

Prospects for the next reform of the Mainland bond market

The underdevelopment of the Mainland bond market has to do with the limited openness of onshore interest rates and foreign exchange derivatives markets. For example, under the Northbound Bond Connect, only cash bond transactions are allowed and foreign institutional investors cannot carry out transactions such as bond repos and bond futures. In addition, although foreign investors can use CNY for investment under Bond Connect, they can only hedge their foreign exchange risk in the offshore market. These constraints have weakened the attraction of the Mainland bond market to foreign investors and become one of the major shortcomings of Bond Connect.

Therefore, to enhance the depth and breadth of the Mainland bond market and to better meet the needs of foreign investors, further opening the domestic interest rate derivatives market for foreign institutions should be necessary.

In early July, PBoC said that repurchase and derivatives trading would be further opened to foreign investors under Bond Connect, while 10 more market makers would be added on top of the existing 24 market makers. In addition, fees for related trading platforms under Bond Connect will be substantially reduced to strengthen cooperation between domestic infrastructure and international mainstream electronic trading platforms.

In the future, with improving arrangements of the Mainland bond market, overseas investors will be provided with a friendlier and more convenient investment environment, and the attraction of the Mainland bond market will be further enhanced.