

“Bond Connect” lifts RMB internationalization to a higher level

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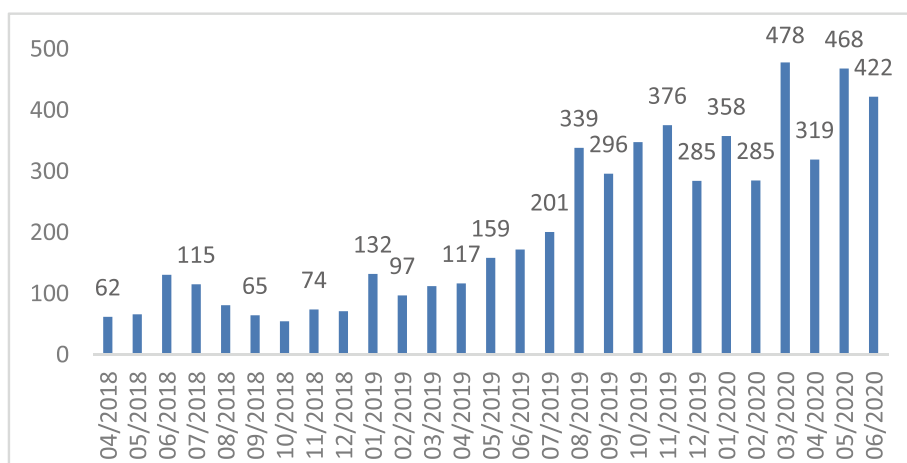
As of July 3, 2020, Bond Connect has been operating smoothly for three years. This scheme, which effectively connects infrastructures of onshore and offshore bond markets, makes full use of trading, custody and settlement arrangements of different markets, providing convenience for investors to conduct cross border bonds transactions. The scheme achieved desired results, welcomed by the market, and has become a successful case of interconnection between financial markets.

I. The operation of Bond Connect

Bond Connect is an important initiative of China’s financial sector reform. In recent years, China has stepped up to open up bond market and facilitate overseas investors’ access to onshore bond market with a variety of measures. There are mainly two modes: First is allowing eligible offshore institutions to apply market entry and trade RMB bonds through onshore settlement agents; Second is to establish “Bond Connect”, i.e. allow foreign institutions to trade onshore bonds overseas, through HKMA’s Central Money markets Unit (CMU). The two modes complement each other and have their own strengths and characteristics.

By end of June this year, 2012 institutional investors from 33 countries had filed with Bond Connect, including 72 of the world’s top 100 asset managers. Since July 2017, the total trading volume has reached RMB 6 trillion.

Figure 1 Bond Connect Monthly Turnover (RMB billion)



Source: BOCHK research, CEIC

In the past three years, transactions through Bond Connect has been increasing with the growing proportion of foreign institutions' holding RMB bonds.

In terms of number of institutions, a total of 459 overseas institutions entered into China inter-bank bond market in 2017, among which 249 were through Bond Connect, accounting for more than half of all new entrants. This number reached 256 (accounting for 80%) in 2018 and 1096 in 2019. In 1H 2020, 550 overseas institutions gained market entry through Bond Connect. By the end of 2019, the number of overseas participants has reached 2608, among which 1601 were through Bond Connect, accounting for over 60% of the total.

In terms of trading value, the average daily trading value of Bond Connect was between RMB 2 billion and RMB 3 billion in 2017. The amount grew to RMB 1.03 trillion in 2018, accounting for 28% of overseas institutions total trading volume, and rose to RMB 2.6 trillion in 2019 (49%). In 1H 2020, the total trading volume of Bond Connect reached RMB 2.33 trillion, with an average daily volume of RMB 19.9 billion. Among which, RMB 468.2 billion worth of bonds were traded in May, with an average daily volume of RMB 26 billion, hitting a record high.

II. The characteristics of Bond Connect

The two bond investment modes mentioned above are quite different in terms of structures, operation mechanisms, regulations and investment costs. Their respective advantages and benefits are prominent, which allows investors to choose between the two according to their own situations, market changes and investment strategies.

The advantage of direct market entry is that foreign institutions are able to fully participate and conduct active investment in the onshore market with large variety of product choices. Therefore, capable investors are more willing to choose this investment mode. According to the rules, overseas institutions shall appoint an onshore settlement agent (commercial bank) to conduct services including filing, account opening and bond transactions. As most investors who invested in onshore bonds are willing to hold to maturity, the liquidity of the secondary market is not high, therefore it is easier for overseas investors to subscribe desired bonds via onshore settlement agent. At the same time, by extending their network in China, overseas investors will have a better understanding of onshore policies and market behaviors, which helps institutions react quickly to market changes.

Bond Connect was designed for investors' operation convenience. According to the operation guidelines of Bond Connect, relevant transaction settlement practices follow the regulations and business rules of where the transactions take place. Bond Connect undoubtedly provides convenience without adding extra costs to investors who are familiar with overseas market rules.

The depository settlement scheme is the key for Bond Connect connecting onshore and offshore bond transactions -- an overseas custodian (CMU) opens a nominee holder bond account with a domestic custodian (China Central Depository & Clearing Co., Ltd., hereinafter referred to as "CCDC"; or Shanghai Clearing House, hereinafter referred to as "SHCH") to record the bonds holdings balance held in nominee's name. Foreign investors submit buy/sell orders through overseas electronic trading platforms (e.g. Tradeweb). After the deal is confirmed by the domestic electronic trading platform (CFETS), CMU and CCDC/SHCH will cooperate and complete the bond transfer, delivery, settlement and depository. Foreign investors are not involved in any domestic transaction process (and it feels like trading bonds in offshore market). This nominee holding arrangement, also

known as multi-level depository arrangement, is a common practice in international bond market. Its management approach is relatively loose with lower entry threshold and higher operation flexibility. In addition, law systems offshore provide long-established and mature arrangements for dealing with bond trading disputes, which effectively protects the interests of investors.

China fully respects the differences between domestic and international markets in terms of legal systems, regulatory approaches and trading rules. On one hand, Bond Connect creates a new mode of connectivity through domestic single-level depository scheme and overseas multi-level depository arrangements. On the other hand, Bond Connect broadens the investor base of asset management companies. Through lowering the transaction costs and entry threshold, some relatively small institutions, or those with no immediate interest participating in domestic bond market, might start to trade and hold RMB bonds.

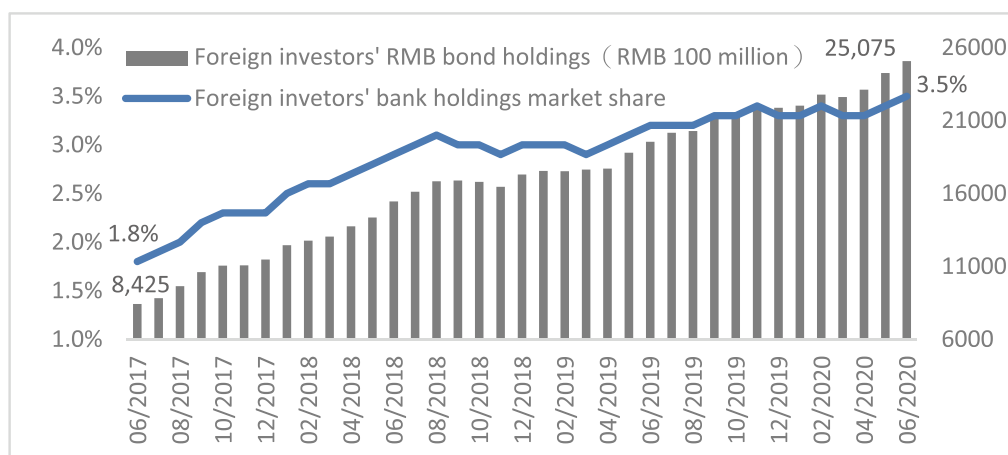
Due to the convenience brought by trading through Bond Connect, it has been developing rapidly and complementing with direct market entry mode, jointly pushing foreign investors to increase their holdings of RMB assets.

III. The Significance of Bond Connect

The launch and smooth operation of Bond Connect is of great significance to promote RMB internationalization in the following aspects:

1. Meeting the increasing demand of RMB assets from global investors, and conducive to rational asset allocation of foreign central banks and institutional investors. After the IMF's announcement of including RMB in the SDR currency basket in 2015, China has further opened up the domestic financial market, in particular the launch of "Bond Connect" with increasing overseas investments. As of the end of June 2020, foreign institutions held a total of RMB 2.5 trillion RMB bonds, an increase of RMB 1.66 trillion (nearly up 2 times) compared to June 2017 (before the launch of Bond Connect). The proportion of RMB bonds held by foreign institutions rose to 3.5% from 1.8%. By 1Q 2020, global central Banks held USD 221.5 billion in RMB foreign exchange reserve, up 1.2 times compared to the 2Q 2017 and well above the 18% increase of total foreign reserve over the same period.

Figure 2 Volume and Proportion of Foreign Holdings of RMB bonds



Source: BOCHK, CEIC

2. Successfully promoting Shanghai as a global RMB asset allocation center and enhancing Hong Kong function as the channel for offshore investors to invest in onshore RMB assets. Shanghai has the largest RMB market with great product penetrations. As of the end of June, the market value of onshore RMB bonds was nearly RMB72 trillion, making it one of the best choices for overseas investment. However, the importance of Hong Kong in attracting overseas institutions to invest in RMB assets cannot be ignored. Hong Kong is the most important asset management center in the APAC region, with HKD 24 trillion AUM in 2018. Among them, 62% (about HKD14 trillion) was from outside Hong Kong, with many overseas institutions using Hong Kong as a platform to invest onshore equities and bonds. Since the launch of the Bond Connect, the function of Hong Kong as an investment channel has been further strengthened. In the past two years, SWIFT messages sent by Hong Kong banks for bond transaction confirmation have increased significantly, accounting for 65% of total in 2019. Bond Connect has made considerable contributions to consolidate Hong Kong's position as an offshore RMB business hub.

3. Promoting offshore RMB business innovation is conducive to China's capital account convertibility and financial markets reform. The mainland's capital account is not fully convertible at the moment. The mainland China is such a big economy that has been developing with a unique market system for many years. It is impossible to fully open the mainland's financial market from the perspective of financial risk control. Therefore, the mainland has been connecting onshore and offshore financial markets with innovative solutions while retaining existing market mechanism and regulatory system. In addition to Bond Connect, the mainland has also launched Shanghai-HK stock connect, Shenzhen-HK stock connect, achieving decent results in building connection between financial markets. The great success in Shanghai-HK stock connect, Shenzhen-HK connect and the Bond Connect boosts confidence in regulators and market participants, which helps promoting more mutual connect measures in the future.

4. Continuously enhancing modern bond trading mechanism of the onshore bond market and competitiveness of RMB bonds in the global bond market. The China's bond market is currently the world's third largest bond market. However, the market is relatively less developed and mature compared to bond markets in Europe and the US. For example, the debt issuance, trading structure and debt default mechanism are not fully developed, the bond credit rating system is not mature, and most agent banks are also lack of experience in providing services to offshore investors. After the launch of Bond Connect, a competitive mechanism for cross-border bond investment was formed, which triggered further reform of the mainland's bond market, and would improve the trading mechanism, product scope and service capability, helping RMB bonds better integrate into global financial markets. On the other hand, Hong Kong's CMU is one of the most advanced bond depository systems, which seamlessly connects major bond trading systems, instant payments systems and foreign exchange trading systems, helping RMB bonds access to major markets around the world.

5. Encouraging major bond indices to include RMB bonds to promote interconnectivity between global bond markets and increase investment and reserves functions of RMB. The launch and stable operation of Bond Connect has gathered huge interests from major international bond indices providers. Bloomberg included China Government bonds and policy bank bonds into Bloomberg Barclays Bond Index (6% share) last year; JP Morgan included several highly liquid China Government bonds into several bond indices (Some with more than 10% share); FTSE Russell has also announced putting China in its indices watchlist, showing global markets' confidence on the China economy and RMB bonds, which helps to establish RMB bonds as a major international bond. Besides, bond yields of the 3 major currencies fell to extremely low level due to US introduction of

unlimited QE. In comparison, RMB exchange rate is stable while RMB bonds maintain reasonable investment returns, giving global investors an opportunity to achieve a more flexible investment portfolio.

On the other hand, Bond Connect has a significant impact on Hong Kong. RMB business grew against the trend although Hong Kong has encountered various difficult situations in recent years. Major indicators showed signs of recovery, contributing to stable growth in the financial sector and easing the pressure of negative economic growth. The mainland has prioritized Hong Kong as the pilot location for Bond Connect, which would boost market confidence and help with the recovery of the Hong Kong economy.

IV. The Prospects of Bond Connect

The Bond Connect has been launching for 3 years and there are constant improvements in the related mechanisms. First is introducing tax related measures regarding offshore investors investing in onshore bond markets. For interest income arising from bond investments, a temporary waiver of 3 years is granted for the corporate tax and value-added tax. Second is expanding the number of bond pricing institutions while significantly reducing fees in using Bond Connect Platform. Third is achieving DvP settlement to increase settlement efficiency and reduce settlement risk. Forth is establishing online allocation function for block trades, so as to facilitate investors to allocate transactions to a greater number of individual accounts before submitting orders.

The PBOC has provided policy guidance and announced four new measures for further enhancing Bond Connect in its third year anniversary. First is to further lower transaction costs, second is to reasonably increase the service time of the transaction platform, third is to promote interconnection with new offshore transaction platforms, forth is to further improve service quality of risk hedging for foreign investors in the primary market, including Repo, bond lending, bond forwards, IRS and FRA, etc.

Another opportunity to explore is the “Southbound trading” business. “Northbound trading” was first launched through Bond Connect in 2017, while the mainland and Hong Kong also pledged to explore opportunities in launching “Southbound trading” and opening the Hong Kong bond market to eligible mainland investors. In May 2020, four government bodies including the PBOC released “the Opinions on financial support for construction of the Guangdong-Hong Kong-Macao Greater Bay Area”, proposing for the first time to optimize and improve financial market connectivity arrangements in Shanghai-HK connect, Shenzhen-HK connect and Bond Connect, including the research on the expansion “Southbound trading”. The launch of “Southbound trading” is getting closer.

Hong Kong is an important international financial center, the main market for issuing G3 currency bonds in APAC region, also the largest offshore dim sum bond market, connecting bond markets in Europe and the US. Therefore, the launch of “Southbound trading” could attract the mainland’s capital to invest in Hong Kong financial market therefore further promoting the development of Hong Kong bond market, and create opportunities for onshore institutions to allocate assets and diversify investment risks. Bond Connect is going to step up a higher level in the near future.

主要經濟指標 (Key Economic Indicators)

一. 本地生產總值 GDP	2018	2019	2019/Q4	2020/Q1
總量 (億元) GDP(\$100 Million)	27,355	27,030	7,238	6,371
升幅 (%) Change(%)	2.9	-1.2	-3.0	-8.9
二. 對外貿易 External Trade			2020/5	2020/1-5
外貿總值 (億元) Total trade(\$100 Million)				
總出口 Total exports	41,581	40,961	3,176	14,574
進口 Total imports	47,214	45,714	3,313	15,991
貿易差額 Trade balance	-5,633	-4,753	-137	-1,417
年增長率 (%) YOY Growth(%)				
總出口 Total exports	7.3	-5.6	-7.4	-8.0
進口 Imports	8.4	-8.1	-12.3	-9.8
三. 消費物價 Consumer Price				
綜合消費物價升幅 (%) Change in Composite CPI(%)	2.4	2.9	1.5	1.8
四. 樓宇買賣 Sale & Purchase of Building Units			2020/6	2020/1-6
合約宗數 (宗) No. of agreements	79,193	74,804	8,254	32,749
年升幅 (%) Change(%)	-5.5	-5.5	32.9	-24.7
五. 勞動就業 Employment			2020/2-2020/4	2020/3-2020/5
失業人數 (萬人) Unemployed(ten thousands)	10.5	12.4	20.3	23.0
失業率 (%) Unemployment rate(%)	2.8	3.3	5.2	5.9
就業不足率 (%) Underemployment rate(%)	1.1	1.2	3.1	3.5
六. 零售市場 Retail Market			2020/5	2020/1-5
零售額升幅 (%) Change in value of total sales(%)	8.8	-11.1	-32.8	-34.8
零售量升幅 (%) Change in volume of total sales(%)	7.6	-12.3	-33.9	-36.5
七. 訪港遊客 Visitors				
總人數 (萬人次) arrivals (ten thousands)	6,515	5,590	0.8	350.1
年升幅 (%) Change(%)	11.4	-14.2	-99.9	-88.2
八. 金融市場 Financial Market			2020/4	2020/5
港幣匯價 (US\$100=HK\$)				
H.K. Dollar Exchange Rate (US\$100 = HK\$)	783.6	779.3	775.1	775.3
貨幣供應量升幅 (%) change in Money Supply(%)				
M1	-0.4	2.6	6.8	9.3
M2	4.3	2.8	2.0	2.4
M3	4.3	2.7	1.9	2.3
存款升幅 (%) Change in deposits(%)				
總存款 Total deposits	5.0	2.9	1.1	1.8
港元存款 In HK\$	3.6	2.5	-1.1	-0.1
外幣存款 In foreign currency	6.4	3.2	3.3	3.8
放款升幅 (%) in loans & advances(%)				
總放款 Total loans & advances	4.4	6.7	7.3	3.3
當地放款 use in HK	4.0	7.1	7.2	6.9
海外放款 use outside HK	5.3	5.8	7.3	7.0
貿易有關放款 Trade financing	-7.7	-0.7	0.6	-4.4
最優惠貸款利率 (%) Best lending rate (%)	5.1250	5.0000	5.0000	5.0000
恆生指數 Hang Seng index	25,846	28,189	24,644	22,961