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Hong Kong China Bond Connect – How to get exposed to the second largest bond market in the world

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History of Bond Connect

In May 2017, the People's Bank of China (PBoC) and the Hong Kong Monetary Authority (HKMA) jointly announced the Bond Connect initiative, with the program officially commencing on 3 July 2017. Like the Stock Connect, it aims to provide mutual market access for bond investors between Mainland China and Hong Kong, allowing foreign investors to gain access to the RMB denominated domestic bond market. Currently, only Northbound Trading (i.e. overseas investors buying/selling Chinese onshore bonds) is allowed.

Prior to Bond Connect, the channels for overseas investors to participate in China's onshore bond market were limited in scope and had their own restrictions. They include QFII, RQFII and China Interbank Bond Market. With Bond Connect being the fourth channel, it aims to enhance operational efficiency for overseas investors, particularly regarding account opening and trade settlement. Another aim for the Bond Connect was to encourage potential inclusion of China onshore bonds into major global indices. This was achieved in 2019 when Bloomberg included Chinese Government Bonds and policy banks bonds into the Bloomberg Barclays Bond Index (with a 6% weighting) as well as JP Morgan which included several highly liquid Chinese Government bonds into several bond indices.

Overview of Bond Connect: How does Bond Connect work?

Under Bond Connect, investors send settlement instructions to the Hong Kong Central Moneymarkets Unit (CMU), which acts as the nominee holder of these securities and settles with onshore clearing houses.

As such, overseas investors do not have to open an onshore account but instead are allocated a CMU account number for the settlement process. The CMU can provide certificates as proof of investors' bond holdings which are recognized by PBoC.

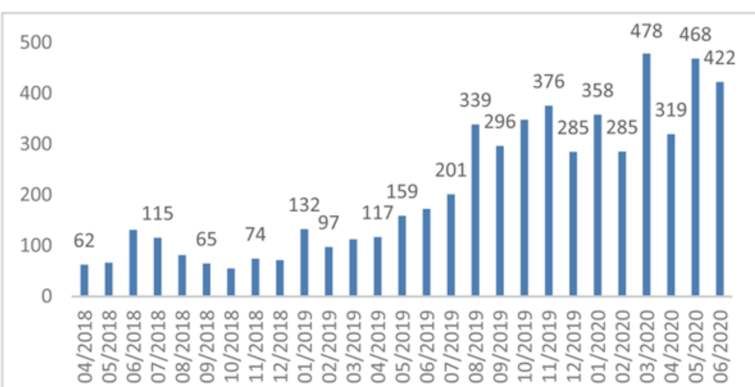
To buy and sell bonds, investors need to send a request for quote (RFQ) to selected participating onshore dealers on offshore trading platforms (e.g. Bloomberg or Tradeweb) and subsequently lift/hit the most favourable price quote. These offshore trading platforms are connected to the onshore trading platform CFETS (China Foreign Exchange Trade System). Once a trade is completed, CFETS sends the trade information to two onshore central securities depositories: Shanghai Clearing House (SHCH) and China Central Depository & Clearing Co. Ltd. (CCDC)

The funding currency can be either offshore Renminbi (CNH) or foreign currencies. Investors can choose to exchange foreign currencies or CNH for onshore Renminbi (CNY) using prevailing exchange rates through offshore banks. Note that the repatriation currency should always be the same as the funding currency.

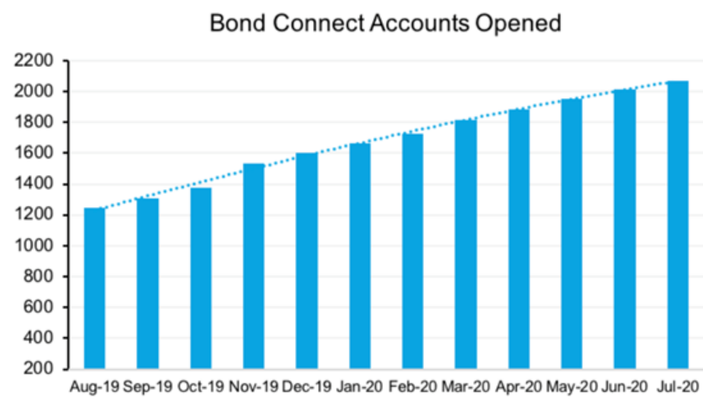
Reception of Bond Connect since launch

3 July 2020 marked the third year anniversary of Bond Connect and since then, 2068 institutional investors (among which JK Capital) from 33 countries have set up accounts with Bond Connect, including 72 of the world's top 100 asset managers. In terms of activity, the average daily trading value of Bond Connect in 2017 was about RMB 2-3 billion and grew to RMB 19.9 billion in 1H20 (or USD2.8bn per day). As we can see in the graph below, the Bond Connect's monthly turnover followed a healthy upward trajectory.

Figure 1 Bond Connect Monthly Turnover (RMB billion)



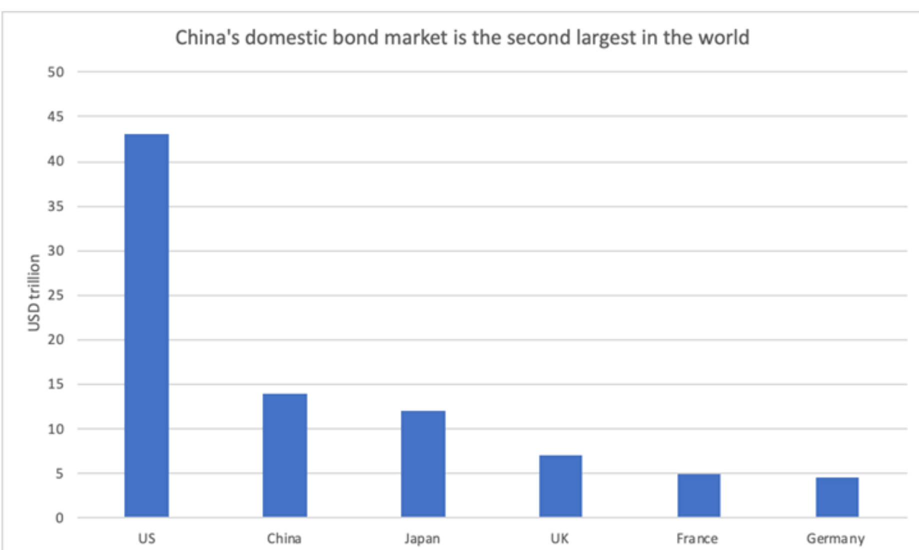
Source: CEIC



Source: Bond Connect

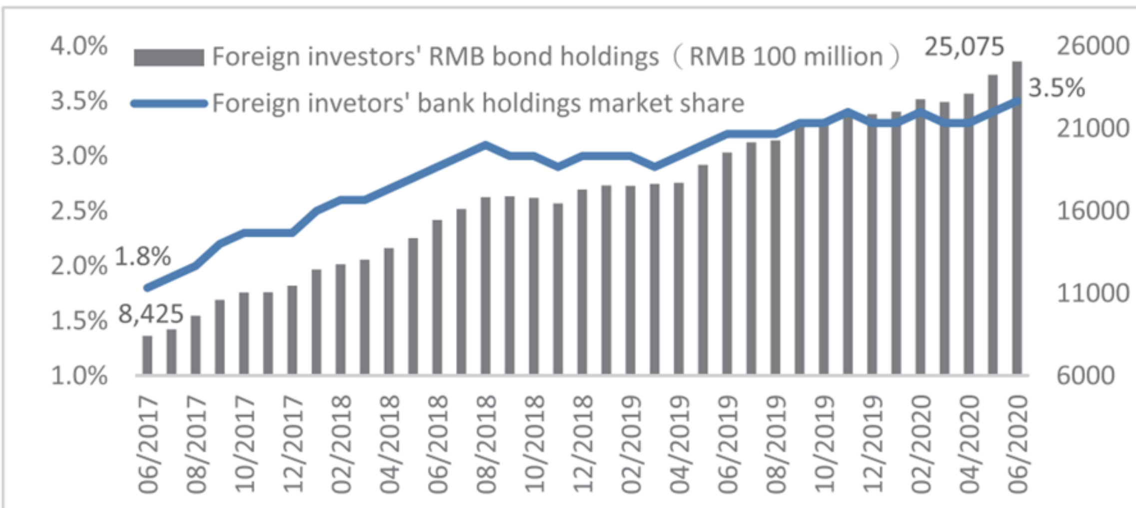
The significance of the Chinese Onshore Bond market

China's onshore bond market totaled over RMB 97 trillion (USD 14 trillion) in bonds outstanding in 2020 and is home to the second largest bond market in the world behind the US but ahead of Japan, the UK and other European countries. This represents an annual growth rate of over 20% per year for the past 5 years.



Source: SIFMA, Bloomberg.

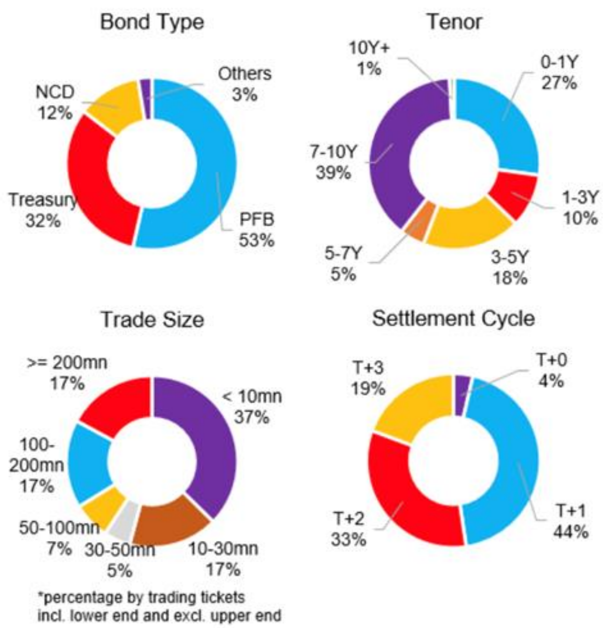
Despite its size, foreign investors only held approximately 3.5% of the broader Chinese onshore bond market as at the end of June 2020 according to CEIC. This is largely due to regulatory restrictions as the Chinese government exercises tight capital controls. However, with the launch of the Bond Connect, the PBoC is looking to ramp up global investors' access to financial markets. This number will continue to grow as major international bond index providers continue to include Chinese onshore bonds in the respective indices.



Source: CEIC

What have overseas investors been buying?

Foreign investors flows have been mainly concentrated on Policy Financial Banks (PFBs), Treasury (i.e. Chinese government bonds) and Negotiable Certificate of Deposits (NCDs) with short tenor. Tax-free features of government bonds and higher yields of NCDs with short tenor have driven the inflows.



Source: Bond Connect

Inflows into "Others" include the corporate/enterprise bonds. Inflows into this category of bonds have been relatively muted given the poor liquidity of these instruments. In addition, the Chinese onshore rating agency market remains very much in its infancy as US rating agencies Moody's, Fitch and S&P were only allowed to open wholly owned operations onshore in 2017. One obstacle for the Chinese onshore ratings market is that 81% of Chinese onshore bonds have a "national scale rating" ranging between AA and AAA. As such this makes comparisons against international bond ratings quite difficult given the different weights the agencies give the various factors. For example, domestic agencies will put more emphasis on asset size as a positive factor when global agencies assign more value to leverage as a negative factor. Profitability and state-ownership also carry more positive weight for international agencies.

What is next for the Bond Connect?

The Bond Connect has seen constant improvements since its launch three years ago. Firstly, it introduced tax related measures regarding offshore investors investing in onshore bond markets. For interest income arising from bond investments, a temporary waiver of three years is granted for corporate taxes and VAT. Secondly, the Bond Connect is constantly expanding the number of participating onshore dealers while significantly reducing fees related to the use of the Bond Connect platform. Lastly, the Bond Connect also introduced DvP settlement (Delivery versus Payment) to increase settlement efficiency and reduce settlement risk.

Another possible opportunity that can be explored is the "Southbound trading" business. In May 2020, four Chinese government bodies including the PBoC released a white paper entitled "the Opinions on Financial Support for Construction of the Guangdong-Hong Kong-Macau Greater Bay Area" which has proposed for the first time the optimisation and improvement of financial market connectivity in the Greater Bay Area, along the Pearl River delta. In the paper, research on the expansion of "Southbound trading" was mentioned thoroughly. We could expect developments to proceed soon and mainland investors to be given access to international bond markets.