A GRAND OPENING

WHAT DOES ACCESS TO THE CHINA INTERBANK BOND MARKET MEAN FOR INSTITUTIONAL INVESTORS?

BNP PARIBAS

The bank
for a changing
world

New regulations announced this year make it much easier for foreign investors to access the China Interbank Bond Market.

Why is this such a significant move?

What opportunities does it present for foreign institutions looking to invest in Chinese bonds?

And what issues need to be resolved before they can do so confidently?

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A GIANT LEAP

In February 2016, China's authorities took the unprecedented step of announcing that a wide range of foreign institutional investors would be given quota-free access to the Chinese Interbank Bond Market (CIBM). This marks a dramatic shift in the process of opening China's capital markets, making it much easier for international investors to access the world's third-largest bond market and paving the way for further liberalization of cross-border investment in mainland securities.

Why is this such a significant move? What opportunities does it present for foreign institutions looking to invest in the CIBM? And what issues need to be resolved before they can do so with confidence?

WHAT'S HAPPENED?

The relaxation of restrictions on investing in the CIBM is the latest and biggest step in a series of moves to open China's capital markets to foreign investment. Until now, such investment had been permissible principally through schemes under which certain investors could apply for quotas, such as the Qualified Foreign Institutional Investor (QFII) and Renminbi QFII (RQFII) programs.

In July 2015 the People's Bank of China (PBoC, China's central bank) relaxed rules on investing in the CIBM for foreign central banks and sovereign wealth funds, allowing them to trade without quota limits and with registration rather than pre-approval. In February 2016, similar access was granted to a much wider range of institutional investors, including commercial lenders, insurance companies, securities firms and asset managers (excluding short-term or 'speculative' investors). In May 2016, the PBoC published implementing rules that were even more flexible than had been expected.[1]

WHO CAN INVEST?

Eligible investors

COMMERCIAL BANKS INSURERS
The total assets on their balance sheet should exceed USD 5bn*

SECURITY HOUSES ASSET MANAGERS
Securities under management should exceed USD 1bn or USD 2 bn*

PUBLICLY RAISED PRODUCTS
The investor shall provide relevant license obtained from the regulatory authority

PRIVATELY LAUNCHED PRODUCTS**
The investor shall provide sufficient documentation to evidence the source of funds for PBoC's review***

OTHER LONG TERM INVESTORS**
Pension funds, Charity funds, Endowment funds

*SOURCES: PBoC's verbal guidance, entry threshold for investors at the initial stage. **Investment products lawfully launched by the foresaid financial institutions. ***PBoC's verbal guidance, entry threshold for investors at the initial stage

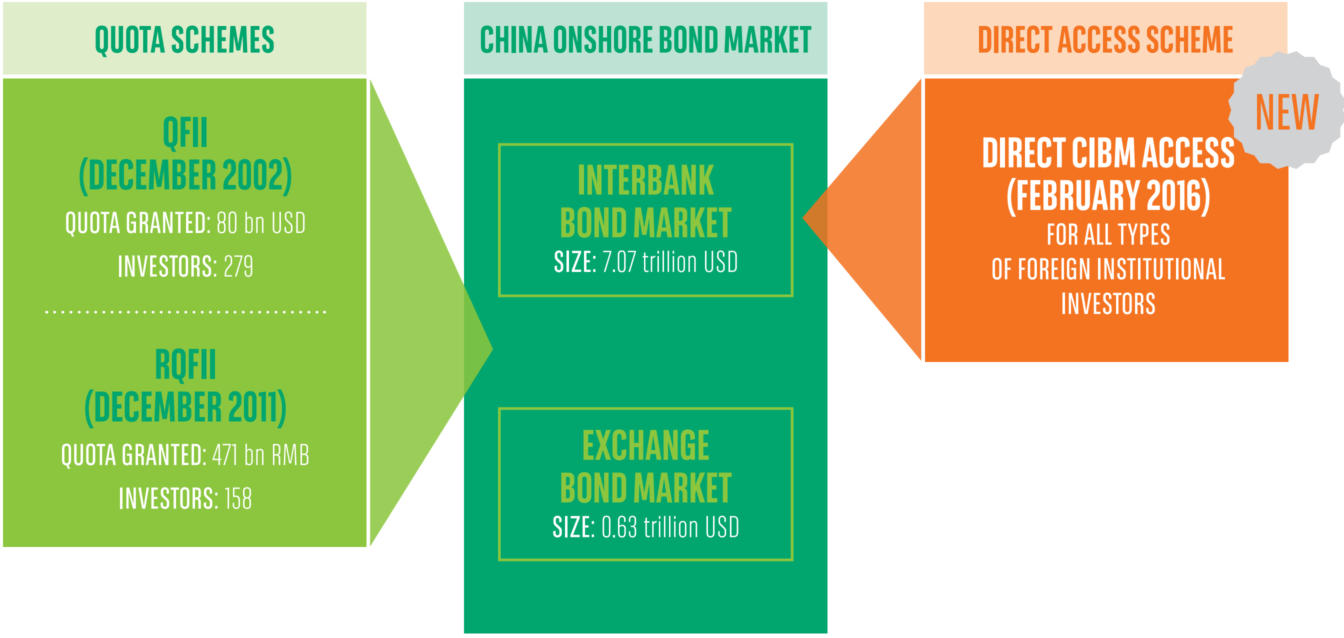
What can be traded

	FOREIGN CENTRAL BANKS	COMMERCIAL BANKS	OTHER INVESTORS
Tradable Instruments	• Cash Bonds • Repo • Bond Lending • Bond Forward • IRS • Forward Interest Rate Agreement • FX (Spot, Forward, Swap & Option)	• Cash Bonds • Repo • IRS, FRA, Bond Lending and Bond Forward for hedging purpose	• Cash Bonds • IRS, FRA, Bond Lending and Bond Forward for hedging purpose
Bond Settlement Agent	Can entrust either PBoC or other qualified Type A agent	Can entrust qualified Type A agent	
Quota	Unlimited quota after filing with PBoC		

SOURCES: BNP Paribas, PBoC, as of February 2016.

1. "New China bond market rules more flexible than expected", *Asian Investor*, 31 May 2016.

MARKET ACCESS
A NEW INVESTMENT CHANNEL



SOURCES: BNP Paribas, PBoC, SAFE, HKEx as of February 2016.

WHAT'S CHANGED?

	QFII/RQFII	CIBM DIRECT ACCESS
OPEN TO	Qualified foreign institutional investors approved by China's regulators	Long- and medium-term foreign institutional investors, including commercial lenders, insurance companies, securities firms and asset managers, subject to PBoC criteria. Excludes short-term or 'speculative' investors
APPLICABLE MARKETS/ ASSETS	Exchange-traded and interbank equity and debt instruments, some derivatives	Interbank market cash bonds only (foreign central banks can trade some derivatives including FX; commercial banks can also access repo market, both commercial banks and other investors are allowed to trade IRS and other bond related derivative)
QUOTAS?	Yes	**No**
APPLICATION PROCEDURE	Requires registration and pre-approval of investment plan	**Filing only**
TYPICAL TIME TAKEN	Previously up to 12-18 months for entire process	**PBoC acknowledgment in 20 working days. 6-8 weeks to start trading**
REPATRIATION	Subject to various restrictions including lock-up period for repatriation of investment principal	**No restrictions other than that ratio of RMB to foreign currency should be same as initial investment (within 10% deviation)**

SOURCES: BNP Paribas, PBoC, HKEx as of February 2016.

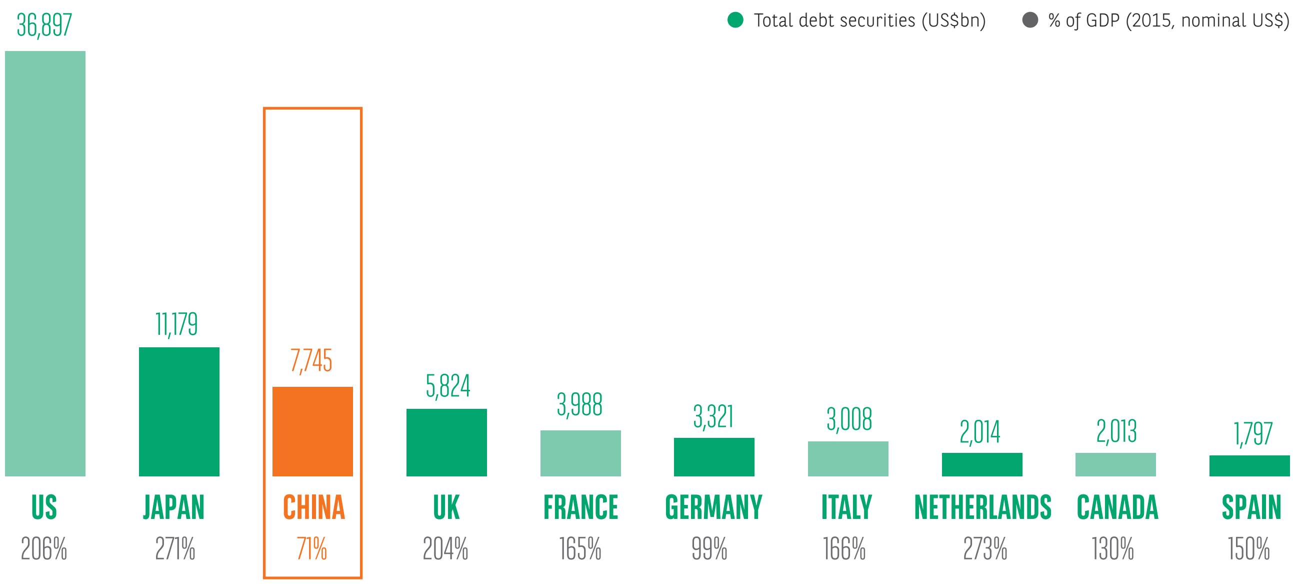
WHY IS IT SIGNIFICANT?

Worth some RMB49trn (US$7.7trn)[2], China's onshore bond market is the world's third largest, behind only those of the US and Japan. Since 2002 the outstanding balance of debt securities in China has expanded at a compound annual growth rate of 21%. The CIBM accounts for the bulk of such securities, around 90% of the total, with the remaining 10% traded on the Shanghai and Shenzhen Stock Exchanges.

Despite such significant growth in recent years, China's total outstanding debt securities amounted to just 71% of its GDP as of the fourth quarter of 2015, compared with 206% in the US and 271% in Japan.[3]

Such figures illustrate why the opening of the CIBM to quota-free investment is so significant, particularly since foreign investors currently hold just 2% of it, mostly in the form of central government bonds and policy bank bonds held by foreign central banks, RMB clearing banks and other selected investors (mostly in Greater China and Singapore). Now the opportunity to participate is open to a much larger pool of potential investors, on a much wider range of securities issued by thousands of Chinese companies and financial institutions, as well as government entities.

The world's third-largest bond market



As of Q4 2015. **SOURCES:** BIS, IMF.

Crucially, these bonds are now much easier to access. This is significant, given that two features of the QFII and RQFII schemes, the need for pre-approval and to trade within quotas granted by China's authorities, make them a cumbersome way of accessing the market. The whole application and approval process for QFII/RQFII could take between 12 and 18 months previously. But the new rules for investing in the CIBM that do away with the quota and pre-approval issues at a stroke, allow investors merely to register with the PBoC and report as required on an ongoing basis. When a registration application has been filed, a response from the PBoC can be expected in as little as 20 days.

"Compared with all the other initiatives this is the first one that basically completely opens the market," notes Lawrence Au, Executive Advisor Asia Pacific at BNP Paribas Securities Services. "There are no restrictions on the amount, and as long as you're a long-term investor you are eligible. None of the schemes before have done that."

2. As of December 2015, according to BIS data.
3. Measured in nominal US$; according to BIS and IMF data.

WHAT INVESTMENT OPTIONS ARE AVAILABLE?

RATES BONDS

BOND TYPE	SHARE	ISSUING ENTITIES	TENOR	MARKET
Government Bonds	21.1%	MoF	3m - 50yr	Interbank & Exchange
Local Government Bonds (Municipal Bonds)	9.9%	Local governments	1yr -10yr	
Policy Bank Financial Bonds	21.8%	China Development Bank Agricultural Development Bank of China Export-Import Bank of China	6m - 30 yr	Interbank
Central Bank (PBoC) Bills	0.8%	PBoC	3m,6m,1yr, 3yr	

SOURCES: Wind, BNP Paribas.

CREDIT BONDS

BOND TYPE	SHARE	ISSUING ENTITIES	TENOR	MARKET
Commercial Paper (CPs & SCPs)	5.0%	Corporates & securities	1yr or below	Interbank
Medium Term Notes (MTNs)	8.4%	Non-financial firms	3yr, 5yr, 7yr, 10yr, Perp	
Government-Supported Corps	2.3%	China Railway Corp	7yr – 30y	
Interbank Certificate of Deposits (CDs)	7.7%	Commercial banks	1m, 3m, 6m, 9m, 1yr	
Private Placement (PPN)	1.4%	Non-financial institutions	Less than 3yr	
Financial Bonds	7.1%	Deposit-taking institutions and other financial firms	2yr - 15yr	Interbank & Exchange
Dual-Listed Enterprise Bonds	6.2%	Unlisted enterprises	3yr - 30yr	
Asset-Backed Securities	1.2%	Financial institutions & non-financial institutions	1yr – 30yr	
Corporate Bonds	4.0%	Listed & unlisted companies	3yr - 30yr	Exchange
Convertible Bonds	0.1%	Listed companies & banks	5yr – 10yr	

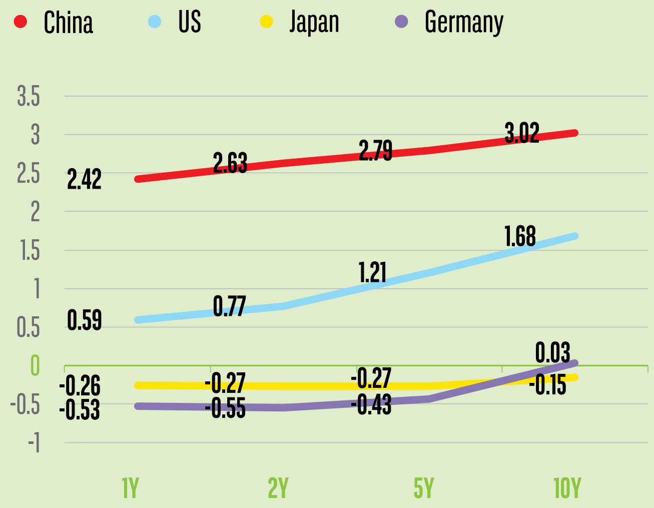
SOURCES: Wind, BNP Paribas.

WEIGHING OPPORTUNITY AND MATURITY

Although doubts have grown in recent months about the trajectory of China's economy, and the risks with regard to growing corporate indebtedness, the long-term potential of the domestic bond market is seldom questioned. Realizing that potential is another matter: China's authorities have underlined their commitment to expanding credit activity beyond commercial lending into market financing, but doing so requires the broader establishment of market-oriented principles in factors such as the pricing of risk and the resolution of defaults. Opening the market to foreign investors is one of the ways to potentially accelerate this process, even though questions remain whether Chinese regulators and agencies have the appetite to fully embrace international-standard ratings and transparency regimes.

It is worth noting, the attractions for foreign investors of investing in the CIBM go beyond the sheer size of the market and its liquidity. Yields are an obvious one, especially given the proliferation of negative interest rates in many markets, even for some corporate bonds and government securities of longer tenors. China's 10-year sovereign yield of 3%[4] compares to -0.15% in Japan, the world's second biggest bond market, and 1.68% in the US, the world's biggest.[5] Similar spreads can be seen across the yield curve. Nonetheless, investors might still be cautious about taking full advantage of this market opening.

CHINESE GOVERNMENT BOND YIELDS STAND OUT



As of 9 June 2016 (China, 8 June 2016).
SOURCES: Bloomberg, ADB, investing.com, US Treasury.

WHAT ABOUT VOLATILITY IN CHINA'S CURRENCY?

One issue is the stability of China's currency, the Renminbi (RMB), which after years of steady appreciation has come under pressure in recent months following greater capital outflows. This was in part because the government, in August 2015, relaxed its control over the currency and allowed market forces to play a greater role in establishing the daily fixing rate. Yet, in this more market-driven environment, using the movements of a controlled currency as the main consideration when investing in Chinese bonds, rather than examining the fundamentals underlying particular assets, is arguably a short-sighted approach.

"When the Chinese bond market is the third largest in the world, if people still want to judge [whether to invest] on a hedged basis it doesn't make any sense," says CG Lai, Head of Global Markets, Greater China, at BNP Paribas. Instead, investors should take comfort from the fact that the Renminbi is becoming a global investment currency: its inclusion in October in the IMF's Special Drawing Rights (SDR) basket, alongside the US dollar, the Euro, the Yen and the British pound, will cement this status. With the greater stability that such status implies, "Chinese bonds will still emerge as among the highest yielding in the market," says Mr Lai, "and people will invest in them for their own value instead of worrying about currency volatility."

4. ADB data as of 7 June 2016.
5. Data as of 8/9 June 2016 from Bloomberg, ADB, investing.com, US Treasury.

WHAT ABOUT THE QUALITY OF MAINLAND RATINGS?

Another consideration is the quality of information available about Chinese credit. One issue that might puzzle some investors is the standards and methodology employed by domestic ratings agencies: some 51% of outstanding bonds in China are given AAA ratings locally. By contrast, in April 2016, following the downgrade of ExxonMobil by Standard & Poor's, just two US companies were left with AAA status.[6] In some cases the same Chinese company has been rated investment grade on the mainland by a domestic agency and junk offshore by an international one.[7]

Explaining onshore ratings

MORE THAN
4,000
CORPORATE BOND ISSUERS IN CHINA

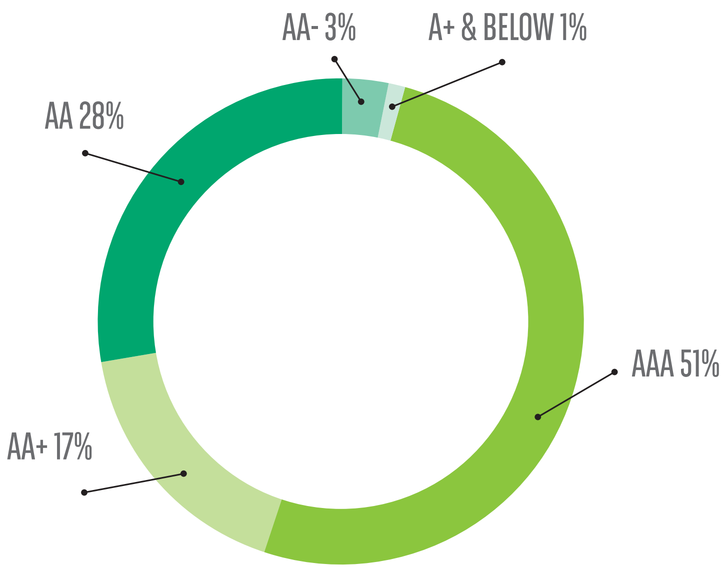
MAJORITY RATED
AAA
BY DOMESTIC RATING AGENCIES

REFLECTS LEGACY FACTORS:
- STATE-OWNED ENTERPRISES (SOEs) ARE AMONG BIGGEST ISSUERS
- MAJOR CHINESE BANKS ARE UNDERWRITERS
- HISTORICALLY LOW DEFAULT RATES

THIS IS CHANGING AS GOVERNMENT REFORMS SOEs AND ALLOWS MORE DEFAULTS, BUT WILL TAKE TIME TO REACH INTERNATIONAL STANDARDS

REQUIRES INVESTORS TO RESEARCH FUNDAMENTALS OF ISSUING ENTITIES

Bonds outstanding – local rating distribution



SOURCES: PBoC, Wind, BNP Paribas, as of February 2016.

6. "Now There Are Only Two U.S. Companies With the Highest Credit Rating" *Fortune*, 26 April 2016.
7. "Can All Chinese Debt Be Rated Top Quality?", *Wall Street Journal*, 26 July 2015.

The discrepancy doesn't mean variations between ratings in China are immaterial, as spreads between bonds issued by the central government, policy banks and different companies attest. But the methodology employed by local ratings agencies does take into account legacy issues such as the fact that a lot of debts have been issued by State-Owned Enterprises (SOEs) or government-linked companies, and that China's major banks have underwritten much of it and are perceived as likely to support issuers in distress. This has been reflected in very rare instances of default, which has tended to underscore questions about the gauging and pricing of risk in the mainland.

These legacy issues are slowly being resolved, as the government works to implement reform in SOEs and to allow market forces to play a greater role in onshore markets (including, from last year, in the setting of interest rates). Indeed, in recent months there have been several cases of SOEs being allowed to default, even amid considerable volatility in mainland equity markets and concern about the impact of some reforms. As defaults occur, "The Chinese rating agencies will have to adapt their ratings criteria to make them closer to the Western ones," says Mr Lai, predicting that reforms along these lines will be underway in the next six months to one year.

Until the market matures, the situation does put the onus on foreign investors to do more of their own investigation into issuers, an investment that is more worth making now access to the CIBM has been liberalized. "If investors are serious about investing in this market on a long-term basis they need to put the resources in place to do company research and compare with the credit rating agencies, in order to establish a level of comfort and confidence," Mr Au explains.

HOW SOON WILL ONSHORE BONDS BE INCLUDED IN GLOBAL INDEXES?

If some foreign investors may be cautious about investing in the CIBM straight away, the inclusion of mainland debt instruments in global bond indices, such as the JP Morgan GBI-EM or the Citi World Global Bond Index, could help to reduce their trepidation, not least because asset managers who benchmark against such indices will then be obliged to buy Chinese bonds in line with their weightings. The two key considerations are credibility and liquidity. The former, as discussed, will require reforms in the way debt is rated in China and the way defaults are handled (including the rollout of a new bankruptcy law), while the latter depends in part on the participation of a greater number of global institutional investors.

China's authorities are aware of the boost to inbound investment that the inclusion of Chinese bonds in global indices will have, in the same way that the inclusion of A-shares in global equity indices would have a dramatic impact on the constitution of portfolios worldwide. Event though, MSCI, an index provider, delayed the inclusion of A-shares in its influential emerging markets index in June this year, the inclusion of Chinese securities in such benchmarks is thought to be only a matter of time.

WILL CHINA BONDS BE INCLUDED IN GLOBAL INDICES?

> **Inclusion in major indices like JPMorgan GBI-EM, Citi World Global Bond Index would push global fund managers to buy**

> **Liquidity and credibility are key factors**

> **Trustworthiness of domestic credit ratings and new bankruptcy law need resolving**

> **Stepping stones are in place: ChinaBond has 20+ China bond indices; FTSE Russell launched China Bond Index in 2015**

PRACTICAL MATTERS

The announcement to open the CIBM was made in February 2016 and the implementing rules were issued by the PBoC in May, after it took into consideration queries and feedback from financial market participants. Despite this process, the momentous nature of the reform means that inevitably some issues still need clarification, and there are some idiosyncrasies that foreign investors need to be aware of before entering the market.

REPATRIATION AND QFII/RQFII RULES

Under QFII and RQFII rules the repatriation of funds is subject to various restrictions, including a lock-up period for the repatriation of quota-holders' investment principal and rules governing inbound and outbound remittances (some of which were eased in reforms also announced in February 2016).[8] The CIBM requirements are more straightforward, with no limits or restrictions other than the State Administration of Foreign Exchange (SAFE) guideline that when repatriating funds, the ratio of Renminbi to foreign currency should be the same as when the investment principal was remitted into China, with a maximum permissible deviation of 10%.[9]

Investors may choose to access the CIBM in their capacity as QFII/RQFII quota holders, and in that case they will need to follow regulations relevant to those schemes. But if QFII/RQFII investors launch new funds or have new mandates, they will be able to enter the CIBM through the new rules and thus avoid quota and repatriation restrictions. Hence, if the purpose of the fund is to invest solely in Chinese fixed income, direct access to the CIBM will be the easier and preferred route.

TAX RULES

Another point that will need clarification is the applicability of tax rules for investors in the CIBM. For example, how withholding tax on coupon payments from corporate bonds will be collected is unclear. This suggest investors should make adequate provisions for such taxes, until such time as the rules are clarified.

PREFUNDING AND RAPID SETTLEMENT

One issue that investors will need to be aware of is that investment in the CIBM must be pre-funded; they cannot rely on credit lines provided by brokers or agents to complete trades. While in many markets credit facilities are made available to settle trades that complete the same day, such facilities are not currently permissible in China's interbank bond market.

This feature goes hand-in-hand with the fact that settlement period is very short and often must be made on T+0 or T+1. This is of particular relevance to institutions in Europe or North America, given time differences, and puts the onus on them to ensure their processes are streamlined.

This means that choosing the right partner as settlement agent or custodian will be crucial: those with global teams operating round the clock, and that can manage streamlined processes across several parties to ensure trades are executed and settled promptly, will be able to best serve investors in the CIBM. For investors that lack the resources to deal with the operational challenges, an integrated execution-to-settlement/custody model should be considered.

"When investors in Europe or the US wake up, the day [in China] is already well advanced," notes Hugues Williamson, COO at BNP Paribas Securities Services in Hong Kong. "You need to have an operating model that is very efficient from front to back: the flow of information from the front office to the back office, as well as to global and local custodians, needs to be seamless."

8. "China's SAFE relaxes QFII quota and funds flow restrictions", Linklaters, 6 February 2016.
9. "Implementing rules issued for foreign investors to access the China inter-bank bond market", Clifford Chance Client Briefing, 1 June 2016.

CONCLUSION: OPEN FOR BUSINESS

None of the issues mentioned under "Practical Matters" are show-stoppers, just as minor clarifications needed to the QFII and RQFII schemes in the past did not prevent foreign institutions applying for quotas. Indeed, such is the scope of the opening of the CIBM that it might well make the QFII and RQFII schemes irrelevant for those seeking access to China's massive fixed-income market.

Of course, giving greater access to China's capital markets, thereby promoting their maturation and also the integration of Chinese financial markets and participants with the global economy, has always been the ultimate goal: schemes such as QFII, RQFII, Stock Connect and others are stepping stones on the way to full market maturity. "It is quite evident that if all these schemes work it's a matter of a couple of years down the road, when China's regulators are comfortable, then the next step will be free access," says Mr Lai.

In this context, it is important to note just how significant opening the CIBM is. When added to programs that ease cross-border investment into Chinese equities (including, soon, the Hong Kong-Shenzhen Stock Connect scheme), the opening of the CIBM means mid- and long-term foreign institutional investors will have trading access to 90% of China's domestic securities market with no quotas.[10]

"Short of the total lifting of capital controls, [liberalizing the CIBM] is a very important part of China's capital opening," says Mr Lai. "Foreign investors who participate will be leading the platform to tap into China in a complete fashion."

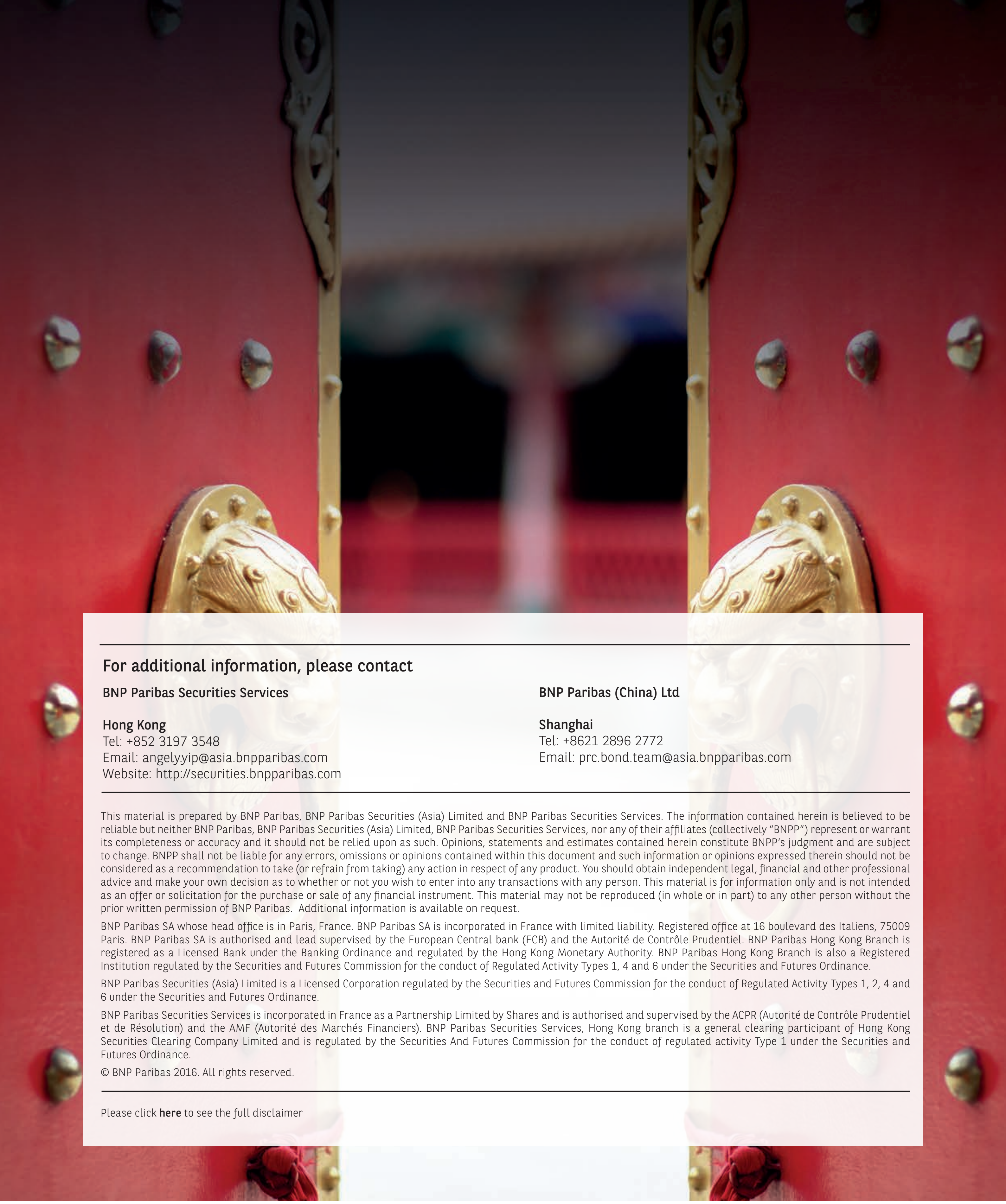
Post-Trade Practicalities - 4-Step Trading Process*

FUND DOCUMENTATION UPDATE	CONNECTING TO A CHINA ENTITY	REGULATORY FILING (3-4 WEEKS)	START INVESTING
> Include China risks disclosures in Key Investor Information Document (KIID) /Prospectus	> Contractual framework set up > Client onboarding process	> File relevant forms with PBoC Shanghai > Open market accounts: China Foreign Exchange Trade (CFETS) China Central Depositary & Clearing (CCDC) Shanghai Clearing House (SHCH)	> Cash injection > Trade and settle CIBM

A SIMPLE AND EFFICIENT PROCESS TO INVEST IN CIBM IN APPROXIMATELY 6 TO 8 WEEKS

*For illustrative purposes only

10. The Hong Kong-Shanghai Stock Connect scheme has total daily limits for cross-border flows but there are no limits or application processes for individual investors.



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