

MEMO# 32823

October 9, 2020

China's Bond Markets: Additional Information for Member Calls

[32823]

October 9, 2020 TO: Global Operations Advisory Committee

Global Operations Advisory Committee - Asia

ICI Global Investing Subcommittee

ICI Global Regulated Funds Committee

ICI Global Regulated Funds Committee - Asia

Securities Operations Advisory Committee RE: China's Bond Markets: Additional Information for Member Calls

Background

As we informed you last week, the People's Bank of China (PBOC), the State Administration of Foreign Exchange (SAFE), and the China Securities Regulatory Commission (CSRC) on 2 September jointly released for public consultation the Circular on Matters Concerning Foreign Institutional Investors' Investments in China's Bond Markets (Consultation Paper) (Circular) outlining the policy design for the opening up of China's onshore bond market (comments on the consultation were due by 1 October 2020).[\[1\]](#) We understand that, pursuant to the policy dictate in the Circular, the CSRC is currently formulating detailed implementation rules to facilitate access to the onshore bond markets. This provides us with an opportunity to recommend to the CSRC user-friendly and market-oriented implementation/operation rules.

Below please find a chart comparing the different channels for investing in China's onshore bond market. This is followed by a series of potential questions and issues for the CSRC and other PRC regulators that we have identified thus far and propose to discuss with members on the upcoming member calls (call details are included at the end of the memorandum). We welcome your feedback on these issues/questions, as well any additional ones you may have.

Comparison of Different Channels

The table below sets out a high-level summary of key differences of the various channels for investing in China's onshore bond market: (a) direct investment in the inter-bank bond market (CIBM Direct), (b) Bond Connect, and (c) QFII/RQFII.

PBOC's Direct CIBM Scheme

Bond Connect

QFII/RQFII

Pre-Investment Requirement

Registration with PBOC Shanghai Head Office through a settlement agent.

Registration with PBOC Shanghai Head Office through a member of the Central Moneymarkets Unit (CMU) via Bond Connect Company Limited.

Regulatory approvals.

Regulators

PBOC and SAFE.

PBOC, SAFE, and HKMA.[\[2\]](#)

PBOC, SAFE, and CSRC.

Tradable Products

Foreign central banks and similar institutions, overseas RMB business clearing banks and overseas participating banks: All tradable products including cash bonds,[\[3\]](#) bond repos, bond lending, bond forwards, forward rate agreements and interest rate swaps.

Other overseas institutional investors: Cash bonds except bond repos; bond lending, bond forwards, interest rate forwards or swaps traded only for hedging purpose.

Cash bonds only.

Cash bonds except bond repos;

bond lending, bond forwards, interest rate forwards or swaps traded only for hedging purpose;

all products of exchange bond market.

Eligible Investors

(i) Foreign central bank-type institutions (including foreign central banks or monetary authorities, international financial organizations and sovereign wealth funds);

(ii) QFII/RQFIs;

(iii) Commercial banks, insurance companies, securities companies, fund management companies and other asset management institutions or the non-legal-person products issued by any of the above institutions;

(iv) Pension funds, charitable funds, or donated funds;

(v) Other mid- and long-term institutional investors recognized by the PBOC.

Same as for CIBM scheme.

Overseas fund management companies, commercial banks, insurance companies, securities companies, futures companies, trust companies, government investment management institutions, sovereign funds, pension funds, charity funds, endowment funds, international organizations and other institutions recognized by the CSRC.

Currency of funds to be remitted into and outside China

Foreign currencies or CNH.

Foreign currencies or CNH.

Foreign currencies or CNH.

Trading Counterparty

More than 22,000 participants in the CIBM including 84 onshore market makers.

56 onshore market makers.

More than 22,000 participants in the CIBM including 84 onshore market makers.

Trading Platform

CFETS/Bloomberg, Tradeweb (directly connected with CFETS).

CFETS/Bloomberg, Tradeweb (directly connected with CFETS).

CFETS/Bloomberg, Tradeweb (directly connected with CFETS).

Trading Mechanism

Entrusting the settlement agent to initiate transactions and make inquiry trading.

Sending request for quotation (RFQ) to 84 onshore market makers.[\[4\]](#)

Sending RFQ to 56 onshore market makers.[\[5\]](#)

Entrusting the settlement agent to initiate transactions and make inquiry trading.

Sending RFQ to 84 onshore market makers.[\[6\]](#)

FX Hedging

3 onshore financial institutions.

3 Hong Kong settlement banks.

Qualified custodian or onshore financial institutions.

Bond Settlement

Gross DVP

Gross DVP

Gross DVP

Settlement Period

T+0/T+1/T+2/T+3

T+0/T+1/T+2/T+3

T+0/T+1/T+2/T+3

Account Structure

Direct holding.

Indirect holding (omnibus account).

Direct holding.

Quota

No individual or aggregate quota limit. An applicant is required to indicate its anticipated investment size on the PBOC registration form.

No individual or aggregate quota limit.

No individual or aggregate quota limit for CIBM.

Only one-time registration with PBOC Shanghai Head Office required if entering CIBM via both CIBM Direct and QFII/RQFII.

Lock-in Period

No restrictions.

No restrictions.

No restrictions.

Repatriation Restriction

For investment via either RMB or a foreign currency – no restrictions for a single currency.

For inward remittance of “RMB + foreign currency” – outward remittance of RMB/foreign currency in total shall not exceed 110% of the RMB/foreign currency inward remittance.

No restrictions.

No restrictions.

Non-trade Transfer

The same overseas institutional investor is allowed to make non-trade bond/funds transfer between its QFII/RQFII account and its CIBM Direct account.

Within CIBM Direct (merger, split, change of entities, etc.).

N/A

The same overseas institutional investor is allowed to make non-trade bond/funds transfer between its QFII/RQFII account and its CIBM Direct account.

Potential Questions and Issues for the CSRC and other PRC Regulators

Simplified Application Procedures and Account Opening Requirements

The Circular simplifies the relevant procedures for investing in the CIBM market in the following ways:

- a. Online electronic submission is available;
- b. FIIs are no longer required to submit a settlement agency agreement with an onshore settlement agent;
- c. FIIs are no longer required to submit an application for each product;
- d. A model of “Global Custodian Bank + Local Custodian Bank” is introduced. Under this model, an FII that invests in the interbank bond market may, directly or via its global custodian bank, entrust a qualified local custodian bank to exercise custody over its assets.

Below are potential issues/questions pertaining to the responsibilities of the global and local custodians for consideration:

1. The corresponding drafting notes of the Circular (“Drafting Notes”) explain that FIIs entering the market can use the new model of “Global Custodian Bank + Local Custodian Bank.” It is unclear whether the new model can apply to both new FIIs and existing FIIs already investing in the CIBM.
2. It is unclear whether, after the adoption of the new global/local custodian model:
 - a. both the existing bond settlement agency relationship between FII and local custodian (BSA model) and the global/local custodian model are available to FIIs;
 - b. the BSA model can be converted into the global/local custodian model, or vice versa?
3. It is unclear whether, under the new model of Global Custodian Bank + Local Custodian Bank, the cash and bond holding accounts opened with local custodians and CCDC/SHCH will be in the name of the global custodian or in the name of the FII, or whether the FII can choose. Need details on the account structure contemplated under the new global/local custodian model.
4. Paragraph 3 of Article 6 of the Circular stipulates that CIBM bonds purchased by FIIs through the local custodian shall be registered under the name of the local custodian while FIIs shall enjoy the rights to securities according to law. Reading this provision literally, this indicates that for CIBM bonds owned by an FII and registered under the name of the local custodian, the local custodian will be a nominee holder for the FII. Under the current CIBM Direct and QFII/RQFII schemes, FIIs are directly holding bonds in the custody of relevant bond holding accounts under their name. According to the existing practice, the local custodian, *i.e.* the settlement agent merely helps each of the FIIs or each of their products open an account with CCDC or SHCH respectively, but does not hold any bonds on behalf of any of FIIs or products. Also, the local custodian opens segregated accounts for each of FII or its managed products so that each FII or its managed products’ assets will be segregated from the local custodian’s proprietary assets. Moreover, the current naming method adopted by local custodians when opening relevant bank or bond trading accounts for the products, namely,

“investment manager name + product name” can distinguish relevant accounts under the name of the product from its investment manager’s proprietary account, thereby confirming the beneficial owner identity of the fund product as the investor.

- a. It is unclear whether the relationship between an FII and its onshore settlement agent under the existing BSA model (the existing direct holding regime) would be affected.
- b. It is unclear, when the new global/local custodian model is adopted, whether the global custodian can open an omnibus account with the local custodian for all of its underlying clients, i.e. FIIs. This would allow the global custodian to open a cash account and a bond holding account in its name with the local custodian to pool the cash and bonds of all of its underlying clients, so that FIIs would only have indirect holding of onshore securities through the omnibus account of the global custodian, which would be similar to the existing account structure adopted by the Bond Connect.

5. Consider whether more flexibility is needed for the global custodian to support FIIs’ post-trade process, including:

- a. Currently under the CIBM Direct, FIIs are only allowed to execute FX transactions with up to three local financial institutions including the local custodian. From the global practice perspective, FIIs would prefer to have their global custodian arrange their FX transaction for them. Consider recommending that the new global/local custodian model allow global custodians to carry out FX transactions for their FII clients.
- b. Global asset managers may manage multiple funds and client accounts on behalf various clients, and therefore they may need to appoint more than one global custodian based on different requirements of different clients. Consider requesting that PRC regulators allow an asset-manager-type FII to appoint multiple global custodians to access China’s bond markets, or agree to it as long as an FII provides reasonable justification.

Integrated Access to CIBM and Exchange-Traded Bond Market

The Circular specifies that foreign institutions that invest in the interbank bond market through CIBM Direct or Bond Connect are not required to additionally apply for the qualification to invest in the exchange bond market. Instead, they may invest in the exchange bond market either directly or under the domestic intra-market connect scheme.

Consider whether further details/clarification in the implementing regulations is needed on the following issues:

1. When will the intra-market connect scheme between the CIBM and the exchange-traded bond market be implemented?
2. How will the scheme allow FIIs trading on one market to trade on the other market?
3. Will FIIs be required to open and maintain accounts with depository and custody institutions to support trades on both trading platforms, e.g. CIBM investors to open and maintain accounts with CSDC?
4. Will FIIs trading on one market be able to trade other types of bond products available in the other market other than cash bonds (QFII is now allowed to trade exchange bond repos and asset-backed securities under the new QFII/RQFII regulations)?

5. How will the global/local custodian model work in the context of the exchange bond market?

Permissible Investment Scope Among Different Channels

The Circular allows FII to conduct bond spot trading and to trade related derivative products and bond funds (including ETFs), as well as to conduct other trading activities permitted by the PBOC and the CSRC. There is no change in the permitted investment products and investment scope for FIIs, namely, foreign investors qualified to invest in the bond markets may carry out spot trading of bonds, and may also conduct bond lending, bond forwards, interest rate forwards, and interest rate swaps based on hedging needs. At the moment, bond repo is only available to foreign central banks and similar institutions, overseas RMB business clearing banks, and overseas participating banks.

Consider whether to request that the investment scope for FIIs be expanded to include:

1. Bond-type and interest-rate-type derivative products for Bond Connect investors – Extend the investment scope for FIIs trading through Bond Connect to bond lending, bond forward, interest rate forward, interest rate swap based on hedging needs.
2. Bond repos – Consider whether to suggest that PRC regulators should allow FIIs access through CIBM Direct and/or QFII/RQFII schemes to trade reverse repos only as the first step. Under the reverse repo trading, an FII, acting as reverse repurchasing party, is obliged to lend out funds to its repo counterparty, which may promote the foreign capital inflow. For Bond Connect, due to its direct holding account structure, the regulators may further evaluate and seek opportunities to open a full bond repo to all schemes at a later stage.
3. Bond futures – Extend the investment scope for FIIs to China government bond (“CGB”) futures as essential for bond market participants including FIIs to effectively hedge and manage their market risk and/or adjust their interest rate exposure.

Non-Trade Transfers

The Circular on Further Facilitating Foreign Institutional Investors’ Investment in the Interbank Bond Market (Consultation Paper) issued by the PBOC and the SAFE on 10 May 2019 allows a two-way transfer of bonds and funds under the QFII/RQFII and CIBM Direct for the same investor. Pursuant to the Consultation Paper, the same investor may, according to its own investment management needs, make a two-way non-trade-type transfer between its bonds and funds under the QFII/RQFII and the bonds and funds under the CIBM Direct in accordance with the Consultation Paper. Since the Circular includes bonds invested through CIBM Direct and Bond Connect, consider requesting that the relevant detailed implementation rules to be issued in the future allow the transfer of bonds and funds under all related accounts of QFII/RQFII, CIBM Direct and Bond Connect with respect to the same institution. Consider requesting that the process for non-trade transfer of bonds simplified and more efficient, so that FIIs can make its cash or bond positions fungible between these different schemes.

Taxation

Currently, a 3-year exemption from PRC withholding tax, VAT and local surcharges on bond interest income derived by FIIs is in effect until November 2021 by the PRC regulators under Circular 108. It is unclear what will happen after 6 November 2021. Consider

requesting that the PRC tax authority extend the Circular 108 exemption and clarify the scope of bonds to include relevant types of debt instruments, e.g. asset backed notes (ABN), asset-backed securities (ABS) and Interbank Certificates of Deposit (CD) and the exchange traded bonds. Also, an advance announcement by the tax authority of at least six months would be much appreciated.

Member Call Details

Call #1: October 13, 9:00 p.m. US EST / October 14, 9:00 a.m. Hong Kong/Shanghai

Join Zoom Meeting:

<https://ici-org.zoom.us/j/95683661551?pwd=Q2RBTHJqZ1ZoV2l4SGt5SU1VbUdyZz09>

Meeting ID: 956 8366 1551

Passcode: 182316

Dial-in: +1 646 558 8656

Find your local number: <https://ici-org.zoom.us/u/adIVp0lxqp>

Call #2: October 14, 8:00 a.m. US EST / October 14, 8:00 p.m. Hong Kong/Shanghai

Join Zoom Meeting:

<https://ici-org.zoom.us/j/97121874720?pwd=a2wyS3pBM2RwMGsyVythbi92MjFtZz09>

Meeting ID: 971 2187 4720

Passcode: 030104

Dial-in: +1 646 558 8656

Find your local number: <https://ici-org.zoom.us/u/abj3CMqXI7>

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endnotes

[1] See Memorandum No. 32800, Soliciting Feedback for CSRC Submission on Unifying China's Bond Markets - Member Call Details, *available at* <https://www.iciglobal.org/iciglobal/pubs/memos/ci.memo32800.global>.

[2] Hong Kong Monetary Authority.

[3] Government bond, PBOC bill, policy bank bond, finance bond, corporate bond, enterprise bond, commercial paper, mid-term note, etc.

[4] Latest data as of Sep 9, 2020 sourced from CCDC.

[5] Latest data as of Sep 9, 2020 sourced from CCDC.

[6] Latest data as of Sep 9, 2020 sourced from CCDC.

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