

MEMO# 32800

October 2, 2020

Soliciting Feedback for CSRC Submission on Unifying China's Bond Markets - Member Call Details

[32800]

October 2, 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: Soliciting Feedback for CSRC Submission on Unifying China's Bond Markets - Member Call Details

The purpose of this memorandum is to briefly summarize the current channels available for investing into China's onshore bond markets and invite members to participate in one of two calls to identify the key issues and changes necessary for facilitating easier and smoother access to China's bond markets for global fund managers. Based on the information gathered, ICI Global will prepare a submission to the China Securities Regulatory Commission (CSRC) with the assistance of JunHe LLP, counsel based in the People's Republic of China.

We will hold two members calls at the times indicated below to gather member feedback. We will also send a calendar invite for the calls to make it easier to access the calls if you are able to participate.

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/j/95683661551?pwd=Q2RBTHJqZ1ZoV2l4SGt5SU1VbUdyZz09>

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/j/97121874720?pwd=a2wyS3pBM2RwMGsyVythbi92MjFtZz09>

Background on China's Onshore Bond Markets

On 2 September 2020, the People's Bank of China (PBOC), the State Administration of Foreign Exchange (SAFE), and the CSRC jointly released for public consultation the *Circular on Matters Concerning Foreign Institutional Investors' Investments in China's Bond Markets (Consultation Paper)*^[1] (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.

Technically there are two bond markets in China - the interbank bond market (CIBM) and the exchange-traded bond market, which are regulated separately by the PBOC and CSRC, respectively. CIBM is an OTC market where approximately 90% of the fixed income products are traded. The two bond markets are separate and distinct from one another, with different account opening requirements, trading platforms, market participants, and bond varieties. In recent years, the Chinese government has steadily opened up the onshore bond market by streamlining access and removing barriers for foreign investors in order to attract foreign investment and move towards internationalization of the RMB.

As the existing regulatory requirements for foreign institutional investors (FIIs) who wish to access China's onshore bond markets vary across different channels, the Circular aims to unify the qualification requirements for the two markets for FIIs and simplify procedures in order to encourage foreign investment. 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. We believe this gives us an opportunity to present to the CSRC, based on members' actual experience in China and drawing references from their international practices, suggestions for user-friendly and market-oriented implementation/operation rules.

Current Channels for Investing in China's Onshore Bond Market

Currently, foreign investors may invest in the CIBM via any of three channels, namely, (1) QFII/RQFII, (2) direct investment in the interbank bond market (CIBM Direct) or (3) Bond Connect. In contrast, foreign investors can invest in the exchange-traded bond market only through QFII/RQFII.

QFII and RQFII Schemes

The QFII and RQFII schemes, introduced in 2002 and 2011, respectively, allow overseas institutional investors, banks, and asset managers to make capital account investments in China and trade Chinese domestic securities. As the QFII/RQFII rules are rather antiquated, FIIs have largely relied on alternative channels (such as Stock Connect, CIBM Direct, and Bond Connect) to invest in China's securities markets. Over the years, the CSRC has made continuous modifications to the QFII and RQFII schemes to make the schemes more accessible to FIIs, such as removing investment quota restrictions and giving permissions to FIIs to trade foreign exchange derivatives for hedging purposes. On 25 September 2020, CSRC and SAFE jointly released new regulations^[2] to combine the QFII and RQFII schemes and relax some of the existing hurdles, aiming to further ease FIIs' access to China's capital markets. The new rules will come into effect on 1 November 2020.

To make the QFII/RQFII program more attractive and thus better equipped to compete for global liquidity with other investment channels such as the Stock Connect, Bond Connect, and CIBM Direct, the eligibility requirements for QFII/RQFIIs have been relaxed - quantitative criteria on minimum operation period and minimum size of AUM are removed. The investment scope of QFII/RQFIIs has been significantly broadened - in addition to stocks, bonds, and depository receipts traded in the exchange market, beginning 1

November, QFII/RQFIIs will be allowed to invest in bond/interest rate/foreign exchange derivatives traded in the CIBM. Excluding new share issuances, bond issuances, and secondary share offerings, QFII/RQFIIs will also be able to engage in margin financing and securities lending and refinancing.

CIBM Direct

Launched in 2016, the CIBM Direct scheme created a route for FIIs to access a wide range of onshore fixed income instruments in China, effectively augmenting the not-so user-friendly QFII and RQFII schemes. However, it has certain restrictions. Except for foreign central banks, international financial organizations and sovereign wealth funds, other qualified FIIs, including fund management companies, are not allowed to engage in bond repurchase agreements (repos). Other than buying cash bonds, these FIIs can only engage in bond lending, bond forwards, interest rate swaps, and forward rate agreements for hedging purposes.

One of the disadvantages of the CIBM Direct is the lengthy account opening process. FIIs are required to appoint an onshore settlement agent as their Bond Settlement Agent to submit the filing to the PBOC. Because most FIIs already have a regional custody agreement in place covering global and local custody services, additional time may be required for negotiating and entering into an agreement with the onshore settlement agent. Another hurdle is the inefficiency of transferring cash and assets between QFII/RQFII accounts and CIBM Direct accounts. The FII has to liquidate its positions in its QFII/RQFII account, repatriate, and then fund the CIBM Direct account with “new money.” This process is not only costly, but it also involves foreign exchange and market risks.

On 1 September 2020, China’s National Interbank Fund Center (NIFC) rolled out a new pilot direct trading service under CIBM Direct, through which FIIs can conduct request-for-quotes (RFQ-based) transactions via Tradeweb or Bloomberg. Prior to the launch of this direct trading service, FIIs had to entrust their Bond Settlement Agents to initiate bond transactions or make inquiry trading. The direct trading service will enhance the efficiency of foreign investors’ investment and trading of Chinese bonds.

Bond Connect

Shortly after the launch of the CIBM Direct in 2016, the Bond Connect for northbound was launched in July 2017. Bond Connect gives overseas investors access to China’s fixed income market via trading infrastructure in Hong Kong (such as Bloomberg and TradeWeb) for the placement of orders with onshore participating dealers through an RFQ.

The account opening process under Bond Connect is simpler compared to the CIBM Direct. In order to trade under the Bond Connect, overseas investors must be registered with the PBOC Shanghai Head Office. Offshore investors must appoint a local custodian, either via a direct appointment or through the investor’s appointed global custodian. Unlike under CIBM Direct, investors are not required to open segregated onshore securities accounts or cash accounts. The scope of eligible overseas institutions for the Bond Connect is the same as that for the CIBM Direct. In terms of the scope of products covered by Bond Connect, all bonds circulated in the CIBM are eligible. Foreign investors may subscribe for bonds during initial offerings or purchase bonds on the secondary trading CIBM. In contrast to the CIBM Direct, Bond Connect participants are not allowed to engage in bond borrowing and lending, bond forwards, interest rate swaps and forward rate agreements. This limits the tools available to the participants to hedge their interest rate exposure.

Key Provisions of the Circular

Simplified Application Procedures and Account Opening Requirements

The Circular proposes to simplify the current procedures for investing in the CIBM market. When submitting the filing, FII are no longer required to submit a settlement agency agreement with an onshore settlement agent. A model of “Global Custodian Bank + Local Custodian Bank” is introduced under which 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. FIIs will not need to submit applications in the name of specific products, which will eliminate the need to submit an application for each product.

Integrated Access to CIBM and Exchange-Traded Bond Market

FIIs who are already investing in the interbank bond market, through CIBM Direct or Bond Connect, will not be required to apply for qualification to invest in the exchange-traded bond market. Instead, they may invest in the exchange market either directly or under the domestic intra-market connect scheme,^[3] which was announced by the PBOC and CSRC in July 2020. Under this scheme, qualified investors in the interbank bond market and exchange-traded bond market are allowed to trade bonds in both markets via an integrated trading infrastructure connecting both markets. The bond registration, custody and clearing institutions for both markets will, in the future, be able to jointly provide services to issuers and investors.

Unified Regulatory Requirements Across Bond Markets

The Circular states that the regulators will unify the regulatory requirements for fund receipts and payments, currency exchange, and foreign exchange risk management of FIIs investing in China’s bond markets, and further optimize and facilitate the inward and outward remittance of investment funds. On 21 September, the PBOC and SAFE issued a joint consultation^[4] on capital/fund controls, proposing that the limit on outward remittances will be removed for FIIs who have invested in the bond markets with a single currency – either RMB or a foreign currency. The currency outward remittance restriction will only be applicable if a FII uses both RMB and foreign currency to invest in the onshore bond markets. The limit on the amount of forex capital repatriation (currently at no more than 110% of total foreign currency invested in bonds by the FII) will be relaxed (to no more than 120%). The restriction that FIIs must handle spot foreign exchange settlement and sale via their settlement agents is also removed – they will be allowed to use other qualified domestic financial institutions to handle these procedures on their behalf.

Next Steps

We understand that, over the years, members have come across a number of procedural difficulties when accessing China’s onshore bond market. As described in this memo, each of the access channels comes with its own idiosyncratic restrictions, making the investment process cumbersome for foreign investors. With the Chinese regulators working out implementing rules under the Circular, this presents a good opportunity for ICI Global to make recommendations on how to smooth the process and address operational challenges. We will gather input in the calls mentioned above and through bilateral discussions and intend to prepare a submission to the CSRC within the next four-to-six weeks. If you are unable to participate in one of the calls, but would like to provide feedback, please contact me at emykolenko@ici.org to set up a time to discuss.

endnotes

- [1] The Circular is available (in Chinese) at:
http://www.csrc.gov.cn/pub/zjhpublic/zjh/202009/t20200902_382532.htm.
- [2] The new regulations on QFII/RQFII are available (in Chinese) at:
http://www.csrc.gov.cn/pub/zjhpublic/zjh/202009/t20200925_383650.htm
- [3] The announcement is available (in Chinese) at:
http://www.gov.cn/zhengce/zhengceku/2020-07/19/content_5528196.htm.
- [4] The consultation paper is available (in Chinese) at:
<http://www.safe.gov.cn/safe/2020/0921/17123.html>.