The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

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ICI Global's Submission to PBOC, CSRC, SAFE for Further Improving the Access of Foreign Institutional Investors to China's Bond Market (pdf)

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ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has ofices in London, Hong Kong, and Washington, DC. 2 □□□□□ 2020 □ 9 □ 2 □□□□□□□□□□□□□□□□□□□ □□□□□□□□□□□□□□□□□□□□□□□ □□□□□□ 9 □□□□□□□□□□□□□□□□□□ Notably, on September 2, 2020, the Regulators jointly released for public consultation the Circular on Matters Concerning Foreign Institutional Investors’ Investments in China’s Bond markets (“September Consultation Paper”). 3 “□□□□□□”□□□□1940□□□ □□□□ □□ UCITS□□□□□□□□ □□□□□ UCITS□□□ ICI Global | Page 2 of 10 □□□ □□□□□□□□□□□□□□□□□□□□□□ ICI Global1 is pleased and encouraged that the People’s Bank of China (“PBOC”), State Administration of Foreign Exchange (“SAFE”), and China Securities Regulatory Commission (“CSRC,” and these three regulators shall be collectively referred to as “Regulators”) are taking concrete efforts to ease and standardize the process for foreign investors to access the Chinese bond market.2 Managers of global regulated funds3, such as our member irms, generally are very interested in the Chinese bond market and support efforts to facilitate avenues through which foreign investors can access this market. □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ □□□□□□□□□ □□□□□□□□□□□□□□□□□□/□□□□□□□□□□□□□□□□□□□□□□□□□□□ □□ □□□□□□□ □□□ □□□□□□□□□□□□□□□□□□□□□□□□ Foreign investors, including regulated funds, however, continue to face various challenges when investing in the Chinese bond market. These challenges make it more dificult to access and/or transact in Chinese bonds and ultimately impact the attractiveness of Chinese bonds for foreign investors altogether. Progress in these areas, and in particular greater alignment with global standards, would improve China’s capital markets and encourage additional foreign investment, to the beneit of both China capital markets and foreign investors. □□□□□ □□ □□ □□□□□□□ □□□□□□4 □ Described below are a series of recommendations we request that the Regulators consider as they adopt further rules intended to improve foreign investors’ access to the Chinese bond market. These recommendations have been compiled based on discussions with our members who are active investors in emerging markets around the world and currently invest in the Chinese capital markets4. The term “regulated funds” includes US funds, which are comprehensively regulated under the Investment Company Act of 1940 (Investment Company Act), and non-US funds, that are organized or formed outside the US and substantively regulated to make them eligible for sale to retail investors (e.g., funds domiciled in the European Union and qualiied under the UCITS Directive (UCITS)). 4 □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ 9 □□□□□□□□□□□□□□ 2□□□□□□□□□□ □□□□□□□□□□□□□□□□□□□□ □□□□ We are aware that the Regulators have previously received feedback from the industry, including in response to the September Consultation Paper (see note 2). This paper seeks to provide feedback and recommendations that have not yet been submitted to the Regulators for consideration. ICI Global | Page 3 of 10 1. □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ Adoption of Global Standards to Facilitate Settlement Failure and Netting 1.1. □□□□□□□□□□□□ □□ Global Standards for Settlement Failure Procedures □□ □□□□□□ □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ 3 □□□□□□□□□□□□□□ □□□ □□□□□ □□ □□□ □□ □□□ □□ □□□□ We recommend that the Regulators adopt procedures for failed trades that are in line with global standards. The recently launched Recycling Settlement Service for failed trades in the interbank bond market allows foreign investors to rearrange the settlement of a cash bond trade that has failed on the original settlement date within the next three business days. Although this service could be used as a tool for foreign asset managers to manage operational risks, the recycling settlement is not the optimal solution for asset managers as it may give rise to trade cancellation risk. Under the Recycling Settlement Service, both parties (i.e. the buyer and seller) are required to renegotiate the terms of the new contract. Should the negotiation break down and the trade is cancelled, the buyer faces the risks of entering into a contract with less favorable terms in order to acquire the target securities. Furthermore, the accrued interests to be settled would have to be revised according to the new settlement date, and this may create potential cash management challenges for the asset managers. □□□ □□ □□□□□□□□□□□□ □□ □□ □□□□□□□□□□ □□□ □□□ □□□□□□□□ □□□ □□□ □□□□□□ □□ □□ In contrast, under the global standard adopted in key jurisdictions, settlement fails are generally not viewed as events of contractual default. It is the standard practice to address failed trades by allowing a failing seller to make delivery the next business day with original terms and conditions unchanged until the trade inally settles. For instance, a trade that fails to settle on Monday will be rescheduled on Tuesday; if it fails to settle on Wednesday, it will be settled on Thursday, etc. The global practice is preferred because it avoids potential changes to the original settlement date and terms, including the accrued interests earned on the securities. The buyer does not pay the seller until the seller delivers the securities; yet the buyer will be entitled to receive the ICI Global | Page 4 of 10 accrued interests calculated from the date of the original contract. Hence, the prospect of losing the time value of the transaction proceeds provides an incentive for the seller to make delivery on the settlement date or as soon as possible thereafter. For these reasons, we recommend that the Regulators amend the terms of the current Recycling Settlement Service to allow failed trades to settle on a new settlement date without the possibility of trade cancellation and the need to recalculate the accrued interests. 1.2. □□□□□□ Clariication on Netting □□□□□□□□□□□□□□□□□□□□ □□□□□□□□□□□□□□□□□□□ □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ □□□□□□□□□□□□□□□□□□□□□□□ □□□□□□□□□□□□□□□□ □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ □□□□□□□□□□□□□□□□□□□□□□□□□□ □□□□□□□□□□□□□ □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ □□□□□□□□□□□□□□□□□□□□□□□□□□□□ □□□□□□□□□□ □□□□□□□□□“□□□□”□□□□“ □□□□□”□□□□□□□□□□□□ □□□□□□□□□□□“ □□□□”□□□□ “ □□□□□” □□□□□□□□□ □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ □□□□□□□□□□□□□□□□□□□ Foreign asset managers often incur challenges with netting settlement in the China bond market due to the settlement time difference for buy and sell transactions. In other jurisdictions, in accordance with the global standard, it is possible for both the buy and sell transactions to be settled on the same date and at the same time (“netting”). This netting service is a common service offered by custodians under their contractual settlement agreement with an asset manager. By allowing parties to combine their obligations into a single payment, netting mitigates the credit risk associated with trading bonds and derivatives. In China, custodians currently are not able to offer this netting service, which gives rise to a funding gap (which could create substantial dificulties even if it is for a few hours) between when the proceeds are received from the buy and sell transactions. For example, the provisions of the settlement date of forex transactions related to bond transactions create such a funding gap. Currently, the settlement date of “buying CNY” pertaining to “buying bond” is the business day preceding the bond settlement date. The settlement date of “selling CNY” pertaining to “selling bond” is the business day following the bond delivery date. This effectively results in a pre-funding requirement on asset managers for these transactions. We recommend that these provisions be revised in a manner that minimizes the funding gap risk. □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ □□□□□ □□□□□□□□□□□□□□□□□□□□□□□□□□□□ 2020 □□□□□□□□□□ □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ □□□□□ □□ □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ □□□ □□□□□□□□□□□□□□□□□□□□□ ICI Global | Page 5 of 10 For these reasons, we recommend that the Regulators take action to formally recognize netting as soon as possible and allow custodians to provide netting service under their contractual settlement service with the asset managers. Furthermore, we understand that the China Banking and Insurance Regulatory Commission (CBIRC) has issued a draft notice to clarify enforceability of close-out netting in China in early 2020, but that this notice has not been inalized or issued. The risk of netting provisions not being recognized in China is a key concern for foreign asset managers trading derivative products with PRC onshore counterparties. We therefore urge the CSRC to work with the CBIRC to have netting be formally recognized. 2. □□□□□ China Bond Connect Issues 2.1. □ BCCL □□□□□□□ Requirement to Provide Documentation to BCCL □□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□/□□□□□□□□□□□ □□□ □ □□ □□□□□□ BCCL□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□□ □□□□□□□□□□□□□□□□□□□□□□□□□□□□/□□□□□□□□□□□□□□□□□□□ □□□ □ A □□□□□□□□□□□ We request that the Bond Connect account opening process be revised to require investment managers to provide documentation to the global custodian/sub-custodian only, which is the typical process followed globally (and used for the Stock Connect). The current Bond Connect account opening process requires the investment manager to coordinate and provide documentation to both the global custodian bank and the Bond Connect Company Limited (“BCCL”). This process is ineficient and unnecessarily time- consuming. The Stock Connect model only requires investment managers to provide documentation to the global custodian bank/sub-custodian to open a Stock Connect bank account without the need for documents to be submitted to the regulator. It is, therefore, currently signiicantly easier for an investment manager to open bank accounts for China equity A shares than to open Bond Connect bank accounts. 2.2. Requirement to have Fund Assets Upon Account Opening We request that the procedures for opening a Bond Connect account be revised not require that a fund have actual fund assets (in an amount greater than zero) for the Bond Connect application to be approved and inalized. We understand from our members that a newly created fund that does not yet hold assets is unable to open a Bond Connect bank account because fund assets in an amount greater than zero ICI Global | Page 6 of 10 continue to be required to be listed on the application for approval. We recommend that the application focus on conirming the legal existence of the fund rather than size of current assets under management. 2.3. Requirements for Idle Cash and Calculating Hedge Limits We request that the Regulators provide further clarity regarding the management of CNY idle cash and the calculation of hedge limits. The existing regulation for handling onshore CNY idle cash and calculating hedge limits in the Bond Connect market provides that it must be handled in a “genuine and reasonable” manner, which is ambiguous. As a result, in the Bond Connect market global custodians and/or their Bond Connect sub-custodians manage idle CNY cash and set FX hedging limits differently and in an inconsistent manner. This inconsistency makes it dificult for investment managers that use multiple global custodian banks to follow a uniform set of idle CNY cash and CNY hedging control limits. For example, some banks derive CNY hedge limits using par value and other banks derive CNY hedge limits using market value. To address this issue, we recommend that market value be used in the calculation of CNY hedge limits consistently across all global custodians and their sub- custodians. We believe this approach is appropriate because hedging using market value of the China bonds allows an investor to best hedge the underlying securities’ currency risk. 3. QFII/RQFII CIBM Rationalizing the QFII/RQFII Scheme, Bond Connect and CIBM Schemes 3.1. QFII/RQFII Consolidation of QFII/RQFII Rules 3.1.1. Requirement to Buy and Sell a Security from the Same Broker QFII/RQFII ICI Global | Page 7 of 10 We request that the requirement that securities be purchased and sold by the same broker be removed. The new QFII/RQFII rules remove the cap on the number of securities and futures brokers which QFIIs may appoint. However, QFIIs are still required to buy and sell a security from the same broker, which, in practice, limits investors to a single broker model in substance. 3.1.2. Repatriation Complexity We appreciate the relaxation of the previous provisions on the repatriation of income and capital gains by QFIIs, which required the completion of an audit and payment of tax. We understand that QFIIs are now able to repatriate their earnings, net of prior years’ losses, upon the provision of a tax payment undertaking to the QFII custodian, which will check that amounts repatriated are covered by the tax payment undertaking. Depending on the amounts sought to be repatriated, QFIIs have the lexibility of electing to provide a tax payment undertaking for either a deined portion of the gains or the gains for a whole period. It is unclear how long it will take to clear the repatriation after issuance of the tax payment undertaking letter. Because repatriation remains an issue for regulated funds with daily liquidity that invest in Chinese bonds, the possibility of an extended repatriation period raises concerns. We request that the Regulators consider whether and how the repatriation process can be further expedited and simpliied. 3.2. [illegible] Non-trade Transfers [illegible] 2019 [illegible] 5 [illegible] 10 [illegible] QFII/RQFII [illegible] CIBM [illegible] 9 [illegible] QFII/RQFII [illegible] CIBM [illegible] QFII/RQFII[illegible]CIBM [illegible] We recommend that the Regulators permit non-trade transfers across all of the schemes and that such transfers be performed electronically, on a real-time basis. The Circular on Further Facilitating Foreign Institutional Investors' Investment in the Interbank Bond Market (Consultation Paper) issued by the PBOC and the SAFE on May 10, 2019, allows a two-way transfer of bonds and funds under the QFII/RQFII and CIBM ICI Global | Page 8 of 10 Direct for the same investor. Pursuant to the September Consultation Paper, the same investor may, according to its own investment management needs, make a two-way non-trade transfer between its bonds and funds under the QFII/RQFII and the bonds and funds under the CIBM Direct. Despite being included in the Circular more broadly, it appears that non-trade transfers with Bond Connect accounts are not contemplated. We request that the Regulators allow the transfer of bonds and funds among all related accounts of QFII/RQFII, CIBM Direct and Bond Connect with respect to the same institution. We also recommend that the process for non-trade transfer of bonds be simpliied and made more eficient, so that foreign investors can make their cash or bond positions fungible between these different schemes. [illegible] We also recommend that the Regulators permit certain exceptions to the non-trade transfer rules, such as in the case of default, as is standard global practice. As the various access schemes open up and allow for more products to be used, there will be greater use of Chinese assets as collateral for various transactions. In the case of default, due to the existing non-trade transfer rules, the assets need to be sold before the proceeds are given to the secured party. This process is ineficient and may impact the pricing of these securities during this period. An exception to the non-trade transfer rules that would permit these securities to be transferred to the secured party (non- defaulting party) would be seamless and remove the need to liquidate assets in the market. 3.3. [illegible] Extend CFETS Cutoff Time [illegible] 20:00[illegible] T [illegible] 20:00 [illegible] T+1 [illegible] CIBM [illegible] With the recent extension of CIBM trading hours to 8pm, we request that the Regulators extend the cut-off time for reporting trades to CFETS to either later than 8pm on T date or to a given time on T+1. If the CFETS cut-off time is missed, such a trade would be considered invalid. Such an extension would afford investors additional time to ensure that their transactions under Direct Access are timely and appropriately reported to CFETS. ICI Global | Page 9 of 10 4. [illegible] Further Development of Bond Repo Market Especially for Off-the-run Bonds to Address Liquidity [illegible] 82 [illegible] 20 [illegible] 5 [illegible] 1 [illegible] Repos are a crucial component of global inancial markets in increasing market eficiency and liquidity. We recommend that the Regulators further develop the Chinese repo market to enhance the liquidity of the off-the-run bonds. Compared to the on-the-run bonds in China, liquidity of off-the-run bonds is much more challenging. There are only a few off-the-run bonds offered by major brokers, making it especially dificult for passive funds to replicate the indices. Although currently there are 82 Chinese government bonds in the FTSE World Government Bond Index, major brokers are only able to offer less than 20 issues. Additionally, there is a signiicantly higher cost for trading off-the-run bonds. We understand that the difference of the bid-ask spreads between on-the-run and off-the-run Chinese government bonds is around 5 bps, while it is less than 1bps on average for US government bonds. For these reasons, we recommend that the Regulators take action to further develop the Chinese repo bond market, by allowing foreign institutional investors to engage in bond repos on both the interbank and exchange bond markets. 5. [illegible] Formal Notiication on Capital Gains Tax Exemption from the Tax Authority [illegible] 2017 [illegible] 11 [illegible] 10%[illegible] In respect of gains derived by foreign institutional investors from the trading of China bonds, the PBOC, in their operation rule for foreign institutional investors investing in the Chinese interbank bond market issued in November 2017, expressed their view that the gains are not taxable. Although the Chinese tax authorities have taken the view that such gain is not China-sourced income and have not enforced the collection of China corporate income tax, there is nothing in writing conirming this. There is, therefore, uncertainty regarding whether retrospective taxation at a rate of 10% on the capital gains may be charged. We urge the State Administration of Taxation to issue a formal notiication to clarify capital gains tax exemption measures for foreign institutional ICI Global | Page 10 of 10 investors, including those are who based in jurisdictions without an existing tax treaty with China. [illegible] ICI Global truly appreciates the opportunity to express our comments to the Regulators and look forward to the issuance of the inal implementation rules. Please free feel to contact me if you have any questions regarding our recommendation or would like any additional information. [illegible] Sincerely, [illegible] Alexa Lam [illegible] CEO, ICI Global Asia Paciic 2020 [illegible] 11 [illegible] 26 [illegible] 26 November 2020