China’s Bond Market

White Paper

July 2014

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Investing in the Chinese Bond Market

A guide to the market and the opportunities for offshore investors

Introduction

It is a well known fact that China is the world's second largest economy after the US. Perhaps less well know is the fact that China has a large and actively traded bond market. Three aspects are adding to the potential attraction of this asset class: First, the comparatively high interest rates available in the Chinese market. Second, the relative safety of the bonds traded. Third, the high liquidity of the Chinese bond market. The following pages attempt to answer questions such as:

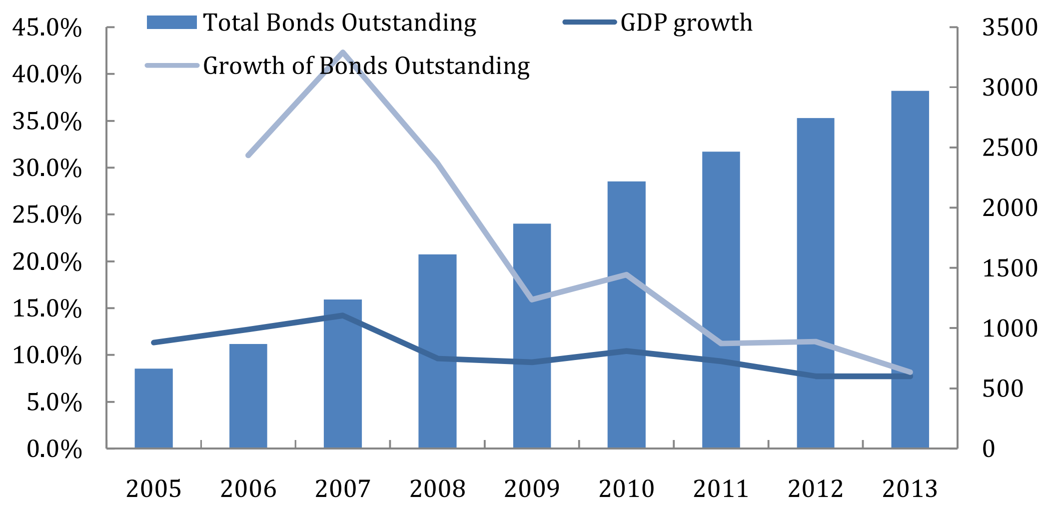
- How large is China's bond market?
- What types of bonds are available to investors?
- How are those bonds traded?
- What is driving the growth of China's bond market?
- How to invest in China's bond market?
- The case for investing in China's bond market

1. Description of the Domestic Chinese Bond market

1.1. Size of market

As China's economy has grown, the country has developed a large and increasingly diverse market that includes both public and private debt (Fig. 1).

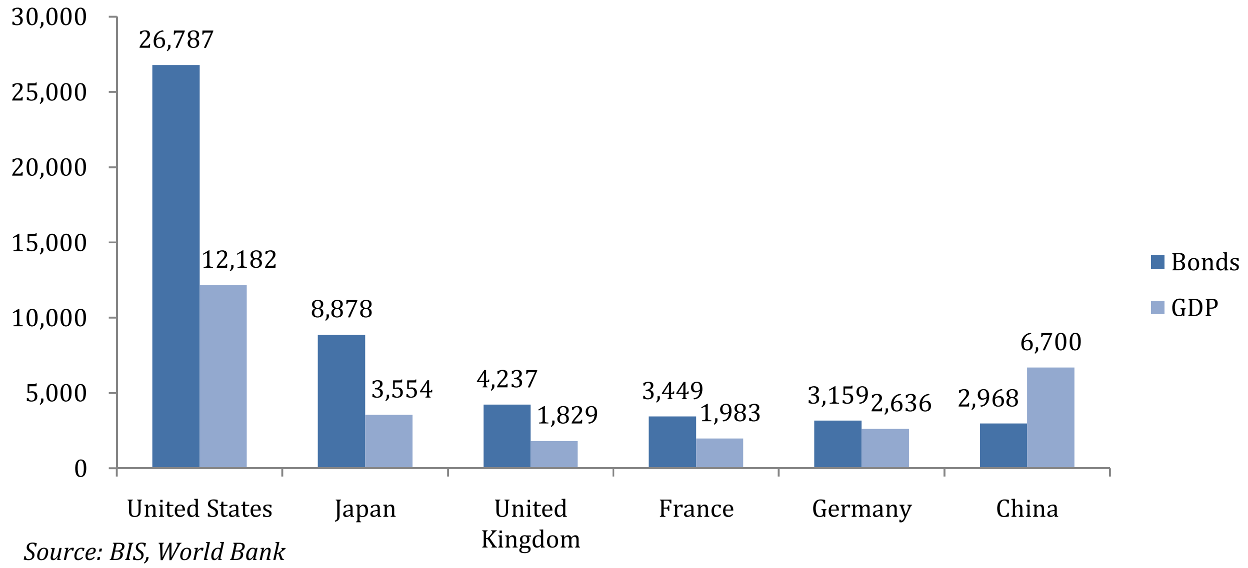
Fig. 1 - The Growth of China's Bond Market (EUR Billion)



Source: BIS, World Bank

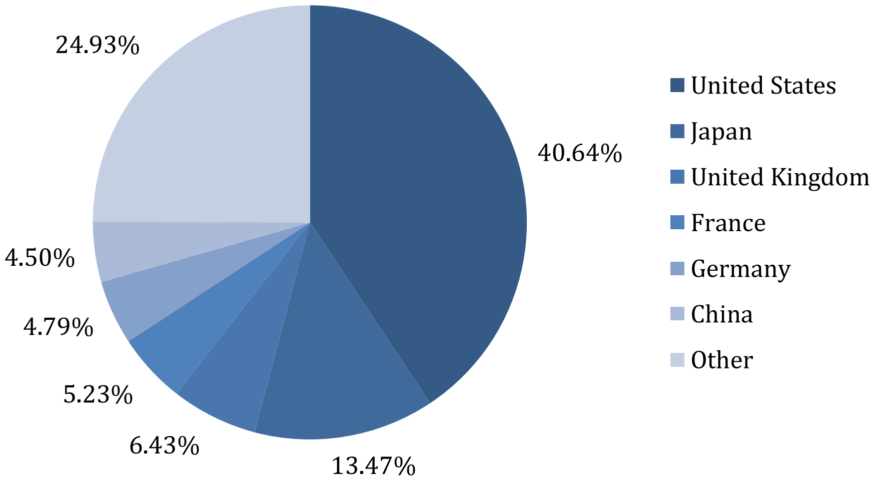
China's outstanding bonds stood at EUR 2.97 trillion (CNY 24.78tn) as at the end of 2013, making it the 6th largest bond market in the world - just behind Germany and France (Fig. 2 and Fig. 3).

Fig. 2 - Comparison Bond Market and GDP (EUR Billion)



Source: BIS, World Bank

Fig. 3 - Sixth Largest Bond Market in the World (EUR Billion)



Source: BIS

1.2. Type of bonds

The major types of bonds available in the Chinese market can be grouped into four broad categories:

- **Government Bonds**
- **Central Bank Notes**
- **Financial Bonds**
- **Non-Financial Corporate Bonds**

Each of these bond types are described in more detail, below:

Government bonds are issued by the Ministry of Finance (MoF) in a range of maturities to finance government spending. Local governments also issue bonds, similar to municipal bonds in the US.

- Government bonds (CGB): Central government bonds are issued by the Ministry of Finance (MoF) for the purpose of funding the budget deficit. Maturities range from 3M to 50Y. These bonds are generally tax-exempt and are traded in both the interbank and exchange markets. There are three types of MoF bonds: book-entry bonds, retail (certificate) bonds, and retail (electronic) bonds.
- Local government bonds are issued to fund local governments' budget deficits. Under a pilot programme, all issuance (except paper issued by four local governments) is conducted by MoF on behalf of local governments. In all instances, principal and coupon amounts are repaid via the MoF. Maturities are 3Y, 5Y and 7Y. These bonds are tax-exempt and traded in both the interbank and exchange markets.

Central Bank Notes are short-term securities issued by the Peoples Bank of China as a tool for implementing monetary policy. Central bank notes are the most actively traded sector of China's bond market and are often used in money market and liquidity management portfolios due to the notes' short maturities.

- PBoC bills are issued by the central bank for the purpose of adjusting market liquidity. Maturities range from 3M to 3Y. These bills trade only in the interbank market.

Financial Bonds are the most actively traded bonds in China and are issued by policy banks, commercial banks and other financial institutions. The policy banks are the largest issuers and include the China Development Bank, the Export-Import Bank of China and the Agriculture Development Bank of China. Only policy bank bonds are backed by the central government.

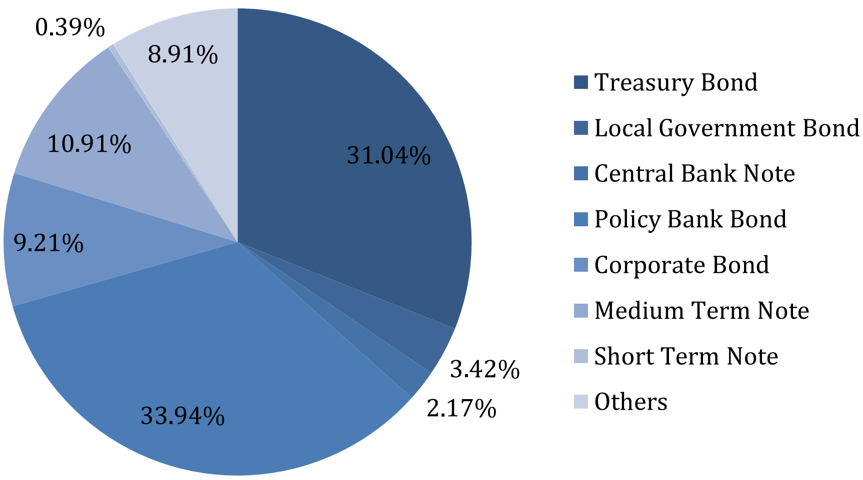
- Financial bonds are issued by policy banks, commercial banks and other non-bank financial institutions. Senior debt is primarily issued by the three policy banks, as they are not allowed to take deposits. On the other hand, commercial banks mainly issue subordinated notes to meet capital requirements. Financial bonds trade only in the interbank market.

Non-Financial Corporate Bonds include a wide variety of bonds but the largest sectors are known as "enterprise" bonds and "medium-term notes". Enterprise bonds are issued by institutions affiliated to Central Government departments, enterprises solely funded by the State, state-controlled enterprises as well as other large-sized state-owned entities. Enterprise bonds are a much larger and more actively traded sector of the Chinese bond market compared to corporate bonds. Private companies of any size can also issue corporate bonds. Companies can also issue short-term financing bills (or commercial paper) and medium-term notes, which are the most liquid non-financial corporate bonds.

- **Enterprise bonds** are issued by central and local state-owned enterprises (SOEs). The issuance programme is regulated by the National Development and Reform Commission (NDRC), and bonds are traded in both the interbank and exchange markets. Enterprise bonds are bonds issued by institutions affiliated to Central Government departments, enterprises solely funded by the State, state-controlled enterprises and other large-sized state-owned entities. Examples of issuers in this market include companies like China National Petroleum, the state-owned fuel production company, China Petrochemical, Asia's largest refining and petrochemical enterprise, and China Telecom, a state-owned telecommunications company. Typically, enterprise bonds are issued to provide funding to infrastructure construction, fixed asset investment, key technical renovations, public welfare undertakings and other projects that are vital to national well-being and the people's livelihood.
- **Corporate bonds** are issued by companies listed on the Shanghai or Shenzhen Stock Exchange. The issuance programme is regulated by the CSRC, and bonds are traded only in the exchange market. Corporate bonds can be issued by any company. There are no restrictions on the issuers of corporate bonds. Even small companies can issue corporate bonds as long as they meet the relevant criteria. Corporate bond issuance requires verification and approval from China Securities Regulatory Commission (CSRC). However, the approval system for corporate bonds is quicker, easier and more market-driven compared with enterprise bonds. Companies file for corporate bond issuance according to their own business operational needs.
- **Short-term commercial paper** (SCP), commercial paper (CP) and medium-term notes (MTN) are issued by non-financial companies. SCP refers to notes of maturity shorter than 270 days; CP is shorter than 1Y; and MTNs are longer than 1Y. The issuance programme is regulated by the National Association of Financial Market Institutional Investors (NAFMII), and securities are traded only in the interbank market.
- **Others** include convertible bonds (traded only on an exchange), asset-backed securities, and Panda bonds.

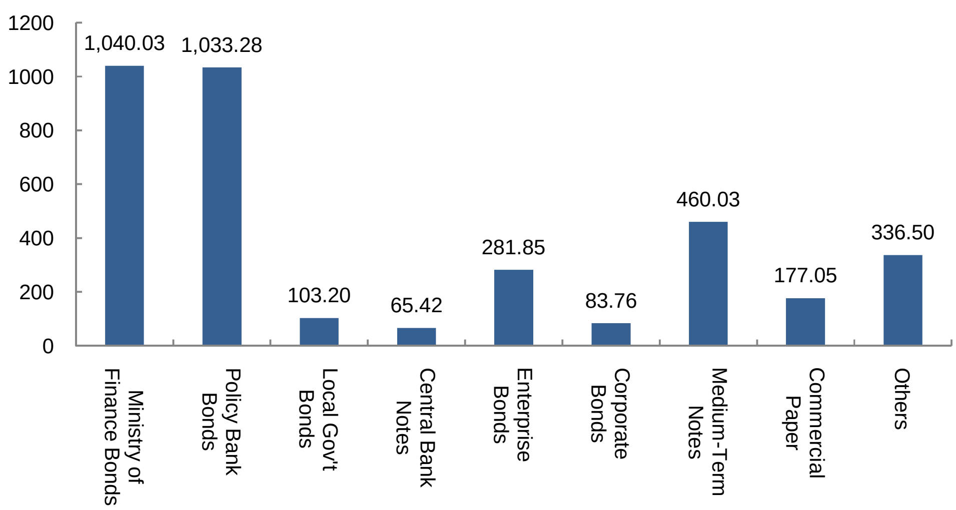
Corporate bonds accounted for a very small pro-portion of the bond market until recently, yet between 2008 and 2013, total corporate issuance more than doubled, and corporate issuance stood just under 30% of the total bond market in 2013 (Fig. 4). It is still small relative to central and local government bonds, even after several years of rapid growth. Some of the growth was also exaggerated as part of the bonds that were counted as corporate bonds in 2007, 2008 and 2009 were actually bonds issued by corporations established by local governments.

Fig. 4 - Bond Market Sectors – December 2013



The number of corporate bonds issued in 2012, 484, was nearly 50% higher than the number issued in 2011, and over 60% greater in total value. By December 2013 the value of corporate bonds was close to CNY 700bn or EUR 83.76bn (Fig. 5).

Fig. 5 - China Bond Market – Sector Sizes as at December 2013 (EUR Billion)



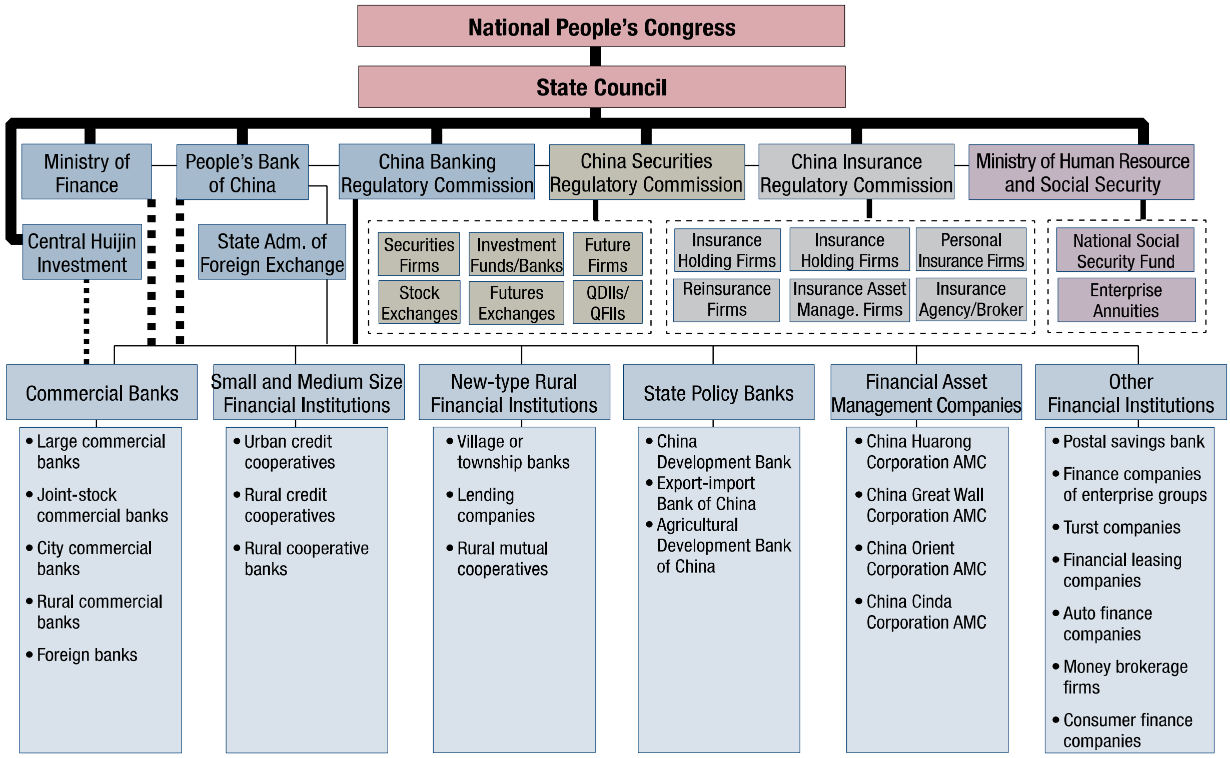
Source: Wind Info, as of November 2013

China is in the process of establishing a more actively traded credit bond market. One goal of this effort is to encourage corporations to seek more financing through the marketplace rather than through bank loans. In 2012, China's National Association of Financial Market Institutional Investors (CNAFII) issued rules that allow non-financial companies to sell bonds through private placements, similar to US and other developed corporate bond markets.

1.3. Regulations and regulators; investor protection rules

China's regulators are divided primarily by the broad types of activity they oversee, although, there are some overlaps and oddities, as is the case in most countries. Sitting at the top of the system is the National People's Congress which promulgates all financial sector laws. The State Council then executes financial regulation and issues policy directives to the financial regulators and supervisory agencies (Fig. 6).

Fig. 6 – China's financial regulatory organisation chart



Notes: The thickest connecting lines correspond to the highest levels of authority in financial policy making. The NPC promulgates all financial sector laws and the State Council executes financial regulation and issues mandatory policy directives to all the financial regulatory and supervisory agencies. The dotted connecting lines indicate the three primary functions of PBC—formulating monetary policy, maintaining financial stability, and providing financial services—and the triple role of the MOF as tax administrator, treasurer, and owner of several commercial banks. The thinner connecting lines emerging from CBRC, CSRC, CIRC, and MHRSS reflect that these entities are mostly responsible for regulating and conducting supervision and oversight of their respective financial sectors *Additional notes:* The SAFE is responsible for foreign exchange operations of securities and insurance companies. The China Development Bank and the Postal Savings Bank are in the process of reforming into commercial banks. Central Huijin exercise rights and obligations as an investor in major state-owned financial enterprises on behalf of the State. The National Social Security Fun has also a dual role as an institutional investor and a stakeholder in some of the largest commercial banks.

Source: IMF: "The People's Republic of China: Financial Stability Assessment Report"

Banks are regulated primarily by the China Banking Regulatory Commission (CBRC), securities and financial markets by the China Securities Regulatory Commission (CSRC), and insurance industry by the China Insurance Regulatory Commission (CIRC).

The China Banking Regulatory Commission (CBRC) regulates deposit-taking institutions and related asset management companies. The CBRC and the PBoC jointly approve commercial banks‟ bond issuance.
The China Securities Regulatory Commission (CSRC) regulates domestic stock exchange markets. It is responsible for regulating and supervising securities issuers and overseeing the issuing, trading, custody and settlement of equities, bonds and futures. It is also responsible for granting QFII licences to foreign investors under the programme.
China's Central Bank, the People's Bank of China (PBOC), also has important regulatory responsibilities, in addition to managing monetary policy. It is in charge of drafting regulatory bills, regulating systemic risks, and managing financial stability. As is true for virtually all central banks, it can serve as a lender of last resort during a financial crisis. The PBOC also used to sets limits on deposit interest rates and lending interest rates. Further, it controls the State Administration of Foreign Exchange (SAFE), which manages the exchange rate. The SAFE governs the foreign exchange market and cross-border foreign-currency activities. It also manages China's FX reserves and grants approval for QFII investment quota after investors receive their investment licences from the CSRC.

The PBoC's monetary policy division is the main regulatory body responsible for the development of RMB internationalization. The PBoC is responsible for supervising the interbank market. Foreign investors require approval from and quota assignment by the PBoC to gain access to the domestic interbank market.

The central bank has delegated certain powers to the National Association of Financial Market Institutional Investors (NAFMII), which is a self-regulated non- profit association under the supervision of the PBoC. The NAFMII is responsible for approving short-term commercial paper, commercial paper and MTNs in the interbank market

The Ministry of Finance (MOF) also touches on financial regulation through both its share holdings in the major commercial banks and its control over the Central Huijin Company, through which it indirectly owns substantial stakes in commercial banks.

The National Development and Reform Commission (NDRC) is a macroeconomic management agency under the State Council. It approves the issuance of enterprise bonds.

1.4. Rating agencies and bond ratings

The expansion of China's bond markets and increased diversity of products has led to the development of the credit rating industry in China. With accumulated experience, increased competition and stronger supervision, China's credit rating agencies continue to refine their own structures. This is evidenced by improvements in their compliance, technology, systems, expertise and internationalisation. The largest domestic credit rating agency, Dagong Global Credit Rating Co Ltd., was founded in 1994 and is controlled by the State-owned Assets Supervision and Administration Commission (ASAC), which is a government agency dedicated to supervising all state-owned enterprises.

China's credit rating agencies have steadily improved their operating procedures, establishing more compliance-oriented systems with improved codes of conduct and supervision in areas relating to professionalism, independence, conflict of interest, information disclosure and transparency. To further support professionalization of the industry, on 21 October 2010, the Professional Committee of Credit Rating under the National Association of Financial Market Institutional Investors (NAFMII) was founded in Beijing and is the first self-regulated organisation approved by the Bureau of Civil Affairs.

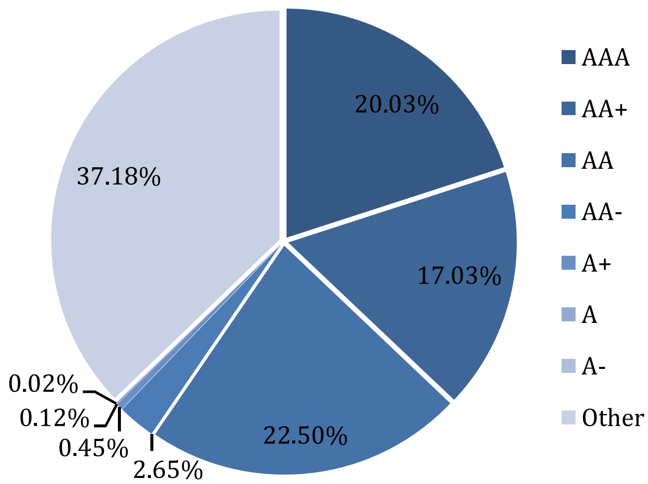
In terms of methodologies and standards, credit rating agencies have established systematic approaches towards qualitative and quantitative analysis. They have learnt from the rating methodologies and techniques used by international rating agencies and applied these to the credit environment in China although China's agencies apply a different standard to the rating of companies and securities.

China's rating agencies have made great strides in strengthening international ties. At the end of 2010, several credit rating agencies established joint ventures and other forms of cooperation with their international peers although in the same year Dagong applied to the SEC to enter the US. The request was rejected because the SEC refused to allow "cross-border regulation." Several agencies have become members of the Association of Credit Rating Agencies in Asia (ACRAA), applied to certify as international rating agencies, and have issued sovereign rating reports. Credit rating agencies in China have seized the post-crisis opportunity to increase their international standing, and have actively participated in the formulation and setting of international credit rating methodologies, rules and standards to stabilise the global financial system together with the international market.

Foreign rating agencies such as Standard and Poor's and Moody's all have offices in Beijing. But seldom do they rate bonds issued by domestic companies. Their main business in China is to provide ratings for bonds issued overseas, and also to serve as a financial consultant for domestic companies that are listed abroad.

Bond issues in China are assigned ratings from AAA through to BBB. Current bond issues rated AA- and above represent more than 62% of total issues (Fig. 7)

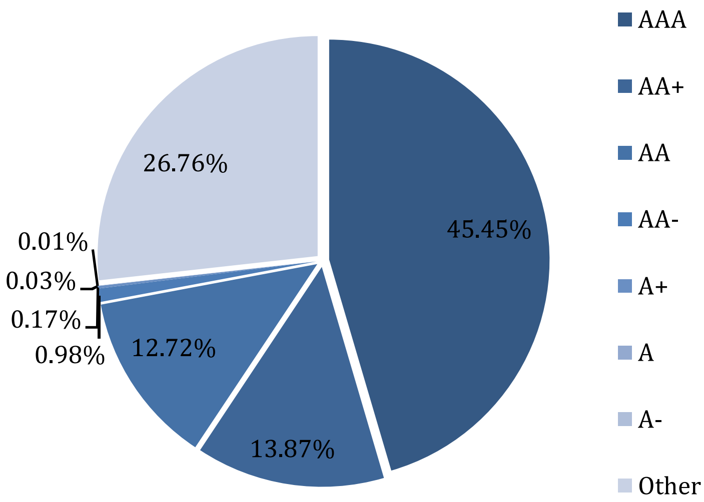
Fig. 7 Market weight by number of bonds outstanding (2014Q2)



Source: Wind

In respect of the value of the bonds outstanding current bonds issued at AA- and above also represent more than 73% of the market. AAA rated bonds represent the majority and account for more than 45% of the value of bonds outstanding. (Fig. 8)

Fig. 8 - Market weight by value of bonds outstanding (2014Q2)



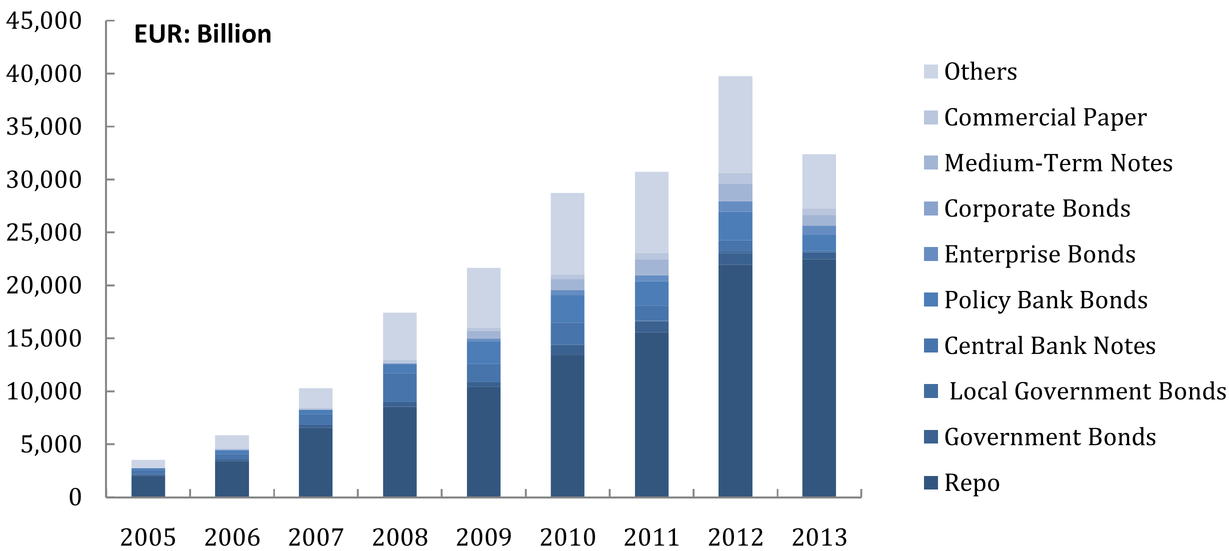
Source: Wind

1.5. Trading venues, trading volumes & pricing

From a trading perspective, China has two bond markets: the Interbank bond market which was launched in 1997 is regulated by the Peoples Bank of China. The Exchange Traded market began operations in 1990 and is regulated by the China Securities Regulatory Commission. The Interbank market now dominates trading volume accounting for 95% of total outstanding domestic bonds. Most types of domestic bonds – except corporate and convertible bonds – are traded on the interbank market.

Trading activity has grown rapidly and the market is very liquid, with about EUR 40 trillion in total trading volume in 2012 (Fig. 9). Trading volume declined to EUR 32 trillion in 2013 mainly due to regulatory activity aimed at imposing tighter controls on the industry. This resulted in the closing down of several trading accounts in addition to the imposition of a temporary ban on new account openings.

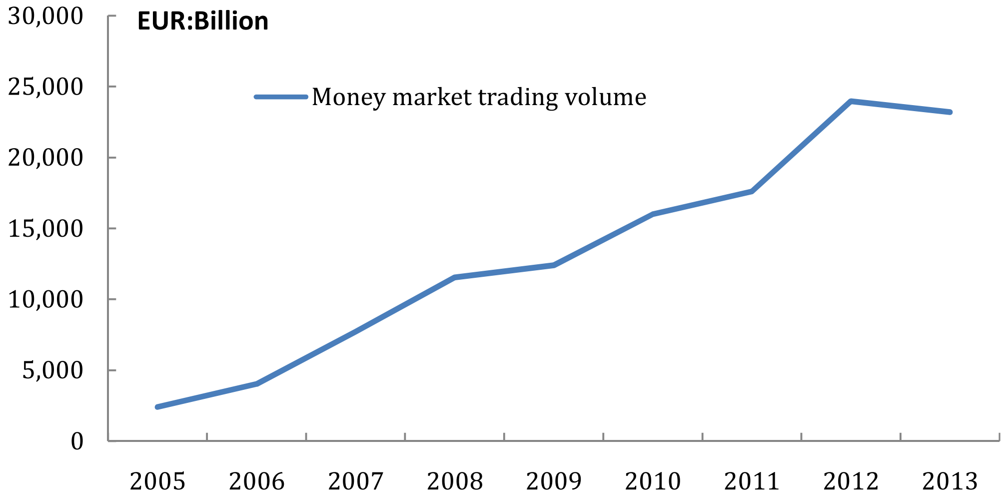
Fig 9 - Secondary Bond Market Trading Activity



The following charts illustrate the growth in trading volume of China's money market and interbank market.

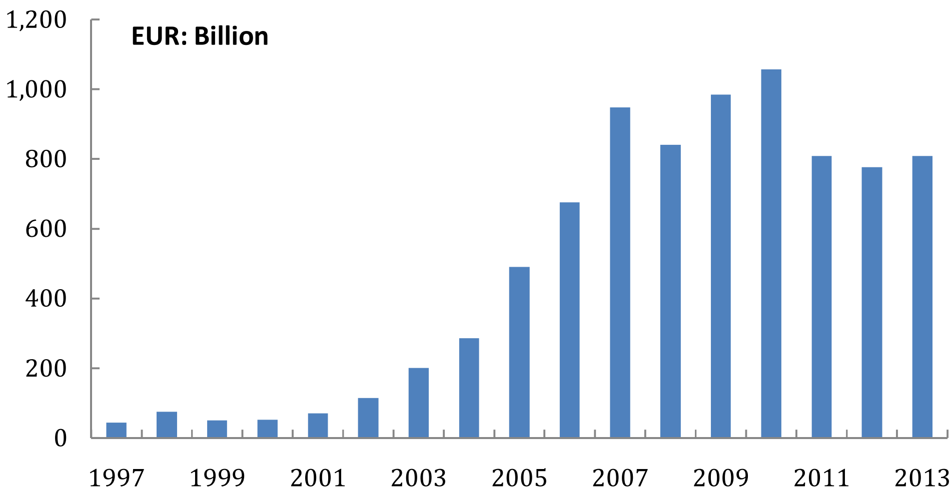
Trading volume on the money market has grown from EUR 2.4 trillion in 2005 to EUR 23 trillion by the end of 2013 (Fig. 10)

Fig. 10 - Money Market Trading Volume – EUR 23tn at 31 Dec 2013



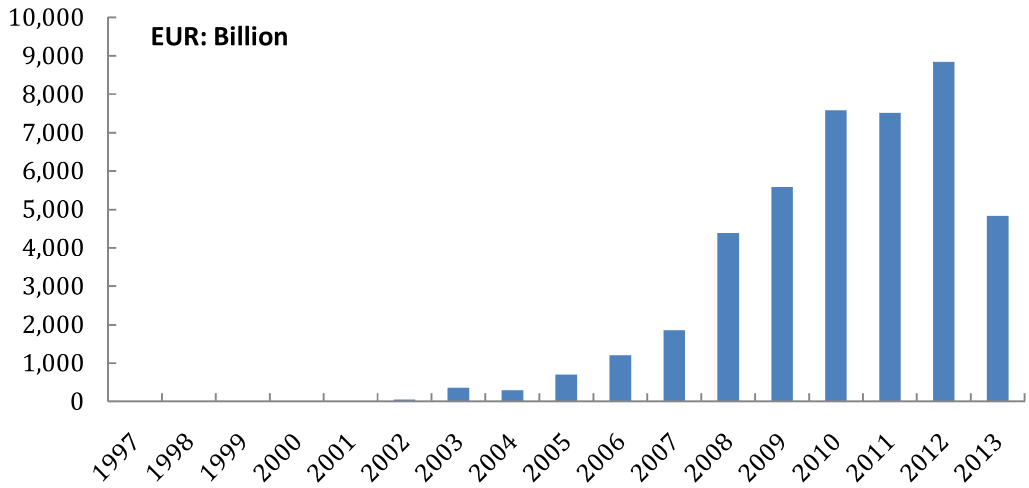
Annual issuance volume in the interbank bond market has grown by a factor of 18 between 1997 and 2013. Since 2011 issuance has been steady at around EUR 0.8 trillion per annum but bond issuance is set to increase as China's credit markets mature and fiscal reforms are announced (Fig. 11).

Fig. 11 - Interbank Bond Market Issuance Volume



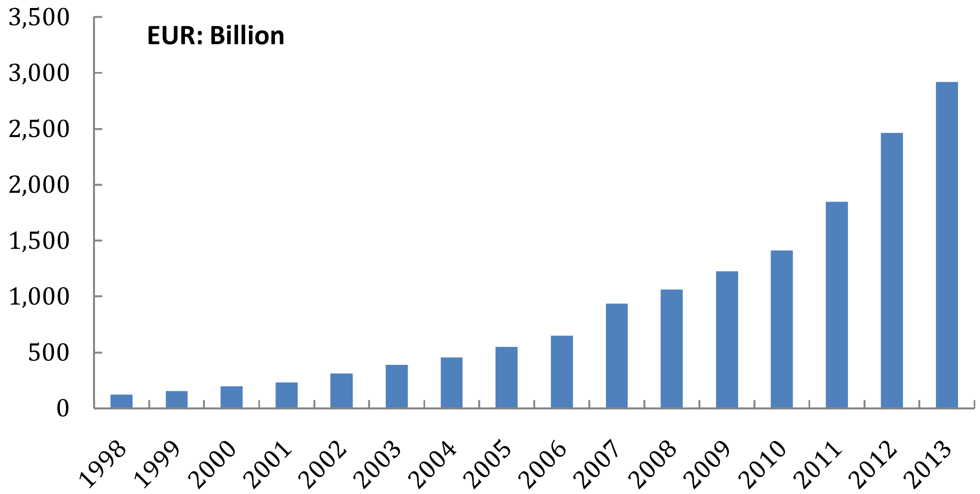
Trading volumes on the interbank bond market have grown dramatically in recent years. Since the opening of the market it took more than 5 years for trading volume to reach over EUR 1 trillion. Since then growth has been rapid, peaking in 2012 at almost EUR 8.8 trillion (Fig. 12).

Fig. 12 - Interbank Bond Market Trading Volume



Volume of trades under custody in the interbank bond market has seen steady growth with almost EUR 3 trillion traded at December 2013 (Fig. 13).

Fig. 13 - Interbank Bond Market - Volume under Custody



There are two ways for Foreign Qualified Investors (see below) to trade on the Inter-bank market:

Direct access: the investor opens a trading account in CDC (China's Inter-bank bank clearing house) and connects trading terminals to CFETS (the Inter-bank trading centre). After setting up the trading and back office platforms, a central bank could trade directly on the market and conduct all daily operations including trade settlement and confirmation, etc.

Agent access: the investor appoints a qualified agent bank as proxy. The Central bank sends trading instruction to agent bank and the agent bank trades on the market on behalf of central banks and takes care of all the operations.

1.6. Bond Market Participants

Issuers - Bond issuers include the MoF, PBoC, local governments, policy banks, commercial banks, non-banking financial institutions, state-owned enterprises, listed companies, and international agencies.

Investors - Special settlement members (SSM) include the PBoC, MoF, the policy banks, the Shanghai Stock Exchange, the Shenzhen Stock Exchange, CGSDTC and CSDCC, amongst others. Major investors include commercial banks, insurance companies, mutual funds, foreign commercial banks, securities firms, non-financing institutions and foreign financial institutions holding Qualified Foreign Institutional Investor (QFII) licences.

Commercial banks dominate trading activity in China's Inter-bank bond market, accounting for around 70% of trading volume. Because bank deposits are the most important investment tools for Chinese households, commercial banks have very large balance sheets. However, local commercial banks have limited channels for investing, because regulations prohibit these banks from investing in equities or futures markets. Other large participants include asset managers and insurance companies, although both are small relative to banks in terms of bond trading.

Bond Holders (Fig 14) - Commercial banks are the main holders of domestic bonds with 65% of the total outstanding of all types of bonds. Specifically, they hold nearly 70% of CGBs and more than 80% of policy bank bonds owing to these securities' zero risk weighting. On the credit side, they hold 25% of all corporate issues including a substantial amount of Medium Term Notes (53%), as they have been the main underwriters of such bonds. Their holdings of other credit products (enterprise bond/commercial bank paper) are low, at around 30% of the total for each type. Commercial banks' trading activity is principally in the interbank market.

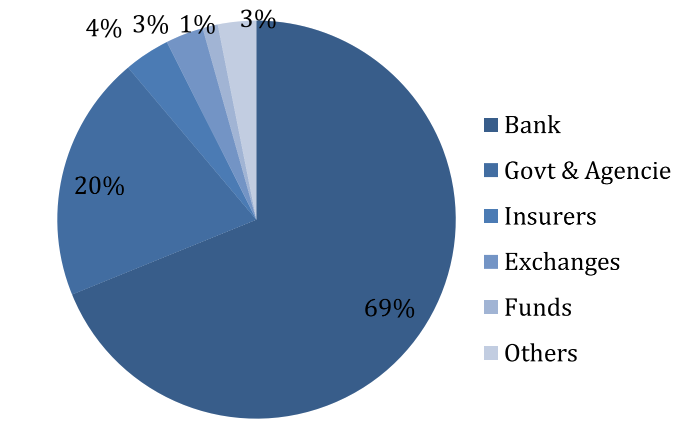
The second-largest group of domestic bond holders are insurance companies, holding 10.5% of total outstanding bonds. They are also the largest holders of commercial bank paper, accounting for 53% of the total outstanding. Their holdings of government bonds, however, are low (4% of CGBs while their corporate bond holdings at 15% make them the fourth largest holders of these securities.

The third-largest investors are funds, accounting for 9.9% of the total outstanding. Similar to insurance companies, their holdings are heavily skewed towards non-government bonds, particularly MTNs (34% of the total outstanding) and enterprise bonds (21%). Conversely, they hold only 1% of CGBs owing to their lower yields. The share of the debt market held by funds in China is low compared with the international standard. According to data from Wind, the AUM of bond funds accounted for only 5% of total domestic funds at the end of 2010, compared with 20% in the US.

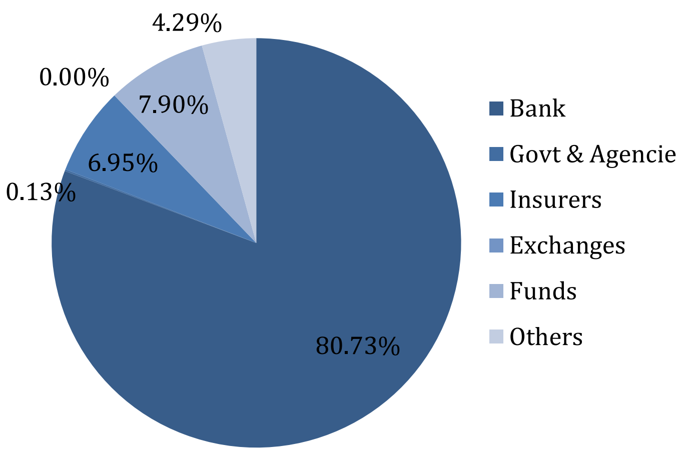
Other entities, including credit unions, non-bank-FIs, security firms, corporations, exchanges and retail investors, own around 5% of total outstanding

Fig 14 - Holders of Chinese Bonds as at December 2013

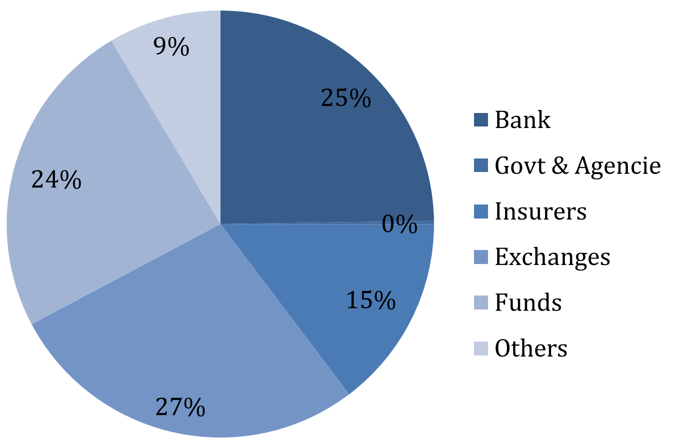
Government Bonds



Policy Bonds



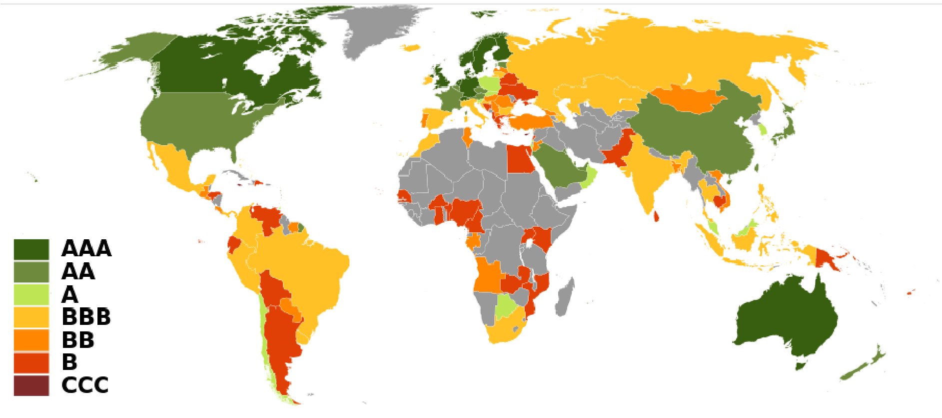
Corporate Bonds



1.7. Yield curve by type of bonds

Chinese bonds have historically offered significantly higher yields relative to other major bond markets, despite China's strong sovereign credit quality (Fig.15).

Fig. 15 – S&P Sovereign Ratings showing China & US as AA



Moreover, foreign investors can also gain exposure to China's currency by investing in Chinese bonds. Unless currency exposure is hedged, appreciation in China's currency versus the foreign investor's currency could enhance total returns. The following line charts (Figs. 16 and 17) show the relative attractiveness of China's long term and short term rates.

Fig. 16 - Historically attractive bond yields over other major markets

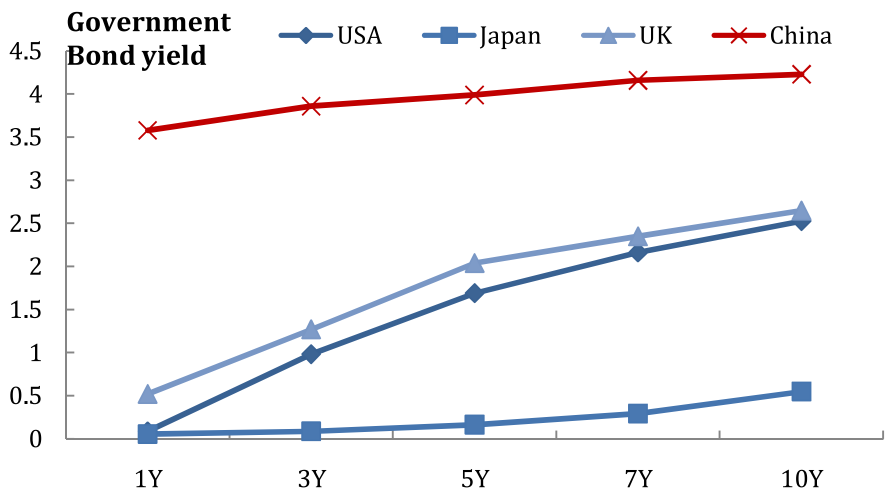
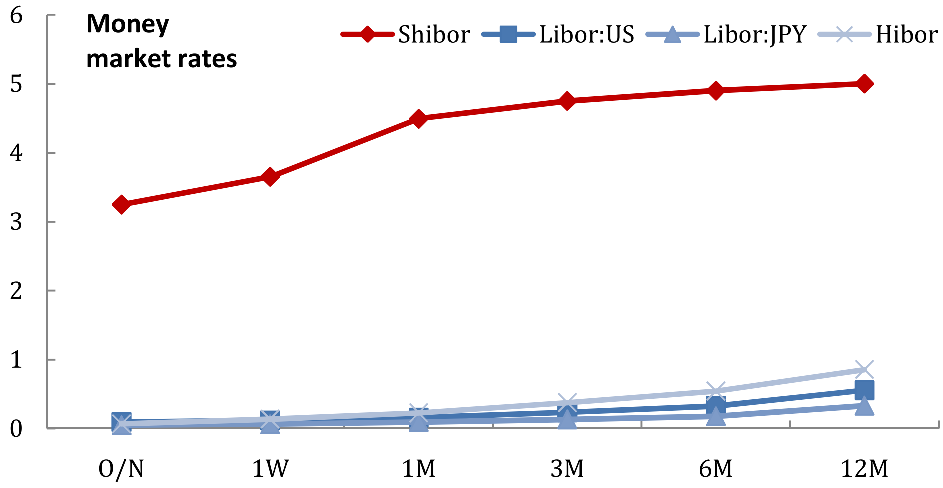


Fig. 17 - Historically attractive money market rates over other major markets



1.8. Settlement and tax issues

Bonds traded on the interbank market are settled via China Government Securities Depository Trust & Clearing Co. (CDC), at T+0 or T+1. Bonds traded on the exchange are settled via China Securities Depository & Clearing Corporation Limited (CSDCC) at T+1. Interest income derived from government bonds is exempt from all PRC taxes. For domestic investors, interest income from non-government bonds is subject to 25% corporate income tax, and capital gains are subject to an additional 5% business tax (i.e., 30% in total). China is yet to introduce a complete tax system for non-local investors such as QFII. It is generally advised that either 10% or a lower treaty rate (in accordance with double-tax treaties between China and individual countries) be applied for non-government bonds.

2. Description of the Off-Shore Chinese Bond market

China's offshore bond market is relatively small at around 5% of China's domestic bond market.. The market has grown steadily since the mid 2000's initially in USD bonds but since 2007/8 increasingly in RMB bonds. China's Offshore RMB (or CNH) market gives foreign investors access to China's debt market which otherwise would not be available under China's strict capital controls.

There are three main types of Chinese offshore bonds. They are:

1. China USD bonds – these are bonds denominated in USD and issued by companies incorporated in China. They represent close to 40% of the Asian USD bond market
2. Hong Kong USD bonds – these are bonds denominated in USD and issued by companies incorporated in Hong Kong. This includes a large number of China mainland companies.
3. Bonds issued in RMB – known as CNH bonds and also as Dim Sum Bonds, these can be issued by any company or government agency anywhere in the world.

2.1. Size of market

Total Renminbi deposits in key offshore centres – including Hong Kong, Singapore, Taiwan, and London – doubled in 2013 to CNY 1.2tn. Taiwan's deposits rose particularly fast, to CNY 182bn (EUR 21.8bn) in December 2013 from CNY 1.3bn (EUR 0.16bn) in January that year. Hong Kong deposits rose by CNY 257bn (EUR 30.8bn) in 2013 (Fig 18). As of May 2014 RMB deposits in Hong Kong stand at CNY 955.8bn (EUR 112.4bn) and reached CNY 290bn (EUR 34.1bn) in Taiwan.

The chart below shows total CNY outstanding including bonds, deposits, CD's and loans (Fig 19).

Fig. 18 – Outstanding CNY products to exceed CNY 2.5tn (EUR 0.3tn) by 2014

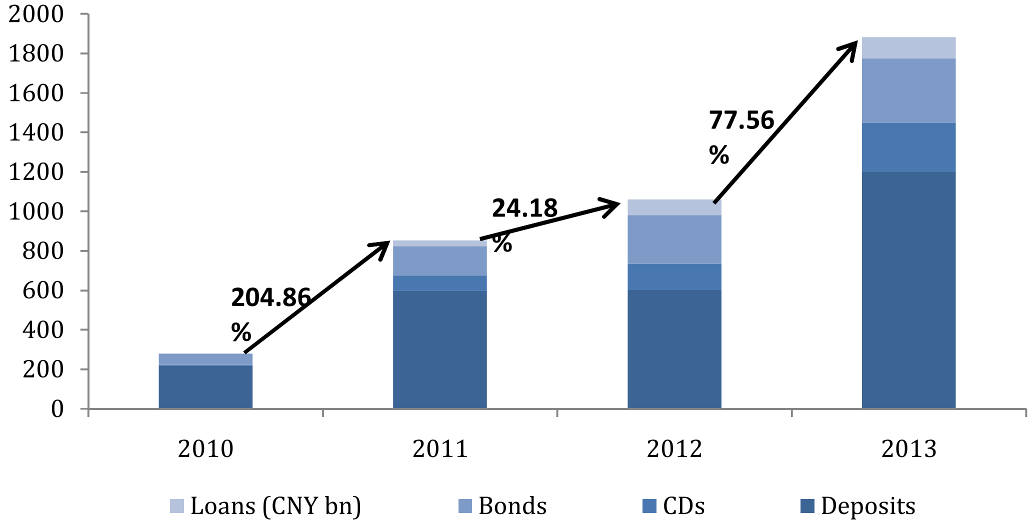


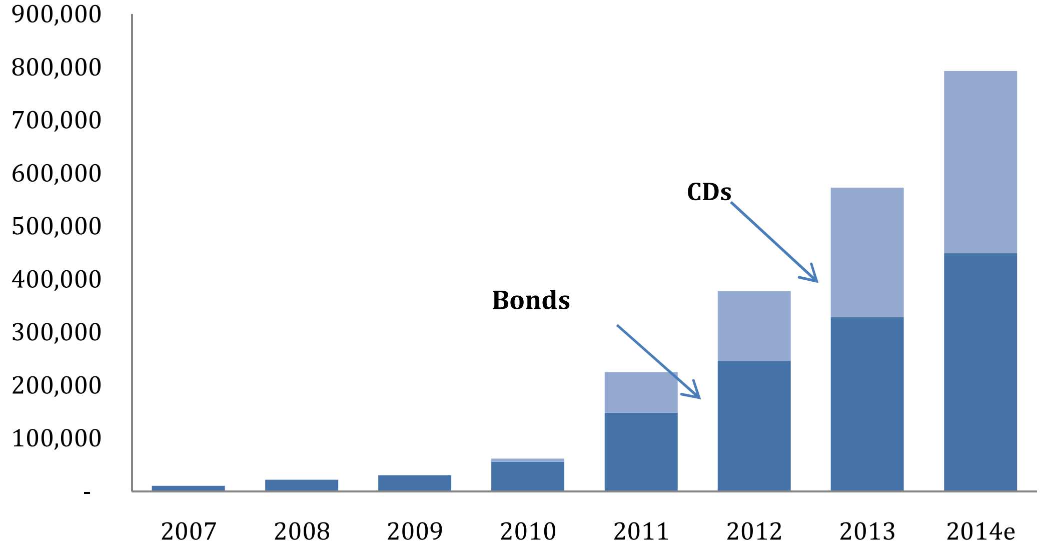
Fig. 19 – Summary of the key offshore RMB centres

	Hong Kong	Singapore	Taiwan	London
RMB deposits	CNY 955.8bn*	CNY 220bn**	CNY 290bn*	CNY 14.6bn***
Clearing bank	BOC HK	ICBC Singapore branch	BOC Taipei branch	CCB
Clearing bank demand deposit rates	0-50mn: 0.75%; 50-100mn: 0.86%; >100mn: 1.05%	1.05%	1.05%	NA
Personal account arrangement	Local residents can convert up to CNY 20,000/day under personal account, at CNY exchange rate. **** No limit for non-residents, at CNH rate	No conversion limit for residents or non-residents, at CNH rate	Local residents can convert up to CNY 20,000/day under personal account, at CNY exchange rate	No conversion limit for residents or non-residents, at CNH rate
PBoC swap	CNY 400bn	CNY 300bn	No (in discussions)	CNY 200bn
Local RMB liquidity facility	• Overnight, settled T+0 • Tomorrow/next, settled T+1 • 1-week, settled T+1	• Trade-related: 3M, rollover possible, settled T+1 • Others: 1W or 1M, T+1	NA	NA
Offshore RMB bond issuance	• No regulatory approval needed locally • Settle via CMU, linkage to Euroclear/Clearstream	• No regulatory approval needed locally • Settle via CDP, linkage to Euroclear/Clearstream	• Local approval needed; CNY10bn annual quota for eligible mainland issuers • Subject to 0-15% tax	• No restriction on bond issuance/investment

Source: Standard Chartered Research; Updated RMB Deposits
*As of May 2014; **As of March 2014; *** As of December 2013; **** Conversion limit is currently under review and expected to be raised

Outstanding Dim Sum bonds and CDs are likely to exceed CNY 750bn (EUR 89bn) by the end-of 2014, an increase of 30-40% from the December 2013 level of CNY 572bn (EUR 68.5bn) (Fig. 20). This makes the Dim Sum market one of the largest in the region exceeding the Philippine peso bond market (around EUR 76bn) and larger than the Japanese Samurai bond market (currently EUR 88bn).

Fig. 20 – Dim Sum market expected to exceed CNY 750bn (EUR 89bn)



3. How can foreign investors access China's bond market

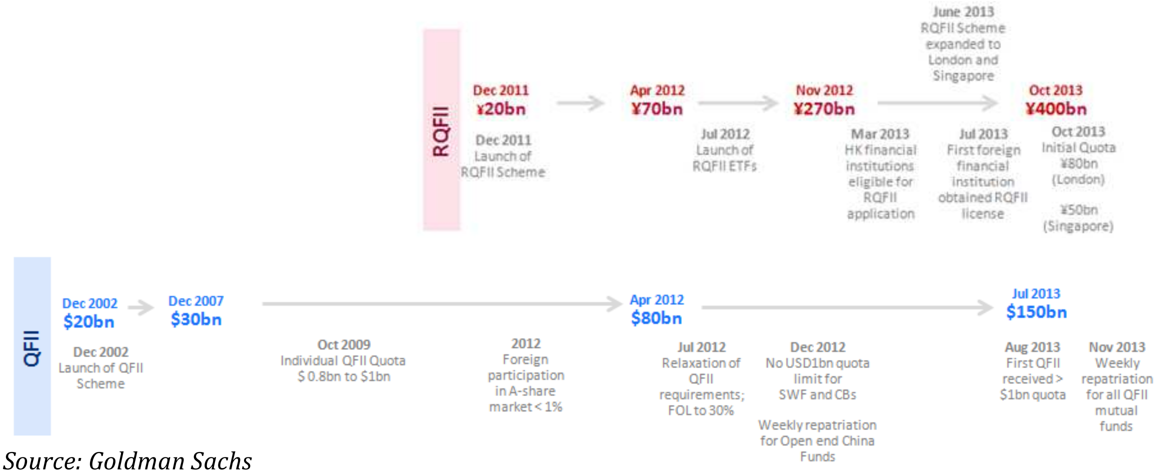
3.1. How do foreign investors access China's bond market

China's domestic markets are now more open than ever to international investors. Three programmes allow direct access to onshore markets:

- The PBoC's interbank investment programme
- The Qualified Foreign Institutional Investor (QFII) programme
- The Renminbi Qualified Foreign Institutional Investor (R-QFII) programme

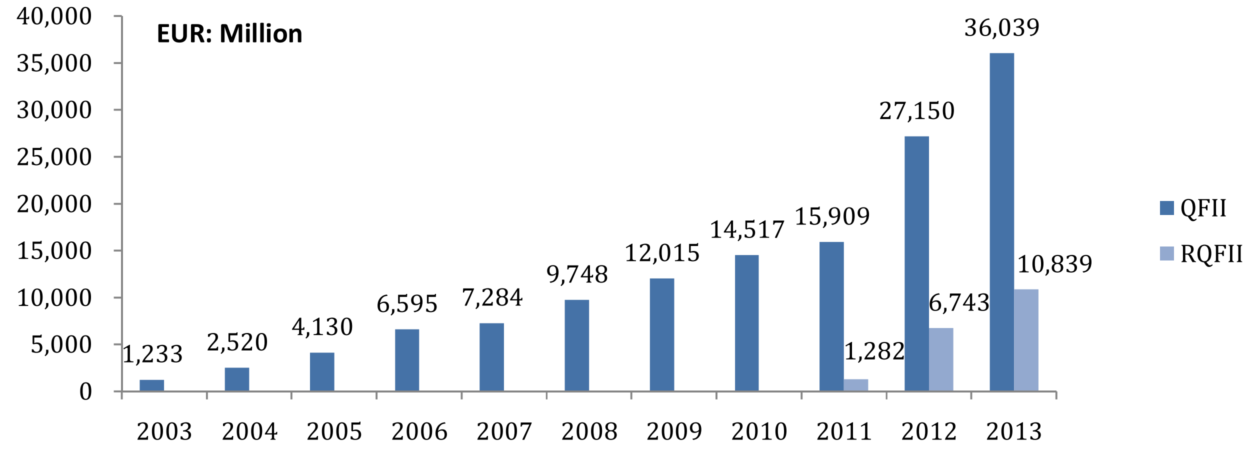
The pace of domestic market opening will continue to accelerate. Foreign central banks and sovereign wealth funds will be prioritised over other investors as China's authorities seek reserve currency status for the RMB. Long-term foreign investments, such as those by insurance companies and asset management funds, are also likely to be welcomed. We expect investment quotas to be increased and the range of eligible foreign investors to be widened.

Fig. 21 – How China's QFII and RQFFI Schemes have developed



Source: Goldman Sachs

Fig. 22 – Quota granted QFII and RQFII



Source: CUAM, Wind

3.2. PBoC's interbank investment programme

In 2010, the PBoC announced a programme to allow three types of foreign investors – foreign central banks, clearing banks and settlement banks – to apply for direct access to the domestic interbank market within a quota approved by the central bank. The scope of eligible applicants was expanded in 2012 to include foreign insurance companies. Foreign central banks‟ RMB investments have mainly been made via this programme given its much larger size than QFII and the direct access it offers to the interbank market (which accounts for more than 95% of domestic bond issuance and trading activity). Unlike the QFII scheme, which aims to secure incremental foreign investment, the main purpose of the PBoC's interbank investment programme is to support the RMB internationalisation and hasten the acceptance of the currency as a global reserve currency. As such, for the foreseeable future, eligible entities are likely to be limited to central banks, banks involved in RMB cross-border trade settlement business, and long-term investors.

China has two additional programs that allow foreign investors access to the bond market:

3.3. Qualified Foreign Institutional Investor (QFII) program

This allows foreign investors access to both the Exchange bond market and the inter-bank bond market. This program was launched in 2002 to allow licensed foreign investors to buy and sell RMB-denominated equities and bonds in China's mainland stock exchanges (in Shanghai and Shenzhen) using foreign currency (mainly US dollars) obtained outside mainland China. This was the first time in history that China allowed foreign investors to invest and trade in the domestic securities market. Chinese mainland stock exchanges were previously closed to foreign investors due to China's exercise of tight capital controls, which restrict the movement of assets in-and-out of the country.

The China Securities Regulatory Commission (CSRC) approves eligibility for investment in onshore securities, and the State Administration for Foreign Exchange (SAFE) is in charge of investment quota approvals. In July 2012, CSRC published new rules on QFII, which included granting QFIIs access to the inter-bank bond market. Prior to that, QFIIs could only access bonds traded on stock exchanges.

QFIIs can transfer an approved amount of US dollars to a special QFII account in a qualified custodian account and convert to RMB under the supervision of the State Administration of Foreign Exchange (SAFE). QFIIs are allowed to invest in 1) publicly listed shares on the Shanghai or Shenzhen Stock Exchange other than B shares; 2) bonds traded on the exchange market and inter-bank market; 3) open-ended funds and close-ended funds; and4) other financial instruments approved by China Securities Regulatory Commission (CSRC).

The QFII programme was significantly expanded in 2012 with investment quota more than doubling from USD 30Bn to USD 80Bn and again in July 2013 when the ceiling was lifted to USD 150bn. Also in July 2012 the CSRC lowered minimum application requirements, which widened the range of eligible foreign investors. SAFE has simplified its application and quota approval processes, shortening the general approval time to around 3-6 months from 18 months or more previously.

By June 2014 the QFII programme had grown to EUR 40.8Bn with quota granted to 249 foreign institutions. The pace of approvals has accelerated sharply in 2012 and 2013.

QFII Eligibility: Minimum requirements for QFII application were lowered materially in June 2012.

- Asset management/funds/insurance companies: Minimum years of operation reduced to two years and minimum assets under management (AUM) set at USD500m (from previous requirements of five years and USD 5bn, respectively)
- Securities companies: Minimum years of operation set at five years, minimum net assets at USD 500m, and minimum AUM at USD 5bn (reduced from 30 years, USD 1bn and USD 10bn, respectively).
- Commercial banks: Minimum years of operation set at 10 years, core capital of USD 300mn, and minimum securities assets of USD 5bn (previously, total assets were required to rank within the global top 100 and securities assets had to be no less than USD 10bn).

QFII Quota: A maximum quota of USD 1bn is granted to each QFII investor, with a minimum application amount of USD 50mn. An exception was made for sovereign wealth funds in December 2012, granting them investment quotas above USD 1bn. At the end of Q2 2014 there were 6 central banks and sovereign wealth funds with quota in excess of USD 1bn.

Investment scope: QFII investors are allowed to invest in equities and bonds listed on the Shanghai and Shenzhen stock exchanges. With reference to fixed income products, exchange-listed government bonds, enterprises bonds, corporate bonds and convertible bonds are available.
In June 2012, the CSRC announced that QFII investors are eligible to apply for domestic interbank market access. However, the PBoC (the interbank market regulator) has not yet clarified its stance on the change or granted any approvals.

Asset allocation: Firms generally need to submit their investment plans upon initial application. They can subsequently apply for a change, but frequent adjustments are usually not supported. General guidance is for no less than 50% to be allocated to equities and no more than 20% to cash.

Repatriation: A maximum of 20% of the previous year’s total assets can be repatriated each month. Minimum lock-up periods apply and repatriations are subject to SAFE approval. In November 2013 in a move to create additional liquidity QFII mutual funds were granted weekly repatriation.

3.4. Renminbi Qualified Foreign Institutional Investor (RQFII) programme

This programme was announced in December 2011 allowing foreign investors access to domestic markets using RMB funding obtained outside Mainland China. Despite having a similar name, the scheme differs from the QFII programme in several ways as indicated below.

By the end of May 2014 the RQFII programme had grown to CNY 240bn (EUR 28.23bn) granted to 78 offshore institutions.

Eligibility: Qualified asset management and security companies are eligible subject to approval from the China Securities Regulatory Committee. Originally only Hong Kong subsidiaries of mainland asset management and security companies were eligible for RQFII quota but this has since expanded to any foreign institution in Hong Kong with access to RMB. The first foreign financial institution received an RQFII licence in July 2013. Since then China has granted RQFII status to new markets including Singapore (CNY 50bn), London (CNY 80bn), Paris (CNY 80bn), Frankfurt (CNY 80bn), Seoul (CNY 80bn), with Taiwan expected to be announced in 2014.

Asset allocation: When the initial quota of CNY 20bn was granted at least 80% had to be allocated to fixed income products. The subsequent quota increment of CNY 50bn was used solely to support ETFs tracking onshore equities. Today there are no restrictions on allocating quota between equity , bonds and cash.

Investable onshore products: RQFII investors are allowed to access both the onshore interbank market and stock exchanges. With reference to fixed income products, investors have full access to all types of onshore cash bonds, including government bonds, PBoC bills, financial bonds, enterprise bonds, corporate bonds, MTNs, commercial paper, convertible bonds, etc.

Cross-border transmissions/repatriation: These are generally more flexible under the RQFII scheme than QFII. Daily transmissions are allowed for open-ended funds, and monthly for others. No prior approval is required for open-ended fund repatriation.

4. The case for investing in RMB and in China's Domestic Bond Market

4.1. Three key attractions

Three significant factors identify China's bond market as a potentially attractive asset class for foreign investors:

- **Sovereign Credit Quality** – China's sovereign credit quality is strong given its low debt-to-GDP ratio
- **High Yields** - Chinese bonds have historically offered significantly higher yields relative to other major bond markets, despite China's strong sovereign credit quality
- **Currency** – Foreign investors in China's bond markets can also gain exposure to China's currency. Unless currency exposure is hedged, appreciation in China's currency could enhance total returns.

4.2. A dynamic economy and active reform

Entering the Year of the Horse in 2014 China's economy gallops along at a steady pace maintaining its position as the world's second largest economy. At the end of 2013 GDP was just over EUR 6.6tn trailing the US with a GDP of Eur 11.9tn but ahead of Japan with a GDP of close to EUR 4.4tn.

China's macroeconomic landscape has emerged through 2013 relatively intact and with the potential for steady growth and a more stable economic environment through 2014. Among the key indicators are GDP (steady at 7.7%), interest rates (variable within a tight band) currency (continuing to appreciate but at a slower rate) and inflation (steady and within limits). Within this environment we see a rich opportunity set for a deep research-driven fundamental bottom up stock picker. Our expectations are that traditional state owned companies especially in the poorly performing property and banking sectors will show renewed vigour but the more interesting opportunities lie in emerging sectors such as healthcare, media, TMT and select consumer stocks. Risks to this outlook revolve around interest rates which, with tight liquidity conditions, we see moving higher. Valuations will be affected by a higher risk free rate however relatively low valuations in blue chip stocks suggests that this has been priced into the market.

The call for reform will be the key driver of change in China coupled with the structural economic transformation that will result from the CPC's ambitious reform agenda. The trigger for the current wave of market and economic reform was the 18th Third Plenum in late 2013 when the CPC made it clear that reform and the shift from a manufacturing, investment driven economy, to a services-led consumer economy was critical for China's future growth prospects. We expect this programme of reform will lift the market through revival of the private sector and improvement in the efficiency of the public sector (monopolies and State Owned Enterprises).

See above – funding will continue to be a challenge but the growing use of alternative funding sources will help to drive the private sector while SOE's continue to benefit from government largesse. But SOE's are under the spotlight and calls for reform have resulted in a range of measures designed to improve efficiency and accountability among the SOE's which will drive higher level of profitability and opportunities for the private sector as SOE's undergo a process of market rationalisation creating merger and acquisition opportunities.

Through China's regulatory bodies corporate governance will be stepped up and will rapidly develop in terms of sophistication and broad market practice.

After the end of the second quarter of 2014, the macro trends in both domestic and foreign markets appear positive. China's GDP grew 7.4% in the first quarter and 7.5% in the second quarter. This trend is expected to continue throughout the year with China's GDP growing at a steady rate, around 7%-7.5%. Recent domestic reform policies will boost market confidence and improve the overall business and market environment, despite the potential risk of rising interest rates.

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