IX

Challenges and Opportunities in the Inter-Bank Bond Market

This chapter discusses some of the real and perceived challenges facing the CIBM, its market institutions, and its participants. This chapter also describes some of the possible mitigating factors or market developments that could address these challenges in an appropriate manner.

The China bond market has been a pioneer in the opening of the capital market in the PRC. Measures such as the launch of Bond Connect, the inclusion of the PRC's government bonds and indexes in global bond market indexes, and the abolition of quotas for the QFII and RQFII schemes have created both opportunities and challenges for the CIBM.

Yet, there is still ample room for further opening of the CIBM, with holdings of overseas investors accounting for only about 3% of the outstanding amount in the CIBM. In addition, available investment channels can be extended. Currently, overseas investors may participate in the CBIM through the QFII and RQFII schemes, or use CIBM Direct or Bond Connect. In the future, more flexible investment channels may be introduced.

A. Challenges in the Inter-Bank Bond Market

Despite the rapid and successful development of the CIBM, particularly in recent years, there remain a number of challenges for policy bodies and regulatory authorities, market participants, and the bond market as a whole.

The purpose of this section is to state the challenges facing the CIBM and its constituents, together with any remedial action that is being implemented or in the planning stages.

1. Improving Participation by Foreign Investors

NAFMII recently noted that the ratio of bonds outstanding to GDP in the PRC is far lower than the ratio in Japan, the US, and other developed economies, suggesting the China bond market has tremendous potential for further growth.

Specifically, the holdings of foreign investors in the China bond market accounted for only around 3% of all debt financing instruments outstanding, which is far less than corresponding shares of foreign holdings in Japan, the US, and other developed economies. With the further opening of the China bond market, and given the potentially attractive returns, it should be expected that more international investors will enter the China bond market.

2. Improving the Investor Protection Mechanisms

NAFMII continues to undertake efforts to further improve the investor protection mechanisms to ensure the smooth operation of the CIBM; a selection of the challenges in this regard that NAFMII is trying to address is given below.

a. Application of Investor Protection Covenants

NAFMII has been promoting the application of investor protection covenants. In September 2016, NAFMII published examples of investor protection clauses (投资人保护条款范例) for the first time. In April 2019, NAFMII published the Model Investor Protection Clauses (投资人保护条款示范) based on the 2016 version.

The 2019 model clauses provide six categories of investor protection clauses including cross-protection clauses, prior commitment clauses, prior binding clauses, change of control clauses, debt repayment guarantee clauses, and asset collateral clauses. To date, the 2019 model clauses have been for reference by the market only, and market organizations may apply these clauses as they deem necessary. Further development and application of the clauses in market practice among market participants is expected in the near future.[108]

b. Feasibility of Tender Offer and Exchange Offer

NAFMII has been contemplating the feasibility of a tender offer and exchange offer concept for the CIBM and consulted with market experts.

An exchange offer is a form of tender offer in which bonds or other debt financing instruments are offered as consideration instead of cash. In a bond exchange offer, bondholders may consent to exchange their existing bonds for another class of debt financing instruments, or even equity securities. Companies may seek to exchange their debt financing instruments to extend maturities, reduce debt outstanding, or convert debt into equity.

3. Building a Benchmark Interest Rate

Feedback from market participants and observers identified the lack of a defined benchmark rate for the China bond market, particularly for the CIBM since significant fundraising is done via shorter-term debt financing instruments. In recent times, the market recognized the significance of the 7-day reverse repo rate applied in the PBOC's open market operation as a key indicator, even a policy rate; this is also because the PBOC has not issued central bank bills regularly since 2016. At the same time, a formal short-term interest rate exists, the Shanghai Interbank Offered Rate (SHIBOR), but it may not be a suitable benchmark for bond issuance.

It is necessary for the policy bodies and regulatory authorities to formulate a strategy for the building of a sustainable benchmark interest rate. This would also improve liquidity in the secondary market, facilitate the innovation process of hedging instruments for interest rate risk (such as futures and options), and make possible the implementation of a monetary policy through direct financing instruments.
The Government of the PRC and the PBOC recognize this need and have started to include this goal in the list of initiatives that policy bodies and regulatory authorities are

[108] This section is based on an abstract from a 2019 article《投资人保护条款范例》版之解读 from the *China Business Law Journal*《商法》月刊 by Wu Jiejiang 吴杰江, Jingtian & Gongcheng 竞天公诚律师事务所 13 June 2019, with permission from the author. http://www.jingtian.com/Content/2019/08-09/1817561535.html (in English); https://www.vantageasia.com/zh-hans/%E3%80%8A%E6%8A%95%E8%B5%84%E4%BA%BA%E4%BF%9D%E6%8A%A4%E6%9D%A1%E6%AC%BE%E8%8C%83%E4%BE%8B%E3%80%8B2019%E7%89%88%E4%B9%8B%E8%A7%A3%E8%AF%BB/ (in Chinese).

working on; see also Chapter IX.A for information on the new Financial Stability and Development Commission and other relevant developments.

4. More Financing Opportunities for Small and Medium-Sized Private Enterprises

Presently, the corporate credit fixed-income market is facing the challenge of establishing a submarket that can bring together those issuers with lower credit ratings, such as SMEs, private enterprises that are excluded from the market, and enterprises that rely on higher-cost bank loans to access the fixed-income market to raise money.

Several innovations in relation to SMEs were launched in recent years, including the ability to issue SME collective notes, as well as the initiation and establishment of China Bond Insurance Co., Ltd. So far, these measures have only partially achieved their declared targets.

Companies with a lower credit rating planning to enter the market may face legal restrictions on the investment risks their potential issuances may represent, as stipulated by the regulatory authorities. A more flexible approach would enable the creation of a segment of eligible investment-grade type companies (such as BBB–, which is three levels below the ratings currently accepted by the market) to issue bonds.

Reform measures for both the buy-side and the sell-side are needed, along with innovations to attract appropriate investors. For instance, on 19 September 2018, the PBOC called for financial institutions to improve their service provisions related to the fundraising by private companies. The PBOC now requires financial institutions to treat fairly the private companies and SOEs in their fund- and capital-raising efforts.[109]

5. Ringfencing of a Professional Investor Market

Traditionally, while participation in the CIBM was considered, typically by its participants, for an institutional investor only market, the absence of a formal professional investor concept and the existence of a number of individual investors among NAFMII's membership provided doubt as to whether the CIBM could indeed be considered a ringfenced professional marketplace like those in many regional bond markets.

The introduction of the concept of DIIs, or private placement investors, in 2011 and the subsequent promulgation of regulations supporting SIIs in 2015, in combination with bond issuance via private placement, have led to a clearly defined issuance method that, for all intents and purposes, represents a closed market place for institutional investors that is comparable to a professional market.

Please also see Chapter III.N for more information on the private placement investor and SII concepts.

6. Language of Issuance Documentation

Nonresident issuers are already able to issue Panda bonds in either the CIBM or exchange bond market, and recent changes have seen many more nonresident investors access the China bond market, both directly and via other market access concepts, including CIBM Direct and Bond Connect. Common to these parties is the familiarity with English as the typical, common language for issuance documentation

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[109] Adapted by ABMF SF1 from an article on aastocks.com at https://www.theasset.com/china-today.

and disclosure items in international markets. The increasing participation of nonresident constituents may press for further concessions to use the English language in the context of debt financing instrument issuance and investment.

Policy bodies and regulatory authorities in the PRC have already recognized this demand and introduced the concession that, in the case of Panda bonds offered to private placement investors or DIIs (see Chapter III.N for a description of this investor type) via private placement, nonresident issuers may provide a summary of the issuance documentation and disclosure items in a language other than Chinese, such as in English, in addition to (or instead of) the Chinese language documentation and disclosure.

According to Article 29 of the 2019 NAFMII Guidelines, for debt financing instruments offered by nonresident issuers through private placement, the principal registration and offering documents (private placement agreement for DIIs or private placement offering memorandum for DIIs and SIIs) shall be in Chinese or in English accompanied with a Chinese version. Other documents may be in either Chinese or English as agreed between the issuer and the investors. Information disclosure during the life of such instruments may be made in Chinese or English as agreed between the issuer and the investors. Similar such concessions exist for Panda bond issuers that regularly issue and are subject to continuous disclosure in English in other markets.

7. Credit Rating Quality

The announcement on the introduction of unified credit rating rules and regulations (see Chapter IX.A.3) has started to address one of the lingering challenges in the China bond market. Until now, the credit ratings given to debt financing instruments issued by enterprises tended to be of very high quality, with a distinct gravitation toward AA and AAA ratings. In a bond market with diversified issuers and instruments, such rating concentration was viewed with concern, and a recent string of defaults has given rise to further doubts.

However, this challenge has been recognized by policy bodies and regulatory authorities in the CIBM and measures taken, such as the proposed uniform credit rating guidelines, together with granting permission to foreign CRAs to enter the bond rating business, are intended to significantly improve the credit rating process and outcome.

On 14 February 2019, in a first-of-its-kind action, NAFMII and the Securities Association of China (the SRO for the exchange market) jointly issued a circular on the fourth quarter of 2018 business operation and compliance of CRAs operating in the China bond market.

8. Inclusion in Global Bond Indexes

Recently, PRC government bonds have begun to be included in global bond market indexes. Index providers had previously argued that a number of market features would first have to be evident and remaining limitations reduced to make the China bond market and its instruments more comparable to international markets.

However, the recent very rapid developments in the China bond market, particularly in the CIBM, in combination with the significant liberalization of foreign investor access, have changed the perception of the index providers. Please see Chapter IV.F for more information on bond indexes with relevance to the China bond market.

The inclusion in global bond market indexes of PRC government bonds is expected to bring significant additional capital inflows and new investor groups, such as passive (i.e., index-driven) investment funds, into the China bond market.

9. Straight-Through Processing Limitations under CIBM Direct

Feedback from market participants identified a lack of straight-through processing in the order placing process for investors via CIBM Direct, in particular in comparison to the process prevalent for Bond Connect investors. At present, a trade from a CIBM Direct investor may be placed in Bloomberg (or another trading platform) and requires confirmation on CFETS by the bond settlement agent before trade execution. At the same time, a trade—entered in the same trading platform—placed by a Bond Connect investor will be executed directly in CFETS without further confirmation. For international investors accessing the CIBM through a number of market access channels, this multitude of processes may not be easy to understand and adopt. Market participants have begun to engage the regulatory authorities on this subject.

10. Separate Registration for Each Investment Fund

At the time of compilation of this bond market guide, the registration of new foreign investors in the CIBM through CIBM Direct was required for every investment fund or vehicle, regardless of whether multiple investment funds are being managed by the same asset manager. The need to provide the same or similar documentation, translated into Chinese, for each investment fund is cost- and time-intensive and represents significant work for both the investing entity and market intermediaries, including the CSDs. Market participants have started a dialogue with the PBOC to address this subject and potentially make the registration process simpler and more efficient.

11. Repo Transactions Only for Selected Investor Types

Under present regulations, only foreign central banks, international financial organizations, sovereign wealth funds, RMB clearing banks, and foreign participating banks are able to participate in repo transactions in the CIBM. With the majority of repo transactions in the market concluded to achieve additional returns on existing holdings, this opportunity is not available to the majority of QOII accessing the CIBM.

Given that policy bodies and regulatory authorities have signaled a continued liberalization of the China bond and capital market, including the CIBM, this subject may be addressed at the appropriate time.

B. Opportunities in the Inter-Bank Bond Market

The opportunities described here represent in part the response by policy makers and regulatory authorities to the challenges mentioned earlier, as well as those inherent in recent, announced, or planned market developments in their own right.

1. Panda Bonds

The increasing issuances of Panda bonds in the China bond market, particularly in the CIBM, is evidence that more issuers and more diversified issuer types are seeing the Panda issuance concept as a viable market access method to raise funds either for domestic use or outside the PRC. The clarification of the Panda bond regulations announced in September 2018 (Interim Measures jointly announced by the MOF and the PBOC) and the subsequent NAFMII Guidelines released in January 2019 (see Chapter X.A.10) might have further led nonresident issuers to consider issuing Panda bonds, as institutional arrangements, including the possibility of issuance documentation and disclosure information in English, continue to be improved.

2. Liberalization of Market Access

The significant changes brought by policy bodies and regulatory authorities to the market access regime for the China bond market in recent years, including the introduction of CIBM Direct and, particularly, Bond Connect, have already resulted in strongly increased investments in the CIBM by nonresidents. Further liberalization measures already announced will amplify the market's attractiveness, and offer opportunities for both investors and domestic service providers.

Please also see Chapter I for a description of the major steps taken in the liberalization of the CIBM and Chapter II.N for more information on the market access avenues available to foreign investors.

3. Inclusion of People's Republic of China Government Bonds into Global Bond Indexes

In 2019, a number of international providers of bond indexes announced the inclusion of PRC government bonds in global bond indexes, with the participation of these bonds phased in over a period of 10–20 months (see Chapter X.A.2 for details).

Investors tracking these global indexes have increased their holdings of PRC government bonds to more closely match their portfolios to these indexes, which is expected to result in significant inflows of additional capital in the next 2 years. The indexes will also provide additional visibility for PRC government bonds to the international investment community.

4. ASEAN+3 Multi-Currency Bond Issuance Framework

The discussion around implementation of AMBIF in the PRC could serve as a conduit for the formal recognition of a professional investor concept and of the CIBM as a professional bond market segment featuring the key market elements that would support issuances under AMBIF. This is likely to significantly increase interest among international institutions—both issuers and investors—to do business in the China bond market.

For a more detailed description of AMBIF, please refer to Chapter X.B.