The Development of the Offshore Market of the Yuan-Denominated Bonds

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Outline

- Reasons for the PRC to promote yuan internationalization and offshore bond market
- Measures to promote offshore yuan-denominated bonds
- Current situation of market development
- Issues and problems
- Outlook and implications
- Conclusions

Reasons to promote RMB internationalization and offshore bond market in Hong Kong, China

- RMB internationalization
  - Reduce exchange-rate risks for Chinese firms
  - Greater funding efficiency for Chinese financial institutions
  - Boost trade with neighbors by reducing transaction costs
  - Reduce need for PRC to hold US dollar foreign exchange reserves
- Offshore RMB bond market
  - Provide investment vehicle for offshore RMB, as channels for return of RMB to mainland and offshore investment vehicles remain limited
  - Facilitate FDI flows to mainland as they become more liberalized
  - Provide a more liberalized but still controlled environment for development of the bond market and more general financial development—Mainland and HK regulators have close relationship

Measures to promote offshore yuan-denominated bonds in Hong Kong, China

- 2004: HK banks offer yuan-denominated bank deposits
- 2007: Issuance by mainland financial firms of "Dim Sum" bonds – bonds denominated in RMB and issued in Hong Kong
- 2009: First offshore RMB sovereign bond
- 2010:
  - Memorandum allowing broad range of RMB trading, including futures and spot market
  - Corporates allowed to open RMB deposits
  - Issuance by HK-based companies and other foreign firms
  - First global RMB bond fund
  - First high-yield bond
- 2011
  - Relaxation of issuance rules for PRC firms, including allowing non-financial firms, easier issuance procedures, and easier remittance to domestic market
  - Japanese government to buy RMB bonds for foreign exchange reserves

Measures to promote offshore yuan-denominated bonds (2)

- August 2011—Major speech by Vice Premier Li Keqiang in Hong Kong
  - Central government will actively support the growth of the RMB market in Hong Kong and its drive in building itself into an offshore RMB center
  - Cross-border trade settlement in RMB "should be extended to cover the whole country”
  - Support for enabling Hong Kong, China firms to FDI investment in PRC using RMB
  - Establishment of RMB QFII scheme for HK-based subsidiaries of mainland securities firms and asset management firms (RMB 20bn)
  - More mainland-based financial institutions and enterprises will be allowed to issue RMB bonds in Hong Kong
  - Increased bond issuance by central government in Hong Kong

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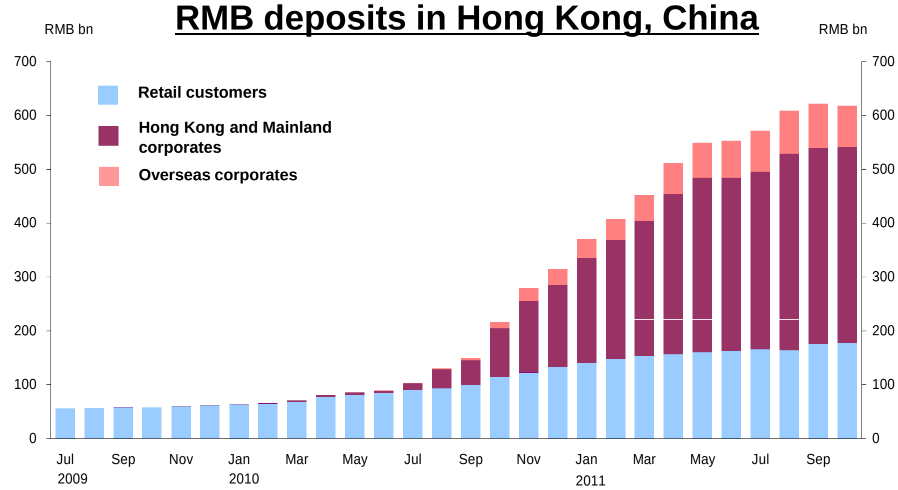
Growth of RMB deposits was rapid, but has lost momentum

RMB deposits in Hong Kong, China



Source: HKMA

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Factors driving the rise of RMB deposits in Hong Kong, China

- Belief that the RMB is substantially undervalued and expectation of exchange rate gains
- Arbitrage opportunities between onshore and offshore RMB rates
- However, this increase was not necessarily based on fundamentals and other long term non-speculative considerations, and hence easy to reverse—as shown by recent stalling
- Without a deep, liquid domestic bond market, the incentives for non-residents to hold RMB as store of value are limited

Comparison of offshore and onshore bond market features

	Offshore	**Onshore**
Size (RMB)	>200bn	>20,000bn
Issuers	PRC government Supranational (ADB, World Bank) PRC Quasi-Sovereigns (China Development Bank) Mainland Chinese Banks and Corporates International Corporates	All onshore entities
Investors	All foreign investors	Central Banks and RMB offshore settling and clearing banks
Liquidity	Poor	Good
Instruments	Treasury Notes Financial Bonds International Corporate Bonds Supranational Bonds Corporate Bonds Certificates of Deposit	Treasury Notes PBoC liquidity bills Financial Mainland Corporate MTNs Commercial paper
Clearing	CMU/Euroclear/Clearstream	PRC Gov't Depository, Trust and
Tax	Tax free except income tax of 16.5% on corporate bond	5% tax on capital gains on govt bonds if sold before maturity 25% on income tax and capital gains subject to 30% tax (25% income + 5%
Law	Hong Kong Law	PRC Law

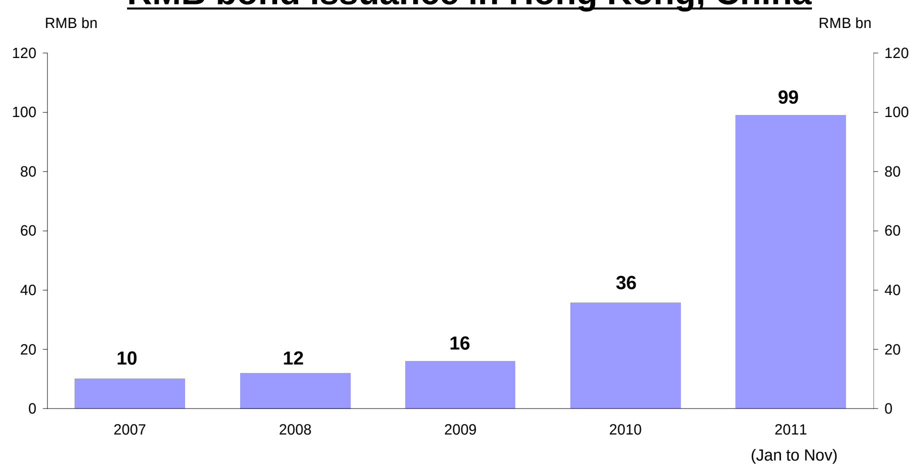
Source: HKMA, PBoC, Bloomberg

Dim Sum bond issuance

- As of September 2011, 325 dim sum bond issues from 85 issuers for a total of RMB 228 billion
  - RMB 160 billion worth of bonds
  - RMB 68 billion worth of certificates of deposit
- Synthetic renminbi bonds (settled in US dollars) have recently appeared, roughly RMB 25 billion.

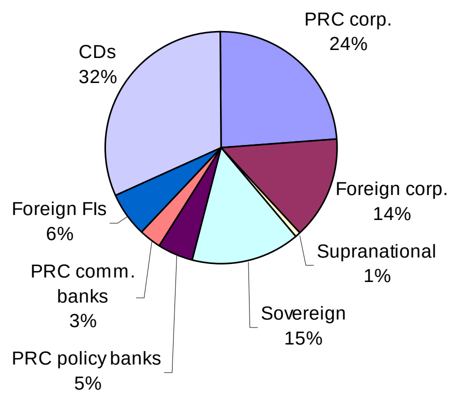
Rapid Expansion of Offshore RMB Bond Issuance

RMB bond issuance in Hong Kong, China



Source: HKMA

Issuance dominated by private corporates and CDs



Source: HSBC, Bloomberg (as of Dec. 2011)

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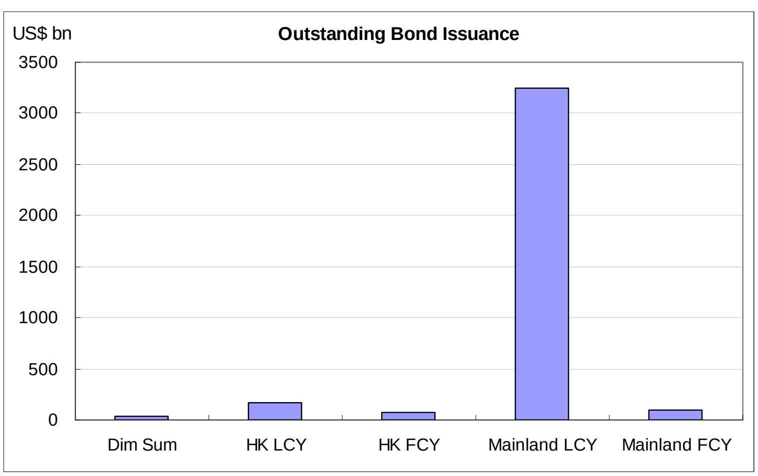
But Dim Sum bond market size still small relative to mainland domestic bond market



Note: As of Sept. 2011

Source: HKMA, AsianBondsOnline

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Dim Sum bond market characteristics

- Strong demand for off-shore bonds has led to lower yields versus onshore bonds, especially at the short end, making them an attractive source of debt finance, but risky for investors
- By September 2011 average maturity had lengthened slightly to 3.6 years from 2.1 years in 2007 (excluding CDs), which make the market less attractive for longer-term investors and investment funds

Issues and problems facing offshore yuan-denominated bond market

- Lengthy and rigorous approvals relating to the issuance of bonds and the remittance of proceeds
  - For PRC corporates, approvals from the PBoC, NDRC and State Council are required to issue offshore RMB bonds; process may take several months
  - Foreign issuers subject to mainland authorities' approval if they wish to remit proceeds to the onshore market
- Gaps between offshore and onshore yields leave investors open to capital loss from convergence
- Investor preference for shorter-maturity issues
- Limited ratings
- Thin liquidity
- Lack of size, yield curve and benchmarks: Limited AAA-rated issues

Issues and problems (2)

- Individual yuan purchases are limited to RMB20,000 per day
- Banks may square their short positions in RMB from trade settlement transactions with the Clearing Bank (Bank of China [Hong Kong]), but their ability to do so is constrained by the existing supply of offshore RMB for nontrade transactions
- Banks are limited in their open position to 20% (formerly 10%) of their RMB assets or liabilities (depending on whether the bank is net long or net short).

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Outlook and implications for offshore yuan-denominated bonds

- Potentially favorable developments
  - Expansion of offshore markets (Shanghai, Singapore, London, New York)
  - Extension cross-border RMB settlement to all of PRC
  - Expanded issuance of RMB debt instruments for use outside of PRC
  - Increased PRC government bond issuance in HKC
  - Establishment of thresholds for reduced application procedures for onshore FDI
  - Further role for offshore bonds as reserve assets
  - Development of foreign sovereign bond issues
- Potentially unfavorable developments
  - Pressures for liberalization of domestic bond market
    - Example of euro-dollar and euro-yen markets and Japan
    - Expansion of QFII quotas, eventual elimination
  - But differential tax treatment and legal and regulatory environments will constraint onshore bond market development for a considerable time

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Conclusions

- RMB offshore bond market has seen rapid growth, but partly related to speculative demand for RMB—this may be less of a factor going forward
- Significant hurdles to further development remain

-Controls on issuance by domestic firms

-Controls on inward remittances of RMB

- Market remains too small to be very attractive to international investors
- Easing of domestic capital controls will lessen attractiveness of offshore market, but taxation and law/regulation remain issues

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Thank you
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