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

Growth of RMB deposits was rapid, but has lost momentum

RMB deposits in Hong Kong, China

Source: HKMA
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

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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)

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

Note: As of Sept. 2011
Source: HKMA, AsianBondsOnline
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).

Outlook and implications for offshore yuan-denominated bonds

- Potentially favorable developments
  - 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.
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

Thank you
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