FEATURE ARTICLE

A Closer Look at Bond Connect and the Journey Ahead

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Mainland onshore bonds offer relatively attractive yields and a lower correlation with global markets, and are improving in liquidity and included in global bond indices. All these factors/advantages have generated significant interest from foreign investors. The Mainland's strong long-term growth prospects and continued efforts to open up its capital markets will drive investment activity, especially in the bond market, which has been the world's second-largest since 2019. Its Bond Connect with Hong Kong has played an active role in the development and liberalisation of the Mainland onshore bond market. Since its launch in 2017, Northbound Trading under Bond Connect has become a widely accepted and convenient channel for foreign investors to access the onshore bond market. Following the success of Northbound Trading, the launch of Southbound Trading in September this year will deepen the two-way opening up of the Mainland onshore bond market and enable Mainland investors to increase their allocation to offshore bond assets through Hong Kong. This article reviews the journey of Bond Connect and looks ahead to future developments of the scheme.

Overview

Foreign investors can currently access the Mainland onshore bond market via three avenues. The first is the Qualified Foreign Institutional Investor (QFII) scheme, which was established in 2002 to let select foreign institutional investors invest in onshore equities and bonds using foreign currency. This was followed in 2011 by the introduction of the renminbi version of the QFII (RQFII). In late 2020, the two schemes were combined to operate under a unified Qualified Foreign Investor scheme, featuring an expanded investment scope and relaxed qualification requirements. The second channel, China Interbank Bond Market (CIBM) Direct scheme, was launched in 2016 to enable foreign investors to trade onshore bonds in the CIBM directly through banks. Both channels require investors to set up onshore custodian and cash accounts.

The third and newest initiative, Bond Connect, represents a major step in making onshore bonds more accessible to foreign investors. Bond Connect is a mutual market access scheme that allows investors in Mainland China and overseas to trade, settle and hold bonds tradable in the Mainland and Hong Kong bond markets through a linkage between the Mainland and Hong Kong financial infrastructure institutions. Complementing the other two channels, Bond Connect aims to improve the ease of access and enhance operational efficiency, particularly with regard to account opening and trade settlement. Its most distinctive feature is that Mainland and international investors can continue to follow common trading practices in their respective bond markets while gaining efficient and convenient access to each other's bond markets.

Northbound Trading began on 3 July 2017, allowing foreign investors to invest in bonds traded in the CIBM. Under Northbound Trading, foreign investors need not open onshore accounts in Mainland China or engage an onshore trade and settlement agent. Instead, they can hold CIBM bonds through their global and/or local custodians via the Central Moneymarkets Unit (CMU) of the Hong Kong Monetary Authority (HKMA), which acts as the nominee holder of the bond securities and establishes a clearing and settlement linkage with onshore clearing houses, namely China Central Depository & Clearing Co., Ltd. (CCDC) and Shanghai Clearing House (SHCH). Through the CMU, foreign investors can continue to settle and hold bonds using this nominee holding arrangement, which is an established practice in Hong Kong and most overseas markets. It differs from the direct holding arrangement for bond registration and custody on the Mainland. Furthermore, foreign investors can transact in the CIBM with onshore market makers through international trading platforms recognised by the People's Bank of China (PBoC).

Similar to the Stock Connect schemes, Bond Connect operates under a closed-loop structure with one-to-one bundling of designated remittance and bond purchases.

Since its launch, Northbound Trading has become increasingly popular among foreign investors seeking to participate in the Mainland onshore bond market – the world's second-largest with about US$19 trillion outstanding. As at end-August 2021, more than 2,700 foreign investors from 34 jurisdictions have registered and participated in the CIBM through Bond Connect, including 78 of the top 100 global asset management companies[1].

The successful development of Northbound Trading has laid a solid foundation for the implementation of Southbound Trading. In September 2021, the HKMA and PBoC jointly announced the launch of Southbound Trading, which would complete the two-way connection under the Bond Connect scheme and provide Mainland institutional investors with a convenient and secure channel to invest in the Hong Kong bond market via the connection between the Mainland and Hong Kong financial infrastructure institutions.

Enhancements to Northbound Trading under Bond Connect to support the opening up of the Mainland onshore bond market

Like other mutual market access arrangements, Northbound Trading under Bond Connect has undergone a number of upgrades and market-oriented enhancements since its launch to meet investors' needs, raise operational efficiency, lower trading costs and provide more flexibility. These include (i) delivery-versus-payment settlement to increase settlement efficiency and reduce settlement risk; (ii) a block trading function which allows investors to allocate block trades across individual accounts prior to submitting orders; (iii) tax exemption for interest income arising from bond investments; (iv) the addition of new electronic trading platforms; (v) extension of the settlement cut-off time; (vi) increased options for the settlement cycle; and (vii) flexibility for investors to engage more than one bank to conduct currency conversion and foreign exchange hedging. More details are set out in Table 1.

[1] Source: Bond Connect Company Limited (BCCL).

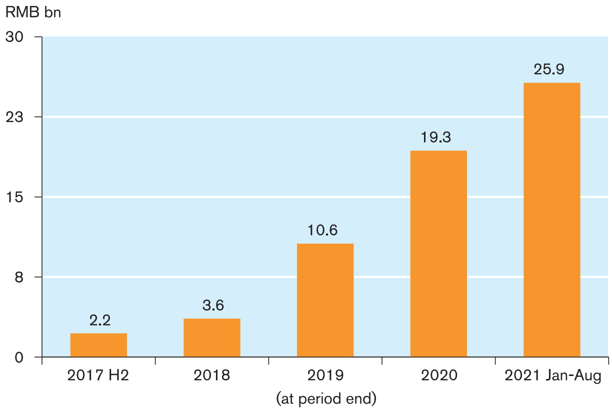
TABLE 1
Enhancements to Northbound Trading under Bond Connect

Date	Event
July 2017	Launch of Northbound Trading
August 2018	Implementation of delivery-versus-payment
	Introduction of block trading functionality
	State Council announcement of three-year tax exemption on bond interest for foreign investors in the Mainland onshore bond market
January 2019	Addition of a new electronic trading platform
April 2019	Rollout of Negotiable certificates of deposit (NCDs) primary subscription service to Bond Connect investors
	CMU extension of securities settlement and cash input deadlines
August 2019	Extension of settlement cycle to T+3
March 2020	Enablement/Provision of special settlement cycles beyond T+3 and recycling settlement
July 2020	Announcement of four new measures announced to enhance Bond Connect, namely reduced fees, extended trading hours, expanded trading platforms and primary market services
February 2021	CMU extension of cut-off time for securities instructions and Hong Kong dollar real-time gross settlement funding instructions
March 2021	Introduction of Enhanced CNY Conversion Service, which allows Bond Connect investors to engage up to three banks for currency conversion and foreign exchange hedging
April 2021	Introduction of dealer pay model, which allows trading fees to be built into quoted bond prices
	Primary participation through SHCH's tendering service was made available to Bond Connect investors
September 2021	Addition of a new electronic trading platform

Recent developments in Northbound Trading under Bond Connect

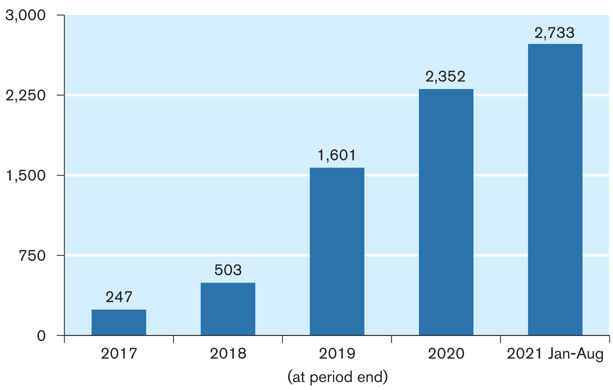
Northbound Trading saw rising overseas investment and trading activity in the first eight months of this year, accounting for 55% of foreign investors' total turnover in the CIBM. Average daily turnover (Chart 1) rose by over 30% from 2020 to RMB25.9 billion, which was more than 18 times the average daily turnover in the first month after launch. The scheme has added 381 new investors since the beginning of this year, taking the total number to 2,733 (Chart 2).

CHART 1
Bond Connect average daily turnover (Northbound)



Source: China Foreign Exchange Trade System.

CHART 2
Number of Bond Connect registered institutional investors (Northbound)

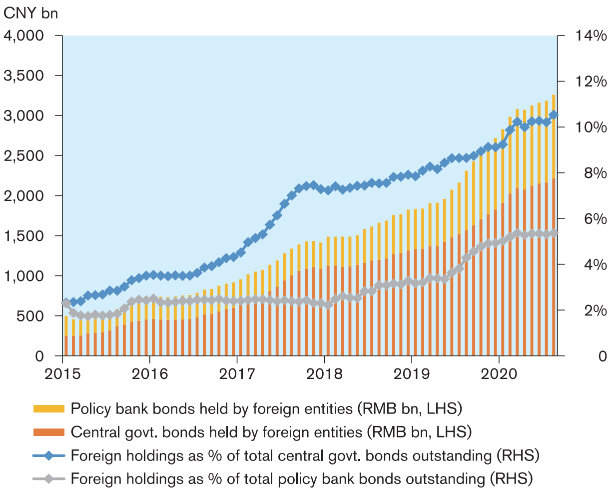


Source: BCCL.

As a result of improved market access, liquidity and tradability, foreign holdings in Mainland government and policy bank bonds have been on the rise. Foreign investors have nearly tripled their holdings of Central Government Bonds to more than 10% in the last four years (Chart 3). As at end-August 2021, foreign investors were holding a total of RMB3.78 trillion Mainland onshore bonds, an increase of RMB2.9 trillion, or more than three times, compared with end-July 2017 at the launch of Bond Connect. The scheme contributed 36% of the increase, or RMB1.1 trillion. Some market participants have projected that the share of Mainland assets in global central bank reserves could rise to 5–10% by 2030 from 2.45%[2] in the first quarter of 2021, a possible fourfold increase.

CHART 3

Foreign holdings in Mainland government and policy bank bonds



Sources: Chinabond, Goldman Sachs, SSE, SZSE and Wind.

For investors, in addition to the renminbi's inclusion in the International Monetary Fund (IMF)'s Special Drawing Rights basket in 2016 alongside major reserve currencies such as the US dollar and euro, another important development has been the phased inclusion of Mainland China into major global bond indices, which was facilitated in part by the smooth operation of Bond Connect. FTSE Russell's decision to add Chinese government bonds to its flagship World Government Bond Index in stages starting from October 2021, and the inclusion of Mainland onshore bonds in the Bloomberg-Barclays Global Aggregate Index and the J.P. Morgan Government Bond Index (Emerging Markets) since April 2019 and February 2020 respectively, suggest that Mainland onshore bonds will be widely held by foreign investors with accelerating inflows into the onshore bond market.

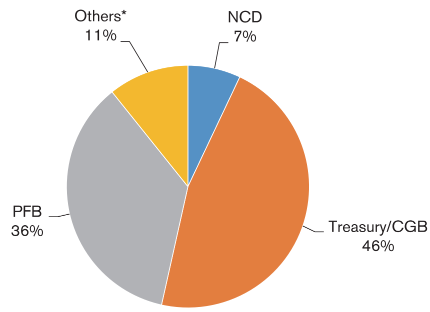
Investor analysis

The Mainland onshore bond market can be divided into (i) the rates market, which accounts for the bulk of the bond market and comprises Central Government Bonds (CGBs), local government bonds and Policy Bank Financial Bonds (PFBs); and (ii) the credit market, which includes NCDs, corporate bonds, enterprise bonds and medium-term notes issued by state-owned enterprises and privately owned enterprises.

Foreign investment flows under Northbound Trading have mainly concentrated on CGBs and PFBs, which make up 46% and 36% of investor holdings respectively, followed by NCDs with 7% of investor holdings (Chart 4), thanks to the better liquidity and relative stability of the government bonds and the higher yields of the NCDs. In terms of duration, investors' holdings under Northbound Trading are mostly in the 7–10 year and 0–1 year tenors[3].

CHART 4

Bond Connect (Northbound) investor holdings by bond type



* Others include: Medium-term notes, Commercial Bank Bonds, Asset management company financial bonds, Corporate bonds and Asset-backed securities, etc.

Source: CMU, as at 30 July 2021.

On the other hand, participation in corporate credit has been relatively muted, mainly due to the lower liquidity and the lack of standardised credit assessments. On this front, Mainland policymakers are focused on creating a more robust credit rating system through reforming domestic credit rating

[2] Source: *IMF Currency Composition of Official Foreign Exchange Reserves*, 30 June 2021.

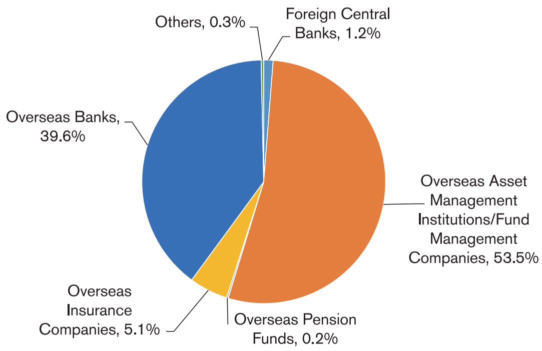
[3] Source: *Bond Connect Flash Report*, BCCL.

agencies and allowing foreign firms to enter the credit rating market. This development should speed up the convergence of local and global ratings standards, which will facilitate foreign investors' assessments of corporate credit and eventually widen the investor base of the onshore credit market.

Looking at the investor breakdown (Chart 5), holdings under Northbound Trading are held mainly by overseas asset managers/fund managers (54%) and overseas banks (40%), while a smaller proportion is held by other investors such as central banks and pension funds, many of which had been able to gain access to the Mainland onshore bond market via earlier schemes such as the QFII.

CHART 5

Bond Connect (Northbound) holdings by investor type



* Others include: other Overseas Medium and Long-Term Institutional Investors and Overseas Securities Companies.

Sources: CMU and BCCL, as at 30 July 2021.

Mainland bonds as an emerging asset class

Mainland onshore bonds have gained broader traction as an emerging asset class, given the dual benefits of yield enhancement and diversification with manageable currency risk, especially in today's environment of persistently low global interest rates. As at end-August 2021, the 10-year Chinese Government bond yielded a return of 2.85%, compared with 1.31% on the comparable US Treasury bond[4], making Mainland onshore bonds a very attractive option for yield pick-up. The comparison is even more favourable in the light of low-yielding Australian bonds and negative-yielding German and Japanese bonds.

The more domestically focused policies and idiosyncratic characteristics of the Mainland economy suggest that its bond market may react differently to global economic shifts. Mainland onshore bonds have proven to be less correlated to traditional asset classes such as developed market government bonds and global equities, enabling Mainland fixed income assets to be an effective diversifier in a global portfolio.

On an unhedged basis, Mainland onshore bonds have also exhibited lower return volatility compared with most other government bonds as the renminbi is less volatile than other global currencies and the renminbi exchange rate has been largely stable in recent years.

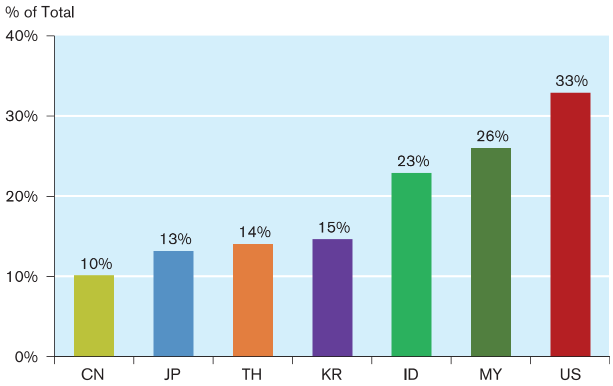
The way forward for Northbound Trading and the launch of Southbound Trading under Bond Connect

Foreign investor participation in the Mainland onshore bond market is just at the beginning of a long journey. The Mainland remains under-represented in global investors' portfolios, with foreign ownership of Mainland debt representing only 3% (and foreign ownership of CGBs at 10%), which remains low compared to foreign investor holdings of developed and emerging market debt (Chart 6). Going forward, foreign investment allocations to Mainland fixed income are expected to align more with Mainland share of global growth, which amounts to over 18%.

[4] Source: Bloomberg.

CHART 6

Foreign holdings in local currency government bonds



Sources: Asian Development Bank, Securities Industry and Financial Markets Association and US Department of the Treasury, as at March 2021.

The forces driving foreign investor inflows into Mainland fixed income, including the Mainland government's commitment to liberalise the onshore bond market, the internationalisation of the renminbi, global bond index inclusion and the high interest rate premium in the current low rate environment, remain in place and will continue to drive foreign inflows in the coming years. The demand for Mainland onshore bonds is likely to be structural in nature and an allocation to this asset class will be a strategic decision that is increasingly difficult to ignore. According to the Global Public Investor 2021 report[5], 30% of central banks are planning to increase their exposure to the renminbi over the next 12–24 months, compared with just 10% last year.

With inflows into the Mainland onshore bond market set to continue to rise, we expect turnover of Northbound Trading under Bond Connect to increase. The scheme will continue to play an important role in helping foreign investors access the onshore bond market and raising bond market depth and liquidity, thereby strengthening Hong Kong's role as an offshore renminbi business centre.

As investors increasingly recognise that Mainland onshore bonds have a strategic, long-term role in their portfolios, the demand for tools to manage related exchange rate risk, interest rate risk and liquidity risk is also growing. A priority in the next stage of enhancements to Northbound Trading under Bond Connect would be on the provision of diversified risk management tools, including the introduction of derivatives such as interest rate swaps.

More than four years since Northbound Trading began, Bond Connect has become an important channel for overseas investors to enter the Mainland onshore bond market. Alongside the increasing scale of foreign capital inflows into the market and the steady development of the Mainland economy, demand has also been rising from onshore institutional investors to make outbound investments to meet their asset allocation needs. The launch of Southbound Trading in September 2021 will deepen the two-way opening up of the Mainland onshore bond market and promote healthy cross-boundary capital flows, as well as create opportunities for onshore Mainland investors to diversify investment risks and build exposure to offshore fixed income through Hong Kong in a convenient, efficient and secure manner. Southbound Trading will bring more Mainland investors and overseas bond issuers to Hong Kong and facilitate the development of the local bond market, as well as attract intermediaries to operate through the bond market platform in Hong Kong, thus creating new opportunities for the financial industry.

As in the case of Northbound Trading, Southbound Trading will start prudently and develop gradually with an emphasis on proper risk control. Cash bond transactions will be launched in the initial stage and the scope of eligible investors will include a selected number of primary dealers for open market operations in the Mainland as well as QDIIs and RQDIIs. The scheme will also be subject to an initial daily and annual quota which will be reviewed and adjusted in line with cross-boundary fund flows. The key features of Southbound Trading are summarised in Table 2.

[5] *Global Public Investor 2021*, Official Monetary and Financial Institutions Forum.

TABLE 2

Key features of Southbound Trading

Investor scope	• Selected primary dealers for open market operations in the Mainland as approved by the PBoC (41 large- and medium-sized Mainland banks in total) • QDIIs and RQDIIs
Investment quota	• Annual quota: RMB 500 billion (net outflow) • Daily quota: RMB 20 billion (net outflow)
Scope of tradable products	• Cash bond transactions • Tradable bonds: all bond types issued offshore and tradable in the Hong Kong bond market
Counterparties	• Market makers designated by the HKMA
Settlement routes	• Financial infrastructure connection (with reference to the operating model of Northbound Trading; Mainland central securities depositories: CCDC and SHCH; Hong Kong central securities depository: CMU) • Custodian bank connection (via Mainland pilot custodian banks)
Trading arrangement	• Eligible investors under both settlement routes have to trade with the designated market makers • China Foreign Exchange Trade System will establish system connection with offshore electronic trading platforms to provide trading service to eligible investors
Currency conversion	• Investment can be conducted in renminbi and foreign currencies • Investors using renminbi to invest in bonds denominated in foreign currencies can conduct currency conversion and foreign exchange hedging via the Mainland interbank foreign exchange market

The experience of Northbound Trading has shown that a smooth launch, coupled with incremental enhancements, is the best way to ensure robust and healthy development of the Bond Connect scheme. We will adopt the same approach in developing Southbound Trading. Following the smooth launch of Southbound Trading, we will review and enhance the operational arrangement from time to time according to actual operation and market development needs.