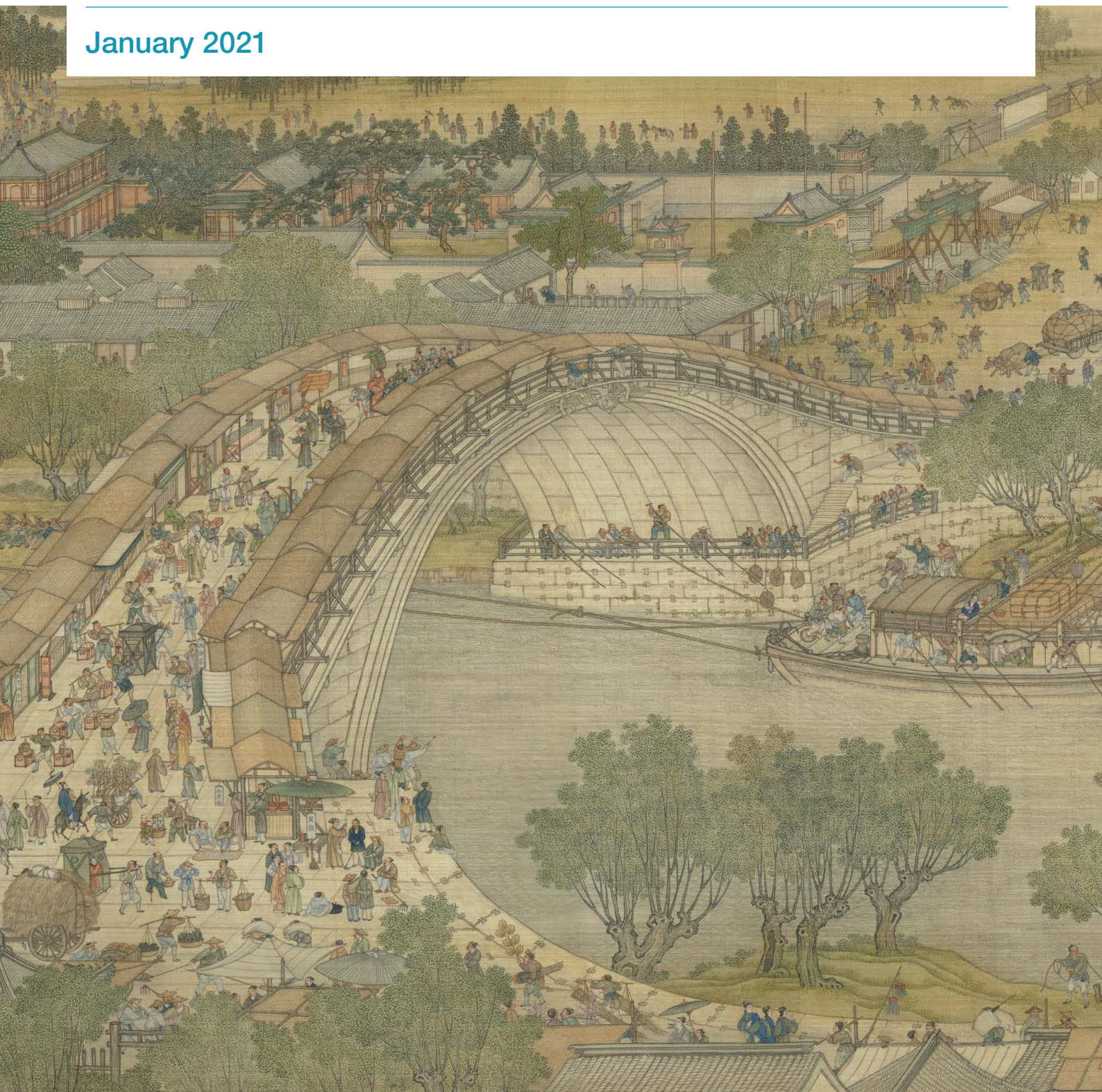


The Internationalization of the China Corporate Bond Market

January 2021



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Executive summary

Why this report?

Given the increasing importance of China in the global bond markets, particularly in light of significant reforms and initiatives to attract foreign investors, as well as the inclusion of China in major global bond indices, ICMA recognised that there was a need to focus more closely on the trends, opportunities, and challenges related to the internationalization of the China corporate bond market, both from an onshore and offshore perspective.

Onshore market

China's onshore bond market, at approximately \$15trillion equivalent of outstandings, is the second largest in the world, after the US. ICMA estimates the overall size of the outstanding onshore credit bond market to be approximately valued at \$5.8trillion of which \$3.7trillion are non-financial corporates and \$2.1trillion are financial bonds. Yet while foreign investors take up some 3% of the total market and continue to increase holdings of government and policy bank bonds, it is estimated that overseas holdings of corporate bonds constitute less than 1% of the market.

There are three main routes via which the international investor community can access the China onshore bond market: (i) QFII/RQFII; (ii) CIBM Direct; and (iii) Bond Connect. Interviewees outline the pros and cons of each of these, and some suggest that ideally there should be one single point of entry for foreign investors. Ongoing initiatives to make the QFII/RQFII regime less operationally burdensome, as well as to connect the exchange and interbank markets, are intended to open the overall bond market further to foreign investors and can only be helpful in providing global access to the China credit bond market.

Participants indicate that one of the main draws for investing in China's corporate bond markets is the strong economic backdrop. While the rate of GDP growth has slowed over the past decade, it remains on a strong upward trajectory. Interviewees also note that despite the extensive lockdown imposed in early 2020 in response to the COVID-19 pandemic, this proved to be effective in containing the spread of the virus, and by the second quarter the economy was back into growth mode.

Interviewees also cite the relatively high nominal returns of China's onshore bond markets, especially in comparison with more developed global bond markets where yields are close to zero or even negative, including higher rated corporate bonds. However, interviewees also note that while nominal returns are competitive, on a relative value basis onshore credit markets are expensive, particularly when compared to the offshore market.

A major catalyst for foreign inflows into the onshore bond market since 2019, particularly passive investment flows, has been the inclusion of China in various global bond indices. Interviewees suggest that these anticipated inflows off the back of index inclusions are likely to be conservative, with some suggesting \$600billion or more of passive investment flows are still to find their way into the onshore market.

Interviewees cite challenges with assessing the credit quality of underlying corporates as one of the main barriers to entry to the onshore market. There are nine domestic credit rating agencies (some state-owned), which adds to the confusing landscape, but perhaps more disconcerting is the general skew to the higher end of the credit spectrum and the resulting lack of credit differentiation. This implies the need for investors to dedicate time and resources to their own proprietary credit analysis.

Intertwined with the challenge of assessing credit quality is the incidence and outcome of corporate defaults. Prior to 2015 corporate defaults were relatively unheard of, but even as the credit market began to grow, there was still an assumption, and observation, that particularly in the case of State Owned Enterprises (SOEs), the government would intervene to backstop any company in difficulty. Since 2018 it has become clear that the state has taken a less interventionist stance, and while defaults remain relatively few, they are no longer the rarity they were. However, interviewees point out that the increase in corporate defaults is not in itself a bad thing and is an important element of a maturing market.

Interviewees consistently cite a lack of secondary market liquidity as a major barrier to the internationalization of the onshore credit market. This lack of liquidity is attributed to a number of factors, including bifurcated liquidity across exchange and interbank markets, a fragmented landscape of market-makers, small infrequently traded issues that rarely come back into the market, a lack of supply of longer maturities, concerns around market transparency and opacity of price formation, and the absence of both a credit repo specials market and a Single Name - Credit Default Swaps (SN-CDS) market.

Offshore market

Since 2010, China has come from virtually nowhere to dominate the Asia-Pacific international corporate bond market. ICMA estimates the size of the offshore China corporate bond market to be approximately \$752 billion equivalent nominal outstanding, or around 30% of the total APAC international corporate bond market and 38% of APAC international USD issuance.

Unlike the onshore corporate bond market, the offshore market is heavily skewed to financials (50% of outstanding nominal value), and predominantly real estate financing (45% of financials), with banks making up most of the remainder. Among non-financial corporate issuers, energy, industrials, utilities and communications constitute approximately 75% of outstandings.

Much of the impetus for Chinese corporates to tap the international debt markets is the result of China's rapid global economic expansion, and the need to fund overseas investment and acquisitions, primarily in USD. Furthermore, it is suggested that while in many cases Chinese corporates could fund themselves through the onshore market, potentially at better levels, there has been a big push in recent years, particularly at the local government level, for Chinese credits to establish themselves as familiar names in the international market.

Interviewees suggest that initially as the international market began to grow, investors were almost exclusively the offshore entities of Chinese investment firms, securities houses, and private banks looking to invest their USD. These investors were familiar with the names coming to market and comfortable with the more conservative international credit ratings. However, this investor base appears to be diversifying in recent years, with more

regional and global asset managers looking to diversify their portfolios while seeking out higher returns.

Interviewees paint a mixed picture of liquidity in the offshore China corporate bond market. This is against a backdrop of an international APAC credit market where participants already report challenged secondary market liquidity that is intrinsically skewed toward the bid side of the market. Interviewees also point to smaller issue sizes, the propensity for Chinese investors to hold to maturity, the lack of a developed SN-CDS market, and patchy repo availability as significant constraints on secondary market liquidity. That said, several suggest that liquidity in the offshore credit market is comparably better to that in the onshore market.

Conclusion

While barriers to the \$5.8 trillion onshore credit market for international investors appear to be multiple and many are likely to persist in the short-term, they are not insurmountable. As international investors and investment firms become more comfortable investing and operating in the rates segment of the onshore, so it would seem inevitable that in time they will begin to look further along the credit curve. The potential for transforming the China onshore credit market into a truly global market is significant.

Introduction

Why this report?

In 2018, ICMA published the report *The Asia-Pacific Cross-Border Corporate Bond Secondary Market*,¹ which aimed to analyze and document the state and evolution of the international APAC credit markets, primarily from the perspective of USD, EUR, and GBP denominated issuance. The analysis highlighted two major themes: the growing prominence of corporates from mainland China in the cross-border market, particularly issuing in USD, and also the ongoing liberalization of the onshore bond markets, which provided opportunities for the internationalization of the CNY corporate bond market.

In terms of the offshore APAC market, the past few years have seen Chinese corporate issuers come to dominate that market, making up 41% of new issuance (nominal value) since 2010. Meanwhile, since 2015, China's onshore corporate bond market has grown rapidly, not only in terms of nominal size but also as a relative segment of what is now the world's second largest bond market. Yet despite significant strides to make China's onshore bond markets accessible to international investors, the corporate bond market remains a relatively small portion of foreign holdings.

Given the increasing importance of China in the global bond markets, particularly in light of significant reforms and initiatives to attract foreign investors, as well as the inclusion of China in major global bond indices, ICMA recognised that there was a need to focus more closely on the trends, opportunities, and challenges related to the internationalization of the China corporate bond market, both from an onshore and offshore perspective.

Scope and methodology

The report applies a triangulation approach, utilising relevant data and analysis where available as well as qualitative input from market stakeholders. The quantitative data is taken from a variety of sources, most notably Bloomberg and Wind. The qualitative input was obtained through a series of semi-structured interviews with relevant institutions, including regional sell-sides, buy-sides, trading venues, and market infrastructures (a list of participating institutions is provided in the acknowledgements). Initial interviews were conducted in September 2019, with a second series of interviews in October and November 2020.

In terms of scope, the research focuses firstly on the domestic CNY credit bond market (see Annex I), including both financial and non-financial corporate issuers, and the extent to which this is becoming more accessible and interesting to the international investor community. It then turns its attention to the offshore China corporate bond market, primarily USD denominated, and its prominence as part of the cross-border APAC credit market.

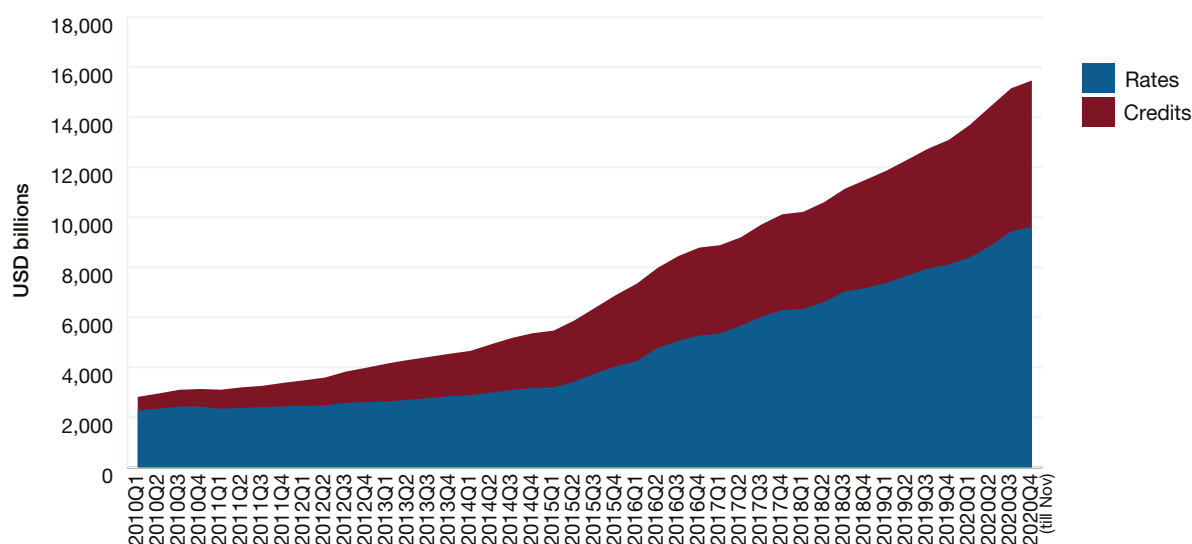
¹ <https://www.icmagroup.org/assets/documents/About-ICMA/APAC/ICMA-APAC-Cross-Border-Corporate-Bond-Secondary-Market-Report-300818.pdf>

The onshore corporate bond market

Market size

China's onshore bond market, at approximately \$15trillion² equivalent of outstandings (See Figure 1), is the second largest in the world, after the US. The market can largely be divided between rates, which consist of government bonds, local government bonds, policy bank bonds³ and central bank bills, and credit, which includes corporate bonds, enterprise bonds, financial bonds, debt financing instruments (DFI), asset back securities, and other non-public bonds. [See Annex 1 for all bond types.]

Figure 1: China onshore bond market size since 2010



Source: ICMA analysis using Wind data (November 2020)⁴

Based on Wind data,⁵ ICMA estimates the overall size of the outstanding onshore credit bond market as of November 2020 to be approximately valued at \$5.8trillion (CNY 38trillion), of which \$3.7trillion (CNY 24trillion) are non-financial corporates (NFCs) and \$2.1trillion (CNY 14trillion) are financial bonds (see Figure 2). In terms of domestic corporate bond markets, this places China in second place behind the US (\$10trillion) and well ahead of the largest European and Asian markets. By currency, it is the third largest credit market after USD (\$15trillion) and EUR (\$7trillion).

Yet while foreign investors take up some 3% of the total market and continue to increase holdings of government and policy bank bonds, it is estimated that overseas holdings of corporate bonds constitute less than 1% of the market.

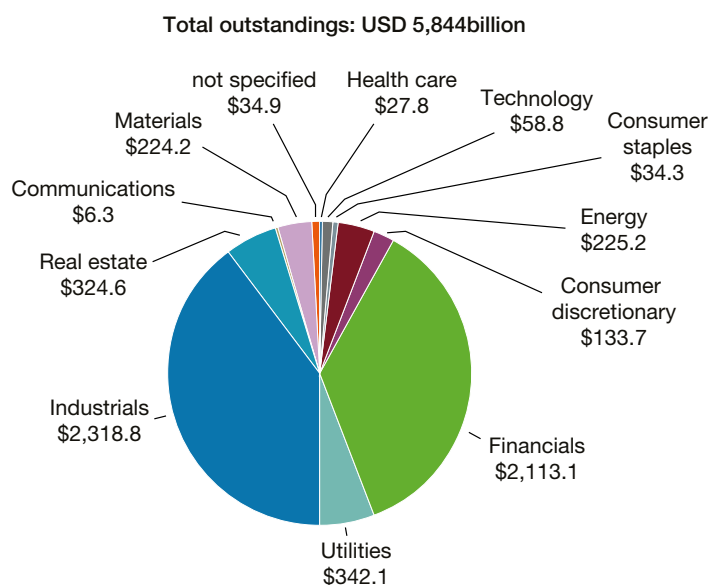
² as of Nov 2020, Wind data.

³ Policy bank bonds are those issued by the China Development Bank, the Agricultural Development Bank of China, and the Export-Import Bank of China.

⁴ 2020Q4 data in all figures in publication cover data till the end of November 2020.

⁵ Based on the nominal value of outstanding credit bonds.

Figure 2: Outstanding China onshore credit bond market (USD equivalent) by sector



Source: ICMA analysis using Wind data (November 2020)

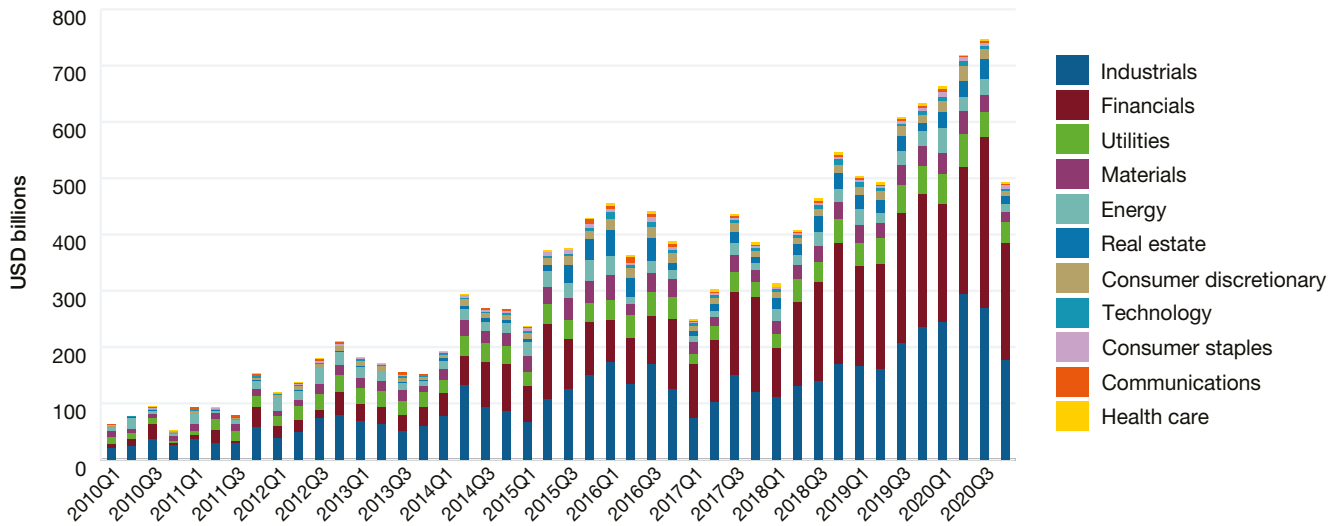
China's onshore credit bond market remained relatively undeveloped until 2014-15 from where it has seen steady growth, before accelerating in terms of new issuance and outstandings from late 2018 and continuing through 2020 (see Figures 3 and 4). Previously, indirect financing such as loans had been the main form of debt financing. But in recent years there has been a concerted move to market financing, not only for state and governmental institutions, but also corporates and financials. By the end of 2018, the ratio of outstanding bonds to loans was at 63%, compared with 36% at the end of 2007.⁶ A key development for the corporate bond market came in 2015 when the China Securities Regulatory Commission (CSRC) allowed for non-listed corporates to issue corporate bonds⁷ (previously issuers of corporate bonds had to have been listed). This was largely aimed at reducing the interlinkages of state-owned banks and state-owned enterprises (SOEs). Over the ensuing five years the outstanding amount of corporate bonds grew by approximately tenfold.

Much of the growth in issuance in 2020 has been underpinned by government support for SMEs through the introduction of the new fast-track regulatory process for issuing 'virus prevention and control bonds', as well as regulatory pressure on state-owned banks to buy these bonds.

⁶ Investing in China's Interbank Bond Market: A Handbook, NAFMI and ICMA (pending).

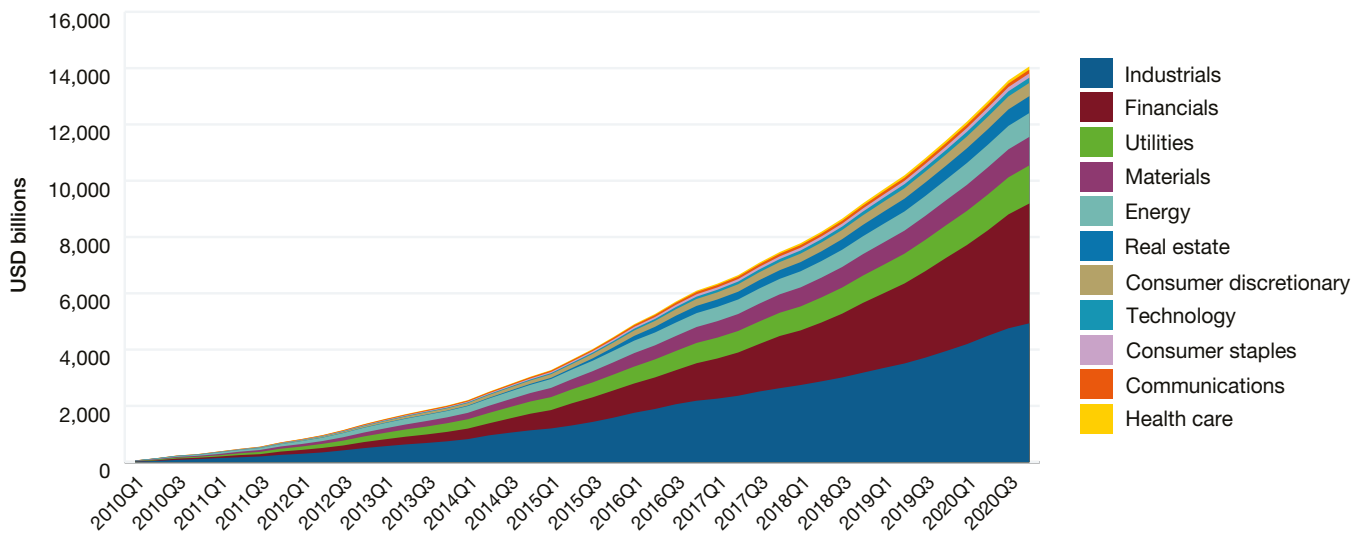
⁷ Corporate bond here refers to the specific type of bond regulated by CSRC.

Figure 3: Onshore credit bond issuance since 2010



Source: ICMA analysis using Wind data (November 2020)

Figure 4: Cumulative onshore credit bond issuance since 2010



Source: ICMA analysis using Wind data (November 2020)

Regulatory framework for accessing the onshore bond market

There are three main routes via which the international investor community can access the China onshore bond market: (i) QFII/RQFII; (ii) CIBM Direct; and (iii) Bond Connect. Interviewees highlight the pros and cons of each of these, and some suggest that ideally there should be one single point of entry for foreign investors. While the majority of bonds are traded in the interbank market (some 90%), many credit bonds are listed and traded on the two exchanges, the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE), ensuring that the QFII/RQFII access routes have retained importance. However, ongoing initiatives to make the QFII/RQFII regime less operationally burdensome, as well as to connect the exchange and interbank markets, are intended to open the overall bond market further to foreign investors and can only be helpful in providing global access to the China credit bond market.

QFII/RQFII

In 2002, the China Securities Regulatory Commission (CSRC) and the People's Bank of China (PBoC) jointly issued the Provisional Measures on Administration of Domestic Securities Investment of Qualified Foreign Institutional Investors, initiating the pilot QFII scheme, allowing foreign investors to enter China's capital market directly. Over time, the QFII Rules were revised to diversify the types of institutions from those in the pilot scheme and to relax restrictions on the scope of investments. The scope of Qualified Foreign Institutional Investors (QFIIs) has been expanded to include asset management companies, insurance companies, securities firms, commercial banks, and others such as pension funds, charity foundations, endowment funds, and sovereign wealth funds.

QFIIs also need to register with the State Administration for Foreign Exchange (SAFE) and are subject to an investment quota (in USD) based on the investor's total assets under management. After bringing their USD onshore, QFIIs can convert this to CNY and trade in exchange traded products (such as equities and bonds), or invest in the interbank bond market (after registering with the PBoC).

In 2011, the Renminbi Qualified Institutional Investor (RQFII) scheme was initiated. This allows the use of offshore CNY funds (CNH) raised offshore by the subsidiaries of domestic fund management companies and securities companies in Hong Kong to invest in the domestic securities market. Similar to the QFII scheme, investors apply for approval from the CSRC and register with SAFE. RQFIIs are also subject to a quota, but based on CNY.

Recently there have been a number of initiatives to open up the QFII/RQFII programs, including the removal of lock-up periods, allowing hedging of foreign exchange for QFIIs, and increasing the quota (from \$150million to \$300million). SAFE announced in September 2019 that it would repeal the QFII/RQFII investment quotas. In May 2020, the PBoC and SAFE officially removed the investment quotas and relaxed custodian management, including the possibility for multiple custodians.

Further expansion of the QFII/RQFII programs is outlined in the new rules released in September 2020, and includes: (i) consolidating the QFII and RQFII programs; (ii) streamlining the application process; (iii) broadening the scope of accessible investments (including fixed income repo and financial futures and options).

Since their introduction, over 500 institutional investors, from 30 countries/regions, have used the QFII/RQFII programs to access the onshore market.

CIBM Direct

In 2010, the China Interbank Bond Market Direct scheme was introduced, allowing international investors access to the Chinese interbank bond market (both rates and credit bonds). Similar to the QFII scheme, over time it has evolved to provide access for a range of investors (commercial banks, asset managers, insurers, securities houses, pension funds, charitable funds, and other long-term investors), and provides for three categories of investors:

- Type A can trade, settle and provide settlement agent services for interbank bond market instruments both for themselves and on behalf of Type C investors.
- Type B can trade and settle in the interbank bond market for themselves, and trade directly with others.
- Type C must appoint a Type A investor for settlement to carry out bond trading on their behalf. As of November 2020, most foreign investors are Type C.

Under the CIBM Direct scheme, investors are able to invest in all fixed income securities tradable on the CIBM (cash bond), as well as bond lending, bond forwards, interest rate forwards, interest rate swaps and FX derivatives for hedging purposes. Additionally, foreign central banks and monetary authorities, sovereign wealth funds, offshore RMB clearing banks and participating banks are allowed to do repo.

Investors are required to register with the PBoC and must appoint an onshore settlement agent. The settlement agent opens a bond account and a dedicated cash account on behalf of the investor. There are two main clearing houses: the Shanghai Clearing House (SHCH), which is used to settle medium-term notes (MTNs) and commercial paper (CP), other types of DFIs and credit risk mitigations, etc., and the China Central Depository and Clearing Company (CCDC), which is used to settle government bonds (treasury and local government bonds), central bank bills, policy bank bonds, financial bonds, enterprise bonds, asset backed securities, etc. The settlement agent will also open an account with the China Foreign Exchange Trading System (CFETS). In case an investor enters the CIBM with one single currency, the first repatriation amount cannot exceed 110%. However, there is no limit starting from the second repatriation. Offshore investors must invest within a nine-month period at least 50% of the investment amount that they mentioned in their PBoC registration filing form. The CIBM also provides access to new instruments available for hedging purpose (i.e. bond lending, bond forwards, and forward rate agreements), subject to completing legal documentation.

Recent developments aimed at making the CIBM even more accessible to international investors include the introduction of flexible settlement cycles (T+N, N \geq 3) for cash bond trade, a reduced minimum size for RFQs (CNY 10,000), an enhancement of the pre- and post-trade allocation process (to 50 sub-accounts), the automation of repo and securities lending, an increase in API capacity to support the full transaction lifecycle, direct RFQ service, and an extension of trading hours in the CIBM to 20:00 BJT.

By the end of November 2020 there were 467 overseas institutional investors registered through CIBM Direct.⁸ The same month turnover was CNY 390.3billion (\$59.4billion) with net purchases of CNY 71.9 billion (\$10.9billion).⁹

Bond Connect

In July 2017, the PBoC and the Hong Kong Monetary Authority (HKMA) jointly announced the launch of the Bond Connect program. Similar to the Stock Connect program (launched in 2014), Bond Connect facilitates access for international investors to the CIBM through connection between infrastructure providers in Hong Kong and the mainland China ('northbound'). In time, Bond Connect will also provide domestic investors with access to the international bond markets ('southbound').

Unlike the CIBM Direct scheme, Bond Connect does not require the appointment of an onshore settlement agent. The direct settlement counterparty for offshore investors is the HKMA's Central Moneymarkets Unit (CMU), which settles trades through accounts opened with SHCH and CCDC. International investors are able to submit electronic request for quotes (RFQs) with one or more onshore participating dealers, and are able to invest in all fixed income securities tradable on the CIBM, including treasury bonds, local government bonds, central bank papers, financial bonds, corporate credit bonds, CP, and asset-backed securities. Registered Bond Connect onshore market-makers can be accessed by investors through both the Tradeweb and Bloomberg trading terminals, with further platforms expected to be introduced in time.

⁸ See: <http://shanghai.pbc.gov.cn/fzhshanghai/113595/4086647/index.html>

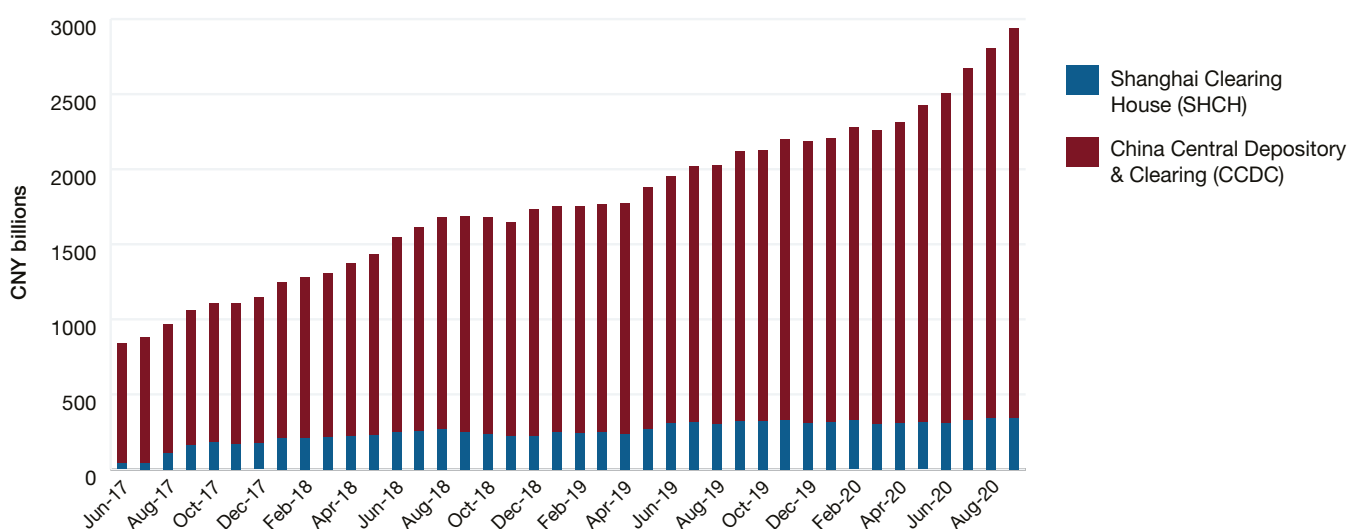
⁹ China Foreign Exchange Trade System

Other initiatives to expand the accessibility and functionality of Bond Connect include fee reductions, extended trading hours, and enhancements to Bond Connect’s primary market service offering (‘ePrime’).¹⁰

By the end of November 2020, 2,307 overseas investors¹¹, including 75 of the world’s top 100 asset management companies, were registered with Bond Connect and 612 have started trading in the interbank market. That month total trading volumes were CNY 485billion (\$73.8billion) with net purchases of CNY 51billion (\$7.8billion)¹².

Figure 5 illustrates the overall growth in foreign investor bond holdings in the interbank market since the launch of Bond Connect in June 2017.

Figure 5: Foreign investor bond holdings in the CIBM



Source: ICMA analysis using CCDC and SHCH data

Connecting the interbank and exchange markets

In September 2020, the PBoC and CSRC announced that they would build the Infrastructural Connection Mechanism (‘the Connect’) between the interbank and exchange markets. This pilot initiative is intended to enhance infrastructure operability and market integration, allowing access to qualified investors in either market access to both, moving closer to the realization of a single access point. In particular, this has the potential to open up international access to the credit bond market.

Tax exemption

In November 2018 the Ministry of Finance (MoF) and the State Administration of Taxation (SAT) published ‘Circular 108’ which provides foreign investors in China’s onshore bond market with an exemption from both corporate withholding tax (WHT) and value added tax (VAT) on derived interest income.¹³ This exemption runs from November 7, 2018 to November 6, 2021, and has provided another helpful initiative in the regulatory framework to attract international investment into the onshore bond markets.

¹⁰ Bond Connect’s ePrime service, launched in October 2020, facilitates access to offshore new issuance denominated in USD (‘Kungfu’) and CNY (‘Dimsum’)

¹¹ Bond Connect

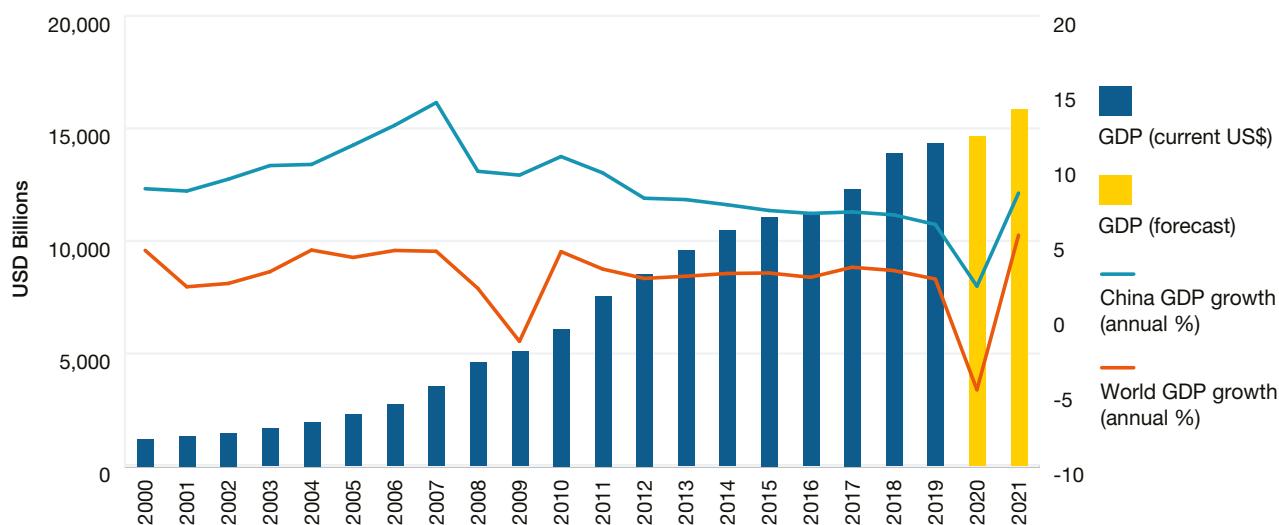
¹² China Foreign Exchange Trade System

¹³ Ordinarily income interest on bonds for international investors is charged at 10% WHT and 6% VAT

The economic backdrop

Participants suggest that one of the main draws to investing in China's corporate bond markets is the strong economic backdrop. While the rate of GDP growth has slowed over the past decade, it remains on a strong upward trajectory (see Figure 6). Interviewees also note that despite the extensive lockdown imposed in early 2020 in response to the COVID-19 pandemic, this proved to be effective in containing the spread of the virus, and by the second quarter the economy was back into growth mode (see Figure 7). GDP is forecast to increase by 2% annualized in 2020 and 8.2% in 2021.¹⁴

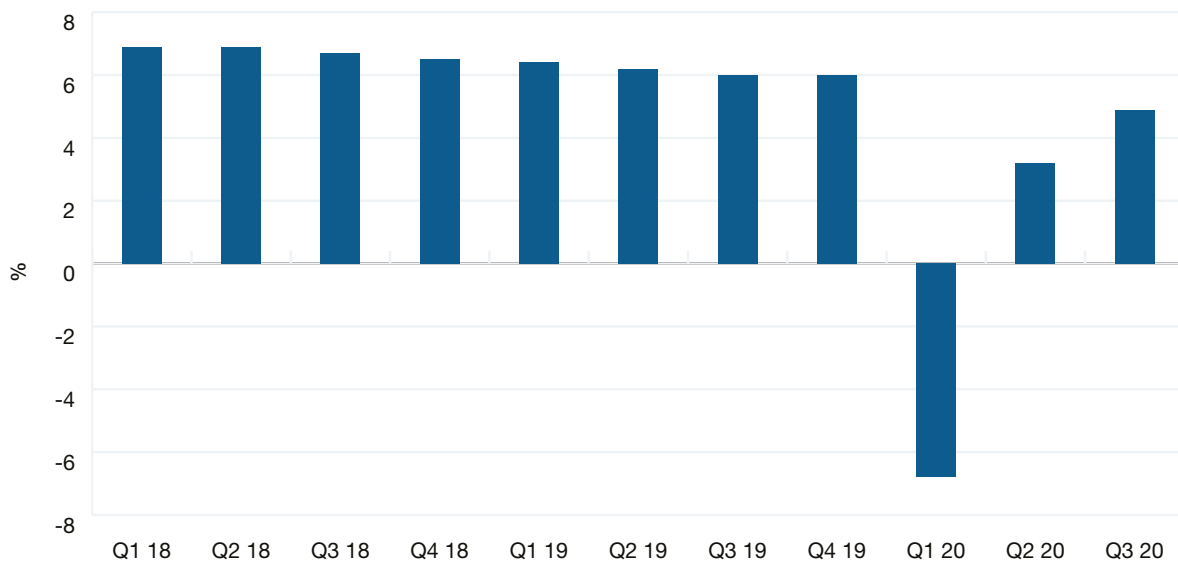
Figure 6: China annual GDP



Source: ICMA analysis using World Bank and IMF data

¹⁴ IMF World Economic Outlook, October 2020

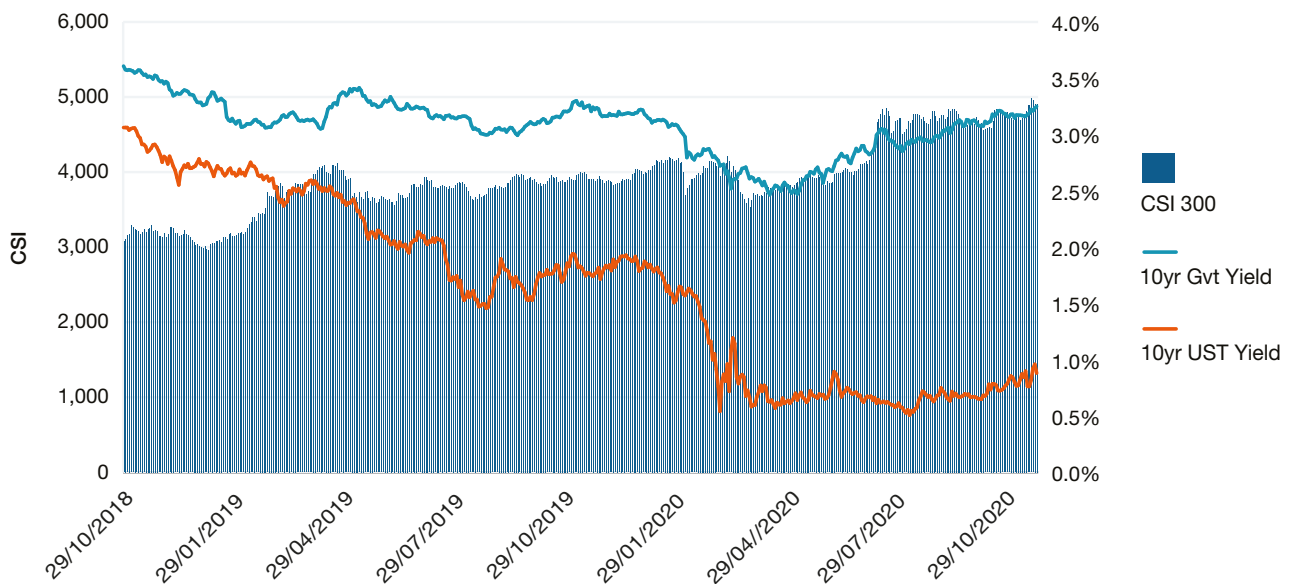
Figure 7: Quarterly GDP 2018-2020



Source: ICMA analysis using Bloomberg data

The speedy recovery of China's economy from Q2 of 2020 is reflected in stock market prices and also the sharp recovery in government bond yields (see Figure 8).

Figure 8: China Equity and Government Bond Markets

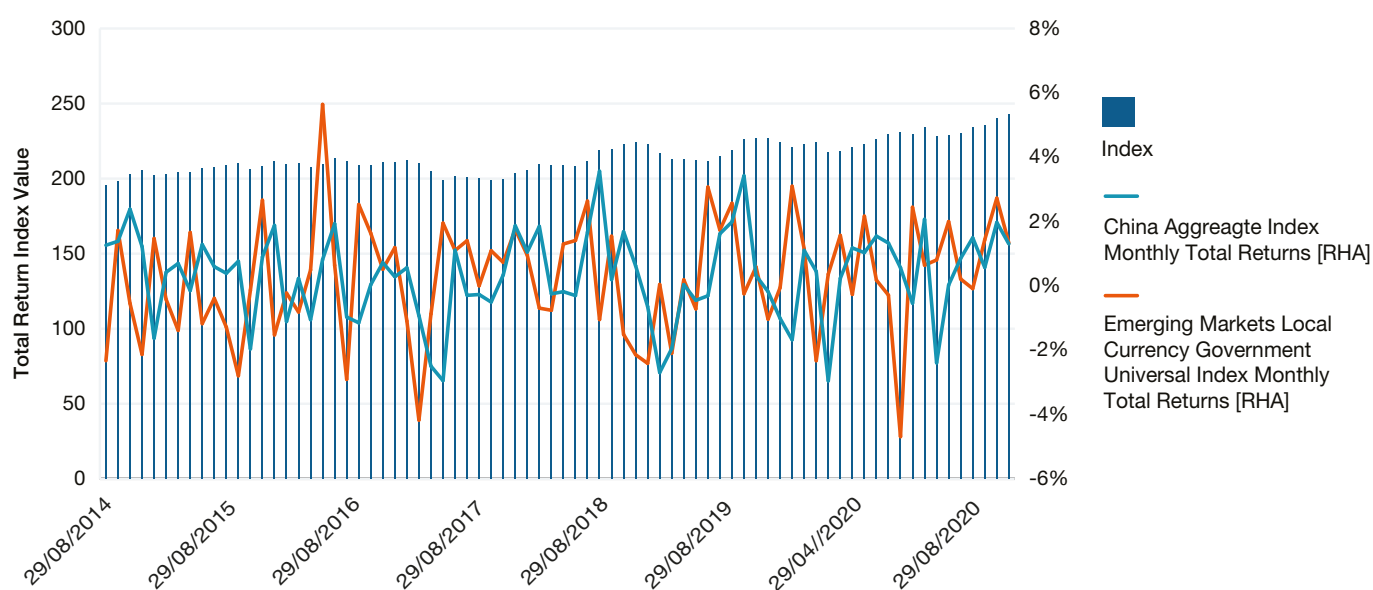


Source: ICMA analysis using Bloomberg data

Returns

Interviewees also cite the relatively high nominal returns of China’s onshore bond markets, especially in comparison with more developed global bond markets where yields are close to zero or even negative, including higher rated corporate bonds. A proxy for returns from the China bond markets is provided by the Bloomberg Barclays China Aggregate Index¹⁵ (see Figures 9 and 10), while returns from the more liquid investment grade segment of the onshore credit market is provided by the Bloomberg Barclays Liquid China Credit Index¹⁶ (see Figure 11). However, interviewees also note that while nominal returns are competitive, on a relative value basis onshore credit markets are expensive, particularly when compared to the offshore market. This can be seen in the option-adjusted credit spreads in Figures 10 and 11.

Figure 9: Bloomberg Barclays China Aggregate Index value and monthly total returns

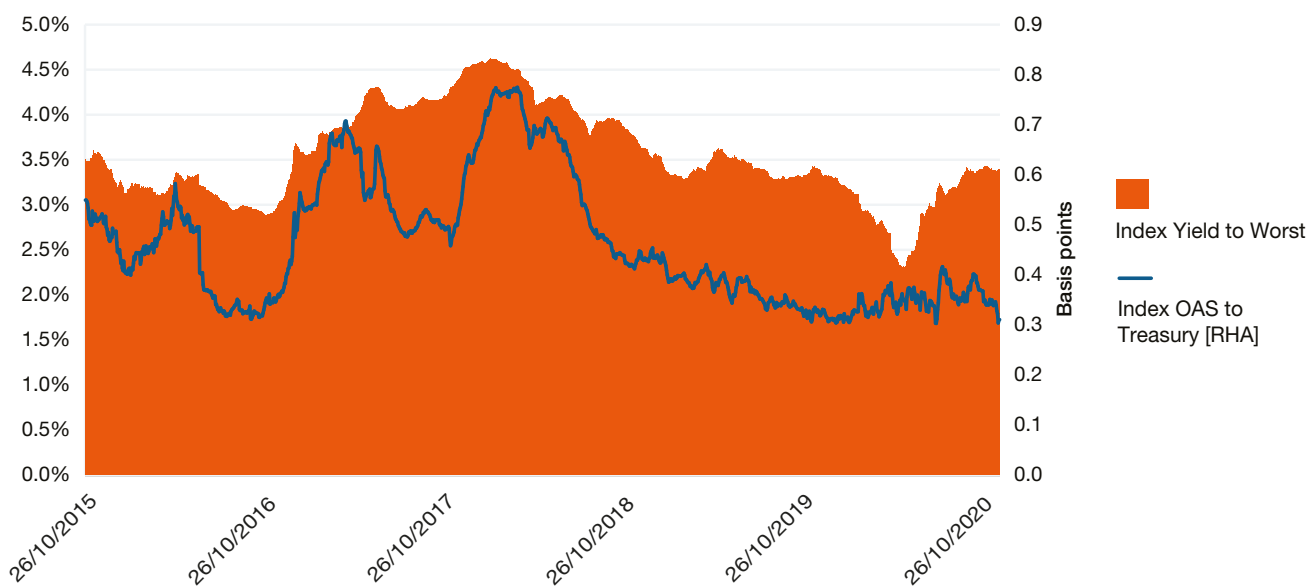


Source: ICMA analysis using Bloomberg data

¹⁵ The Bloomberg Barclays China Aggregate Index tracks the performance of the CNY-denominated fixed income market. The China Aggregate Index was launched in March 2004, with an inception date of January 1, 2004. It contains fixed-rate Treasury, government-related (including policy banks), and corporate securities that are listed on the China Interbank market. Returns are in USD, unhedged.

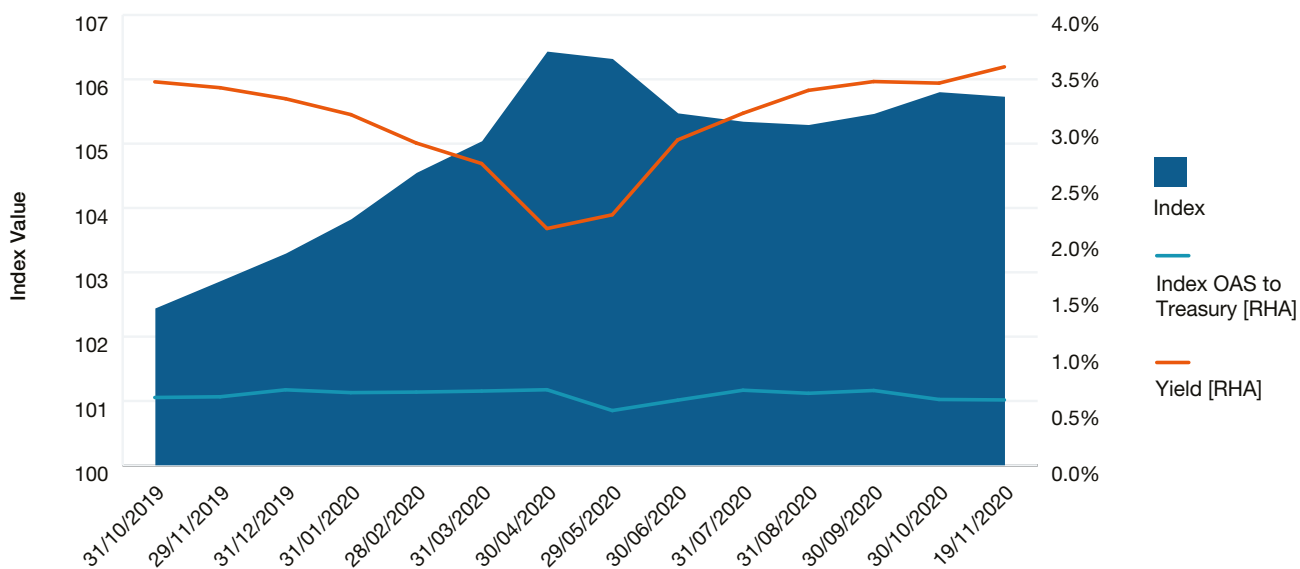
¹⁶ The Bloomberg Barclays Liquid China Credit Index tracks the liquid tradable portion of the CNY credit market. The index contains fixed-rate Government-related (excluding policy banks) and Corporate bonds that are listed on the Interbank Market. Bonds must have an IG rating and maturity >1 year at inclusion. Newly eligible issues are added on a quarterly basis based on past 3 months trade volume. Returns are in CNY, unhedged.

Figure 10: Bloomberg Barclays China Aggregate Index yield and option-adjusted-spread



Source: ICMA analysis using Bloomberg data

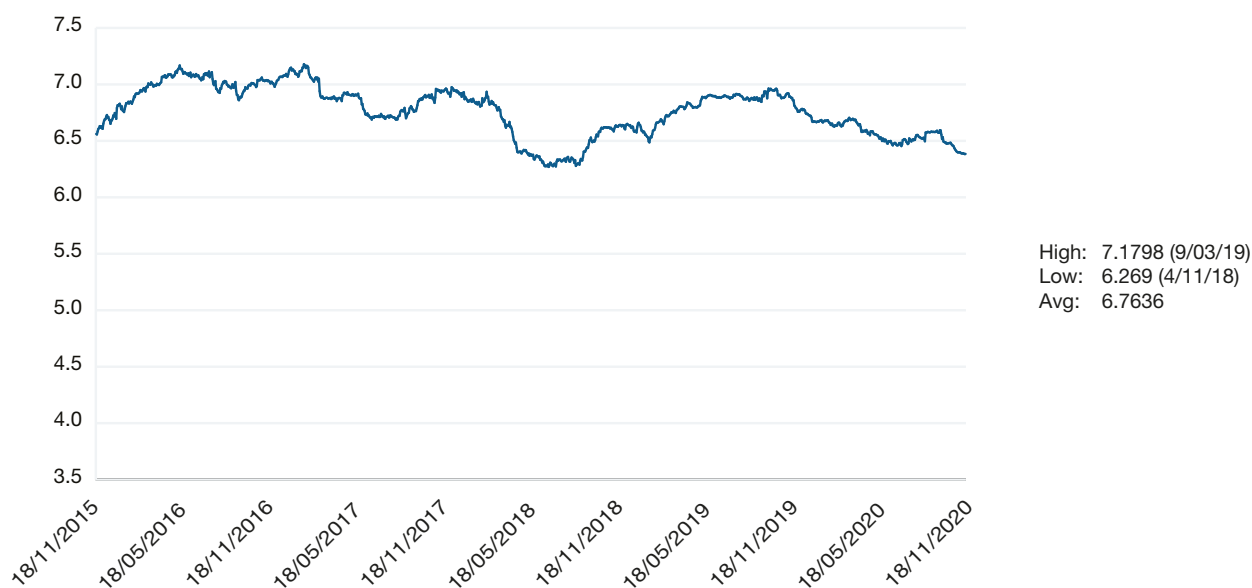
Figure 11: Bloomberg Barclays Liquid China Credit Index



Source: ICMA analysis using Bloomberg data

While the costs of hedging currency risk can be high (participants suggest anywhere from 60bp 100bp), making relative returns less attractive, it is also noted that the CNY has remained relatively stable within a tight range for a number of years, making currency risk less of an issue for longer-term investors (see Figure 12).

Figure 12: USD-CNY spot



Source: ICMA analysis using Bloomberg data

Global index inclusion

A major catalyst for foreign inflows into the onshore bond market since 2019, particularly passive investment flows, has been the inclusion of China in various global bond indices.

In March 2018, Bloomberg Barclays announced that domestic Chinese sovereign and policy bank bonds would be added to its Global Aggregate index (BBGA). The inclusion would be phased over a 20-month period, starting in April 2019, with CNY bonds ultimately constituting 6.5% of the \$67trillion index (approximately \$3trillion value). Based on the outstanding value of funds tracking the BBGA, it is estimated that this could prompt around \$150billion of foreign inflows into the China bond market over the phase-in period.

In September 2019, JP Morgan announced that Chinese CNY sovereign bonds would be included in its Emerging Market Bond Index (EMBI) Global, with a ten-month phase-in from February 2020. At the end of this period China would account for 10% of the index (valued at \$20trillion), giving it equal top weighting with Brazil. It is estimated that this would result in around \$100billion of passive inflows.

In September 2020, FTSE Russell announced that China CNY government bonds would be included in its World Government Bond Index (WGBI) as from October 2021. China's weighting will be 5.7% of the \$21trillion valued index, slightly less than that of Germany (6%). Resulting passive inflows are estimated to be around \$140billion.

Interviewees suggest that these anticipated inflows off the back of index inclusions are likely to be conservative, with some suggesting \$600billion or more of passive investment flows are still to find their way into the onshore market. And while corporate bonds are not directly affected, the fact that China's bond markets are increasingly becoming viewed as an international asset class, and as investors become more comfortable with the mechanics and risks of investing and trading in the onshore market, it would seem inevitable that it is only a matter of time before interest starts to move further along the credit curve.

Credit ratings and defaults

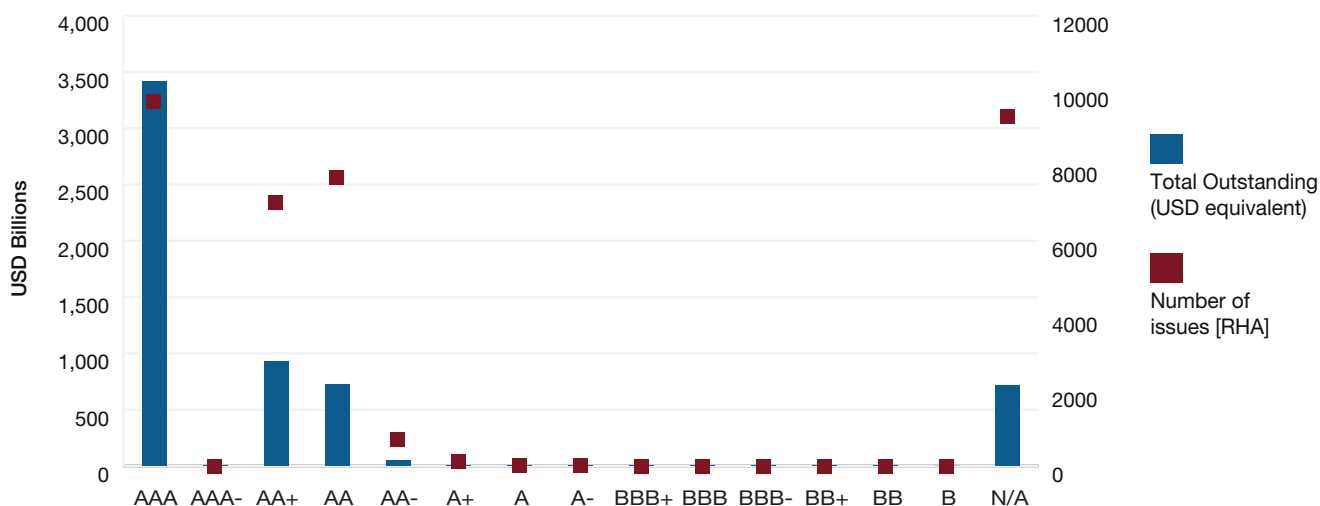
Interviewees cite challenges with assessing the credit quality of underlying corporates as one of the main barriers to entry to the onshore market. There are nine domestic credit rating agencies (some state-owned), which adds to the confusing landscape, but perhaps more disconcerting is the general skew to the higher end of the credit spectrum and the resulting lack of credit differentiation. This is illustrated in Figure 13, which shows that 38% of credit bonds carrying a credit rating are rated AAA, while 96% are rated AA or better.

Interviewees also note that ratings tend to remain static, and a credit can easily go straight from AA status to default.

This suggests the need for investors to dedicate time and resources to their own proprietary credit analysis. While corporate accounts and company disclosures are publicly available, local expertise is often required in sourcing such information, as well as local language skills, given that much of this is not published in English. Interviewees note that a number of banks and asset managers are already setting up onshore domestic entities with a view to being better positioned to conduct independent research and credit analysis.

A familiarity with issuers that are also active in the offshore market, and subject to international rating standards, can also help provide a point of reference in assessing onshore credit quality. However, there is broad consensus among interviewees that a critical development in the internationalization of the onshore market will be the introduction of internationally comparable credit ratings. Already two of the major international rating agencies have obtained licenses to rate bonds traded in the interbank market (S&P and Fitch). It remains to be seen, however, if the international credit rating agencies can bring significant changes to the rating regime. So far, the local subsidiaries of S&P and Fitch have produced a few ratings for issuers in the onshore market and the ratings remained consistent with the domestic rating regime.

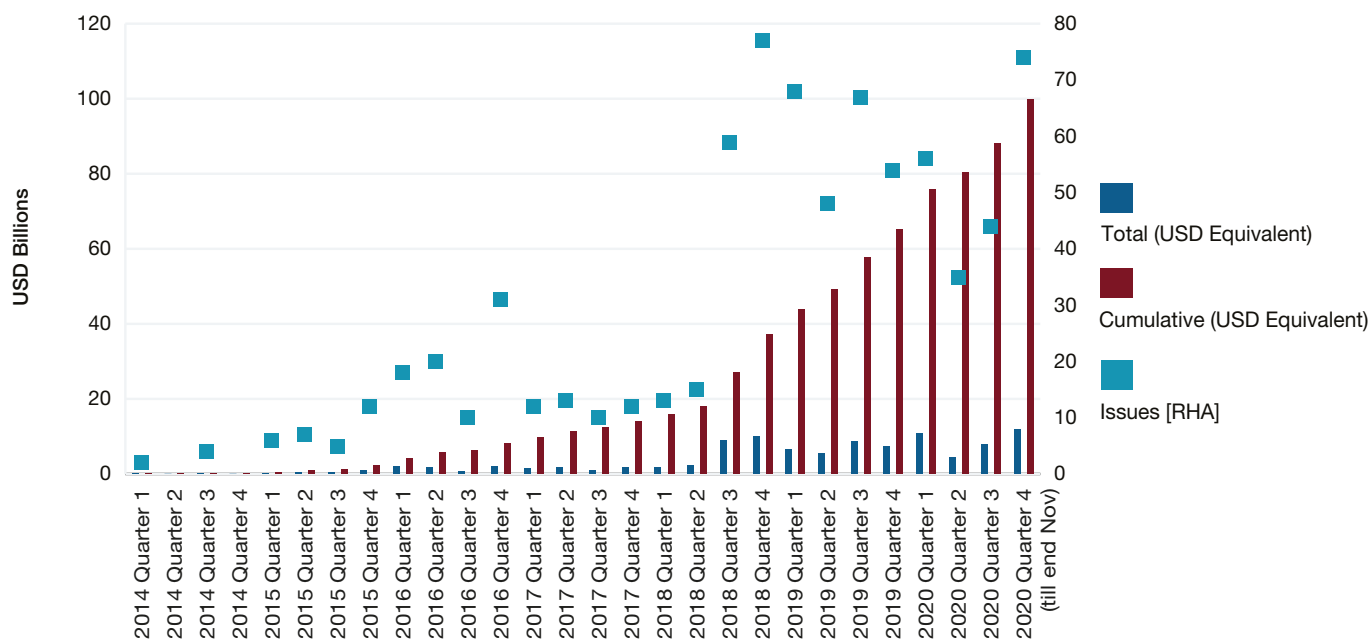
Figure 13: Onshore credit bond market by credit rating



Source: ICMA analysis using Wind data (November 2020)

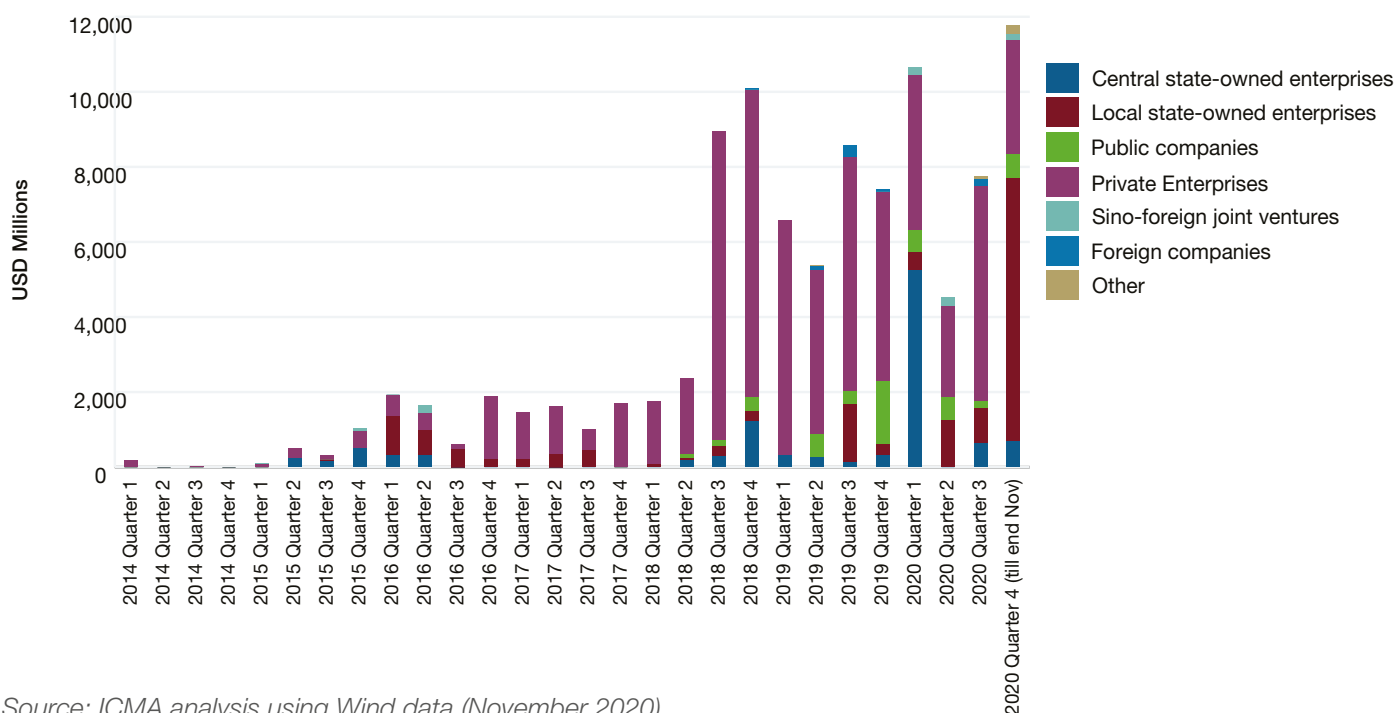
Intertwined with the challenge of assessing credit quality is the incidence and outcome of corporate defaults. Prior to 2015 corporate defaults were relatively unheard of, but even as the credit market began to grow, there was still an assumption, and observation, that particularly in the case of SOEs, the government would intervene to backstop any company in difficulty. Since 2018 it has become clear that the state has taken a less interventionist stance, and while defaults remain relatively few, they are no longer the rarity they were (see Figures 14 and 15). Furthermore, defaults are broadly dispersed and not limited to any particular sector (see Figure 16).

Figure 14: Onshore credit bond defaults



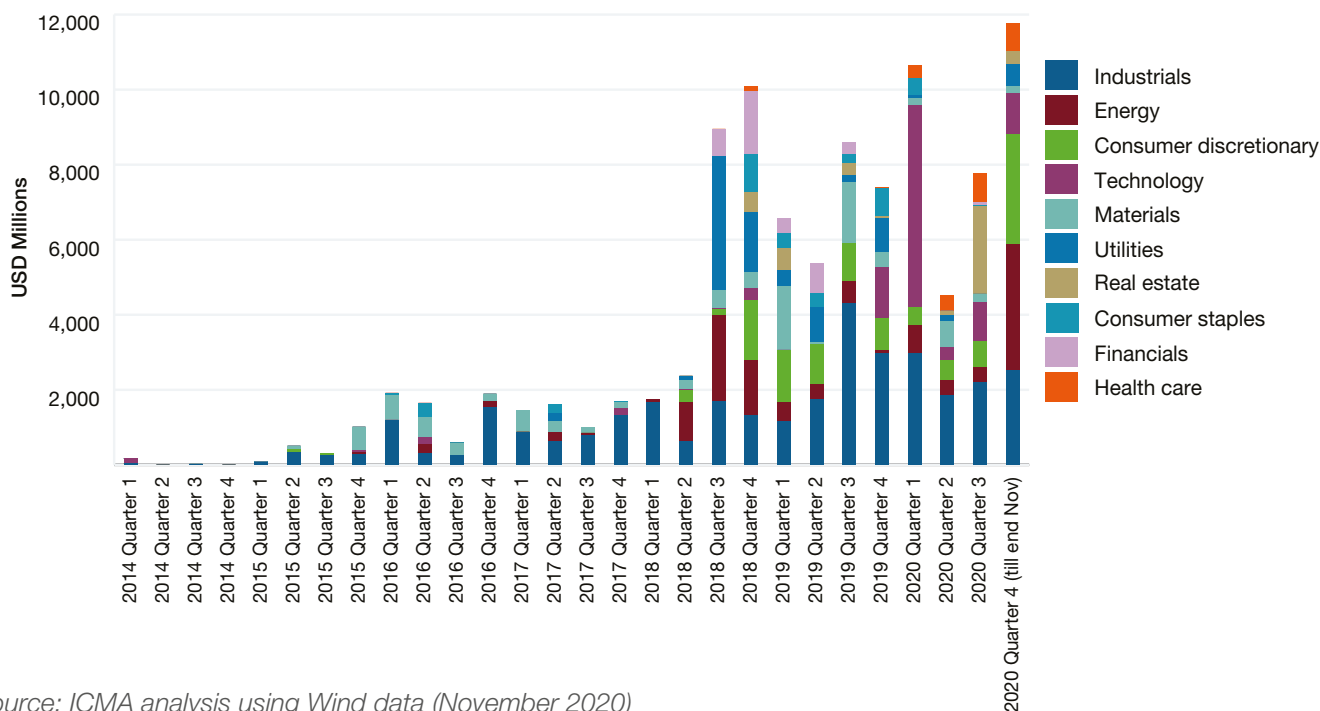
Source: ICMA analysis using Wind data (November 2020)

Figure 15: Onshore credit bond defaults by issuer type since 2014



Source: ICMA analysis using Wind data (November 2020)

Figure 16: Onshore corporate bond defaults by sector since 2014



Source: ICMA analysis using Wind data (November 2020)

Interviewees point out that the increase in corporate defaults is not in itself a bad thing and is an important element of a maturing market. Firstly, it helps to promote credit differentiation and underscores the need for more thorough credit analysis and more reliable, independent rating structures. Secondly, defaults provide case studies for how Chinese bankruptcy law is applied in practice and an indication of recovery values, which also helps in the fundamental assessment of credit evaluation and pricing. Finally, increasing corporate defaults also support the argument for developing an onshore credit default swap (CDS) market as a mechanism for market stabilization and investor protection.

Secondary market liquidity

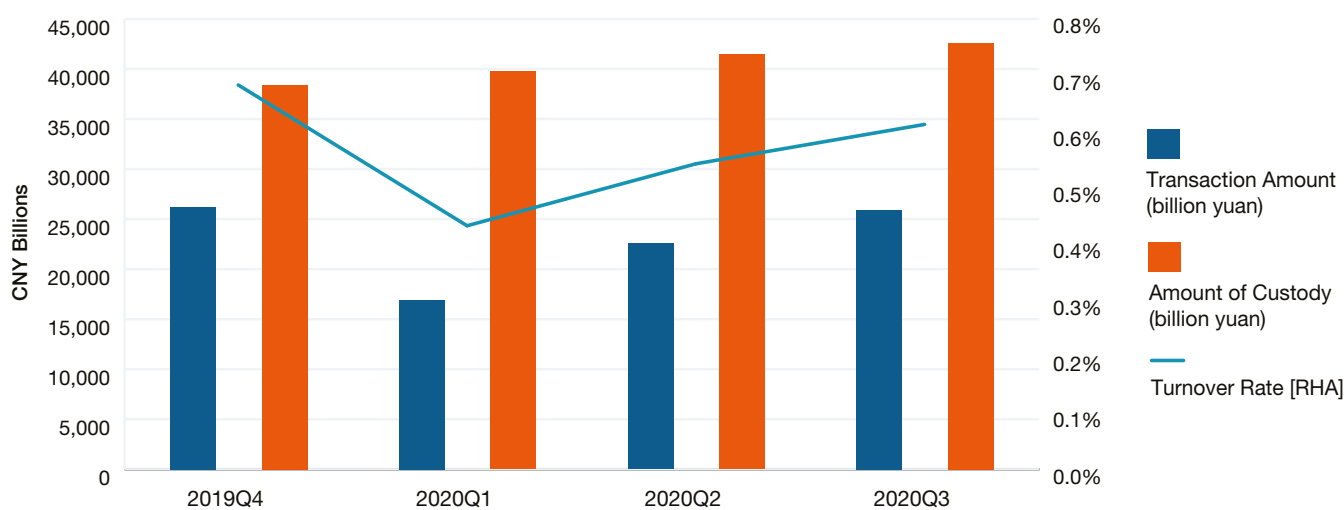
Interviewees consistently cite a lack of secondary market liquidity as a major barrier to the internationalization of the onshore credit market. This lack of liquidity is attributed to a number of factors.

Secondary market structure

Accessing the onshore credit market is not as straightforward as the rates market, particularly as it is bifurcated across the interbank and exchange markets (with financials tending to be concentrated on the former and non-financials on the latter). Interviewees explain that to have access to a broad range of onshore debt securities investors need to be connected to both the interbank and the exchange markets, noting further that many corporate bonds, particularly legacy bonds, are not registered for trading through Bond Connect. The ‘Connect’ initiative to provide interoperability between the two markets could help in this respect.

Interviewees complain of very little transparency and price visibility in the secondary credit markets, making it difficult to know where to go to find prices. They report that many Tier 1 banks limit their market-making capacity in credit to perhaps only the 20-or-so most liquid issues, with a skew towards financials. Meanwhile, less liquid issues, in particular NFCs, tend to be traded by the Tier 2 or Tier 3 banks and securities houses, and even then, interviewees note that this tends to be more in a broking capacity than as a true market-maker. Figure 17 shows traded volumes and turnover rates in the secondary market, which are relatively low compared to the size of the market.

Figure 17: China Onshore credit bond secondary market activity

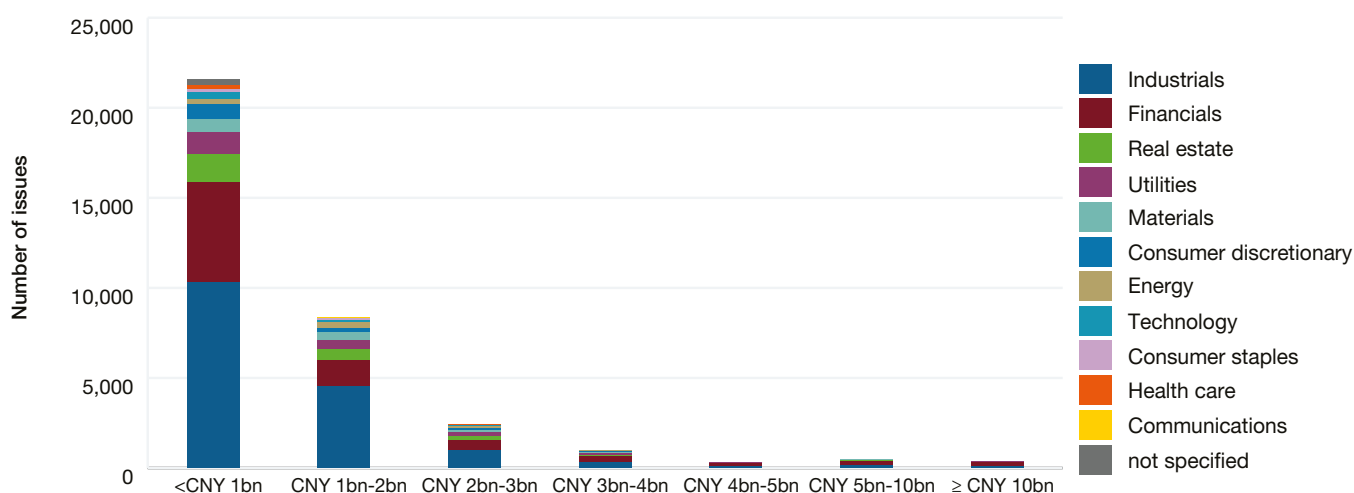


Source: ICMA analysis using CDCC data

It is suggested that the distribution of credit bond holders does not help. New issues tend to get soaked up by commercial banks, or private wealth managers, where they are often held to maturity. In the case of commercial banks, who also tend to be the largest market-makers, given that these bonds sit with the banks' treasuries, rather than in the securities trading division, they rarely find their way back into the secondary market. As China's institutional investor base continues to diversify, particularly with the development of onshore corporate bond index funds and ETFs targeted at asset managers, this should help to improve secondary market liquidity. More overseas participation can only be a further plus. And while there is a reticence to provide easy access for international hedge funds, interviewees note that they serve a useful auxiliary role in creating two-way flows which helps to create liquidity.

Issue sizes and maturity profiles of the credit market are also identified as impacting liquidity. Issue sizes tend to be small by international standards: ICMA, using Wind data, estimates the weighted average issue size of credit bonds to be CNY 1.1 billion or \$167 million equivalent. In terms of distribution, the majority of issues tend to be at the smaller end of the spectrum (see Figure 18). Fewer, larger issues, would most likely help to enhance liquidity.

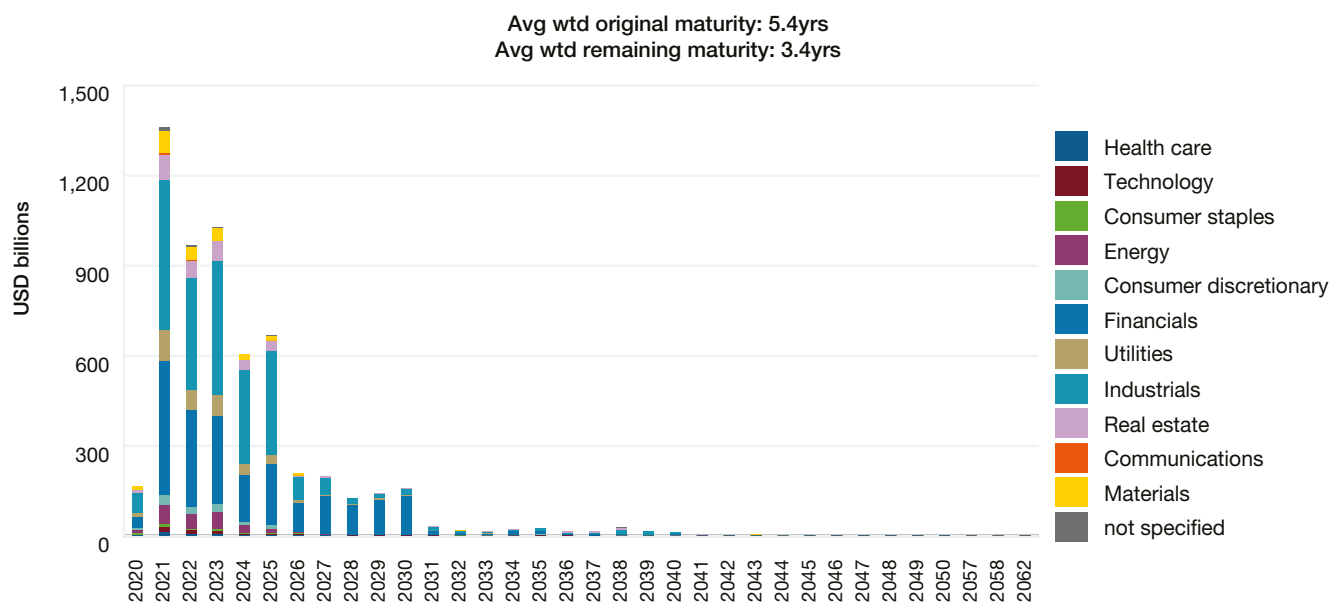
Figure 18: Onshore corporate bond market issue sizes



Source: ICMA analysis using Wind data (November 2020)

Maturity profiles also play an important factor. Average maturities tend to be relatively short. Using Wind data, ICMA estimates the average weighted maturity of the outstanding credit market at issuance to be 5.4 years, with a current average weighted remaining term to maturity of 3.4 years. Furthermore, longer maturities tend to be dominated by financials (see Figure 19). Longer maturities not only tend to be more attractive to longer-term investors such as pension funds and insurance companies, but a credit market with a longer maturity profile reduces issuer refinancing risk, making the market less vulnerable to short-term credit or liquidity shocks.

Figure 19: Onshore corporate bond market maturity profile



Source: ICMA analysis using Wind data (December 2020)

Hedging and funding markets

Interviewees highlight the lack of developed hedging and financing markets, particularly for credit, as being a major impediment to market liquidity, noting that both are not only important risk and liquidity management tools for investors, but they are also required to enable market-makers to provide liquidity.

In the case of repo, access is relatively limited, with only foreign central banks, international financial institutions, sovereign wealth funds, offshore RMB clearing banks and participating banks able to access the market through CIBM Direct. Furthermore, the onshore repo market is largely based on pledge structures, with no title transfer, which limits the scope for a 'specials market' and the ability to short-sell. Interviewees suggest that while there are ways to circumnavigate this in the rates market, there is essentially no real credit repo market. Without the ability to take short positions, market-makers are limited in their scope to provide offers, forcing them to act more as principal brokers.

Avenues for foreign investors to hedge interest rate risk are also relatively limited. CNY interest rate swaps (IRS) have existed for more than a decade and can be traded through CIBM Direct. However, interviewees report that daily volumes remain relatively thin, while others express concern that international standard ISDA documentation is not accepted by domestic institutions. Shorting government bonds to hedge interest rate risk can be difficult, given the lack of a title transfer repo specials market.

Meanwhile, access to the recently relaunched onshore CGB futures market¹⁷ is limited to only the largest domestic commercial banks, with the piloted introduction of further large commercial banks and insurance institutions. In 2017, HKEX introduced a cash-settled five-year China Ministry of Finance Treasury Bond contract,¹⁸ however this was soon after discontinued for regulatory reasons. Interviewees highlight the importance of international investors having ready access either to the onshore futures market, or via the reintroduction of an offshore market, as critical in the internationalization of the onshore bond market.

¹⁷ 2.5, and 10-year CGB contracts are available on the China Financial Futures Exchange (CFFE).

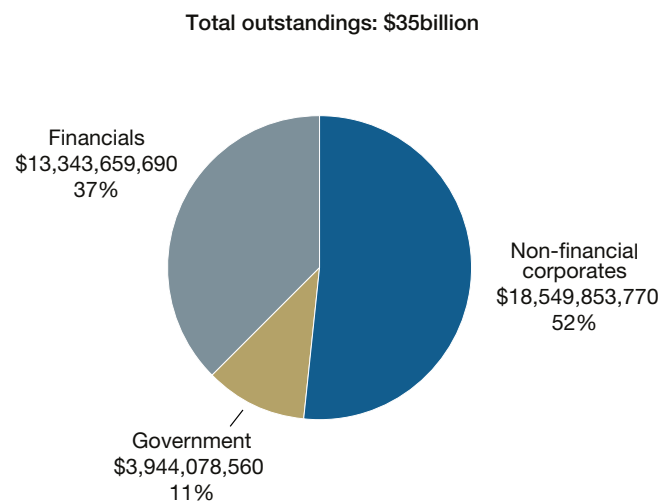
¹⁸ See: https://www.hkex.com.hk/-/media/HKEX-Market/Products/Listed-Derivatives/Interest-Rate/MOF-T-Bond-Futures_b/MOF-T-Bond-Futures-Infosheet/MOF_FUT_Mar17_E.pdf

The ability to hedge credit risk, which is seen as fundamental to opening up the onshore credit market, presents even more challenges. China has resisted the development of a single name (SN) CDS market, instead introducing its own onshore credit risk management instruments: the Credit Risk Mitigation Agreement (CRMA) and Credit Risk Mitigation Warrant (CRMW). The former is a bilateral agreement between parties, while the latter is a freely traded security. Both instruments, however, only provide protection on a specific bond or loan, rather than on a particular credit or class of debt. While interest in protection against defaults has increased in recent years, interviewees point to the lack of uptake in these instruments, explaining that the one-way nature of the underlying market (i.e. long) means that there is very little incentive for anyone ever to sell protection, while the fact that they are referenced to specific bonds provides very little flexibility as a generic hedging instrument. Again, they suggest that the development of a SN-CDS market, based on international structures and standards, will help to underpin liquidity.

Panda bond market

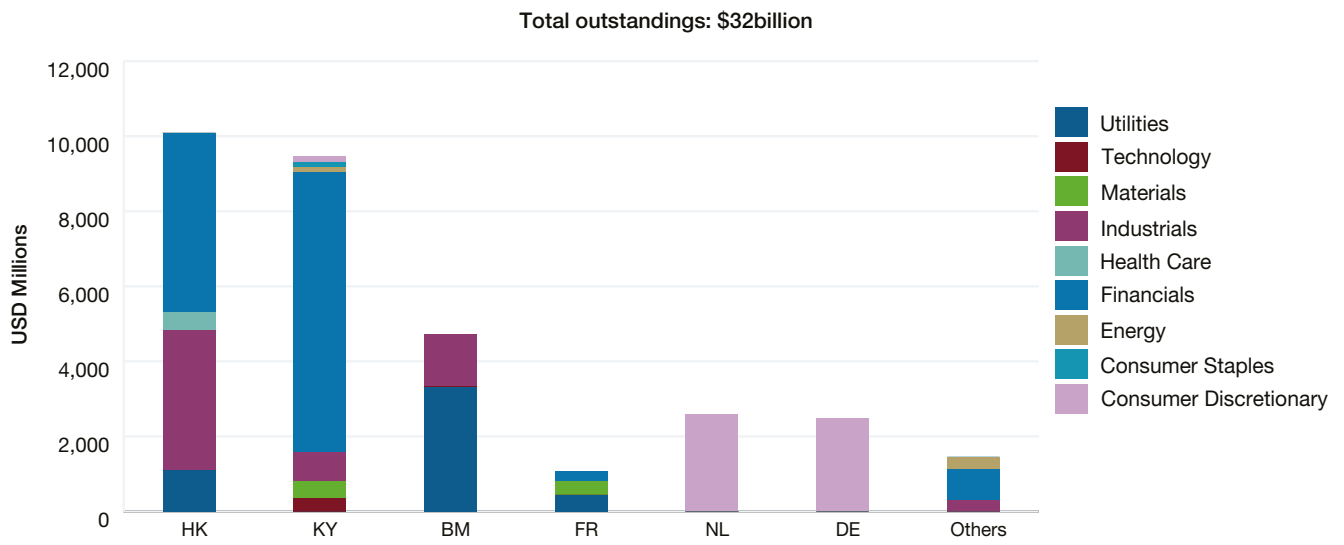
In the same way that onshore Chinese corporations becoming regular issuers in the international market can help to foster investor confidence in the onshore market (see next section), so overseas issuers accessing the onshore market can bring more international attention. The so-called ‘Panda bond’ market (CNY issuance by non-Chinese issuers) has grown in traction over the past few years, bringing in a range of international sovereign, supranational, and corporate issuers, either looking to fund CNY liabilities or to diversify their funding sources. While this remains a relatively small segment of the overall onshore market (See Figure 20) it can be viewed as an important trend in the internationalization of the market. Furthermore, while financial issuers (primarily global banks) dominate the market, non-financial corporates form a significant part of the market, with household names such as BMW and Daimler (see Figure 21).

Figure 20: Panda bond market outstandings by issuer type



Source: ICMA analysis using Bloomberg data (January 2021)

Figure 21: Panda corporate bond market outstandings by issuer country of risk



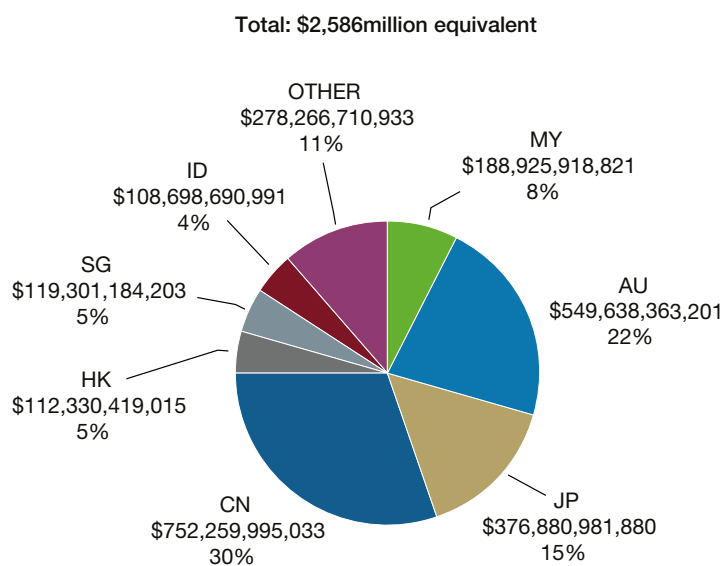
Source: ICMA analysis using Bloomberg data (January 2021)

The offshore corporate bond market

Market size

Since 2010, China has come from virtually nowhere to dominating the Asia-Pacific international corporate bond market.¹⁹ Based on Bloomberg data, ICMA estimates the size of the offshore China corporate bond market to be approximately \$752 billion equivalent nominal outstanding,²⁰ or around 30% of the total APAC international corporate bond market (see Figure 22), and 38% of APAC international USD issuance (see Figure 23).²¹

Figure 22: APAC international corporate bond market outstandings by country of risk



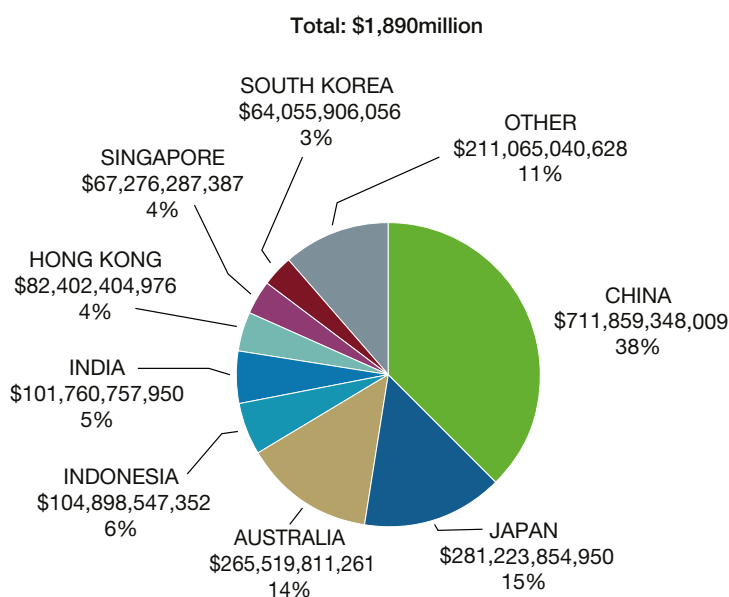
Source: ICMA analysis using Bloomberg data (November 2020)

¹⁹ See: ICMA (2018), *The Asia-Pacific Cross-Border Corporate Bond Secondary Market*.

²⁰ Based on the nominal value of outstanding bonds issued offshore by Chinese (country of risk) non-governmental corporations, issued in all currencies, and with maturities at time of issuance greater than one year.

²¹ 92% of China's offshore corporate bond issuance is denominated in USD (with 4% Euro, 2% HKD, 1% AUD, and 1% others).

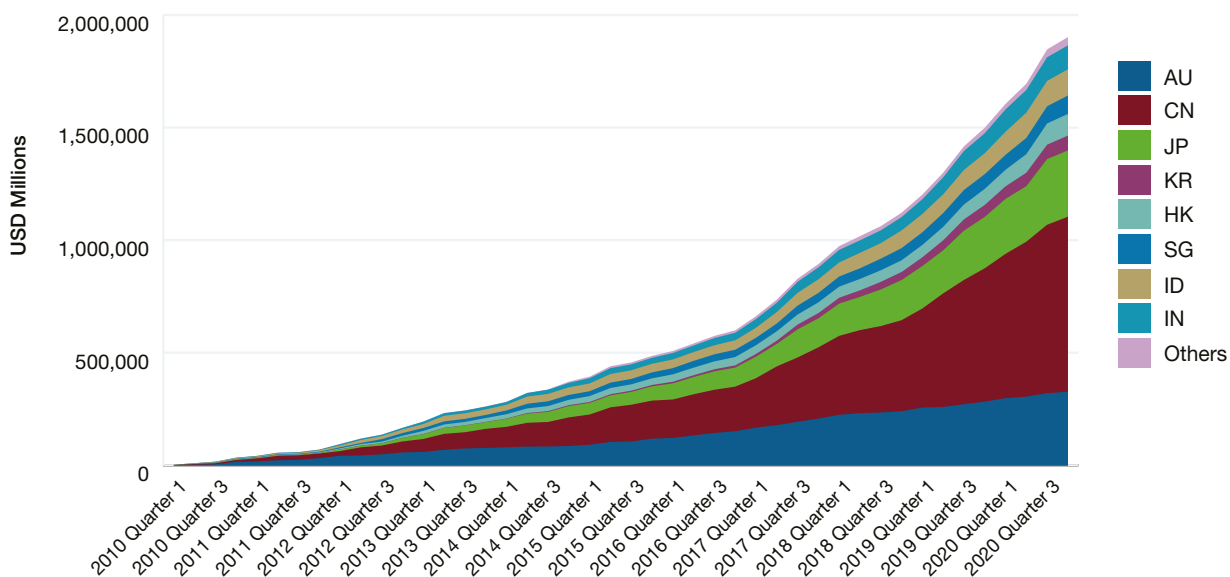
Figure 23: APAC international USD corporate bond market outstandings by country of risk



Source: ICMA analysis using Bloomberg data (November 2020)

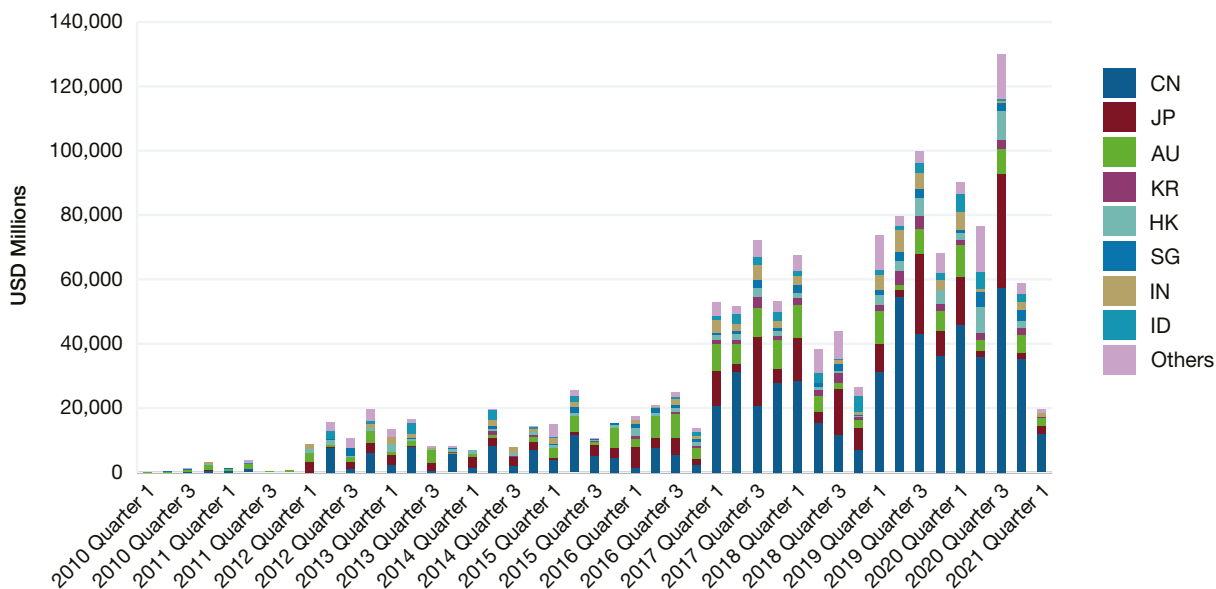
In terms of total issuance since 2010, Chinese corporates account for over 40% of the APAC USD corporate bond market (see Figure 24) and as of November 2020, China accounted for 52% of 2020 new issuance in USD (see Figure 25).

Figure 24: Cumulative APAC USD corporate bond issuance by country of risk since 2010



Source: ICMA analysis using Bloomberg data (November 2020)

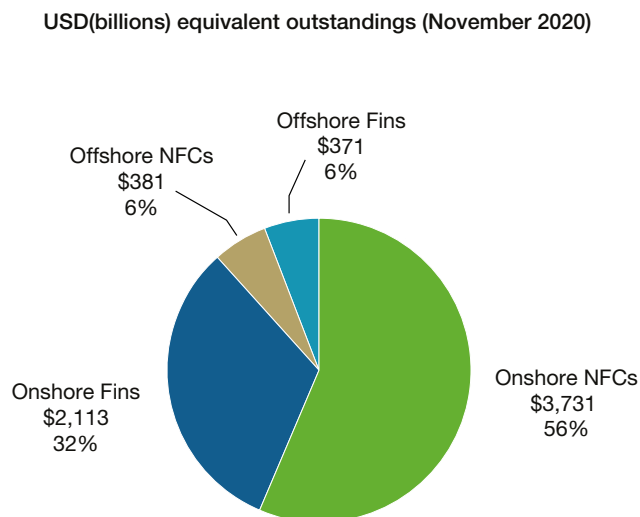
Figure 25: APAC USD corporate bond new issuance



Source: ICMA analysis using Bloomberg data (January 2021)

Comparing the offshore China credit market with the onshore market, the onshore market is almost eight-times larger, as illustrated in Figure 26.

Figure 26: Size of China onshore and offshore credit markets (USD equivalent outstandings)

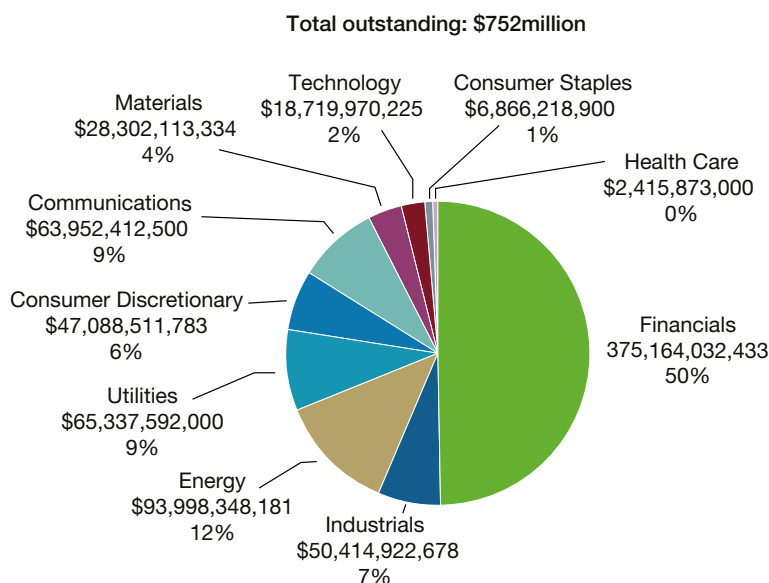


Source: ICMA analysis using Wind and Bloomberg data

Sector analysis

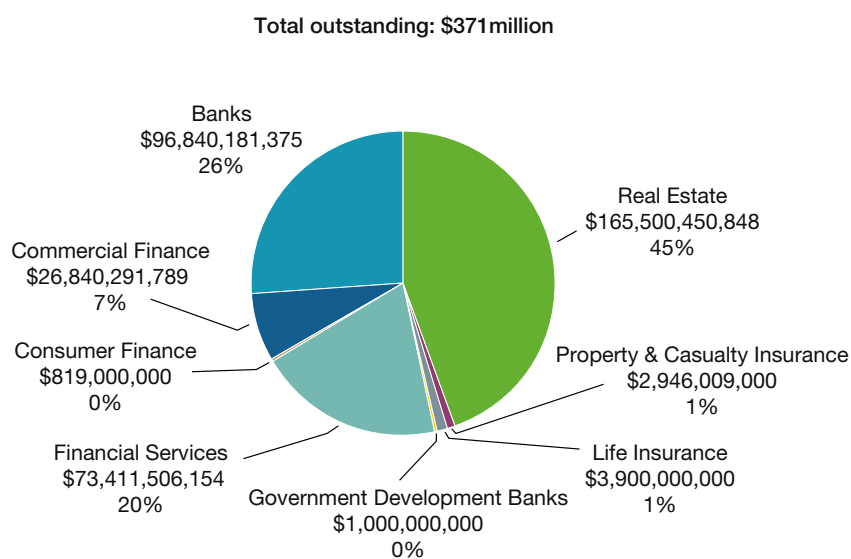
Unlike the onshore corporate bond market, the offshore market is heavily skewed to financials (50% of outstanding nominal value), and predominantly real estate financing (45% of financials), with banks and other financials making up most of the remainder (see Figure 28). Among non-financial corporate issuers, energy, industrials, utilities and communications constitute approximately 75% of outstandings.

Figure 27: China offshore corporate bond market by sector



Source: ICMA analysis using Bloomberg data (November 2020)

Figure 28: China offshore corporate bond market: financials



Source: ICMA analysis using Bloomberg data (November 2020)

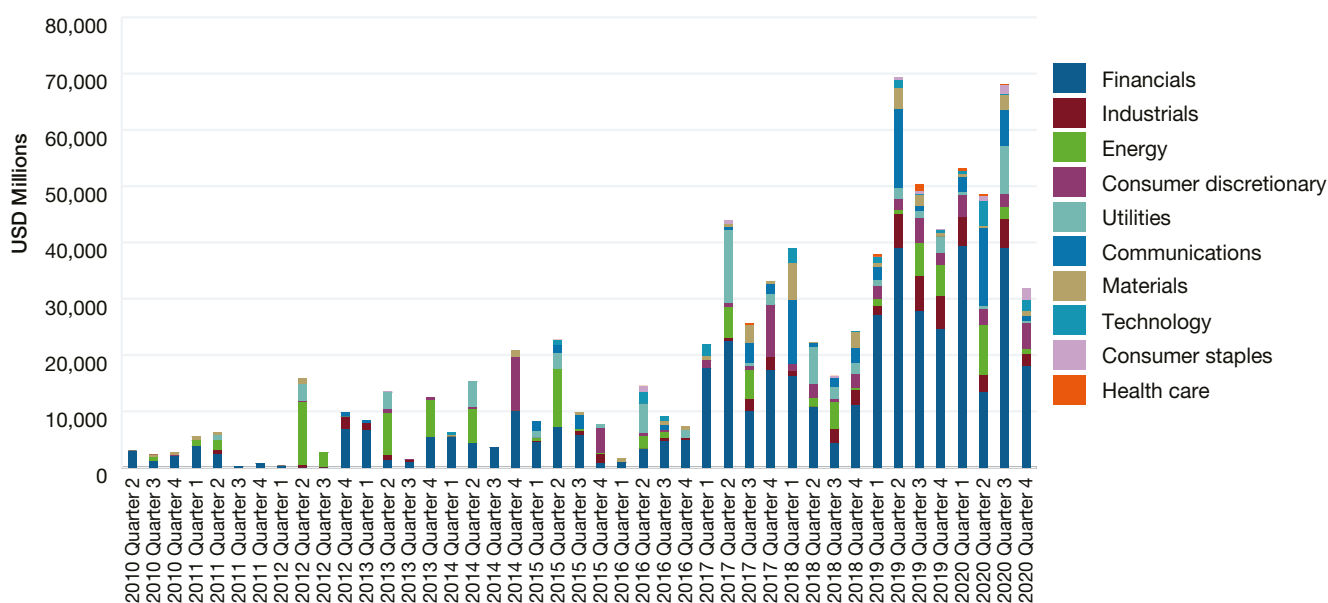
Market structure

Issuance

Much of the impetus for Chinese corporates to tap the international debt markets is the result of China's rapid global economic expansion, and the need to fund overseas investment and acquisitions, primarily in USD. Furthermore, it is suggested that while in many cases Chinese corporates could fund themselves through the onshore market, potentially at better levels, there has been a big push in recent years, particularly at the local government level, for Chinese credits to establish themselves as familiar names in the international market.

However, interviewees suggest that while China financials and corporates dominate the APAC international credit market, one of the biggest challenges is the lack of supply of Chinese names to meet demand. This is partly attributed to a requirement by China's National Development and Reform Commission, introduced in May 2018, for onshore enterprises to conform to stricter standards when engaging in foreign debt financings.²² These new stipulations were more specifically aimed at reducing levels of corporate and institutional leverage, particularly with respect to local government funding vehicles (LGFVs) which had become more prominent in the offshore market since 2016.

Figure 29: China offshore corporate bond new issuance

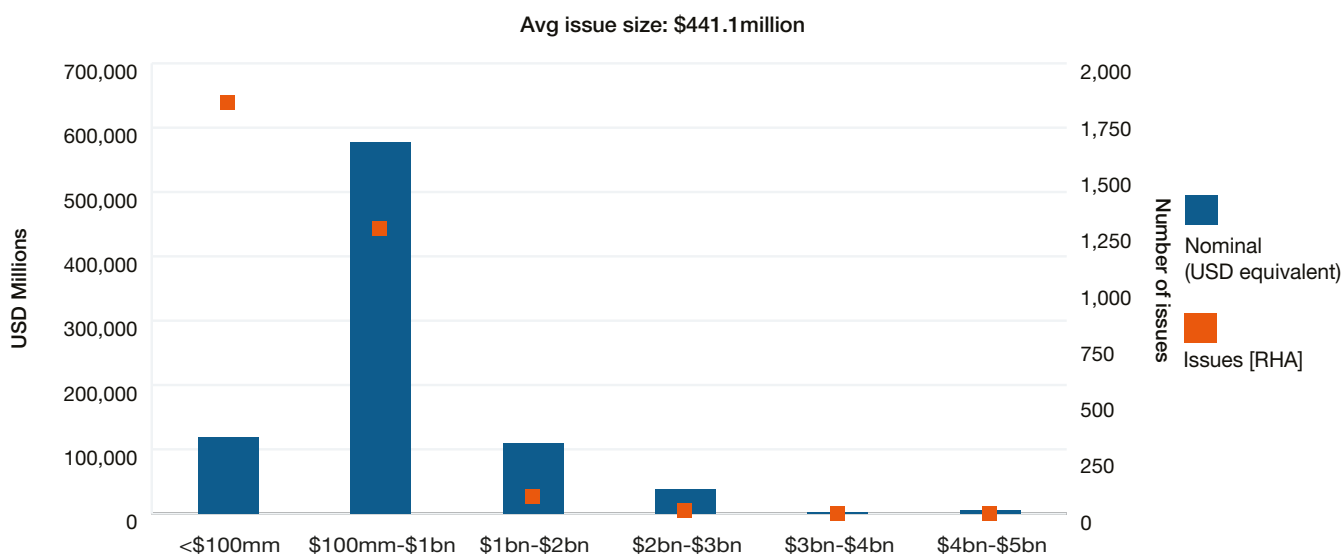


Source: ICMA analysis using Bloomberg data (November 2020)

Interviewees further suggest that supply is often restricted by syndicate managers (usually Chinese banks), and where otherwise demand could support significantly larger new issues without any material change in pricing. They note that while there has been an increase in jumbo issues in recent years (particularly by more internationally recognized names) issue sizes tend to be at the smaller end of the spectrum, which also constrains liquidity in the secondary market (see Figure 30).

22 NDRC Circular 2044 (May 11, 2018)

Figure 30: China offshore corporate bond market by issue size (outstandings)



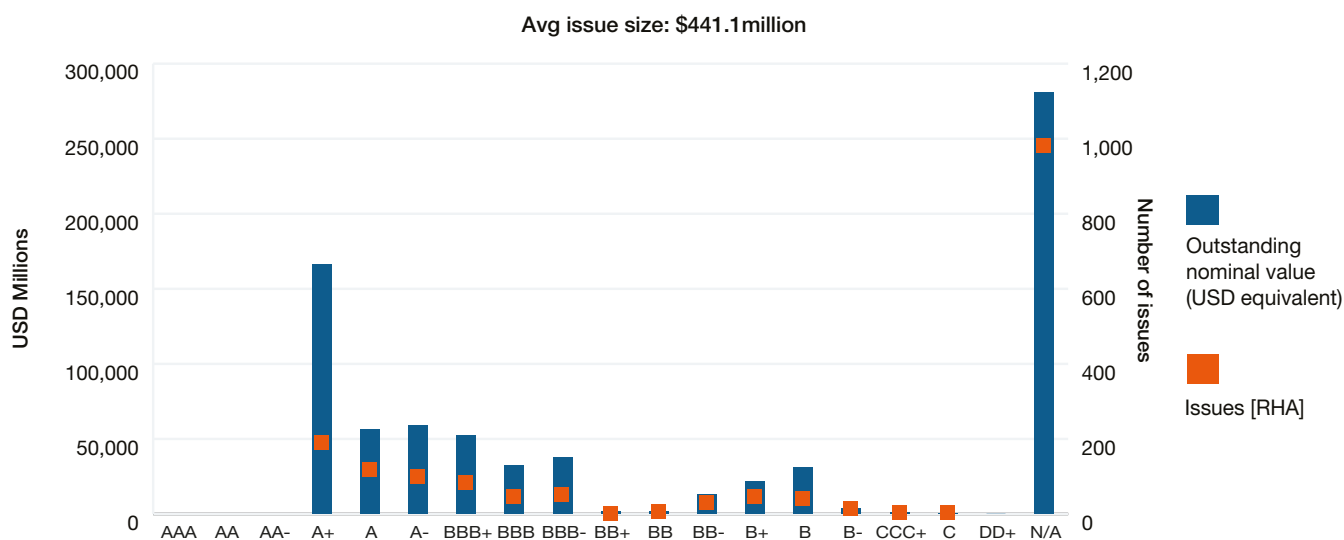
Source: ICMA analysis using Bloomberg data (November 2020)

Investors

Interviewees suggest that initially as the international market began to grow, investors were almost exclusively the offshore entities of Chinese investment firms, securities houses, and private banks looking to invest their USD. These investors were familiar with the names coming to market and comfortable with the more conservative international credit ratings. However, this investor base appears to be diversifying in recent years, with more regional and global asset managers looking to diversify their portfolios while seeking out higher returns. Importantly, as Chinese names become a familiar feature of the APAC credit space, so international investors are likely to feel more comfortable venturing into the significantly larger onshore market.

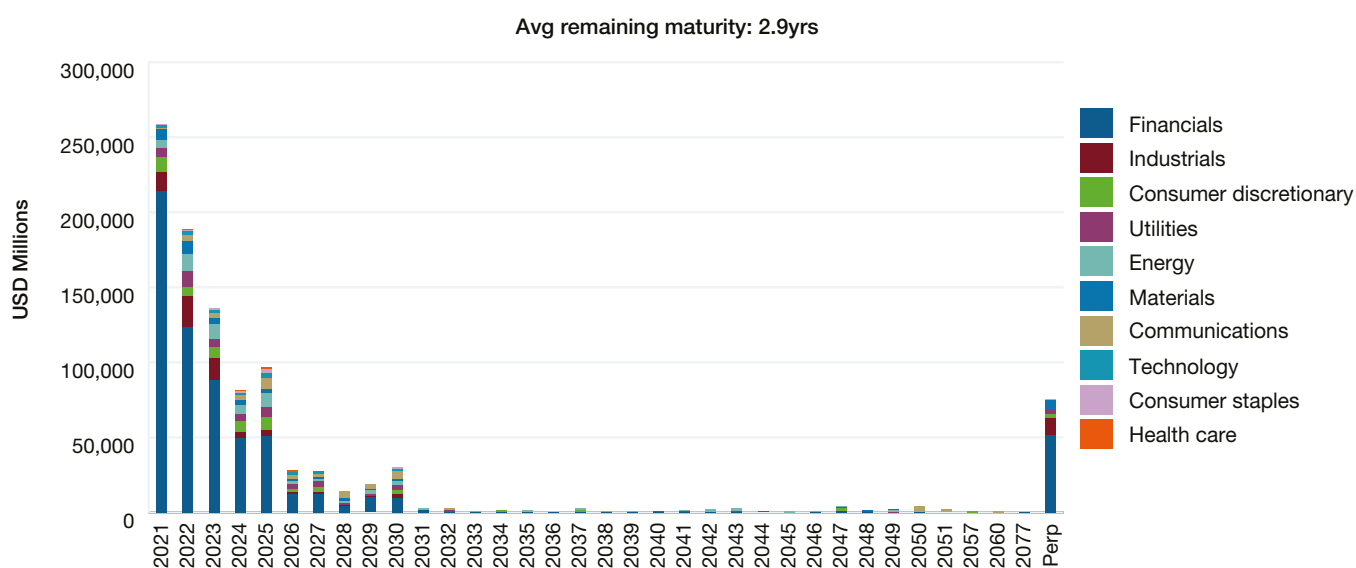
However, interviewees point to structural barriers for many international investors, including a lack of international credit ratings for many issuers (see Figure 31), as well as a heavy concentration toward very short maturities (see Figure 32).

Figure 31: China offshore corporate bond market by credit rating (outstandings)



Source: ICMA analysis using Bloomberg data (November 2020)

Figure 32: China offshore corporate bond market by maturity profile (outstandings)



Source: ICMA analysis using Bloomberg data (November 2020)

Secondary market liquidity

Interviewees paint a mixed picture of liquidity in the offshore China corporate bond market. This is against a backdrop of an international APAC credit market where participants already report challenged secondary market liquidity that is intrinsically skewed toward the bid side of the market. It is noted that secondary liquidity for Chinese credits is largely provided by the offshore (invariably Hong Kong based) entities of onshore banks and securities houses, and that this is an extremely competitive market where turnover appears to be more of a priority for dealers than profitability.

Otherwise, interviewees point to smaller issue sizes, the propensity for Chinese investors to hold to maturity, the lack of a developed SN-CDS market, and patchy repo availability as significant constraints on secondary market liquidity. That said, several suggest that liquidity in the offshore credit market is comparably better to that in the onshore market.

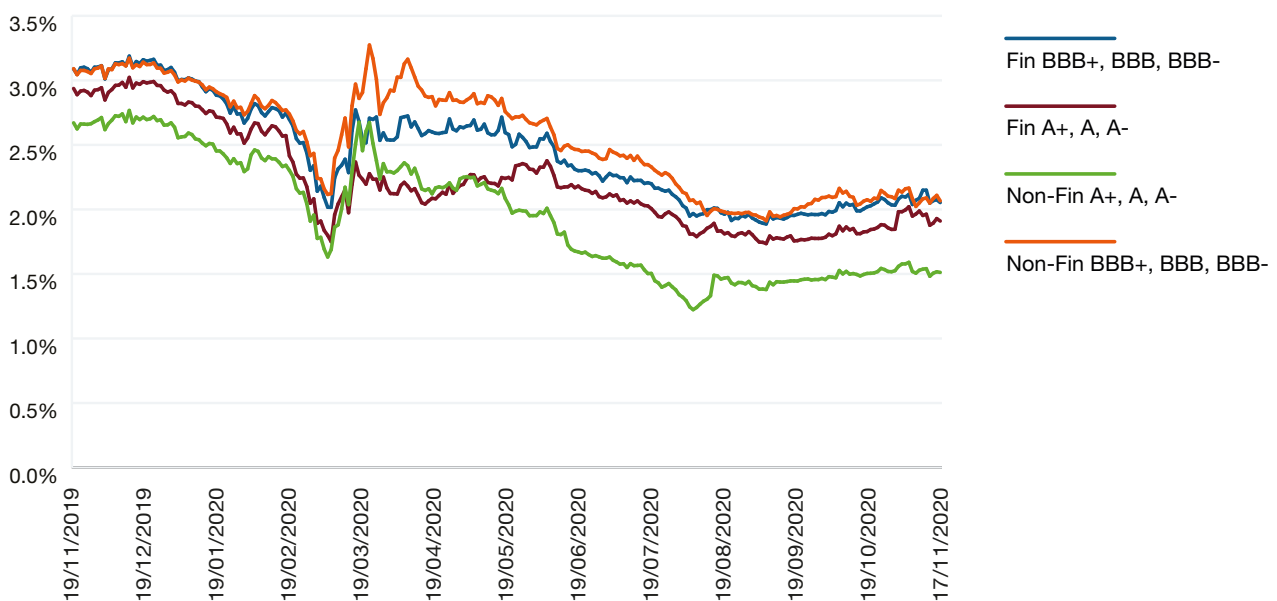
Valuations

Interviewees suggest that apart from better liquidity, ease of access, and less opacity with respect to price formation and credit analysis, the offshore China credit market offers better value to investors. Despite a heavy demand-supply imbalance, valuations are more fundamentally driven and pricing less disparate. It is reported that comparing similar names in the onshore and offshore markets can often provide significant discrepancies in terms of spread valuations, and that these can be as much as 100-200bp at the high yield end of the credit spectrum. However, some argue that Chinese investors tend to be more focused on absolute returns, rather than relative value, which can often result in anomalous price behaviour, such as credit spreads tightening when the rates markets sell-off.

Perhaps not surprisingly, pricing in the offshore market also shows less resilience than the onshore market in response to adverse macroeconomic shocks, as was highlighted by the COVID-19 turbulence in the first half of 2020 (for example, compare Figures 10 and 11 with 33 and 34).

However, in line with credit markets globally, and largely in response to Federal Reserve and other central bank monetary stimulus, the China offshore credit market has recovered well, and quickly, with spreads back to pre-COVID levels (see Figure 34), and outright yields broadly lower than at the start of 2020 (see Figures 35 and 36).

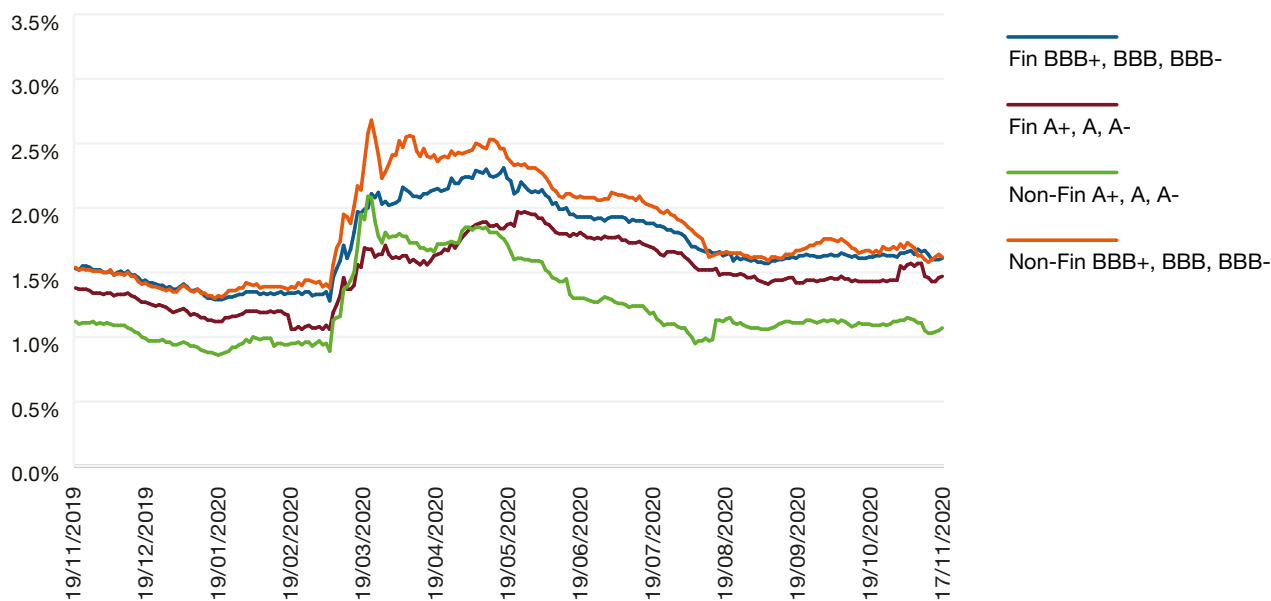
Figure 33: China corporate bond USD 5-year yields (BVAL)²³



Source: ICMA analysis using Bloomberg data (November 2020)

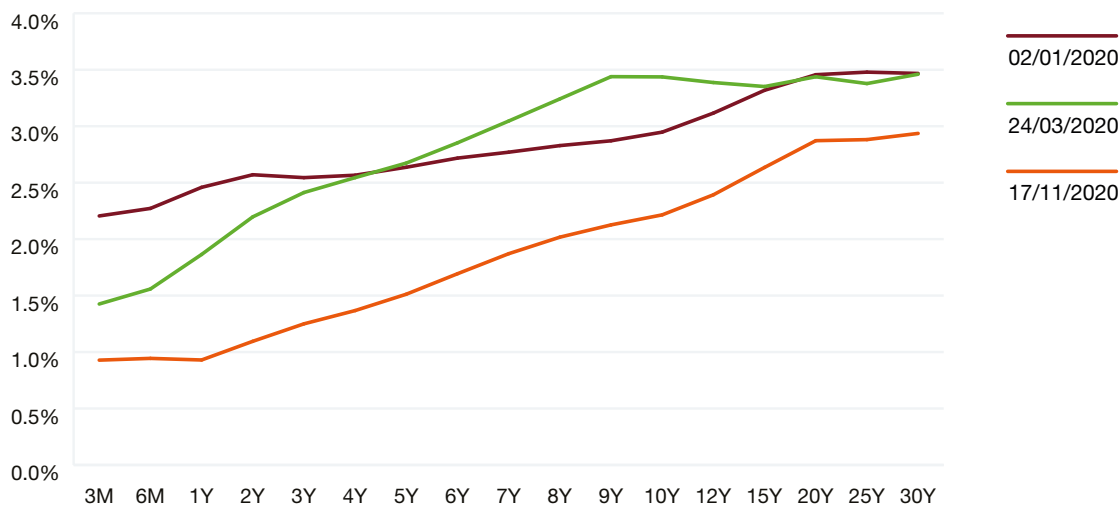
²³ The Bloomberg China USD BVAL curves are populated with USD denominated senior unsecured fixed rate bonds issued by Chinese financial and non-financial companies, grouped by the relevant Bloomberg composite ratings. In this case bonds with maturities of close to 5 years.

Figure 34: China corporate bond USD 5-year swap spreads (BVAL)



Source: ICMA analysis using Bloomberg data (November 2020)

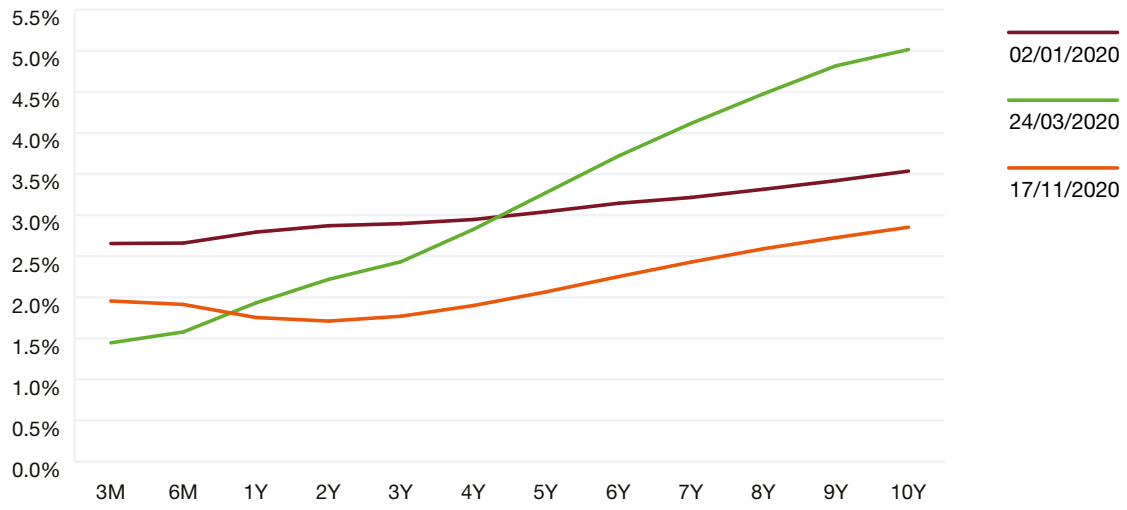
Figure 35: China USD non-financial IG corporate bond yield curve (BVAL)²⁴



Source: ICMA analysis using Bloomberg data (November 2020)

²⁴ The Bloomberg China USD non-financial BVAL curves are populated with USD denominated senior unsecured fixed rate bonds issued by Chinese non-financial companies, grouped by the relevant Bloomberg composite ratings.

Figure 36: China USD non-financial cross-over corporate bond yield curve (BVAL)



Source: ICMA analysis using Bloomberg data (November 2020)

Conclusion

Over the past ten years, Chinese financial and non-financial corporates have become a familiar, and dominant, feature of the APAC cross-border credit market, particularly the USD segment of this market. Chinese issuance of hard currency bonds has been key in supporting China's global economic expansion, and while investors in these bonds have predominantly been the offshore entities of Chinese investment firms, securities houses, and private banks, Chinese credits have become an important source of diversification for regional and global emerging market portfolios, offering competitive and consistent outright and relative returns.

Meanwhile, the significantly larger onshore China credit market remains relatively untapped by foreign investors. Over the past five years China has introduced a stream of regulatory and infrastructure initiatives to improve global access to its onshore bond markets and to attract international investment. China's inclusion in global indices had added impetus to foreign inflows, which look set to increase, particularly with more market-friendly policies in the pipeline. However, to date the internationalization of China's onshore bond markets has remained relatively modest, and almost exclusively concentrated at the sovereign and quasi-sovereign (i.e. 'rates') end of the credit spectrum.

Barriers to the \$5.8trillion credit market for international investors appear to be multiple: bifurcated liquidity across exchange and interbank markets; a fragmented landscape of market-makers; small infrequently traded issues that rarely come back into the market; a lack of supply of longer maturities; concerns around market transparency and opacity of price formation; challenges with credit analysis; uncertainty around bankruptcy law and recovery values; and the absence of both a credit repo specials market and a SN-CDS market. While many of these challenges are likely to persist in the short-term, they are not insurmountable, and as international investors and investment firms become more comfortable investing and operating in the rates segment of the onshore, so it would seem inevitable that in time they will begin to look further along the credit curve. The potential for transforming the China onshore credit market into a truly global market is significant.

Annex I China onshore bond types

Categories	Bond types
Rates	Treasury bonds (government bonds)
	Local government bonds
	Central bank bills
	Policy bank bonds
Credit bonds	Financial bonds
	Enterprise bonds
	Corporate bonds
	Medium Term Notes (MTN)
	Short-term Commercial Paper (CP)
	Private Placement Notes
	International institution bonds
	Government-sponsored organisation bonds
	Asset-backed securities
	Convertible bonds
	Exchangeable bonds
Standardised bills	

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Annex III Acronyms used in this report

APAC	Asia-Pacific
API	Application Programming Interface
BBGA	Bloomberg Barclays Global Aggregate index
bp	Basis Point (0.01%)
BJT	Beijing Time
BVAL	Bloomberg Valuation service (evaluated pricing service)
CCDC	China Central Depository and Clearing Company
CDS	Credit Default Swap
CGB	Chinese Government Bond
CIBM	China Interbank Bond Market
CNH	Offshore Chinese Renminbi (or Yuan)
CNY	Chinese Renminbi (or Yuan) (also see RMB)
CFETS	China Foreign Exchange Trading System
CMU	(HKMA) Central Moneymarkets Unit
CP	Commercial Paper
CRMA	Credit Risk Mitigation Agreement
CRMW	Credit risk Mitigation Warrant
CSRC	China Securities Regulatory Commission
DFI	Debt Financing Instrument
EMBI	(JP Morgan) Emerging Market Bond Index
ETF	Exchange Traded Fund
GDP	Gross Domestic Product
HKEX	Hong Kong Exchange
HKMA	Hong Kong Monetary Authority
HY	High Yield
ICMA	International Capital Market Association
IG	Investment Grade
IRS	Interest Rate Swap
ISDA	International Swaps and Derivatives Association
LGFV	Local Government Funding Vehicle
MoF	Ministry of Finance
MTN	Medium Term Note
NAFMII	National Association of Financial Market Institutional Investors
NFC	Non-Financial Corporate
OAS	Option Adjusted Spread
PBoC	People's Bank of China
QFII	Qualified Foreign Institutional Investor

RFQ	Request For Quote
RMB	Chinese Renminbi or Yuan) (also see CNY)
RQFII	Renminbi Qualified Foreign Institutional Investor
SAFE	State Administration for Foreign Exchange
SAT	State Administration of Taxation
SHCH	Shanghai Clearing House
SN-CDS	Single Name Credit Default Swap
SME	Small and Medium sized Enterprise
SOE	State-Owned Enterprise
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange
T+N	Trade Date + Number of days (settlement cycle)
VAT	Value Added Tax
WGBI	(FTSE Russell) World Government Bond Index
WHT	Withholding tax

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