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RESEARCH REPORT

BOND CONNECT AND OUTLOOK FOR FURTHER OPENING UP OF THE MAINLAND BOND MARKET

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SUMMARY

From over-the-counter trading of treasury bonds in the 1980s to subsequent on-exchange trading and the interbank market, China’s bond market has evolved and grown to become the world’s third largest one. Systems and mechanisms have been effectively reformed and enhanced, including the reform of issuance approval, the introduction of industry self-regulation and the enhancement of market making. Facilitated by the Renmnbi (RMB)’s internationalisation, China’s bond market accelerated its pace of opening up in the past decade. The successful launch of Bond Connect, the announcement of the planned inclusion of Mainland bonds into major global bond indices (such as the Bloomberg Barclays Aggregate Index) and other milestones highlighted the fruits of the opening up of the Mainland bond market and the international recognition of such efforts.

The opening up of the Mainland bond market is a two-way process centred on “inward opening” and “outward opening”. By “inward opening”, foreign institutions are gradually allowed to issue bonds in the Mainland market and invest in domestic Mainland bonds. In parallel, “outward opening” is reflected in the orderly progress in overseas bond issuance and bond investment by domestic Mainland entities. The experience of developed bond markets in the US and Europe shows that further two-way opening up of the Mainland bond market could be explored by extending “inward opening” and “outward opening” to the offshore dimension — allowing and promoting the development and trading of offshore financial derivatives on Mainland bonds alongside the establishment and development of the offshore RMB bond market. This would strengthen the RMB as a pricing and settlement currency in overseas financial markets.

1. "INWARD OPENING": POLICY EVOLUTION, CURRENT STATUS AND OUTLOOK OF FOREIGN PARTICIPATION IN THE MAINLAND BOND MARKET

1.1 Bond issuance by foreign institutions in the Mainland

1.1.1 Policy evolution

The pilot issuance of Renminbi (RMB) bonds by foreign institutions in the Mainland (commonly known as "panda bonds") preceded foreign investment in Mainland bonds. In February 2005, the People's Bank of China (PBOC), the Ministry of Finance (MOF), the National Development and Reform Commission (NDRC) and the China Securities Regulatory Commission (CSRC) issued the *Interim Measures for the Administration of the Renminbi Bond Issuance by International Development Organisations* (《國際開發機構人民幣債券發行管理暫行辦法》), allowing international development entities to issue RMB bonds in the Mainland domestic market. Under this guideline, the International Finance Corporation and the Asian Development Bank were the first to issue RMB bonds in the China's Interbank Bond Market (CIBM) in October 2005. In September 2010, the four ministries revised the above interim measures based on the genuine funding needs of bond issuers. A major enhancement is the permission of the proceeds from such bond issuance to be converted to foreign exchange (FX) and remitted and deployed overseas. Subsequently in October 2014 and December 2016, in support of the progress in RMB internationalisation, the PBOC, based on cross-border RMB settlement policies, clarified and enhanced the account arrangement and currency conversion rules for foreign institutions to issue bonds (including debt financing instruments) in the Mainland. In September 2018, the PBOC and the MOF issued a joint announcement to incorporate RMB bond issuance by international development entities into a unified administration framework governing foreign institutions' bond issuance in the Mainland. The announcement further enhanced the arrangements for bond issuance by foreign institutions in the CIBM.

The opening up of the panda bond market is part of the continuous streamlining of operating procedures and the gradual alignment with international practices. After more than a decade of development and enhancement, panda bonds have attracted an increasing number of market participants. The types of issuer are broadening and the market size is growing.

Table 1. The evolution of major policies for bond issuance by foreign entities in the Mainland

Year	Regulations	Key details and enhancements
2005	*Interim Measures for the Administration of the Renminbi Bond Issuance of International Development Organisations* (Announcement [2005] No. 5 of PBOC, MOF, NDRC and CSRC)	(1) MOF accepts applications and together with PBOC, NDRC and CSRC review applications and submit them to State Council for approval; (2) PBOC manages coupon rates of bonds; (3) Proceeds from RMB bond issuance are to be used in the Mainland. They must not be converted into FX and transmitted overseas.
2010	*Interim Measures for the Administration of the Renminbi Bond Issuance of International Development Organisations* (Announcement [2010] No. 10 of PBOC, MOF, NDRC and CSRC)	With approval of the State Administration of Foreign Exchange (SAFE) , international development entities can convert their proceeds from RMB bond issuance into FX for use outside the Mainland.

Table 1. The evolution of major policies for bond issuance by foreign entities in the Mainland

Year	Regulations	Key details and enhancements
2014	*Notice on Matters concerning the Cross-Border RMB Settlement for the RMB Debt Financing Instruments Issued within China by Overseas Institutions* (PBOC General Office [2014] No. 221)	Sets out cross-border fund payment and receipt arrangements for issuance of RMB debt financing instruments by overseas non-financial enterprises in the Mainland and allows remittance of proceeds in RMB to overseas markets.
2016	*Notice on Matters concerning the Cross-Border RMB Settlement of RMB Bonds Issued within China by Overseas Institutions* (PBOC General Office [2016] No. 258)	The applicable scope of cross-border RMB payment and receipt policies are extended from overseas non-financial enterprises to overseas entities (including foreign government entities, international financial bodies, international development entities and various types of financial institutions and non-financial enterprises).
2018	*Interim Measures for the Administration of Bond Issuance by Overseas Issuers in the China Interbank Bond Market* (Announcement of PBOC and MOF [2018] No.16)	RMB bond issuance by international development entities is included in the framework governing bond issuance by overseas entities in the Mainland for unified administration, improving arrangements for bond issuance by overseas entities in CIBM and facilitating rules alignment with international practices.

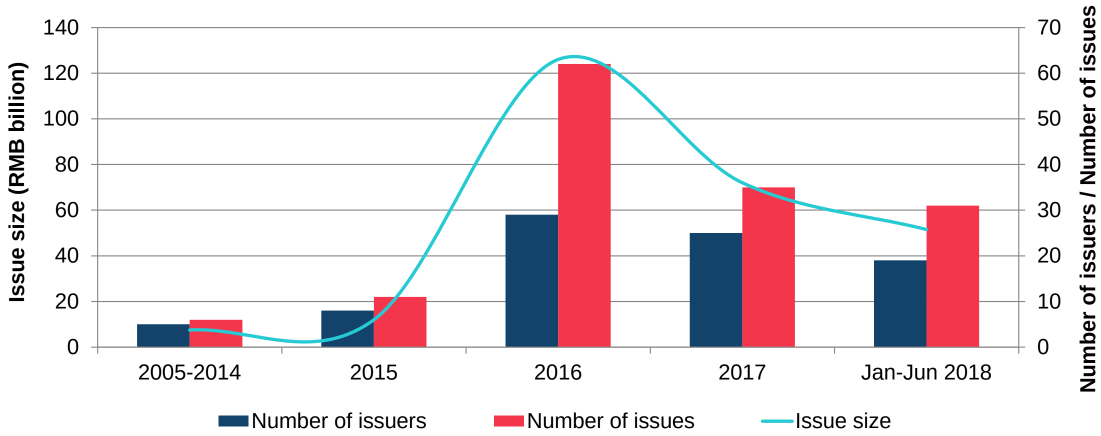
Sources: Based on publicly available information.

1.1.2 Current status and outlook

Before 2014, panda bond development was relatively slow in the issuance market, with limited number of issuers and issuance scale. After 2015, with clearer cross-border settlement policies for panda bonds and improvement in the market conditions, relatively rapid grown was observed in the number of bond issuers and funds raised — all-time highs were reached in 2016 when domestic RMB lending rate was lower than that outside the Mainland. Although panda bond issuance since 2017 has somewhat retreated, overall market development has been orderly and the types of issuer have diversified. It is noteworthy that the Hungarian government successfully issued a three-year RMB bond in the CIBM, which was the first RMB-denominated sovereign bond issued to both Mainland and overseas investors under Bond Connect by a foreign government. In 2018, the panda bond market continued to thrive. In the first half of 2018, issuance amounted to RMB 51.49 billion, more than 70% of the total issuance in 2017. Of which, RMB 41.26 billion worth of bonds (over 80% of the total) were issued in the CIBM[1].

[1] Source: China Lianhe Credit Rating.

Figure 1. Annual panda bond issuance since launch of the activity



Source: China Lianhe Credit Rating.

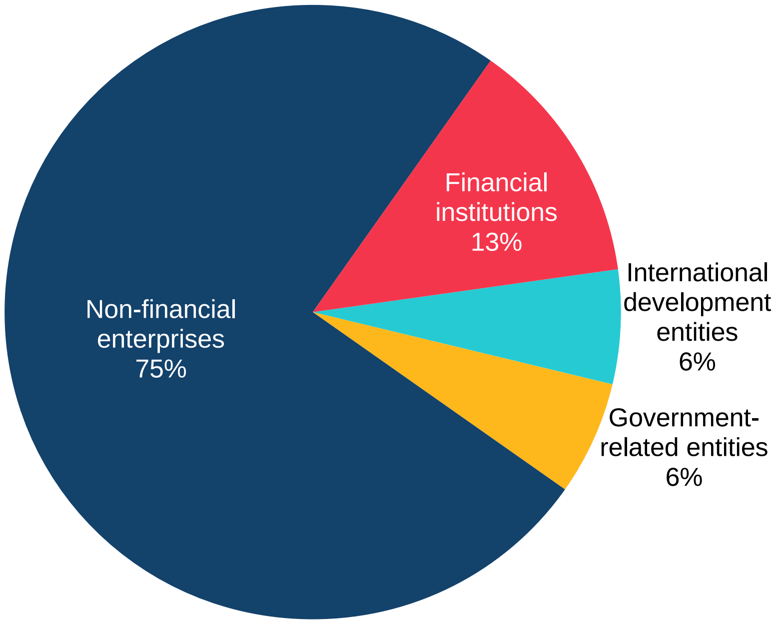
As at the end of July 2018, 57 overseas institutions have been registered or approved for bond issuance in the CIBM with an approved issue amount of RMB 453.3 billion — RMB 433.7 billion in RMB bonds and RMB 19.6 billion in International Monetary Fund (IMF)'s Special Drawing Right (SDR) bonds; and 89 bonds worth RMB 174.74 billion were issued[2]. Overseas issuers are diverse, ranging from international development institutions, government-related institutions, and financial institutions to non-financial enterprises. Demand for issuance mainly comes from overseas non-financial enterprises. Their planned issues account for 75%[3].

Boosted by new administrative measures, RMB internationalisation, Belt & Road initiatives and Bond Connect, the panda bond market is expected to continue its development in breadth and depth. Firstly, the new administrative measures will have greater alignment with international practices. More streamlined issuance approval and registration mechanisms, appropriate accounting standards and convenient fund remittance procedure will increase the market's attractiveness to potential overseas issuers. Secondly, RMB internationalisation will stimulate overseas entities' active management of their RMB assets and liabilities, boosting the panda bond market's further development. Thirdly, multiple Belt & Road countries have already issued panda bonds. Under regulatory efforts to promote Belt & Road bonds, panda bond issuers will become even more diversified and issue size will grow further. Fourthly, Bond Connect and panda bonds reflect overseas entities' investment and financing needs. They are complementary and mutual drivers to each other. While panda bonds provide quality underlying assets familiar to global investors, Bond Connect introduces a wide range of overseas investors for panda bonds and offers a convenient and effective channel of investment.

2 In 2016, World Bank and Standard Chartered issued SDR 2 billion and SDR 100 million of bonds in the CIBM.

3 Source: National Association of Financial Market Institutional Investors (NAFMII).

Figure 2. Panda bond issuers by type (End-Jul 2018)



Source: National Association of Financial Market Institutional Investors.

1.2 Investment by overseas institutions in Mainland bonds

1.2.1 Policy evolution

In 2005, Pan-Asia Bond Index Fund and Asia Debt China Fund were granted pilot access to the CIBM. In August 2010, to support RMB internationalisation and to satisfy overseas entities' desires for capital gains through RMB holdings, with widened RMB repatriation channels and a robust loop mechanism for cross-border RMB flows, the PBOC opened up the CIBM in a timely manner to overseas central banks or monetary authorities, overseas RMB clearing houses and overseas RMB participating banks. In 2011, the PBOC, the CSRC and the State Administration of Foreign Exchange (SAFE) jointly launched the RMB Qualified Foreign Institutional Investor (RQFII) pilot programme, allowing RQFII access to China's bond market. In 2013, Qualified Foreign Institutional Investors (QFIIs) were also granted access to the CIBM at the same time when RQFII policies were further relaxed. In 2015, the PBOC implemented rules time and again to expand the range of eligible products for foreign participation in the CIBM. An announcement issued in March 2016 opened up the CIBM fully to overseas financial institutions, further streamlined application procedures and abolished quota restrictions. On 3 July 2017, another milestone was achieved — the official launch of Bond Connect, under which overseas investors can access the CIBM with their familiar international practices (trading system, mode of trading and way of settlement, etc.). The mechanism for overseas investors to trade Mainland bonds became easier to operate and replicate. The participation of overseas institutions in the Mainland bond market grew rapidly in terms of both number and amount.

Table 2. Policies for overseas entities' investment in Mainland bond market and their evolution

Year	Regulations	Key details and enhancements
2010	*Notice on Issues Concerning the Pilot Program on Investment in the Interbank Bond Market with RMB Funds by Three Types of Institution Including Overseas RMB Clearing Banks* (PBOC [2010] No.217)	Overseas central banks and monetary authorities, RMB clearing banks and participating banks can invest in CIBM within approved quota
2011	*Measures for the Pilot Program of Securities Investment in China by Fund Houses, Securities Companies and RQFIIs* and relevant detailed implementation rules (CSRC Order No. 76, PBOC [2011] No. 321, SAFE [2011] No. 50, etc.)	The Hong Kong subsidiaries of Mainland fund houses and securities companies, with CSRC-granted licences can use RMB funds raised in Hong Kong to invest in the Mainland securities market within SAFE-approved limits. Investment in fixed-income securities (including bonds and various types of fixed-income fund) must not be less than 80%. Application to PBOC is required for investment in CIBM.
2013	*Measures for the Pilot Program of Securities Investment in China by RQFIIs* and relevant detailed implementation rules (CSRC Order No. 90, PBOC [2013] No. 105, SAFE [2013] No.9)	Superseded related administrative measures announced in 2011. RQFII business extended to countries and regions outside Hong Kong that have quotas granted by PBOC. The types of entity that may apply to conduct such business are the same as those of QFIIs. The restriction on investment ratio between equity securities and fixed-income securities by RQFIIs was abolished.
	Notice on Investment in Interbank Bond Market by QFIIs (PBOC [2013] No. 69)	With PBOC approval, QFIIs can invest in CIBM within authorised investment quota.
2015	*Notice on Bond Repo Trading by Overseas RMB Clearing Banks and Participating Banks in Interbank Bond Market* (PBOC [2015] No. 170)	Overseas RMB clearing banks and participating banks admitted to CIBM may conduct trades in bond repurchases (repos).
	Notice on Issues concerning Investment in the Interbank Market with RMB Funds by Foreign Central Banks, International Financial Organisations, and Sovereign Wealth Funds (PBOC [2015] No. 220)	Streamlined procedures for market entry by overseas central banks, abolished quota restrictions, extended eligible products to include cash bonds, bond repos, bond borrowing and lending, bond forwards, interest rate swaps and forward rate agreements, etc.
2016	PBOC Announcement [2016] No. 3	CIBM opened up further to overseas investors, with the types of entity extended to all types of financial institution and investment product, and other medium- and long-term investors approved by PBOC. Investment quota for overseas entities was abolished and administrative procedures were streamlined..
2017	*Interim Measures for the Administration of Mutual Bond Market Access between Mainland China and Hong Kong SAR* (PBOC Order [2017] No. 1)	Bond Connect was launched to operate alongside other channels. Overseas investors can access CIBM more efficiently through familiar e-trading platforms, trading modes and custodian and settlement arrangements. They can also subscribe for bonds at issuance in the Mainland.

Source: Based on publicly available information.

Table 3. Comparison between Bond Connect and settlement agency model[4]

	Settlement agency mode	Bond Connect
Pre-trade preparation		
Account opening	Opening of money and bond depository accounts in the Mainland is required.	Existing overseas money and bond depository accounts are used
Advanced fund deposit	Advanced deposit of funds into Mainland money accounts is required	Not required.
Participation procedures	Mainly handled by Mainland settlement agents	Participation guidance provided by Bond Connect Company Limited (BCCL)
Trade execution		
Mode of trading	Price enquiry input, request for quote, click-to-trade etc.	Request for quote in e-trading
Platform	Bond trading system on China Foreign Exchange Trade System (CFETS)	Through international e-trading platforms
Traded products	Cash bonds, derivatives and repos in CIBM	Cash bonds currently, to be extended to other products in the future
Counterparties	Settlement agents to trade with counterparties on behalf of participants	Obtain quote from and trade with counterparties directly
Price discovery	Quotes to be provided by agents; transparency to be enhanced	Transparent quotes conducive to price discovery
Post-trade custody and settlement		
Custody framework	Primary custody	Multi-tiered custody and nominees system
Money settlement	Through China National Advanced Payment System (CNAPS)	Through China's Cross-Border Interbank Payment System (CIPS)

1.2.2 Current status and outlook

Since the opening up of the CIBM in 2010, the number of overseas investors grew every year. Since the launch of Bond Connect in 2017, there has been healthy interactions between the settlement agency model and the Bond Connect channel, resulting in significant increase in the number of overseas investors (see Figure 3). As of the end of the third quarter of 2018 (2018Q3), 726 overseas investors accessed the CIBM through settlement agents and 445 through Bond Connect[5]. In terms of bond holdings, the outstanding balance of overseas institutions' investment in the CIBM steadily climbed as well. As of the end of 2018Q3, holdings by overseas institutions in the CIBM approached RMB 1.7 trillion, an increase of more than 100% from before the launch of Bond Connect (see Figure 4).

In terms of overall participation by overseas institutions, the degree of participation in China's bond market is still low when compared with other developed bond markets. Currently, overseas holdings of Mainland bonds account for only about 2% overall and about 4% in Chinese treasury bonds (see Figure 5). Nevertheless, the low degree of participation reflects massive room for further opening up of the Mainland bond market[6].

[4] See HKEX's research report, "Supporting the opening up of the Mainland financial market — Innovations and implications of Bond Connect", 15 November 2017 (published on HKEX's website).

[5] Source: CFETS and BCCL. The statistics go down to the level of specific products. There may be duplicate counting of overseas investors who trade through both settlement agents and Bond Connect.

[6] See HKEX's research report, "Tapping into China's domestic bond market — An international perspective", 16 May 2017 (published on HKEX's website).

Figure 3. Number of overseas investors in CIBM

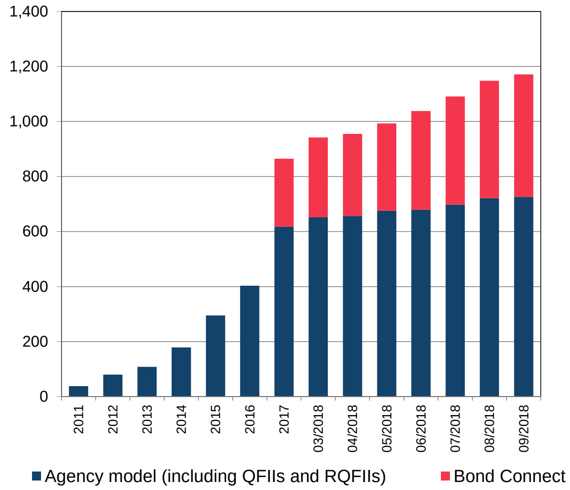
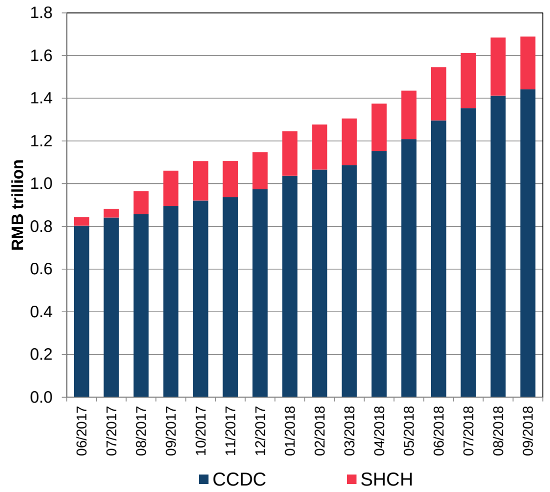
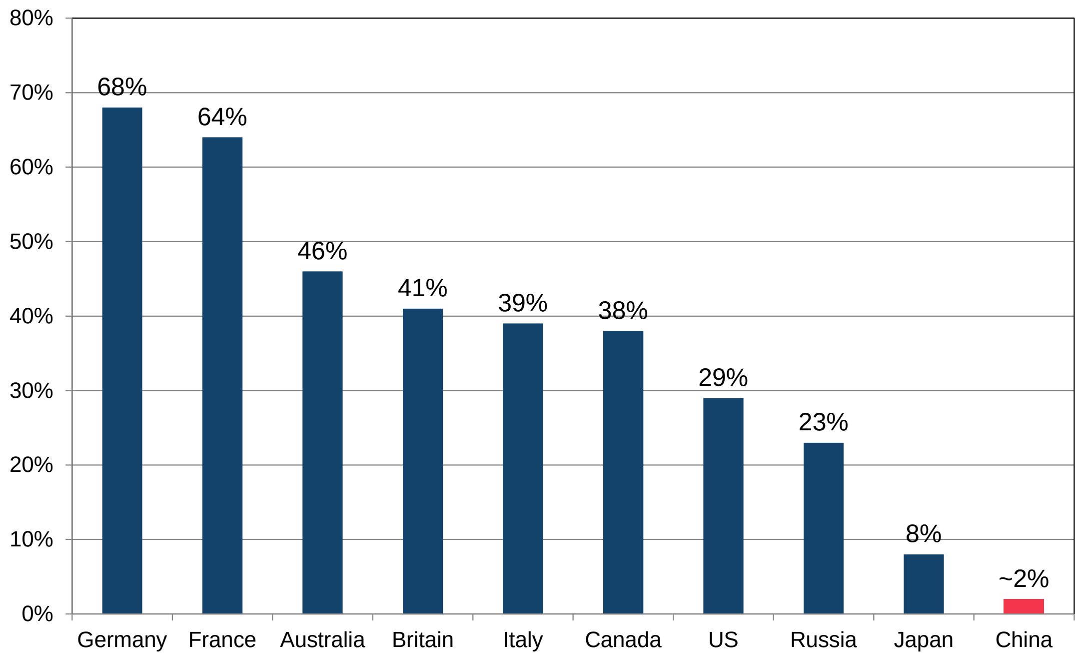


Figure 4. Outstanding bonds held by overseas institutions in CIBM



Source: CFETS, BCCL, China Central Depository & Clearing Co., Ltd. (CCDC), SHCH

Figure 5. Foreign institutional participation in bond market by country



Source: Bank for International Settlements.

Going forward, the inclusion of Mainland bonds into major international bond indices (such as the Bloomberg Barclays Aggregate Index) means that large asset management houses tracking these indices will allocate more of their assets to Mainland bonds[7]. As the effect of the RMB's inclusion into SDR begins to show, foreign central banks, sovereign wealth management funds and other institutions are expected to increase their RMB bond assets. Under these two drivers, it is foreseeable that the number of overseas institutions investing in Mainland bonds, the size of their investment and their market share will continue to grow.

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[7] On 23 March 2018, Bloomberg announced its plan to include RMB-denominated Chinese treasury bonds and policy bank bonds into Bloomberg Barclays Global Aggregate Index in phases from April 2019 onwards. For details, see HKEX's research report, "The inclusion of China into global bond indices: Current status and future development", 7 June 2018 (published on HKEX's website).

Furthermore, system improvement and product expansion under Bond Connect, as well as the convergence of the Mainland's domestic credit ratings with international practice will increase foreign institutions' overall degree of participation, and lead to further diversification of the product and tenor structures of foreign entities' investment in Mainland bonds.

2. "OUTWARD OPENING": POLICY EVOLUTION, CURRENT STATUS AND OUTLOOK OF DOMESTIC INSTITUTIONS' PARTICIPATION IN OVERSEAS BOND MARKETS

2.1 Overseas bond issuance by domestic institutions

2.1.1 Policy evolution

As early as 1980s, rules were implemented by the PBOC to explore overseas bond issuance by domestic institutions in a regulated manner. On entry to the 21st Century, with the formal release of the *Notice of the General Office of the State Council on the Guidelines on Further Strengthening the Supervision over Issuing Bonds Abroad* (promulgated by the State Development and Planning Committee and the PBOC) (《國務院辦公廳轉發〈國家發展計劃委員會、中國人民銀行關於進一步加強對外發債管理的意見〉的通知》), the *Provisions on the Administration of Foreign Debts* (《外債管理辦法》) published in January 2003, and the *Interim Measures for the Administration of the Issuance of RMB Bonds in Hong Kong Special Administrative Region by Domestic Financial Institutions* (《境內金融機構赴香港特別行政區發行人民幣債券管理暫行辦法》) announced in 2007, a stringent approval system for overseas bond issuance by Mainland institutions has essentially been established. In recent years, as reform and opening up intensified, the regulation of overseas bond issuance by Mainland institutions has shifted from an approval system to a registration and filing system. The regulation of the issuance of bonds in RMB and of those in foreign currencies have been unified and the mechanism of all-dimensional macro-prudential management of cross-border financing has been established. These resulted in accelerated overseas bond issuance by Mainland institutions.

Table 4. Recent key policies and measures that promote overseas bond issuance by Mainland institutions

Year	Regulations/Initiatives	Key details and enhancements
2015	*Notice on Promoting the Administrative Reform of the Filing and Registration System for Issuance of Foreign Debts by Enterprises* (NDRC [2015] No. 2044)	Abolished quota approval for issuance of medium- and long-term foreign debts by enterprises, implemented a filing and registration system, and unified the administration of foreign debts denominated in RMB and other currencies.
2016	Pilot reform on foreign debt size administration in 2016 (NDRC)	21 enterprises were selected for the 2016 pilot reform on foreign debt size administration. Within the annual approved size of foreign debt, pilot enterprises can choose their own window of issuance, conduct issuance in batches and do not have to perform pre-issue registration. Issuers are encouraged to repatriate proceeds back to the Mainland and are allowed to allocate them inside and outside the Mainland for use as necessary.
	Pilot reform on foreign debt size administration in provinces and cities of the four free trade zones (NDRC)	For overseas bond issuance by local enterprises registered in the zones, the local branches of NDRC shall issue to them the foreign debt size registration certificates. Mainland parent companies of enterprises in the zones are encouraged to issue foreign debts directly, and repatriate proceeds back to the Mainland for use as necessary to support Belt & Road and other national strategies and major investments.

Table 4. Recent key policies and measures that promote overseas bond issuance by Mainland institutions

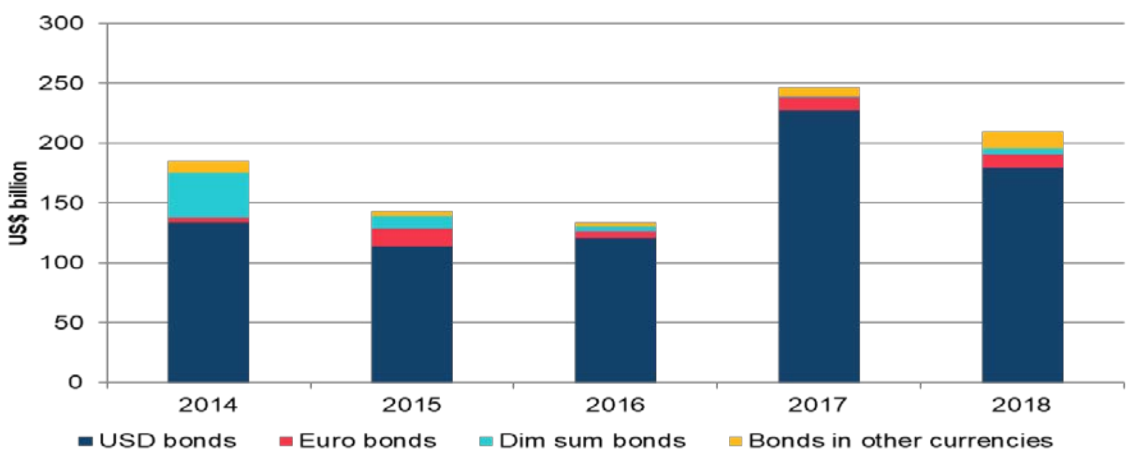
Year	Regulations/Initiatives	Key details and enhancements
	Notice on Nationwide Implementation of Macro-Prudential Administration of Cross-Border Financing in All Dimensions (PBOC [2016] No. 132)	Apply unified administration of bonds denominated in local and foreign currencies to cross-border financing like repatriated proceeds from Mainland enterprises' overseas bond issuance and foreign borrowings. These are subject to administration linked to the borrowers' capital and net assets and adjusted according to financing leverage ratios and macro-prudential parameters.
2017	*Notice on Further Promoting the Reform of Foreign Exchange Administration and Improving the Examination of Authenticity and Compliance* (SAFE [2017] No. 3)	Through loan extension, equity investment or other channels, debtors may directly or indirectly repatriate funds under guarantee to the Mainland for use.

Source: Based on publicly available information.

2.1.2 Current status and outlook

Under the relaxed policies for overseas bond issuance, and motivated by low financing costs and easy issuance procedures in overseas markets as well as global strategic planning, domestic institutions in the Mainland increasingly prefer to raise funds through overseas bond issuance, with record-breaking issue size time and again. According to Bloomberg, overseas bond issuance in 2017 amounted close to US$250 billion, an increase of nearly 85% from 2016; and in 2018, the issue volume remained at a relatively high level even though the market environment of domestic and overseas bond issuance were not favourable. Bonds in US dollar (USD), euro and Australian dollar, and RMB dim sum bonds were issued. The largest issues were in USD. Dim sum bonds were picking up (see Figure 6).

Figure 6. Annual overseas bond issuance by Mainland institutions



Source: Bloomberg.

Given the increasing connectivity between financing activities inside and outside the Mainland, the policy support for the Belt & Road national strategy and the internationalisation plan of market entities, Mainland institutions' demand for overseas bond issuance will continue to grow. The RMB bonds issued in Hong Kong by the MOF has produced a relatively complete benchmark yield curve that provides important reference for

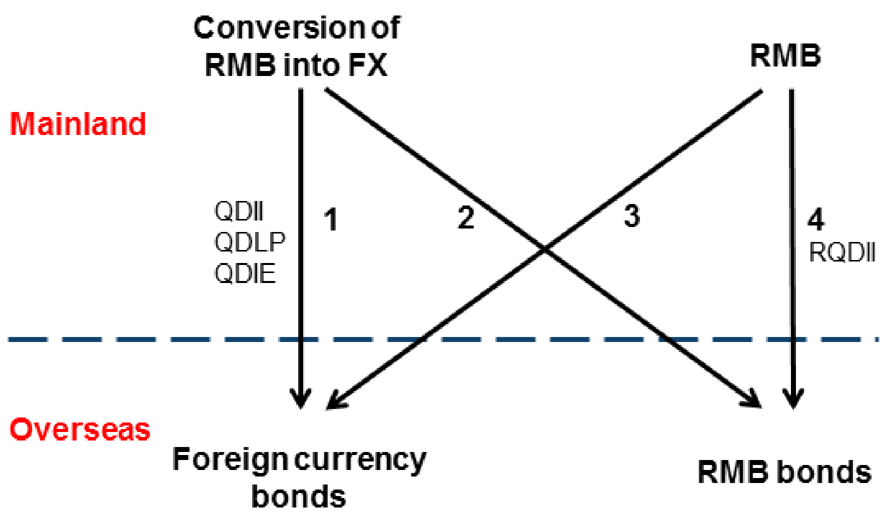
Mainland institutions' RMB bond issuance, RMB asset pricing and risk management. The MOF's reactivation of USD bond issuance in the fourth quarter of 2017 also contributed to the formation of a benchmark yield curve for Mainland companies' overseas issuance of USD bonds. The gradual completion of benchmark yield curves in respect of RMB and foreign currency bonds issued by Mainland institutions overseas will further stimulate their overseas bond issuance.

2.2 Investment by Mainland institutions in overseas bonds

2.2.1 Policies

In respect of investment in overseas bonds, different policies and channels are applied to different types of Mainland institution. Different types of Mainland institution may invest in overseas bonds denominated in RMB and foreign currencies using RMB, FX purchased with RMB or their own FX deposits in accordance with different permitted channels. The use of proprietary FX to purchase overseas bonds is mainly applicable to banking institutions. Investment in overseas bonds using proprietary FX is managed as part of total FX positions and not subject to FX purchase quota or remittance quota. The mass majority of non-banking institutional investors participate in overseas bond markets using FX purchased with RMB or though cross-border RMB remittance, subject to qualifications and quotas. These multiple channels are depicted in Figure 7 below.

Figure 7. Major paths of overseas bond investment by Mainland non-banking institutions

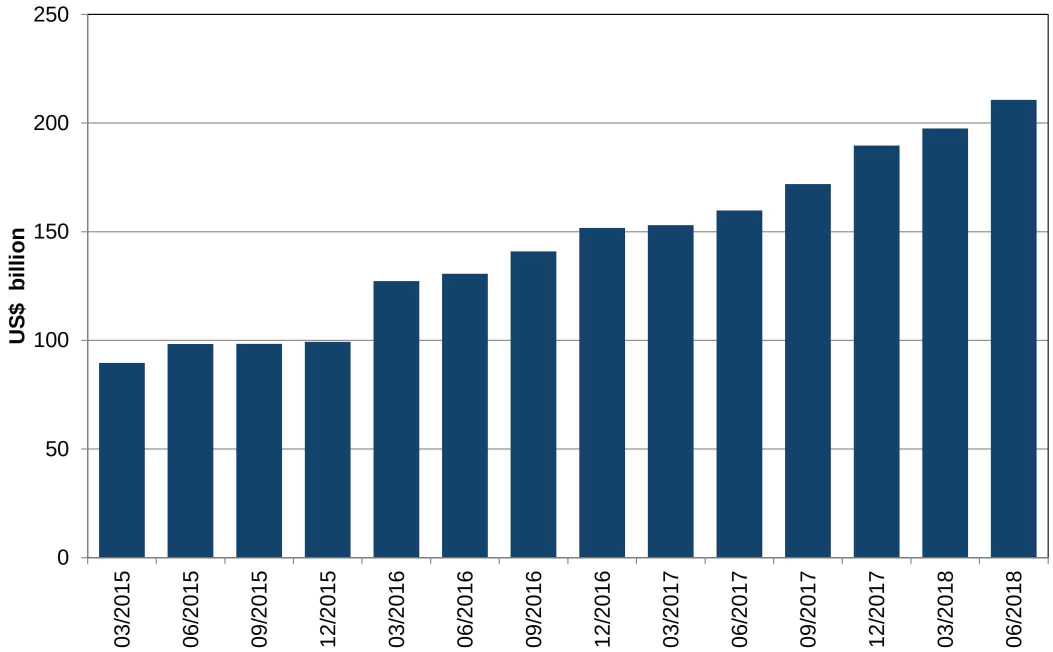


Channel 1 includes mainly Qualified Domestic Institutional Investors (QDII), and the policy channels of Qualified Domestic Limited Partnership (QDLP) (pilot scheme implemented in Shanghai, etc.) and Qualified Domestic Investment Enterprise (QDIE) (pilot scheme implemented in Shenzhen). Channel 2 falls under the policy scope of QDII, but actual demand is little. Channel 4 mainly refers to the business of RMB Qualified Domestic Institutional Investors (RQFII). There is relatively high demand for Channel 3, but this is not available for the time being.

2.2.2 Current status and outlook

Just as overseas institutions are interested in investing in Mainland bonds, an increase in domestic Mainland entities' investment in overseas bonds is also observed in recent years. As of the end of June 2018, excluding FX reserve assets, China had US$210.7 billion holdings in foreign bonds, representing 40% of all its investment in foreign securities[8]. A vast majority of such investment was by domestic Mainland banks which purchased overseas foreign currency bonds using proprietary FX. Investment in overseas bonds through QDII and RQDII was less significant.

Figure 8. Outstanding value of China's foreign bond holdings



Source: SAFE, "The time-series data of International Investment Position of China" (《中國國際投資頭寸表》).

Driven by the need for global asset allocation and risk management, domestic Mainland institutions' demand for investment in overseas bonds will continue to grow. Policy support enhancements in the following three directions should be welcomed:

(1) Expansion of the range of entities eligible to invest in overseas bonds using proprietary funds

Currently, mainly commercial banks are allowed to invest in overseas bonds using proprietary funds. Since 2018, letters of no objection have been issued by the CSRC to certain securities companies to allow them to conduct cross-border businesses using proprietary funds. With the support of the foreign exchange authority, such pilot scheme is expected to be further developed or expanded to other types of financial institution.

(2) Enhancement of quota management for QDII and RQDII

In April 2018, SAFE reactivated the approval of QDII quota applications after a break of three years and increased the quotas. In May 2018, the PBOC further defined its RQFII policies. The trend is expected to spread to quota management for QDII such that it would shift towards a model based on the value of the entity's assets or assets

[8] Source: SAFE, "The time-series data of International Investment Position of China" (《中國國際投資頭寸表》).

under management, one similar to that for QFII and RQFII under which only investment that exceeds the filed base quota is subject to approval. Such quota management is also expected to align with the quota filing system for RQDII.

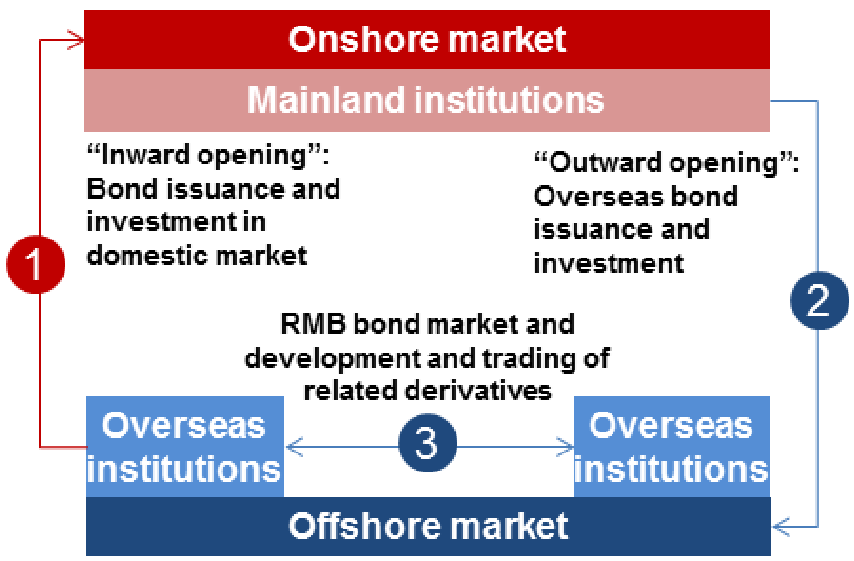
(3) Timely launch of Southbound trading of Bond Connect

No doubt there is strong demand for Southbound trading under Bond Connect. Strategically, Southbound trading will deepen two-way opening of the Mainland bond market, contributing to a healthy state of two-way cross-border capital flows and two-way RMB exchange rate movement. It will enhance cross-border RMB trading in financial accounts, foster the interaction between secondary and primary markets, promote overseas issuance and trading of RMB bonds and move ahead the internationalisation of the RMB. It will facilitate the circulation of foreign currencies in the private sector, reduce the pressure on the FX reserves to invest overseas, and lead to the diversification asset allocation. In consideration investment channels, investment in overseas bonds using proprietary funds, FX purchased with RMB and direct cross-border remittance of RMB should be allowed under Bond Connect Southbound trading alongside banks' overseas investment using proprietary funds, and the QDII and RQDII schemes. Mutual market access and the closed-loop design will increase the ease of operation and strengthen monitoring of cross-border trading and capital flows, and ensure that investment in overseas bonds is secure and effective.

3. OFFSHORE BUSINESS: DEVELOPMENT AND TRADING OF PRODUCTS ON MAINLAND BONDS

As mentioned above, the opening up of the Mainland bond market has been fruitful and further development in breadth and depth will continue. However, judging by developed bond markets in the US and Europe, there is a need for the Mainland bond market to extend from the existing mode of cross-border "inward" and "outward" market opening to offshore development, so as to open up the market in a more profound level (see Figure 9).

Figure 9. Conceptual model of opening up of the Mainland bond market



3.1 Vigorous development of offshore RMB bond market and related infrastructure

The success of the USD's internationalisation shows that development of the Eurodollar bond market has promoted the use of the USD as an international currency for denomination, settlement and reserves purposes. Likewise, further internationalisation of the RMB also requires support from the offshore RMB bond market, particularly before China's capital account is fully opened up. An initial offshore RMB bond market made up of dim sum bonds in Hong Kong and Formosa bonds in Taiwan has been formed, but the development is slow. To step up the development of the offshore RMB bond market represented by Hong Kong and others, maintenance of abundant RMB liquidity for the offshore market is recommended. Infrastructure for trading, custody, settlement and payment that are conducive to the development of the offshore RMB bond market and RMB's internationalisation should also be established.

3.2 Direct trading among overseas investors under Bond Connect

At present, trading under Bond Connect is restricted to between overseas investors and Mainland market makers. Direct trading between two overseas investors under the scheme is not permitted. It is proposed that overseas large banks should in the future be allowed to provide liquidity through CFETS' bond trading platform for overseas investors under Bond Connect. This will increase the number of overseas participants and enhance bond liquidity. As quotation and trading take place at CFETS, and settlement, delivery and custody ultimately take place through CCDC and SHCH, there will be high price transparency and no tiered prices or tiered markets. There will also be no lingering of bond transactions and bond settlement in the overseas market such that risks will be under control. In actual implementation, the pilot scheme may start with selected Mainland and foreign institutions in Hong Kong regulated by the Hong Kong authorities, where have established branches in the Mainland regulated by the Mainland authorities, thereby taking advantage of One Country Two Systems under the connectivity framework between the Mainland and Hong Kong.

3.3 Use of Mainland bond holdings by overseas investors in collateral management and pledging for finance

To bondholders, bond investment is both for capital gain and liquidity management. Taking US treasury bonds as an example, these are widely held by global investors mainly because of their strength as an alternative to cash and of their high liquidity. US treasury bonds can be pledged for finance, and used as collateral or margin deposit for various financial transactions. They can serve as tools for liquidity management to improve the efficiency of investors' capital use. Mainland Chinese bonds, however, cannot be used by overseas investors as collateral or to pledge for finance. Their effectiveness in liquidity management and efficiency in capital use are low which, to a certain extent, has undermined overseas institutions' desire for holding Mainland bonds. Going forward, it is proposed to explore the use of the connectivity between Mainland and Hong Kong custodians under Bond Connect to gradually increase the usage of Mainland bond holdings. This would increase overseas investors' desire to hold Mainland bonds and enhance overseas recognition of RMB-denominated assets, thereby facilitating the RMB's internationalisation.

3.4 Development and trading of bond futures and other risk management tools in the offshore market

The pursuit of investment return and the management of risks are eternal and inseparable goals of financial investment. The same applies to bond investment. When investing in Mainland bonds, overseas institutions inevitably also ask for instruments that manage interest rate and tenor risks. In the Mainland, a complete set of derivative products has already been developed in the CIBM and the exchange-traded market. Overseas investors currently trade risk management tools like interest rate swaps, forward rate agreements, bond forwards in the

CIBM through Mainland agents, but they also wish to do so through Bond Connect. The Mainland's exchange-traded market of treasury bonds is currently not open to overseas investors. Even if it is subsequently opened up, overseas investors will have to open and maintain a new set of accounts in the Mainland. This will increase the cost and difficulty of operation, and go against Bond Connect's philosophy of allowing home market rules for overseas investors.

In view of the above, policy-makers may consider permitting the launch of futures products on Mainland bonds in overseas markets. Given that the settlement of overseas futures on Mainland bonds will ultimately be subject to onshore cash bond prices, it can be assured that such futures prices will be under Mainland influence and risks are controllable. Moreover, overseas derivatives like futures on Mainland bonds can help investors to do risk management without the need to adjust their cash bond positions. This would effectively reduce substantial changes to bond positions or frequent cross-border capital flows triggered by market shocks and therefore help maintain stability in the Mainland's domestic bond market. As a second-to-home pilot market with risk isolation functions, Hong Kong can try out such futures without affecting the pace of opening up in the Mainland market. The experience accumulated will facilitate the future opening up of the Mainland derivatives market and support the continual reform and deeper opening up of the Mainland bond market.