

Research Report

# Broadening International Investor Participation in the Mainland Bond Market



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## SUMMARY

China's onshore bond market has grown rapidly into the world's second-largest as the Mainland authorities have opened onshore capital markets to international investors and passed reforms to increase direct financing to the real economy.

Despite these developments, international investors' onshore bond holdings remain low. However, we expect that the attractive yields and diversification benefits on offer in the onshore bond markets, plus the inclusion of the asset class into global benchmarks, will increase the flow of international capital into onshore bond markets.

Nevertheless, more investment channels will be needed to meet international investor demand for exposure to China's onshore bond markets. Direct access channels, such as Bond Connect, China Interbank Bond Market (CIBM) Direct and the Qualified Foreign Institutional Investor programme, are currently only available to offshore institutional investors but not retail investors.

Indirect channels like offshore bond mutual funds and exchange traded funds (ETFs) covering onshore bonds have no access restrictions. As such, demand from offshore investors for offshore Chinese bond funds is currently much stronger than for onshore Chinese bond funds.

This opens an opportunity for Hong Kong to develop a wide spectrum of offshore bond ETFs to bridge access gaps and potentially increase foreign participation in China's onshore bond market, particularly from retail investors.

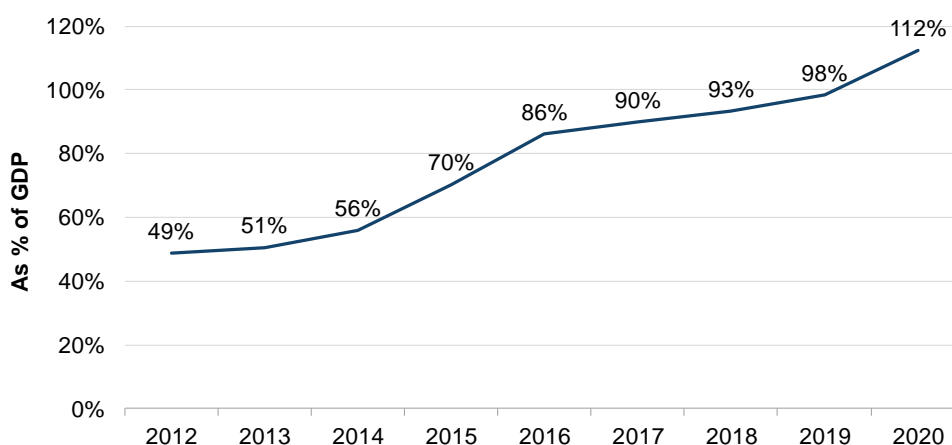
Compared to mutual funds, ETFs are more liquid and have attractive cost-return profiles. Further, cost incentives in Hong Kong may grow a diverse range of fixed income and money market ETFs to better serve offshore investors and grow foreign participation in the onshore bond market.

## 1. STRATEGIC DRIVERS FOR THE MAINLAND BOND MARKET

China's economy and financial markets have grown rapidly in recent years and now play an increasingly important role in the global economy.

China's onshore bond market became the world's second largest at the end of the second quarter of 2019<sup>1</sup>. As of end-2020, the outstanding amount of onshore bonds reached 112% of China's gross domestic product (GDP) (see Figure 1).

**Figure 1. Outstanding amount of onshore Chinese bonds as a percentage share of China's GDP (2012 – 2020)**



Source: Wind.

The opening-up and liberalisation of China's capital market, including both equity and bond markets, have continued with increased breadth and depth. China's two-way opening-up and on-going capital market reforms have brought benefits to both China and foreign investors.

For China, capital market opening is intended to attract diversified global institutional investment, increase the sophistication of onshore capital markets, and support the internationalisation of the renminbi (RMB).

For international investors, the opening of China's bond markets brings access to favourable interest rate differentials and diversification benefits from onshore bonds, since onshore markets have relatively low correlation to global bond benchmarks.

China's policymakers have also opened up domestic markets as part of an agenda to make structural reforms to the financial sector, diversify financing sources and reduce the role of bank loans as the main engine of financing to the real economy.

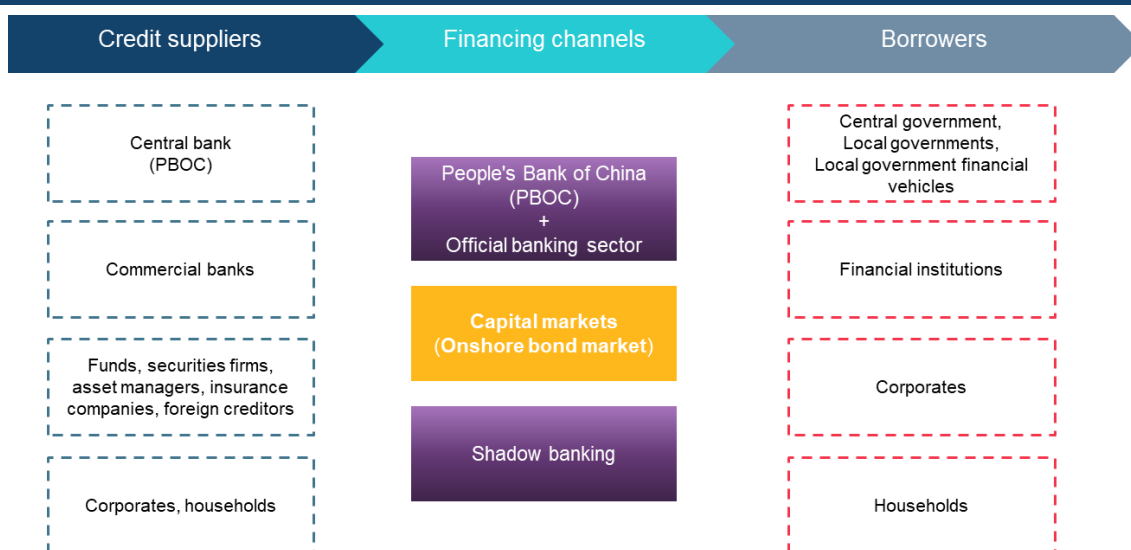
Figure 2 gives an overview of China's domestic credit market structure, showing the main categories of credit suppliers and borrowers and the relative positioning of the onshore bond market.

The development of China's onshore bond market, as an important source of direct financing in the economy, plays a vital role in supporting China's financial structural reform.

<sup>1</sup> Source: "China's bond market: A playground of untold potential", published on Bloomberg's website, 12 November 2019.

As outlined in the 14th Five-Year Plan, vibrant bond markets are essential for efficient capital allocation and the longer term goals of rebalancing the economy and increasing total factor productivity.

**Figure 2. Illustration of China's domestic credit market structure**



Source: HKEX analysis.

Looking forward, with continued opening-up and reform of China's capital markets, and with the onshore bond market playing an increasingly important role in supporting China's financial structural reform, there is substantial potential for further growth in China's onshore bond market, in terms of market size, depth and product variety.

## 2. THE LIBERALISATION AND DEVELOPMENT OF THE MAINLAND BOND MARKET

### 2.1 Overview

#### 2.1.1 Fast-growing and diversified

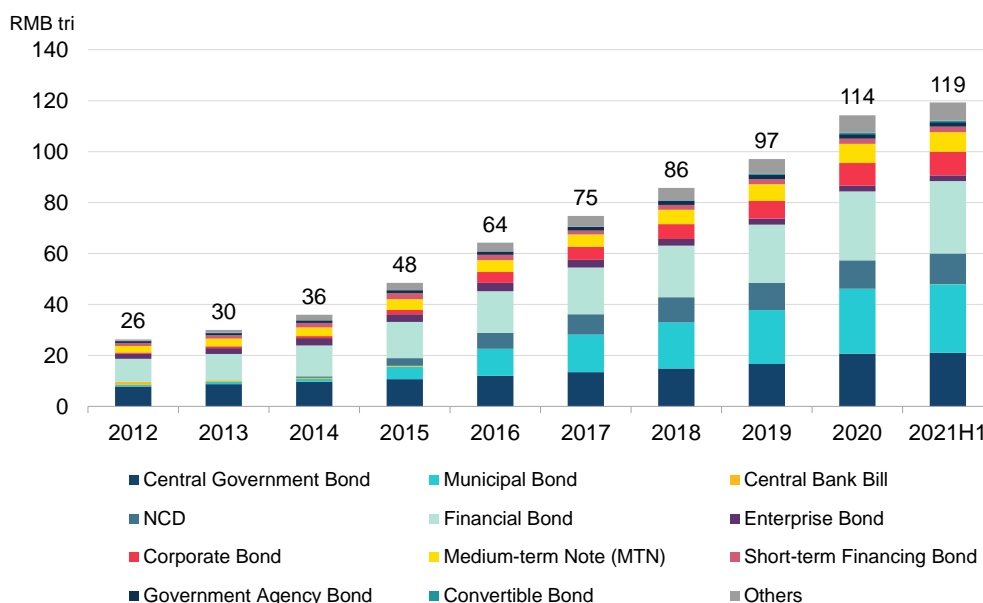
China's onshore bond market has grown at a steady pace over the past decade (see Figure 3). As of the end of the first half of 2021 (2021H1), the outstanding amount of onshore bonds reached RMB 119 trillion, achieving a compound annual growth rate (CAGR) of 20.3% from 2012 to 2020.

A number of factors contributed to the rapid growth in China's bond market. In addition to the policy-driven factors discussed in Section 1, the further development of the municipal and corporate bond markets have also enabled a wider range of issuers to tap China's onshore bond market.

As of end-2021H1, the five largest categories of bond type were financial bond<sup>2</sup> (including policy bank bond), municipal bond, central government bond (CGB), negotiable certificate of deposit (NCD), and corporate bond. Together, these categories accounted for 82% in aggregate of total outstanding amount of onshore bonds (see Figure 4).

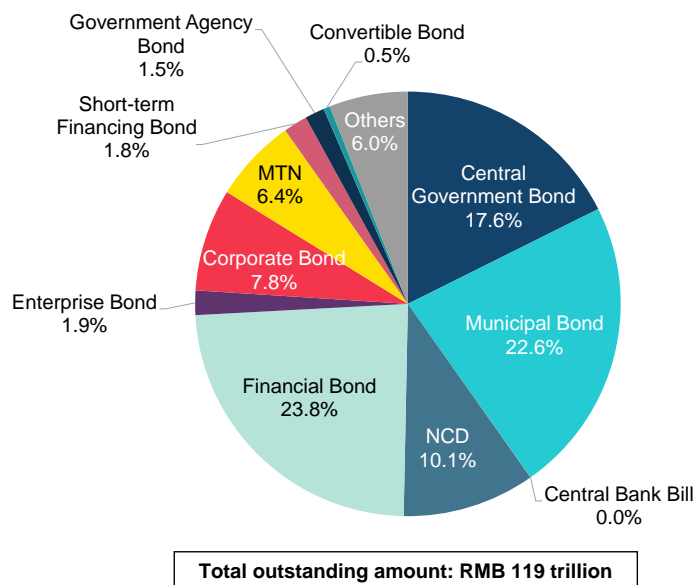
<sup>2</sup> The financial bond category specifically comprises policy bank bonds, special financial bonds, commercial bank bonds, non-bank financial institution bonds, commercial bank perpetual bonds, tier-2 capital bonds, securities companies' corporate bonds, securities companies' commercial papers, insurance companies' subordinated bonds, insurance companies' financial bonds, and insurance companies' capital replenishment bonds.

**Figure 3. Outstanding amount of China’s onshore bonds by bond type (2012 – 2021H1)**



Source: Wind.

**Figure 4. Composition of the outstanding value of China’s onshore bonds by bond type (end of 2021H1)**



Source: Wind.

### 2.1.2 Market segments

The main channels where onshore bonds can be traded are the China Interbank Bond Market (CIBM), the on-exchange market on the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE), and the commercial banks’ counter market (commonly referred to as the over-the-counter, or OTC market).

The CIBM is regulated by the People’s Bank of China (PBOC) and operated by the China Foreign Exchange Trade System (CFETS, or the National Interbank Trading Centre). The

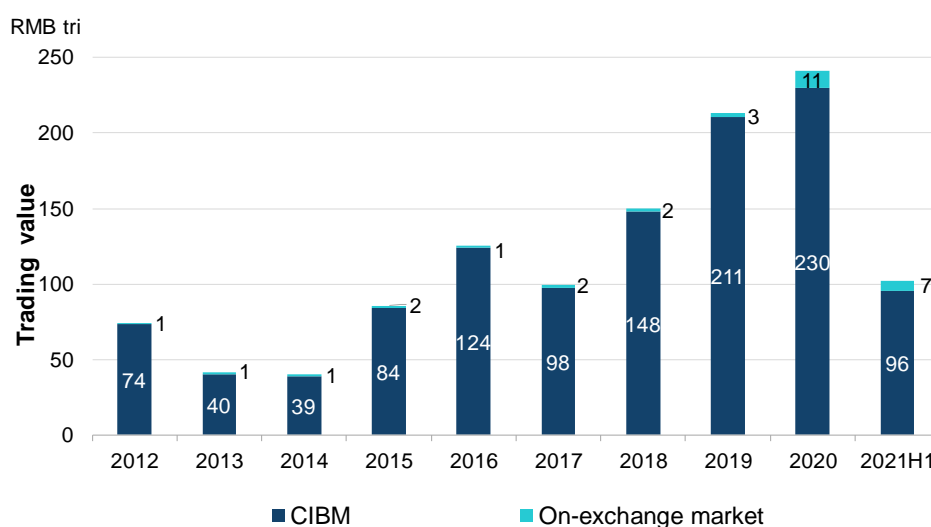
CIBM is restricted to institutional investors, while retail investors can trade bonds through the OTC market. Debt instruments traded on the CIBM are mainly CGBs, municipal bonds (or local government bonds), central bank (PBOC) bills, policy bank bonds, financial bonds, enterprise bonds, medium-term notes (MTNs), asset-backed securities (ABSs) and commercial papers. Repurchase agreements (repos) are available in CIBM.

The on-exchange market is regulated by the China Securities Regulatory Commission (CSRC). The main products traded on the exchanges include CGBs, municipal bonds, enterprise bonds, corporate bonds, convertible bonds and exchangeable bonds<sup>3</sup>. Repos are available in the on-exchange market.

The OTC market is regulated by the PBOC. This is a market segment for general and retail investors to trade debt financing instruments issued and traded in the CIBM. The types of bond traded in the OTC market are limited to CGBs, policy bank bonds and enterprise bonds.

Among these three onshore bond market segments, the CIBM is the main venue in terms of total bonds outstanding. As of end-2020, bonds registered in the CIBM accounted for about 86% of total bonds outstanding<sup>4</sup>. In value terms (see Figure 5), the large majority of onshore bond turnover was also conducted on CIBM. Though turnover in the on-exchange market has increased in recent years, turnover in the CIBM is much larger.

**Figure 5. China's onshore bond trading value by market segment (2012 – 2021H1)**



Source: Wind.

On 20 January 2022, the National Interbank Funding Center, the SSE, the SZSE, Shanghai Clearing House (SHCH), and China Securities Depository and Clearing Co., Ltd. (CSDC) jointly issued the *Interim Measures for the Connectivity Business between the Interbank Bond Market and the Exchange-traded Bond Market*<sup>5</sup>. This marks an important progress in

<sup>3</sup> Convertible bonds can be issued by listed companies with embedded options to exchange for newly issued shares of the issuing companies while exchangeable bonds are issued by shareholders of listed companies with embedded options to exchange for shares held by the shareholders (e.g. a parent company can issue an exchangeable bond with an embedded option to exchange for shares of its subsidiary). The issuance of these bonds are subject to the approval by the CSRC and the exchange. More details on the differences between enterprise bonds and corporate bonds and between convertible bonds and exchangeable bonds can be found in the HKEX research report, "The rising on-exchange bond market in Mainland China and Hong Kong", published on HKEX's website, 9 September 2020.

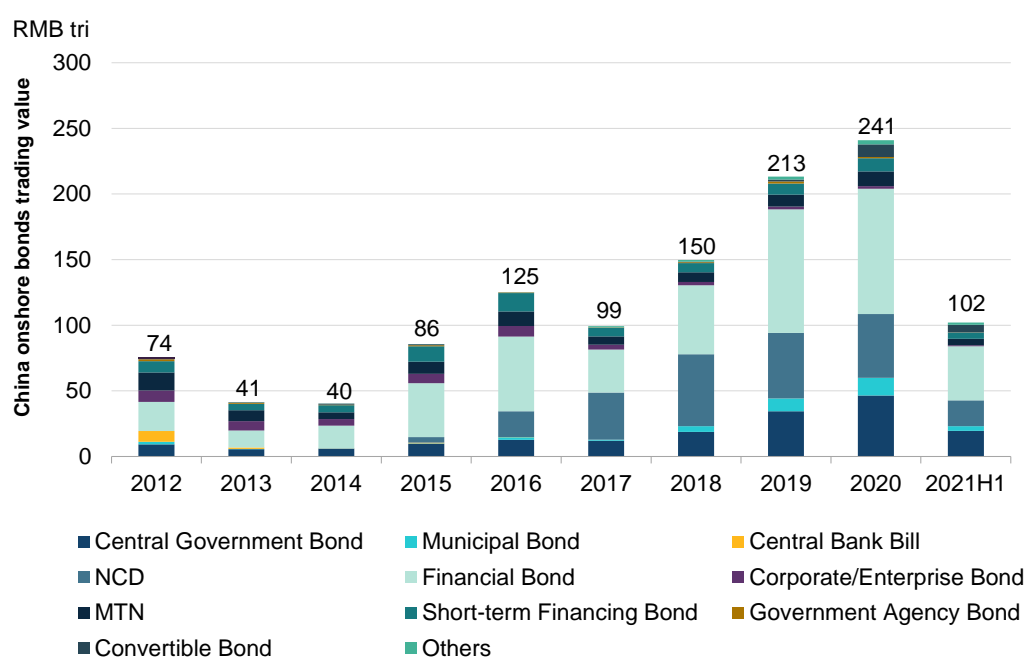
<sup>4</sup> Source: Wind, China Central Depository and Clearing Co., Ltd, Shanghai Clearing House.

<sup>5</sup> See "Interbank Bond Market, Exchange-traded Bond Market Co-issue Supporting Measures for Connectivity", news release published on the SSE's website, 20 January 2022.

the construction of the connectivity mechanism for the domestic bond market. In addition, China Development Bank, policy banks, state-owned commercial banks, joint-stock commercial banks, urban commercial banks, foreign banks operated in Mainland China as well as other listed banks in China, can choose to trade cash bonds in on-exchange bond markets through negotiated trade mechanism, either through the above connectivity mechanism or directly opening accounts in on-exchange markets. The implementation date of the connectivity mechanism will be further notified. Upon implementation, the bond registration, custody and clearing institutions for both markets will be able to jointly provide post-trade services to issuers and investors.

Over the past few years, there has been a big increase in the turnover value of onshore bonds. Total turnover reached RMB 241 trillion in 2020, almost three times that of 2015 (see Figure 6).

**Figure 6. Trading value in China onshore bond market by bond type (2012 – 2021H1)**

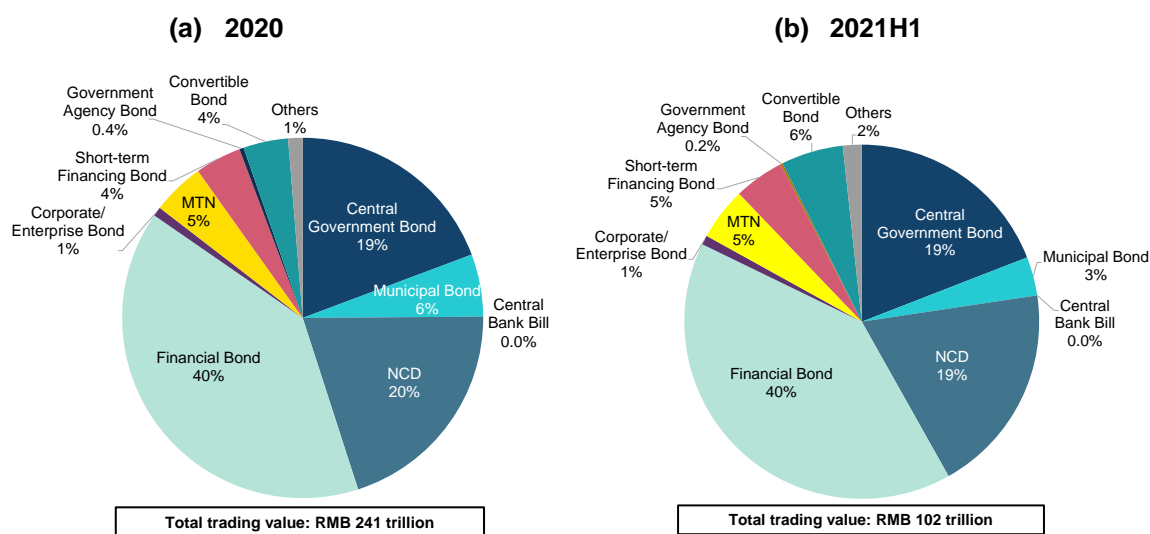


Source: Wind.

In respect of trading composition by product type, financial bonds, NCDs and CGBs account for the majority of turnover (see Figure 7).



**Figure 7. Composition of China's bonds trading value by bond type (2020 and 2021H1)**



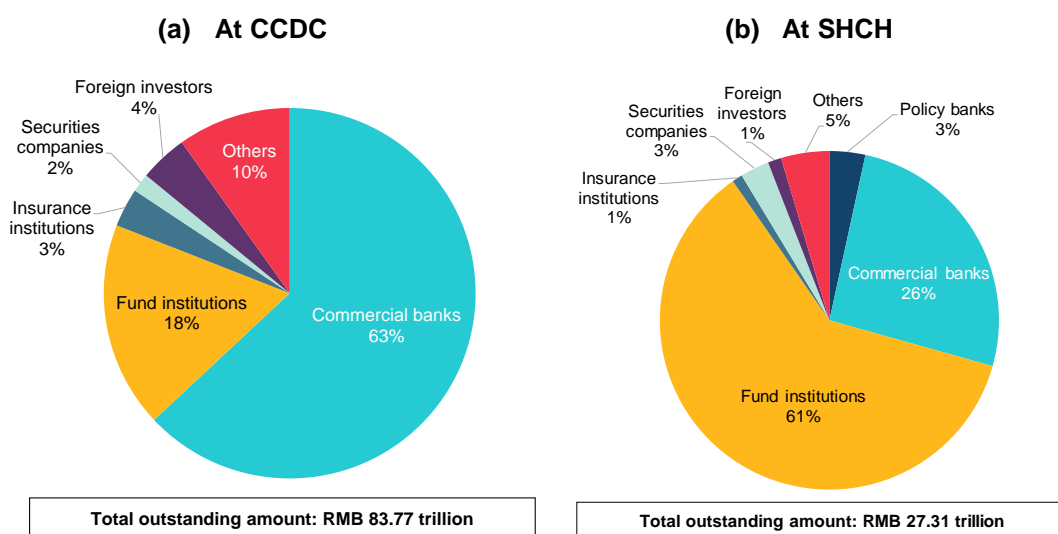
Source: Wind.

### 2.1.3 Market participants

In respect of market participant, banks are the largest holders of onshore bond in value terms, followed by fund institutions. As of end-September 2021, commercial banks held 63% and 26% of the total amount of outstanding onshore bonds registered at China Central Depository and Clearing Co., Ltd (CCDC) and SHCH, respectively (see Figure 8).

As of the same date, fund institutions held 18% and 61% of the total amount of outstanding onshore bonds at CCDC and SHCH respectively. As Chinese households increase their allocations to investment products and diversify away from bank deposits and real estate, fund institutions' onshore bonds holdings are expected to increase further.

**Figure 8. Distribution of total bond holding value by holder type (end-Sep 2021)**



Source: CCDC and SHCH.

## 2.2 Market opening-up and internationalisation

### 2.2.1 International investors' market access channels

In the past two decades, policymakers in China have made continuous steps to liberalise the onshore bond market. International investors can now access China's onshore bond markets through three existing channels: (1) the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) programmes; (2) CIBM Direct; and (3) Bond Connect.

On 25 September 2020, the CSRC, the PBOC and the State Administration of Foreign Exchange (SAFE) announced enhancements to the QFII and RQFII programmes that were intended to further open onshore capital markets<sup>6</sup>.

Major revisions to the QFII and RQFII rules included: (1) relaxing qualification requirements and facilitating investment and operations of QFIIs and RQFIIs; and (2) gradually expanding the investment scope to cover securities admitted on the National Equities Exchange and Quotations (NEEQ) market, private investment funds, financial futures, commodity futures, options, bond repos, etc. Financial products including financial derivatives contracts as well as related trading models, will be gradually relaxed for the access of QFIIs and RQFIIs upon agreement with the PBOC and the SAFE.

Table 1 gives a brief introduction of current access channels to the onshore bond market.

	<b>QFII / RQFII</b>	<b>CIBM Direct</b>	<b>Bond Connect</b>
Launch time	Dec 2002 / Dec 2011	Jul 2016	Jul 2017 (Northbound)
Applicable market segments	CIBM, on-exchange market	CIBM	CIBM
Quota limit	No quota limit since May 2020	No quota limit	No quota limit
Currency	Foreign currencies / RMB	Foreign currencies / RMB	RMB
Scope of investment	Cash bonds traded in CIBM and on-exchange market, mutual funds, asset-backed securities, bond forwards, interest rate swaps, forward rate agreements, bond lending and bond repos	Cash bonds traded on CIBM, bond lending, bond forwards, interest rate swaps and forward rate agreements and bond repos	Cash bonds traded on CIBM
Eligible investors	Foreign institutional investors approved by CSRC who meet certain qualifications to invest in equities and bonds in onshore markets	Foreign institutional investors approved by PBOC, including sovereign institutions and other private investors	
Transaction tax	Nil	Nil	Nil
Regulators	CSRC, PBOC, SAFE	PBOC, SAFE	PBOC

Source: Publicly disclosed information on the websites of Bond Connect Company Limited (BCCL), CSRC, PBOC and CFETS.

<sup>6</sup> Accordingly, the regulatory regime of the QFII and RQFII schemes have been unified since November 2020. See "CSRC, PBOC and SAFE release the *Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors*", news release on the CSRC's website, 25 September 2020.

## 2.2.2 Mainland bonds' inclusion into global bond indices

China's onshore bonds have been included into three global bond indices:

- (1) **Bloomberg Barclays Global Aggregate Index (GAI)**<sup>7</sup>: In March 2018, Bloomberg announced that it will add RMB-denominated CGBs and policy bank bonds to the GAI. Initial projections estimated that China's weight will be 5%-6% upon full inclusion. The inclusion started from April 2019 with a 20-month phase-in period and completed in November 2020.
- (2) **JP Morgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified Index**<sup>8</sup>: In September 2019, JP Morgan stated that the bank will start a phased inclusion of CGBs into its benchmark emerging-market indices. China's weight will be capped at 10% of the GBI-EM global diversified and narrow diversified indices. The inclusion started from 28 February 2020 with a 10-month phase-in period and completed December 2020.
- (3) **FTSE World Government Bond Index (WGBI)**: In March 2021, FTSE Russell confirmed that CGBs will be included into the WGBI<sup>9</sup>. FTSE estimated that China's weight will be around 5.25%, based on the latest available data then. The inclusion has officially started from 29 October 2021, with a 36-month phase-in period<sup>10</sup>.

The inclusion into global bond indices could have a material impact on the allocation of global portfolios if, as expected, passive index-tracking funds and actively managed funds use these indices as benchmarks for their investments. Looking forward, international investors may consider making a greater allocation to onshore bonds along with the continued index inclusion process of onshore bonds.

## 2.2.3 Degree of international participation in the onshore bond market

Despite the rapid increase in international investors' holdings of onshore bonds, their overall share of the onshore Chinese bond market remains low.

As of end-July 2021, international investors held RMB 3.86 trillion of onshore bonds, representing 3.2% of the total amount of outstanding bonds (see Figure 9). Their total holdings have grown rapidly since the launch of CIBM Direct and Bond Connect in February 2016 and July 2017, respectively.

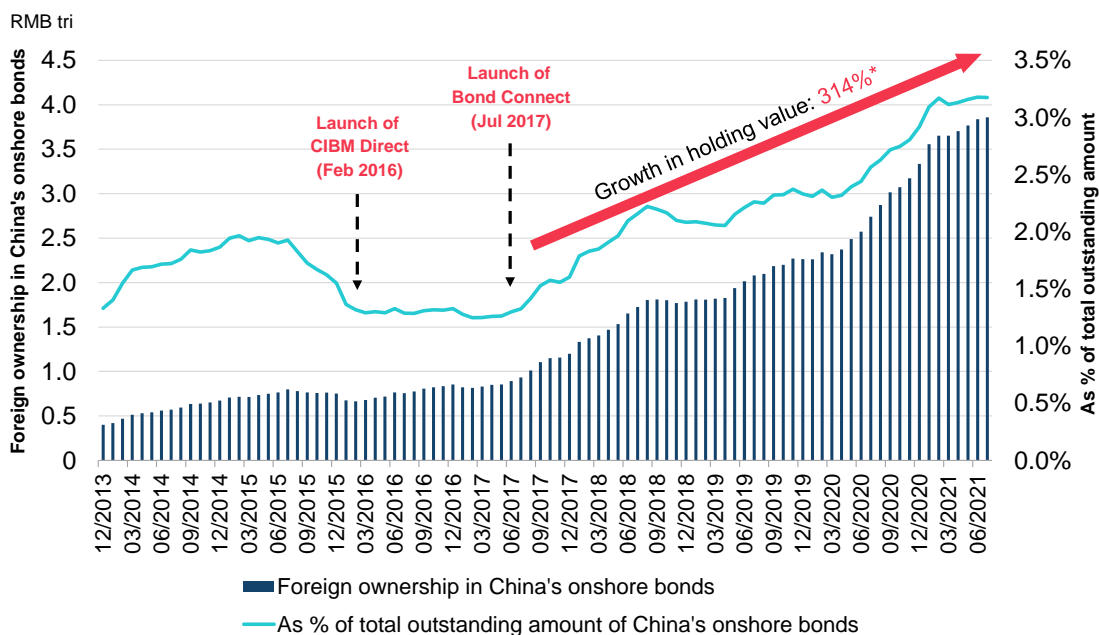
<sup>7</sup> See "Bloomberg to add China to the Bloomberg Barclays Global Aggregate Indices", news release on Bloomberg's website, 23 March 2018.

<sup>8</sup> See "JPMorgan says China to be included in benchmark bond indexes", news release on Bloomberg's website, 4 September 2019.

<sup>9</sup> See "FTSE fixed income country classification announcement March 2021", published on FTSE Russell's website, 29 March 2021.

<sup>10</sup> See "London Stock Exchange Group welcomes the China Bond inclusion to FTSE WGBI", news release on London Stock Exchange's website, 29 October 2021.

**Figure 9. Foreign ownership in China’s onshore bonds (Dec 2013 – Jul 2021)**

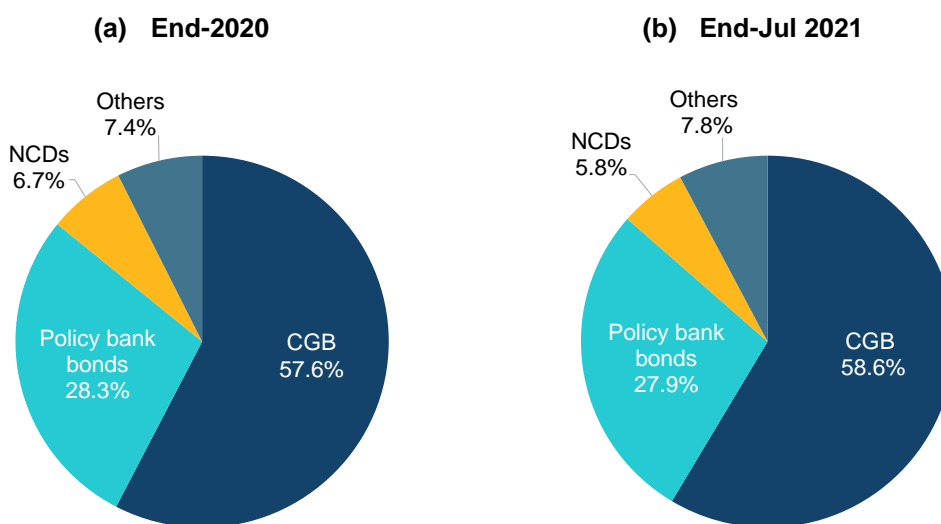


\* Calculated based on month-end data of July 2017 and July 2021.

Source: PBOC, Wind.

By bond type, foreign holdings of onshore bonds were concentrated on CGBs and policy bank bonds, which accounted in aggregate for more than 86% of international investors’ total onshore bond holdings as of end-July 2021 (see Figure 10).

**Figure 10. Distribution of foreign holdings in China’s onshore bonds by bond type (end of 2020 and Jul 2021)**



Source: CCDC, SHCH.

Looking forward, international investor participation in China’s onshore bond market is expected to grow, underpinned by the continuous development of the breadth and depth of the market and continued reforms to facilitate market access.

### 2.3 Offshore investment products for accessing Chinese bonds<sup>11</sup>

Serving the opening-up of the Mainland bond market, market connectivity programmes and other direct access channels for onshore Chinese bonds have been developed. Bond funds, including mutual funds and exchange traded funds (ETFs) have been developed in both onshore and offshore markets.

Certain eligible unlisted bond funds/wealth management products are now accessible to foreign retail investors through Mutual Recognition of Funds (MRF) and Wealth Management Connect schemes<sup>12</sup>.

Although physical ETFs are eligible for the MRF scheme, Northbound trading of onshore-listed funds on exchanges is not currently allowed. Onshore-listed funds include ETFs and listed open-ended funds (LOFs) which can be traded on exchanges. In December 2021, regulators in Mainland China and Hong Kong approved to include ETFs into the Stock Connect schemes and the detailed trading arrangements are expected to be announced in the first half of 2022<sup>13</sup>.

The creation and redemption of fund units can be cash-settled for both ETFs and LOFs, but physical settlement is available for ETFs only. If listed onshore bond funds can be made also accessible by foreign retail investors<sup>14</sup>, the growth in foreign participation in onshore Chinese bonds could be boosted further.

Currently, given international investors' limited direct access to onshore bond funds, offshore bond funds offer an indirect access channel. The growth in assets under management (AUM) of offshore funds covering Chinese bonds skyrocketed by 836% during 2018 to September 2021, faster than the 86% increase in onshore bond funds and 54% expansion in the onshore bond market over the same period<sup>15</sup> (see Figure 11).

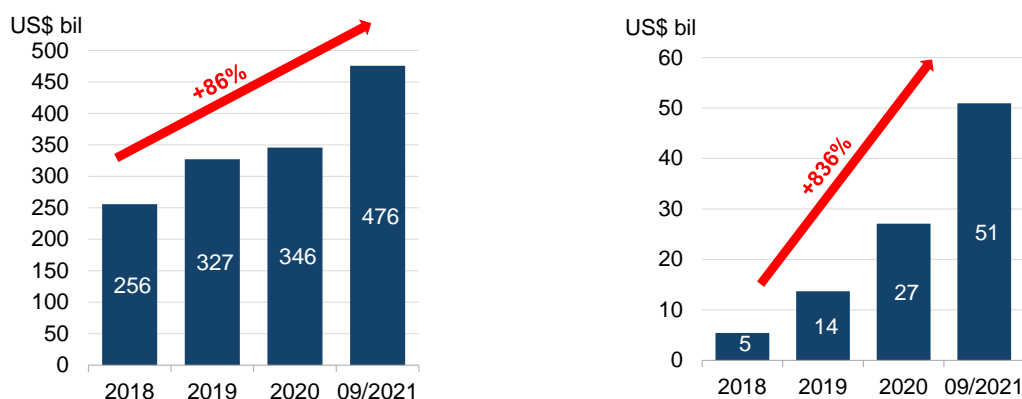
<sup>11</sup> In this section, the sample are the mutual funds and ETFs covering Chinese bonds, classified as such by Morningstar (detailed information on whether the scope of asset coverage of a fund is confined to onshore Chinese bonds or not is not available). In the sample, onshore funds are those domiciled in Mainland China and offshore funds are domiciled elsewhere.

<sup>12</sup> See *Mutual Recognition of Funds (MRF) between the Mainland and Hong Kong*, issued by the Securities and Futures Commission, 22 May 2015; *Implementation Rules for the Cross-border Wealth Management Connect Pilot Business in the Guangdong-Hong Kong-Macao Greater Bay Area* (《粵港澳大灣區「跨境理財通」業務試點實施細則》), jointly issued by Guangzhou Branch and Shenzhen Branch of the PBOC, Guangdong Office and Shenzhen Office of the China Banking and Insurance Regulatory Commission and Guangdong Office and Shenzhen Office of the CSRC, 10 September 2021.

<sup>13</sup> See "HKEX reaches agreement with Mainland partners on adding ETFs to Stock Connect", news release published on HKEX's website, 24 December 2021.

<sup>14</sup> These funds can be accessed by offshore institutions (but not retail investors) through QFII and RQFII schemes. See *Shanghai Stock Exchange Trading Rules on Eligibility No.1 — QFII and RQFII* (《上海證券交易所證券交易規則適用指引第 1 號——合格境外機構投資者和人民幣合格境外機構投資者》) and *Shenzhen Stock Exchange Detailed Implementation Rules on Securities Trading of QFII and RQFII (2020 Revision)* (《深圳證券交易所合格境外機構投資者和人民幣合格境外機構投資者證券交易實施細則 (2020 年修訂)》), issued by Shanghai Stock Exchange and Shenzhen Stock Exchange respectively, 30 October 2020.

<sup>15</sup> The growth rate of onshore Chinese bond market was calculated based on the data of bond market size from debt statistics available on the website of Bank for International Settlements (BIS).

**Figure 11. AUM of onshore and offshore Chinese bond funds (2018 – Sep 2021)****(a) Onshore bond funds covering Chinese bonds**      **(b) Offshore bond funds covering Chinese bonds**

Note: The sample comprise all bond funds covering Chinese bonds available in Morningstar.

Source: Calculated based on data from Morningstar.

These mutual funds and ETFs covering Chinese bonds are useful tools for global portfolio managers seeking exposure to China. In fact, ETFs with the underlying assets being bond indices covering onshore Chinese bonds offer a good starting point for foreign investors.

There are currently a large variety of local, regional and global bond indices covering onshore Chinese bonds. For example, there are over 600 domestic bond indices tracking onshore bonds in the CIBM and the exchange market, compiled by Chinabond Pricing Center (referred to as “Chinabond”, a subsidiary of CCDCC) and China Securities Index Company Limited (referred to as “CSI”)<sup>16</sup>.

These domestic bond indices can be categorised by trading venue (e.g. CIBM or on-exchange market), by bond type (e.g. financial bonds or MTNs), by issuer type (e.g. local governments or local government financing platforms) and by bond duration and rating.

Certain domestic bond indices are thematic indices adopting smart beta and environmental, social and governance (ESG) factors. Besides, major global and regional bond indices started to include onshore Chinese bonds since 2019. These include the inclusion of Chinese government bonds and policy bank bonds into Bloomberg Barclays’ GAI, and the inclusion of Chinese government bonds into FTSE Russell’s WGBI and JP Morgan’s GBI-EM benchmarks (see Section 2.2.2 above)<sup>17</sup>.

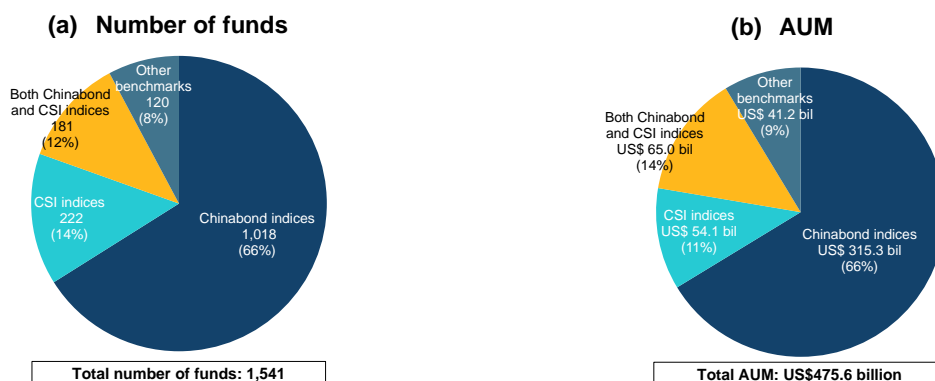
A number of onshore investment funds covering Chinese bonds have been introduced to the Mainland bond market, including funds tracking bond indices and funds with bond indices as performance benchmarks.

As of end-September 2021, there were 1,541 bond funds in the Mainland amounting to total AUM of US\$476 billion and the performance benchmarks of these funds were dominated by domestic bond indices, particularly Chinabond indices and/or CSI indices, which in aggregate accounted for 92% of the total number of funds and 91% of total AUM (see Figure 12).

<sup>16</sup> According to information on the Chinabond’s and CSI’s website (viewed on 13 May 2021), there were 242 indices and 386 indices compiled by Chinabond and CSI respectively.

<sup>17</sup> See “Government Bond Index-Emerging Markets Global Div 10% Cap 1% Floor”, published on JP Morgan’s website, 19 January 2021; “Bloomberg Barclays methodology”, published on Bloomberg’s website, viewed on 17 May 2021; “FTSE fixed income index guide”, published on FTSE Russell’s website, September 2020.

**Figure 12. Distribution of number and AUM of onshore bond funds covering Chinese bonds by type of benchmark index (end-Sep 2021)**



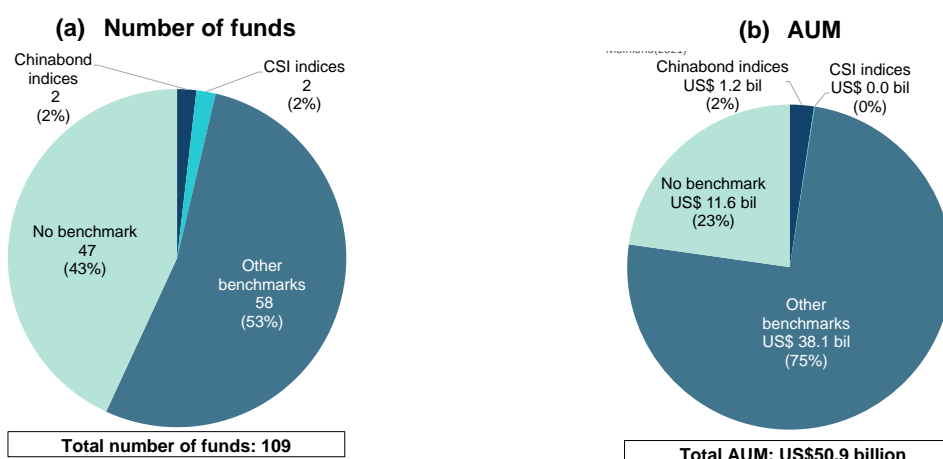
Note: The sample comprise all bond funds (including ETFs) covering Chinese bonds available in Morningstar and these funds are domiciled in Mainland China. Other benchmarks include Mainland deposit rates, SSE bond indices, regional and global bond indices.

Source: Calculated based on data from Morningstar.

In offshore markets, demand from foreign investors for Chinese bonds has been rising. The inclusion of onshore Chinese bonds into global indices has boosted demand and facilitated the introduction of related index products, such as bond funds (including ETFs), to serve the diverse needs of global investors whose preferences for Chinese bonds may be different from onshore investors.

The performance benchmarks of these offshore bond funds were largely offshore bond indices, rather than the onshore indices adopted by most onshore bond funds. As of end-September 2021, Chinabond indices and CSI indices accounted for only about 4% of the total number of offshore bond funds and 2% of offshore AUM, while other benchmarks accounted for 53% by number and 75% by AUM<sup>18</sup>. Notably, a significant proportion of them (43% by number and 23% by AUM) did not adopt any benchmark indices (see Figure 13).

**Figure 13. Distribution of number and AUM of offshore bond funds covering Chinese bond by type of benchmark index (end-Sep 2021)**



Note: The sample comprise all offshore bond funds (including ETFs) covering Chinese bonds available in Morningstar and these funds are domiciled outside Mainland China. Other benchmarks include global and regional bond indices, onshore and offshore RMB interest rates.

Source: Calculated based on data from Morningstar.

<sup>18</sup> In our sample as of 10 December 2021, 22 out of 70 bond funds (31%) used bond indices of Bloomberg Barclays, FTSE Russell indices and JP Morgan as benchmarks. Source: Morningstar.

Complementary to direct access to individual bonds, offshore bond funds covering a portfolio of Chinese bonds further widen foreign access to onshore Chinese bonds and support the opening up of China's bond market.

### 3. HOW TO GROW INTERNATIONAL INVESTOR PARTICIPATION IN THE ONSHORE BOND MARKET

#### 3.1 Expected demand and current gap

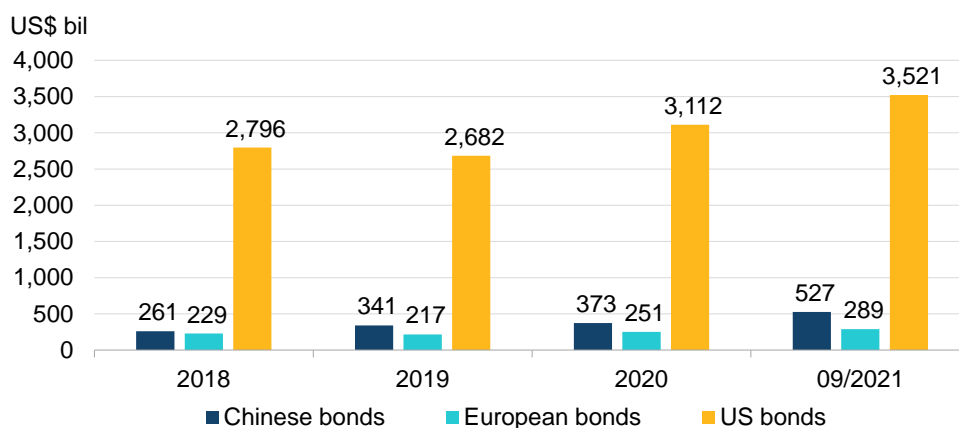
The growth of investment in Chinese bonds by international investors is expected to be driven firstly by the potential increase of global asset allocation into bonds, especially through investment funds.

The increasing demand for global bond investment is attributed to loose monetary policies and the prolonged low interest rate environment in advanced economies.

The allocation of global mutual funds' and ETFs' net assets into fixed income market rose from US\$8.0 trillion in 2017 to US\$10.1 trillion in 2019, with the corresponding increase in their percentage share of the funds' total net assets from 21.6% to 24.0%<sup>19</sup>.

The AUM of global funds (including mutual funds and ETFs) covering US bonds far exceeded that of funds covering Chinese bonds and European bonds. Notably, the AUM of funds covering Chinese bonds exceeded that of funds covering European bonds and has been on the rise (see Figure 14).

**Figure 14. Total AUM of bond mutual funds and ETFs covering bonds in China, Europe and the US (2018 – Sep 2021)**



Note: The sample comprise all bond mutual funds and ETFs covering Chinese bonds, European bonds and US bonds respectively.

Source: Calculated based on data from Morningstar.

The potential upside of allocation into Chinese bonds is huge, given the growing importance of the RMB in global investment.

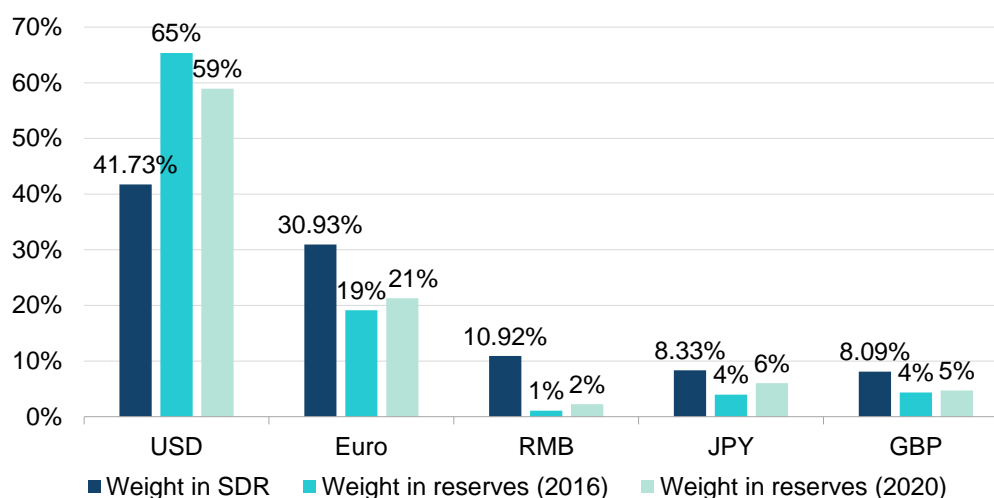
<sup>19</sup> Source: "2017 Global asset flows report" and "Morningstar direct fund flows commentary: 2019 Global report", published on Morningstar's website.



The RMB started to be included into the International Monetary Fund (IMF)'s special drawing rights (SDR) basket in October 2016, which is an alternative reserve asset and may serve as a reference for transactions of official institutions<sup>20</sup>.

RMB assets held in global foreign exchange reserves by central banks are mainly government securities, with the share rising from 1% in 2016 to 2% in 2020. This share was still small compared to the RMB's 10.92% weighting in the SDR basket (see Figure 15). In comparison, global bond investments in the private sector have apparently a higher proportion allocated to Chinese bonds — it was reported that the allocation to Chinese bonds in 2020 accounted for 3.3% of total assets of pension funds and 5.0% of total assets of endowments and foundations<sup>21</sup>.

**Figure 15. Weight of each currency in SDR and foreign exchange reserves (2016 and 2020)**



Note: The weights in SDR remained unchanged since October 2016.

Source: "WGBI inclusion confirms China's arrival on global bond stage", published on FTSE Russell's website, May 2021.

Another driver for an expected rising allocation to Chinese bonds is its attractive risk-return profile compared to those in major advanced economies.

Looking into the Bloomberg Barclays USD Aggregate Index series (unhedged) tracking the bond markets covering different geographical regions, the ratio of index return to its return volatility (referred to as "return-to-volatility ratio") of the China Aggregate Index was the highest among major bond markets during 2011 to September 2021 (see Table 2).

According to a JP Morgan study<sup>22</sup>, China's long-term government bond yield has been higher than that of US and the yield differential is expected to stay positive in 2022 even if the monetary policies of major central banks are normalised.

In addition, the China Aggregate Index, which covers only onshore Chinese bonds, had the lowest correlation coefficients with other bond market indices (see Table 2). These factors may contribute to the attractiveness of the Chinese bond market for portfolio diversification.

<sup>20</sup> See "The renminbi in the SDR basket and its future role in the international financial system", published on BIS' website, 20 June 2016.

<sup>21</sup> Source: "Crafting the optimal China allocation strategy: The asset owner's perspective", conducted by Greenwich Associates and Matthews Asia, published on Greenwich Associates' website, 27 April 2020.

<sup>22</sup> "2022 Long-term capital market assumptions", published on JP Morgan's website, viewed on 29 November 2021.

<b>Table 2. Correlation coefficients and risk-return profile of selected bond indices (2011 – Sep 2021)</b>							
	Global	US	Europe	Japan	UK	China	EM
<b>Correlation coefficients of daily returns</b>							
Global	—	0.60	0.44	0.24	0.75	0.18	0.38
US	0.60	—	0.48	0.15	0.42	0.02	0.39
Europe	0.44	0.48	—	0.15	0.40	0.04	0.35
Japan	0.24	0.15	0.15	—	0.11	0.05	0.09
UK	0.75	0.42	0.40	0.11	—	0.17	0.35
China	0.18	0.02	0.04	0.05	0.17	—	0.16
EM	0.38	0.39	0.35	0.09	0.35	0.16	—
<b>Average correlation coefficient</b>	<b>0.43</b>	<b>0.34</b>	<b>0.31</b>	<b>0.13</b>	<b>0.37</b>	<b>0.10</b>	<b>0.29</b>
<b>Risk-return profile</b>							
10-year period return (%) (A)	27%	43%	48%	17%	43%	63%	77%
10-year annualised return volatility (%) (B)	4.5%	3.3%	3.0%	2.0%	8.7%	3.2%	4.0%
<b>Return-to-volatility ratio [(A)/(B)]</b>	<b>6.0</b>	<b>13.2</b>	<b>16.2</b>	<b>8.5</b>	<b>4.9</b>	<b>19.6</b>	<b>19.5</b>

Note: 10-year annualised return volatility is calculated as the standard deviation of daily returns times the square root of 252 (the assumed number of trading days in a year).

Global — Bloomberg Barclays Global Aggregate Index (USD unhedged)

US — Bloomberg Barclays US Aggregate Index (USD unhedged)

Europe — Bloomberg Barclays Euro Aggregate Index (USD unhedged)

Japan — Bloomberg Barclays Japan Aggregate Index (USD unhedged)

UK — Bloomberg Barclays UK Aggregate Index (USD unhedged)

China — Bloomberg Barclays China Aggregate Index (USD unhedged)

EM — Bloomberg Barclays EM Aggregate Index (USD unhedged)

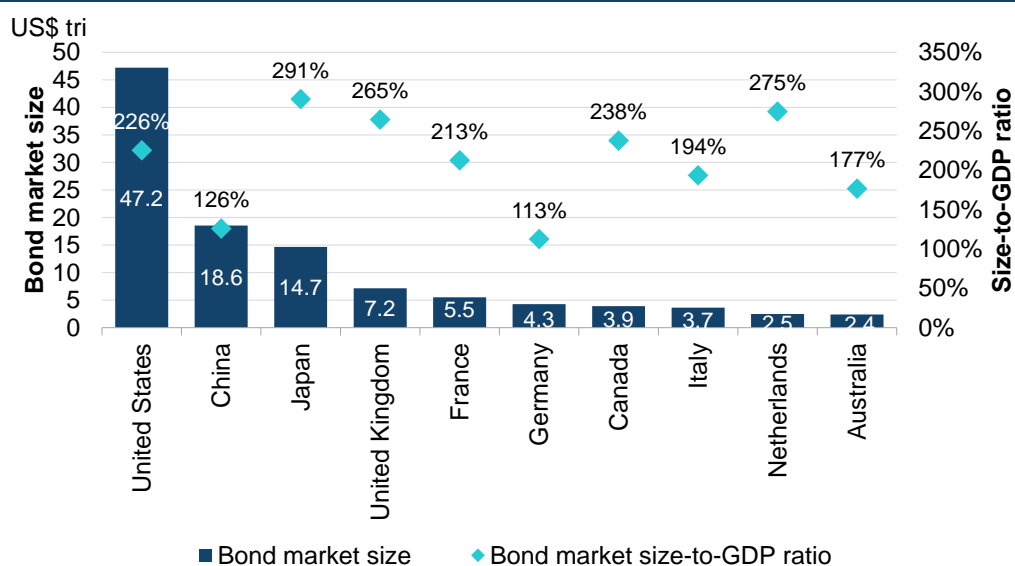
Source: Bloomberg.

Moreover, the potential future size of the Mainland bond market would offer a significant asset pool to global portfolios. Bond markets in major economies are often well-established and are important funding sources for public and private sectors.

As of end-2020, the size of the bond market was over 170% of GDP for major economies (except Germany) while China's bond market was only about 126% of GDP (see Figure 16). Given the Mainland authorities' determination to increase the proportion of direct financing in both the public and the private sectors<sup>23</sup>, the supply of Chinese bonds is expected to significantly increase to meet the financing demand of the real economy.

<sup>23</sup> See "Yi Hui Man: Increasing the share of direct financing" (〈易會滿：提高直接融資比重〉), published on CSRC's website, 3 December 2020.

**Figure 16. Bond market size and size-to-GDP ratio of top 10 largest bond market in the world (2020)**

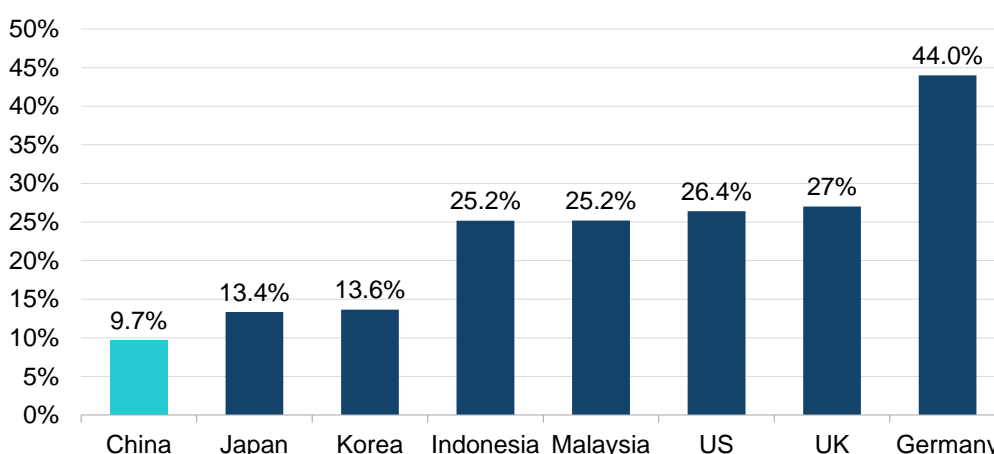


Source: Bond market size from BIS' debt statistics; GDP data from IMF's World Economic Outlook April 2021 database.

Attracted to the big asset pool of the Mainland bond market, foreign participation in this onshore market indeed has a big potential upside in comparison with other international markets.

Foreign investments in domestic market bonds are usually concentrated firstly to government bonds which offer higher security than corporate bonds — Chinese CGBs are firstly included into global bond indices which serve as major benchmarks for global bond investments. However, in this respect, foreign participation in government bonds is still relatively low for China, compared to other markets. As of end-2020, foreign ownership in government bonds was 9.7% for China, compared to 13.4% for Japan and 26.4% for the US (see Figure 17).

**Figure 17. Share of foreign ownership in government bonds of selected markets (end-2020)**



Source: China, Japan, Korea, Indonesia, Malaysia from Asian Development Bank; US, UK and Germany from "WGBI inclusion confirms China's arrival on global bond stage", published on FTSE Russell's website, May 2021.

A higher degree of inclusion of Chinese bonds into global indices would be a key driver for increased participation by foreign investors.

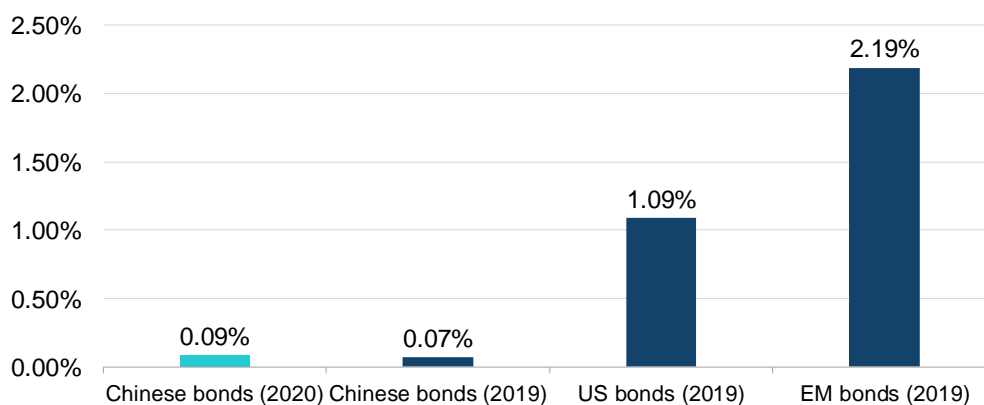
According to FTSE Russell, total potential inflows into Chinese bonds would be about US\$271 billion to US\$299 billion upon the full inclusion of Chinese government bonds into global

indices at current weightings and may further increase by US\$207.5 billion if the weightings further increased<sup>24</sup> — this would be about 3% of the size of the Mainland onshore bond market as of end-June 2021 on top of the current level of foreign holdings. These will also stimulate the development of index products tracking these bond indices, especially ETFs.

The expected growth in global asset allocation into Chinese bonds may boost demand through direct and indirect channels. While there exist efficient direct access channels without any quotas on holdings (see Table 1 above), indirect access channels such as offshore bond ETFs are currently relatively under-developed.

The AUM of ETFs covering Chinese bonds is still relatively small. As of end-2019, it accounted for less than 0.1% of the bond market in China, compared to 1.1% for US bonds and 2.2% for emerging markets (EM) bonds in their respective bond markets (see Figure 18).

**Figure 18. Ratios of bond ETF AUM to bond market capitalisation for selected markets (2019 / 2020)**



Note: Data available for Chinese bonds was up to end-2020 while data available for US bonds and EM bonds were up to end-2019.

Source: Data for Chinese bonds was calculated based on AUM of individual ETFs from Morningstar and bond market size from BIS' debt statistics; data for US bonds and EM bonds from "Fixed income ETFs fact vs fiction", published on State Street Global Advisors' website, 12 October 2020.

In a nutshell, the existing large Mainland onshore bond market, with its expectedly high growth momentum, offers a tremendous investment opportunity to foreign investors.

However, international investor participation at its current low level has been limited by gaps in direct and indirect access channels. These gaps are observed to exist in terms of investor type, bond type and product type.

- **Investor type:** Currently, the direct channels to onshore Chinese bonds, including QFII/RQFII, CIBM Direct and Bond Connect, are limited to institutional investors only. Retail investors can only invest in onshore Chinese bonds through indirect channels, including mutual funds and ETFs.
- **Bond type:** Foreign investors' holdings of Chinese bonds are concentrated in CGBs and policy bank bonds. In other words, commercial bank bonds and corporate bonds are yet to attract much foreign investment.
- **Product type:** The number of mutual funds and ETFs covering Chinese bonds were still small in the offshore market (see Section 2.3) and this has limited the diversity of exposure to Chinese bonds. Besides, global investors only have currently limited access to onshore

<sup>24</sup> See "WGBI inclusion confirms China's arrival on global bond stage", published on FTSE Russell's website, May 2021.

mutual funds and ETFs (e.g. through Mutual Recognition of Funds (MRF) scheme or cross-listing), not to say those covering Chinese bonds.

### 3.2 Possible enhancements to products and channels

As China's bond market continues to open up, both direct and indirect channels of foreign access are expected to be broadened and deepened. However, these access channels are currently confined to offshore institutional investors only.

Offshore retail investors, who can only access the onshore market through indirect channels like offshore bond funds, should be not overlooked.

In Hong Kong, for example, local and overseas retail investors accounted for 20.3% of total cash market trading value in 2019<sup>25</sup>. Retail investors also supply capital to institutional funds since very often their money would be invested in investment funds managed by institutional investors. Expanding the suite of China bond instruments available to retail investors may stimulate or satisfy their demand.

In the global bond market, transactions conducted by retail investors usually have smaller sizes. Given the flat rates of certain transaction costs, small-sized transactions means higher transaction cost per unit of transaction value.

Empirical evidence<sup>26</sup> showed that the transaction costs of individual bonds were significantly higher in percentage terms of transaction value for retail investors than institutional investors because of their smaller transaction sizes — in the US, the average implied transaction cost of buying an individual investment-grade municipal bond was 0.72% during January to September 2020 for retail investors, which was higher than the 0.17% for institutional investors.

This difference can be significant relative to investment returns, particularly in the prevailing low-yield environment. The higher costs to retail investors may also be attributable to mark-ups in transaction prices or wider bid-ask spreads of an individual bond for small transaction sizes<sup>27</sup>. Besides, investments in certain bonds may be subject to minimum investment amounts that limit retail investors' choices of bonds.

Instead of direct trading in the bonds, retail investors may trade through portfolio vehicles like mutual funds and ETFs to get a wider choice of investible bonds at lower investment costs.

Global bond mutual funds and ETFs are cost-effective choices to provide a diversity of bond exposures, but which one is better — bond mutual funds or bond ETFs?

An empirical study<sup>28</sup> found that the investment performance of bond mutual funds and ETFs depends on their portfolio composition. In the US, the average expense ratio across bond mutual funds and ETFs, as measured by the ratio of total expenses of a fund as a percentage of its AUM, has been declining in the past decade (see Figure 19).

Compared to actively managed bond mutual funds, ETFs tracking bond indices have lower expense ratios — in 2020, the asset-weighted average expense ratio was 0.42% for bond mutual funds and 0.13% for bond ETFs. In addition to costs, ETFs are more liquid and

<sup>25</sup> Source: *Cash Market Transaction Survey 2019*, published on HKEX's website, 25 November 2019.

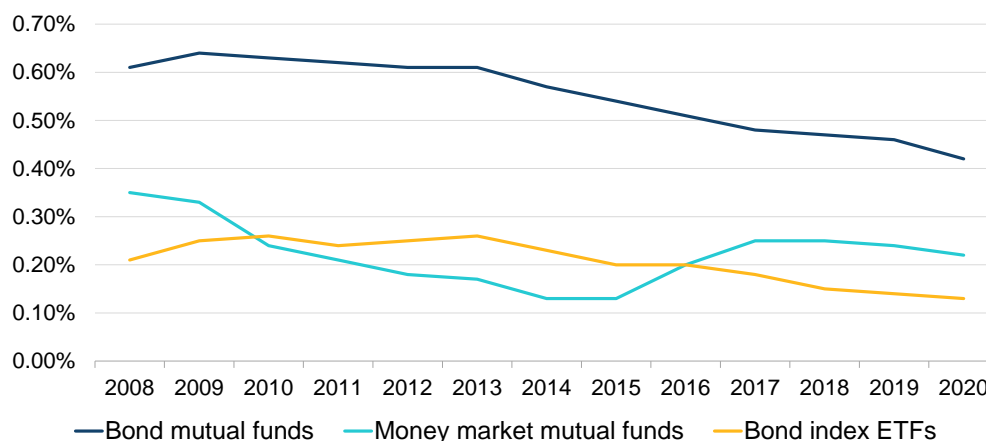
<sup>26</sup> See "The hidden costs of retail purchases in municipal bonds", published on S&P Global's website, 23 February 2021.

<sup>27</sup> See "A topic of current interest: bonds or bond funds?", published on Vanguard's website, July 2017.

<sup>28</sup> Stankevičienė, J. and I. Petronienė. (2019) "Bond mutual funds vs. bond exchange traded funds: Evaluation of risk adjusted performance", *Administrative Sciences*, Vol. 9, pp.1-14.

transparent than mutual funds as they are tradable in the secondary market and have daily disclosure of portfolio composition.

**Figure 19. Asset-weighted average expense ratio of bond mutual funds and ETFs in the US (2008-2020)**



Source: "Trends in the expenses and fees of funds, 2020", published on Investment Company Institute's website, March 2021.

In the case of Chinese bonds, bond ETFs would also be an efficient access channel. While foreign participation in onshore bond ETFs is currently limited only to offshore institutions, there are no restrictions on the types of offshore investor, whether institutional and retail, to invest in offshore bond ETFs.

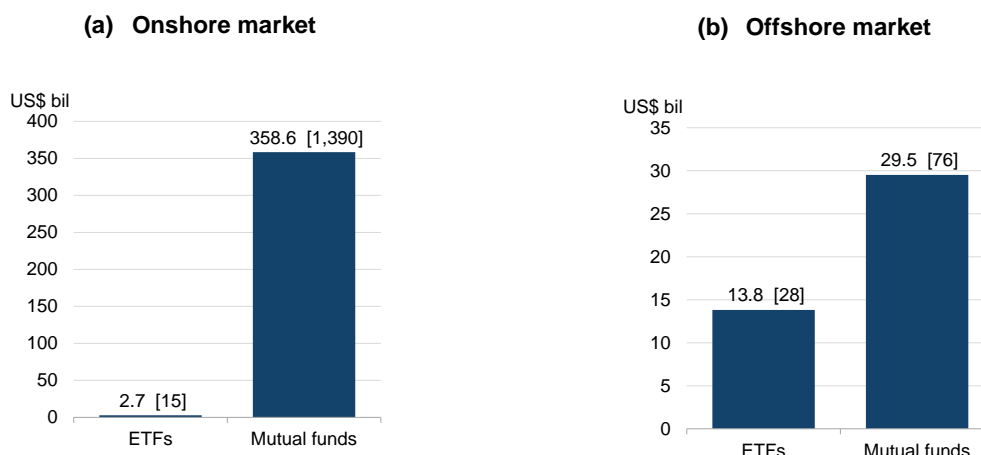
Compared to bond mutual funds, the development of bond ETFs appeared to be faster in the offshore market than in the onshore market (see below). This hints at strong demand from offshore investors, probably mostly from retail investors (given the product nature of ETFs discussed above), for ETFs as the tool for investment in Chinese bonds.

Moreover, compared to domestic ones, offshore bond ETFs covering Chinese bonds may have different cost-return profiles that attract investors:

- For bond funds (covering Chinese bonds) in the Mainland onshore market, onshore bond ETFs are relatively under-developed in terms of size — the AUM of bond ETFs was only 0.8% of that of bond mutual funds as of end-2020 (see Figure 20a). In terms of cost and return, onshore bond ETFs appeared to be less attractive than onshore bond mutual funds (see Table 3). During 2020, the average gross return<sup>29</sup> of bond ETFs was about two percentage points lower than that of bond mutual funds and the average expense ratio of bond ETFs was a bit lower by about 17 basis points than that of bond mutual funds.
- For bond funds (covering Chinese bonds) in the offshore markets, the AUM of bond ETFs was close to half of that of bond mutual funds in 2020 (see Figure 20b). The average gross return of bond ETFs was about one percentage point lower than that of bond mutual funds. Besides, the average expense ratio of offshore bond ETFs was much lower (by about 37 basis points) than that of offshore mutual funds, and the cost-saving was larger than that in the onshore market (see Table 3). Cost-saving appeared to support the demand for bond ETFs in the offshore markets.

In other words, more offshore bond ETFs covering Chinese bonds are available and accessible to offshore investors than onshore ones, and in comparison with offshore bond mutual funds, they appeared to have attractive cost-return profiles.

<sup>29</sup> Gross return refers to the total return adjusted for expenses. See "Gross returns methodology", published on Morningstar's website.

**Figure 20. AUM of bond mutual funds and ETFs covering Chinese bonds in onshore and offshore markets (end-2020)**

[ ] Total number of funds

Note: The sample comprise all bond funds covering Chinese bonds available in Morningstar.

Source: Calculated based on data from Morningstar.

**Table 3. Average gross investment return and average expense ratio of bond mutual funds and ETFs in onshore and offshore markets (2020)**

	Onshore			Offshore		
	Bond ETFs	Bond mutual funds	Difference	Bond ETFs	Bond mutual funds	Difference
Average gross investment return (%)	9.43	11.58	-2.15	9.78	10.69	-0.91
Average expense ratio (%)	0.50	0.67	-0.17	0.55	0.92	-0.37

Note: The sample comprise all bond funds covering Chinese bonds available in Morningstar. The data of expense ratio is "prospectus net expense ratio" from Morningstar for offshore ETFs and "annual report net expense ratio" from Morningstar for other funds. The average expense ratio is calculated as the simple average of expense ratio across the funds by type.

Source: Calculated based on data of individual funds from Morningstar.

Passive investments like ETFs have become increasingly popular for investment in different asset types, including bonds<sup>30</sup>.

Globally, the AUM of bond ETFs rose from US\$138.4 billion in 2017 to US\$230.3 billion in 2020 and these accounted for about 3% of total AUM of all ETFs in both 2017 and 2020<sup>31</sup>.

While bond mutual funds are usually not available on exchanges, bond ETFs are listed and traded on exchanges and contribute to the price discovery of the underlying bonds, whether under normal or volatile market conditions<sup>32</sup>.

<sup>30</sup> See HKEX research, "Hong Kong's ETF market as a door to global investment", published on HKEX's website, 12 September 2019.

<sup>31</sup> Source: "ETFGI reports assets invested in ETFs and ETPs listed globally increased by 36% during 2017 to reach a new high of \$4.83 trillion" and "ETFGI reports assets invested in ETFs and ETPs listed globally reach a new milestone of US\$7.99 trillion at the end of December 2020", published on ETFGI's website, 18 January 2018 and 14 January 2021 respectively.

<sup>32</sup> See HKEX research, "The functioning of market products during the 2020 market turmoil — are ETFs volatility absorbers or amplifiers", published on HKEX's website, 22 December 2020.

These characteristics of ETFs allow investors to buy and sell the fund units in the secondary market at a price reflecting the prevailing market conditions. The associated costs are usually low, similar to those for trading equities.

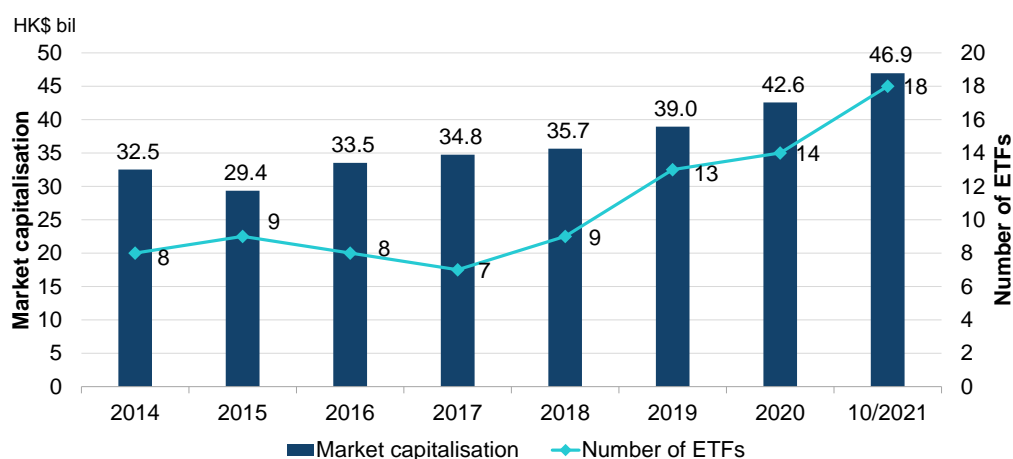
In contrast, bond mutual funds are normally traded in the primary market through subscriptions and/or redemptions, which may require additional fees (called “loads”) at about 1%-2% of the investment value<sup>33</sup>.

Therefore, bond ETFs are considered more cost-effective, i.e. a better cost-return profile, than bond mutual funds and are more convenient than managing a portfolio of individual bonds for non-sophisticated investors, especially retail investors.

In the Hong Kong market, fixed income and currency (FIC) ETFs have been growing steadily. The number of FIC ETFs rose from 8 in 2014 to 18 in October 2021 and the total AUM rose from HK\$32.5 billion in 2014 to HK\$46.9 billion in October 2021 (see Figure 21).

As of end-October 2021, 8 out of 18 FIC ETFs listed in Hong Kong were China-related bond ETFs covering onshore Chinese bond indices or money market (see Table 4). It is worth noting that 3 of these 8 ETFs on onshore Chinese bonds were issued in 2021 after the last one issued in 2018, reflecting increasing investor interest.

**Figure 21. Number and AUM of FIC ETFs in Hong Kong (2014 – Oct 2021)**



Source: "ETF and L&I product market perspective", issues during 2014 to October 2021, published on HKEX's website.

**Table 4. List of bond ETFs on onshore Chinese bonds listed in Hong Kong (end-Oct 2021)**

Listing date	ETF name	Benchmark	Stock code	Trading currency
19/02/2014	CSOP Bloomberg Barclays Ch Treasury + Policy Bk Bond Idx ETF	Bloomberg China Treasury + Policy Bank Index	3199	HKD
			83199	RMB
20/01/2015	CSOP RMB Money Market ETF	7-Day Fixing Repo Rate	3122	HKD
			83122	RMB
29/12/2017	Ping An of China CSI 5-10Y CGB ETF	CSI 5-10y Liquid CGB Index	3080	HKD
09/06/2018	ChinaAMC Bloomberg Barclays China Treasury+Policy Bk B Idx ETF	Bloomberg China Treasury + Policy Bank Index	2813	HKD
			82813	RMB
			9813	USD
12/12/2018	CICC Bloomberg Barclays China Treasury 1-10 Years ETF	Bloomberg China Treasury 1-10 Years Index	3079	HKD
			83079	RMB

<sup>33</sup> Source: "ETFs vs. mutual funds: Cost comparison", webpage on Fidelity's website, viewed on 10 August 2021.



Listing date	ETF name	Benchmark	Stock code	Trading currency
14/04/2021	Premia China Treasury and Policy Bank Bond Long Duration ETF	ICE 10+ Year China Government & Policy Bank Index	2817	HKD
			82817	RMB
			9817	USD
21/10/2021	iShares China Government Bond ETF	FTSE Chinese Government Bond Index	2829	HKD
			82829	RMB
			9829	USD
21/10/2021	iShares Short Duration China Policy Bank Bond ETF	FTSE Chinese Policy Bank Bond 6 Months-3 Years Index	3125	HKD
			83125	RMB
			9125	USD

Source: HKEX.

ETFs are liquid and cost-effective tools for investing in onshore Chinese bonds<sup>34</sup>. Although subscription and redemption of ETF units (usually in blocks) in the primary market also involve additional costs like the case for mutual funds, trading ETFs in the secondary market may be subject to lower trading costs than in the primary market, especially for small trade sizes. In addition, in terms of taxation for Chinese bond ETF investors, the Hong Kong market has comparable after-tax returns to other offshore markets<sup>35</sup>.

In 2021, the Hong Kong market introduced cost incentives to support the development of FIC ETFs<sup>36</sup>. Previously, the minimum settlement fee of HK\$2.00 and the trading tariff of HK\$0.50 per transaction are two cost components for ETFs, which were the major cause for an elongated breakeven holding period.

For small trade sizes (e.g. HK\$1,000), these costs equate to 25 basis points (i.e. HK\$2.5/HK\$1,000) of costs eroding away the yield of fixed income ETFs. To minimise the effect of these costs, issuers of fixed income ETFs have structured the board lot value around HK\$1,000,000, effectively an institutional size<sup>37</sup>, which discouraged retail participation.

In the light of these, HKEX introduced fee waivers to reduce costs of fixed income and money market ETF transactions<sup>38</sup> on (1) trading tariffs and (2) minimum stock settlements borne by Exchange Participants.

These fee waivers effectively lower the cost of investing in bond ETFs and incentivise their issuers to reduce the board lot value. As such, bond ETFs in Hong Kong would become more attractive for offshore investors, particularly for retail investors. This advantage can be leveraged on for issuing ETFs on Chinese bonds to better serve the needs of offshore investors.

<sup>34</sup> The total cost of investing in an ETF include costs like holding costs and trading costs in addition to the management and other administrative costs covered in the expense ratio. Holding costs of ETFs include tracking difference between the ETF and its benchmark index and investor-level taxation, which are also applicable to mutual funds. Trading costs include the bid-ask spread and broker's commission (the fee paid to a broker for trade execution services). See "ETF handbook: A practical guide to exchange traded funds", published on HKEX's website, 5 July 2021.

<sup>35</sup> See "ETF taxation report for investors Hong Kong", produced by Ernst and Young (commissioned by HKEX), July 2020.

<sup>36</sup> See "HKEX introduces new initiative to facilitate development of fixed income ETFs in Hong Kong", news release on HKEX's website, 31 May 2021.

<sup>37</sup> Source: HKEX.

<sup>38</sup> These transactions comprise exchange trade (a trade in a CCASS Eligible Security (other than a China Connect Security) as defined in the Rules of the Exchange either reported to the Exchange by an Exchange Participant or effected on the Exchange) and crossed exchange trade (a trade where the buy and sell of an Exchange Trade is handled by the same Exchange Participant).

More can be done on leveraging the Hong Kong market to bridge the gap in foreign access to the Mainland onshore bond market, in terms of broadening the bond type (government and corporate), product type (different kinds of bond funds, including ETFs) and investor type (accessible to both retail and institutions).

As global demand for onshore Chinese bonds continues to grow, institutional investors may increase their allocations to a variety of bond types including commercial bank bonds and corporate bonds in the Mainland. These institutional investments in individual Chinese bonds can be packaged into investment funds for retail investors. Bond ETFs may provide liquid and cost-effective means for offshore investors to invest in onshore Chinese bonds.

Offshore bond ETFs covering Chinese bonds are expected to help increase the participation from offshore retail investors. These ETFs can have diversified benchmarks of global, regional and local bond indices covering onshore Chinese bonds for portfolio management and diversification.

In the Mainland, as bonds have become an increasingly important financing channel, the issuer base will be widened and different types of bond will be issued. These will help broaden the types of bonds available to investors, stimulate the development of bond indices on the Mainland market and grow the number of onshore bond ETFs.

Further enhancing access channels through cross-listing arrangements and implementing mutual market access mechanism for ETFs between Mainland and Hong Kong exchanges, such as ETF inclusion into Stock Connect as announced, can widen the access channels of Mainland-listed Chinese bond funds for offshore investors. This will be complementary to the possible expansion of the suite of offshore Chinese bond ETFs, as suitable tools to serve offshore investors, particularly retail investors.

#### 4. CONCLUSION

China's onshore bond market has become the world's second largest. Further growth and development of the market will not only be driven by Mainland policy support and the increasing need for direct financing from the real economy, but will also require continued efforts to further internationalise and liberalise the market to meet growing demand from offshore investors.

Foreign participation in Chinese bonds has been rising but the level is still low relative to other major bond markets. While market access channels for directly trading onshore bonds are efficient and continue to be enhanced, indirect access channels, particularly offshore Chinese bond ETFs, remain under-developed.

China bond index ETFs have attractive cost-return profiles and could contribute to the price discovery and liquidity of underlying onshore Chinese bonds.

By taking advantage of the cost incentives provided by the Hong Kong market, expanding the suite of offshore Chinese bond ETFs listed in Hong Kong could increase the participation of international investors in China's onshore bond market.

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