

THE COMMENCEMENT OF THE LONG-AWAITED CHINA-HONG KONG BOND CONNECT

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Investment Management Alert

By: Choo L. Tan

At present, the China bond market is the third largest in the world after the USA and Japan. In order to further promote the China bond market, the People's Bank of China ("**PBC**") and the Hong Kong Monetary Authority ("**HKMA**") announced on 2 July 2017 that, starting on 3 July 2017, being the first trading day after the 20th anniversary of the handover of Hong Kong, a trial operation of a bond trading link between the People's Republic of China ("**PRC**") and Hong Kong ("**Bond Connect**") would be launched. This follows the grant of approval of the Bond Connect by the PBC and the HKMA on 16 May 2017.

The Bond Connect is a mutual access arrangement that enables overseas investors (including Hong Kong investors) to directly invest in the China Interbank Bond Market ("**CIBM**") through Hong Kong ("**Northbound Trading**") and, similarly, enables domestic PRC investors to invest in the Hong Kong bond market via the trading platform in the PRC ("**Southbound Trading**").

Domestic or onshore bonds in the PRC ("**PRC Domestic Bonds**") generally consist of PRC government and policy bank bonds which are traded on the CIBM and PRC corporate bonds which tend to be traded on the domestic (Shanghai and Shenzhen) stock exchanges.

Currently, to access Renminbi ("**RMB**")-denominated assets, foreign investors primarily invest in "Dim Sum" bonds rather than PRC Domestic Bonds. Dim Sum bonds are RMB-denominated bonds issued offshore that clear through international clearing houses like Euroclear and Clearstream. The Dim Sum bond may be issued by both PRC and non-PRC entities, but its market is significantly smaller than the PRC Domestic Bond market.

However, prior to the Bond Connect, the only ways in which foreign, non-PRC investors could invest in the PRC bond Domestic Bonds market were through the CIBM direct access scheme, and the Qualified Foreign Institutional Investor (QFII) and the Renminbi Qualified Foreign Institutional Investor (RQFII) schemes. All of these schemes require foreign investors who may not be familiar with PRC laws and practices to open onshore accounts and follow certain onshore compliance procedures in the PRC such as clearing and settlement and therefore, add many layers of complexity, lead to additional time and costs and, since the only requirement is that the Dim Sum bonds be denominated in RMB but not that the issuer is necessarily from the PRC, arguably do not give them "true" access to RMB onshore PRC onshore assets.

With the introduction of the Bond Connect, the fourth bond market liberalization measure in the PRC, however, the process required for overseas investors to invest in the PRC Domestic Bond market is simplified by enabling them to directly access the PRC Domestic Bond market through Hong Kong under Hong Kong law, regulations and procedures.

The Bond Connect is modelled in part on the Shanghai-Hong Kong Stock Connect Scheme^[1] and the Shenzhen-Hong Kong Stock Connect Scheme^[2]. However, unlike the two stock connect schemes, at this initial stage, only Northbound Trading (by overseas investors in respect of PRC Domestic Bonds) of the Bond Connect is permitted with no investment quota being set, though Southbound Trading is expected to commence subsequently.

To facilitate the Bond Connect, the PBC and the HKMA have entered into a memorandum of understanding ("MOU"). Under the MOU, the PBC and the HKMA have agreed, in accordance with the laws and regulations of the PRC and Hong Kong respectively, that they will establish effective supervisory cooperation arrangements and liaison mechanisms in order to ensure effective operation of the Bond Connect.

The Bond Connect's link to international trade systems is expected to increase the willingness of overseas investors to invest in PRC Domestic Bonds. It is a further step in the liberalization of the RMB and its success will likely boost China's eligibility for inclusion in major global bond indices.

Notes:

^[1] Also see our publication: *An Overview of the Shanghai-Hong Kong Stock Connect* (<http://www.klgates.com/an-overview-of-the-shanghai-hong-kong-stock-connect-10-06-2014/>).

^[2] Also see our publication: *The commencement of the Shenzhen-Hong Kong Stock Connect – a new and direct way to access China's capital market* (<http://www.klgates.com/the-commencement-of-the-shenzhen-hong-kong-stock-connect--a-new-and-direct-way-to-access-chinas-capital-market-01-18-2017/>).

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