Impact of Bond Connect on Hong Kong Capital Markets

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What is Bond Connect

On 16 May 2017, the People's Bank of China announced that in order to promote the common development of Hong Kong and Mainland China's bond market, the People's Bank of China and the Hong Kong Monetary Authority has authorized the China Foreign Exchange Trade System and the National Interbank Funding Center; the China Central Depository and Clearing Company; the Shanghai Clearing House; the Hong Kong Exchanges and Clearing Limited; and the Central Moneymarkets Unit to cooperate in establishing mutual bond market access between the two markets.

The People's Bank of China stated in the announcement that Bond Connect will be officially launched after the relevant rules and systems have been completed, the relevant regulatory approvals obtained and all other necessary work in place. The Bank announced that in the initial phase, Bond Connect will only be available for 'Northbound Trading', i.e. foreign investors investing in the mainland interbank bond market. In due time, the availability will be extended to 'Southbound Trading', i.e. domestic investors investing in the Hong Kong bond market. The scope of Bond Connect includes bonds issued by the Ministry of Finance, policy banks, commercial banks, and other international issuers.

Necessity of Bond Connect

In November 2016, the Hong Kong Monetary Authority issued a paper entitled 'Proposal on the Mainland-Hong Kong Bond Market Connect'. Benefitting from the Mainland's interest rate marketization and the internationalization of the renminbi, Bond Connect will provide foreign small and medium-sized investors with a straightforward path to enter the domestic bond market. At the same time, Bond Connect can further enrich the structure of the bond market investors and improve the construction of China's interest rate market.

The mainland bond market and the Hong Kong bond market have their individual advantages and there are many differences in their respective market structures and sizes. The mainland bond market is mainly based on the interbank market and exchange market, the interbank market has become the main force in bond trading in the Mainland, accounting for 99% of the entire bond market.

The size of the Hong Kong bond market is smaller than that of the mainland bond market. By the end of 2016, the balance of all bond products in the Hong Kong market was close to HK$1.7 trillion, approximately 60% of which are exchange fund paper and bond products.

At present, the mainland bond market is expanding, and many foreign financial institutions continue to enter the interbank bond market. Foreign institutions in the Mainland China primarily invest in fixed rate bonds, 95.8% of which are government or policy bank bonds. With the strengthening of cooperation between the two market, the proportion of foreign institutions participating in the mainland bond market is increasing. The establishment of Bond Connect and Northbound Trading will provide international investors with an unobstructed pathway to enter the domestic market and thus further diversify the market.

Feasibility of Bond Connect

Bond Connect will give priority to Northbound Trading, that is to allow Hong Kong investors to purchase bonds in the Mainland. After the success of Northbound

Trading is realized, the investment mechanism will be extended to allow domestic investors to invest in international markets by starting Southbound Trading.

There is no investment quota to Northbound Trading through Bond Connect. Presently, the Shenzhen-Hong Kong and Shanghai-Hong Kong stock connects are both capped with a daily trading limit. The daily trading volume of the Hong Kong bond market is approximately HK$10 billion, while the daily trading volume of the Mainland bond market is approximately HK$200-300 billion. If Bond Connect is only open to Northbound Trading, it is expected that the total amount of foreign funds expended to buy mainland bonds will have little overall effect on the Mainland bond market. The People's Bank of China have already opened the domestic interbank market up to all types of foreign institutions and have completely abolished all restrictions and limits. Bond Connect can allow the interbank bond market to attract international investors to invest in the domestic market at a lower cost.

Impact of Bond Connect

In view of the current situation, this is an opportune time to establish Bond Connect with Northbound Trading, as there are no major obstacles in the trading system. Currently, the daily trading volume of the Hong Kong bond market can meet the demand of Northbound funds. At the same time, foreign institutions of all sizes can enter the mainland interbank bond market. Northbound Trading will drive domestic investors to invest in the Hong Kong bond market. Southbound Trading is an inevitable consequence of Bond Connect. A north and south, two-way trading system will allow Bond Connect to become a bridge between the Mainland and Hong Kong.

Bond Connect is an indispensable mechanism in the process of China's interest rate marketization and RMB internationalization. Its introduction will further enrich the structure of China's bond market investors and provide more efficient and convenient investment channels for overseas funds.

Bond Connect will use approved banks in Hong Kong and China as trading intermediaries to assist in the completion of transactions, settlement and custodian arrangements. This mechanism can bring about the refinement of the transaction process and help Bond Connect meet the needs of the international market. For example, the banks can verify the identity of the ultimate beneficial owner of a bond and ensure that the requirements for international bond trading regarding anti-money laundering and counter terrorist financing are met, thereby strengthening the international recognition of Bond Connect.

Conclusion

The establishment of Bond Connect will be essential to consolidate and enhance the status of Hong Kong as an international financial center, which is conducive to the steady opening up of China's financial market. This would diversify the investment channels of foreign investors, thus benefiting Hong Kong's long-term prosperity and stability. Bond Connect will be a challenge and an opportunity for Hong Kong and the Mainland. It will promote and fortify the cooperation and development between both financial markets.

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