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Global Bond Index Inclusion - The Chinese Case

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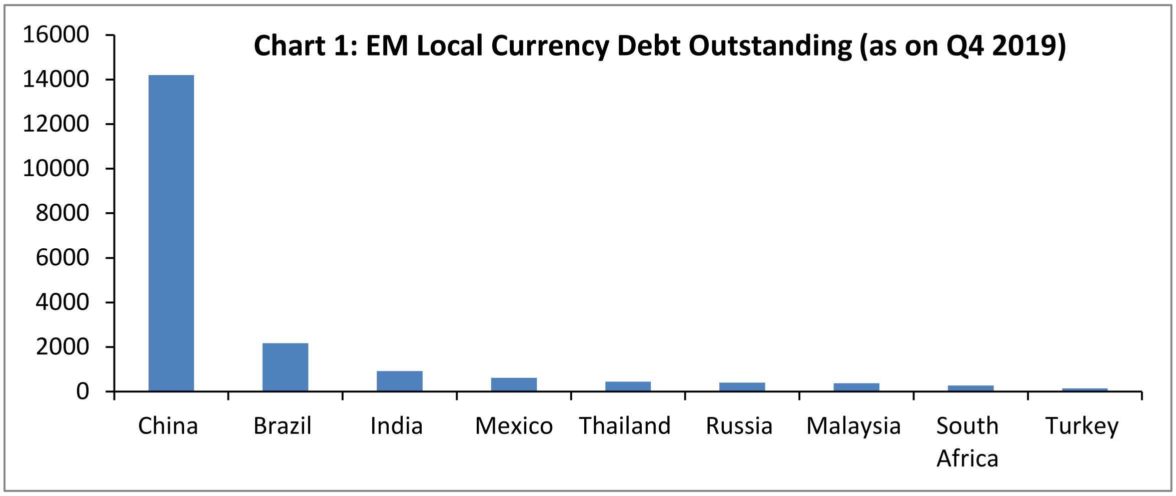
The announcement by the Finance Minister Smt. Nirmala Sitharaman in the Union Budget FY21 that the government will issue rupee denominated special bonds with no FPI caps, for passive foreign investors like sovereign wealth funds (SWFs), Pension Funds and Insurance Companies, has sparked off interest in the subject of index inclusion in Global Bond Indices. Subsequent to the announcement in the Budget, the COVID-19 crisis unfolded and led the Indian central government to announce huge relief packages worth ~USD 22.6 billion, creating a wide fiscal gap, partly funded by the additional borrowing programme announced later on by the central government. The economic consequences of the unfolding crisis will also mean that both domestic and foreign capital will be needed to ensure support to the economy as far as possible.

As announced in the Union Budget FY21, the Indian Government, in consultation with the Reserve Bank of India, has opened the 5, 10, 30 year maturity buckets with no limits, to the foreign investors. These bonds are termed as Fully Accessible Route (FAR) bonds. This is the first step towards global bond index inclusion. In light of these developments we take a look at the Chinese experience of inclusion in Global bond indices, and see if that can help as a roadmap of whether India will be able to attract the desired global investors and rake in the elusive capital it needs for a robust growth path in the medium term.

Emerging Markets (EM) local currency debt markets are highly concentrated in three countries China, India and Brazil. Of the three, the Chinese bond markets are the largest, with a total outstanding size of USD 14 trillion as of Dec 2019, and stand as the second largest bond markets in the world, recently overtaking the Japanese bond markets. Hence the inclusion of China in the Bloomberg Barclays Aggregate Global Bond Index has been in the spotlight. On 1st April 2019, the onshore China Government Bonds (CGBs) and policy bank bonds were included in three major indices published by Bloomberg, including the largest index i.e. the above mentioned Bloomberg Barclays Aggregate Index. The inclusion is to be done in a phased manner, and the Chinese bonds will achieve a target portfolio weight of ~6% by November 2020.



Source: Bank of International Settlements (BIS)

Opening China's Bond Markets: The integration of China, with global markets has been rapid, with significant economic gains. Though the speed of integration has been rapid on the trade side, China's financial markets have been slow to respond to the global financial markets, in terms of opening up. The Chinese policymakers have undertaken the task to make access to the Chinese bond markets easier, through initiatives like the "Bond Connect" only recently. These reforms are a part of a larger policy framework to open the economy on both the aspects of trade and capital flows. The speeding up of the reforms also has its roots in the recent trade war between US and China. Similarly, the huge trade surplus of China is dropping and China will need foreign capital flows to support the economy and the currency, which is also one of the reasons for Chinese regulators to speed up the process of opening up.

Figure 1: The timeline of opening up of China Bond Markets

August 2010- The PBOC allowed foreign central banks , monetary authorties , and overseas RMB settlement and participating banks to enter the interbank bond market

In 2013, Qualified Foreign Institutional Investors (QFIIs) were allowed to invest in the interbank bond market within the aproved investment quota, Also, the scale of investment for Renminbi Qualified Foreign Institutional Investors (RFQIIs) was enlarged to fixed income products in the interbank bond market

In June 2015, the PBOC approved overseas RMB settlement and participating banks investing in the interbank bond market to conduct bond repurchase

In July 2015, restrictions on the investments of foreign central banks, international financial instituions, and SWFs were lifted to a large extent and issuance regulation converted to a filing system

In February 2016, restrictions on the investment quota of QFII to invest in the interbank market were abandoned

In July 2017 the Bond Connect started

Overseas investors investing in China's Bond Markets were exempt from corporate income tax and added value tax from November 2018 to November 2021.

Source: A brief introduction to China's bond Markets: Feng Lin et al, Analytical Credit Ratings Agency, February 2019

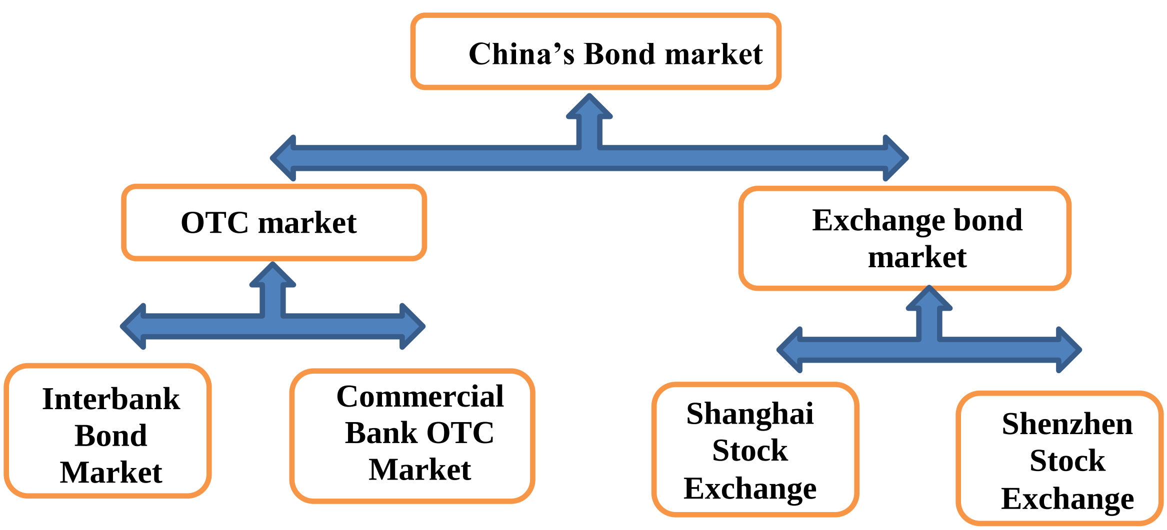
China's Market Microstructure: As mentioned above the size of the mainland Chinese bond market is huge with an outstanding of USD 12-14 trillion. Although that is the case, the markets were fragmented and the largest onshore markets were closed for foreign investors. The opening up of the Chinese bond market started with the Panda bonds in 2005. The pace of opening up in the bond market has been very slow and even today the extent of investor freedom, especially for foreign investors, is not on par with the advanced economies. Moreover the bond markets in China are highly illiquid because the major investors in sovereign bonds are commercial banks which by design hold a large part of the debt to maturity. Commercial banks held almost 56% share of the bond market as of end 2018. This has been a major hurdle in attracting foreign investors as they demand considerable liquidity especially in terms of having a smooth exit from the country exposure as and when needed.

China's bond market is a sum of three parts and this fragmentation is a key feature of the Chinese bond markets. The most familiar being the dollar denominated bond market, the size of which is roughly USD 300 billion, the second being the so-called Dim Sum bond market which is the offshore CNH denominated market worth roughly USD 80 billion. The third and the largest is the onshore renminbi (RMB) denominated bond market worth USD 12-14 trillion which has not been fully open to the foreign investors, and hence, has not been accessed by the international investment community till recent times.

The Chinese currency is also unique, as it has two aspects to it. The Renminbi or People's currency is the onshore official medium of exchange which is used exclusively in Mainland China. The unit of account for this official currency is the Chinese Yuan (CNY) and is strictly managed by the Peoples Bank of China. The official CNY exchange rate to the dollar and other currencies is fixed by the PBOC. The Renminbi is fully convertible on the current account but not convertible on the capital account.

The CNH, on the other hand, is the Chinese offshore currency freely traded in exchange markets around the world and its rates determined as per market forces of demand and supply. So, the CNY and the CNH may have different rates on any given day. Hence, the onshore bond markets are Renminbi (RMB) denominated, since that is the official currency used in Mainland China, while the Dim Sum bond market is mostly CNH denominated , which is the Chinese currency traded offshore. The "H" in CNH stands for Hong Kong, the deepest markets for the offshore CNH.

Figure 2: The organisation of the Chinese Bond Markets



Source: A brief introduction to China's bond Markets: Feng Lin et al. Analytical Credit Ratings Agency, February, 2019

The organisation of the bond markets is as follows:

- Interbank bond market is a wholesale market for institutional investors. This is the mainstream bond market onshore, mainly due to the large participation of commercial banks.
- The exchange market is a combination of retail and wholesale markets. The wholesale market is composed of a fixed income platform and bulk trading system.
- The commercial bank OTC market is a very small retail market for Treasury bonds and local government bonds.

Bloomberg's decision to include China in the index was based on the People's Bank of China (PBOC) and the Ministry of Finance and State Taxation, Administration completing reforms that increase investor confidence and improve market accessibility. These reforms included the following:

- Delivery Versus Payment
- Ability to allocate block trades across portfolios
- Clarification on tax collection policies.

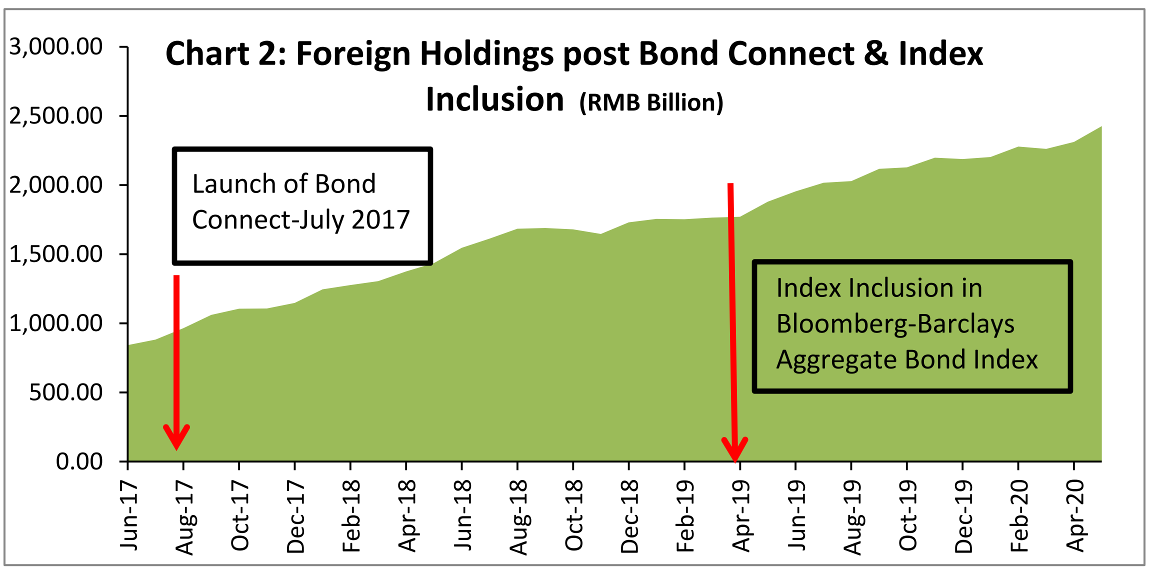
A key development for investors was the launching of the Bond Connect platform and the opening of the interbank bond market in China in July 2017. Bond Connect is a new mutual market access (MMA) scheme that allows investors from mainland China and abroad to trade in each other's markets, through the related mainland and Hong Kong financial infrastructure institutions[1].

Since the bond markets were fragmented and dominated by the commercial banks they had faced an issue of secondary market liquidity which has been corrected by the "Bond Connect". As noted above, the Chinese markets are divided into the interbank and the exchange traded bond markets. The dominant issuers are the government and its institutions, and dominant holders are the commercial banks. This scenario is slowly changing with the rise of fund investors. The PBOC and the other Chinese regulators have been proactive in helping investors but there are operational issues like:

[1] A brief introduction to China's bond Markets: Feng Lin et al. Analytical Credit Ratings Agency, February, 2019

- Onshore Currency Hedging
- Eligibility for pan-European Undertaking for collective Investment in Transferable securities (UCITS) funds
- And liquidity in off the run bonds.

Bond Connect: This was a key development for both the Chinese and international investors to trade both ways i.e. to and from mainland China. Bond connect was launched in July 2017, to open China's domestic bond markets to international investors, or Northbound Trading as it is called in China. Bond Connect is a trading platform established by the China Foreign Exchange Trade System (CFETS) which specialises in services related to the Renminbi trading products, and Hong Kong Exchanges and Clearing Markets (HKEX), which is the operator of the exchanges and clearing houses in Hong Kong, where most of the trading activity is settled in CNH. Bond connect provides mutual market access (MMA) allowing investors from mainland China and overseas to trade in each other's bond markets through a market infrastructure set up in Hong Kong.



Source:Bond Connect

Trading in China is classified as Northbound and Southbound, where "Northbound" trading indicates overseas investors trading in offshore markets especially Hong Kong, and settling in Renminbi, and "Southbound" trading indicates Mainland Chinese investors trading in the official Renminbi, to trade foreign assets. The Bond Connect started operation in July 2017, offering access to overseas investors to the China Interbank Market (CIBM), while southbound trading is still in an exploratory stage. Bond Connect offers offshore investors the access to all Cash Bonds in CIBM, which includes all the rates and credit bonds.

Table 1: Products offered in Bond Connect to International Investors

Rates	Credit
Chinese government bonds (CGBs) Local government bonds (LGBs) Policy financial bonds (PFBs)	Negotiable certificate of deposits (NCDs) Asset backed securities (ABS) Panda bonds Financial bonds Enterprises bonds CPs, SCPs, MTNs, PPNs, ABNs Others

Source: Bond Connect

All trades on Bond Connect are settled in the onshore CNY, and offshore investors can access their own funding in CNH or request the services of a foreign exchange settlement bank to convert FX into CNY at the onshore USD/CNY rates to settle Bond Connect trades. Offshore investors may also hedge FX exposure with FX Settlement Banks by engaging in various FX trades which match with the bond position. FX Settlement Banks may square positions in either offshore or onshore FX markets. The FX Settlement Banks are banks in Hong Kong approved by CFETS to access the FX market of CIBM as RMB participation banks. Offshore investors can contact their Hong Kong custodians, who will appoint one FX Settlement Bank for its FX conversion and hedging. To an extent, this takes care of the onshore currency hedging essential to foreign investors.

The FX conversion and hedging transactions are required to comply with the "genuine and reasonable" principle, solely for the purpose of Bond Connect investments. After investment, a similar proportion of CNY is required to be converted back into foreign currency, if not being re-invested in CIBM market again. This has made the Chinese domestic bond market accessible to the overseas investors as it has never been before, and the effect of the opening up can be seen in the international investment flows to China since 2017.

The issue of Credit ratings: An important issue for the international investor community is the bond credit ratings since China has its own credit rating system which is also highly fragmented like its bond markets. The regulation of these indigenous rating agencies is fragmented as well, which leads to a significant problem of credit rating inconsistencies across markets and regulatory borders. Hence since September 2018, the People's Bank of China and the China Securities Regulatory Commission announced the promotion of gradual unification of the credit rating industry. The initial credit ratings of bonds and issuers are generally between AAA and AA subject to the constraints of regulations and issuance.Usually, the ratings assigned by domestic rating agencies are on average, at least 5 sub-notches higher than the ratings assigned by international rating agencies[2]. This is a major drawback and even though the policymakers have announced a gradual unification of the various rating agency standards, the international investor community will be sceptical with regards to the credit quality of Chinese assets.

Macro Benefits for China: Research suggests that benchmark index driven capital flows are the dominant factor in today's highly globalised investment scenario. Almost 80% of the total capital investments are driven by the benchmark indices like the Bloomberg Barclays Global Aggregate Index and the J.P. Morgan GBI-EM (Global Bond Index – Emerging Markets). Hence inclusion in a global bond index like the ones mentioned above can be a game changer for any economy, especially for emerging markets where investment opportunities are many, though few are realised due to want of capital at an agreeable cost. The recent Chinese inclusion in the Bloomberg Barclays Global Aggregate Index is estimated to bring USD 150 billion to 400 billion worth of capital flows into China once the phased inclusion is completed by November 2020. This would also mean that other EMs, most notably India, has lost an opportunity to attract some of these capital flows. Further, the following benefits will accrue to China:

- Additional avenues for capital inflows will be created which will offset, to an extent, the potential outflows due to trade wars.
- Help in internationalising of the Renminbi following its inclusion in the IMFs SDRs
- Increased competition in the domestic capital markets

Even though, the size of the Chinese bond markets is huge as compared to developed nations, it has been underrepresented as a result of the unique and stringent regulations of the Chinese bond markets. International investors have not felt comfortable investing in the domestic debt markets of China. Notably, China has undertaken many reforms to make the domestic bond market accessible to investors, and yet the global investor community is not fully aligned with the idea of investing in China. As the case of the FTSE Russell Index indicates, its investors had refused to include Chinese bonds in its flagship government bond index in 2019. The index providers said that measures taken by the Chinese authorities to increase market access

[2] The inclusion of China into global bond Indices: Current Status and future Development- Chief China Economist's Office :Hong Kong Exchanges and Clearing Limited.

to foreign investors in government bonds "mark significant progress" toward China achieving inclusion in the FTSE Russell's World Government Bond Index, but investors had also given the feedback stating they would like to observe further improvements to secondary market liquidity and increased flexibility in foreign exchange execution and settlement of transactions.

Post Index-inclusion experience for China: The Bond Connect data shows that the monthly volume in May 2020 has increased to around RMB 468.2 billion (~USD 66 billion) from RMB 296.3 billion (~USD 41.84 billion) in September 2019, up by almost 58%, as foreign investors swarmed to the Chinese bond markets, mainly due to the wide yield differentials between US and China, and the inclusion of China bonds in global index like the Bloomberg-Barclays Aggregate Bond Index. It is also to the detriment of many of the other Emerging Markets like Indonesia (39%) and Malaysia (24%) which have a large foreign investment holding in their sovereign bond markets, as investors tend to choose safe haven assets like the CGBs, over less robust countries in crisis times. Also, tracker funds or funds which replicate the major global indices like the Bloomberg Barclays Aggregate Bond Index or the JPM- Emerging Market Bond Index will automatically tend to increase their holdings of Chinese assets in a bid to replicate the performance of these benchmark bond indices, which also has led to a robust increase in the investment flows from abroad.

Conclusion: As India opens up its domestic debt markets with the so-called Fully Accessible Route (FAR) securities, the Chinese experience may provide useful insight for policymakers. Notwithstanding the huge size of the Chinese bonds market and the plethora of reforms implemented by the Chinese authorities, investors will be wanting much more in terms of ease of accessibility, secondary market liquidity and most of all having a safe and easy exit option from domestic debt, as and when required. Policymakers in India have little choice as far as widening of the gates to foreign investors on the back of recent COVID-19 crisis and the relief packages announced, and the government will need all the capital it can get. Though in the near term India is faced with the Hobson's choice of opening up, the greater issue of opening up of domestic bond markets in particular, and full capital account convertibility in general, still loom large and will remain important and tricky points of contention as far as attracting foreign capital via the route of global benchmark bond indices is concerned.

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