China’s Integration with Global Capital Markets

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Here’s the question for Chinese capital markets: Broaden the onshore markets or broaden the offshore markets… or both? Can liberalisation keep up with a supply of new investment products? Offshore investors would welcome more financial vehicles, originated in China, (from both Chinese and non-Chinese issuers), but lack of integration between domestic and international markets is arguably holding up the next big development.

After decades of anticipation, we are on the verge of a new epoch. Although full implementation will take time, a two-way door is already swinging open, allowing for a glimpse of the future order. The dynamic represents a historic watershed, as the flows of investment corridors widen, more demands appear from both domestic and international participants.

The path to integration will inevitably twist and wind, but the underlying vision is clear. From the onshore perspective, robust and well-functioning capital markets are essential, to support liberalisation and spur economic growth. China’s “outgoing” trend is set to continue, and will require fresh sources of capital, which global capital markets can provide.

At the same time, offshore investors are recognizing China’s potential as a productive home for deploying their capital resources. China’s giant burgeoning market holds vast, unexploited opportunities.

The offshore RMB bond market has grown dramatically in recent years, encouraged by favourable interest rate and regulatory backdrops. Volumes have ballooned, from 2010, when the tally stood at RMB200bn, through 2012, when it reached RMB300bn. In just the short period, from 2013 to 2014, gross issuance jumped 43%, from RMB371 billion to RMB530bn as at the end of 2014. HSBC forecasts similar growth issuance for 2015.
China’s domestic bond market now ranks third worldwide, only trailing the United States and Japan, with the last year having achieved total outstanding amount of 34 trillion RMB.

**Onshore and Offshore Constituencies**

On and offshore markets will eventually converge, dovetailing as a unified structure. The onshore component, which is and will remain the significantly larger of the two elements, will play an increasing role in supporting the nation’s ongoing economic growth.

That economy continues to steam ahead. Recent growth rates may indicate a moderate slowdown, but levels of around 7% still represent a level to be envied in the eyes of other nations. Chinese onshore enterprises require capital infusions to preserve their momentum and growth trajectories. Mainland banks have been underwriting some of those needs, however the shadow banking system arguably may have to fill some of funding gaps. Yet mature growth ultimately depends on the efficient workings of capital markets, in particular on more note sales, which might attract international investors.

Reforms are being contemplated toward resolving domestic challenges. While the country harbours an enormous pool of savings, the next step is to leverage the skills of sophisticated global issuers and investors to boost capital market efficiency. HSBC has demonstrated sustained leadership and commitment to the development of infrastructure, liquidity and benchmarks for the RMB markets. We now acknowledge the dilemmas created by the current “chicken and egg” situation, and stand at the forefront for evolving more flexible structures and innovative solutions to match the demands of both issuers and investors.

At the moment, only a handful of channels exist for international investors to access the onshore market. Relatively few western issuers have managed to do so onshore, although the Asia Development Bank and the International Finance Corporation have been selling onshore RMB notes since 2005. Most domestic bonds have been vanilla in nature, and issued by government and policy bank entities.

We can, however, expect to see more in the corporate space. For example, German auto manufacturer Daimler AG in March 2014, broke new ground with its onshore bond for RMB 500 million, which was the first ever non-financial bond to be directed to Chinese investors as a private placement. Daimler intends to use those fixed income funds to refinance its Chinese business; it is renovating its Mainland factories for the manufacture of its Mercedes C Class sedan, engineered for Chinese customers. The onshore bond market is now likely to become increasingly active, as foreign companies seek to sell RMB debt onshore to fund their operations. Multinational companies should be able to raise large sums more efficiently and swiftly, avoiding complex remit procedures.

**Developing the Onshore Bond Market**

Chinese authorities have recently made progress along a number of avenues, which are proving fertile ground for attracting foreign capital for onshore purposes. Some of the areas receptive to new issuances include municipal bonds, asset backed securities, infrastructure funding and sustainable financing.

Municipal financing requirements have hitherto relied on central government funding provisions, but those days are drawing to a close. China must now foster its local fixed income markets, in order to fulfil the imperatives of regional infrastructure requirements. Under a less restrictive regime, city and provincial governments will accordingly be positioned to raise money themselves. In an important announcement, in May 2014, the Chinese government, through the Ministry of Finance, decreed that municipalities would now be allowed to issue local bonds directly. As the government increases the number of provinces entitled to do so, funding should no longer need to depend solely on Local Government Finance Vehicles.

Securitization is an essential tool in the modern financial system, for banks and companies to utilize their balance sheets to free up additional capital. That capital can then be directed toward new enterprises. As securitized structures can help to create an abundance of projects for investors, asset backed financing also helps to nurture further economic expansion.

China initially allowed foreign banks to participate in Asset Backed Securities (ABS) offerings in late 2013, and since that time, HSBC has been also been a leader in this field leveraging our international knowledge and expertise. Clearly, the time beckons for further deregulation. To help propel the movement toward integration, regulation must be enacted to open ABS to foreign institutions as lead underwriters as well.

A third issuance leg involves infrastructure funding, which by its nature becomes inextricably linked to sustainability concepts. The two sectors are often interdependent, because many of the methods designated to deliver green results fall under the infrastructure remit, such as building plants to treat waste water or to generate clean energy. China is keen to develop a functional green bond markets domestically, while it recognises the importance of parallel opportunities available in the wider global market.

In terms of sustainable financing, China is expected to need to raise up to USD 234 billion per year for operations to curb the impact of climate change and to invest in low-carbon development. Those projections are cited in a report commissioned by the Chinese government’s powerful National Development and Reform Commission, and prepared by The Climate Group (2013). Green and/or infrastructure bonds offer promising opportunities that will be appealing to a wide base of investors in China, both on and offshore.
The Road to Convertibility

Initiatives are well under way to liberalise the Chinese capital account, which would eventually allow residents and non-residents to engage in cross-border asset transactions, based on a freely convertible currency. The current account is already fully convertible. Contrary to perceptions, though, the capital account is also already 85% convertible, with only 4 out of its 40 subcategories remaining unconvertible.

While trade settlement in RMB has dramatically increased, only a small proportion is yet denominated in that currency. Reform has allowed much progress to be made across exchange rates, interest rate liberalisation and other aspects. Meanwhile the Shanghai Free Trade Zones have now been expanded at a national level.

On and offshore markets continue to operate separately but are indeed converging at last. Quota based qualified investor programs, the so-called “Q” schemes, allow foreigners to buy Mainland stocks, bonds and money market instruments. Most recently, the transformational pilot program Stock Connect was initiated in November 2014. This cross-border investment channel provides a platform into China, permitting Hong Kong investors to trade specified eligible Mainland shares, using local brokers and clearing houses. To some extent, Stock Connect is bypassing all the Q schemes, and is certainly facilitating flexible access, faster and more efficient transactions for eligible stock to be invested. Shezhen is soon to join Shanghai to connect with Hong Kong. But more ‘connectivity’ is still awaited, and expected to be achieved with potential connections for fixed income, ETFs, commodity and derivatives.

China is making strides in achieving best practises via international connectivity. During the sixth UK-China Economic and Financial Dialogue in London in November 2014, leading public and private representatives met from both countries, particularly banking and financial sectors. They agreed to improve co-operation directed to globalizing the RMB and specially to drive the onshore capital market development with specific work plans outlined above. The self-regulatory organization National Association of Financial Market Institutional Investors of China (NAFMII), authorized by the Peoples Bank of China (PBOC), represents market members. Together with the International Capital Market Association, NAFMII is supporting this private sector working group to forge a closer dialogue between China and other global markets.

Conclusion

The challenges remain though...

State-owned and private companies, as well as local government, still feel an intense level of credit pressure in the onshore market. (At least RMB2.1 trillion in local government debt needs to be refinanced this year alone.*) That is one of the reasons why the People’s Bank of China undertook a large cut in the bank’s reserve requirement ratio in April this year, together with all the other previous easing measures. Many expect that the central bank may directly buy commercial bank assets to drive down borrowing costs, in a move similar to quantitative easing. The difference is that QE was introduced when rates hit zero; rates in China are much higher.

The recent stock market boom has acted as a major counter-cyclical force, by helping to ease some corporate funding needs, but many structural issues still need to be resolved. Some examples include establishing a default mechanism, improving the rating system, rationalising the implicit guarantee between corporates and the government, and diversifying the investor base. In spite of the substantial progress that has been made, the era of direct debt financing in China remains at an early stage. (Note that there has yet to be a default for a publicly issued debt instrument. All the near defaults on principal have resulted in bail-outs by either regulators or third parties.)

It is certain, however, that further reform of the onshore capital market will be instrumental for China’s global capital market integration - and more importantly, that the new Chinese government has already demonstrated their firm commitment to that path.

*Chinese National Audit Office 2013 Audit (Quoted in HSBC Research paper: China’s Local Government Debt, March 2015)