China's Global Integration - Developments in China's Onshore RMB market

Thank you Martin for your kind words

It is a pleasure to be here today….. I'm grateful to be given the chance to share a platform with such a quality set of speakers.

I'm also particularly pleased that I get to talk about a subject that is so dear to my heart - China's global integration – probably THE defining event of this century and is core to ICMA's future strategy.

China's globalisation presents an unprecedented opportunity for the world's business and capital markets community. And as China continues to integrate with international markets and increasingly influences global policy making, we will all be profoundly affected.

The opportunities presented by China globalizing falls into two broad categories:

- Those arising from China going out into the rest of the world and
- Those from within China itself.

It is the second of these that I will be focussing on today.

Onshore opportunities

Both the Chinese Government and the international community share the same view that ultimately both onshore and offshore markets will converge.

We will hear later from Mingyou Bao, Chief Representative of the People's Bank of China in Europe, how strong the level of dedication is from Chinese authorities to make this integration a great success.

Now, the onshore capital markets need, and *are,* rapidly making progress towards global integration.

The onshore bond market is already the third largest in the world in terms of total bonds outstanding, and it continues to show strong growth potential.

The bond market however remains dominated by the central government and policy banks, who represent the majority of issuers.

This is rapidly changing though, in 2000 c. 98 % of issues were from government or quasi-government bodies. Last year this was down to 55% as more and more corporates look to tap the bond market.

Rapidly changing dynamics, such as this, lead to some truly exciting opportunities, and I see **five key areas** that show real promise and require real actions in China's onshore markets.

The first, and I have already touched on this, is the **corporate bond market**. There is enormous strength of will from the Chinese authorities to continue to develop this market, to diversify credit risk currently concentrated in the banking system.

Regulators continue to relax restrictions and simplify approvals to make it easier for corporates to issue debt. Including this past January when the securities regulator issued new rules allowing all firms with a shareholding structure to issue corporate bonds.

There remain key unresolved issues, however. Including the fact that corporate bonds cannot be traded in the interbank market, by far China's biggest bond market.

The second exciting area of development is the **municipal bond market**.

Some believe in this more than others, but the rationale is simple - China needs to solve its local government debt issue.

This year local governments were given a RMB 600 bn quota for bond issuance. We also saw recently an enormous debt swap programme through which local government bank loans were swapped for bonds.

This scheme included a crucial development that local government bonds are now eligible for repo collateral. The effect of this is that banks can obtain cheaper funding and local government debt has become increasingly attractive.

Jiangsu province kicked off the new municipal bond programme last month, completing a landmark bond sale of more than RMB 52 bn, with a very attractive cost of funding.

We are sure that we could see many more such issues in the near future.

The third area relates to **infrastructure and sustainable financing**. Internationally the Chinese government has made some powerful signals about how seriously it takes infrastructure. Profoundly demonstrated by its establishment of the Asia Infrastructure Investment Bank (AIIB) and attempts to develop a new silk road, opening new land and sea trading routes. These initiatives will further integrate China's financial markets with the rest of the world.

Now China's rapid economic development has meant that it urgently needs solutions to the pressing environmental challenges that this development has contributed to.

For China to achieve a low carbon/green economy it needs for sustainable growth it will require a huge amount of infrastructure, and crucially funding.

The Development Research Centre of the State Council (DRC) has recently estimated that ‘green development’ in China will require an annual investment of RMB 2trn.

Now I believe that Green Bonds have great potential to help close the investment gap and raise critical finance for sustainable infrastructure projects.

Around USD 8bn of outstanding Chinese corporate bonds already have links to green themes. And we are set to see significant growth in this sector.

ICMA has been doing on developing the green bond market and the critical publication of a set of green bond principles and more is needed for sure.

And China has been hard at work setting the foundations for sustainable green finance markets. We have seen ‘Green Credit Guidelines’ from the banking regulator (CBRC); guidelines for energy efficient lending; and recently the establishment of a Special Green Task Force within the PBoC.

Interestingly the taskforce will look at incentive structures, including tax measures and possible RWA exemptions to encourage a green bond market. This makes China the first country in the world to link incentive structures with green bonds.

The opportunities here are not just limited to green bonds, there is also great potential for green lending, green securitisation and possibly set up its own China Green Investment bank and link with AIIB to support the country's ongoing infrastructure needs and help drive the latest 'one belt, one road' national initiative,

Which brings me nicely to my **fourth opportunity**, **<u>asset backed securities</u>**.

The ABS market in China is surging.

Last year it expanded from RMB 13 bn to 285 bn. And is expected to expand even further this year.

There is significant regulatory support for this market, with recent simplifications in the approval process, and greater participation from new types of issuers.

The authorities are keen to give lenders an enhanced toolkit to help them dynamically manage their balance sheets. ABS allows them to efficiently manage their assets, while minimising the need for new liabilities.

We have seen rapid growth in this market, because there is increasing acceptance among domestic issuers and investors, but also greater participation from foreign investors through the 'Q schemes'.

HSBC was the first foreign bank to issue Chinese ABS and we look forward to seeing this blossoming market develop further.

My fifth and final opportunity is the **onshore equity market**.

Perhaps less of a focus on for the audience today but very important for us to appreciate. The current total market capitalisation for China A-Shares is USD 4trn. HSBC expects this to expand to USD 10trn by 2020.

The market has remained bullish even during the relative economic slowdown and new cross-border channels look to encourage further demand.

In November last year we saw the Shanghai-HK Stock Connect, through which we have seen steady flows from Hong Kong to the mainland.

Flows from the mainland, though, remain subdued, but we expect this to pick up as domestic investors become more familiar with the new investment opportunities.
Recent development on China/HK 'mutual fund recognition' and FTSE launches 2 transitional index etc.
We will soon see a stock connect between HK and Shenzhen, which is particularly exciting due to Shenzhen's focus on

technology and small cap stocks. We estimate very conservatively c. RMB500bn funds flow to HK just from Chinese domestic asset managers. But this is just the beginning – we could expect potential bond connect, commodity connect, derivatives and cross border ETF connect etc.

[Conclusion – link with Reforms]

Now these are all fantastic opportunities, but there remain risks and there remain significant barriers. The Chinese government though has shown a great dedication to liberalisation of its financial markets and we have only seen this pick up pace over the last year.

There are clearly challenges with many are structural issues, and we can debate endlessly about what we can and can't do to overcome them.
So what areas do we think require further attention?

I think **firstly credit rating** is an important area. Only 32% of onshore bonds have a rating and the market is dominated by domestic rating agencies.

Ratings are critical to give investors accurate information about potential new assets. And if ratings do not accurately reflect an issuer's quality then how can they adequately price those investments?

Better rating information will attract new investors and develop greater trust in the market.

A second key area is the **<u>lack of a comprehensive default mechanism</u>**. There remains an implicit state guarantee, which protects investors in the short term but is detrimental to the long term development of China’s capital markets.

Investors are drawn to high-yielding products without carrying out significant due diligence. This disadvantages high quality issuers that deserve lower yields.

It also exposes investors to risks should it transpire that those guarantees don’t materialise.

Another area is the **lack of investment choices and still fairly restricted access** for the onshore market. ICMA/NAFMII WG is making progress but lots of more need to be done on both sides. It’s often ‘Chicken/Egg situation’ but one has to lead and break the ice.

Greater participations from foreign institutions will help spur this on, and more cross-border issuance & investment channels will further add to the momentum.

I think these challenges, though, will be corrected as more market discipline enters China’s financial system. ICMA members have considerable knowledge and expertise that China needs and mutual benefits could be created.

Many of us here today, of course HSBC has been leading this and continue inspire to be at the forefront of China's journey and I hope everybody in this room could actively explore and involve as we explore the endless new opportunities presented by this blossoming market.

There will be a few bumps along that road, but China's integration with the international financial system is an unprecedented event that is going to change global markets irrevocably.

I'll be back shortly for a discussion with Mingyou Bao from the PBoC, but before then I will hand you over to Deputy Secretary General Jianhong Liu of NAFMII.

Thank you.