

Asia FI & FX Strategy Watch

Get ready for Swap Connect

One step further towards enhancing mutual market access

On 4 July 2022, financial regulators in mainland China and Hong Kong released a joint announcement on the new initiative of Swap Connect. Following the success of Stock Connect and Bond Connect, the announcement marks a further step in enhancing mutual access by allowing offshore and mainland investors to trade financial derivatives offered in each other's market. Similar to the two-phased setup of Bond Connect, the northbound trading of Swap Connect will be launched first, offering overseas investors the access to interest rate swaps (IRS) traded in the onshore interbank market at the initial stage. The original target launch date was early January, but there has been some delay and the market now expects an official kick-off in the coming months.

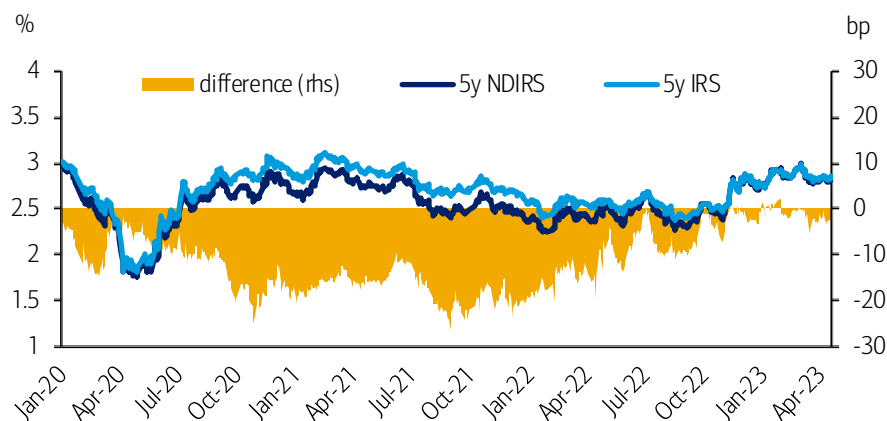
Synergy between Swap Connect and Bond Connect

As of February 2023, offshore investors hold about CNY3.2tn onshore bonds, mostly in central government bonds and policy financial bonds. Eddie Yue, the chief of HKMA, commented that *'Swap Connect will create synergy with Bond Connect to facilitate global investors' management of interest rate risks for their bond investment on the Mainland'*.

Offshore investors have been using non-deliverable interest rate swaps (NDIRS) to hedge against interest rate risks of their underlying China bond positions and express their views on China economy. Since the announcement of Swap Connect, the gap between 5y NDIRS and IRS has narrowed meaningfully (Exhibit 1). Once Swap Connect is officially launched, any rate differences between onshore and offshore swap rates market would likely attract arbitrage flows, which in turn should help compress the gap.

Exhibit 1: Spread between 5y NDIRS and IRS

The spread has narrowed meaningfully after the announcement of the Swap Connect initiative



Source: Bloomberg, BofA Global Research

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21 April 2023

GEM FI & FX Strategy
Asia

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

HKMA – Hong Kong Monetary
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Overview of onshore IRS market

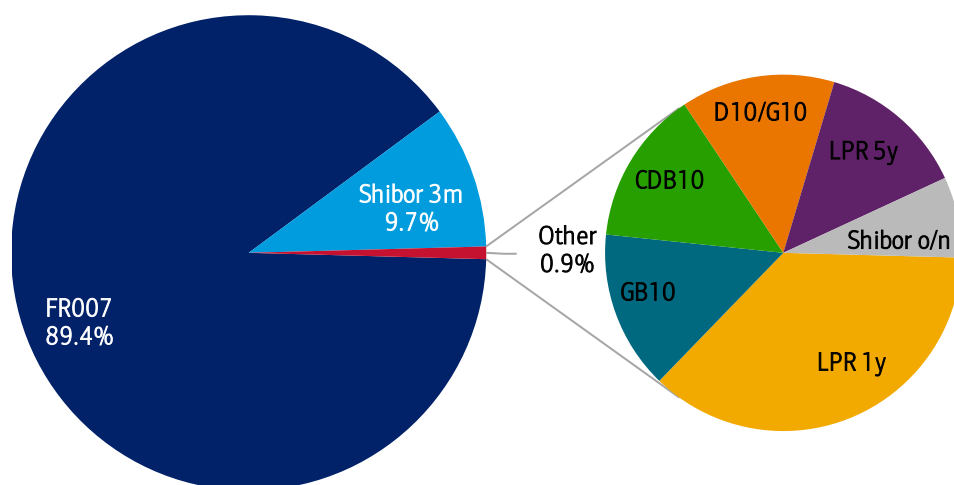
Interest rate swap products debuted in the onshore interbank market back in 2006 and have been growing steadily in terms of market size and product offerings. In 1Q 2023, total notional principal traded reached almost CNY8tn, an 82% increase from a year ago.

Despite the wide varieties of reference rates available, in practice, the onshore swap rates market is heavily dominated by 7d-repo fixing (FR007) IRS and complemented by 3m Shanghai Interbank Offered Rate (Shibor) IRS (Exhibit 2). Loan prime rate (LPR) swap rates were also introduced to the market in recent years, which have the potential to serve as an instrument to gauge market expectation on policy rate changes. However, lack of market participation and thin liquidity remain big issues for LPR IRS.

- **FR007** stands for 7-day repo fixing rate, which is calculated based on repo transactions among all financial institutions in the interbank market between 9:00am and 11:30am. The following tenors are offered for 7d-repo IRS: 1m, 3m, 6m, 9m, 1y, 2y, 3y, 4y, 5y, 7y, and 10y. 1y and 5y are the most-liquid tenors, contributing 42% and 25% of total notional principal transacted in 2022, respectively (Exhibit 3).
- **Shibor** series are unsecured wholesale interest rates. They are calculated by taking the arithmetic average of quotations submitted by 18 banks, after excluding the four highest and four lowest values. Available in eight tenors from overnight up to one year, Shibors are announced at 11:00am each business day. The following tenors are offered for 3m-Shibor IRS: 6m, 9m, 1y, 2y, 3y, 4y, 5y, and 10y. 1y is the most frequently traded tenor, followed by shorter tenors like 6m and 9m (Exhibit 4).
- **1y and 5y LPR** were introduced in August 2019 to replace the benchmark lending rate as the reference rates for bank loans. They are determined based on the quotes submitted by 18 quoting banks. LPRs are announced on the 20th of each month at 9:15am. The following tenors are offered for 1y/5y LPR IRS: 6m, 9m, 1y, 2y, 3y, 4y, and 5y.
- **Other reference rates:** GB10 (10y CGB yield), CDB10 (10y CDB yield), and D10/G10 (spread between 10y CDB and 10y CGB).

Exhibit 2: Market structure of onshore IRS market

The market is heavily dominated by 7d-repo fixing (FR007) IRS and complemented by 3m-Shibor IRS



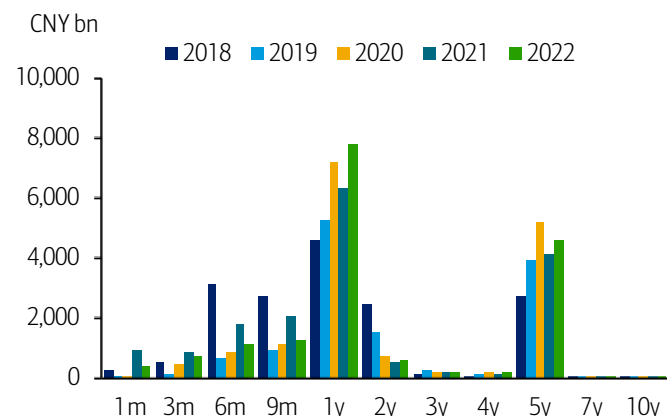
Source: CFETs, BofA Global Research

Note: Shibor - Shanghai Interbank Offered Rate; GB10 - 10y China government bond (CGB) yield; CDB10 - 10y China Development Bank bond (CDB) yield; and D10/G10 - spread between 10y CDB and 10y CGB.

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Exhibit 3: Notional principal of 7d-repo IRS

1y and 5y are the most widely traded tenors

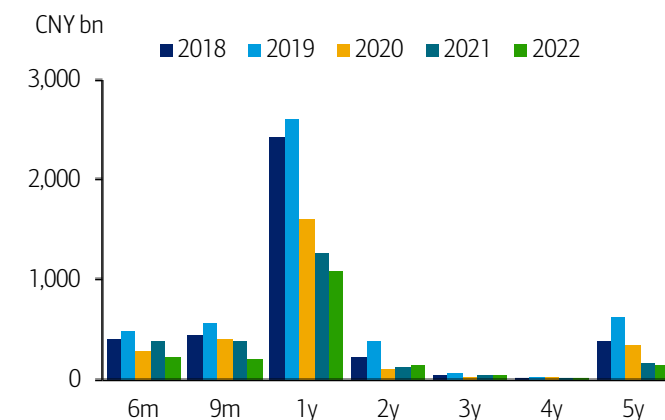


Source: CFETS, BofA Global Research

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Exhibit 4: Notional principal of 3m-Shibor IRS

1y is the most frequently traded tenor, followed by shorter tenors like 6m and 9m



Source: CFETS, BofA Global Research

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Potential mutual benefits of northbound trading

Once officially launched, offshore investors would gain access to the onshore IRS market, which has greater market depth compared with NDIRS. As shown in Exhibit 5, the average bid-ask spread is 0.25bp for 7d repo IRS, which is much narrower than the bid-ask spread of NDIRS. That said, one thing to note is the average ticket size tends to be larger in the offshore space. From the onshore market perspective, just like other mutual access schemes, Swap Connect and the participation of overseas investors would help diversify the investor base, improve price discovery, and further increase market liquidity.

Exhibit 5: Summary statistics of China onshore & offshore interest rate swaps

7-day repo swaps have gained market share and are the most liquid

Product	Avg daily trading volume	Avg transaction size	Bid-Ask spread
Interest Rate Swap (7d repo)			
1-year	CNY50bn	CNY140mn	0.25bp
5-year	CNY25bn	CNY40mn	0.25bp
Non-deliverable Interest Rate Swap (7d repo)			
1-year	CNY3-5bn	CNY 500mn	1.5bp
5-year	CNY1-2bn	CNY 100mn	1.5bp
Interest Rate Swap (3m Shibor)			
1-year	CNY6bn	CNY120mn	2-3bp
5-year	CNY0.6bn	CNY40mn	2-3bp
Non-deliverable Interest Rate Swap (3m Shibor)			
	n/a	n/a	5-10bp

Source: CFETS, BofA Global Research

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