Mainland-HK Bond Connect

to attract HK retail investors

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China's plan to introduce a bond trading link between Hong Kong and Mainland allowing mutual market access by year-end is likely to attract the city's retail investors, who chase for higher interests for their capital.

Maytree Poon, a Public Enquiry Service officer from Hong Kong Monetary Authority said they were currently studying a "bond connect" scheme with relevant Mainland authorities, with a view to further facilitating the participation of investors of both places in the bond markets and enhance the connectivity between bond market infrastructures.

Last year, China opened up its inter-bank bond market to foreign institutional investors, providing them with a flexible way to access the onshore bond market.

Therefore, the bond connect may be more suitable for retail investors or investors who would like to test the water by small investment. "Mainland bond's coupon rates are higher than Hong Kong's, so that the mainland bond market will attract Hong Kong's retail investors," said Thomas Fung, an analyst of Ample Capital. Also "the minimum cost is expected to be significantly lower than the purchase of ordinary bonds in the bank," he added.

However, the exposure of foreign investment in the Mainland bond market remains small, accounting for only1.2% of the market by the end of last year.

Financial columnist Lydia Tong said the choice of Hong Kong bond market is too few. She said, "In addition, more and more people will be retiring in the future. As long as the bond sale of convenience, the cost is not high, they want to have low-risk investment options."

The bond connect will bring benefits to Hong Kong. China's Premier, Li Keqiang said earlier this year, that the scheme will "help Hong


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Kong maintain its status as an international financial center, and provide Hong Kong investors with more options."

The new policy will allow mutual market access for both Mainland and Hong Kong retail investors to invest in each other's exchange-traded bond market under the prototype of the Stock Connect scheme and OTC bond market by opening and maintaining a special trading account with designated banks.

According to People's Bank of China, foreign retail investors currently can only invest in the Mainland's bond market indirectly through investment in QFII or RQFII funds, focusing on the Mainland's bond market. QFII allows institutional investors to invest in a limited scope of cross-border securities products. RQFII allows the use of RMB funds raised in Hong Kong by the subsidiaries companies and securities companies in Hong Kong to invest in the mainland securities market. Neither QFII nor RQFII investors are keen on investing in the Mainland's bond market. The total QFII quota is USD 80.1 billion and the total RQFII quota is USD 471.4 billion until to 2016. Also, the average trading volume of the four RQFII ETFs investing in the Mainland's bond market was only 1% of the overall average trading volume of all ETFs listed on the HKSE.

Fung said this scheme can help mainland bond market to attract foreign investors but there are also some downsides. Overseas retail investors are not familiar with mainland bond market, the crisis of increase of interest rate globally and the devaluation of yuan would affect the interest of investing mainland bonds market. These factors would dampen the interest for retail investors at the beginning of the implementation of bond connect. Fung expected it will take one to two years for foreign investors to familiarize with the bond connect before it can help Mainland bond market attract foreign investment.

This policy might not have a major impact on Hong Kong's bond market as a whole because the size of the market is small, Tong said.

Hong Kong has an open bond market, but its size of around USD 400 billion is much smaller than Mainland's market size of USD 8.7 trillion. According to the Hong Kong Monetary Authority, one of the insufficient about Hong Kong's bond market is that under the principle of prudent financial management and higher requirements of rating systems, the circulation of bonds is low. Moreover, with complex procedures of circulation of bonds, the above factors will affect the interest of company borrowers and bond financers. So Lydia believed there would only be foreign capital inflows into the mainland bond market, and not too much mainland funds into Hong Kong via Mainland-Hong Kong bond connect.

Tong said, "the main target of Dim Sum Bond has always been institutional investors. But the main target of bond connect should be retail investors. So there is no serious impact on Dim Sum Bond after implement of bond connect."

But Fung said "After the policy implement, mainland companies will use bond connect to finance instead of Dim Sum bond because the high return in mainland local bond market is more attractive. Also, the devaluation of RMB will bring less interest to global retail investors to buy RMB bonds including Dim Sum bond." The yield of ten-year bonds in mainland about 3.343% is much higher than Hong Kong's 1.475%.

Tong said the low demand for Mainland debt investment by foreign investors was due to tight capital account in the past.

Fung said Mainland bond lacks an internationally acceptance rating system was one of the reasons why foreign investors holding back. The Mainland's bond market has not opened to overseas rating agencies so far.