NORTON ROSE

The Market for Dim Sum Bonds

FINANCIAL INSTITUTIONS · ENERGY · INFRASTRUCTURE, MINING AND COMMODITIES · TRANSPORT · TECHNOLOGY AND INNOVATION · PHARMACEUTICALS AND LIFE SCIENCES

Briefing

February 2012

Introduction

The dim sum bond market, the first offshore market for Chinese currency investments, has experienced a significant increase in transactions since 2009. Increased activity has been driven by a growing amount of Renminbi **(RMB)** deposits available for investment in Hong Kong and by a large supply of debt from issuers in mainland China. This article summarizes key features of dim sum bonds as well as regulations and developments in the dim sum bond market.

What is a dim sum bond?

These offshore debt instruments are named after the bite-size delicacies served in Hong Kong tea houses. Denominated in Chinese RMB and issued in Hong Kong, dim sum bonds represent a growing portion of China's total local-currency debt.

Dim sum bonds (bonds issued in Hong Kong by Chinese and international companies) are structured to avoid Hong Kong and People's Republic of China **(PRC)** regulators' securities laws. All that is required to participate in this market is a Hong Kong Monetary Authority **(HKMA)** settlement account. The requirements for obtaining such accounts have been easing over time.

There are two types of debt instruments collectively known as "dim sum" bonds: (1) retail bonds when settled in RMB, and (2) synthetic bonds when settled in other currencies such as U.S. dollars.

Retail Bonds – Since 2007, banks in the PRC and locally incorporated subsidiaries of PRC banks in Hong Kong have been allowed to issue retail bonds in Hong Kong under an annual quota system. The system is subject to approval by the PRC central bank and the PRC National Development and Reform Commission, the regulator of foreign debt. These retail bonds are often issued in the Hong Kong domestic market under a registered prospectus for retail investor participation, along with an institutional tranche as well. The RMB proceeds are then taken back into the mainland. In October 2011, Baosteel Group Corp., a major iron and steel producer in China, became the first PRC nonfinancial institution to receive approval to issue retail bonds in Hong Kong.

Synthetic Bonds – No Hong Kong or PRC approval is required to issue these bonds in Hong Kong. The first synthetic RMB bond was issued in July 2010 by Hopewell Highways Infrastructure. As of May 2011, there have been some two dozen issues of RMB eurobonds. The list of multinational issuers now includes, among others, the World Bank, McDonald's, Unilever, BP, Volkswagen, and Tesco.

Dim sum bonds usually have short tenors of three years or less, possibly reflecting investors' expectations for the period of future RMB appreciation as well as investors' preference for shorter tenors in the absence of long-dated, offshore RMB liabilities. Some sovereign and supranational issuances of dim sum bonds have had longer tenors: China's Ministry of Finance issued a five-year tranche in 2009 and the Asia Development Bank issued ten-year RMB 1.2 billion ($180 million USD) bonds (Aaa stable) in October 2010.

Why join the dim sum bond market?

The dim sum bond market has attracted issuers and investors for various reasons. Multinational companies, even those without a presence in China, can issue dim sum bonds to professional investors without seeking approval from either PRC or Hong Kong authorities. After issuing such bonds, multinational issuers may use their proceeds freely in Hong Kong without PRC regulatory approval. These international issuers may also use the proceeds to settle cross-border trades.

Complications can arise, however, when multinational companies seek to repatriate their retail bond proceeds into mainland China by way of an inter-company loan or as a capital injection. International issuers must obtain approval from a PBOC local branch and complete a basic registration with the local branch of the State Administration of Foreign Exchange **(SAFE)** before they can repatriate RMB-denominated proceeds into the mainland. Approval is granted on a case-by-case basis and can take up to 4-8 weeks. In contrast, issuers who seek to bring synthetic bond proceeds into the mainland need only complete a basic registration process with the SAFE. This latter type of SAFE registration is easy to obtain since the process is based on well-established guidelines.

Meanwhile, PRC-incorporated issuers can also take advantage of the relatively low financing costs of issuing retail bonds. PRC issuers must obtain approval from the PRC central bank and the PRC National Development and Reform Commission to issue retail bonds before they can bring the proceeds back into the mainland to support their pre-approved business operations.

PRC approval is not required for any investor, even international investors, to invest in dim sum bonds. This market has found its niche as an alternative investment opportunity for investors seeking to diversify their holdings. In the past, banks and institutional investors with accumulated RMB deposits could only invest in low interest deposit accounts. In addition, investors also use the dim sum bond market to bet on RMB appreciation.

How are dim sum bonds documented?

Dim sum bonds may be issued as either standalone regular Eurobonds or under existing medium term note programs, without PRC or Hong Kong regulatory approval.

The only differences between dim sum bond and Eurobond documentation lie in their repayment conditions. With Eurobonds, principal and interest payments are generally made in the currency in which the bonds are denominated. However, with synthetic bonds, issuers are allowed to make payments in a currency other than the RMB, usually U.S. dollars, in case they have trouble sourcing RMB. In the near future, the collective dim sum bond market is expected to move towards a consensus on the use of currency fallback clauses and other covenants.

In the meantime, investors should carefully consider potential business and regulatory risks associated with an issuer's operations prior to making their investments. As dim sum bonds are generally light on covenants and often not rated, there are risks involved with investing in bonds issued by less well-known companies with operations in China.

Overview of relevant Hong Kong and China regulations

The first retail bonds, denominated and settled in RMB, were issued in Hong Kong in 2007 after the People's Bank of China **(PBOC)** issued the "Interim Measures for the Administration of the Issuance of RMB Bonds in the Hong Kong Special Administrative Region by Financial Institutions within the Territory of China." Historically, only financial entities incorporated in the PRC were allowed to issue RMB bonds in Hong Kong, and only following prior governmental approval. All bond proceeds from such issues had to be taken into the PRC instead of remaining in Hong Kong.

However, this changed in February 2010, when the HKMA deregulated cross-border settlements in RMB between Hong Kong and the PRC by issuing the "Elucidation of Supervisory Principles and Operational Arrangements Regarding Renminbi Business in Hong Kong." The circular attracted a great deal of attention as it broadened the class of potential issuers for dim sum bonds. In July 2010, the PBOC and the HKMA expanded the scope of RMB banking and financial products in Hong Kong by signing the "Supplemental Memorandum of Cooperation." Later that month, Hopewell Highway Infrastructure (a Hong Kong listed company) issued the first synthetic bond by a non-financial, nongovernmental entity in Hong Kong. Since then, a growing list of non-mainland, multinational issuers, including McDonald's Corp. and Caterpillar of the U.S., have issued dim sum bonds in Hong Kong. In August 2010, McDonald's Corp. raised RMB 200 million in bonds to finance its expansion in China.

Meanwhile, the PRC has recently begun its push towards the internationalization of the RMB. On June 3, 2011, the PBOC issued the "Notice on Clarification of Issues Related to Cross-border RMB Business." The notice provides an update on RMB settlements of foreign entities' direct investments into China. One relevant change was the new requirement of PBOC head office approval for settlements of direct investments. In July 2011, China expanded its RMB trade settlement scheme. To facilitate the development of the offshore RMB market, the HKMA relaxed its 10 per cent limit on net open positions for RMB, removing restrictions on forex swap trading. These relaxations are expected to enhance liquidity in the offshore RMB swap and bond markets.

Recent regulatory changes

On October 14, 2011, market restrictions were once again relaxed when the PBOC and the Ministry of Commerce **(MOFCOM)** issued new rules governing foreign investment into China using RMB funds. The new rules opened a new channel for offshore RMB funds to flow back into the China market (including foreign direct investment cross-border financing). According to the HKMA chief executive Norman Chan Tak-Lam, these new rules will also expand the use of RMB funds in Hong Kong and is expected to further stimulate the bond market.

Significant points in the PBOC "Administrative Measures on RMB Settlement in respect of Foreign Direct Investment" are as follows:

- Onshore enterprises who receive foreign direct investments in the form of RMB funds must register these investments with local branches of PBOC to obtain a local certificate of approval and a business license. This repeals the requirements under the earlier PBOC Notice from June 3, 2011, which had required approval from the PBOC head office instead of the local branch.

- PBOC approval is no longer required for foreign-invested enterprises to incur RMB denominated foreign debts. Thus, PRC borrowers can now use RMB income to repay foreign debts directly through their banks.

- PRC banks handling account opening and cash flow matters must review and supervise the use of RMB funds paid into China as capital items in accordance with relevant existing regulations. Under existing SAFE regulations, foreign debts borrowed by a PRC enterprise cannot be used to repay its onshore RMB debts and registered RMB foreign capital injected into a PRC enterprise cannot be used for further onshore capital investment purposes (subject to limited exceptions).

- Foreign investors may also grant RMB funds as consideration to domestic shareholders in exchange for equity interests in PRC enterprises.

The MOFCOM “Notice on Various Questions related to Cross-border RMB Direct Investment” bintroduced the following important changes:

- Cross-border RMB foreign direct investment into China must not be used to invest in securities or financial derivative products or to arrange entrustment loans.
- Foreign investors are now allowed to use their offshore RMB funds to invest in PRC listed companies through private placement procedures or share acquisition agreements. Yet foreign investors are still subject to other existing regulations governing their strategic investment in PRC listed companies.

Market developments

Hong Kong was initially a testing ground for China’s financial reforms. Since then, it has grown to become a major offshore RMB financial center. Hong Kong is currently the only place in the world outside of mainland China that contains a closing center for dim sum bonds (the HKMA’s Central Moneymarkets Unit (CMU)) and has permission to issue dim sum bonds. The Euroclear and Cedel systems can serve international investors only because they have a link to the CMU.

The PRC policy to promote RMB use in the international market continues to fuel the demand for dim sum bonds. This trend of RMB outflow can be seen in cross border trade, offshore consumption by PRC residents, currency swaps, RMB cross-border trade settlements, RMB settlements of outbound direct investments, and the listing of foreign companies in China. As the availability of offshore RMB bank accounts and offshore pools grows, so does investor interest in dim sum bonds. Such high demand for these bonds in the past year, especially from private-banking clients, has led to an oversubscription of these issues. Meanwhile, Chinese issuers continue to save as much as 2-3 per cent on their dim sum bonds compared with their U.S. dollar borrowings at the start of 2011.

Developments in the dim sum bond market have been dramatic. In 2010, only 16 issuers issued RMB 36 billion in dim sum bonds in Hong Kong. Yet at the end of January 2011, a total of 31 RMB bonds were issued with an issuance size of around RMB 74.4 billion (about USD 11.5 billion). By the end of July 2011, the outstanding volume of offshore RMB bonds jumped to RMB 135 billion (around USD 21 billion) and is expected to reach RMB 200 billion (USD 31 billion) by the end of 2011, according to a recent IFR Asia Report.

Despite the recent drop in dim sum bond prices, the dim sum bond market is expected to continue to expand as long as there is a surplus of RMB deposits offshore. More multinational corporations may return for a second round of dim sum funding following the successes of U.S. heavy-equipment manufacturer Caterpillar, which printed its second deal in June 2011. More issuers may join the market simply to convert their dim sum proceeds into U.S. dollars at an overall, lower funding cost. There has even been interest from the Islamic finance world with the Khazanah RMB 500 million sukuk run by the Bank of China International Holdings Ltd., CIMB Bank and Royal Bank of Scotland. While there may only be rare demand for issuers who require an Islamically structured debt instrument (Khazanah is the Malaysian sovereign wealth fund which is keen to promote Islamic

finance), this issuance is only one of the many alternative structures available in the dim sum bond market for new investors. Additionally, there may be future opportunities for investors based in the Middle East looking to raise RMB funds for their Chinese investments.

In the near future, the PRC may even push for offshore RMB transactions outside of Hong Kong. London has already taken steps towards becoming the new offshore RMB trading hub for Europe as it recently attempted to secure a swap line with the PBOC. Following Kazakhstan's recent addition to the list, there are 12 countries that currently hold bilateral currency swap lines totaling RMB 841.2 billion with China for three years.

Conclusion

The dim sum bond market has experienced increased activity in recent years. Regulations in Hong Kong and China, as well as the path of development of the dim sum bond market, will continue to be crucial to the success of the market and will continue to be closely watched by current and potential participants.

Related contacts

Ji Liu
Partner
Hong Kong
Tel +852 3405 2458
ji.liu@nortonrose.com

Davide Barzilai
Partner
Hong Kong
Tel +852 3405 2543
davide.barzilai@nortonrose.com

Peter S. Noble
Partner, Norton Rose Group, Lawyer
London
Tel +44 (0)20 7444 5772
peter.noble@nortonrose.com

Tak Matsuda
Partner
London
Tel +44 (0)20 7444 2268
tak.matsuda@nortonrose.com

Sun Hong
Partner
Shanghai
Tel +86 (0)21 6137 7020
hong.sun@nortonrose.com

Thomas Vita
Partner
London
Tel +44 (0)20 7444 3695
thomas.vita@nortonrose.com

Michael Dunn
Partner
London
Tel +44 (0)20 7444 2634
michael.dunn@nortonrose.com

Andrew Bleau
Partner
Hong Kong
Tel +852 3405 2418
andrew.bleau@nortonrose.com

Glenn Hall
Partner
London
Tel +44 (0)20 7444 3613
glenn.hall@nortonrose.com

NORTON ROSE

Norton Rose Hong Kong

Norton Rose Hong Kong is part of Norton Rose Group, a leading international legal practice offering a full business law service to many of the world's pre-eminent financial institutions and corporations from offices in Europe, Asia, Australia, Canada, Africa, the Middle East, Latin America and Central Asia.