Investing in asset-backed notes through the Bond Connect scheme: a new channel to access the Chinese debt capital markets

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Hogan Lovells

Investing in asset-backed notes through the Bond Connect programme

Overview and background

In July 2017, Mainland China and the Hong Kong SAR launched the Bond Connect Scheme ("**Bond Connect**"). Bond Connect is a milestone in the liberalization of the Chinese debt capital markets, a significant opportunity for international market participants that allows overseas investors to access the Chinese domestic bond market under a much-simplified application process.

The Chinese bond market is the third largest in the world (only the U.S. and Japanese markets are larger), with an estimated RMB 76 trillion of outstanding domestic bonds (equivalent to about US$ 11 trillion). Through Bond Connect, investors from outside the PRC can invest in asset-backed medium term notes programmes, a type of securitisation product issued on the China Interbank Bond Market ("**CIBM**"). Here we discuss how they can do this,

What is Bond Connect?

Bond Connect is a mutual access scheme that allows non-PRC investors to access the mainland China bond markets ("**Northbound Trading**") and will, in time, assuming the issues can be worked out, permit PRC investors to access the Hong Kong bond market ("**Southbound Trading**") through market infrastructure linkages between mainland China and Hong Kong. Currently, only Northbound Trading is operational, allowing overseas investors to invest in bonds issued on the CIBM via mutual access trading, custody and settlement arrangements. Southbound Trading, whereby PRC investors will be able to invest in overseas bonds markets and therefore a form of outbound investment, will start at a later date, to be determined by the PRC authorities, when they feel 'conditions are ripe'. The delay in making Southbound Trading operational may be due to well-documented concerns about capital flight from China which has led to a raft of restrictions being imposed by various Chinese authorities on outbound investments by Chinese companies since the end of 2016.

What is its importance?

Bond Connect represents a significant liberalization of the Chinese debt capital markets. It does not replace, but rather complements the existing Qualified Foreign Institutional Investor ("**QFII**"), RMB Qualified Foreign Institutional Investor ("**RQFII**") and direct CIBM access schemes. However, in contrast to these other schemes, Bond Connect imposes fewer restrictions, including no minimum holding period, no quota limits and no repatriation restrictions. For more details on this, please refer to our note China unveils plans to open the domestic bond market to foreign investors.

How does Bond Connect work?

Prior to Bond Connect, foreign investors were required to go through an onerous process of submitting a qualification application, opening an account, applying for an RMB quota and finding a clearing agent with international settlement capacity before being able to access the bond markets. Bond Connect allows investors to register, trade and settle using existing onshore infrastructure in China. Before trading on the CIBM, investors need first to register as eligible foreign investors with the People's Bank of China ("**PBOC**") Shanghai Head Office. Once registration is successfully completed, no other formal approvals are required.

How does trading work?

Offshore eligible investors can input trading orders and instructions to the China Foreign Exchange Trade System ("**CFETS**") in China through the trading links provided by access platforms located outside China. Transaction orders can be executed electronically through any eligible onshore participating dealer that is a member of CFETS. Executed orders will then be sent to the Central Moneymarkets Unit ("**CMU**") for confirmation and matching. Shanghai Clearing House ("**SHCH**") / China Central Depository & Clearing ("**CCDC**") are responsible for settlement and clearing respectively. Investors need to obtain RMB offshore before investing, as the bonds are denominated in RMB, while the bonds themselves will be held in dematerialized form custody onshore in Shanghai.

What are the latest developments?

The launch of the delivery versus payment ("**DVP**") settlement system on 24 August 2018 whereby all Bond Connect trades cleared through CCDC will be settled on a real time DVP basis (i.e., payment for the bonds is due at the time of delivery) further reduces settlement risks substantially, and by removing friction, makes the investment process more efficient. This removes a major hurdle that had hitherto hindered the Bond Connect scheme in attracting overseas investors.

The introduction of DVP settlement was quickly followed by two further major enhancements to the scheme.

On 31 August, Bond Connect launched block-trade allocations, which allow asset managers to allocate block trades to multiple client accounts beforehand so that traders can now execute a single block trade but allocate specific percentages or amounts of the trade to up to 30 individual accounts. This improves the scheme's operational efficiency and simplifies the trading workflows for investors.

Another important development has been clarification on taxation of investments by overseas investors in the onshore PRC bond markets. Foreign institutional investors will be exempted from paying corporate income and value-added tax on interest income on their investments in the Chinese bond market for the next three years, based on a proposal made by the Standing Committee of the State Council on 30 August 2018.

These welcome new developments are expected to give rise to greater participation by global investors in Bond Connect.

What are asset backed medium term notes?

Asset backed securities is the generic name given to the asset class: there are various products within this asset class in China which are detailed below.

Asset-backed medium-term notes ("**ABNs**") are a form of debt financing instrument issued by a non-financial enterprise on the CIBM whereby an investor pays a capital sum to purchase the note, and the principal and interest are repaid by the issuer within a given period of time. Interest and capital payments due on ABNs are backed by the cash flows of the underlying assets.

China has four distinct ABS markets:

(i) Credit asset-backed securitizations ("**Credit ABS**") issued by banks and non-banking financial institutions through special purpose trusts on the CIBM; these are regulated by the PBOC and the China Banking and Insurance Regulatory Commission ("**CBIRC**", formerly known as the China Banking Regulatory Commission).

(ii) Corporate asset-backed securitizations ("**Corporate ABS**") issued by enterprises through special asset management plans ("**SAMP**"), mainly on stock exchanges; these are regulated by the China Securities Regulatory Commission ("**CSRC**"). Corporate ABS are not currently accessible through Bond Connect.

(iii) ABNs issued by non-financial enterprises through special purpose trusts or special purpose companies on the CIBM. Eligible underlying assets include trade receivables, lease receivables or trust beneficiary rights. ABNs are regulated by the National Association of Financial Market Institutional Investors ("**NAFMII**"), a self-regulatory organisation.

(iv) Asset-backed plans ("**ABPs**") issued by insurance asset management companies on insurance exchanges; these are regulated by the CBIRC. Underlying assets can be any assets that may directly generate independent and sustainable cash flows, such as property rights, or asset portfolios comprising property and property rights. This is a rather limited scope market.

The Credit ABS and Corporate ABS markets are the two main ABS markets in China. In terms of the distinction between (ii) and (iii) above, the scope of originators under the ABN programme is similar to that under the Corporate ABS programme, but ABN often use a special purpose trust structure, while Corporate ABS use a SAMP structure.

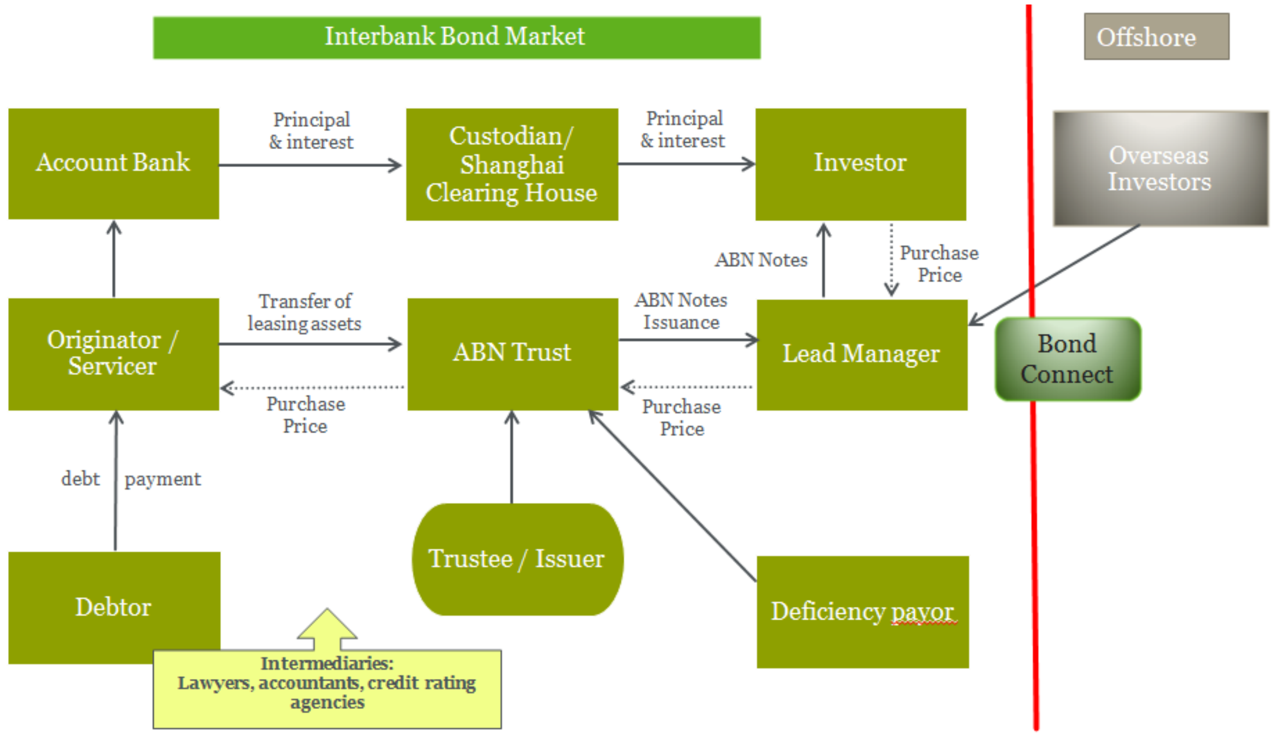
Category	Regulator and Approvals	Trading Market(s)	Issuers
Credit ABS (special purpose trust).	PBOC & CBIRC Registration & filing.	CIBM.	Banks and non-banking financial institutions.
Corporate ABS (SAMP).	CSRC Filing.	Stock exchanges, Inter-agency Quotation and Service System, National Equities Exchange and Quotations and OTC markets of securities companies.	Both financial and non-financial enterprises.
ABN.	NAFMII Registration & filing.	CIBM.	Non-financial enterprises.
ABPs.	CBIRC Approval (for initial ABP). Registration & filing (for subsequent ABP).	Insurance exchanges.	Insurance asset management companies.

What are the benefits of ABNs?

The ABN market supplements the Credit ABS and Corporate ABS markets. The ABN market has undergone rapid development in recent years, because it benefits both issuers and investors such that:

(i) non-financial enterprises have access to an alternative financing channel, reduced financing costs and are able to optimize their asset structure by securitizing their assets, such as trade receivables and leasing receivables; and

(ii) investors can diversify their investment portfolios by investing in ABN, as ABN can be issued through public offerings and via private placements.



What regulatory procedures do overseas investors need to follow?

Access to the CIBM market, and in particular the ABN market was formerly limited to domestic investors. Now the Bond Connect scheme enables overseas investors to gain access to this newly-emerging and fast-developing market. However, overseas investors must check whether they qualify using the following checklist before investing in ABN products via the Bond Connect platform:

Regulatory requirements for investing in ABNs via Bond Connect[1]	
Originator qualification	Non-financial enterprises are qualified originators of ABN notes.
Underlying assets	Trade receivables, leasing receivables or trust beneficiary rights not subject to pledges, security or other restrictions.
Revolving structure	ABNs are allowed to use a revolving structure.
Public offer or private placement	ABNs can be issued publicly or to targeted investors.

[1] Detailed regulations are set out in the *Asset-Backed Notes of Non-financial Enterprises ABN Guidelines* (*非金融企业资产支持票据指引*). Foreign investors are allowed to invest in all fixed income products traded on the CIBM, ABN being used here as an example.

Registration / Filing	Before the first issuance of ABN notes, originators (through a qualified underwriter) must file a registration application with NAFMII for an initial two-year validity period. Thereafter, registered originators only need to do a record filing with NAFMII (through a qualified underwriter) for all following issuances of ABN notes during such two-year period. Registration documents vary between issuances in the form of public offers and private placements.
Qualified investors for bonds issued on CIBM through Bond Connect Scheme	When filing for investment through Bond Connect, foreign investors must qualify as foreign institutional investors permitted to invest in CIBM. This is done by applying to PBOC Shanghai for confirmation of eligibility.[2] Offshore SPVs are now also qualified to invest in the CIBM through Bond Connect.
Lead underwriter	A lead underwriter selected from the NAFMII-designated list of lead underwriters must be selected for the entire ABN transaction.

How can Hogan Lovells help you?

Whether you are an issuer or an investor, our experience and skills can help you take advantage of the opportunities offered by Bond Connect.

Our International Debt Capital Markets practice is consistently recognized as a leading practice by clients and peers worldwide, including in Asia. We provide regulatory and transactional advice to issuers/originators, investors and underwriters on all aspects of the structuring and the issuance of ABNs via Bond Connect, the drafting and negotiation of the relevant underlying documentation, as well as coordination with lead underwriters, accounting firms and rating agencies. Furthermore, we are able to bring to bear our experience in other markets in Asia-Pacific, Europe and the United States in bringing cutting-edge emerging new debt capital markets products to market. Our practice is backed by our world-class global regulatory group, which provides us with a wealth of experience of working through the challenges of new and developing legal frameworks, and the ability to guide our clients when navigating their way through new market opportunities.

Conclusion

Bond Connect marks a milestone in the liberalization of the Chinese debt capital markets. Despite its rapid development in recent years, the ABN market remains modest in size compared to the Credit ABS and Corporate ABS markets, but we believe that making the markets available through the Bond Connect scheme will inevitably attract more overseas investors, thereby boosting the development of the ABN market in China. The first two batches of ABN available via Bond Connect were issued in August 2018.

We look forward to discussing Bond Connect Scheme and ABN product opportunities with you.

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[2] The eligibility application can be done by the foreign investor itself or with the assistance of Bond Connect Company Limited (BCCL), a joint venture between the China Foreign Exchange Trade System (CFETS) and Hong Kong Exchanges and Clearing Limited (HKEX) without cost.

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