The panda's affair with the dim sum

Zsanett Sütő

The gradual opening up of the Chinese financial market entailed the coexistence of not only two foreign exchange markets but also two bond markets. Onshore and offshore bond markets have followed different paths of development over the recent years. Foreign players have mostly been able to enter the offshore market (their bonds denominated in renminbi and issued in Hong Kong are the so-called dim sum bonds), however, the inclusion of the renminbi in the SDR basket (containing several currencies and used by the IMF as an international settlement unit), the changing Chinese interest rate environment and the continued financial liberalisation increasingly attracts the attention of issuers and investors to the onshore Chinese bond markets (where renminbi-denominated bonds from foreign issuers are called panda bonds). Since 2016 one of the main questions on the Chinese bond markets has been whether pandas will devour the dim sum. It seems that a more gradual process is unfolding, and this is not a dog-eat-dog situation (nor a panda-eat-dim sum one), therefore the two markets are now expected to coexist. The article examines the major characteristics of the two markets and the awakening of the panda market.

Bonds denominated in onshore renminbi (CNY) and issued by foreign players on the onshore bond market are the panda bonds, while those issued on the Hong Kong offshore market by foreign participants and denominated in offshore renminbi (CNH) are called dim sum. That is, not all onshore bonds are panda bonds but all panda bonds are Chinese onshore market bonds.

Due to regulation, the panda and dim sum markets are characterised by different degrees of openness, which is reflected in the issuers and investors of the respective markets, as well as in yields, the quantities issued and in other technical conditions too.

The onshore Chinese bond market is currently accessible by fewer investors and issuers than the offshore market. Although based on its size, the Chinese onshore market is among the largest bond markets in the world (Horváth–Teremi, 2015), the panda segment of the onshore market is in the 11-figure USD range, while the dim sum market is in the 12-figure USD range.

From the investor side, the scope of those with access to the onshore market was expanded in the 2010s. In addition to resident Chinese investors, first supranational institutions, central banks and other financial institutions meeting certain criteria, then since 2012 financial institutions possessing the necessary authorisation and quotas have had access to the Chinese onshore bond market. The expansion of the scope and rights of those holding quotas as well as the better utilisation of the quotas may contribute to the further improvement of the bond markets.

An important difference on the issuer side is that non-resident Chinese issuers are represented in greater proportion on the offshore market than on the onshore market. On the onshore market, the primary issuers are the Chinese state, the Chinese development banks and other Chinese resident institutions. One of the reasons for this difference on the issuer side can be attributed to the different degrees of openness between the two markets, which may explain why foreign players mostly entered the dynamically expanding offshore market. Nevertheless, 2015 saw a forty per cent drop in the issue rate on the offshore market, while the panda segment of the onshore market attracted more attention. The rules on the Chinese onshore market first enabled the participation of foreign issuers in the mid-2000s. The first issuers were the International Finance Corporation (IFC) from the World Bank Group and the Asian Development Bank (ADB). The first corporate panda bond was issued in 2014 when Daimler AG entered the market, then in 2015 the HSBC and Standard Chartered banks also appeared as issuers. The panda market is awakening, which may be supported by several factors.

SDR as the catalyst on the panda market?

Last year one of the most important developments in international finance was the **inclusion of the Chinese currency in the SDR basket** (effective from 1 October 2016). This not only signals the acknowledgement of China's international economic role but also foreshadows the further opening up of the financial market, which in itself **may increase the interest of foreign players in renminbi issues.** Hungary has also indicated its wish to issue renminbi bonds.

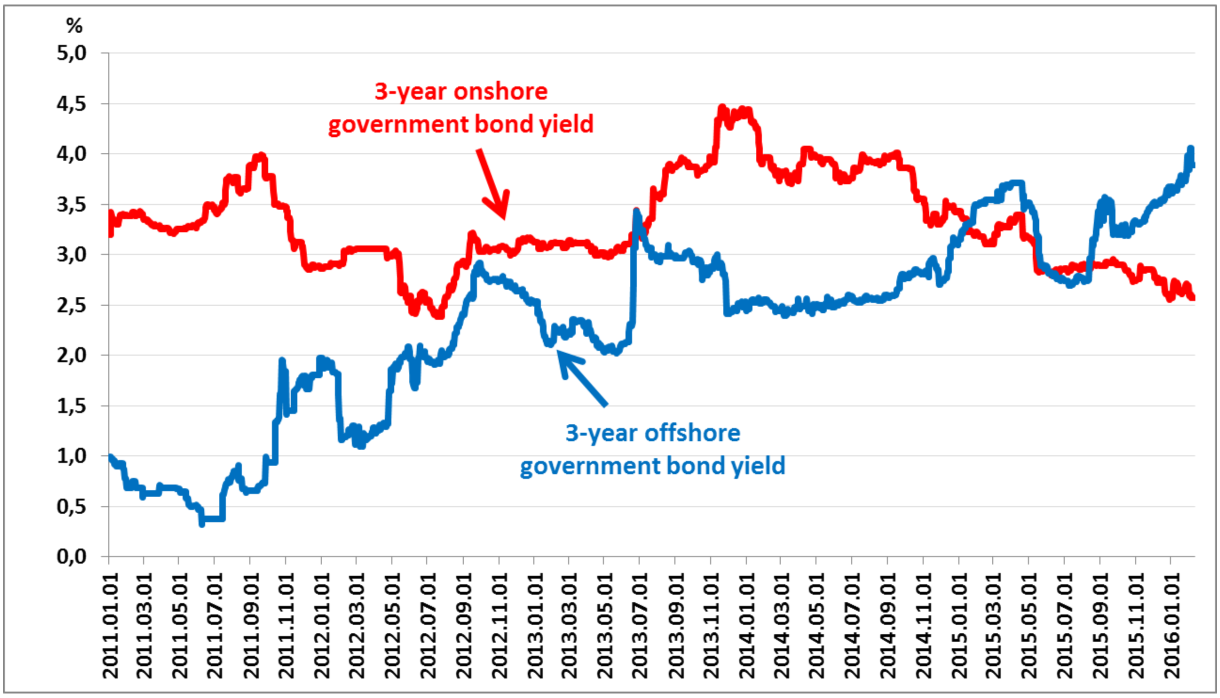
According to expectations, the onshore market will also increasingly open up for both issuers and investors. Out of the players that are already authorised to issue bond, the appearance of supranational and sovereign actors is expected. The developments in recent months also support this. At the end of 2015 South Korea was the first to issue sovereign panda bonds, which was followed by a bond issue by British Columbia, a Canadian province. In addition, Indonesia and Poland indicated their intention to issue panda bonds in January and February 2016, respectively.

Do yields count?

The chart below shows that **in the years following the launch of the dim sum market, there were significant differences in the yields on the panda and dim sum markets.** To put it simply, funding was cheaper on the offshore market than on the onshore market, which – in addition to several other factors – may have contributed to the fact that offshore market issues attracted considerably more attention. **However, in 2015 the advantage of the offshore market over the panda market started to disappear due to the combined effect of the fall in the onshore market interest rates and the rise in offshore market rates, and thus by 2016 the panda market has offered a cheaper source of finance for those considering to issue bonds.**

The slump in the onshore market rates may be attributed to the monetary easing measures of the Chinese central bank. Should the Chinese central bank continue its loose monetary policy to bolster the economy, it may help to preserve the lower onshore rates.

Chart 1: Developments in the 3-year yields on the offshore and onshore Chinese government securities market



Source: Bloomberg

In addition to the developments in long-term yields, the changes in short-term interest rates may also influence the behaviour of bond market participants. Certain investors finance long bond positions from short-term funds, therefore the yields of their investments are influenced by the developments in short-term interest rates, the shape and changes of the yield curve and the fluctuations in interest rates. On the Chinese markets, short-term interest rates may be influenced by the open-market operations of the central bank aimed at managing the difference between the offshore and onshore exchange rates, and by other regulatory measures, an example of which could be seen in early 2016.

Foreign actors' decisions regarding their bond market investments may also be shaped by expectations about the renminbi's exchange rate, since realised yields are not only influenced by the changes in interest rates but also exchange rate fluctuations. The heightening concerns with respect to the weakening of the renminbi in the second half of 2015 may have had an effect on the behaviour of certain bond market participants, which may in turn have been reflected in the changes in bond market yields. Thus developments on the foreign exchange and interest rate markets can exert an impact on bond market yields as well, and as the offshore market is more open, both favourable and unfavourable changes are more perceptible there.

The turbulences on the equity market observed in the first half of 2015 and in early 2016 were also more marked on offshore markets, and they did not only affect equity markets: they may also have influenced the risk sensitivity and behaviour of players on other markets too. In 2015 substantial capital outflows were witnessed in China, primarily through the offshore market, which may have also contributed to the fact that in recent months interest rates on the offshore market started to rise.

Yet for issuers seeking sources of finance, the cost of borrowing and thus their choice between the two markets is **not only influenced by the current yields.** Furthermore, yields are not the only factor investors consider when **choosing between the opportunities on the onshore and offshore markets. The behaviour of the actors concerned may also be influenced by regulations as well as the transaction costs.** We can find examples of issuers being present on both markets among both state and non-state actors. In certain cases, e.g. in the United Kingdom, supporting an offshore renminbi centre through a bond issue may also play a role. Other countries, such as South Korea, employed a gradual approach, and first entered the offshore, then the onshore market.

The future of the panda and dim sum markets – Peaceful coexistence?

For certain issuers, the rules of entering the onshore market require additional resources, which may influence their choice between the two markets. Compared to offshore market issues, issuers may incur additional costs in onshore market issues for example because their financial statements have to be prepared according to either the Chinese or the IFRS requirements. Another condition for onshore issues is that the issuer be rated by a Chinese credit rating agency, although the Chinese regulatory authority granted British Columbia an exemption from this requirement. **In addition to the different degrees of regulation, the coexistence of the two markets may also be warranted by the lengthy process of developing the regulatory requirements that are necessary for gradually eliminating the existing barriers.** On the issuer side, understanding the relevant rules may require additional resources.

The development of onshore and offshore bond markets may also be affected by the availability and accessibility of derivative instruments that enable foreign issuers and investors to hedge for the exchange rate risk. In addition to the variety of derivative products that are available on the two markets and that can be used for hedging, the activity of foreign participants on the Chinese onshore bond market may also be influenced by the regulation governing the repatriation of funds. Currently only a certain group of actors on the panda market may convert the acquired renminbi funds to other currencies. In 2010 two supranational institutions (the ADB and the IFC) received authorisation from the Chinese authorities to do so. Funds obtained on the offshore market may be converted to other currencies there, however, transferring them to the onshore market falls under a separate regulation.

There are further differences between the two markets with respect to trading channels, the group of actors with access to the given trading channels, and the volume of trading on the respective trading channels. These technical conditions may also impact the liquidity of traded bonds, and they may thus influence the behaviour of issuers and investors. The opening up is gradually progressing in these areas as well.

In addition to state issues, both the offshore and the onshore market offer issues by financial and non-financial corporations. Expanding the group of issuers may be the next step in the development of the market. In the process of opening up the bond market, the expansion of the group of issuers and the enhancement of the market may enter into the next phase by the further development of the legal and other regulatory requirements regarding the onshore bond market.

Improving the transparency of the onshore market may increase the activity of foreign players on the onshore market. The further development of the market may be supported by the inclusion of Chinese bonds in the international bond market benchmark indices, as well as the development and review of the onshore bond market benchmarks (last year the FTSE Russell took a step in this direction).

The Chinese bond markets are constantly changing, and in addition to the expansion of the offshore market, the opportunities offered by the onshore market also grow. However, **the opening up of the Chinese economy, i.e. the liberalisation of the financial market** progresses in **several stages and is managed from outside**, therefore, although over the longer term the efforts point towards the merging of the two markets, **for now, the peaceful coexistence of the panda and the dim sum seems to be more realistic.**

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