The development of China's bond market

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I. The structure of China's bond market

China's bond market consists of two main markets: the interbank bond market and the exchange market. After more than ten years of development, China's bond market has become a multi-layered one in which the interbank market plays the leading role, complemented by the exchange market. Each market has its own niche, meeting the needs of different investors.

1. The interbank bond market

The interbank bond market was formed in June 1997, when the People's Bank of China (PBC), under the instruction of the State Council, issued *The Notice on Cessation of Repo and Bond Trading by Commercial Banks in the Stock Exchanges* (PBC Notice no (1997) 240), mandating that all commercial banks move their repo and bond trading out of the Shenzhen and Shanghai stock exchanges and into an interbank market operating through an electronic trading system. The interbank bond market is a quote-driven OTC market outside the exchanges, whereby deals are struck based on bid and ask prices negotiated between two trading counterparties. Institutional investors are the main players in this market.

2. The exchange bond market

The exchange bond market is an order-driven market, where bonds are traded, alongside equities, on an exchange. Deals are struck based on tender prices. Small and medium-sized institutions and individuals are the main players in this market.

II. The current situation of China's bond market

By all measures, China's bond market has been growing in leaps and bounds: bond issues are on the rise; market capitalisation is expanding substantially; turnover in the secondary market is surging; and the number and variety of market participants and instruments are rapidly increasing.

1. **Debt issuance is on the rise.** By end-November 2005, the total value of debt issued during the year had reached RMB 3,686.94 billion, an increase of 74.33% over the same period last year. Of this total, government bonds accounted for RMB 429.71 billion; central bank bills RMB 2,526.2 billion; financial institutions' bonds RMB 616.8 billion; non-financial corporate bonds RMB 50.4 billion; and short-term corporate financing bills RMB 112.1 billion.

2. **Outstanding stock of bonds in China is growing rapidly.** At end-November 2005, total bonds and bills outstanding amounted to RMB 7.07 trillion, a rise of 42% year on year. The value of tradable bonds reached RMB 6.9 trillion, accounting for 98% of total debt outstanding, while that of non-tradable bonds came to RMB 0.17 trillion, representing only 2% of total debt outstanding. The outstanding value of bonds traded in the interbank market reached RMB 6.46 trillion, accounting for

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94% of tradable bonds, while the value of those traded in the exchange market came to only RMB 0.39 trillion, representing less than 6%.

3. **Turnover is surging.** Total turnover in the interbank market during the first eleven months of 2005 reached RMB 20.64 trillion, an increase of some 62% year on year. Of that total, spot transactions came to RMB 5.2 trillion, collateralised repos RMB 15 trillion and outright repos RMB 179.4 billion. Over the same time period, total turnover in the exchange market reached RMB 2.43 trillion. Of that total, spot trading amounted to RMB 254 billion and repos RMB 2.18 trillion.

4. **The number of market players is burgeoning.** As the pace of market liberalisation has accelerated, the number and diversity of investors have burgeoned. By end-November 2005, the number of participants in the interbank market had reached 5,227, an increase of 22% from end-2004. Those participating in this market now include banks, securities firms, mutual funds, insurance companies and other non-bank financial institutions and corporations.

5. **The variety of instruments is expanding.** In terms of instruments on offer, repos and forwards have been introduced, in May 2004 and June 2005 respectively, while debt products now go beyond government bonds to encompass central bank bills; bonds issued by policy banks, banks and other non-bank financial institutions; subordinated debt issued by commercial banks; short-term corporate financing bills; and corporate bonds issued by non-financial firms.

III. The scope and importance of the interbank bond market

As the wholesale OTC bond market serving principally an institutional investor base, the interbank market plays a key role in ensuring the healthy operation of the macroeconomy, effective transmission of monetary policy and effective allocation of financial resources.

First, the interbank market has promoted the development of direct financing, which has reduced the economy’s over-reliance on the banking system for credit, optimised the financing structure of the economy as a whole, mitigated financial risk and enhanced market efficiency.

Second, this market has significantly facilitated market-based interest rate reform. Indeed, it was in the interbank market that China’s market-based interest rate reform began. Thanks to the development of this market, we now have a bond yield curve that provides a benchmark for price-setting in the primary bond market and price-quoting in the secondary market. Such progress is of great significance in terms of pricing financial assets and interest-rate derivatives, as well as providing information concerning inflation expectations.

Third, the interbank market has laid a foundation for macro-control by the central bank and has contributed to the more effective application and transmission of monetary policy. The interbank bond market is where the central bank conducts its open market operations; and the deepening and expansion of this market has provided even more scope for the central bank to act, accelerating the transformation of monetary control from a direct administrative approach to an indirect market approach. The central bank has already been equipped with the capacity to influence interest rates in the money market via its open market operations, and it is now clear that the improvement in the monetary policy transmission mechanism has greatly enhanced the effectiveness of monetary policy.

Fourth, the interbank market has provided a way for financial institutions to better manage their liquidity. Specifically, this market enables commercial banks to hold bonds, adjust their liquidity positions promptly and reduce their excess reserve levels. Recent developments in this market are also now enabling commercial banks to better manage their liabilities, mitigating their mismatch problems and operational risks.

IV. Recent reforms in China’s bond market

Recent reforms in China’s bond market have been in three main areas: financial product innovation, general market infrastructure and corporate bond market development.

1. Active promotion of financial innovation

Accelerating financial product innovation and increasing investor choice

First, commercial banks can now issue subordinated bonds. In order to improve asset quality and capital adequacy levels at commercial banks, as well as advance the reform process of state-owned commercial banks, the PBC issued *The Regulations on the Issuance of Subordinated Bonds by Commercial Banks* in June 2004. At that time, the PBC granted approval for Bank of China, China Construction Bank, Industrial and Commercial Bank, Industrial Bank and China Minsheng Banking Corporation, Ltd to issue subordinated bonds; by end-October 2005 total issuance of subordinated bonds issued by commercial banks had reached RMB 128.8 billion.

Second, other financial institutions can now issue bonds. To expand direct financing channels for financial institutions and provide them with the liability management tools needed to resolve their long-standing problem of term structure mismatch, the PBC, after considerable public consultation, issued *The Regulations on the Issuance of Financial Bonds in the National Interbank Bond Market* in April 2005. By end-October 2005, Shanghai Pudong Development Bank, China Merchant Bank and Industrial Bank have issued bonds for RMB 7 billion, RMB 10 billion and RMB 10 billion, respectively.

Third, non-financial corporations can now issue short-term financing bills in the interbank market. To improve the economy's financing structure and encourage competent enterprises to tap the capital market directly in order to meet their financing needs and reduce their costs, the PBC issued *The Regulations on Short-term Financing Bills* and other related supporting documents in May 2005. Soon after this, the first batch of such short-term financing bills was issued in the interbank market. By end-2005, non-financial corporations' short-term financing bills outstanding were already approaching RMB 140 billion. The issuance and trading of non-financial corporations' short-term financing bills is a major breakthrough in the development of direct financing for non-financial corporations.

Fourth, an asset-securitisation pilot scheme was recently introduced. *The Regulations on Pilot Credit Asset-Securitisation* were enacted in April 2005, paving the way for a trial run for mortgage-backed securities (MBSs) and asset-backed securities (ABSs). Going forward, financial products related to securitised assets are likely to play an active role in direct financing, as well as asset-liability management at banks.

Promoting instruments that aid liquidity, risk management and price discovery

First, outright repos have been introduced for the purpose of increasing bond market liquidity. Specifically, we have learnt from the experiences of other developed bond markets and modified the classic repo for use in our domestic interbank bond market. *The Regulations on Bond Outright Repos in the National Interbank Bond Market*, enacted in April 2004, set down the structure of the outright repo. Outright repo trading has not only increased the liquidity of the bond market, but has also paved the way for the introduction of other derivatives. At end-October 2005, turnover of outright repos in the interbank bond market totalled RMB 283.3 billion.

Second, bond forward transactions were recently introduced. As mentioned above, the success of outright repo trading has spurred us to develop the financial derivatives market further. Consequently, *The Regulations on Bond Forward Transactions in the National Interbank Bond Market*; *the Master Agreement on Bond Forward Transactions in the National Interbank Bond Market;* and *the PBC's Notice Regarding Matters Related to Information Disclosure and Risk Surveillance of Bond Forward Transactions in the National Interbank Bond Market* were issued during April–June 2005. Bond forward transactions can help investors manage interest-rate risk, increase market liquidity and fulfil the price-discovery function. In addition, the trading of forwards can provide key information for the central bank in its conduct of monetary policy, and can play an important role in promoting the future development of the bond market in particular and financial markets generally.

2. Infrastructure development in the interbank bond market

Establishing a legal framework for the market

In the course of bond market development, we follow the principle of "making rules first, conducting business later". This means that the government puts great emphasis on establishing the necessary rules to ensure the sound development of the bond market. In recognition that a proper legal framework is a prerequisite for the emergence of innovative financial products and the development of bond markets generally, we have issued a number of regulations, many of which have been mentioned in Section IV.1 above. In formulating these, we sought the views and comments of intermediaries and market participants on the appropriate legal framework for the bond market. The resulting framework has played an important role in the market's development, by improving the efficiency of transactions and settlements, reducing default risk and reinforcing industry self-discipline.

In addition, incorporating the views and comments of intermediaries and market participants on the appropriate legal framework for the bond market, we have also formulated a number of standardised documents such as

- The Master Agreement on Collateralised Repos in the National Interbank Bond Market;
- The Master Agreement on Outright Repos in the National Interbank Bond Market;
- The Master Agreement on Bond Forward Transactions in the National Interbank Bond Market.

Building market infrastructure

Sound market infrastructure is also essential for the sustainable and healthy development of the bond market. In recognition of this, the PBC has accelerated progress on this front in recent years.

First, a delivery versus payment (DVP) settlement system for the interbank market became operational on 8 November 2004, when the book-entry and payment systems were connected. This connection was a major breakthrough: it has improved operational efficiency, met the demands of financial product innovation, and effectively mitigated and controlled settlement risk - thereby providing reliable technical support for the efficient and safe operation of China's bond market.

Second, in October 2005 the straight-through processing (STP) settlement system was launched on a trial basis in the interbank market, whereby the trading system was linked to the book-entry system. A working group was formed to resolve the data-sharing and transmission frequency issues related to the connection of the trading and book-entry systems, and to draft relevant regulations. This group has also guided the financial intermediaries through the system development testing. Thus far, the STP system has been operating smoothly, and has helped improve trading efficiency and lower operational risk, thereby enhancing the workings of the whole bond market.

Fostering the institutional investor base

First, *The Regulations on Establishment of Pilot Fund Management Companies by Commercial Banks* were enacted in February 2005, authorising commercial banks to establish their own fund management operations and to offer fund management products. Three commercial banks have been approved to set up fund management companies so far, and, by end-November 2005, three stock market funds had been established, with a total issuance of RMB 14.7 billion. In addition to promoting direct finance, this regulatory initiative has also helped to advance the reform of commercial banks, improve resource allocation and diversify the investor base.

Second, strategic foreign institutional investors were given direct access to China's interbank bond market for the first time in 2005, when the Pan-Asia Index Fund and the China Index Bond Fund of the Asian Bond Fund 2, made sizeable investments in bonds there. Foreign institutional investor participation brings with it not only a mature investment philosophy and comprehensive knowledge of bond market operations and corporate governance, but also healthy competition and a forum for institutional investors to learn from each other.

3. Boosting the corporate bond market

In China, the incomplete development of the corporate bond market - with its inadequate supervision and legal framework, lack of investor diversity and low liquidity - has become a pressing problem for the Chinese economy. In particular, restrictions on issuers' qualifications, issuance amounts and pricing of new non-financial corporate issues need to be eliminated, while information disclosure and the credit rating system need to be beefed up. In addition, the official approval procedure for the issuance of corporate bonds should be transformed gradually into a verification system and, ultimately, into a "registration management" system.

To promote the rapid development of the corporate bond market in China, *The Rules on Approving the Circulation of Bonds in the Nationwide Interbank Bond Market* were enacted in December 2004. By end-November 2005, seven non-financial corporate issues had been allowed to trade in the interbank bond market. Prior to the introduction of this rule, corporate bonds could list only on the exchange market. The introduction of non-financial corporate issues to the interbank market should boost both its market capitalisation and liquidity.