NRI

lakyara vol.152

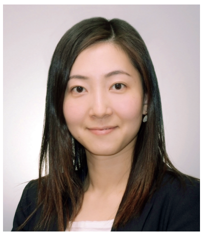
Development of Dim Sum Bonds in Hong Kong's Offshore RMB Market

Jenny Yee Wong

12. November. 2012

Nomura Research Institute, Ltd.

Executive Summary



Jenny Yee Wong
Consultant
Nomura Research Institute
Hong Kong Limited

Supported by the Chinese government, Hong Kong has been developing an offshore RMB market to promote the RMB's use outside of mainland China. Dim sum bonds, the first offshore RMB investment product, have been gaining popularity among issuers and investors by virtue of their uniqueness. However, recent concerns over the RMB's value and issuers' creditworthiness need to be addressed to sustain this market's long-term growth.

To promote the renminbi's use in international trade and investment, the mainland Chinese government has chosen Hong Kong to become the first offshore (i.e., non-mainland) renminbi (RMB) market[1)]. Hong Kong's offshore RMB market has been growing rapidly in terms of RMB deposits, which increased 87% in 2011 to end the year at RMB589bn. Hong Kong offers various types of RMB banking services and investment products. One major investment product is dim sum bonds (i.e., offshore RMB bonds), named after the popular bite-size delicacies served in Hong Kong restaurants. Dim sum bonds have been gaining popularity among both issuers and investors. This report discusses the historical development of and future prospects for dim sum bond issuance and investor demand.

NOTE

1) China's currency has two names: renminbi (RMB) and yuan (CNY). RMB circulating offshore in Hong Kong are referred to as CNH (H stands for Hong Kong). Since China's interest rates are controlled by the government, RMB financial instruments' yields differ depending on whether they are denominated in CNY or CNH, the latter of which is freely convertible in Hong Kong.

Advent of dim sum bond issuance

The first dim sum bond was issued in Hong Kong in July 2007 by China Development Bank, a Chinese policy bank, after the Chinese government authorized selected mainland financial institutions, including domestic policy banks and commercial banks, to issue dim sum bonds[2)]. Total issuance volume was initially very small, amounting to only RMB10 billion in 2007 and RMB12 billion in 2008. In 2009, the Chinese government authorized dim sum bond issuance by a second group of issuers comprising foreign financial institutions incorporated in mainland China, such as HSBC (China). In the same year, the Chinese Ministry of Finance issued the first sovereign dim sum bond with the intention of signaling a long-term commitment to issuance by the Chinese government. Total issuance in 2009 increased modestly to RMB16 billion.

2) The National Development Reform and Commission (NDRC) promulgated "Interim Measures for the Administration of the Issuance of RMB Bonds in Hong Kong by Onshore Financial Institutions" in 2007.

Major growth since 2010

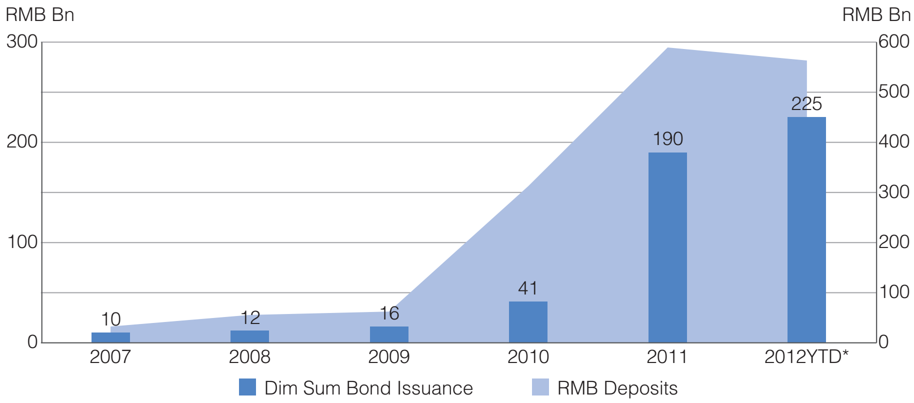
Dim sum bond issuance did not experience rapid growth until the Chinese government expanded the dim sum bond issuer pool beyond mainland financial institutions to include multinational corporations and international financial institutions in 2010 and mainland nonfinancial corporations in 2011[3]. The first corporate dim sum bond issuer was Hopewell Highway Infrastructure, a Hong Kong-listed company, which floated a RMB1.4 billion issue in July 2010. Issuance by other multinational corporations soon followed, including RMB200 million and RMB1 billion issues by McDonald's and Caterpillar in August and November 2010, respectively. Supranational financial institutions also joined the ranks of dim sum issuers, with the Asian Development Bank issuing RMB1.2 billion of bonds in October 2010. In November 2011, Baosteel Group, a state-owned enterprise, became the first mainland corporate issuer by issuing RMB3.6 billion of dim sum bonds. Japanese companies have also begun to participate in the dim sum bond market. The first to do so was Orix Corporation, which issued a 3-year dim sum bond with a 2 percent coupon in March 2011.

3) NDRC issued "Elucidation of Supervisory Principles and Operational Agreements Regarding Renminbi Business in Hong Kong" and signed a "Supplemental Memorandum of Cooperation" with the Hong Kong Monetary Authority.

In addition to expanding the pool of eligible issuers, the Chinese government streamlined regulations on remittance of bond proceeds in 2011 to further promote dim sum bond issuance. Prior to 2011, remittance of dim sum bond proceeds from Hong Kong to the mainland required case-by-case approval by Chinese regulators. This tended to reduce mainland companies' incentive to issue dim sum bonds due to uncertainty about whether permission would be granted to remit the proceeds to China to finance their mainland operations[4]. Effective from 2011, the People's Bank of China (PBOC) and Ministry of Commerce issued new rules governing foreign

4) Mainland financial institution issuers are required to remit proceeds of offshore RMB bond issuance to the mainland. No proceeds may be retained offshore. Other classes of issuers are not required to remit proceeds to the mainland. They have the option of keeping the proceeds offshore or remitting them to China via capital injection or intercompany loans pursuant to case-by-case approval before 2011, or via the foreign direct investment scheme from 2011 onward.

Exhibit 1: Dim Sum Bond Issuance and RMB Deposits



Notes: *2012 End of Sept
Source: Bloomberg, HKMA

5) Since October 2011, foreign investors are allowed to engage in direct investment using offshore RMB, including proceeds from dim sum bond issuance. See the PBOC's "Administrative Measures on RMB FDI Settlement" and Ministry of Commerce's "Notice by Ministry of Commerce on Cross-border RMB FDI".

investment in China using offshore RMB funds[5)]. The new rules have provided an official channel that has made it easier for issuers to repatriate proceeds to the mainland, resulting in rapid growth in dim sum bond issuance. In 2011, total issuance grew to RMB190 billion.

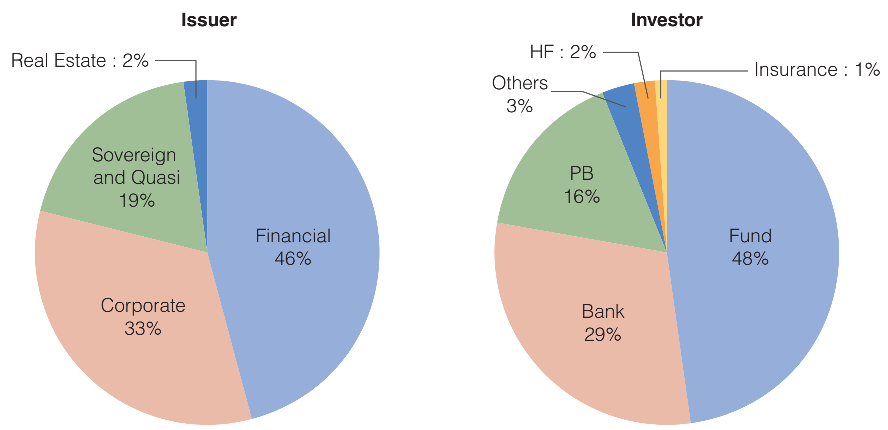
Supply and Demand

In general, 80% of dim sum bonds are issued by financial institutions and nonfinancial corporations. The remainder is issued by sovereigns and supranational financial institutions. Average tenor for corporate issuance is a relatively short three years or less. Tenors for sovereign and supranational issuance tend to be longer.

Dim sum bonds have gained favor among issuers because they offer cheaper funding than issuance of USD bonds in Hong Kong or onshore RMB bonds in mainland China. The average yield on dim sum bonds rated BBB or above was 3.69%, well below the 5.99% minimum 3-year onshore loan rate set by the PBOC as of March 2012. Another reason for dim sum bonds' popularity is that international issuers do not need mainland regulatory approval to issue dim sum bonds in Hong Kong, which is a free market, whereas they would need such approval to issue bonds directly in the mainland market.

On the demand side, dim sum bond purchasers are mainly Hong Kong and international institutional investors, including asset management companies, commercial banks, private banks and, to a lesser degree, insurers and hedge funds.

Exhibit 2: Issuer and Investor Breakdown



Source: Bloomberg, Deutche Bank

Retail investors can invest in dim sum bonds through commercial banks. However, the supply available to retail investors is limited, as some dim sum bond issues are restricted to institutional investors only[6]. Investor demand has been mainly driven by investors' desire to gain exposure to RMB investment products inaccessible to them in the mainland market[7], as well as expectations of medium- to long-term RMB appreciation. Investors betting on RMB appreciation generally tend to buy and hold these bonds until maturity. As a result, the secondary market for dim sum bonds is relatively illiquid in comparison to Asian dollar-denominated bond markets.

6) Every bond prospectus states whether the corresponding bond issue is open to retail investors or restricted to professional (institutional) investors only. Dim sum bonds open to retail investors are regulated by the Hong Kong Securities and Futures Commission (SFC).

7) To invest directly in mainland capital markets, foreign investors must be licensed as Qualified Foreign Institutional Investors (QFII) and Renminbi Qualified Foreign Institutional Investors (RQFII).

Future Prospects

Recently, the dim sum bond market has reportedly experienced some deterioration in investor and issuer sentiment amid the euro zone sovereign debt crisis and global economic slowdown. Investors that previously focused on anticipated RMB appreciation and overlooked dim sum bonds' underlying credit risks have now become more cautious. Credit risks concerns include a lack of ratings and covenant protection for a majority of dim sum bonds[8]. In comparison to a typical USD high-yield bond issue, dim sum bond offering documents include little disclosure of issuers' operational performance beyond their audited financial statements, according to Fitch Ratings. In addition, issuers seem to prefer shorter-term issuance with maturities of less than 3 years. The lack of long-term issuance with 10-15 year maturities precludes establishment of a deeply liquid yield curve that can be used as a benchmark to price other dim sum issues. Lastly, the illiquid secondary market is another concern for investors that may wish to exit dim sum bond positions[9].

8) Omitted covenants include cross-default clauses tying the issuing entity or special purpose vehicle back to the cash-flow generating entity, negative pledges preventing the issuer from using any of its assets for other debt obligations, and restrictions on future borrowings. (Source: Fitch ratings)

9) Trading volume is far below that of more developed dollar-denominated Asian bond markets, where single trades of up to $20 million are not uncommon. Trades in the dim sum secondary market seldom exceed RMB20 million ($3.1 million), according to traders. (Source: "Market for 'Dim Sum' Diminishes", online WSJ article)

Investors increased risk consciousness has recently caused dim sum bond yields to rise. On the supply side, corporate issuance is waning in response to recent narrowing of the funding cost differential between the offshore and mainland markets, according to strategists. The dim sum bond market seems to be temporarily losing its competitive advantage.

2012 and beyond

The latest steps taken by the Chinese government to support the growth of the dim sum bond market include improvement of mainland corporate issuers' creditworthiness. The Chinese authorities are now restricting dim sum bond issuance in Hong Kong by mainland corporate issuers to issuers with "strong profitability" and "good credit status"[10].

Despite the temporary downshift in the dim sum bond supply and demand, many industry experts still believe that the market will continue to grow over the long term, given that dim sum bonds are one of the most important financial instruments for the Chinese government to promote the offshore RMB business.

10) According to the "Circular on the Matters relating to the Issuance of RMB Bonds in Hong Kong by Onshore Non-financial institutions" issued in May 2012 by the NDRC, eligibility requirements for corporate dim sum bond issuance include good corporate governance and credibility with a three year compliance track record and strong profitability. Additionally, although proceeds are not required to be remitted to the mainland, they must be mainly used for fixed asset investment projects that comply with China's foreign and outbound investment policies.

about NRI

Nomura Research Institute, Ltd. ("NRI", TYO: 4307) is an independent, global IT solutions and consulting services provider with annual sales of 335.5 billion yen as of FY ended March 2012. With front-to-back support for the buy- and sell-side, NRI's tradition of innovation has positioned them as a trusted international market leader. Leveraging NRI's global consulting business, NRI is able to provide innovative financial IT solutions for investment banks, asset managers, banks and insurance providers. For more information, visit www.nri.com.

Inquiries to : Financial Technology and Market Research Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.co.jp/english/opinion/lakyara