Strategy Insights | Fixed Income

Introduction to China's onshore credit bond market

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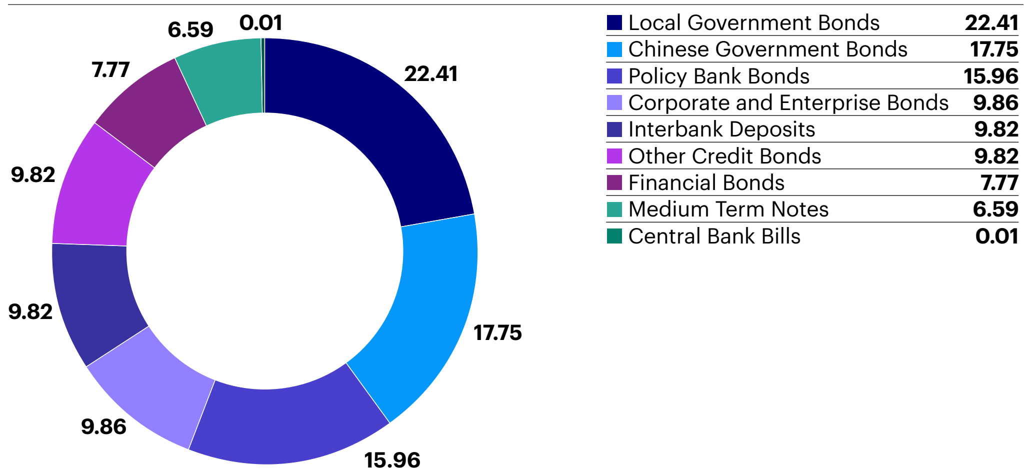
Overview

- China's onshore bond market has grown rapidly in the last decade. It ranks second only to the US bond market in terms of size and represents a diverse set of issuers. The credit bond market accounts for 44% of China's onshore bond market.
- The proportion of Chinese onshore issuers with international credit ratings remains relatively small; thus, we believe it is critical to draw on local resources and a deep understanding of China's local market structure when investing in Chinese onshore credits. We believe rigorous fundamental analysis is key to capturing potential opportunities in this large and varied market.
- Despite recent headwinds caused by the pandemic, the default rate of China's onshore bond market has remained relatively low.

China's onshore bond market is second only to the US bond market in terms of its size. China's market represents a diversified universe of issuers and exceeds USD17 trillion in total amount outstanding.[1] The recent inclusion of Chinese onshore bonds in global bond indices has helped raise international awareness of this important market. International investors may be most familiar with China's so-called onshore "rates" market, which consists of Chinese government bonds, policy bank bonds, local government bonds and central bank bills. In this paper, we seek to familiarize investors with China's onshore "credit" bond market, which includes interbank deposits, corporate bonds, enterprise bonds, financial bonds, medium-term notes (MTN), asset-backed securities (ABS), private placement notes (PPN), short-term commercial paper (SCP), government supported institution bonds, convertible bonds, exchangeable bonds, panda bonds, and standardized commercial instruments. The credit bond market accounts for 44% of China's total onshore bond market.[2]

Figure 1: Chinese onshore bond market overview (% of total bonds outstanding)



Source: Wind, as of February 28, 2021. See definitions below. Other credit bonds include asset-backed securities (ABS) 3.919%, private placement notes (PPN) 1.92%, short-term commercial paper (SCP) 1.851%, governmentsupported institution bonds 1.494%, convertible bonds 0.470%, exchangeable bonds 0.143%, panda bonds 0.026%, standardized commercial instruments 0.002%.

Definitions

Interbank deposits: Deposits held by one bank for another bank. This arrangement requires the holding bank to open a "due to" account, which is a liability account indicating the amount of funds owed to another entity.

Enterprise bonds: Issued by large institutions affiliated with a department of the central government or a state-owned enterprise (SOE). They are administratively oriented and legally registered with the National Development and Reform Commission (NDRC). The NDRC is a macroeconomic management agency under the State Council of Mainland China that is also responsible for deciding the annual issuance quota. Enterprise bonds typically fund government-approved projects or government investments. The minimum required issuance number is RMB1 billion.

Corporate bonds: Issued by corporations or limited corporations, usually focused on financing business operations. Corporate bonds are market-oriented and legally registered with the China Securities Regulatory Commission (CSRC). Trading activities are also supervised by the CSRC. The minimum required issuance amount is around RMB12 million to RMB24 million, and there is no maximum issuance amount.

Financial bonds: Bonds issued by commercial banks and non-bank financial institutions, such as securities firms and insurance firms.

Medium-term notes (MTN): Debt notes issued by companies that typically mature in five to 10 years. However, maturities also exist from less than one year to as long as 100 years. MTNs are offered through various brokers and issued on a fixed or floating basis. Issue amounts typically range from USD100 million to USD1 billion.

Asset-backed securities (ABS): Financial investments collateralized by an underlying pool of income-generating assets such as loans, leases, and credit card receivables.

Private placement notes (PPN): Debt instruments issued in the interbank bond market via a direct sale by non-financial corporate entities to specific institutional investors in the interbank market. Despite similar custody and settlement processes, PPNs require less information from non-financial corporate entities than public placements.

Short-term commercial paper (SCP): Unsecured promissory notes issued by large corporations, generally at a discount from face value and not backed by collateral, to obtain funds to meet short-term debt obligations, such as payroll.

Government-supported institution bonds: Government-guaranteed bonds issued by government-backed companies or financial institutions.

Convertible bonds: Hybrid securities combining features of a bond, such as interest payments, and features of a stock, such as the potential to benefit from a rise in the stock price. A convertible corporate bond can be converted into a specified number of common stock shares in the issuing company or cash of equal value at the bondholder's discretion.

Exchangeable bonds: Hybrid debt securities that can be converted into the shares of a company other than the issuing company, usually a subsidiary. Because of their convertible nature, they tend to carry a lower coupon rate and offer a lower yield than comparable straight debt, while the price is typically higher because the option to exchange adds value to investors.

Panda bonds: Renminbi-denominated bonds sold by a non-Chinese issuer in the Chinese onshore market. Panda bonds were first issued in 2005 by the International Finance Corporation and the Asian Development Bank. Since then, the market has expanded to include German carmakers Daimler and BMW, Singapore's United Overseas Bank, and sovereign issuers like the Republic of Hungary, British Columbia, Emirate of Sharjah, Korea, and the Philippines.

Standardized commercial instruments: Beneficiary certificates divided into equal shares created with the cash flow generated from underlying asset pools formed by depositary institutions. Pools are formed by collecting commercial drafts, which are instruments issued by the drawer to entrust the payer to pay a certain amount of money to the payee or the bearer on an appointed day. Commercial drafts consist of bank acceptance drafts and trade acceptance drafts. The period of presentment for payment is as long as six months.

Privately owned enterprises (POE): Commercial enterprises owned by private investors, shareholders, or owners, in contrast to state-owned enterprises (SOE) largely controlled by the government or a province.

Local government financing vehicles (LGFV): Financing platforms for local governments to facilitate raising capital for infrastructure projects in a market-oriented way. An LGFV is an independent legal entity.

Bond Connect: Mutual market access scheme that allows investors from mainland China and overseas to trade in each other's bond markets through a market infrastructure linkage in Hong Kong.

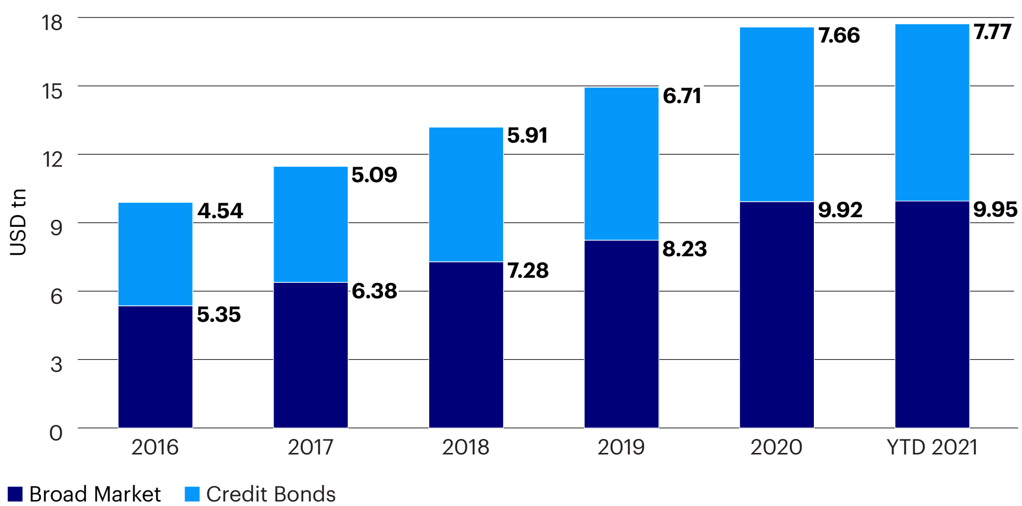
China Interbank Bond Market (CIBM) Direct: The launch of CIBM in February 2016 created a further route for international investors to access Chinese onshore bonds directly by holding a Type A license in mainland China, complementing long-established QFII and RQFII schemes (see below).

Qualified Foreign Institutional Investor (QFII)/ Renminbi Qualified Foreign Institutional Investor (RQFII): QFII, launched in 2002, is one of the earliest programs to allow selective financial institutions, such as commercial banks, securities companies, and insurance companies, to invest in China's stock and bond markets. RQFII refers to the policy initiative that relaxes the existing restriction on QFII by loosening limitations on currency settlement, adding permissible asset classes and expanding investor eligibility.

China's onshore credit market has expanded rapidly

China's onshore credit market has grown rapidly in the last decade. From 2011 to 2021, the total outstanding amount of Chinese onshore credit bonds grew by more than 10 times, from USD0.7 trillion to USD7.8 trillion.[3] The number of issuers also grew sharply, from 1,178 to 6,367.[4]

Figure 2: Growth of China's onshore bond market (bonds outstanding, USD trillion)



Sources: BofA Securities, Wind. Data from Dec. 31, 2016, to Feb. 28, 2021.

Figure 3: Issuer mix has become more diversified (RMB trillion)

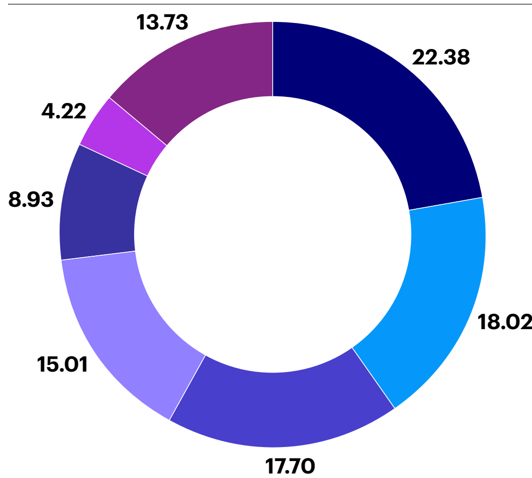
	2011	2021
China Government Bonds	6.81	20.47
Local Government Bonds	0.40	25.83
Central Bank Bills	3.08	0.02
Policy Bank Bonds	5.21	18.40
Financial Bonds	0.69	8.95
Enterprise Bonds	1.13	2.26
Corporate Bonds	0.17	9.11
MTN	1.43	7.59
SCP	0.71	2.13
PPN	—	2.21
Panda Bonds	0.00	0.03
Government-supported Institution Bonds	0.48	1.72
ABS	0.01	4.52
Convertible Bonds	0.08	0.54
Exchangeable Bonds	0.09	0.16
Standardized Commercial Instruments	—	0.00
Interbank Deposits	—	11.32

Source: Wind, Data as of Dec. 31, 2011, and Feb. 28, 2021.

Trading in Chinese credit bonds

Chinese onshore credit bonds are traded in three venues: The interbank market, the Shanghai and Shenzhen stock exchanges, and the over-the-counter (OTC) market. The interbank market is the largest trading venue and is designed for institutional investors. The interbank market is regulated mainly by the People's Bank of China, while the stock exchanges are regulated mainly by the CSRC. International investors may use Bond Connect, China Interbank Bond Market (CIBM) Direct, and Qualified Foreign Institutional Investor (QFII)/Renminbi Qualified Foreign Institutional Investor (RQFII) to access the Chinese interbank market, but may only use QFII-RQFII to access the exchanges.

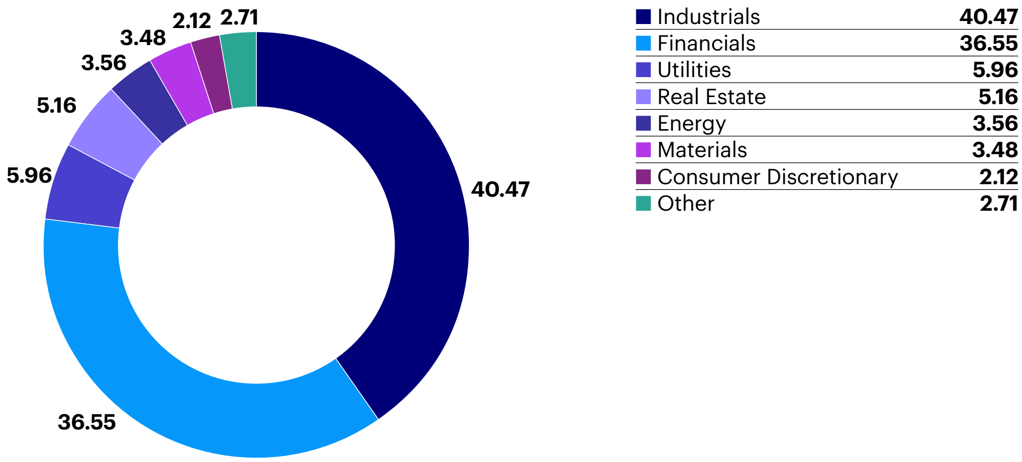
Figure 4: Onshore credit bond issuers (as % of total credit bonds outstanding)



Interbank Deposits	**22.38**
Financial Bonds	**18.02**
Enterprise Bonds	**17.70**
Corporate Bonds	**15.01**
MTN	**8.93**
Panda Bonds	**4.22**
Other	**13.73**

Source: Wind. Data as of Feb. 28, 2021.

Figure 5: Onshore credit bond sectors (as % of total credit bonds outstanding)

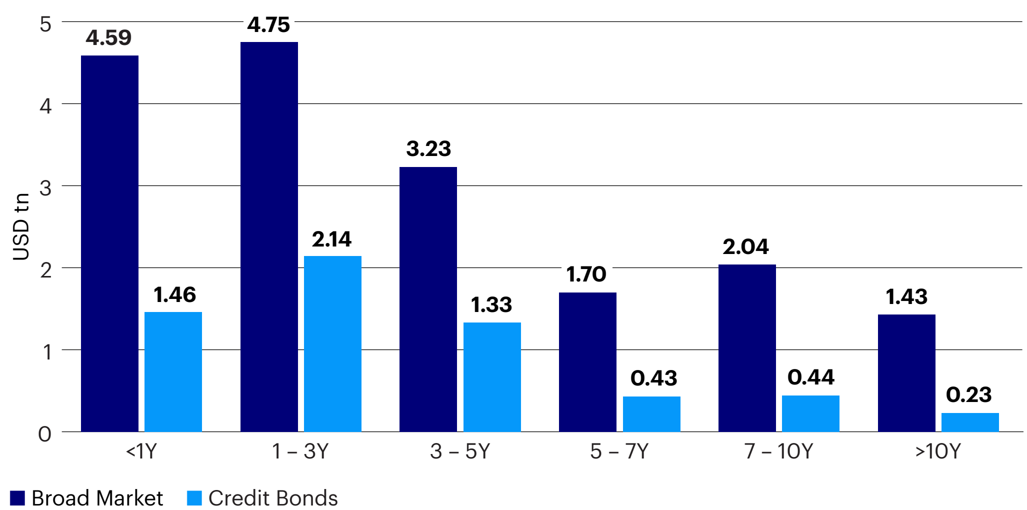


Source: Wind. Data as of Feb. 28, 2021.

Short to medium-term tenors

Chinese onshore credit bonds tend to be concentrated at the short to medium-term end of the maturity spectrum. More than 80% of total credit bonds outstanding have tenors between zero and five years (Figure 6).

Figure 6: Duration of Chinese onshore credit bond market vs broad market – 2021 (total bonds outstanding, USD trillion)

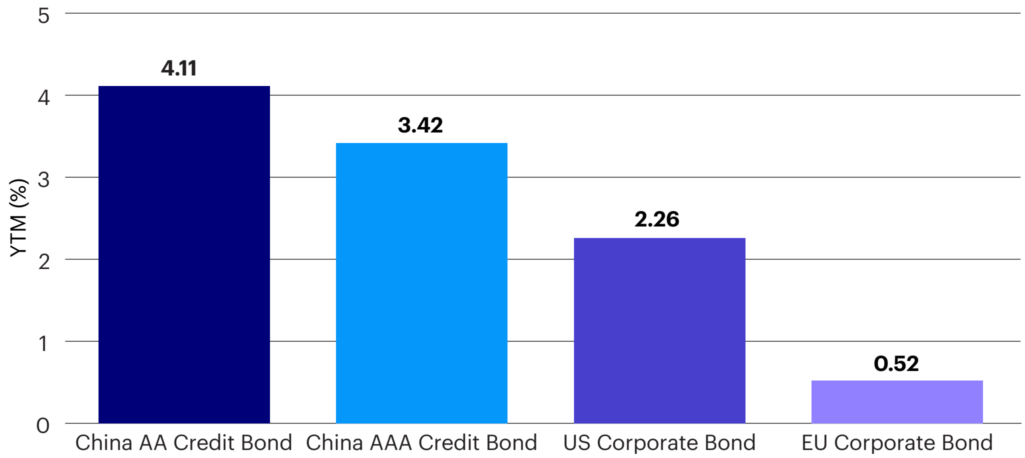


Source: Wind. Data as of Feb. 28, 2021.

Attractive yields relative to major markets

The Chinese onshore bond market offers attractive yields relative to global markets, which has been a key factor driving foreign inflows into the market. Figure 7 compares yields on Chinese credit bonds to developed market credit bonds. The yield pick-up is significant in many cases, especially as many developed market bonds currently trade at historically low yields.

Figure 7: Credit bond yield comparison (yield-to-maturity, %)



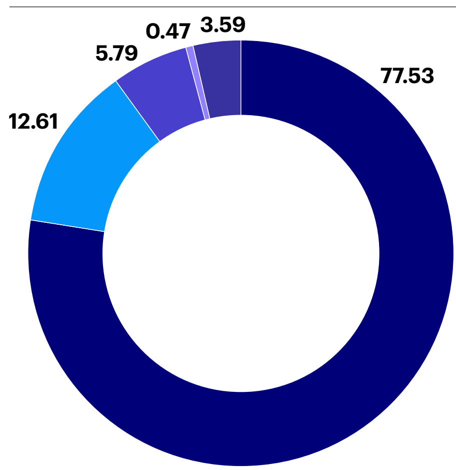
Sources: Bloomberg L.P., Wind, Invesco. Data as of May 19, 2021. Note: China AA Credit represented by 3-year MTN AA (locally rated) bond yield, China AAA Credit represented by 3-year MTN AAA (locally rated) bond yield, US investment grade represented by the ICE BofA US Corporate Index and European investment grade represented by the ICE BofA Euro Corporate Index.

Credit rating considerations

China's onshore rating industry consists of seven agencies but is dominated by four firms — the China Chengxin Credit Rating Group, Lianhe Ratings Global, Dagong Global Credit Rating, and Golden Credit Rating International (Orient). International rating agencies are, however, becoming increasingly involved in the Chinese onshore market. In January 2019, Standard and Poor's China became the first wholly foreign-owned rating agency to be able to issue ratings on domestic issuers — but the domestic rating agencies still dominate.

Local ratings of China onshore bonds also differ from international ratings, which is a common concern among international investors. The rating distribution of the Chinese onshore credit market is very uneven. Of all rated bonds, almost 96% are rated AA or above.[6] The imbalance is a result of legacy and regulation. Chinese regulators, for example, tend to direct commercial banks and insurance companies to invest in higher-rated bonds, leading to less supply and demand for lower-rated bonds. Business incentives may also discourage domestic rating agencies from assigning lower ratings to bonds.

Figure 8: Chinese onshore credit bond ratings (as % of total bond market)



AAA	77.53
AA+	12.61
AA	5.79
AA–	0.47
Below AA–	3.59

Source: Wind. Data as of Feb. 28, 2021. This graph shows the credit rating distribution of rated bonds. Unrated bonds represent 39% of the total China onshore bond universe.

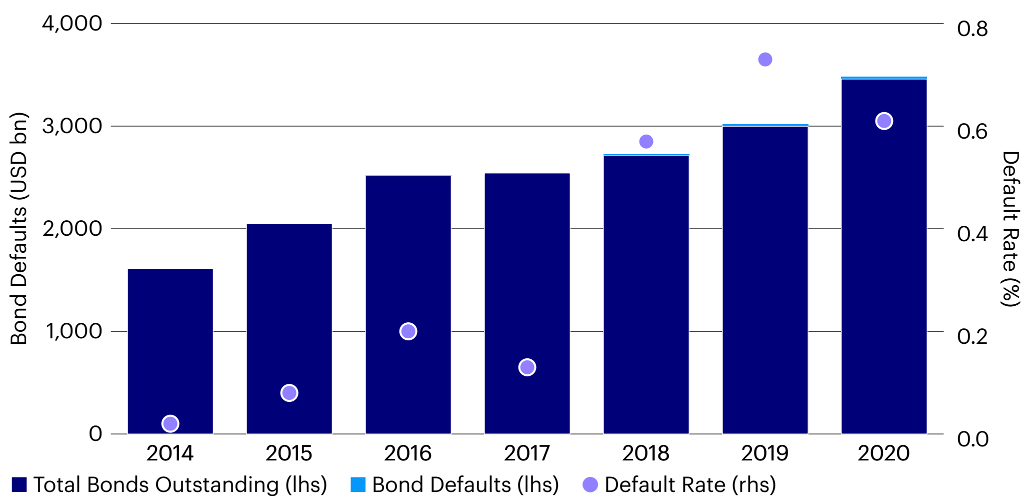
Given the limitations of local ratings, international investors may be more comfortable with onshore issuers that have issued US dollar-denominated bonds in the "offshore" market. Based on our analysis and HSBC data, 237 out of 6,367 onshore issuers hold offshore credit ratings and 145 are rated investment grade.[7] These 237 issuers represent USD0.8 trillion in onshore bonds outstanding and account for 10.5% of the total onshore credit market.[8]

Investing in Chinese issuers with offshore credit ratings may be a good initial approach for international investors. However, the relatively limited universe may impose constraints on investment strategies. For this reason, we believe it is critical to benefit from a deep and specialized understanding of the local market structure and local resources when investing in Chinese onshore credits. We believe rigorous fundamental analysis is critical for capturing potential opportunities in this large and varied market.

Onshore Chinese bond default rate has been historically low

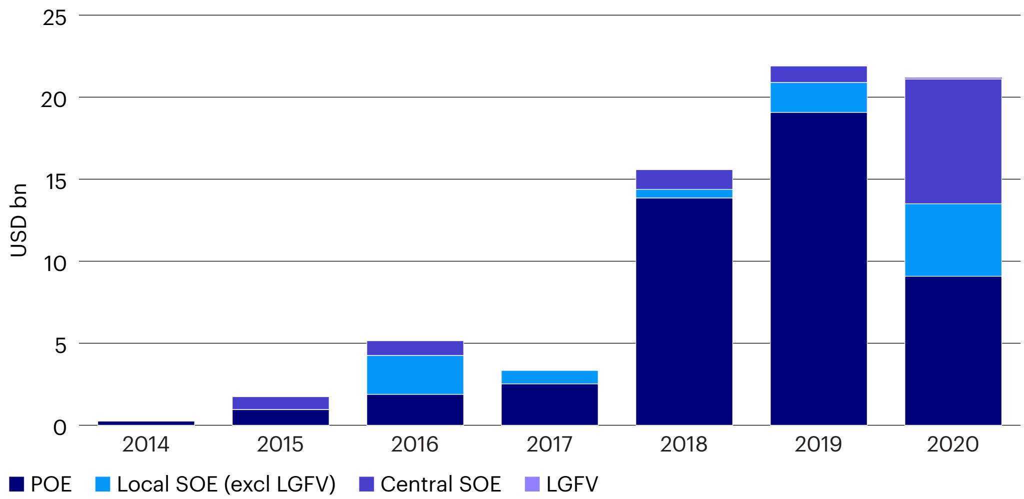
Default risk is the main risk investors monitor. Recent headlines declaring "rising corporate defaults in China" have alarmed international investors. In reality, defaults of Chinese onshore bonds were relatively nonexistent until 2014 and tended to affect mostly private sector companies. The incidence of defaults has risen only recently, with an increased number of defaults among state-owned entities (SOE) and even a bank (Baoshang Bank) in 2020. However, when put into perspective, the overall default rate of Chinese onshore credit bonds is relatively low. In 2020, the default rate among Chinese onshore credit bonds was 0.61%.[9]

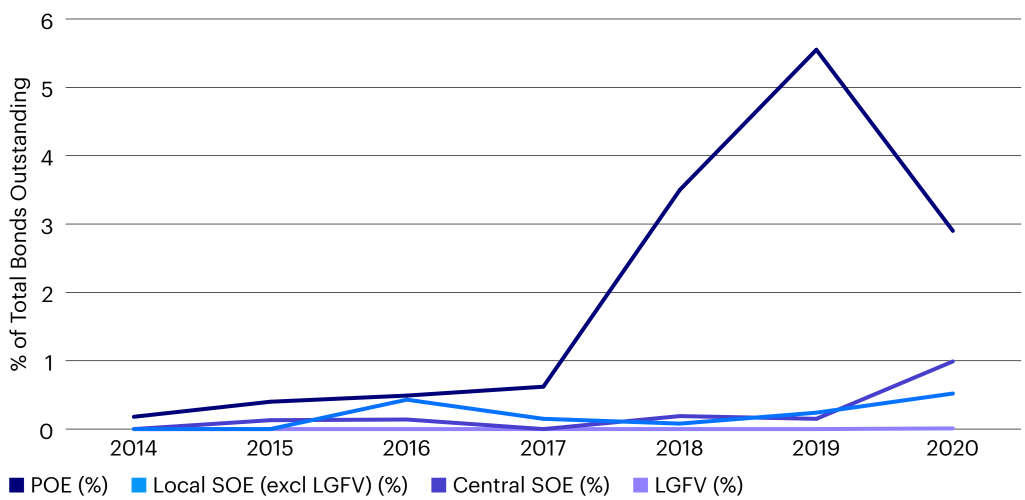
Figure 9: Chinese onshore bond defaults (USD bn and as % of total bonds outstanding)



Sources: HSBC, Wind. Data as of Feb. 28, 2021. The bond universe includes privately owned enterprises (POE), local government financing vehicles (LGFV), central SOE, and local SOE (excl LGFV).

Figure 10: Bond defaults by type (USD billion and % of total bonds outstanding)





Sources: HSBC, Wind. Data as of Feb. 28, 2021.

In our view, it is encouraging that the Chinese regulators have stated that bond default risks should be identified transparently and systematically. Toward this end, we believe the government and regulators will be more tolerant of SOE defaults, which we view as healthy and necessary. In our view, only when companies with weak fundamentals are allowed to default will the market become more efficient and well-functioning.

Conclusion

We believe it is only a matter of time before international investors expand their participation in China's large and vital onshore credit market. Going forward, we expect Chinese policymakers to remain cautious on policy easing, meaning that China's yield advantage should persist for some time. As the world heals from the impact of the COVID-19 pandemic, China's onshore bond market is also likely to face tests, and credit divergence may accelerate. In such an environment, we believe rigorous fundamental analysis and local expertise will be important advantages when investing in Chinese onshore credit bonds.

The Invesco Fixed Income (IFI) Asia-Pacific team is part of IFI's global team with four portfolio managers and eight research analysts, and expanding. The team manages several strategies, including Asian US dollar-denominated credit and Asian local currency strategies, including renminbi-denominated strategies. While the team accesses IFI's global resources, it also leverages its local expertise and presence, including an 18-member investment team with Invesco Great Wall based in China.[10]

1. Source: Wind. Data as of Feb. 28, 2021. Based on CNY 115.3 trillion, exchange rate USD/CNY=6.5. All data in Figures 1 – 11 based on this exchange rate.
2. Source: Wind. Data as of Feb. 28, 2021. Other credit bonds include asset-backed securities (ABS) 3.919%, private placement notes (PPN) 1.92%, short-term commercial paper (SCP) 1.851%, government-supported institution bonds 1.494%, convertible bonds 0.470%, exchangeable bonds 0.143%, panda bonds 0.026%, standardized commercial instruments 0.002%.
3. Sources: BofA Securities, Wind. Data as of Feb. 28, 2021.
4. Source: Wind. Data as of Feb. 28, 2021.
5. Source: Wind. Data as of Feb. 28, 2021.
6. Source: Wind. Data as of Feb. 28, 2021.
7. Sources: HSBC, Wind. Data as of Feb. 28, 2021.
8. Source: Wind. Data as of Feb. 28, 2021.
9. Source: Wind. Data as of Feb. 28, 2021. Bond universe covers POE, Local SOE (excl LGFV), central SOE, and LGFV.
10. Source: Invesco. Data as of Feb. 28, 2021.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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