China

Awaiting the Swap Connect

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- China is due to launch the Swap Connect, which will be the sixth Connect scheme deepening the financial linkage between Hong Kong and mainland China
- Foreign investors will gain access to onshore interest rate swaps, which are more effective interest rate hedges for onshore bonds than offshore swaps
- Mainland China investors could obtain access to Hong Kong's swap market at a later stage

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Since 2014, there have been five Connect schemes launched to deepen the financial linkage between mainland China and Hong Kong. These include the Shanghai-Hong Kong Stock Connect, the Shenzhen-Hong Kong Stock Connect, the Northbound Bond Connect, the Wealth Management Connect and the Southbound Bond Connect. The next instalment is the Swap Connect, which will be the sixth Connect scheme, and allow foreign investors easy access to the onshore interest rate swap market via a quota system. At a later stage, mainland China investors may be allowed to access the interest rate swap market in Hong Kong.

The People's Bank of China (PBoC) released draft rules for the Swap Connect on 17 February 2023, and initiated a public feedback period on the rules, which ended on 4 March 2023. While we await more details on the official launch date and the quota size, it is worth considering the benefits of accessing the onshore interest rate swap market.

The annual volatility of onshore interest rate swaps has been lower than offshore interest rate swaps in eight out of the last ten years and from a portfolio manager's perspective, interest rate hedging for a bond portfolio is more effective with onshore interest rate swaps due to the higher correlation with onshore bond yields. The availability of a multitude of interest rate swap curves in the onshore market also means that investors can take more active positions to express views on different funding rates. We introduce the onshore interest rate swap market in this note, discuss its benefits for investors and take the opportunity to update on the trading activity at the Bond Connect.

Table 1. Timeline of Connect schemes between mainland China and Hong Kong

Cross-border Connect Schemes	Launch date
SH-HK Stock Connect	17-Nov-2014
SZ-HK Stock Connect	5-Dec-2016
Northbound Bond Connect	3-Jul-2017
Wealth Management Connect	10-Sep-2021
Southbound Bond Connect	24-Sep-2021

Source: HKMA, HSBC

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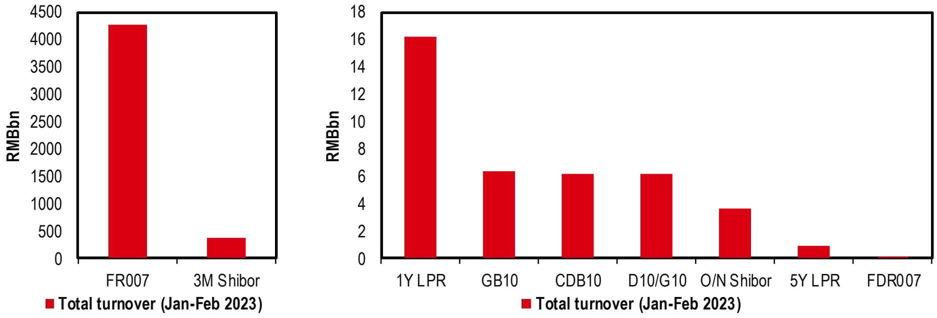
The onshore interest rate swap market

Multitude of interest rate swap curves in the onshore market

There are many interest rate swap curves in the onshore market. Over the past year, market participants have transacted interest rate swaps with the following interest rate fixings:

1. 7-day repo rate (FR007)
2. Overnight banks-only repo rate
3. 7-day banks-only repo rate (FDR007)
4. Overnight Shanghai interbank offered rate (SHIBOR)
5. 3-month SHIBOR
6. 1-year loan prime rate (LPR)
7. 5-year LPR
8. 10-year China government bond yield (GB10)
9. 10-year China Development Bank bond yield (CDB10)
10. Yield spread between 10-year China Development Bank bond and 10-year China government bond (D10/G10)
11. Yield spread between 3-year corporate bond and 3-year China Development Bank bond

Figure 1. Onshore interest rate swap trading volume (Jan-Feb 2023)



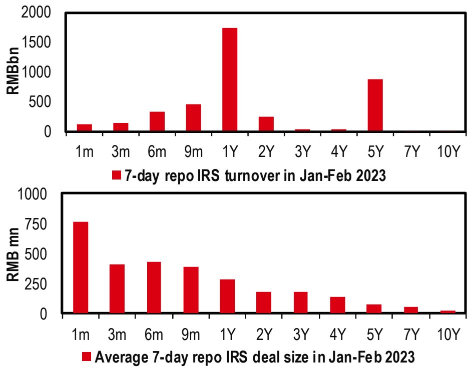
Source: CFETS, HSBC

Trading liquidity is concentrated in the 7-day repo IRS and 3m SHIBOR curves

While there are many interest rate swap curves in the onshore market, trading liquidity is concentrated in the 7–day repo IRS and 3-month SHIBOR IRS curves, which account for 91% and 8% of the trading volume in January and February 2023 (Figure 1).

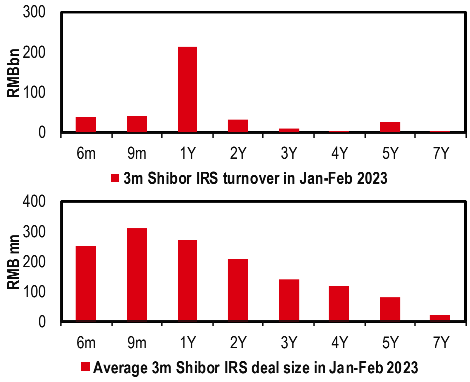
Trading activity is largely in the 1yr and 5yr tenors for the 7-day repo IRS curve and mainly the 1yr tenor for the 3-month SHIBOR curve. The average deal size for both curves are similar at the key tenors, specifically around RMB300mn for 1yr and RMB80mn for 5yr (Figures 2 and 3).

Figure 2. Onshore repo IRS trading activity



Source: CFETS, HSBC

Figure 3. Onshore 3-month SHIBOR IRS trading activity



Source: CFETS, HSBC

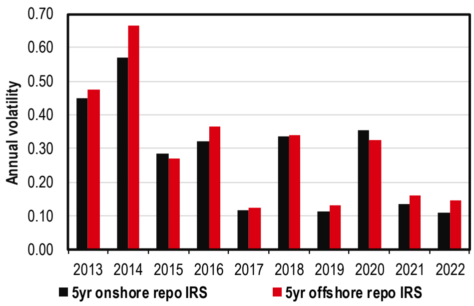
Benefits of accessing the onshore interest rate swap market

- **More efficient interest rate hedge for onshore bonds**

  Compared to offshore interest rate swaps, onshore interest rate swaps are less volatile and correlate better with onshore bond yields (Figures 4 and 5). This makes onshore interest rate swaps more efficient interest rate hedges of onshore bonds.

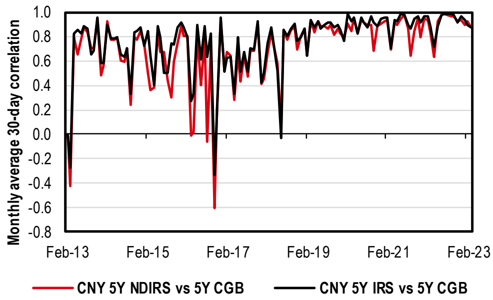
  Offshore swaps are more volatile as the trading activity is dominated by offshore participants, who are influenced not just by developments in China, but also swings in global risk sentiment. Comparatively, onshore swaps are largely traded by onshore participants, who typically manage a China-only mandate. Since 2019, the monthly average rolling correlation between 5yr onshore repo IRS and 5yr government bond yields has ranged between 65% and 99%.

Figure 4. Onshore swaps are less volatile than offshore swaps…



Source: Bloomberg, HSBC

Figure 5. …and correlate better with onshore bond yields



Source: Bloomberg, HSBC

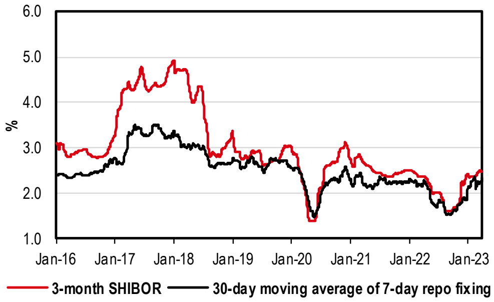
- **Active risk management on funding rates**

  The other benefit of entering the onshore swap market is having access to SHIBOR interest rate swaps, which are rarely quoted in the offshore market.

  For the unacquainted, SHIBOR is an uncollateralised wholesale interest rate benchmark in China. There are 18 banks on the SHIBOR panel and the daily fixing is calculated by averaging the quotations, after removing the four highest and four lowest quotations.

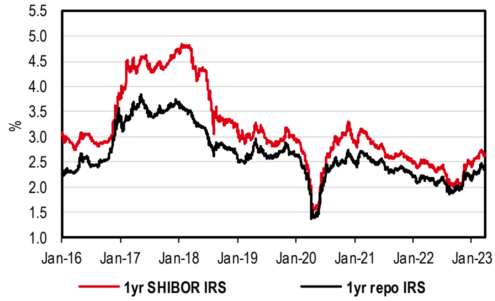
Funding rate turns are typically sharper in 3-month SHIBOR than 7-day repo. This phenomenon is anchored in the fact that the central bank conducts daily open market operations using its 7-day reverse repo tool, while there is no daily facility for 3-month funding. There is therefore more effective policy control over the 7-day rate, than the 3-month rate. Take, for example, during the financial deleveraging episode in 2017, 3-month SHIBOR rose by much more than the 7-day repo rate. Being able to access the onshore SHIBOR curve would allow offshore investors to have an additional instrument to express their views on funding rate turns in China.

Figure 6. Funding turns tend to be sharper for SHIBOR than repo…



Source: Bloomberg, HSBC

Figure 7. …making access to SHIBOR IRS a good addition to portfolio management



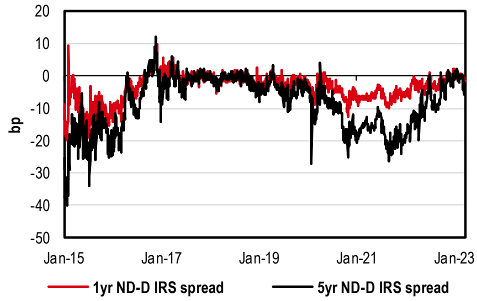
Source: Bloomberg, HSBC

- **Arbitrage trading**

Having access to both onshore and offshore interest rate swaps would allow investors to engage in interest rate arbitrage trading opportunities.

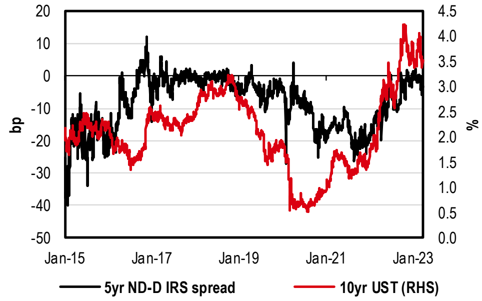
As mentioned earlier, offshore interest rate swap trading is dominated by offshore participants, who are influenced by swings in global risk sentiment. Alongside the tendency for offshore participants to get more bearish on China's growth outlook than onshore counterparts, we have historically seen 5yr offshore IRS trade meaningfully below 5yr onshore IRS. Investors with access to both markets would be able to position for reconvergence of the spread whenever significant divergence emerges, though such opportunities may become more subdued as more investors engage in such trading.

Figure 8. Onshore-offshore interest rate spreads can get quite wide…



Source: Bloomberg, HSBC

Figure 9. …due to swings in global risk sentiment



Source: Bloomberg, HSBC

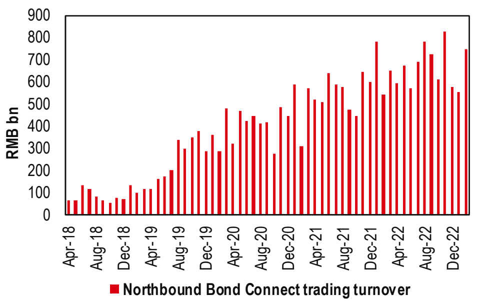
An update on the Northbound Bond Connect

It has been over five years since the Northbound Bond Connect was launched. Some investors may recall there were initial operational issues such as delivery-versus-payment settlement and block trading, but these were eventually ironed out. In a similar fashion, we expect the existing operational hurdles for the Swap Connect to be gradually resolved.

As of February 2023, there are 789 entities registered to trade onshore bonds through the Northbound Bond Connect, up from 520 at the end of Q1 2020.

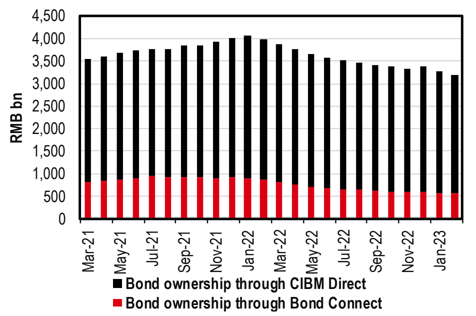
Trading volume has increased from less than RMB100bn a month in the first year of operation to a monthly average of RMB700bn over the last six months (Figure 10). However, even with the increase in Bond Connect trading volume, it is clear that foreign investors' preferred route of access is still via CIBM Direct (Figure 11).

Figure 10. Steady rise in Northbound Bond Connect trading volume



Source: CEIC, HSBC

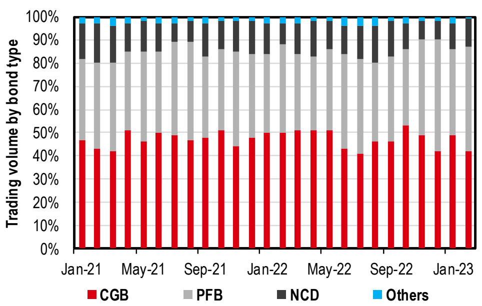
Figure 11. CIBM Direct is still the preferred investment route



Source: BCCL, HSBC

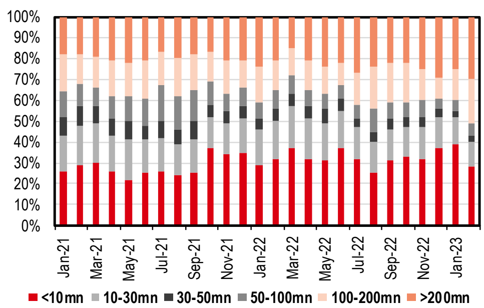
While the Bond Connect scheme offers access to a wide range of onshore bonds, the bulk of investor activity is in government bonds, policy bank bonds and negotiable certificates of deposit (Figure 12). The average ticket size transacted through the Bond Connect has increased, with transactions larger than RMB100mn accounting for 40-50% of total transactions over the past six months (Figure 13).

Figure 12. Offshore interest is still largely on CGBs and PFBs



Source: CEIC, HSBC. Note: CGB refers to China government bonds, PFB refers to policy bank bonds and NCD refers to negotiable certificates of deposit

Figure 13. Bigger ticket sizes transacted through the Northbound Bond Connect



Source: CFETS, HSBC

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