RMB Series:
Panda Bonds – On the Cusp

1 June 2016

Ever since China embarked on its series of economic reforms in the 1970s, the country's rapid progress that has placed it among the leading economies of the world has been unparalleled. It is therefore no surprise that as China embarks on its new phase of capital markets liberalization to go hand in hand with its economic reforms, China's financial markets too have become the object of international investors' sustained interest, in a relatively short period of time.

In particular, the fact that China's bond market is now the third largest in the world from being barely visible on global radar screens a few years ago makes it the ideal candidate to be at the forefront of the Chinese authorities' market opening initiatives. At the same time, as the renminbi ("**CNY**") globalizes, international investors will seek to buy assets denominated in renminbi, while at the same time seeking re-assurance and safety in bonds and other instruments issued by corporations and entities with which these investors are totally familiar, as a means of minimizing credit and other risks.

It is in this context that the arrival of the "Panda bond" on the Chinese and global stage has been perfectly timed. – International investors looking to participate in the China interbank bond market ("**CIBM**"), following the continual liberalization of the capital account, have an investment avenue for which they have a strong appetite and domestic investors can diversify into names that they may have long been familiar with but could not find a way to invest in. With the opening of the Panda bond market, potential overseas issuers now have a way to source renminbi funding for capex and other needs, from the largest renminbi pool on earth. Concurrently, the regulatory authorities could fulfill a mission to liberalize a major component of its capital market by bringing China's bond market on an international pedestal with a product that is likely to be popular and liquid, attracting a wide range of market participants.

Panda bonds are more than just onshore renminbi-denominated debt. They will play an integral part in building out China's onshore bond market and liberalization of the renminbi, both which require active participation by foreign players. A robust Panda bond market will bring foreign issuers and investors together, where the issuer can raise renminbi at low cost while offering attractive yields for investors. Growth in the Panda bond market has so far been capped by technical obstacles, including the difference in accounting and audit requirements, ratings by Chinese versus international credit agencies and the use of proceeds. Removing these hindrances should accelerate the growth of the Panda bond market. The good news is there are signs that regulators are looking at addressing them in hope of making conditions more favourable for issuers.

In this paper, with the contributions from industry players who are active in the China bond market and also ASIFMA, we aim to lay out the substantive benefits of opening up the Panda Bond market not only to issuers and investors, but the longer term implications of a well-developed bond market to China. We will also address the challenges that international issuers are facing for their entry into this burgeoning market with recommendations to resolve these challenges.

1. Benefits of Panda bonds

1.1 Benefits of Panda bond from an issuer's perspective

Optimise funding costs, diversify investor base
From an issuer's perspective, smooth access to the Panda bond market provides a broader fund raising channel with a number of benefits, such as optimizing financing costs and structure as well as diversifying the investor base to include China domestic investors. At the present, the cost of funding on the onshore domestic market is materially lower than similar issuances in the offshore market amid flush liquidity following the relaxation of the local reserve requirement ratio and interest rate cuts***.***

For issuers who need to secure long-term renminbi funding and have onshore subsidiaries, Panda bonds may be preferable to onshore bank loans, which normally carry a shorter tenor. Raising renminbi funds onshore also serves as a natural hedge for issuers who have operations in China with renminbi liabilities and eliminates FX conversion risk. While the renminbi is expected to remain stable against a basket of currencies, market uncertainties could still spark volatility.

Panda bond issuers also have the benefit of accessing China's domestic investors - an investor community that had otherwise been shut to global markets until China started to liberalise its capital account. Panda bonds are available to onshore and offshore investors that have access the CIBM, which is the largest onshore renminbi bond market that accounts for about 91%[1] of bonds (CNY 44.5tn) in China. Foreign ownership was approximately CNY 763bn as of November 2015, which amounted to only 1.6% of the China's onshore bond market, with the rest being domestic investors. As one would expect, many local investors are keen to diversify their fixed-income portfolio by eagerly buying up international credits.

But technical headwinds remain
Despite these advantages, growth of the Panda bond market was inhibited by technical challenges. Since 2015, there have been only eleven Panda bonds issued by nine issuers in the CIBM. There are signs that regulators may consider easing some rules to re-ignite the market (for example, the foreign debt quota is now waived in the situation where an issuer of a Panda bond lends the proceeds of the bond to its onshore subsidiaries as per a notice issued by the People's Bank of China ("**PBOC**") on April 29, 2016), but until then the market may remain subdued.

1.2 Benefits of Panda bond from an investor's perspective

Domestic investors who wish to diversify their renminbi assets and gain exposure to international names will find Panda bonds an attractive alternative, as the issuers are typically frequent issuers in the global markets whose credit is familiar to global investors. By buying renminbi-denominated bonds, it also serves as a natural hedge against domestic investors' renminbi liabilities and removes FX risk.

Access to global issuers of Panda bonds rated by international credit agencies offers domestic investors a balanced risk and return. Currently, an issuer could be selling onshore and offshore bonds carrying the same terms but of two different ratings. This results from the different rating standards adopted by domestic versus international credit agencies.

Since the inception of the Panda bond market in 2005, the market has been illiquid and only a handful of names are available for investment such as International Financial Corporation, Province of British Columbia and Standard Chartered Bank (Hong Kong) Limited. All issuances received overwhelming responses from investors, reflecting strong investor demand but limited supply.

1.3 Benefits of a well-developed Panda bond market to China

A well-developed Panda bond market is beneficial and crucial to the renminbi internationalisation journey, offering entities long-term financing and an effective capital-raising platform that supports China's real economic growth.

Although the market appears to be regaining momentum, it's still a budding market with only a handful of names available for investment. More Panda issuances of different tenors and structures will help contribute to the development of a yield curve. Diverse geographies and sectors are integral in deepening and growing the Panda bond market, bridging the gap between international issuers and domestic investors.

[1] Source: Standard Chartered Research

This development is supported by renminbi's inclusion into the IMF's Special Drawing Rights ("**SDR**") basket. As China opens up its capital account, foreign inflows should increase. Current foreign ownership of bonds issued in China remains very low, hovering at about 1.6% as of November 2015. This level is materially lower than other currencies in the SDR. For instance, foreign holdings of onshore Japanese treasury bonds were around 10% while Germany's were about 60%. We believe there is ample upside for foreign holdings in China bonds to increase.

2. Key challenges of issuing Panda bonds

2.1 Accounting

There is currently an expectation (while this has not been formally codified other than for international development institutions) that Panda bond issuers should:

a) submit their accounts prepared under PRC accounting standards (or the accounting standards that are recognized by the Ministry of Finance ("**MOF"**) as equivalent to the PRC accounting standards) and
b) have their financial reports audited by an appropriately qualified accounting firm in China, unless the country or region in which the issuers are based has signed an agreement with the MOF regarding the equivalence of their regulatory regimes for audits conducted by registered accountants.

As of now, only Hong Kong financial reporting standards and IFRS adopted by the European Union ("**EU**") are recognised as equivalent to Chinese accounting standards. Only Hong Kong has signed a joint declaration with the PRC as to the equivalence of its auditing standards. This is a significant hurdle for issuers who prepare their accounts outside of EU and Hong Kong reporting standards but would like to issue panda bonds.

ASIFMA has made a submission to the PRC authorities (MOF, PBOC and National Association of Financial Market Institutional Investors ("**NAFMII**")) explaining that other advanced jurisdictions such as the US, EU and Australia (among others) do not impose such requirements when foreign issuers issue securities in these jurisdictions.

For instance, the US Securities and Exchange Commission ("**SEC**") changed its rules (in 2007) to allow foreign private issuers to file their financial statements prepared in accordance with IFRS without reconciliation, since the costs for carrying out such reconciliation could be quite steep. In 2008, the European Commission implemented rules that allow foreign entities to prepare their financial accounts using the GAAP of their home jurisdictions instead of having to restate financial statements using IFRS (which is adopted in the EU).

The MOF announced in 2006 the implementation of new PRC accounting standards that brought substantial convergence between PRC accounting standards ("**New PRC GAAP**") and IFRS. The New PRC GAAP is substantially similar to IFRS. Another example of substantial compliance with IFRS is the "FRS 101 – Reduced Disclosure Framework" adopted by some UK companies. On this basis, it is a suggestion that an appropriate step for the PRC to consider admitting the place-of-origin accounting principles at least to the extent they are compliant with IFRS or substantially compliant with IFRS. As a practical matter, a PRC-based audit/accounting firm could attest/testify to the fact that the requirement of "substantial IFRS compliance" has been met by individual Panda bond issuers, without the need for a full audit – this could also meet the "domestic audit supervision" requirement under current PRC guidelines.

Finally, professional investors (such as banks, insurance companies, public authorities and asset managers) are assumed to have a sophisticated understanding of the risks involved in any investment decision and, so require less disclosure than other types of investors. Most securities laws provide exemptions from extensive disclosure for private offerings and offerings to sophisticated investors.

CIBM investors are professional investors and therefore able to assess whether to rely on:
a) accounting information prepared in accordance with the GAAP of another country, and
b) an audit performed by an auditor that is not PRC qualified.

This is another reason for the PRC authorities to consider providing the requested exemptions for foreign issuers of Panda bonds.

2.2 Use of proceeds

The need to obtain approval for proceeds to be used onshore or offshore is another factor dampening interest from potential issuers and keeping good quality names away from the Panda bond market.

As this paper is being written, repatriating funds outside China may seem tricky as the PRC has in place various macro-prudential measures to control excessive capital outflow. But on the other hand, under the newly announced macro-prudential foreign debt management scheme (PBOC Circular 132), which went into effect on May 3, Panda bond proceeds are exempted from being classified as "foreign debt" if the proceeds are to be used onshore China. That means an overseas issuer of Panda bonds can on-lend the bond proceeds to its onshore subsidiaries located anywhere in China without having to utilize the subsidiaries' foreign debt quota. This scheme is eligible for most of the corporate entities and all financial institutions regulated by the PBOC, China Banking Regulatory Commission ("**CBRC**"), China Securities Regulatory Commission ("**CSRC**"), and China Insurance Regulatory Commission ("**CIRC**"). The exception is real estate companies and government financing platforms. This new regulation removes a previous "use of proceeds" hurdle, where leaving the bond proceeds onshore for use by an issuer's subsidiaries required consumption of foreign debt quota, although waiver could be granted on a case-by-case approval.

Ideally, issuers will decide whether to keep the funds inside or outside the PRC. Bond issuers and their potential investors are sophisticated market players. An issuer will be bound by the purpose of the issuance and use of proceeds as disclosed in the offering circular.

2.3 Ratings

The credit risk analysis of Panda bonds is considered more complex given these bonds are not denominated in the functional currency of the issuers, and distributed not in the jurisdiction of the issuers. There is also a practical concern about the alignment of the domestic credit rating system with the international standards. While Panda bonds provide impetus to the internationalization of the rating industry in China, there are also challenges posed in the rating framework, methodology and operation.

2.3.1 Alignment

Due to the variety of Panda bond issuing entities, rating agencies in China, which are used to focusing on analysis in a domestic context, need to evaluate and compare the ability and willingness of Panda bond issuers to repay debt, given that these issuers use different functional currencies and are subject to different operating environments.

The domestic rating industry in China does not currently have a unified view on the rating methodology for Panda bonds. The general consensus is that when evaluating the risk profile of the offshore debt issuing entity, the domicile country of the issuer should form the basis for the risk assessment. The major discrepancy lies between ranking the risk profile of issuers in a "global" context and in a "domestic" context. Some suggest following the existing domestic rating system, that is, by ranking the offshore issuer under the existing industry ranking methodologies, supplemented by taking into account other factors, such as, the issuer's country risk. Others suggest that offshore entities should not be ranked against domestic entities directly because offshore entities operate under different environments. The ranking of issuer's risk profile should then be adopted in a global context using a global rating methodology.

Other considerations are how to reconcile the different risk rankings of the same issuer domestically and globally, as well as the receptiveness of the domestic bond market towards the global risk ranking of Panda bond issuers. Moreover, the rating methodology may need to be revised for any new industry sector and new issuer type. Thought also has to be given as to how to address the situation where corporate ratings are higher than the relevant sovereign rating.

For pricing and risk control purposes, ratings from domestic credit rating agencies ("**CRAs**") are more recognized and accepted by the key stakeholders in the domestic bond market. However, international CRAs can also play a contributing role in supporting the development of the Panda bond market. As many of the companies that would consider issuing Panda bonds already have issuer level ratings from one or more international CRAs, international CRAs are able to help issuers increase awareness of renminbi denominated issuance. Also as international CRAs have broader rating industries and categories as well as wider spread rankings, investors can refer to ratings from international CRAs to make further comparison.

2.3.2 Challenges

Based on the current circumstances, credit ratings for Panda bonds still face challenges. These include (1) the rating system and regulatory framework for Panda bonds is still developing; (2) inconsistent rating methodologies and letters/symbols used by rating agencies, and inconsistent disclosure for the ratings of Panda bonds.

There have been eleven Panda bonds issued by nine issuers in the CIBM market since 2015, all receiving AAA issuer and issue ratings by the rating agencies. With the continuous regulatory relaxation on Panda bond issuance as well as the diversification of issuing entities, the rating mechanism for risk ranking of Panda bonds will gradually improve. The credit risk market of China is undergoing a tremendous transformation - the high concentration of AA or above ratings in the domestic bond market could extend to the Panda bond market. If the risks of Panda bonds cannot be assessed effectively, this could impact the stability of China's financial markets if systemic risk erupts in the corresponding regions of the Panda bond issuers.

The healthy development of Panda bond market relies upon a sound rating framework. The domestic ratings agencies are expected to expedite the improvement of the issuance and rating framework, to unify the management of the rating of Panda bonds including rating fees, principles of rating exemption, operational flow for overseas ratings etc. At the same time, the framework and management of the rating industry will be strengthened. The rating of Panda bonds is undergoing a phased transition to maturity.

2.4 Legal considerations

2.4.1 Approval process

There are currently no specific PRC regulations, rules or guidelines that regulate the offering of renminbi bonds by foreign financial institutions, sovereigns or non-financial enterprises in the CIBM. Measures do however exist for international development institutions ("**IDI**"). The absence of specific applicable law, means that the approval process is currently conducted on a "pilot" basis meaning bespoke approvals, and negotiation of issuance procedures with the PBOC and NAFMII.

Different approval procedures apply according to particular categories of issuer. Issuance of bonds by offshore financial institutions must be approved by the PBOC. Issuance of bonds by offshore non-financial enterprises (companies) must be registered with the NAFMII after approval by the PBOC and possibly the National Development and Reform Commission ("**NDRC**"). Where an offshore government wishes to issue bonds in the CIBM, it must first apply to the PBOC and then NAFMII, based on the instructions of the PBOC, assesses the issue documents for compliance with relevant registration rules and procedures.

The steps to be taken in an onshore issue of renminbi bonds are:

- application for approval to issue onshore renminbi bonds
- submit draft documents to PBOC and NAFMII (including the offering circular, audited financial statements, underwriting agreement, rating reports and draft legal opinions)
- approval on issuance or registration is granted
- publication of issuance plan and offering circular
- roadshow
- admission to the onshore clearing house and book building exchange
- pricing, followed by settlement and trading.

2.4.2 Eligibility of issuers

The measures applicable to IDIs require IDIs to have already provided onshore Chinese projects or companies with loans or equity capital of at least USD 1 billion. There is no equivalent requirement for other types of issuers.

2.4.3 Disclosure

Generally speaking, standards of disclosure in leading offshore markets are acceptable in the PRC although an assessment needs to be made as to whether names that are not as well known in the PRC require more disclosure.

Clearly, PRC investors must be given the same disclosure, and at the same time, as offshore investors. This might involve satisfying on-going disclosure obligations by incorporating by reference to an onshore website and to making copies available at an address or website in China.

It is an expensive and time consuming process to translate a large quantum of financial data and so issuers will aim to translate only summaries of key financial information by way on on-going disclosure. Applications for approval must be accompanied by translated three year results together with management discussion and analysis or other data (including economic data for sovereigns) consistent with the issuer's usual offshore disclosure.

Again, not one size fits all and a careful assessment needs to be made for each issuer.

2.4.4 Governing law

The legal system of the PRC is based on the civil law system. It consists mainly of codified law. The PRC does not have a formal system of judicial precedent.

Although the issuers are non-PRC entities, the expectation is that panda bonds are governed by PRC law. There is no substantive difference between the rights and obligations of the parties to a bond governed by PRC governing law and a bond governed by the laws of a western jurisdiction such as England. The obligations of an issuer of a bond governed by PRC law should be valid, binding and (subject to the terms of such bond) enforceable under PRC law in the same way as the obligations of an issuer of a bond governed by English law.

Issuers should seek legal advice as to whether any particular difference between the rights and obligations of the parties to a bond governed by PRC governing law and a bond governed by the laws of a western jurisdiction is material.

2.4.5 Arbitration

Under PRC law, parties to “foreign-related” contracts are generally free to select a preferred dispute resolution forum to govern their contracts, provided their choice is consistent with PRC law. This means that the issuer is given some flexibility in deciding the precise terms of it agreeing to arbitrate disputes (such as the language in which proceedings are conducted and the nationality of the arbitrators). The seat of the arbitration and the rules which govern the arbitration are likely to be in Beijing, and the China International Economic and Trade Commission Arbitration Rules.

3. Conclusion

Clearly, Panda bonds are a product whose full potential is a long way from being realized – undoubtedly, the market is still in its nascent stage. However, in time, it is not difficult to visualize a market that is so well-developed and established that it is on par with the Samurai, Eurodollar or other Eurocurrency bond markets in their heyday.

Given the unwavering commitment of the Chinese regulatory authorities to fully liberalize the renminbi capital markets and internationalize the renminbi, it is reasonable to expect that the many obstacles and technical hurdles that have stood in the way of progressively higher levels of Panda bond issuance will soon be overcome. It is in the interest of the mainland’s regulatory authorities to gradually ease the regulations and restrictions that stand in the way of the market’s rapid growth and development. Green shoots have already emerged in the Panda bond market. It’s just a matter of time now.

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