

Global Markets, HSBC

China Onshore and Offshore RMB Bond Market - A Foreign Bank Perspective

September 2011, New York

Agenda

- Overview of Onshore RMB Market **Section 1**
- HSBC's Participation into Onshore RMB Market **Section 2**
- Access by Foreign Bank Offshore **Section 3**
- Outlook **Section 4**

Section 1

Overview of Onshore RMB Market

Market Development

Rapid Development

Since the establishment of interbank market in 1997, market size has been increasing rapidly

Interbank market turnover reached more than RMB67 trillion in 2010, close to 3 times of its market size

China bond market is at RMB20 trillion close to 50% of GDP

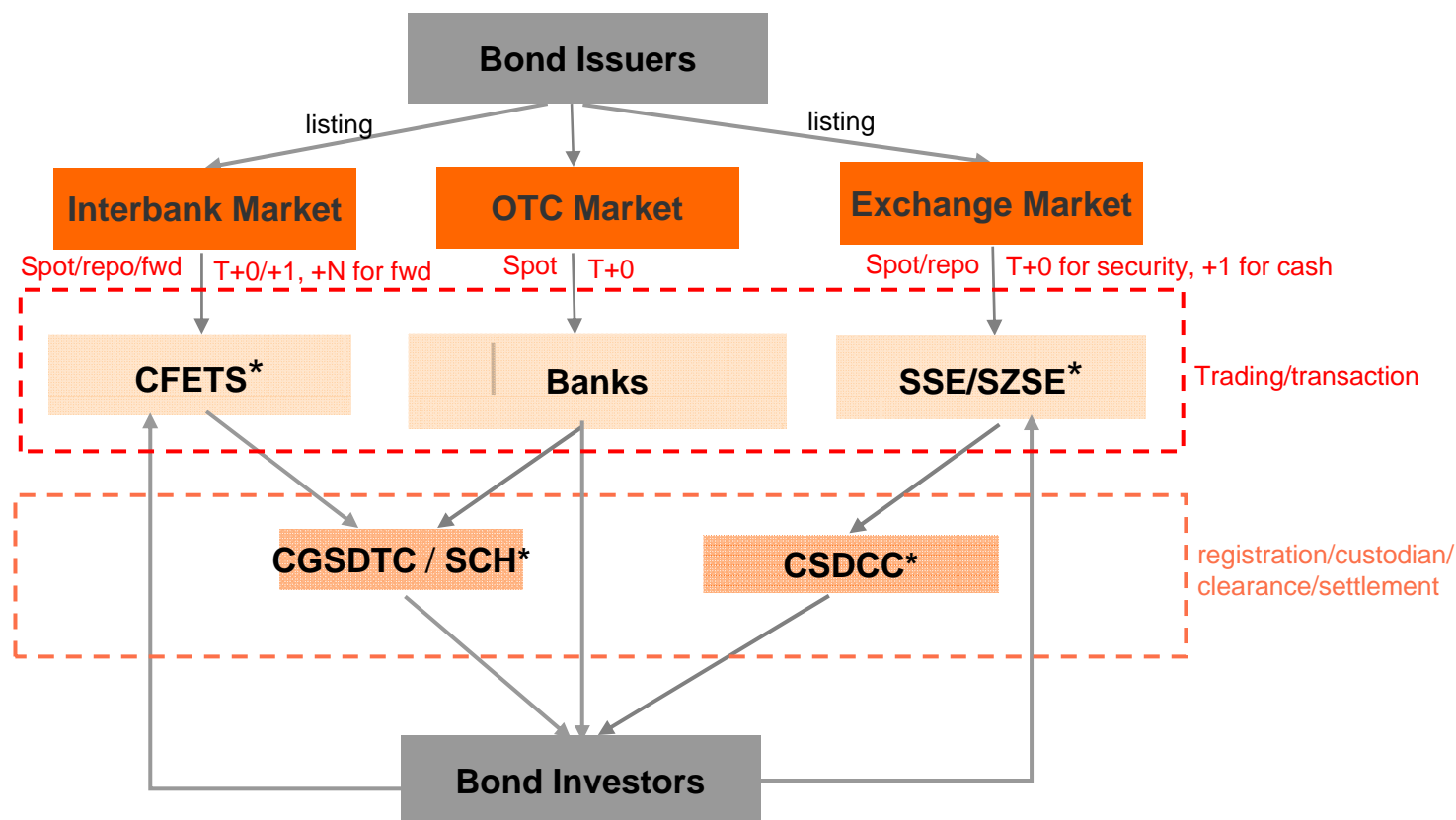
Year	Events
1981	Resume of Government bond issuance
1985	First issuance of enterprise bond and financial bond
1986	OTC trading started
1994	First policy financial bond issuance and first enterprise bond listing
1997	Interbank market established
1998	First non-guaranteed enterprise bond issuance
2002	PBoC opened up domestic exchange market to QFII
2003	Subordinate bond emerged
2005	Enterprise bond staged on interbank market First issuance of commercial papers, common financial bonds, ABS&MBS, and Panda Bond Launch of bond forward
2006	Launch of IRS
2007	Launch of Shibor and FRA, first corporate bond issued
2008	Launch of MTN
2009	Foreign banks allowed to trade credit bonds First domestic USD bond issuance by Non-FI First RMB bond issued by foreign banks in offshore market First MOF bond issuance in Hong Kong Collection Notes by SME
2010	3 types of offshore intuitions allowed to access domestic interbank market Launch of CDS/CRMW/CRMA, SCP

Market Structure

Bonds are traded in *interbank market*, *OTC market* and *Exchange market*.

Interbank market, with its share of 93.9%(by June 2011), dominates the China bond market

CFETS is quote-driven OTC trading system while SSE/SZSE use electronic auto matching system



CFETS: China Foreign Exchange Trade System & National Interbank Funding Center

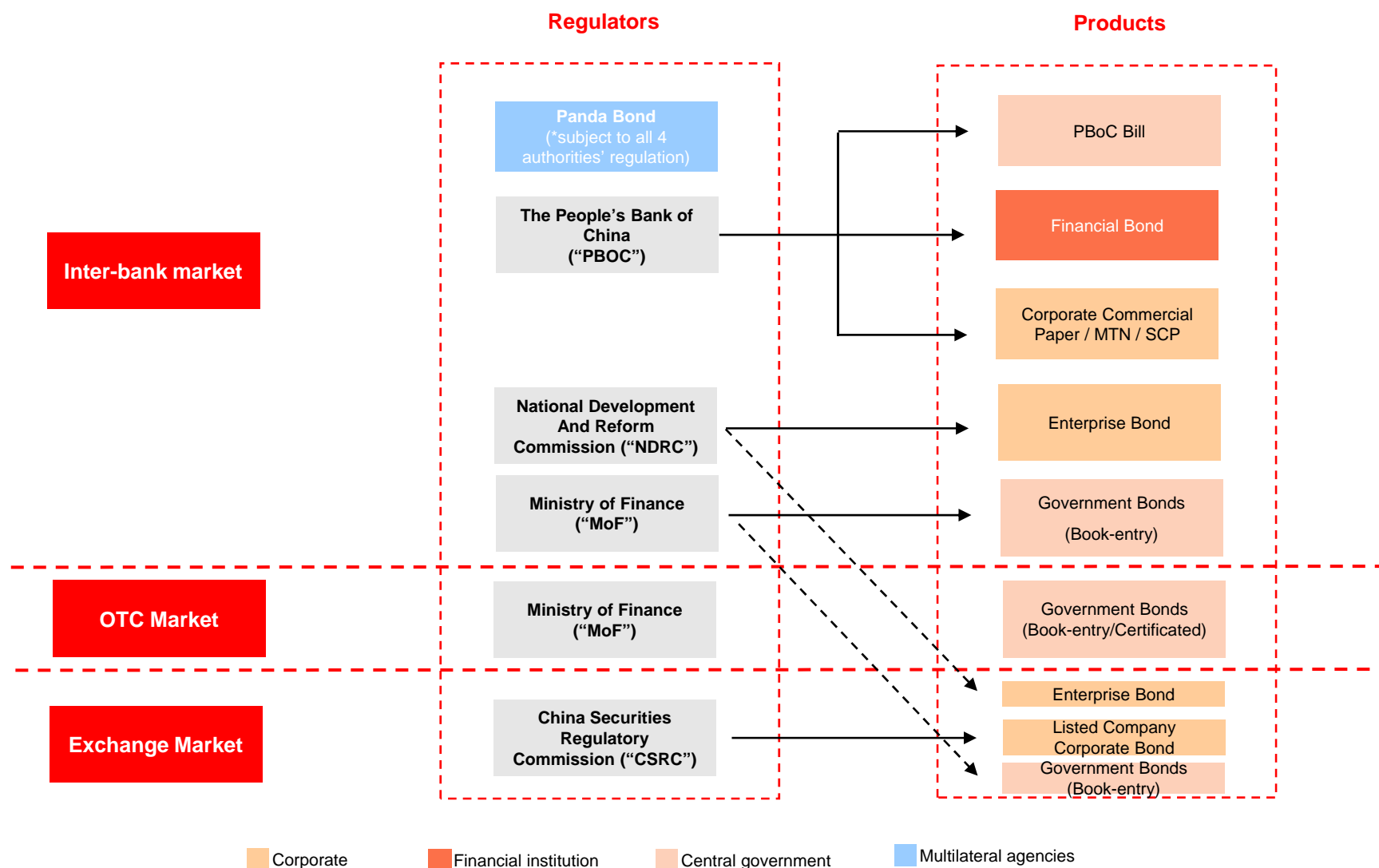
CGSDTC: China Government Securities Depository Trust Clearing Co. , Ltd.

CSDCC: China Securities Depository and Clearing Corporation

SSE/SZSE: Shanghai / Shenzhen stock exchange

SCH : Shanghai Clearing House

Regulation Structure

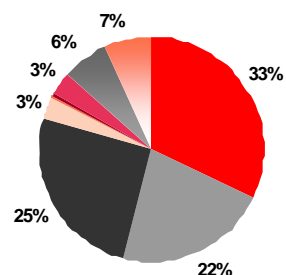


Market Products

Government bond, PBoC bill and financial bond are the three most important rate products

Major Credit products include commercial paper, mid-term note and enterprise bond

Market shares of government bonds, PBoC bills and policy bank notes are 33%, 22% and 25% respectively



■ Government Bond
 ■ Central Bank Bills
 ■ Policy Bank Notes
 ■ Commercial Paper
 ■ Mid-term Notes
 ■ Enterprise Bond

Type	Products	Issuer	Primary Market	Circulation Market	Liquidity	Tenor
Rates Products	Government Bond					
	- Book-entry Bond	MOF	Auction *	Interbank & Exchange	●	3m-50y
	- Certificated Bond	MOF	Auction	OTC	N/A	1y, 3y, 5y
	- Local Government Bond	Local Government	Auction	Interbank & Exchange	○	3y, 5y
	PBoC Bills	PBoC	Auction	Interbank	●	3m, 6m, 1y, 3y
	Financial Bond					
	- Policy Bank Notes	ADB, EXIB, CDB (by 2012)	Auction	Interbank	●	6m-30y
	- Commercial Bank Notes	ICBC, CCB, etc.	Book-running	Interbank	●	2y-15y
	- Non-bank FI Notes	Security firms, etc	Book-running	Interbank	○	1y-20y
	Government Sponsored Agency Debt	China Huijin Investment	Book-running	Interbank	○	5y,7y,20y,30y
Credit Products	Commercial Paper	non-FI companies	Book-running	Interbank	●	3m,6m,9m,1y
	Mid-term Notes	non-FI companies	Book-running	Interbank	●	3y,5y,7y,10y
	Enterprise Bond	non-FI companies	Book-running	Interbank & Exchange	●	3y-30y
	Asset Backed Securities	Trust Companies	Book-running	Interbank	○	9m-5y
	Collection Notes	Small and middle size non-FI companies	Book-running	Interbank	○	1y,2y,3y

○ Poor ● Acceptable ● Average ● Good ● Excellent

* Auction is conducted through PBoC / CGSDTC Auction System.

Market Players

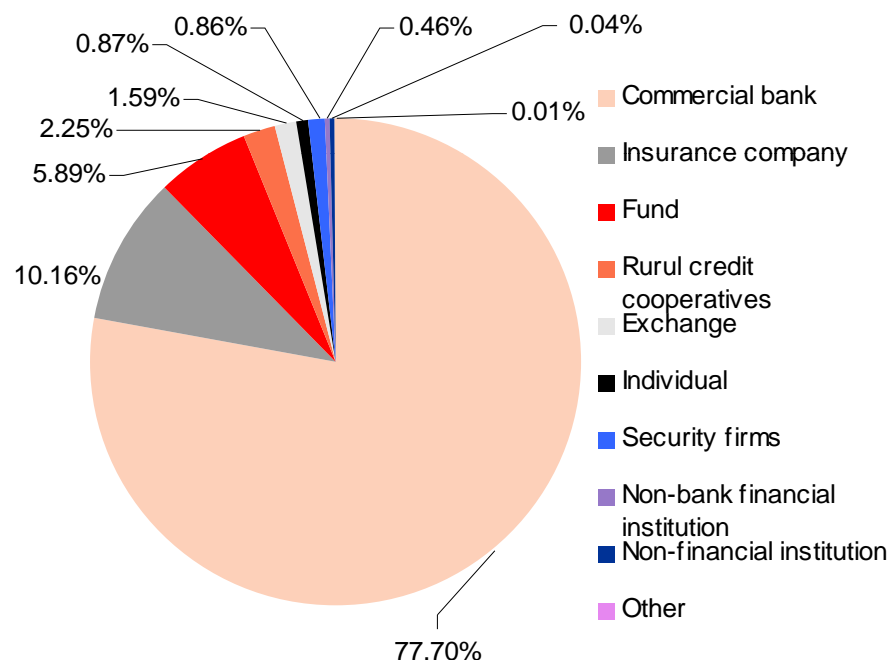
Commercial Banks are the main players in the interbank market

Security firms, insurance companies, funds and trust investment companies have access to both interbank and exchange market

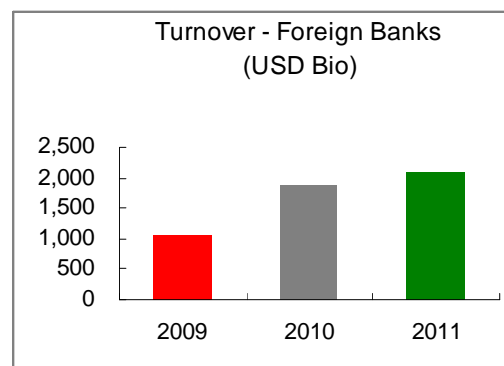
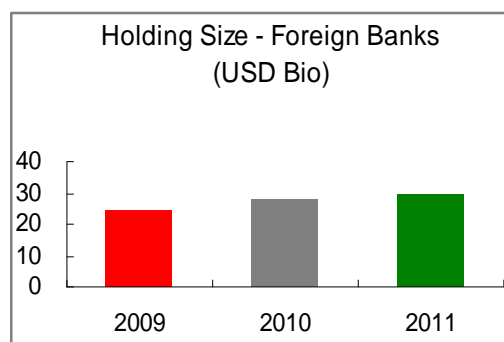
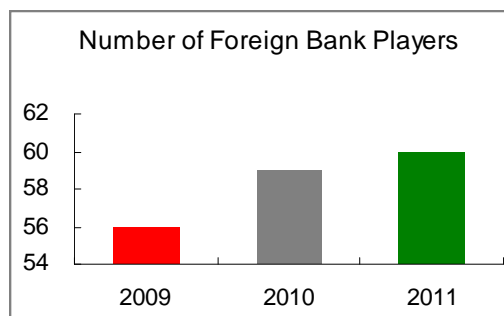
Commercial Banks are also the main investors in China bond market, holding more than 75% of total bonds with a duration less than 5 years.

Insurance companies and funds are the second and third largest players in this market, whose duration depends on its backed properties

Outstanding Volume – Inter-bank and Exchange markets (by investor type)



Foreign Bank's Participation



Type	Year *	Foreign Banks	Market Participants	Foreign Banks' Share
Number of Players	2009	56	9,247	0.6%
	2010	59	10,235	0.6%
	2011	60	10,792	0.6%
Holding Size (USD Bio)	2009	24.6	2,739.0	0.9%
	2010	28.2	3,152.3	0.9%
	2011	29.7	3,239.1	0.9%
Turnover (USD Bio)	2009	1,072.6	15,271.3	7.0%
	2010	1,872.6	21,152.3	8.9%
	2011	1,222.5	12,414.5	9.8%

Source: www.chinabond.com.cn

* Year 2011 refers to the period ended 31 July 2011.

Foreign banks, although accounting for less than 1% market stake (in terms of participant number and holding size), are playing an increasingly active role in the onshore bond market, which is evidenced by the growth in trading volume.

A Glance at Other Onshore RMB Markets

Access to Onshore Money Market

- Accepted by CFETS as the Member
- Sign NAFMII Master Agreement (multi-lateral agreement)

Access to Onshore Inter-bank Derivatives Market

- CBRC Derivatives License
- Bilateral *NAFMII Agreement with Trading Counterparty
- CFETS membership is preferred to facilitate through CFETS platform

* NAFMII – National Association of Financial Market Institution

Market Type	Products	Launch Year	Turnover Jul 11 YTD (USD Mio)	Tenor (Market Practice)
Money Market	Repo			
	- Close-end Repo	1997	8,428,955	O/N – 1Y
	- Open-end Repo	2004	232,885	O/N – 1Y
	SHIBOR (Note 1)	2007	2,764,107	O/N – 1Y
	Bilateral Loan	1996	Not Available	4M above
Derivative Market	Interest Rate Swap	2006	235,713	Up to 10 years
	Cross Currency Swap	2007	Not Available	Up to 10 years
	Credit Risk Mitigation Instruments (Note 2)			
	- Credit Risk Mitigation Warrant (CRMW)	2010	116	Up to 10 years
	- Credit Risk Mitigation Agreement (CRMA)	2010	Not Available	Up to 10 years

Source: www.chinamoney.com.cn

Note 1: SHIBOR - Shanghai Interbank Offered Rate is the arithmetic average RMB interbank offer rate quoted by bank group which includes some high-credit level banks.

Note 2: Credit Risk Mitigation Instruments ("CRMI") are basic credit derivatives used to manage the credit risk, including of Credit Risk Mitigation Agreement and Credit Risk Mitigation Warrant. CRMI is the innovation of china credit derivatives market, which is similar to the CDS traded offshore.

Section 2

HSBC's Participation into Onshore RMB Market

HSBC's Participation Into Onshore RMB Market

**The Leading
Foreign Bank in China**



Large Network and Investment

- The largest service network of 103 outlets as of 13 October; approximately 5,200 employees of which 98% were recruited locally
- Formally opened new China headquarter in the HSBC Building on 09 June 2010, part of the landmark Shanghai IFC commercial complex in the heart of Shanghai's financial district
- One of the largest investors among foreign banks in China – 19% stake in Bank of Communications, 16% stake in Ping An Insurance, and 8% stake in Bank of Shanghai

Market Pioneer

- First MOF bond underwriting license among foreign banks as early as 2004, engaged in almost every single auction
- First Primary Dealer of Open Market Operation among foreign banks at 2007.
- Trial market maker since Dec 2007.
- The first and only foreign bank to perform bond settlement agent to both onshore and offshore clients.
- First foreign bank to trade CRMA and issue CRMW in Dec 2010

Active Player

- 2010 trading volume over RMB 2 Trillion, largest market share among foreign banks

Capital and Risk Management

Highlights of Key Risk Considerations

Capital Requirement (Risk-weighting Assets)

- Local Standard Approach (as elaborated in the next slide)
- Minimum Capital Adequacy Ratio @ 11.5% (SIB, systematically important banks) and 10.5% (non-SIB)
- Plan for migration to Basel II and III by end of 2013 (SIB) and 2016 (non-SIB)
- Cap on net derivatives exposure (net derivatives market risk capital / core capital \leq 3%)

Credit Risk

- Marking credit lines for close-end Reverse Repo and Repo trades
- **Credit Risk for Close-end Reverse Repo:** Lack of self remedy procedure and statutory time line to redeem the pledged bond in solvency;
- **Credit Risk for Close-end Repo:** Same logic applies but the credit risk weighting is lower, because the bank would hold more valuable assets (cash) under repo than pledged bonds under reverse repo transaction during insolvency procedure.

Short-selling mechanism

- Direct (Uncovered) short selling in bond secondary market is not allowed
- Open-ended Repo can be a good alternative

Capital and Risk Management

Book	Product	Basel II - IRB Advanced Approach		* CBRC Standard Approach	
		Market Risk	Credit Risk	Market Risk	Credit Risk
Trading Book	Bond	Trading VaR	N/A	Key drivers for RW%: * Issuer type: government, qualifying or others * Residual tenor	N/A
	Derivatives		Key drivers for RW%: * Underlying index: FX, IR , Equity, etc * Assets class: sovereign, bank or corporate * Counterparty's CRR * Residual tenor	Key drivers for RW%: * Currency * Interest rate * Residual tenor	Key drivers for RW%: * Underlying index: FX, IR, Equity, etc * Assets class: sovereign, bank or corporate * Residual tenor
Banking Book	Bond	N/A	Key drivers for RW%: * Assets class: sovereign, bank or corporate * Issuer's CRR * Residual tenor	N/A	Key drivers for RW%: * Assets class: sovereign, bank or corporate * Residual tenor
	Reverse Repo		Key drivers for RW%: * Market value of underlying bond * Assets class: sovereign, bank or corporate * Issuer's CRR * Residual tenor		Key drivers for RW%: * Assets class: sovereign, bank or corporate * Residual tenor
	Derivatives		Key drivers for RW%: * Underlying index: FX, IR , Equity, etc * Assets class: sovereign, bank or corporate * Counterparty's CRR * Residual tenor		Key drivers for RW%: * Underlying index: FX, IR, Equity, etc * Assets class: sovereign, bank or corporate * Residual tenor

* CBRC – China Banking Regulatory Commission

Section 3

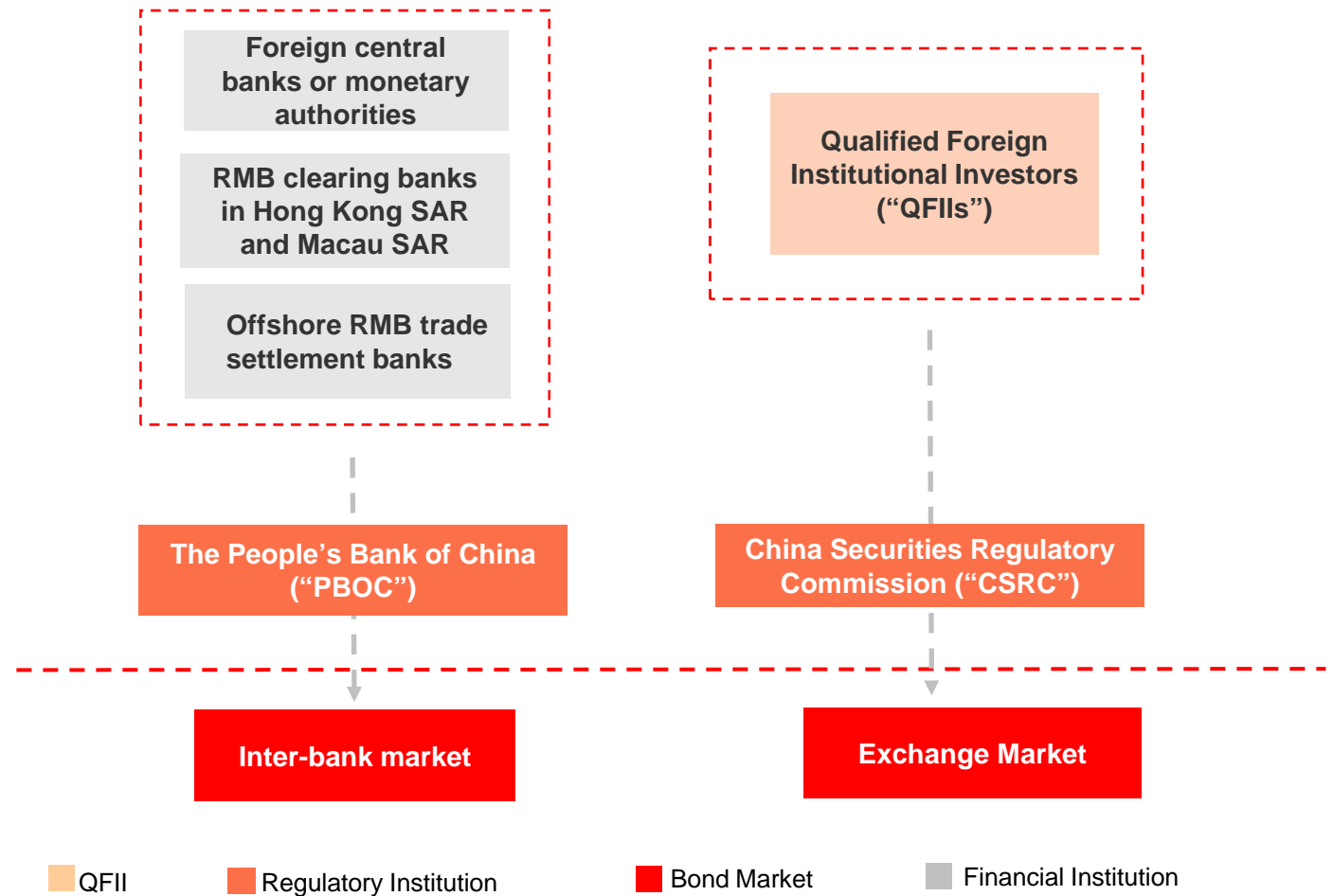
Access by Foreign Banks Offshore

Regulation Structure

On 1 December 2002, the China Securities Regulatory Commission (CSRC) announced the opening of onshore bond / equity market to Qualified Foreign Institutional Investors (QFII).

Total approved QFIIs:
113 (as of June11)
Total approved quota USD19.72 bn (as of 31Dec10)

on 16 August 2010, the People's Bank of China (PBOC) released the pilot program for three types of eligible foreign institutions to invest in the China Inter-bank Bond Market.



Pilot Scheme of Foreign Investor's Participation into China Interbank Bond Market (CIBM)

Foreign Investor's Participation in the CIBM

Item	Rules
<i>Eligible Investors</i>	•Type 1: Foreign central banks or monetary authorities
	•Type 2: RMB clearing banks in Hong Kong SAR and Macau SAR
	•Type 3: Offshore RMB trade settlement banks
<i>Source of Fund</i>	RMB fund generated from central bank currency cooperation, cross-border trading or RMB investment business.
<i>Investment Scope</i>	•Government bonds, PBOC bill, financial bond, commercial paper and mid-term notes
	•Repo transactions, derivatives/structured products and leveraged trading are not allowed
<i>Quota Control</i>	The net remitted-in capital cannot exceed the approved quota at any point of time
<i>Coupon Interest</i>	Coupons could be based on fixed or floating rates and paid on a semi-annual or annual basis.
<i>Regulatory Reporting to PBOC</i>	•File Bond Settlement Agency Agreement within 3 working days after execution
	•Report business details on a monthly basis (e.g. bond transaction settlement amount)
	•Report investor's cash settlement and bond trading information
	•Report any changes on a monthly basis (e.g. Bond Settlement Agency Agreement, account opening/closure, etc)

Who Qualifies for QFII Status?

QFII Eligibility Criteria:				
Type of Institution	Track Record and Operational Experience	Assets under Management	Paid in Capital	Ranking in world
Fund managers	5 years or more	Not less than US\$5 billion in securities assets in the last financial year	N/A	N/A
Insurance companies	5 years or more	Not less than US\$5 billion in securities assets in the last financial year	N/A	N/A
Securities companies	30 years or more	Not less than US\$10 billion in securities assets in the last financial year	USD1 billion	N/A
Commercial banks	N/A	Not less than US\$10 billion in securities asset in the last financial year	N/A	Total assets ranked in top 100 banks in the world
Others (pension fund, charity fund, endowment fund, trust company, government investment institution)	5 years or more	Not less than US\$5 billion in securities asset in the last financial year	N/A	N/A
Investment portfolio Ratio	N/A	Equity Investment \geq 50% of total quota; Cash \leq 20% of total quota	N/A	N/A

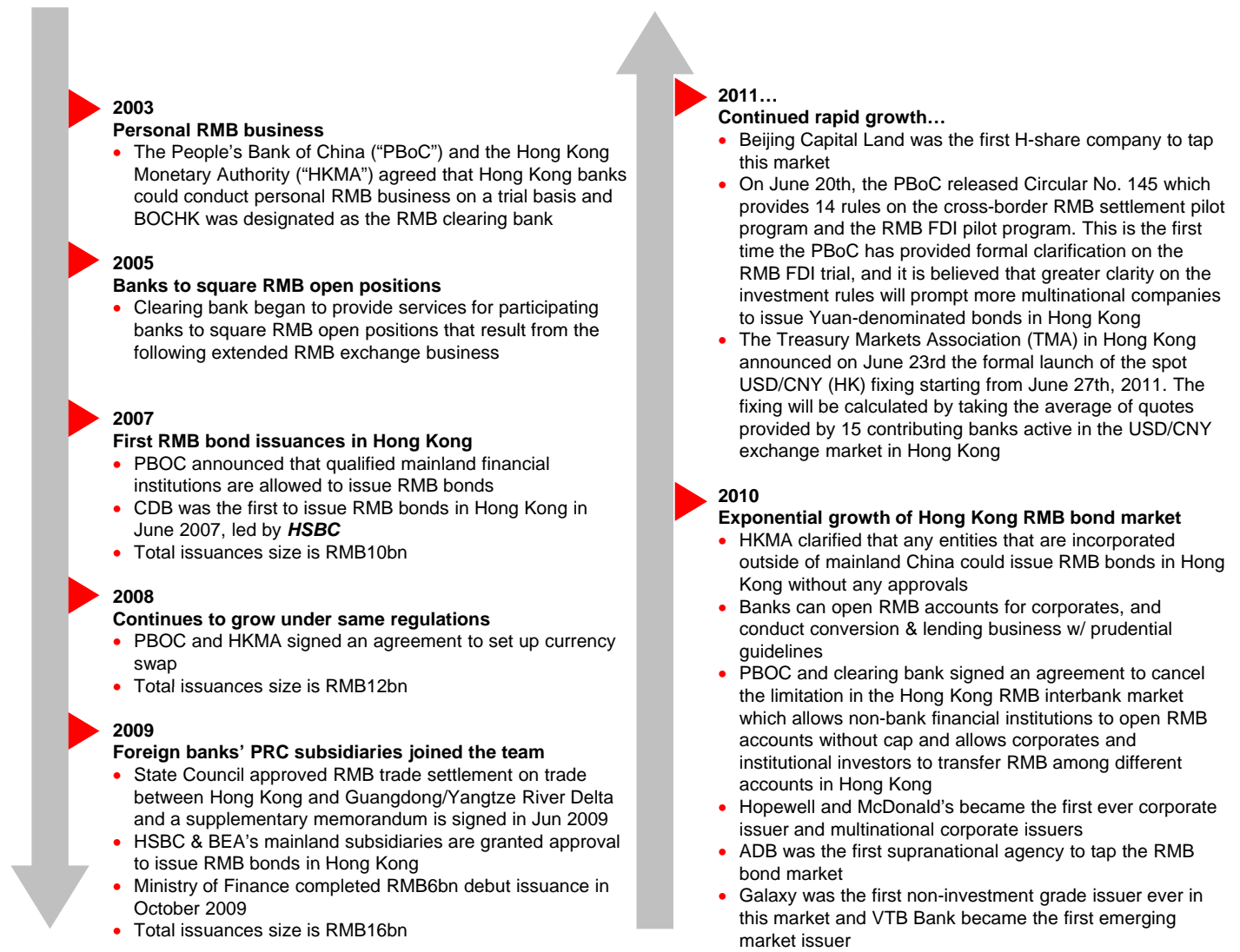
Note: The securities regulatory authorities of the applicants' domiciled country or region have signed Memorandum of Understanding with CSRC.

Development of RMB Business in Hong Kong

The Hong Kong RMB bond market commenced in 2007 while the RMB business in Hong Kong started in 2003

The market has experienced exponential growth in 2010, and continues in 2011, as Hong Kong is positioned to become the offshore RMB center

We continue to see developments on both the issuer's side and the investor's side this year

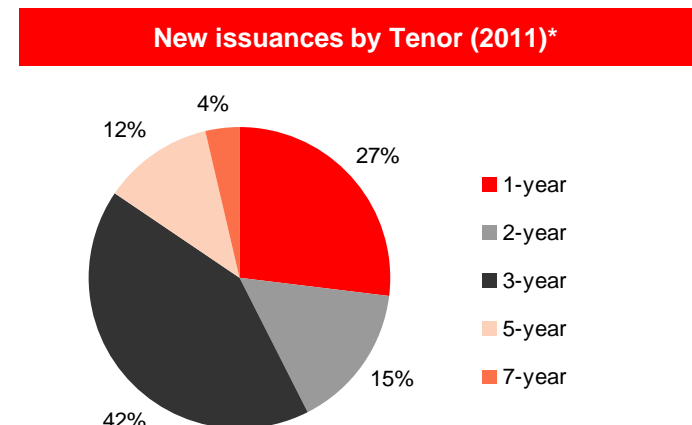
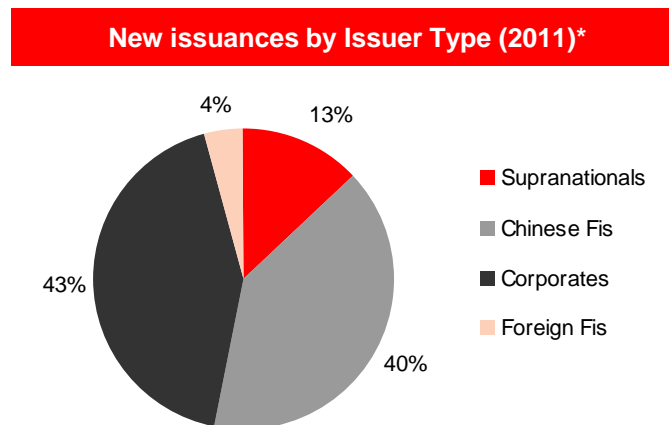
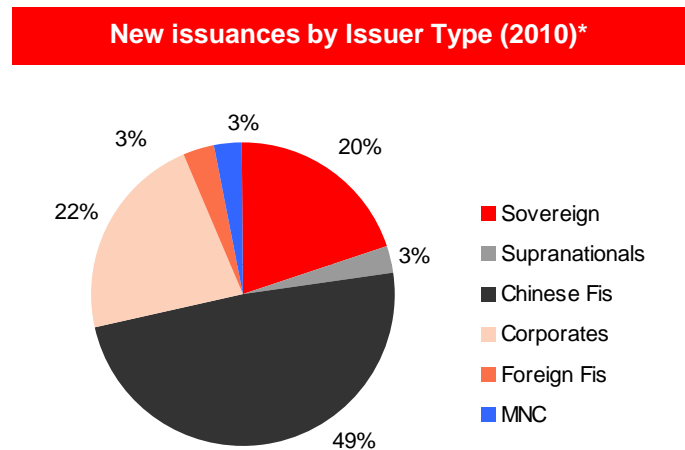
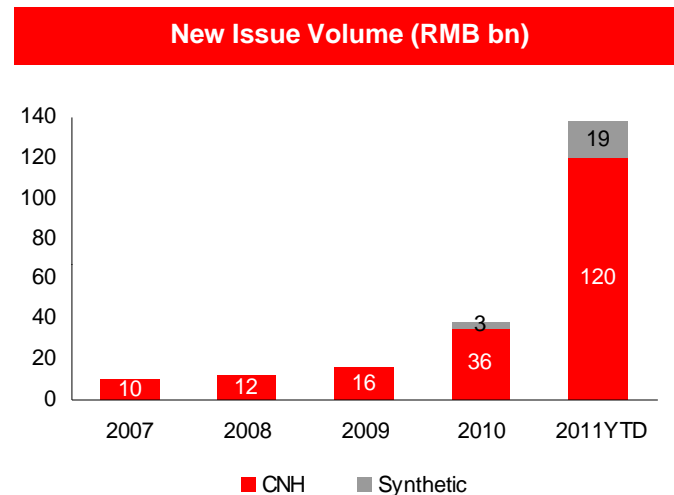


Overview of RMB Bond Issues in Hong Kong

Under the favorable regulatory environment, the offshore RMB bond market has developed rapidly in recent years

1-3 year bonds accounted for 85% of total issuance in 2011YTD, indicating the strong demand for short tenors

Issuer type has broadened significantly and now includes Chinese banks, Chinese corporates, foreign banks, foreign corporates, sovereign, as well as supranational



* excluding synthetic RMB bond issuances

Section 4 Outlook

Room for Growth

- ✓ **Government Debt at 27% of GDP**
- ✓ **Corporate bond market less than 10% of bank loans**
- ✓ **Interest rate liberalisation on the way**
- ✓ **Internationalization in progress**

Room for Improvement

- ✓ **Secondary market liquidity**
 - ✓ **Increase complexity of market participants**
 - ✓ **Robust market making mechanism**
- ✓ **Enhance legal and risk management framework**
 - ✓ **Maturity in treatment of bankruptcy and credit events**
 - ✓ **Clarity of capital and credit implication of risk mitigation tools**
 - ✓ **Clarity in tax treatment**
- ✓ **Wider breadth of financial products**
 - ✓ **Bond futures?**

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