Macro
Asian Currencies

The offshore renminbi

A practical primer on the CNH market

- **The offshore RMB (CNH) market offers an important new option to take and manage RMB risk**
- **CNH offers exposure to real investments and positive yield, but is still illiquid and supply is limited**
- **The NDF market still provides the best liquidity for large positions; multinationals can now choose between four curves for hedging**

What exactly does offshore RMB mean? Why does the RMB in different places trade at different rates? What will determine how fast the offshore RMB market develops? With so many options, what is the best way to take and manage RMB risk?

Understanding the recent developments in offshore RMB markets is no straightforward endeavour. To start, while the RMB which is traded both onshore in China, and offshore (primarily in Hong Kong) are the same currency, they trade at different rates. This is by design: as regulation has explicitly kept onshore and offshore separated, the respective supply and demand conditions lead to separate market clearing exchange rates. Hence the emergence of a new currency code, CNH, to represent the exchange rate of RMB that trades offshore in Hong Kong. However, it does not end here. There is the traditional offshore RMB market, the dollar settled non-deliverable forward (NDF), which itself trades independently of either onshore CNY or offshore CNH, as well as a trade-settlement exchange rate (sometimes called CNT) to which offshore corporates have access, just to add to the complexity.

This primer walks through the what, how, and why of the development and workings of the new offshore RMB market. Besides laying out the various forms of RMB that are now tradable, we also describe how they interact in the market, and in some cases, how they cannot interact. One key conclusion is that while relative value exists, it is complicated by the interaction of multiple factors. We end with a discussion of what to consider when looking at future market developments in offshore RMB.

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CNH: A practical primer

- The Hong Kong RMB (CNH) market offers an important option to take and manage RMB risk which is separate from existing markets
- CNH offers exposure to real investments and positive yield, but is still illiquid and supply limited
- The NDF market still provides the best liquidity for large positions; multinationals can now choose between four curves for hedging

The initiation of the CNH market in recent months is the most significant development for investors and risk managers with RMB exposure. The purpose of this primer is to provide a practical framework for understanding how the various RMB markets work and interact, how to decide which is the best market to take and manage risk, and how to interpret ongoing developments.

One country, two systems, three currencies (and four curves)

Key is that the CNH is effectively a separate currency that, while it does allow exposure to RMB, is not a perfect proxy to either onshore CNY or the NDF curve. This is because by design there are separate jurisdictions where the RMB can exist, and this division creates separate supply and demand conditions, and therefore three separate but related markets.

For this reason, in this document we will use RMB to refer generically to the Chinese yuan, irrespective of jurisdiction and market. We use CNY to refer to currency within Mainland China traded in the onshore market. CNH will refer to RMB offshore, primarily traded on the Hong Kong interbank market, while NDF refers to the offshore dollar settled non-deliverable forward market.

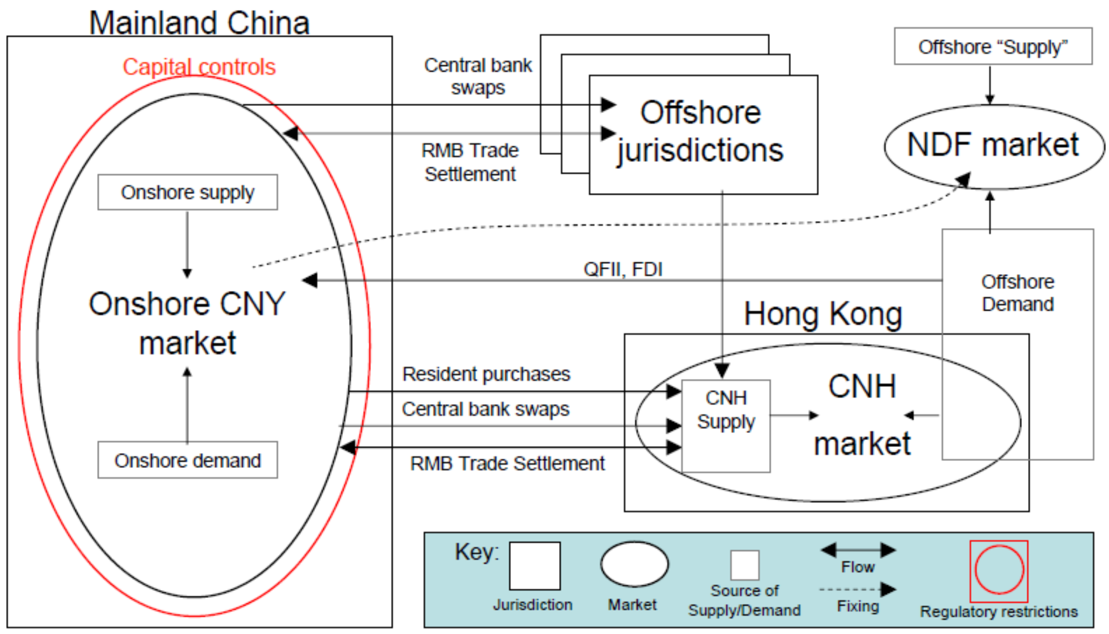
Diagram 1 illustrates how supply, demand and flows of RMB are split up and regulated across the multiple jurisdictions, while Table 1 summarizes the key differences between the different markets. While the schematic looks daunting, some brief points will help to illustrate the key issues:

- **CNY – Onshore RMB and the capital account –** The RMB has traditionally been a non-deliverable currency, convertible on the current account but considerably limited on the capital account. Cross-border capital account flows are limited to FDI, various QFII & QDII schemes, as well as through informal channels.

  Thus, the CNY market is largely determined by trade flows, and other onshore supply and demand. However, regulation and government intervention play a large role in how the market operates. Most notable is active currency market intervention to

HSBC

Diagram 1: One country, two systems, three currencies



Source: HSBC

manage supply and demand, and thus the exchange rate. Meanwhile restrictions, for example, limit the extent to which the CNY forward market acts as an interest rate curve[1].

- **CNH – the offshore RMB market –** Hong Kong was the first jurisdiction to allow accumulation of RMB outside mainland China, starting in 2004[2]. The RMB became officially deliverable in Hong Kong on 19 July 2010, with a joint announcement between the PBOC and the HKMA (see *Asian FX: First take on new Hong Kong RMB rules*, 21 July 2010). Other than Hong Kong, RMB can be accumulated in other jurisdictions as a result of the expansion of the RMB trade settlement pilot scheme beyond Hong Kong and Macau[3]. However, Hong Kong is the only jurisdiction to date where RMB trading is officially sanctioned and regulated (in other jurisdictions, RMB trading is somewhat a grey area in that it is not explicitly restricted, but neither is it explicitly permitted or regulated). Combined with the fact that Hong Kong has been the traditional centre of offshore RMB deposits and liquidity, Hong Kong and the CNH market has become the de facto centre for offshore RMB.

Within Hong Kong the regime is fairly liberal. Most of the management of the market is established at the macro level. Importantly, no intervention occurs (up to the present) to manage the CNH exchange rate. Supply of

[1] The onshore CNY forward curve is restricted to onshore corporates with proper documentation. Furthermore, restrictions on spot USD-CNY will translate to further divergence of the FWD, swaps, and implied interest rate curve. We discuss this type of impact from recent restrictions on the spot market in "G20 – Acting lessons" 12 Nov 2010. A much more in-depth discussion on forward market independence is discussed in Wang, "Convertibility Restriction in China's FX Market and its Impact on Forward Pricing" 9 Oct 2010, http://ssrn.com/abstract=1710911

[2] HKMA "Personal Renminbi Business in Hong Kong" 5 February 2004, http://www.info.gov.hk/hkma/eng/guide/circu_date/20040206e1.htm

[3] As well as through central bank swaps.

Table 1: Summary of the four curves

Currency	What	Regulator	FX mechanism	Participants	Market liberalization	Forward curve
CNY	Onshore RMB	PBoC, SAFE	CFETS, Daily fix, PBoC intervention	Onshore (residents), permitted investors (FDI, QFII, QDII)	Heavily regulated	Futures
CNH	Offshore deliverable RMB	HKMA with the cooperation of PBoC	OTC, market clearing	Offshore	Mostly liberalized	Interest rate
CNT	Cross-border RMB	PBoC, SAFE	Designated clearing banks, cleared through onshore CNY markets	Offshore corporates, permitted clearing banks, onshore banks	Heavily regulated	Interest rate
NDF	Offshore non-deliverable RMB	None	OTC, CNY fix	Offshore	Unregulated, restricted onshore	Futures

Source: HSBC; CFETS is the China Foreign Exchange Trading System

CNH is indirectly calibrated through the management of the channels through which RMB is allowed to flow from onshore to Hong Kong: resident purchases by individuals, trade settlement, and central bank swaps.

Note that a permitted cross-border transaction is not a CNH transaction. It occurs effectively at the onshore CNY rate, and is sometimes referred to a CNT transaction (the "T" referring to trade settlement).

Finally, note that there are few restrictions on CNH account opening in Hong Kong, effectively exposing the market to the universe of offshore demand for RMB. As such, the CNH market has a completely separate set of demand and supply conditions from the onshore CNY.

- **The non-deliverable forward (NDF) market** – Before the establishment of the CNH market, the dollar settled non-deliverable forward (NDF) market has been the traditional market from which to take and manage RMB risk offshore. With onshore participants restricted from participating, this is truly an offshore market. The one link between this and the onshore CNY market is the fact that the NDF fixes off the onshore CNY fix. This link is what separates the CNY NDF and the CNH market, as we will explain in more detail below.

How the markets interact

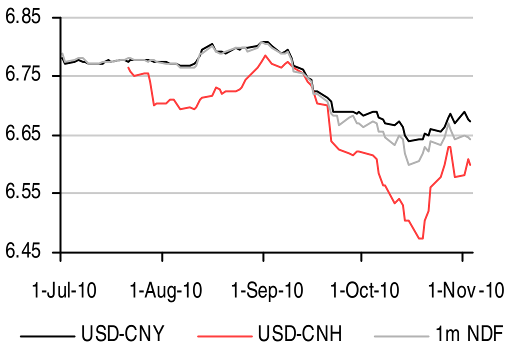
Three flavors of the same RMB

All three currencies represent the RMB and therefore should inherently be closely linked in valuation terms: RMB cash in Hong Kong is valid tender in the mainland as long as one can transfer it via the allowed channels – in other words, the only determinants of difference in the value of CNY and CNH should be the relative difficulty of making cross-border transfers. Therefore, CNY and CNH will converge once the pipes between the mainland and Hong Kong jurisdictions become large enough.

Meanwhile, the NDF curve acts as a "futures" curve (priced off expectations for actual future onshore CNY spot rates), inherently linking the NDF curve with the onshore CNY market.

Moreover, there are various multinational organizations that have multiple entities onshore and offshore, which are able to conduct permitted RMB currency transactions in both onshore and offshore markets. These organizations will naturally be incentivised to participate in the various markets in a way (buying USD-RMB where it is the cheapest and selling USD-RMB where it is the most expensive) that will limit excessive divergence between the various RMB exchange rates. However, this is not an "arbitrage" in any strict sense, since these transactions can only be done in support of underlying permitted corporate activity, rather than in an unlimited sense. They do mean, however, that there are some limitations as to how far the three markets can trade.

Chart 1: The three markets, similar, but not identical



Source: Bloomberg, Reuters, HSBC

Divergent exchange rates by design

Generally, when arbitrage is permitted between various related markets, participants play a role in increasing the efficiency and liquidity of markets[4].

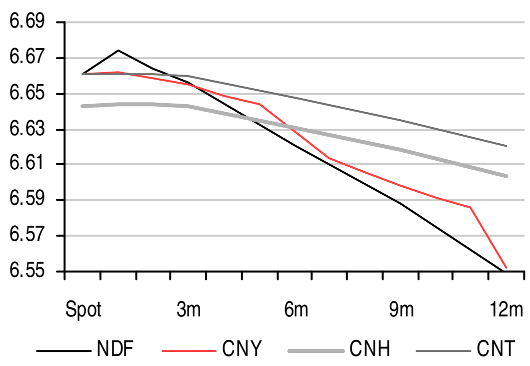
However, the offshore RMB market was created explicitly to allow the RMB to start developing internationalization characteristics, while at the same time keeping domestic markets sequestered from global markets. By deliberately separating onshore from offshore liquidity, the CNY and CNH are designed not to be arbitraged and hence will naturally have distinct market equilibriums.

Meanwhile, there is a natural divergence in the two offshore markets – CNH and NDFs – as well. The two curves can and will sustain material divergence not only because they are anchored by two different spot rates, but also because the dynamics of the two curves themselves are different: the NDF curve acts as a pure "futures" curve (pricing future expectations of the spot rate). However, because of the lack of restrictions in the CNH market, the CNH forward curve is more closely anchored to the interest rate curve. This means any deviation in the CNH swap points from the underlying interest rates will translate into pressure on CNH spot. That is, any selling pressure in USD-CNH forwards that move the points to the left will result in an arbitrage with interest rates which will sell USD-CNH spot and buy the USD-CNH forwards. In other words, any attempt to arbitrage the CNH and NDF curve will generally result in a larger CNY-CNH discount.

Finally, while there are effectively three different currency markets, there are actually four forward curves (Chart 2). This is because offshore corporates can access the onshore CNY exchange rate (i.e. buy CNT), but are able to access the Hong Kong RMB swap curve. This effectively gives corporates conducting permitted transactions access to a forward curve that offers the same swap points as the CNH curve, but which is anchored at the onshore CNY rate.

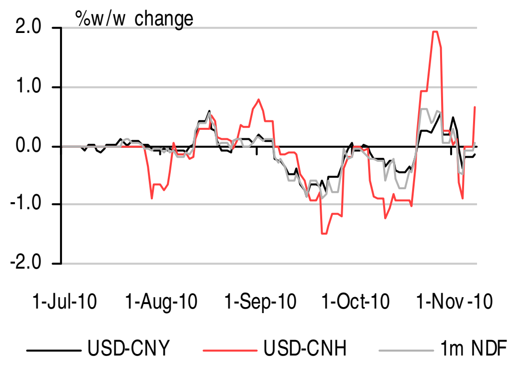
[4] Making sure interest rate and currency forward markets correctly uphold interest rate parity, for example.

Chart 2: Three currencies, four curves



Source: Bloomberg, Reuters, HSBC

Chart 4: Rolling weekly returns



Source: Bloomberg, Reuters, HSBC

Different betas to appreciation expectations

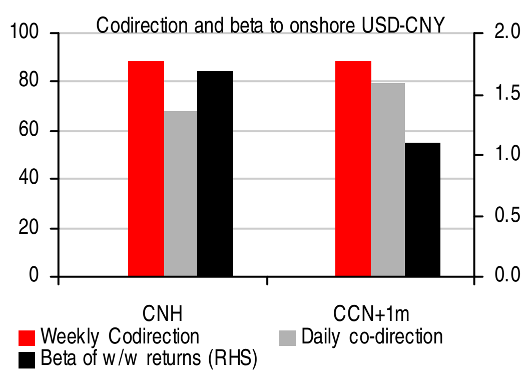
To date, the two offshore markets have traded directionally together with spot. Weekly returns of the two offshore markets have been co-directional with onshore spot 89% of the time, while even the co-direction of daily returns have been 68% and 80% for the CNH and NDF markets, respectively (Chart 3).

While both offshore markets trade directionally well with onshore spot CNY, there are also some notable differences. First, while both do trade with some beta to onshore spot, CNH has a much higher beta, for the time being (Charts 3 & 4). This is due, in part, to the as-yet limited liquidity of the CNH market which, although having grown substantially since the start of the market in July, remains a mere fraction of that of the NDF market (Chart 5). However, this is not the only reason. As mentioned above, the CNH curve is more a true forward curve, such that selling pressure on any individual part of the curve will result in selling pressure across the rest of the curve, including spot, due to the inherent relationship between the CNH forward and interest rate curves.

Different yields

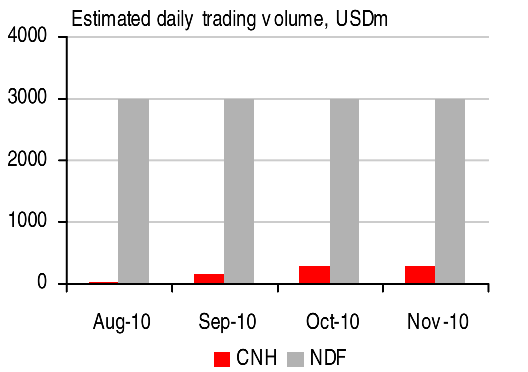
This highlights the other key difference between the two offshore curves – the difference in yields as suggested by the different curvatures of the two curves. The NDF curve as effectively a futures curve (rather than interest rate curve) is much more downward sloping, suggesting less attractive (and

Chart 3: ... shows that CNH and the NDFs are effectively beta plays on the onshore spot



Source: Bloomberg, Reuters, HSBC

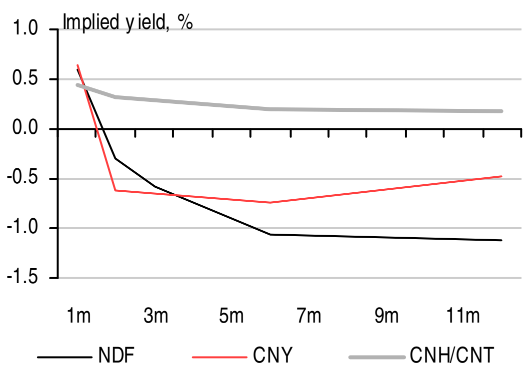
Chart 5: The CNH market is still in its infancy compared to the NDF market



Source: HSBC estimates

indeed negative) implied yields. Meanwhile, the CNH and CNT curves should better reflect implied yields consistent with actual RMB deposit rates available in Hong Kong (Chart 6). This underscores the point that CNH is a more true offshore market, which offers real opportunities for fundraising (issuance), and therefore opportunity for investment that generates actual economic return. This suggests that the CNH market will ultimately grow to a point where it will dwarf the NDF market. We discuss market development in a later section.

Chart 6: Implied yields



Source: Reuters, HSBC

Relative value is therefore not straightforward

One key conclusion from this, therefore, is that assessing relative value across the multiple currencies and curves is not straightforward by any means. Besides assessing the current and future differences between the three sets of supply and demand in the three different markets, to gauge the outlook for the CNY-CNH spread, one must also consider the relative implied return on yield in the various curves.

More options for participants

Therefore, investors and corporate risk managers should not consider the three (or four) curves as interchangeable instruments that can achieve the same thing. Instead, they must consider the different market characteristics, as well as jurisdictional restrictions:

- **Offshore real money investors** – Due to limited access to onshore markets, the two offshore currency markets offer important access for large and long-term investors outside China to gain RMB exposure. CNH has obvious advantages in that investors can buy real underlying assets, including deposits, bonds, and in the likely future, equities as well. However, the market currently is too small and too illiquid to make any sizable core investment. At the same time, to the extent that investors are able to access underlying real assets (e.g. bonds and equities), the relative illiquidity of such underlying markets at present suggests they are much better suited for the buy-and-hold approach of longer-term investors.

  For now, the NDF curve remains the more attractive market to take large RMB appreciation positions in the short term, given the liquidity characteristics and the fact that the curve is fixed off the onshore CNY spot market. However, for longer-term positions, the negative implied carry cost in the NDFs becomes material. For example, the implied carry cost will remain the key downside to position-taking in the NDF curve: at present, the 1.3%-pt yield advantage of CNH forwards over NDFs means that the USD-CNH 0.22% discount is made up for in carry within two months.

- **Small and absolute return investors –** Smaller investors will be relatively less constrained by the as-yet thin liquidity conditions of the CNH market, as compared to the NDF market. Moreover, the positive carry of CNH instruments, particularly if the bond market is accessible, makes this much more attractive to investors that are not benchmarked, but instead are sensitive to the cost of funding. While we have argued that, strictly speaking, there are no arbitrage opportunities across the three different markets, the fact that the three currencies are inherently related does provide opportunities to take specific views on relative value, based on expectations of future FX policy, or on future regulatory changes.

- **Large corporates with onshore entities –** Corporates with onshore and offshore entities now have the option of trading on four different curves. Onshore they can trade the spot and the forward deliverable curve, while offshore they have three options – the NDFs, the CNH, and CNT (i.e. trade settlement transactions that allow access to the onshore CNY rates). This simply gives the corporates more options on how to hedge and more potential to gain economic benefit from situations where they have matching flows of USD and RMB that they can conduct in different markets. Besides pricing, liquidity is a consideration, with the NDFs still offering the deepest liquidity. Thus, the best place to conduct hedging activity will vary over time depending on both the divergence between the curves, as well as relative liquidity conditions. Beyond this, the developments also allow offshore RMB proceeds to be more actively managed, and will allow RMB funding in CNH which may be more attractive compared to onshore CNY funding[5].

- **Corporates without onshore entities –** The development of the CNH market makes RMB trade settlement a more viable alternative for offshore trading companies, as it will allow RMB accumulated in Hong Kong, and potentially other offshore markets in the future, to be investible.

Developments looking forward

What can we expect in further offshore RMB developments, and how will it affect the current state of affairs?

What will determine how rapidly the CNH market will grow?

As we have hinted above, the relative characteristics of the three markets will evolve with the growth and development of the CNH market. The development of the CNH market will ultimately depend on the size of CNH supply available in the market. While this is determined by the degree to which existing channels to bring RMB into Hong Kong are utilized, at the end of the day regulation will be the driving force.

This fact was underscored recently by the announcement that the quota of CNY available for trade settlement by Bank of China (Hong Kong), the territory's largest settlement bank for CNY, had reached its quota – a restriction that was not widely known to market participants[6]. While the existence of this quota system is now well recognized, it is still unclear how it will be managed – what the term of the quota is, and how often quotas are revised. It is likely that the quota system is being used flexibly as a discretionary tool to manage the pace of offshore RMB development. Thus the exact mechanism of the quota may be less relevant than policymakers' medium-term intent.

We expect any regulatory restrictions on the pace of CNH market development to be exactly that – moves that will keep the pace in check, but not reverse market development. Ultimately, the development of the offshore RMB market is integral to China's broader strategic plans to internationalize and to turn the RMB into a viable

[5] RMB funding via CNH will of course be subject to repatriation regulations.

[6] We discussed this in the recent note, *Asian FX & Macro RMB trade settlement takes a breather*, 29 Oct 2010.

Table 2: Selected recent CNH bond issuance

Pricing Date	Issuer	Amount (RMBm)	Maturity (year)
Pipeline*	Rusal	Unknown	3, 5-yr
Pipeline*	BoC Aviation	Unknown	Unknown
11/30/2010*	Ministry of Finance	8000	2, 3, 5, 10-yr
25-Nov-10	Export-Import Bank of China	1000	2
24-Nov-10	Caterpillar	1000	2
15-Nov-10	China Merchants Holdings (Intl)	700	3
9-Nov-10	China Resources Power Holdings Co.	2000	3, 5-yr
9-Nov-10	Export-Import Bank of China	4000	3
22-Oct-10	Sinotruk Hong Kong Ltd	2700	2
18-Oct-10	Asian Development Bank	1200	10
11-Oct-10	China Development Bank	2000	3
8-Oct-10	ICBC (Asia)	117	2
8-Oct-10	ICBC (Asia)	47	3
17-Sep	Deutsche Bank	200	2
16-Sep	Bank of Tokyo-Mitsubishi	20	1
16-Sep-10	ICBC (Asia)	1000	2
16-Sep-10	ICBC (Asia)	1000	2
7-Sep-10	Bank of China	2200	2
7-Sep-10	Bank of China	2800	3
2-Sep-10	China Development Bank	500	2
2-Sep-10	China Development Bank	1000	2
2-Sep-10	China Development Bank	100	1
19-Aug-10	McDonald's Corporation	200	3
10-Aug-10	HSBC	114.45	6m
7-Jul-10	Hopewell Highway Infrastructure	1380	2
6-Jul-10	Citic Bank International	500	1

Source: Bloomberg, various news sources

* Future bond issuance information based on various press reports

reserve currency[7]. The depth and sophistication of Hong Kong markets is one motivation for choosing the territory as the location in which to sanction offshore RMB trading. From Hong Kong, both mainland and local authorities can monitor development. We expect the development of this market to be calibrated by policymakers' level of comfort that they understand the market, can monitor and regulate it, and can be sure that it does not unduly destabilize other related markets.

Bond market development

Integral to the overall development of the offshore RMB market is the growth and development of the CNH bond market. It should be obvious that the overall size of the bond market is linked directly to the overall supply of currency in the market. As such, we would expect the bond market to grow in-step with the pace of the growth of the underlying currency market (and thus by association be subject to all the considerations discussed above).

Given that the large offshore demand for RMB exposure should keep yields in CNH capped, there should not be a lack of entities looking to issue in CNH. We expect relative permissiveness for onshore corporates, particularly Chinese, but multinationals as well, to issue CNH bonds. The recent issuance of MoF bonds lends official support to the growth and development of this market. After all, having a deep and liquid bond market is also one requirement for having an internationalized and reserve currency, and one could argue one reason for the establishment of the CNH market in the first place.

[7] Our economists cover this in much more detail in a recent publication, *The rise of the redback: A guide to renminbi internationalization*, 9 Nov 2010.

Development in other offshore jurisdictions

As explained earlier, there are no restrictions on RMB trading in offshore jurisdictions outside of Hong Kong, but it is only in Hong Kong where RMB trading is explicitly permitted and regulated and also where a critical mass of RMB deposits has developed. It is unlikely, therefore, that without official sanction (from China) RMB trading will grow substantially outside of Hong Kong: offshore entities can already freely conduct CNH business in Hong Kong (even without a local presence), and Hong Kong's superior RMB deposit base, liquidity, and economies of scale will keep Hong Kong as the predominant center of gravity for offshore RMB for the time being.

However, in pursuit of true RMB internationalization, expansion of offshore RMB activity beyond Hong Kong is inevitable. Likely next candidates for sanctioning of official RMB activity would be Singapore or Malaysia – two jurisdictions with relatively developed financial markets, as well as close commercial and regulatory relationships with China.

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Offshore Chinese renminbi (CNH)

- The RMB became deliverable offshore in Hong Kong in July
- In Hong Kong, RMB can be freely transferred between accounts, and banks can create and sell investment products
- There is a daily conversion limit of RMB20,000 for Hong Kong residents

This chapter is an addendum to "HSBC's Emerging Markets Currency Guide 2010" originally published December 2009.

On 19 July 2010, a new rule was introduced to enable transfer of RMB funds between accounts and across banks. RMB in Hong Kong can now be transferred to other persons and entities for any purpose. The transfer of RMB from Hong Kong to onshore is still subject to regulations and approval by mainland authorities. Personal RMB loans, however, are not permitted.

BOC(HK) retains key control of RMB supply flowing into the interbank market, and authorised institutions' ability to cater to demand for RMB products is limited by their capacity to square their positions. CNH is the common currency code used to reference offshore RMB traded in the Hong Kong market.

HSBC is amongst the first banks to start offering clients FX solutions and products in the CNH market, and we are able to offer the following:

- Spot FX, deliverable forwards and FX swaps
- Deliverable FX options out to 1 year with further tenors on a case-by-case basis
- Bonds
- Time deposits and certificates of deposit
- Structured products including structured deposits, notes and swaps

Spot

HSBC is one of the primary market makers in CNH and has been at the forefront of the creation of this market. Overall spot market liquidity has picked up to over USD300m daily since the new rules came into place. Participating banks in Hong Kong quote three types of RMB exchange rate: 1) for personal RMB business; 2) for trade purposes; and 3) for general purposes.

Foreign exchange positions from the first two categories can be squared with the clearing bank based on onshore FX rates, hence they trade close to onshore spot generally. There is currently a quota of RMB8bn on how much can be trade settled with the clearing bank. It was announced that this quota had been filled as of October 2010, though this is likely to be increased in 2011. As banks need to warehouse the risk or square with other banks in the USD-CNH market for general purpose FX transactions, this rate can differ more widely from onshore spot.

HSBC spot, forward and swap rates can be found on Reuters at HSBCRMB.

Forwards / FX swaps

CNH deliverable offshore forwards are available out to 1-year. Liquidity remains poor but is expected to improve. The curve is based broadly on the offshore USD and RMB money market interest rate differential. The curve shape is twisted due to an imbalance of demand and supply in a thin market.

Options

Deliverable CNH options, meaning physical CNH settlement options, are available without restriction to any 'corporate' counterparty that has a physical CNH nostro account in Hong Kong. HSBC offers options on USD-CNH and other crosses and currencies out to 1yr and longer tenors on a case-by-case basis. Average transaction size is USD10m with the daily turnover being up to USD50m. HSBC was the first bank to trade offshore deliverable RMB options.

Currency swaps

HSBC offers cross-currency swaps for CNH, predominantly against USD out to the 1yr tenor, though other transactions will be dealt with on a case-by-case basis. The market is still relatively new and liquidity is limited compared to other more mature RMB products, though we see future growth. Liquidity is better in the shorter tenors out to 1yr with ticket sizes averaging cUSD5m.

Interest rate swaps

The interbank money market has been relatively inactive since 19 July when the CNH market was in effect created. Offshore deposit rates differ from those onshore, driven by a lack of transactional demand for funds which are relatively expensive compared to USD and HKD. We would expect the rates to converge more closely when either offshore bond markets are developed further, or banks are able to access onshore CNY bond markets.

Banking and structured products

HSBC is a leading provider and can offer clients solutions using FX options for risk management or investment purposes. HSBC was able to trade the first FX linked structured deposit in the HK market. We offer hedging products including vanillas, European barriers and digital options, hedging RMB exposure versus any other currencies with physical settlement. We can also structure investment products in RMB such as structured deposits (linked to FX, rates, equities or gold), notes or swaps out to 2 years. These can be traded with RMB as the underlying currency or as part of a basket and can be structured to suit bespoke needs.

Bonds

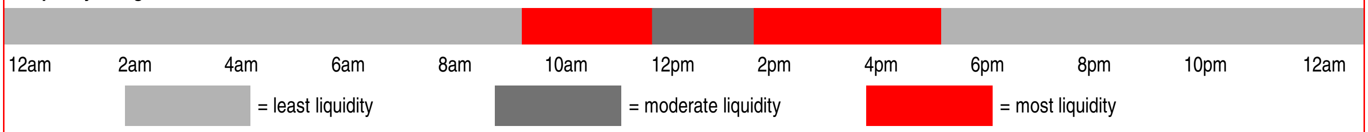
HSBC can deal in RMB bonds issued in Hong Kong settled in CNH. Beyond cash bonds, HSBC can also deal in CNY synthetic bonds (priced out of the NDF curve), and can deal total return swaps (TRS) on HK RMB bonds settled in CNH. Total issuance size is over RMB60bn since 2007 and over RMB20bn has been issued in 2010 YTD, with at least another RMB10bn to come.

Opening an account in CNH

All HSBC clients can open a RMB account with HBAP HK or its affiliates (such as HBEU) and are subject to normal account opening procedures.

HSBC

Liquidity at a glance



Notes: Times are based on Hong Kong local time = GMT + 8 hours
Source: HSBC

Normal market conditions

Normal market conditions

Spot daily average volume	USD300m
Spot volume per transaction	USD5m
Bid/ask spread	10-20pips (0.001-0.002 CNH)
Forward & swap daily average volume	USD100m
Forward & swap volume per transaction	USD5m
Forward spread	50-200 pips (0.005-0.020 CNH)
Implied option volatility spread	1.50

Note: Data above only refers to interbank market. Spreads are subject to change with market developments.
Source: HSBC

Background

- In late 2003, The People's Bank of China (PBOC) and the Hong Kong Monetary Authority (HKMA) agreed that Hong Kong banks could conduct personal RMB business on a trial basis and BOC(HK) was designated as the RMB clearing bank.
- In 2005, the clearing bank began to provide services for participating banks to square RMB open positions that resulted from permitted RMB exchange business.
- The Hong Kong RMB bond market (offshore) was established in 2007 when the PBOC announced 'Interim Measures for the Administration of the Issuance of RMB Bonds in Hong Kong Special Administrative Region by Domestic Financial Institutions".
- China Development Bank (CDB), China's state policy bank, was the first to issue RMB bonds in Hong Kong in June 2007.
- The bond market has developed rapidly since then with approximately RMB40 billion issued since 2007. In 2010, financial institutions or corporates incorporated outside China have been allowed to issue in RMB provided proceeds are kept offshore unless otherwise approved by China regulators.
- In 2008, the PBoC and HKMA signed an agreement to set up a currency swap line.
- 2009 saw an acceleration in market development:
  - The State Council approved RMB trade settlement on trade between Hong Kong and Guangdong/Yangtze River Delta and a supplementary memorandum was signed in June 2009.
  - HSBC and Bank of East Asia's mainland subsidiaries were granted approval to issue RMB bonds in Hong Kong.
  - The Ministry of Finance completed RMB6bn of debt issuance in Hong Kong in October 2009.
- 2010 proved to be a watershed year for the Hong Kong RMB market:
  - In February, the HKMA released a circular to expand the scope of offshore RMB bonds, including the eligibility of issuers, issue arrangement and types of investors. RMB bond proceeds cannot be remitted back to China but can be used outside China for purposes including trade finance and cross-border projects in Southeast Asia.
  - In June, the PBOC and BOC(HK) inked an agreement lifting the last restrictions on Hong Kong's RMB interbank market.

Following this, there were no longer restrictions on banks in Hong Kong establishing RMB accounts for and providing related services to corporates. Individuals and corporations were also able to conduct RMB payments and transfers through the banks. This gave the green light to non-bank financial institutions to open RMB accounts held in different Hong Kong banks, for any purpose.

- This led to many firsts: in June, shortly after the announcement, CITIC Bank International issued the first ever CNH CD and Hopewell Highway Infrastructure issued the first CNH corporate bond. In August, HSBC became the first bank to offer a retail CNH CD, and McDonald's Corporation became the first foreign company to issue CNH bonds in Hong Kong. In October, China Development Bank issued its third CNH bond in Hong Kong.
- The Asian Development Bank became the first supranational to issue CNH bonds. It is also the first 10-year CNH bond in Hong Kong and first foreign issuer to have the bonds listed.

FX framework

- Offshore RMB is traded as with any other deliverable currency.
- There is no fixing rate set by authorities as with the onshore RMB rate.
- Bank of China (Hong Kong) is the designated clearing bank.
- Banks can provide corporate customers with General Purpose RMB accounts which allow free transfer of funds for any purpose, though positions arising from this cannot be squared with the clearing bank. Loans may be made to corporate clients for general purposes. These accounts are for non-trade settlement purposes.
- Banks are required to maintain a minimum 25% of customer deposits in cash or settlement balance with the clearing bank.
- Banks may not offer loans to personal customers.
- The daily conversion limit for Hong Kong residents is set at RMB20,000.
- There is one-way conversion for designated business customers from RMB to USD or HKD through the clearing bank.
- Banks may borrow funds from mainland correspondent banks for up to 1 month for trade financing.

Regulations

Repatriation

- Offshore RMB accounts may be set up in other jurisdictions and offshore RMB may be remitted to any other foreign centre, subject to local regulations, except for mainland China.

Bond market

- Current and eligible issuers – Any financial institutions or corporates incorporated outside China; Chinese FIs on an approved basis from PBOC / National Development and Reform Commission (NDRC)
- Investor base – Hong Kong retail and institutional investors and international investors with CNH funds
- Any offering and marketing activities are subject to the usual restrictions imposed under applicable securities law
- For Chinese FIs, proceeds can be brought onshore

- For offshore issuers, proceeds are to be kept offshore (except those with approval from China regulators to bring funds onshore)
- In 2010, the scope of offshore RMB bonds, including the eligibility of issuers, issue arrangement and types of investors, have been extended
- No approval required as long as the funds stay offshore

Offshore-offshore / offshore-onshore

- CNH is RMB traded primarily in the Hong Kong interbank system. Hong Kong is the only jurisdiction where offshore RMB trading is sanctioned and regulated. However, trading of RMB in other offshore jurisdictions is not explicitly restricted
- Offshore entities may freely establish nostro RMB (CNH) accounts in Hong Kong

Information sources

The People's Bank of China	www.pbc.gov.cn
State Administration of Foreign Exchange	www.safe.gov.cn
China Banking Regulatory Commission	www.cbrc.gov.cn
Hong Kong Monetary Authority	www.info.gov.hk/hkma
HSBC Reuters page	HSBCRMB

Disclosure appendix

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