

Banks and Insurers' Participation in T-Bond Futures Trading and Strong Impetus to Financial Market Reform

Li Yang, Chairman of the National Institution for Finance & Development (NIFD)

Date: February 24, 2020 Source: xinhuanet.com

On February 21, the China Securities Regulatory Commission (CSRC), the Ministry of Finance, the People's Bank of China (PBoC) and the China Banking and Insurance Regulatory Commission (CBIRC) jointly issued an announcement allowing qualified commercial banks and insurers to trade China's Treasury bond futures at the China Financial Futures Exchange (CFFEX) in accordance with the principles of lawfulness, compliance, risk control and business sustainability. This initiative is of great importance in implementing China's financial supply-side structural reforms, bolstering China's capital market systems, and alleviating financial risks.

By participating in Treasury bond futures trading, commercial banks and insurers will be able to improve their risk management strategies, contribute to the sustainability of China's financial market, improve the Treasury yield curve, and bolster the openness of the financial market. Allowing banks and insurers to trade Treasury bond futures marks a milestone in the development of China's financial futures market.

1. Improving the Financial Market System

In advanced market economies, commercial banks and insurers have always been key players in trading a broad portfolio of derivatives such as futures, options, swaps and forward contracts. The integration of financial markets owes largely to the proactive and extensive participation of intermediaries like commercial banks and insurers. Such participation allows financial institutions to diversify their business portfolios and trading strategies. For the market system, the active role of financial intermediaries in financial markets at various levels of trading has blurred the boundaries between direct financing and indirect financing and between exchange-based trading and over-the-counter (OTC) trading, removing barriers to the flow of capital. The well-functioning futures market enables the integration of otherwise divided financial markets, allowing financial information to spread without barriers and financial resource allocation and macro-regulation to become more efficient.

In less than a decade, China's burgeoning derivatives market has developed important market functions and attracted numerous professional and institutional investors. As the world experiences profound changes not seen in a century and the Chinese economy enters the new normal, the need to further improve China's financial system is stronger than ever.

Allowing commercial banks and insurers to trade Treasury bond futures is important for increasing China's bond market connectivity and financial market efficiency and sophistication. By participating in all financial factor markets, commercial banks and insurers will be able to trade a complete range of interest rate

risk management instruments such as Treasury bond futures, interest rate swaps and forward bond contracts, allowing them to reduce their risk management cost and to operate their portfolios more efficiently. Furthermore, inter-market arbitrage by financial institutions will slash price differences for the same sorts of bonds and derivatives, raising bond and derivative price accuracy and the overall pricing efficiency and liquidity of financial assets. Lastly, the Treasury bond futures delivery system will break through the constraint of bond custody transfer between the interbank market and the exchange-based market, bolstering cross-market bond liquidity and inducing investors to trade spot Treasury bonds.

2. Building Capacity for Risk Management

China's deepening financial market reforms have been accompanied by an improving financial system, diversifying financial products, with more robust financial regulation and higher risk resilience. Yet China's economy is also grappling with a juxtaposition of structural, institutional and cyclical challenges amid its transition from rapid growth to high-quality development. Interest rate risks have become evident as interest rate liberalization gives rise to financial market volatility. With numerous interest-rate-sensitive assets, commercial banks and insurers have to cope with these rising interest rate risks. In this context, it has become imperative to provide large financial institutions with market-based risk management instruments and mechanisms. As a low-cost yet efficient risk management tool for financial market participants, Treasury bond futures will help commercial banks and insurers manage their interest rate risks.

Investing in Treasury bond futures allows commercial banks and insurers to rein in changes in market valuations stemming from interest rate volatility and enhance their capacity to ameliorate risks. Treasury bond futures play an important role in keeping market swings in check. During a swift bond market correction, financial institutions are most likely to sell bonds and limit their losses, thus causing liquidity to dry up. The highly liquid futures market, however, allows commercial banks and insurers to hedge downward risks in the spot bond market and divert selling pressures, buoying market resilience and stability.

For commercial banks and insurers, Treasury bond futures offer a tool for managing assets and liabilities and servicing the real economy. By trading Treasury bond futures as a liquid asset, commercial banks can achieve the goals of asset and liability management at a smaller liquidity cost by tweaking portfolio duration without spot trading. Facts have proven that interest rate derivatives like Treasury bond futures allow commercial banks to hedge the risk exposure of basic interest rate products, encouraging them to lend to the real economy at a constant aggregate risk level.

3. Perfecting the Treasury Yield Curve

In planning for future financial reforms, the Third Plenum of the 18th CPC Central Committee for the first time called for "perfecting the Treasury yield curve reflecting market supply-demand relations" as a strategic priority. Subsequent financial reform programs have all identified "perfecting the Treasury yield curve" as being high on the priority list.

The Treasury yield curve reflects the interest rate level of risk-free assets, which provides a pricing benchmark for credit bonds and others. A sound and effective Treasury yield curve is vital to the well-functioning of a country's bond market and financial system at large. The integrity of the Treasury yield curve is a hallmark of a country's financial system sophistication.

Experience from advanced market economies suggests that an effective Treasury bond futures market will increase the liquidity of spot bonds through hedging and arbitrage transactions and raise the pricing efficiency of the spot market, which is vital to the role of the Treasury yield curve as a pricing benchmark. The Treasury bond futures market creates a risk management mechanism for the bond market. It expands the scope of the Treasury bond market and increases the depth and absorbability of the financial market. More importantly, the Treasury futures market increases bond market information and efficiency, as evidenced in the robust operations of China's Treasury futures products launched since 2013.

Commercial banks and insurers are the most important participants in China's bond market. Currently, the interbank bond custody volume exceeds 70% of the total bond balance in China. **There is no doubt that commercial banks and insurers, with such a massive amount of spot bonds, will supercharge China's bond market once they join the Treasury bond futures market.** With its transaction innovations, the Treasury bond futures market will offer commercial banks and insurers cross-market investment modes such as futures-spot arbitrage and inter-temporal arbitrage, thus broadening the scope of their asset management and enhancing the effectiveness of their asset allocation. Participation in Treasury bond delivery through cross-market transactions will increase the liquidity of bonds held by commercial banks and insurers, which is conducive to bond market development in the long run. The extensive participation of commercial banks, insurers and other traders is conducive to the formation of a more continuous and fairer Treasury bond futures price and bond market liquidity and price discovery. These functions will also provide price reference for less liquid spot bonds, perfecting the Treasury yield curve at another level.

4. Expediting Financial Openness

In recent years, China's bond market openness has made significant headway. By the end of 2019, the total onshore renminbi bonds held by overseas investors exceeded 2 trillion yuan. Meanwhile, the Bloomberg Barclays Global Aggregate index and JPMorgan Emerging Market Bond Index (EMBI) have all included Chinese bonds, reflecting overseas investors' confidence and interest in China's bond market.

Despite its tremendous potential, **overseas investors are wary of the structural flaws in China's bond market - not least the lack of effective market-based instruments and mechanisms for interest rate management.** As a mature investment strategy, spot bond holdings must be combined with risk-hedging interest rate derivatives. To put this strategy to work, the market must provide a wealth of low-cost yet efficient interest rate derivatives. The supply of interest rate derivatives like Treasury bond futures in China, however, is a far cry from benchmarking this international practice. In other words, the primary technical and institutional barriers preventing overseas institutional investors from flooding into China's bond market stem from the lack of access to China's bond futures trading. As overseas investors

buy more Chinese bonds amid China's increasing bond market openness, their demand for interest rate derivatives such as bond futures is poised to grow, highlighting the urgency to make up for the dearth of interest rate derivatives.

Renminbi internationalization is a critical prerequisite for China to play an active role in global financial governance. Judging by experience over the years, a core element of renminbi internationalization is to create a multi-tier and flexible Treasury bond market that allows international investors to hold an array of fixed-value renminbi assets in the same basket with fixed-value assets in other currencies.

By deeply participating in China's Treasury bond futures market, commercial banks and insurers will enrich the ground for renminbi internationalization. Their involvement in Treasury bond futures trading will significantly deepen China's futures market, diversify the investor structure and trading strategies in the Treasury bond futures market, bring about Treasury bond futures-spot synergy, promote Treasury bond futures functions, and create favorable market conditions for overseas investors. In offering Treasury bond futures trading services to overseas investors, Chinese commercial banks and insurers will present a full range of services to their international customers, including investment consulting, clearing and collateral custody services. Diverse modes of cooperation with foreign financial institutions will give a push to Chinese financial institutions in going global. The Treasury bond futures market will help commercial banks and insurers gain experience in derivative investment, improve their ability to cope with the challenges and shocks from widening financial openness, and contribute to national financial security.

Involving commercial banks and insurers in the Treasury bond futures market is a gradual process. The number of participants and business offerings should be scaled up in a step-by-step manner. To enhance the development of a healthy Treasury bond futures market, regulators should work closely together, share information and bring regulatory synergy by means of inter-ministerial coordination. For their part, market entrants should enhance internal risk control and supporting procedures, build technical systems, foster professionals, and create clear business operation procedures.