Legal Commentary

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New Rules for Bond Lending – A Comparation with Bond Repos

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China's unified bond market now comprises the inter-bank market, exchange market, and commercial bank counter market; among these, the inter-bank market serves as the principal market with more than 85% of the total bond custody balance by the end of 2021[2]. Bond transactions in the inter-bank market include cash bond transactions, bond repo transactions (including pledged bond repo transactions and outright transfer bond repo transactions), bond lending transactions, and bond forward transactions, of which the transaction volume of cash bond transactions and bond repo transactions accounts for more than 90%. Bond lending business has facilitated the needs of market participants to borrow bonds and improved liquidity and stability of the overall bond market. With the rapid growth of the transaction volume of bond lending business since 2015, the settlement volume of bond lending business in 2021 has increased about sixfold compared to 2015, making bond lending the third largest business in the inter-bank bond market after pledged bond repo transactions and cash bond transactions[3]. In response to the rapid development of bond lending business and in order to further enhance regulation and market activity of bond lending business, the People's Bank of China (the "**PBoC**") has recently promulgated the *Measures for Administration of Bond Lending Business in the Inter-bank Bond Market* (the "**2022 Measures**"), which will take effect from July 1, 2022, and the *Interim Provisions on Administration of Bond Lending Business in the National Inter-bank Bond Market* (the "**2006 Provisions**") promulgated in 2006 will be invalidated accordingly on the same date.

As for the implications of these two rules on the inter-bank bond market, in comparison to the 2006 Provisions, the 2022 Measures further facilitate the conducting of bond lending business by market participants and improve the efficiency of the bond lending market. For instance, each market participant has to formulate its own bond lending agreement under the 2006 Provisions, which is time-consuming and inefficient when negotiating transaction documents with different counterparties. By contrast, the 2022 Measures will require market participants to sign a unified bond lending master agreement, which is likely to significantly save time in negotiations and facilitate transactions. In addition, the 2022 Measures newly

[1] Shirley Liang and Lin Zhu have contributions to this article.

[2] PBoC, Financial Market Operation in 2021 (中国人民银行《2021 年金融市场运行情况》) (http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4463448/index.html).

[3] CCDC, Bond Market Statistical Analysis Report 2021 中央结算公司《2021 年债券市场统计分析报告》 (https://www.chinabond.com.cn/cb/cn/yjfx/zzfx/nb/list.shtml).

introduce a centralized bond lending mechanism, which may help to avoid the risk of settlement failure under bond transactions and improve market efficiency.

In light of the issuance of the 2022 Measures, this newsletter briefly introduces the differences between bond lending and bond repo business in the inter-bank market as well as the main changes between the 2022 Measures and 2006 Provisions.

Transaction type / Element	Bond lending	Outright transfer bond repo	Pledged bond repo
Definition	"Bond lending" refers to bond financing whereby the bond borrower borrows the underlying bonds from the bond lender by providing a certain amount of performance assurance assets and both parties agree that on a future date the underlying bonds shall be returned and the bond lender shall return the performance assurance assets.	"Outright transfer bond repo" refers to a transaction wherein the bond holder (repo party) sells bonds to the bond buyer (reverse repo party) and both parties agree that, on a future date, the repo party shall buy back bonds of the same type and quantity from the reverse repo party at an agreed price.	"Pledged bond repo" refers to the financing transaction where the funds receiver (repo party) receives the funds by pledging bonds to the funds provider (reverse repo party), and both parties agree that, on a future date, the repo party shall return the funds to the reverse repo party at the amount calculated at a stipulated interest rate and the reverse repo party shall release the pledge on the pledged bonds.
Transaction mechanism	Transactions are concluded at the China Foreign Exchange Trade System ("**CFETS**") through bilateral negotiation or centralized lending mechanism. The 2022 Measures newly introduce a centralized bond lending mechanism. Centralized lending refers to the matching and concluding of bond lending transactions by bond settlement service institutions (i.e., China Central Depository & Clearing Co., Ltd. ("**CCDC**"), Shanghai Clearing House ("**SHCH**")	Transactions are concluded at the CFETS through bilateral negotiation.	

<table>
<tr><th>Transaction type
Element</th><th>Bond lending</th><th>Outright transfer bond repo</th><th>Pledged bond repo</th></tr>
<tr><td></td><td>and custodian banks), pursuant to their prior agreements with the market participants that have insufficient bonds for delivery on any bond settlement date and on their behalf, with other market participants at CFETS.
Centralized lending service may effectively avoid the risk of settlement failure. The specific centralized bond lending mechanism is still subject to the implementation rules to be stipulated by CCDC, SHCH, CFETS and other financial infrastructures.</td><td colspan="2"></td></tr>
<tr><td>Collateral</td><td>The 2022 Measures change references to collateral from “pledged property” to “performance assurance asset”, which indicates that the form of security will no longer be limited to pledge. The 2022 Measures also provide room for the introduction of all types of performance assurance (such as “transfer by way of security”) as permitted under the PRC Civil Code and relevant security-related regulations, and even the performance assurance in the form of outright transfer which commonly used under derivatives master agreements.
That said, in practice, implementing new forms of performance assurance is</td><td colspan="2">Applicable law does not impose restrictions on the form of performance assurance, so parties can at their discretion determine the form of performance assurance based on their commercial needs.
According to the form of the NAFMII Bond Repurchase Master Agreement (2013 version), under outright transfer bond repo transactions, parties may adjust the net risk exposure via cash margin or collateral securities; under pledged bond repo transactions, parties may adjust the net risk exposure by creating or releasing the pledge on the underlying bonds. In addition, the parties may also agree on other forms of performance assurance.</td></tr>
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Transaction type / Element	Bond lending	Outright transfer bond repo	Pledged bond repo
	still subject to the bond lending master agreement and other relevant documents, as well as further observation of the market.		
Function	■ Lending bonds to earn a yield. ■ Exchanging bonds to reduce funding costs; for example, a borrower can reduce its funding costs if it borrows funds through a pledged repo transaction by pledging interest bonds which are borrowed in by collateralizing credit bonds under a bond lending transaction, and the interest rate in the bond lending transaction is lower than the differences of funding rates between the pledged bond transaction with credit bonds being pledged collateral and those with interests bonds being pledged collateral.	■ Financing - repo party borrows funds by using bonds in its possession.	
	■ Short selling bonds - borrowing bonds and selling them when the bond price is expected to go down, and buying the bonds of same issue and return them when the price goes down, so as to earn a spread gain. ■ Borrowing bonds for delivery purposes in other businesses (such as cash bond transactions, pledged bond repo transactions, and physical delivery to settle treasury futures short positions).		N/A
Market participants	■ Various types of onshore financial institutions that satisfy	■ Various types of onshore financial institutions that satisfy bond market access requirements and non-legal person products they issue.	

Transaction type / Element	Bond lending	Outright transfer bond repo	Pledged bond repo
	bond market access requirements and non-legal person products they issue. ■ Offshore institutional investors may engage in bond lending transactions for hedging purposes.	■ Offshore central banking institutions, offshore RMB clearing banks, and offshore participating banks that satisfy bond market access requirements; other types of offshore commercial institutions cannot currently engage in bond repo transactions.	
Underlying bonds/repo bonds	Bonds traded in the inter-bank market. The 2022 Measures delete the requirement in the 2006 Provisions that underlying bonds must be self-owned by the bond lender. This can solve the practical problem where the manager is acting as the nominee holder for non-legal person products while the product is the transacting counterparty. In addition, diversified bond lending needs can be satisfied; for example, institutions holding underlying bonds may be entrusted as agents to conclude bond lending transactions.	Bonds traded in the inter-bank market.	
Transaction period	The maximum period shall be no more than 365 days.		
Settlement institutions	Bond registration and settlement institutions and custodian banks recognized by PBoC, i.e., CCDC, SHCH and recognized custodian banks. Compared with the 2006 Provisions, the 2022 Measures add SHCH and custodian banks as the settlement institutions of	CCDC and SHCH.	

Transaction type / Element	Bond lending	Outright transfer bond repo	Pledged bond repo
	bond lending business.		
Agreement form	There is currently no applicable standard agreement form, and each participant formulates its own bond lending (master) agreement. The 2022 Measures newly provide that market participants shall sign a master agreement recognized by PBoC, which is formulated by the self-disciplinary organization in the inter-bank market (i.e., the National Association of Financial Market Institutional Investors ("**NAFMII**")) and filed with PBoC for record.	NAFMII Bond Repurchase Master Agreement (2013 version) issued by NAFMII in January 2013.	

The 2022 Measures provide a framework and foundation for a more efficient bond lending market that is more consistent with international practice. In comparison with the 2006 Provisions, the 2022 Measures newly add a bond lending master agreement, allow the use of various forms of performance assurance, and introduce a centralized bond lending mechanism. As early as 2017, the staff of NAFMII's Secondary Market Surveillance and Development Department (whose functions include regulating transactions and formulating standard agreement forms and transaction term documents) published an article entitled "Title Transfer Bond Lending Transactions: Experience, Status and Development", in which they suggested introducing title transfer bond lending business in the inter-bank market and publishing a standard agreement form for bond lending business, and mentioned the Global Master Securities Agreement (the "**GMSLA**") and the Master Securities Loan Agreement (the "**MSLA**") prevalent in the international bond lending market. We understand NAFMII will draft a Chinese counterpart to the bond lending master agreement by reference to the GMSLA and MSLA, and we will continue to closely monitor the publication of this master agreement and provide timely updates on how the master agreement implements the innovative points of the 2022 Measures (e.g. the performance assurance mechanism and centralized lending mechanism) as well as on the similarities and differences between the Chinese counterpart master agreement and those agreements prevalent internationally.

Important Announcement

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