

# Legal Commentary

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## Swap Connect on Its Way

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### Background

Overseas investors' participation in the China Inter-bank Bond Market (CIBM) has been steadily increasing in recent years due to the implementation of various opening-up regimes that allow access to the CIBM, such as the CIBM Direct, Bond Connect and QFI regimes, and the inclusion of China bonds in major international indices. At the end of 2021, overseas investors held RMB bonds of RMB 4 trillion, accounting for about 3.5% of the total market size of the CIBM.

On 4 July 2022, the People's Bank of China (PBoC), the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA) released a joint announcement<sup>1</sup> (the "**Joint Announcement**") on the Swap Connect (the "**Swap Connect**"), which is intended to meet the increasing demands of overseas investors to manage interest rate risk that arises from their bond holdings in the CIBM. The Swap Connect will promote the development of mutual access between the Hong Kong and Mainland interest rate swap (IRS) markets and facilitate IRS trading, among other derivatives products, in both markets through collaborative efforts among the China Foreign Exchange Trade System (National Interbank Funding Center) (CFETS), the Shanghai Clearing House (SHCH), and the OTC Clearing Hong Kong Limited (OTC Clearing, together the "**Infrastructure Institutions**"). PBoC has further released a Q&A<sup>2</sup> to clarify certain issues related to the Swap Connect.

### Key takeaways

1. **Launch time.** The Swap Connect is expected to be officially launched within about six months, after the finalization of relevant rules, completion of system development and other necessary preparations, according to the Joint Announcement.

<sup>1</sup> English version available at: <https://www.sfc.hk/en/News-and-announcements/Policy-statements-and-announcements/Joint-Announcement-of-the-PBoC-the-SFC-and-the-HKMA>.  
Chinese version available at: <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4592580/index.html>.

<sup>2</sup> English version available at: <http://www.pbc.gov.cn/en/3688110/3688172/4437084/4596781/index.html>.  
Chinese version available at: <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4592586/index.html>.

2. **Trading and clearing links.** Similar to the Bond Connect regime, the Swap Connect will consist of two links: (a) the Northbound Trading, which allows overseas investors to participate in the Mainland interbank financial derivatives market through mutual access between Hong Kong and Mainland Infrastructure Institutions in respect of trading, clearing and settlement; and (b) the Southbound Trading, which allows Mainland investors to access the Hong Kong financial derivatives market through mutual access between Infrastructure Institutions in both locations.

At the initial stage, the Northbound Trading will commence first while implementation of the Southbound Trading will be explored in due course.

3. **Northbound trading and settlement model.** According to the PBoC Q&A, in general, the Swap Connect will leverage the framework and experience of the Bond Connect. Specifically:

- Overseas investors may follow their existing trading practices under the Bond Connect Northbound Trading to conclude transactions on CFETS via its connections with international electronic trading platforms to trade eligible derivatives (i.e., RMB IRS) under the Swap Connect.
- The Swap Connect Northbound Trading will adopt the quoting institution trading model, which is similar to that under the Bond Connect Northbound Trading, i.e., overseas investors can obtain quotes from various PRC onshore dealers by sending request for quotes (RFQs) and confirm transactions after receipt of response from dealers. The concluded RMB IRS transactions will be relayed in real time to OTC Clearing and SHCH as the qualifying central counterparties (QCCP) for central clearing and settlement.
- OTC Clearing and SHCH, as the clearing Infrastructure Institutions in both markets, will jointly provide centralized clearing services in respect of RMB IRS for overseas investors.

While the detailed settlement rules are yet to be issued by the relevant clearing Infrastructure Institutions, we anticipate that OTC Clearing may become a clearing member of SHCH and be responsible for clearing and settlement with all overseas investors and may in turn settle with SHCH. SHCH may be responsible for the central clearing with the relevant PRC onshore dealers. and

- The Swap Connect may be subject to a trading quota by reference to that under the Stock Connect.

4. **Eligible instrument.** Initially RMB IRS will be the only eligible instrument for Northbound Trading under the Swap Connect while other derivatives products, such as bond forwards and credit default swaps, may be included in due course depending on market conditions.

5. **Hedging requirement.** On 27 May 2022, PBoC, jointly with other financial regulators, released the *Announcement on Issues Concerning Further Facilitating Investment in China's Bond Market by Overseas Institutional Investors*, which provides that overseas investors are allowed to trade relevant derivatives products for risk management purposes in China's bond market. As of today, overseas investors are able to trade RMB IRS for hedging purposes under the CIBM Direct and QFI regimes. Therefore, the investments in RMB IRS under the Swap Connect by overseas investors should also comply with this hedging requirement.

6. **Transaction documentation.** While it is yet to be confirmed by the final implementing rules of the Swap Connect, as overseas investors are already able to choose ISDA or NAFMII master agreements to document their RMB IRS transactions under the CIBM Direct and QFI regimes, we believe the same documentation would apply to the Swap Connect Northbound Trading.
7. **Collateral.** SHCH currently accepts cash and eligible bonds that are custodied with SHCH to meet margin requirements (i.e., policy bank bonds, financial bonds, non-financial enterprise debt financing instruments, such as commercial paper, and negotiable certificates of deposit). Treasury bonds and local government bonds are not accepted as collateral by SHCH, as they are custodied with China Central Depository & Clearing Co., Ltd. (CCDC). However, it is still unclear what assets OTC Clearing will accept as collateral, which awaits further clarification in the implementing rules.
8. **Applicable laws.** The Swap Connect is subject to the relevant laws and regulations of both markets. The Swap Connect Northbound Trading will follow the existing policy framework for the opening-up of the Mainland interbank financial derivatives market and take into account international practices.
9. **Regulators' cooperation.** The regulators of the financial derivatives markets in Hong Kong and the Mainland will cooperate with each other to timely handle any misconduct on both sides to maintain the stability, fairness and orderly trading of financial markets.

## Outlook

The Swap Connect Northbound Trading will be warmly welcomed by the overseas investment community to meet their increasing demands for interest risk management. However, there are still several issues pending clarification by the competent regulators or the Infrastructure Institutions. These include, among other things:

### I. Compliance with overseas regulatory requirements

As the intention of the Swap Connect Northbound Trading is to provide overseas investors access to the PRC derivatives market, the Infrastructure Institutions will have to consider overseas regulatory requirements in order for them to provide services to overseas investors.

For example, the U.S. Commodity Futures Trading Commission (CFTC) Letter 20-46<sup>3</sup> extends relief to SHCH to the earlier of (i) July 31, 2022 or (ii) when the CFTC exempts SHCH from registration as a derivatives clearing organization under Commodity Exchange Act Section 5b(h), and expands the product scope under the previous relief from “swaps subject to mandatory clearing in China” (only selected RMB IRS products are subject to the mandatory clearing requirement under PRC laws)<sup>4</sup> to be the clearing of “swaps accepted for clearing by SHCH”. Therefore, SHCH is able to rely on this relief to clear swaps for the proprietary trades of SHCH clearing members that are U.S. persons or

<sup>3</sup> Available at <https://www.cftc.gov/csl/20-46/download>.

<sup>4</sup> On 28 January 2014, PBoC released the *Notice on Establishing a Centralized Clearing Mechanism for OTC Financial Derivatives & Carrying out Centralized Clearing Business for Renminbi Interest Rate Swap* which requires the IRS referencing FR007, Shibor ON and Shibor\_3M with a term of less than 5 years (including 5 years) entered into between financial institutions to be mandatorily submitted with SHCH for central clearing.

affiliates of U.S. persons.

However, the imminent expiration of the CFTC relief and the uncertainty as to its extension may restrict U.S. investors from trading RMB IRS under the Swap Connect.

There are also similar issues for SHCH and other Infrastructure Institutions to provide relevant services under the Swap Connect to overseas investors in other different jurisdictions.

## **II. Trading of “standard” RMB IRS accepted by SHCH for central clearing under the Swap Connect Northbound Trading**

Pursuant to the Joint Announcement and relevant Q&A, it appears that all IRS transactions will have to be submitted for central clearing and settlement, but bilateral settlement will not be available under the Swap Connect.

The upside of the mandatory central settlement is that overseas investors will be exposed to fewer risks and need less capital for the trading in IRS, as both SHCH and OTC Clearing are QCCPs under local laws.

However, the existing SHCH central settlement rules may limit the available product suite under the Swap Connect Northbound Trading as in current onshore market not all products can be accepted by SHCH for central clearing. To provide practical color, SHCH now conducts an element compliance check against its own standards<sup>5</sup> on the transaction elements of RMB IRS transactions, the data of which is received from CFETS in real time, and decides whether to accept such RMB IRS transaction for novation, central clearing and settlement. SHCH will reject the RMB IRS transaction that fails to pass the element compliance check.

As the bilateral settlement is not available under the Swap Connect, it appears that IRS products available to overseas investors may be those “standard” IRS that are acceptable by SHCH for central clearing, subject to specific implementing rules to be issued by SHCH for Swap Connect.

## **III. Collateral accepted to meet margin requirements**

As discussed above, it is still unclear what assets OTC Clearing will accept as collateral. Considering that most of the bonds held by overseas investors in China are treasury bonds and policy bank bonds<sup>6</sup>, if these bonds cannot be used as collateral to meet margin requirements for trading IRS under the Swap Connect, overseas investors will need to use alternative assets (e.g., cash) that are acceptable by OTC Clearing to meet the margin requirements, which may affect the costs of overseas investors.

After the Joint Announcement, the regulators and the Infrastructure Institutions will continue to collaborate with each other to formulate detailed implementation rules for the Swap Connect. We will keep a close eye on material developments and update you in a timely manner.

<sup>5</sup> The standards are available in the central clearing guideline of SHCH: [http://english.shclearing.com.cn/ccpservices/rules/guidelines/202108/t20210811\\_913499.html?xyz=0.38717110390523524](http://english.shclearing.com.cn/ccpservices/rules/guidelines/202108/t20210811_913499.html?xyz=0.38717110390523524).

<sup>6</sup> Policy banks may be custodied with either CCDC or SHCH.

## ***Important Announcement***

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