New Rules for Foreign Investors' Funds in China's Bond Markets

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Background

On 18 November 2022, the People's Bank of China and the State Administration of Foreign Exchange ("**SAFE**") jointly promulgated the *Provisions on Administration of Funds Invested in China's Bond Markets by Foreign Institutional Investors* (《境外机构投资者投资中国债券市场资金管理规定》, the "**New Rules**")[2]. The New Rules were issued following the issuance on 27 May 2022 of the *Announcement on Matters Concerning Further Facilitating Foreign Institutional Investors' Investment in China's Bond Markets* (《关于进一步便利境外机构投资者投资中国债券市场有关事宜》, "**Announcement No. 4 [2022]**")[3], which aimed to provide a unified regulatory framework for foreign investors to invest in both the interbank bond market and exchange-traded bond market.

The New Rules will take effect from 1 January 2023 and replace the current foreign exchange-related rules applicable to foreign investors for their investments in China's bond markets. To be consistent with Announcement No.4 [2022], the New Rules also unify the capital management regulatory regime for foreign investors and relax certain restrictions to facilitate foreign investments. For your ease of reference, we highlight below the key changes in the New Rules.

Key changes

I. Introduction of the multi-tier custody model

Announcement No.4 [2022] introduced a multi-tier custody model, under which foreign investors may invest in Chinese bonds via their local custodian bank instead of a settlement agent bank under the existing settlement agent model. To accommodate the multi-tier custody model, the New Rules provide that foreign investors include foreign institutions that invest in China's bond markets under either the settlement agent model or the multi-tier custody model. If a foreign investor opts for the

1 Shirley Liang (intern) has made contribution to this article.

2 Chinese version available at http://www.pbc.gov.cn/zhengwugongkai/4081330/4406346/4693545/4713898/index.html.

3 Chinese version available at: https://www.safe.gov.cn/safe/2022/0527/21019.html. We previously prepared a newsletter on Announcement No.4 [2022], which is available at https://hankunlaw.com/en/portal/article/index/cid/8/id/6319.html.

multi-tier custody model, the local custodian bank will assume the role of the settlement agent bank and provide foreign exchange services.

II. More counterparty options for spot FX transactions

The New Rules present the first opportunity for foreign investors to conduct spot FX transactions through third-party financial institutions. Previously, foreign investors have only been permitted to conduct FX transactions with their settlement agent banks under the settlement agent model. As specified in Articles 13 and 14 of the New Rules, foreign investors will be permitted to directly carry out spot FX transactions with their settlement agent banks or custodian banks (as the case may be), any other financial institution, or indirectly trade in the interbank FX market via a prime broker. The expansion in the scope of counterparties for spot FX transactions may offer more options to foreign investors and help them to obtain better FX rates.

III. Lifting the restriction on the maximum number of counterparties for FX derivatives transactions

Since 13 January 2020, foreign investors have only been permitted to conduct FX derivative transactions with up to three (3) financial institutions, following SAFE's issuance of the *Notice on Issues concerning Improving the Management of Foreign Exchange Risks of Foreign Institutional Investors on the Interbank Bond Market* (《国家外汇管理局关于完善银行间债券市场境外机构投资者外汇风险管理有关问题的通知》). The New Rules will lift this restriction on the number of counterparties for FX derivative transactions, which may benefit foreign investors by allowing them to seek more competitive prices among counterparties. However, the filing requirement will remain applicable; hence, foreign investors will still need to file with the China Foreign Exchange Trade System prior to trading with any new financial institution counterparty, either on their own or through a custodian bank or settlement agent bank.

IV. Relaxation on repatriation of capital

Currently, where a foreign investor remits inbound both RMB and foreign currency for investment in China's bond markets, the investor may not subsequently repatriate more than 110% of their accumulative RMB and foreign currency inbound remittances, following SAFE's issuance on 27 May 2016 of the *Notice on Issues of Foreign Exchange Administration concerning Foreign Institutional Investors' Investment in the Interbank Bond Market* (《国家外汇管理局关于境外机构投资者投资银行间债券市场有关外汇管理问题的通知》). Article 11 of the New Rules relaxes the percentage restriction so that foreign investors will be able to repatriate up to 120% of their accumulative foreign currency inbound remittances, and the restriction on RMB repatriations will be lifted entirely. Article 11 further provides that this percentage restriction may be further relaxed for "long-term investors" in the China's bond markets; however, regulators have yet to clarify the definition of "long-term".

Outlook

The promulgation of the New Rules is another significant step for China's opening-up of its bond markets to foreign investors, who will benefit from their relaxed rules and greater optionality. We expect regulators will continue to optimize the opening-up policies and measures for foreign investors, such as the expansion in the investment scope under the Bond Connect channel, the launch of the connect scheme between the interbank bond market and exchange-traded bond market, and other initiatives that foreign investors have long been eagerly anticipating. We will monitor and keep you updated on any further developments.

Important Announcement

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