

Legal Commentary

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CIBM Bond Repo to be Further Opened to Overseas Investors

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Background

On 24 January 2024, to deepen the opening-up of the bond market and further facilitate the liquidity management of overseas institutional investors, the People's Bank of China ("PBOC") and the State Administration of Foreign Exchange published the *Announcement on Further Supporting Overseas Institutional Investors Engaging in Bond Repurchase Business in the China Interbank Bond Market* (draft for comments) (the "Announcement") (《关于进一步支持境外机构投资者开展银行间债券市场债券回购业务的公告(征求意见稿)》) to solicit public opinion. On the basis of the opening-up of cash bond trading to overseas institutional investors, the Announcement aims to further open up the onshore bond repo business in the China Interbank Bond Market ("CIBM") to overseas institutional investors to meet their liquidity management needs.

CIBM opening-up history

Since 2005, the CIBM has been advancing its reform, innovation and development processes, steadily promoting the opening -up, and progressively introducing overseas investors. In line with the market development needs, it has launched the CIBM Direct / settlement agent model and the Bond Connect model.

In August 2010, the PBOC issued the *Notice of the People's Bank of China on Issues Concerning the Pilot Program on Investment in the Interbank Bond Market with RMB Funds by Three Types of Institution Including Overseas RMB Clearing Banks* (Yin Fa No. 217 [2010])(银发[2010]217号《关于境外人民币清算行等三类机构运用人民币投资银行间债券市场试点有关事宜的通知》), allowing overseas central banks or monetary authorities, RMB business clearing banks in Hong Kong and Macao regions, and overseas participating banks for RMB settlement in cross-border trade to engage in bond investment business in the CIBM.

In May 2015, the PBOC issued the *Notice of the People's Bank of China on Bond Repo Trading by Overseas RMB Business Clearing Banks and Overseas Participating Banks in the Interbank Bond Market* (Yin Fa [2015] No.170) (《银发[2015]170号<关于境外人民币业务清算行、境外参加银行开展银行间债券

市场债券回购交易的通知》), permitting overseas RMB business clearing banks and overseas participating banks to carry out bond repo trading in the CIBM.

In July 2015, the PBOC promulgated the *Notice on Issues Concerning Investment of Overseas Central Banks, International Financial Institutions and Sovereign Wealth Funds with RMB Funds in the Inter-bank Market* (Yin Fa [2015] No.220) (《银发[2015]220号<关于境外央行、国际金融组织、主权财富基金运用人民币投资银行间市场有关事宜的通知>》), allowing overseas sovereign institutions to conduct cash bond trading and bond repo business, among other types of transactions, in the CIBM.

In February 2016, the PBOC issued the PBOC Announcement [2016] No. 3 (《中国人民银行公告[2016]第3号》) to allow overseas commercial institutions to entrust a settlement agent competent in international settlement business to carry out cash bond transactions (excluding bond repo) in the CIBM under the settlement agent model.

In June 2017, the PBOC released the *Interim Measures for the Administration of Mutual Bond Market Access between Mainland China and Hong Kong SAR* (《内地与香港债券市场互联互通合作管理暂行办法》). According to PBOC's Q&A, cash bond trading is available for overseas investors through the Northbound Trading under the Bond Connect model for the moment. In the future, the trading instruments of bond repo, bond lending and borrowing, bond forwards, interest rate swaps and forward rate agreements will gradually be available to overseas investors.

Upon the official implementation of the Announcement, all overseas institutions that have entered the CIBM, including overseas sovereign and commercial institutions under the CIBM Direct / settlement agent model and the Bond Connect model, may participate in the bond repo transactions.

Key points and interpretation of the Announcement

I. Scope of overseas investors

According to Article 1 of the Announcement, any overseas institutional investor that has engaged in cash bond transactions in the CIBM may conduct bond repo transactions in the CIBM. As mentioned in Section II above, prior to the issuance of this Announcement, only overseas sovereign institutions, overseas RMB business clearing banks and overseas participating banks can participate in bond repo transactions under the settlement agent model. The Announcement will significantly broaden the scope and trading channels of investors for trading in the CIBM repo market. Specifically, in addition to the existing overseas RMB business clearing banks and participating banks, overseas central banks, international financial organizations and sovereign wealth funds, various financial institutions (such as commercial banks, insurance companies, securities companies, fund management companies, futures companies, trust companies, and other asset management institutions), and medium and long-term institutional investors (such as pension funds, charitable funds and endowment funds) will be granted access to bond repo transaction through the CIBM Direct / settlement agent model or the Bond Connect model.

Since the Announcement has not addressed bond repo transactions under the Southbound Trading under Bond Connect, it remains uncertain whether domestic investors will be able to trade overseas

bond repo through the Bond Connect in the future.

II. Repo transaction mechanism

According to Article 2 of the Announcement, the bond repo business mentioned in the Announcement, including pledged repos and outright transfer repos, refers to the transaction under which the cash borrower (the repo party) sells bonds to the cash lender (the reverse repo party) and simultaneously receive funds, and both parties agree that the repo party will repurchase the underlying bonds from the reverse repo party at an agreed price on a certain future date and pays funds. The PBOC further clarified in the explanatory drafting note of the Announcement that the Announcement aims to support the convergence of the CIBM repo market with international practices, explicitly stating that when overseas institutional investors engage in bond repos in the CIBM, the underlying bonds should be transferred by purchase and sale, regardless of pledged repos or outright transfer repos, to facilitate the disposal of the bonds by the reverse repo party.

Based on the Announcement and its explanatory drafting note, the Announcement should cover both types of pledged repo and outright transfer repo. The arrangement in the Announcement aims at bridging the gap between the CIBM bond repo market and the overseas bond repo market, i.e., pledged repos account for over 90% of the bond repo transactions in the CIBM while the majority of the bond repo transaction in overseas markets are outright transfer repos. However, the following issues of the bond repo transaction mechanism under the Announcement still need clarification:

1. Title of bonds under pledged repo: title transfer by way of security vs nominal holding?

According to Article 3 of the *Measures for the Administration of Bond Transactions in the National Interbank Bond Market* (《全国银行间债券市场债券交易管理办法》), Article 2 of the *Provisions for the Administration of Bonds Outright Repurchase Business in the National Interbank Bond Market* (《全国银行间债券市场债券买断式回购业务管理规定》) and Article 24 of *China's National Association of Financial Market Institutional Investors Bond Repurchase Master Agreement (2013 Version)* (“**NAFMII Bond Repo Master Agreement**”)(《中国银行间市场债券回购交易主协议(2013年版)》), CIBM repo market includes two types of bond repo transactions, namely pledged repos and outright transfer repos. The pledged repo means the transaction under which one party (repo party) pledges the repurchased bonds to the other party (reverse repo party) and the reverse repo party pays the purchase amount on the purchase date to the repo party simultaneously, and both parties to the transaction agree on a certain date (i.e. the repurchase date) on which the repo party pays the repurchase amount to the reverse repo party and the reverse repo party release the pledge over the repurchased bonds. The outright transfer repo means the transaction under which one party (repo party) sells the repurchased bonds to the other party (reverse repo party) and the reverse repo party pays the purchase amount on the purchase date to the repo party simultaneously, and both parties to the transaction agree on a certain date (repurchase date) on which the repo party will repurchase the repurchased bonds from the reverse repo party at an agreed price(repurchase amount).

Given the above, the core difference between pledged repo and outright transfer repo in the current CIBM lies in whether the title of the underlying bond has been transferred. Under the pledged repo, the title of the underlying bonds remains vested in the repo party and the underlying bonds are not

transferred to the reverse repo party but marked as pledged in the repo party's bond account. But under an outright transfer repo, the title of the underlying bond shall be completely transferred to the reverse repo party before the repurchase.

However, according to the Announcement and its explanatory drafting note, the underlying bonds shall be transferred anyway regardless of pledged repos or outright transfer repos, which raises a question as to the belonging of the title to the underlying bonds. We tend to take a view that there are two possible interpretations of the pledged repo transaction mechanism under the Announcement:

Title transfer by way of security

Article 68 of the *Interpretation of the Supreme People's Court on the Application of the Security System of the Civil Code of the People's Republic of China* (《最高人民法院关于适用<中华人民共和国民法典>有关担保制度的解释》) confirms the validity of title transfer by way of security. The pledged repo under the Announcement contemplates the transfer of title to the underlying bonds onto the reverse repo party by way of security and as the collateral for the repurchase obligation of the repo party. Where the repo party fails to pay repurchase amount upon the repurchase date, the reverse repo party may, by referring to the provisions on security interests in the PRC Civil Code (《中华人民共和国民法典》), enforce the underlying bonds by way of conversion into value, auction or private sale and get repaid in priority from the proceeds therefrom, but the reverse repo party cannot claim title to the underlying bonds without the enforcement procedure given the prohibition of strict foreclosure under PRC laws.

Although the aforesaid mechanism of title transfer by way of security can achieve similar security effect as the pledged repo, on the one hand, title transfer by way of security is not equivalent to pledge, and it poses uncertainty to whether such repo transaction can still fall in the scope of pledged repo as it cannot fit into the definition of pledged repo; on the other hand, where the title to the underlying bonds are transferred by way of security, some issues need to be further clarified, such as how to ensure that the reverse repo party, as the secured party and owner of the underlying bonds, does not dispose of the underlying bonds during the repurchase period, how to ring-fence the self-owned bonds of the reverse repo party from the underlying bonds as collateral, and how to protect the underlying bonds held by the reverse repo party from enforcement by the creditors of the reverse repo party.

Nominee holding

Under the pledged repo transaction under the Announcement, despite the title transfer of underlying bonds, the reverse repo party only serves as the nominal holder of the underlying bonds to hold the underlying bonds on behalf of the repo party, while the repo party remains the beneficial owner of the underlying bonds. The bond registration, custody and settlement institutions may facilitate the pledge registration over the underlying bonds by means of registering the beneficial owner, the pledgor, the pledgee and creating pledge mark on the bonds.

The nominal holding system allows the pledged repo under the Announcement to align with the existing definition of pledged repo to the greatest extent, but the bond registration, custody and settlement institutions need to make adjustments to the existing pledge registration system.

The title transfer by way of security and nominal holding above represent our speculation, based on the limited available information, on the potential operational models of the pledged repo contemplated under the Announcement. The specific operational model of the pledged repo contemplated under the Announcement is still subject to further clarification by regulatory authorities and bond registration, custody and settlement institutions.

2. Pledge registration

In accordance with Article 441 of the PRC Civil Code, where a pledge is created over bonds, the pledge shall be perfected upon the delivery of documents of title to the pledgee. Where there is no document of title, the pledge shall be perfected upon the registration of the pledge. Under the pledged repo stipulated in the Announcement, the underlying bond is transferred to the reverse repo party, similar to an outright transfer repo. However, how the repo party can conduct pledge registration over the bond already transferred to the reverse repo party needs further clarification by the bond registration, custody, and settlement institutions.

In addition, the Northbound Trading under Bond Connect adopts the internationally prevalent multi-layer custody structures, i.e., the Central Moneymarkets Unit of the Hong Kong Monetary Authority (“**CMU**”) opens nominee holder accounts with the Shanghai Clearing House (“**SHCH**”) and the China Central Depository & Clearing Co., Ltd. (“**CCDC**”), overseas investors open Bond Connect sub-accounts with CMU through CMU members, and overseas investors’ accounts are held by CMU members. The bonds purchased by overseas investors through the Bond Connect channel are registered under the nominee account opened by CMU with SHCH or CCDC. Under the aforementioned multi-layer custody structure, the procedures for completing pledge registration for pledged repo transactions between overseas investors and domestic counterparties, and how the reverse repo party can dispose of the underlying bonds smoothly in the event of default by the repo party, require further clarification in detailed business rules.

According to Article 4 of the Announcement, the relevant CIBM infrastructures shall formulate or revise the business rules and detailed operating rules and report them to PBOC as required, and properly carry out the service and monitoring work for the relevant transactions, custody, settlement and clearing, and timely handle and report significant problems and abnormal situations to the PBOC. Therefore, we anticipate that the bond registration, custody and settlement institutions will review their business rules to adapt to the special transaction mechanism under the Announcement.

3. Coordination with the existing bond repo market

The pledged repo transaction mechanism under the Announcement differs significantly from the current pledged repo trading mechanism, in particular with respect to the title transfer of the underlying bonds and the pledge registration. Further observation is needed to determine whether and how adjustments to the existing bond repo market are necessary after the Announcement takes effect.

III. Transaction documentation

In December 2012, the PBOC promulgated the *Announcement on Promulgating the Master Agreement on Bond Repurchase Transactions in the Interbank Bond Market (PBOC Announcement [2012] No.*

17) (《关于发布<中国银行间市场债券回购交易主协议>的公告》(中国人民银行公告(2012)第 17 号)), requiring market participants to sign the NAFMII Master Repo Agreement when engaging in bond repo transactions and file the executed NAFMII Master Repo Agreement and its supplemental agreements to National Association of Financial Market Institutional Investors (“NAFMII”) in a timely manner.

According to the *Business Process for Overseas Commercial Institutional Investors’ Access to the Chinese Interbank Bond Market* (《境外商业类机构投资者进入中国银行间债券市场业务流程》) and the *Business Process for Overseas Central Bank Type Institutions’ Access to the Chinese Interbank Bond Market* (《境外央行类机构进入中国银行间债券市场业务流程》), overseas central banks and sovereign institutions, overseas RMB business clearing banks and participating banks that participate in bond repo transactions through CIBM Direct / settlement agent model are required to sign the NAFMII Master Repo Agreement.

Based on the above, before the issuance of the Announcement, all participants in the CIBM repo market need to sign the NAFMII Master Repo Agreement to conduct bond repos. The Global Master Repurchase Agreement (“GMRA”) issued by the International Capital Market Association (“ICMA”) is commonly used to document repo transactions in the international market. Several associations and overseas institutions expressed their wishes that the PBOC would allow overseas institutions to use the GMRA to document their onshore bond repos.

Article 5 of the Announcement provides that the overseas institutional investors shall enter into the bond repo master agreement with their counterparties, and the relevant self-regulatory organization shall file such master agreement with the PBOC. The following points regarding the transaction documentation of the master agreement for the bond repo under the Announcement need to be further clarified:

1. Whether the GMRA can be used

The Announcement does not clarify whether the bond repo master agreement mentioned in Article 5 only refers to the NAFMII Master Repo Agreement. Considering that overseas central banks and sovereign institutions, overseas RMB business clearing banks and participating banks are still required to enter into the NAFMII Master Repo Agreement, we tend to believe that once the Announcement comes into effect, overseas commercial institutions will also be subject to the same rules and cannot use GMRA.

Notwithstanding the above, on the one hand, in 2020, several financial regulatory authorities including the PBOC jointly issued the *Opinions on Accelerating the Building of Shanghai into an International Financial Hub and Financially Supporting the Integrated Development of the Yangtze River Delta* (《关于进一步加快推进上海国际金融中心建设和金融支持长三角一体化发展的意见》), permitting that overseas institutions may sign the NAFMII Master Agreement, Securities Association of China Master Agreement and International Swaps and Derivatives Association Master Agreement for derivatives transactions at their sole discretion. The PBOC may adopt a similar approach to allow overseas institutions to sign GMRA at their sole discretion; on the other hand, Article 5 of the Announcement requires that the relevant self-regulatory organizations should make a record filing of the master agreement with the PBOC, while the NAFMII Master Repo Agreement has already been filed with the

PBOC. Whether this clause is intended to leave room for ICMA to file the GMRA with the PBOC, and allow overseas agencies to use the GMRA to document bond repos, requires further clarification from the PBOC.

2. Filing requirements

Whether the filing requirements of the master agreement under Article 5 of the Announcement shall apply to the executed bond repo master agreements by various overseas institutions or to the master agreement templates promulgated by various self-regulatory organizations, including ICMA's GMRA, remains to be further clarified by the PBOC. If overseas institutions are permitted to use the GMRA to document bond repos, it remains to be seen how to make a record filing of the GMRA.

3. Coordination with the transaction mechanism of the announcement

As mentioned in Section 3.2 above, the transaction mechanism of the pledged repo under the Announcement is different from the currently prevailing pledged repo. Whether and how the terms of the NAFMII Master Repo Agreement need to be adjusted to align with the transaction mechanism under the Announcement remains to be seen.

Outlook

The Announcement expands the scope of overseas institutions (i.e., overseas commercial institutions) and the channels (i.e., Bond Connect) through which they can participate in the bond repo business, thereby increasing the liquidity of CIBM and satisfying overseas investors' risk management needs. However, there are still many ambiguities about the bond repo transaction mechanism under the Announcement, which are inconsistent with the existing bond repo transaction mechanism and still need to be further clarified by the regulatory authorities, relevant financial market infrastructures and self-regulatory organizations, including but not limited to the bond transfer mechanism under the pledged repo, pledge registration arrangement, and execution and recording filing requirement of the master agreement. We will closely monitor the further development of relevant transaction mechanisms in the Announcement and promptly share our insights.

Important Announcement

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