

# New Regulatory Developments in China's Derivatives Markets

As investment continues to pour into China's capital markets, more financial institutions are hedging risk with renminbi derivative transactions. Regulatory authorities have quickly responded with related legislation on exchange forwards and swaps. Will the authorities liberalize constraints on the derivative markets to meet international market standards?

Han Qimeng and Jiang Qian explains the rules of the game, and how they are changing.

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In recent years, there has been an acceleration of foreign direct investment in China and a fast growth in the Chinese trade surplus. In August 2006, China's trade surplus hit a record of US\$18.8 billion, a level that has renewed pressure for a further revaluation since Beijing's 2.1% renminbi revaluation against the US dollar in July 2005. The rapid rise of the trade surplus - which totalled more than US\$170 billion at the end 2006 - has been fuelled by strong export growth. In the meantime, "hot money" anticipating the appreciation of the renminbi is flowing into China's capital markets. All these phenomena add tremendously to China's foreign exchange reserves. By the end of October 2006, the amount of these reserves exceeded US\$1 trillion, making them the biggest foreign exchange reserves in the world.

The vigorous activity in China's economy has not only boosted profit-seeking activities, but has also promoted hedging risk through derivative transactions. More and more international and domestic financial institutions and industrial enterprises are interested in derivative transactions based on renminbi exchange rates, interest rates, stocks and commodity prices. The relevant Chinese regulatory authorities have kept pace with this trend by promulgating successive rules to regulate China's derivatives markets. They have paid particular attention to products such as foreign exchange forwards and swaps, interest rate derivatives, as well as equity and commodity derivatives.

International market principles and practices such as these promoted by the International Swap and Derivatives Association (ISDA) could be used to build a contractual framework for derivative transactions in China. However, the specific features of Chinese laws and regulations governing the derivatives business must be carefully taken into account when entering into such transactions, by completing or adapting the international contractual frameworks in line with Chinese laws and regulations.

For example, according to China's regulations on derivatives transactions, each licensed financial institution must fully disclose the risks incurred by its customers. Moreover, the financial institution must also obtain confirmation letters from its customers, stating that they understand, and are capable of undertaking, the risks associated with the derivative transactions.

Indeed, this requirement under Chinese laws and regulations put the onus on the qualified financial institutions to disclose information concerning risks. In practice, this obligation involves efforts to be made by sellers from financial institutions to educate customers about derivatives products.

The following is a short outline of the main characteristics of the new Chinese regulations governing the derivatives market in China. It also touches upon the specific derivatives products that are currently encouraged by Chinese authorities.

## FORWARDS AND SWAPS - BREAKTHROUGH DEVELOPMENTS

Since the reform of the renminbi exchange rate regime, domestic companies are looking forward to engaging in foreign exchange forwards and swap transactions and demanding more and better exchange-rate risk hedging services. In practice, foreign exchange forwards and renminbi swaps are the major foreign exchange risk management tools for hedging currency-related risks.

In light of market requirements, the People's Bank of China (PBOC) promulgated the *Notice on Issues Regarding Expanding Designated Banks' Forward Sale and Purchase of Foreign Exchange Business to Customers and Launching RMB Swaps against Foreign Currencies* (PBOC Notice) on August 2 2005.

Before the PBOC Notice came into effect, only four large state-owned commercial banks and three joint stock domestic commercial banks were licensed to conduct renminbi forwards as part of a pilot scheme. The PBOC Notice now allows almost all commercial banks, including branches of foreign-owned banks in China to engage in the renminbi forward trading business. This can be done after registration with the State Administration of Foreign Exchange (SAFE) on the condition that such banks have:

- (i) a license granted by SAFE allowing them to conduct the sale and purchase of foreign exchange;
- (ii) not committed any major violations of any administrative rules concerning the sale and purchase of foreign exchange during the past two years; and
- (iii) a license granted by the China Banking Regulatory Commission (CBRC) to conduct derivatives business pursuant to the *Interim Rules on Derivative Business of Financial Institutions* issued in 2004.

Furthermore, the PBOC Notice allows banks that have been approved to conduct forward sale and purchase of foreign exchange for more than six months to engage in renminbi currency swap transactions after registration with SAFE.

When compared with international market practices, it appears that foreign exchange derivative transactions as regulated by the relevant Chinese authorities are unique in several ways:

- (i) non-financial institutions shall only carry out derivatives transactions with hedging purposes and backed by true trade business;
- (ii) when engaging in the foreign exchange forward and swap business, banks are required to verify whether the settlement of foreign exchange by the domestic entity complies with the applicable regulations; and
- (iii) at the maturity of the forwards and swaps, banks are not able to perform their contractual obligations before they have examined the validity of the documents provided by the domestic entities. This is consistent with the traditional position under SAFE regulations where these documents are required before the settlement of foreign exchange occurs.

#### THE CHINA FX TRADING CENTRE

In order to accelerate the development of the foreign exchange derivatives market, the PBOC has authorised more risk management tools. It has also allowed a greater number of qualified participants access to the official uniform foreign exchange market - China FX Trading Centre. These changes are outlined in the *Notice of the People's Bank of China on Accelerating the Development of the FX Market* (PBOC Accelerating Notice) promulgated by the PBOC on August 8 2005.

According to the PBOC Accelerating Notice, the PBOC has started to permit non-financial enterprises and non-banking financial institutions to attend the Spot FX Market on the condition that they (i) obtain preliminary approval from the Centre (ii) apply for registration with SAFE and finally (iii) apply for membership in the Centre.

More importantly, the PBOC Accelerating Notice has introduced forward forex transactions to the Centre, forming a regulated and organised forex derivatives market. From now on, members may engage in the renminbi forward transactions on the Centre's forex market after applying for preliminary approval from the Centre, registering with SAFE and applying for final approval from the Centre, provided that:

- (i) they are members of the Centre; and
- (ii) they have licences from CBRC to deal in financial derivatives if they are either policy banks, commercial banks, trust and investment companies, financial leasing companies, finance companies or auto finance companies. Other non-banking financial institutions need approval of the authorities which regulate them, such as CSRC for securities companies and CIRC for insurance and reinsurance companies. Non-financial enterprises need approval from SAFE.

In relation to management of the derivatives markets, the Chinese authorities have taken a traditional approach when addressing the unique features of the Chinese markets as follows:

- (i) SAFE manages the registration of legal entities for the participants of the Centre's renminbi forward market;
- (ii) SAFE also determines the maximum amount of renminbi and foreign currencies that non-financial enterprises and non-banking financial institutions can trade, on the basis of the amounts of their forex settlement level, capital and operating capital;
- (iii) The market participants must have at least six months experience in engaging in forwards in the Centre before they will be allowed to start to deal in renminbi against foreign currency swaps.

Compared to a directly-negotiated foreign exchange forwards and swaps market, such an organised, uniform centre presents numerous advantages, such as higher liquidity thanks to the establishment of a market quotation system, higher transactions security, and reduced credit risk through the mechanism of margins deposits affected by members with the Centre.

#### MASTER AGREEMENT FOR FOREX FORWARDS AND SWAPS

The PBOC and the Centre are making considerable efforts to speed up the development of the forex derivatives market. For the purpose of clarifying their rights and obligations, participants who trade through the Centre have to sign the Centre-designed Master Agreement for forward transactions. They must also comply with the rules promulgated by the Centre in the *Notice on promulgating the Master Agreement and rules on RMB forward exchange transaction* on October 18 2005.

However, both the Forward Master Agreement and the Trade Guidelines for renminbi forwards promulgated by the Centre have generated much debate amongst market participants, especially branches of foreign banks.

The most controversial debate is over the fact that Centre's Forward Master Agreement, which states that only the Agreement, the renminbi forward transaction confirmations, and the supplementary contracts for renminbi forward transactions will together constitute a complete and entire renminbi forward transaction agreement. However, according to prevailing international practices, such as transactions documented under the ISDA documentation, the master agreement together with all transaction confirmations, ranging from equity derivatives to currency derivatives, from credit derivatives to commodities derivatives, governed by the said master agreement, shall form a single agreement in respect of all of the transactions. Thus all transactions are connected and could terminate, and the reciprocal obligations between the parties could be netted upon default, with the result of considerably reducing the credit risk of the participants.

As a result of intense lobbying and debates, the Centre promulgated the *Notice on Promulgating Rules of RMB FX Swap in the Centre* on April 21 2006 (the Swap Rules). The Swap Rules continue to emphasize that transaction confirmations and supplementary contracts shall comply with the general principles of the Centre's Master Agreement. In

particular, the transaction confirmations and supplementary contracts must designate Chinese law and Chinese courts as applicable law and competent jurisdiction. Even though a new master agreement for forwards and swaps is still under discussion, the authorities have already made it clear that the new master agreement for swaps and forwards, and transaction confirmations as well as supplementary contracts, will still be governed by PRC law.

However, the above master agreements and rules only apply to the derivative transactions between the members of the Centre in this regulated uniform market. As such, branches of foreign banks in China can still use the ISDA documentation governed by English law or the law of the State of New York, with their Chinese clients for their OTC derivative transactions. However, it is a different story if the clients are also members of the Centre and, having signed the Centre's Master Agreement, are committed to complying with the Centre's rules. In that case, branches of foreign banks and their Chinese counterparties must not violate the rules and sign any supplementary contracts choosing either English law or the law of the State of New York as applicable law to their transaction confirmations. Failure to comply with the Centre's Master Agreement on this issue may trigger severe penalties.

#### **INTEREST RATE SWAPS DENOMINATED IN RENMINBI**

In response to the rapid increase in China's foreign exchange reserves, the Chinese authorities are putting more renminbi into the financial market. This is accompanied by a current in-depth reform to the Chinese interest rate regime, which tends to be more flexible and market-based. As a result, market participants have to find new and more efficient tools to manage interest rate risks on the derivative market. On January 24 2006, the PBOC issued the *Notice on the Conduct of Pilot RMB Interest Rate Swap Transactions* (the PBOC Interest Rate Swap Notice). The PBOC Interest Rate Swap Notice is gradually liberalizing the renminbi interest rate swap business, by allowing members of National Inter Bank Bond Market which hold derivatives business licenses, including branches of foreign banks which are licensed to trade in derivatives, to carry out interest rate derivatives business.

According to the PBOC Interest Rate Swap Notice, commercial banks which hold the derivative business licence could conduct interest swaps with their clients, or with other commercial banks that also hold a derivatives licence. Such commercial banks may also provide brokerage services for interest rate swap transactions to their clients. Other members of the National Inter Bank Bond Market can only conduct interest swap transactions for hedging purposes with their usual commercial banks which hold the derivative business licence.

#### **EQUITIES AND COMMODITIES DERIVATIVES**

On December 2 2005, the CBRC issued the *Notice on the Issues of Business Scope of Derivatives Product Transactions by Domestic Commercial Banks* (the CBRC Business Scope Notice). In the CBRC Business Scope Notice, the CBRC has lifted the prohibition on domestic commercial banks from engaging in derivatives products linked to equities and commodities.

In the past, financial institutions were not permitted to engage in derivatives transactions relating to equities and commodities. The CBRC was very unwilling to approve these types of derivatives products due to the principle of segregating the banking sector from the securities and futures sector in China.

Despite this, the CBRC has started to approve derivatives products linked to equities or commodities. This is done on a case-by-case basis after a thorough review of the suitability of these derivatives products. For this purpose, domestic commercial banks need to submit the feasibility study report and marketing plans to CBRC for review and approval.

However, branches of foreign banks cannot take advantage of the provisions under the CBRC Business Scope Notice and engage in trading derivatives products linked to equities and commodities in China. In light of the Chinese government's intention to gradually develop the Chinese derivatives markets, branches of foreign banks which are interested in the derivative business must communicate with the CBRC at an early stage. They must also submit applications outlining their skills and other documents to the CBRC pursuant to the *Implementation Measures on Administrative Licensing Items Relating to Foreign-Invested Financial Institutions*, effective on February 1 2006. These measures also provide a route for branches of foreign banks to apply to expand their derivatives business into new structured derivatives products by submitting a specific application to the CBRC.

In conclusion, despite all the uncertainties and obstacles, the Chinese authorities have focused on developing the Chinese derivatives market, in order to provide tools for domestic companies and banks to manage renminbi exchange rate risk, interest rate risk and other market risks in China. With the speedy growth in the Chinese trade surplus, Chinese authorities are strongly expected to be gradually liberalizing the constraints imposed on the domestic and foreign participants in the Chinese derivative markets in line with international market standards.