

Covering All Bases

China's new derivatives regulations promise to strengthen obligations borne by banks to better safeguard Chinese corporations, says *Blandine Cantrel*.

IN 2009, CHINESE STATE-OWNED enterprises such as Air China, China Eastern and Shanghai Airlines reportedly suffered losses of up to USD1.94bn on aviation fuel hedging derivatives contracts entered into in the beginning of 2008, when oil prices were rising. However, since covering risks by entering into derivatives without undertaking other risks in respect of the same contract is expensive, Chinese airlines have preferred to execute derivatives contracts that protect them against price increases but allocate to them the risk of any price decrease.

Consequently, in the event of a price increase, banks with which derivative products have been entered into should pay their corporate counterpart any price increase since the execution date of the derivative contract. If prices decrease, Chinese companies should pay that decrease to banks. When oil prices collapsed as a result of the global economic crisis, derivatives, which were meant to insure airlines against price increases, turned out to insure banks against the price decrease, causing Chinese airlines to owe significant sums of money to banks.

Other Chinese companies also suffered losses resulting from bad bets on volatile foreign exchange markets. Consequently, the Chinese regulatory authorities decided that the domestic market needed regulatory reinforcement, especially for derivatives transactions that Chinese corporations had entered into.

In April 2009, the State-Owned Assets Supervision and Administration Commission (SASAC), the Chinese authority regulating state-owned enterprises, published the conditions under which state-owned companies can enter into derivatives.

Then, on 31 July, the China Banking

Regulatory Commission (CBRC) issued the Circular on Further Strengthening Risk Management of Derivatives Transactions between Banking Financial Institutions and Institutional Clients (the Circular). The Circular strengthens the Chinese domestic derivatives market by issuing and reaffirming stringent requirements and restrictions on domestic transactions between China-based banks and Chinese corporate clients. This is in order to safeguard domestic companies against speculative products, while protecting domestic banks from exposure to excessive risks.

Corporations must prove a 'real need' to enter into derivatives transactions, making it clear that their use is for hedging purposes only

Legal Framework

The new Circular follows two major steps that created the Chinese regulatory framework for derivatives.

The first was in 2004, when the CBRC issued the Interim Administrative Measures for Derivatives Transactions by Financial Institutions (the 2004 Regulations), allowing banking institutions regulated by the CBRC

to enter into derivatives transactions for speculative purposes.

The second, made this year, was when the National Association of Financial Market Institutional Investors (NAFMII), a self-disciplinary industry organisation mandated by the People's Bank of China, published a Master Agreement for the Chinese Derivatives Market. Known as the NAFMII master agreement on financial derivatives transactions, it merged two pre-existing master agreements. It records uniform Chinese standards for onshore OTC derivatives and provides a fair and sophisticated contractual document, including the same fundamental concepts and mechanisms as the most widely used international documentation, for example, that of ISDA (International Swaps and Derivatives Association).

The Circular protects Chinese companies against risks related to the use of derivatives. It requires banks to better manage their own risks, to provide more information to their corporate clients and to ensure that Chinese companies enter into derivatives for hedging purposes only and not for profit-making.

Banks located in China and licensed to offer derivatives had to submit a detailed report to the CBRC by 31 October, outlining their plans for compliance with the Circular.

Enhancing Onshore Banks' Risk Management

For better risk management, banks must focus on internal sales training. Remuneration for sales personnel cannot be directly linked to the profit generated from derivatives transactions. Banks must internally approve transactions at the appropriate level of competence.

Onshore banks cannot engage in back-

to-back derivatives with counterparties designated by corporate clients. Corporate clients cannot negotiate derivatives products with unregistered overseas financial institutions and pull in an onshore registered bank as a sales channel for complex and high-risk products. However, onshore banks can engage in back-to-back transactions, even with overseas counterparties, which is a key risk management tool for the derivatives industry. Indeed, onshore banks are expected to choose their back-to-back counterpart independently so as to pick the best option to cover all possible risks such as onshore and offshore legal risks, reputation risk and credit risk.

Banks must behave as 'responsible sellers', controlling their own risk, as well as their clients'.

Additional Protection for Domestic Companies

To avoid misleading marketing of complex and high-risk products, the Circular expressly prohibits sales people hired by offshore banks from jointly marketing derivatives products with onshore banks.

Banks must better assess and manage corporate client risks by improving the evaluation of client sophistication and product suitability, while better managing client creditworthiness through margin calls.

Based on the 2004 Regulations, the Circular provides more detailed and stringent disclosure requirements for banks at each stage of a derivatives transaction:

Before entering into a derivatives transaction, banks must introduce the product structure, the underlying asset, basic transaction terms and the relevant legal documents in writing. Banks must also disclose the rate of return and major risks relating to the transactions, for example, the maximum possible loss. Corporate clients must confirm their understanding of this disclosure in writing.

Onshore banks are legally bound to provide corporate clients with a written monthly price assessment of their derivatives products, or even more frequently when markets are

volatile. Banks must assess all involved agreements at least every six months.

Basic Derivatives Products for Hedging Purposes only

Corporations must prove a 'real need' to enter into derivatives transactions, making it clear that their use is for hedging purposes only.

The Circular states that banks are expected to exercise greater control by assessing the purpose of the derivatives transactions for their clients, as well as vetting the authenticity of underlying assets. Banks cannot rely

CBRC clearly has a strict understanding of that 'degree of relevance', most notably since the Circular prohibits the use of renminbi debt as the basis for derivatives products linked to non-renminbi market indices. The CBRC recently confirmed that although products linked to non-renminbi market indicators have reduced corporations' renminbi-financing costs, they have also introduced additional risk to domestic markets and, consequently, preference shall be given to banks' more basic derivatives product offerings.

However, banks' obligation to ensure that a derivatives transaction is for hedging purposes is limited in practice. For example, it is impossible for banks to know whether clients have over-hedged their exposure by entering into multiple hedging contracts with different banks regarding the same underlying asset or liabilities, thereby turning derivatives transactions into speculative tools.

Future Implications

The Circular, along with the publication of the NAFMII, is a clear sign that the Chinese authorities are willing to develop their as-yet nascent domestic derivatives market.

In a notice published shortly after the Circular, in August 2009, SASAC encouraged state-owned enterprises to challenge foreign banks over derivatives contract losses and to contest cross-border derivatives contracts, provoking anger and dismay in financial circles.

While cracking down on cross-border transactions with foreign banks, China is progressively promoting a sounder environment for domestic derivatives transactions. As a result, the derivatives market for Chinese corporations is likely to expand as a domestic market, or rather a market for onshore transactions, instead of a market for cross-border transactions. **SBR**

Blandine Cantrel is an associate with Gide Loyrette Nouel, a leading international law firm with offices in Beijing, Shanghai and Hong Kong. Rebecca Major of GLN Hong Kong and Wang Yi of GLN Beijing contributed to this article.



New derivatives regulations help protect Chinese corporations.

merely on representations from their clients. This means that corporate clients have to give evidence of underlying assets or liabilities to be hedged, for example, by providing the underlying contract to banks.

Derivatives transactions must maintain a 'degree of relevance' to the main risk profile of the underlying assets or liabilities, indicating that risk in a matching transaction must equal the hedged risk. Therefore, banks cannot enter into derivatives transactions whose notional amount is higher than the amount of the underlying assets or liabilities. The