

Legal Commentary

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A Step towards the Launch of Swap Connect

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Background

On 17 February 2023, the People's Bank of China (PBoC) issued for public comments the *Interim Measures for the Administration of Interconnection and Cooperation between the Interest Rate Swap Markets of the Mainland and Hong Kong (Draft for Comments)*¹ (the “**Draft Swap Connect Measures**”). The public comment period is open until 4 March 2023.

Soliciting public comments for the Draft Swap Connect Measures is the latest move since the PBoC, the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA) released a joint announcement on 4 July 2022, which officially confirmed the future launch of the Swap Connect (the “**Joint Announcement**”)². According to PBoC in a separate explanatory statement on the Draft Swap Connect Measures³, the Swap Connect initiative is designed to facilitate the participation of offshore investors in the onshore RMB interest rate swap (IRS) markets, considering that RMB interest risk management needs of overseas investors have been steadily increasing in recent years in response to the constant improvements to the opening-up of China Inter-bank Bond Market (CIBM)⁴.

Further to our previous newsletter on the Swap Connect on 7 July 2022⁵, we would like to share with you the key takeaways of the Draft Swap Connect Measures, especially the differences compared with the

¹ Chinese version (only) available at: <http://www.pbc.gov.cn/tiaofasi/144941/144979/3941920/4797472/index.html>.

² 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>.

³ Chinese version available at: <http://www.pbc.gov.cn/tiaofasi/144941/144979/3941920/4797472/2023021714465055292.pdf>.

⁴ In 2022, we witnessed various measures to deepen the opening up of the CIBM by PBoC and other financial regulators, including the issuance of the Announcement on Issues Concerning Further Facilitating Investment in China's Bond Market by Overseas Institutional Investors issued on 27 May 2022, and the Administrative Provisions on Funds Invested by Foreign Institutional Investors in China's Bond Market issued on 10 November 2022.

⁵ Our previous newsletter on the Swap Connect, Swap Connect on its Way, is accessible at: <https://hankunlaw.com/en/portal/article/index/cid/8/id/9406.html>.

PBoC Q&A (the “Q&A”) released along with the Joint Announcement⁶. The capitalized terms referenced herein but not otherwise defined have the same meanings given to them in our previous newsletter.

Key takeaways

In general the Draft Swap Connect Measures have provided a high-level framework for the Swap Connect and are consistent with the operating model described in the Joint Announcement and Q&A back in 2022. Further to the Joint Announcement and Q&A, the Draft Swap Connect Measures have newly provided the followings:

- **Eligible offshore investors.** Article 4 of the Draft Swap Connect Measures provides that offshore investors that meet the requirements of PBoC and have completed the filing procedure to access CIBM would be able to participate in the Northbound Swap Connect. Therefore, we believe all foreign investors that have entered CIBM under either CIBM Direct or Bond Connect should be eligible investors under the Swap Connect, subject to PBoC’s further clarification on its requirements.
- **Eligible onshore dealers.** Article 5 of the Draft Swap Connect Measures specifies that onshore dealers under the Northbound Swap Connect must have strong pricing, quotation and risk management capabilities, good international reputation, and business systems and professionals to support quotation and trading under the Northbound Swap Connect. Onshore dealers would be required to sign a quotation institution agreement with the domestic electronic platform recognized by PBoC, which we understand should be CFETS.
- **Transaction documentation.** Article 6 of the Draft Swap Connect Measures requires the parties to Swap Connect transactions to enter into master agreement or other agreement recognized by PBoC. We anticipate both NAFMII and ISDA Master Agreements should be acceptable as they have been accepted by CFETS for IRS transactions under CIBM Direct scheme.
- **Transaction model.** Article 8 of the Draft Swap Connect Measures confirms the trading model described in the Joint Announcement and Q&A, provided that Article 8 requires the transfer of existing contracts to be carried out through CFETS, unless otherwise provided by PBoC. It remains unclear whether this model would also apply to the transfer of contracts between offshore investors and the role of offshore trading platforms in this transfer arrangement.
- **Central clearing model.** Article 9 of the Draft Swap Connect Measures confirms the central clearing model described in the Joint Announcement and Q&A. Notably, Article 9 further specifies that the onshore clearing institution, i.e., SHCH, will provide feedback to both onshore dealers and offshore investors as to whether an executed transaction has been accepted for central clearing through CFETS; those transactions that are refused for central clearing will be handled pursuant to the agreement between the transaction counterparties prior to the trade.

While the Draft Swap Connect Measures do not provide further details on how to handle the transactions

⁶ 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>.

that fail to be centrally cleared, it is anticipated that the transaction counterparties could choose to either resubmit the transactions with SHCH after reasonable adjustment to the transaction elements or cancel the transactions after the refusal by SHCH. However, bilateral settlement may not be an available option for transaction counterparties as there may not be a feasible account structure for both parties to settle the transactions.

- **Transaction reporting.** Article 13 of the Draft Swap Connect Measures requires the investors and financial infrastructures under the Swap Connect to report transaction-related data to the trade repository recognized by PBoC and to properly preserve all transaction-related data and communications; where the transactions are executed via CFETS, CFETS will fulfill such reporting obligation on behalf of the investors, and the reporting obligation will be waived if CFETS itself is the PBoC recognized trade repository.

From a foreign investor perspective, it is worth noting that the data preservation obligation is not waived and PBoC does not specify the data retention period applicable to such data.

- **Data transmission and monitoring obligation.** Articles 14 and 15 of the Draft Swap Connect Measures require the electronic trading platforms and clearing institutions under the Swap Connect to record and transmit trade and clearing data in a timely, accurate and complete manner, and to jointly monitor trading and clearing activities. Specifically, offshore trading platforms and clearing institutions would be required to cooperate with onshore financial infrastructures to monitor the market; therefore, market monitoring would mainly be under the leadership of the onshore financial infrastructures, i.e., CFETS and SHCH.

While not specified under the Draft Swap Connect Measures, offshore trading platforms and clearing institutions will likely be under an obligation to report to CFETS and SHCH (as applicable) if they discover any suspected violations under the Northbound Swap Connect.

- **Currency exchange.** According to Article 16 of the Draft Swap Connect Measures, offshore investors may use RMB or foreign currencies to participate in trading and clearing under the Northbound Swap Connect. As the quotation, trading and settlement under the Northbound Swap Connect will be denominated in RMB, offshore investors would be allowed to convert their foreign currencies into RMB via their RMB account with an RMB business clearing bank or an overseas RMB business participant bank in Hong Kong (collectively the “**Hong Kong Clearing Bank**”). This is generally consistent with the currency exchange arrangement under the Northbound Bond Connect scheme, so that offshore investors under the Bond Connect scheme could utilize their existing banking services for transactions under the Swap Connect.

Article 16 of the Draft Swap Connect Measures further provides that, upon the maturity of transactions or where the offshore investors will no longer participate in Swap Connect transactions, the relevant foreign currencies used for transactions should, in principle, be converted back from RMB. However, there are no practical guidelines for determining when the conversion should be initiated nor any hard timeline for the completion of such conversion.

- **Risk management purpose.** Offshore investors may only participate in Northbound Swap

Connect transactions for risk management purposes, and the Hong Kong Clearing Banks are tasked with ensuring foreign exchange transactions by offshore investors are based on the actual and reasonable needs under the Northbound Swap Connect.

As part of CFETS' marketing monitoring obligations discussed above and considering its role as a trading platform under CIBM Direct, Bond Connect and Swap Connect, we believe CFETS may also be involved in the monitoring of bond holdings and relevant IRS positions of offshore investors to implement risk management purpose requirements.

- **Trading quota.** The Northbound Trading of Swap Connect will be subject to a trading quota which will be adjusted in due course based on market conditions.
- **Regulators' cooperation.** PBoC, SFC, HKMA and financial regulators in other jurisdictions will establish cooperation arrangements with each other to jointly protect the legitimate rights and interests of investors in cross-border investments and enhance anti-money laundering.

Outlook

When the Joint Announcement was made in July 2022, the Swap Connect was said to be launched in 6 months, in January 2023. The issuance of the Draft Swap Connect Measures offers a positive signal to the market that the Swap Connect is indeed forthcoming. We expect that the Draft Swap Connect Measures will be finalized soon, followed by the implementing rules of each relevant financial infrastructure. We will continue to keep a close eye on material developments and update you in a timely manner.

Important Announcement

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