

China starts mandatory clearing of OTC derivatives

Mandatory clearing of OTC Renminbi interest rate swaps ("RMB IRS") on the Shanghai Clearing House ("SCH") will start 1 July 2014. The launch of mandatory clearing of RMB IRS represents a significant step by China in the regulatory reform of the domestic OTC derivatives market. This briefing note provides a summary of this new clearing mandate.

In compliance with China's G20 OTC reform agenda, the People's Bank of China ("**PBOC**") on 28 January 2014, published a *Circular on Matters Relating to Establishment of Central Clearing Regime for OTC Financial Derivatives Products and Launch of Renminbi Interest Rate Swap Central Clearing Business* ("**PBOC Circular**"), requiring mandatory clearing of Renminbi OTC interest rate swaps between domestic financial institutions through the SCH from 1 July 2014 ("**Compliance Date**"). At the same time PBOC announced that SCH had been recognised as a qualifying central counterparty ("**QCCP**") for the purpose of complying with the new China Basel III capital requirements. Accordingly, banking financial institutions subject to the risk capital regulations issued by China Banking Regulatory Commission ("**CBRC**") are allowed to apply (and benefit from) the capital treatment relevant to a QCCP where they clear new derivatives on the SCH.

From 2 January 2014, RMB IRS were initially cleared through SCH on a voluntary basis. In order to provide this clearing service, SCH published on 31 December 2013 their *Rules on Renminbi Interest Rate Swap Central Clearing Business* ("**Business Rules**") and *Guidance on Renminbi Interest Rate Swap Central Clearing Business* ("**Business Guidance**", together with the Business Rules, collectively "**SCH Rules**"). The SCH Rules (which have been updated recently in line with the PBOC's clearing mandate) set out the details and scope of the mandatory clearing requirement on SCH. Below we explain briefly the mandatory clearing requirement established by the PBOC Circular and the SCH Rules.

I. What is PBOC's clearing requirement?

1. Scope of RMB IRS trades which must be cleared through SCH

Pursuant to the PBOC Circular many of the RMB IRS trades to be entered into on or after the Compliance Date between financial institutions in China will be subject to mandatory clearing. Only the following transactions will not fall within the mandatory clearing requirement:

- Transactions of a financial institution on a cross-border basis
- Transactions between a financial institution and their customer
- Transactions between two corporates

Even with these requirements, there are still some grey areas. For example, it is uncertain whether a financial institution will be subject to the PBOC's clearing mandate where (1) a "related party" of the financial institution (but not the financial institution in China) is designated as the ultimate contracting party to the RMB IRS trade even if the trader who executed the transaction on behalf of the related party was employed by the financial institution in China; or (2) the local office of the financial institution in China is not to be the party to the RMB IRS trade but has acted as an intermediary for the RMB IRS trade for an overseas branch or a subsidiary of the financial institution. We expect that as long as the transaction is not booked in the financial institution's own account in China, such transaction is likely to be treated as outside of the scope of the central clearing obligation.

Further details on the clearing obligation are set out below.

Type of product	Entity subject to the mandate
RMB IRS trades with a tenor of five years or less and with reference rate FR007, Shibo_ON or Shibor_3M	Financial institutions in China, being those institutions trading on the inter-bank market and which have signed the NAFMII Master Agreement. Subsidiaries of foreign banks in China and local branches of foreign banks are also included.

The clearing requirement does not currently apply to other OTC derivatives transactions. However, the scope of OTC derivatives transactions subject to the clearing requirement is expected to be expanded over time.

2. Exemptions and grace period?

There are no exemptions in the PBOC Circular on entities subject to the clearing mandate nor is a grace period granted for compliance with the mandate, although PBOC does not exclude the possibility of granting an exemption on a case-by-case basis. However, it is uncertain how the PBOC would carry out the review of such an application for the exemption.

The exemption will be an important issue for those entities which may be subject to central clearing requirements under more than one regulatory regime. For example, PRC branches of foreign banks may encounter now or in the future a situation where their transactions may be subject to a clearing obligation under a foreign regulation as well as under this Chinese regulation. There are no clear

PRC rules or guidelines that indicate how to deal with such overlapping regulations. The extent to which this regulatory overlap will become an insurmountable problem will depend on (1) whether a non PRC clearing house is authorised to provide clearing services as a foreign clearing house in China or (2) the applicable Chinese clearing house is registered, authorised or recognised to provide clearing services in the foreign jurisdiction (such as under the European clearing mandate introduced under the European Market Infrastructure Regulation (EMIR)).

II. What does SCH offer in relation to the clearing mandate?

The SCH was established in 2009, laying the foundation for the centralised clearing of OTC derivatives in China. As mentioned, SCH Rules were updated in June mainly to address the market needs for the purpose of complying with the clearing requirement. The key changes were:

Client clearing

The introduction of client clearing and rules in respect of client clearing will provide access to clearing to those institutions who do not have direct access to the SCH but are subject to the PBOC's clearing mandate.

The SCH was adopted an agency-like model, i.e. the SCH will have a direct relationship with the client and the relevant clearing member acts an agent and guarantor of the client. The SCH categorizes their clearing members into two groups:

- General Clearing Member ("**GCM**") means a clearing member permitted to clear its own trades with SCH as well as acting as agent for other market participants to clear with SCH. Currently only five Chinese banks are designated as a GCM by the SCH. However, the SCH's list of GCMs is expected to expand and foreign funded banks at a later time may be selected.
- Ordinary Clearing Member ("**OCM**") means a clearing member which can clear its own trades with SCH only. There are 35 financial institutions designated as OCMs, among which nine foreign funded banks are on the list. These are BEA China, Citibank China, Credit Suisse Shanghai branch, Deutsche Bank China, DBS China, HSBC China, OCBC China, SCB China and SocGen China.

Those who are neither an OCM nor a GCM but are subject to the PBOC's clearing mandate will need to sign up to a client clearing agreement with a GCM in order to gain access to the SCH. The client clearing agreement (although not publicly available) will be based on a standard form prepared by the SCH with limited room to negotiate changes by the parties. A signed copy will also need to be filed with the SCH.

Two-way margin

In the updated SCH Rules, the SCH agreed to provide market participants with two-way margin. In other words, the SCH will no longer only be holding mark-to-market collateral it receives from market participants who are out-of-money and also SCH will release mark-to-market collateral to market participants who are in-the-money. This is a change from the SCH's previous position as well as the general practice of clearing houses in China.

III. Further Issues

In addition to the problem local branches of foreign banks face with regard to the competing clearing mandates, a further issue that foreign banks in China (including subsidiaries of foreign banks in China) will have to consider is their regulatory capital exposures to SCH and whether SCH will be recognized as a QCCP in such bank's home jurisdiction.

In addition, market participants who are not subject to the PBOC's central clearing obligation as of 1 July 2014 should continue to pay attention to developments in this area. The mandatory obligations are expected to expand both the scope of the types of OTC derivatives transactions subject to the mandatory clearing obligation and/or the types of counterparties subject to the mandatory clearing obligation.

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