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C H A N C E

Client briefing
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CBRC further revises the banking derivatives rules

On 5 January 2011 the China Banking Regulatory Commission (CBRC) published the revised *Measures on the Administration of Derivatives Transactions by Banking Financial Institutions* (Revised Derivatives Measures), which became effective on the same day. The Revised Derivatives Measures is the latest prevailing version of the *Interim Measures on the Administration of Derivatives Transactions by Financial Institutions*, first issued in 2004 and later revised in 2007 (2007 Interim Measures). At that time, as some PRC banks and companies had already begun to suffer substantive losses from cross-border derivatives transactions, CBRC issued the *Circular on Further Strengthening Risk Management on Derivatives Transactions between Banking Financial Institutions and Institutional Clients* (Circular) in 2009 to enhance regulation by imposing risk management, product marketing and on-going services requirements. The Revised Derivatives Measures seek to further improve regulation by introducing a tiered licensing regime, integrating the Circular and the outgoing 2007 Interim Measures and reshaping the risk management mechanism to effectively address the market risk, credit risk, operational risk and legal and compliance risk that commonly arises from derivatives transactions.

Application of the Revised Derivatives Measures

The Revised Derivatives Measures are applicable to all types of financial institutions regulated by CBRC, including banks, trust companies, finance companies, financial leasing companies, auto finance companies with legal person status and foreign bank branches in China that used to be regulated under the 2007 Interim Measures. In addition, the Revised Derivatives Measures, for the first time, expressly regulate urban credit cooperatives, rural credit cooperatives and financial asset management companies. In reality, notwithstanding the wider scope, CBRC has so far only licensed banks to conduct derivatives transactions. According to public sources, while some trust companies have applied to conduct derivatives business, none has apparently been approved.

Like the 2007 Interim Measures, the Revised Derivatives Measures apply to derivatives transactions between financial institutions as well as those between banking financial institutions and their non-financial institutional clients. In the latter case, where a banking financial institution offers wealth management products with derivatives features to its clients, the Revised Derivatives Measures apply to regulate the design, trading and management of such products, while the relevant CBRC rules on wealth management business apply to regulate the eligibility requirements of clients and sale of products. The relevant CBRC rules on wealth management business for individuals apply to regulate the sale of products and risk assessment requirements where the client is an individual.

Key Issues

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Classification of Derivatives Transactions

The Revised Derivatives Measures have re-classified derivatives transactions into two categories, namely hedging types of derivatives transactions (Hedging Transactions) and non-hedging types of derivatives transactions (Non-hedging Transactions). Under the 2007 Interim Measures, derivatives transactions were classified instead on the basis of whether a transaction is initiated by a banking financial institution or entered into by the banking financial institution as an end user.

Hedging Transactions refer to derivatives transactions initiated by a banking financial institution for the purpose of mitigating the credit risk, market risk or liquidity risk associated with its own assets and liabilities. Hedging Transactions must, presumably, also comply with the relevant accounting rules on hedging, namely the *Accounting Standards for Enterprises No. 24 – Hedging* issued by the Ministry of Finance. Although the Revised Derivatives Measures do not expressly state as such, it is believed that only derivatives transactions that comply with those accounting standards could qualify as Hedging Transactions.

Non-hedging Transactions refer to all other derivatives transactions that are not Hedging Transactions. Broadly, they include the following three types:

(i) transactions initiated by clients and provided by a banking financial institution to satisfy the clients' demand, and any subsequent transactions conducted by the banking financial institution to hedge risks associated with those transactions which have been entered into with clients;

(ii) transactions a banking financial institution conducts, in its capacity as a market maker, with other market participants in accordance with its quotations (in order to fulfill its obligations as market maker on a continuing basis, the banking financial institution provides quotations of the two way (bid/ask) prices for buyers and sellers); and

(iii) proprietary transactions initiated by a banking financial institution for profit-making purposes, using its own funds.

In relation to the Revised Derivatives Measures, a banking financial institution must have personnel with accounting expertise in hedging transactions in order to obtain a derivatives licence to conduct derivatives business in China.

Tiered Licensing Regime

The new classification under the Revised Derivatives Measures now distinguishes between different types of derivatives transactions by virtue of their risk profile. Using the same approach, CBRC has also designed a tiered licensing regime under the Revised Derivatives Measures. A banking financial institution intending to conduct Hedging Transactions only must obtain a **Basic Qualification** from CBRC, while a banking financial institution intending to conduct both Hedging Transactions and Non-hedging Transactions must obtain a **General Qualification**. The position under the 2007 Interim Measures was different in that only a single licensing regime applied and a banking financial institution with a derivatives licence could conduct all types of derivatives transactions.

Compared to the requirements for obtaining a derivatives licence under the 2007 Interim Measures, there are fewer requirements now under the Revised Derivatives Measures for obtaining a Basic Qualification but increased requirements for obtaining a General Qualification. Specifically, the Revised Derivatives Measures no longer require a banking financial institution with only the Basic Qualification to have in place a transaction processing system, real-time risk management system and a specially qualified head of its derivatives department, although having an employee familiar with hedge accounting rules, a legal and compliance department and corresponding professional personnel are now necessary conditions for obtaining the Basic Qualification. However, a banking financial institution applying for a General Qualification must, in addition to satisfying all the eligibility requirements under the 2007 Interim Measure, also have a strict business isolation system to segregate market information, risk management and profit and loss determinations for Hedging Transactions and Non-hedging Transactions, as well as a sound risk management framework for managing market risk, operational risk and credit risk.

CBRC may also specify in the General Qualification derivatives licence the particular type of derivatives transactions a banking financial institution may conduct or the permitted derivatives products it may provide. CBRC has sole discretion to impose different treatments between institutions with a General Qualification, such as the type of Non-hedging Transactions an institution may trade. This regulatory power is expected to be used by CBRC to control the specific risks to which a banking financial institution is exposed in its derivatives business. The consequence of this is that applicants will now have less certainty about the derivatives business in which they will be allowed to engage.

The Revised Derivatives Measures do not specify the transitional arrangements for banking financial institutions that have already obtained a derivatives licence under the 2007 Interim Measures. One immediate concern is whether a banking financial institution that has already obtained a derivatives licence will be required to re-apply under the Revised Derivatives Measures in order to continue conducting derivatives transaction in China.

It should be noted that, under the Revised Derivatives Measures, banking financial institutions with a General Qualification will continue to be prohibited from trading in, or offering to clients products facilitating naked short selling that may result in unlimited losses (which is not defined in the Revised Derivatives Measures), or any derivatives which are linked to other derivatives products.

Innovation of Derivatives Transactions

The 2007 Interim Measures required all banking financial institutions to submit relevant documents to, and consult with, CBRC in writing before launching new, sophisticated derivatives products in China's domestic derivatives market. No further elaboration on what constituted "new and sophisticated" products or "domestic derivatives market" was previously provided. The Revised Derivatives Measures now provide a clearer indication in that all innovations, including the introduction of new derivatives products and exploration of new markets, must be the subject of consultation with CBRC by being submitted to CBRC in writing and in advance. This would necessarily increase the need for communication between banking financial institutions and CBRC. As part of the mandatory internal management rules, CBRC now also requires a banking financial institution conducting derivatives transactions to establish internal rules and processes for the internal approval of new business and new products. Final approval must be sought from one of the board of directors, a special committee or the senior management as may be authorized by the board of directors.

Market Risk Reserve Requirements

The Revised Derivatives Measures require a banking financial institution that engages in Non-hedging Transactions to provide for a market risk reserve in respect of their exposure to such derivatives transactions. The market risk reserve under the Standardized Approach[1] may not exceed 3% of the core capital of the banking financial institution. Within this limit, CBRC may further impose specific measures based on the operational risk of the banking financial institution. That is to say, if the operating conditions of a banking financial institution worsen such that they fall to a certain level (which CBRC may specify later on), CBRC may choose to lower the limit of the institution's core capital ratio in order to restrict its Non-hedging Transactions. From a regulatory point of view, such a restriction may help to mitigate systemic and operational risks (and may also provide an incentive for institutions to put in place effective risk management processes) as the size of derivatives transactions which a banking financial institution is permitted to conduct would be restrained by its capital.

The calculation of the market risk reserve must be conducted in accordance with the relevant provisions of the *Measures on the Administration of Capital Adequacy Ratio of Commercial Banks* and the *Guidelines on the Supervision of Internal Model Method of Market Risk Measurement by Commercial Banks*.

Looking Forward

China's derivatives market is far more underdeveloped than that found in many Western countries. Yet, it is clear that financial innovation, while allowed, may only be conducted on a stable and gradual basis as reflected by the provisions of the Revised Derivatives Measures. The different qualification requirements for the conduct of different types of derivatives transactions, to some extent, lower the market entry threshold while also limiting high-risk transactions. Banking financial institutions are also obliged to provide an annual assessment and to report to CBRC with respect to the

[1] The calculation methods for market risk reserve under the Standardized Approach are elaborated in Schedule 4 of the *Measures on the Administration of Capital Adequacy Ratio of Commercial Banks*.

derivatives business they have conducted in the preceding year. Considering that certain vanilla derivatives transactions are both transparent in operation and low in certain risks, CBRC has catered for flexible periodical assessment arrangements for risk management and counterparty services in respect of such products. It is therefore expected that China's derivatives market may expect to welcome more participants to join in the time to come.