NAFMII Upgraded Rules for Credit Derivatives

First introduced in 2010, China's credit derivatives market has remained nascent in the past few years. While western markets have focused on standardizing credit derivatives following the Global Financial Crisis, China sees greater demand in developing a well-functioned credit derivatives market to which increasing credit risks associated with financing transactions could be allocated. On 23 September 2016, the National Association of Financial Market Institutional Investors (NAFMII) amended and reissued the *Rules for the Pilot Programme of Credit Risk Mitigation Instruments in the Inter-bank Market* (Revised Rules), aiming to further develop China's credit derivatives market.

Legal framework

The Revised Rules provide the necessary framework for NAFMII to regulate China's credit derivatives market. On the same day when the Revised Rules were issued, NAFMII published the *Key Definitions and Application Rules for China OTC Credit Derivatives Market* (**Definitions**) and various guidelines for the following products (**Guidelines**):

- credit risk mitigation agreements (CRMA);
- credit risk mitigation warrants (CRMW);
- credit default swaps (CDS); and
- credit linked notes (CLN).

While CRMA and CRMW were already covered in NAFMII's rules when they were first issued in 2010, CDS and CLN are newly added under the Revised Rules. NAFMII has flexibility to introduce guidelines for other products under the current framework.

While CRMA and CRMW can only reference specific debts, CDS and CLN can reference specific entities.

While CRMA and CDS are categorized as contracts, CRMW and CLN as classified as financial instruments.

The Financial Derivatives Professional Committee under NAFMII (**NAFMII Derivatives Committee**) is responsible for overseeing China's credit derivatives market.

Eligibility requirements

The Revised Rules substantially reduce the requirements for an institution to participate in the credit derivatives market. An institution can become a credit derivatives participant (**Participant**) as long as it is a member of NAFMII and files its internal operational rules and risk management systems for credit derivatives with NAFMII. The Participants are divided into two categories: those which can trade with all other Participants (referred to as the **Core Participants**), and those which can only trade with the Core Participants (referred to as the **Normal Participants**). Financial institutions and credit enhancement institutions are classified as Core Participants upon filing with NAFMII, while unincorporated investment schemes and non-financial institutions are Normal Participants.

Offshore investors intending to participate in the onshore credit derivatives market will be subject to a separate set of rules to be issued by NAFMII in due course.

Issuer institutions

A Core Participant which can meet certain prescribed conditions may apply for recognition as an **Issuer Institution** by the NAFMII Derivatives Committee.

In order to issue CRMW and CLN, one must be an Issuer Institution.

A Core Participant must have the following in order to be qualified as an Issuer Institution:

(i) net assets of at least RMB4 billion;

(ii) competent professionals;

(iii) necessary business systems and IT systems;

(iv) sound internal operational rules and business management systems; and

(v) strong credit risk management and evaluation capability, extensive experience in credit risk management with at least five risk officers.

There is no qualification for trading CRMA, CRMW, CDS or CLN.

Trading restrictions

The Revised Rules and the Guidelines impose the following restrictions on trading credit derivatives:

- a Participant may not trade credit derivatives that reference its own debts or where the Participant itself is a reference entity. If a Participant trades in credit derivatives that reference its affiliates and/or their debts, it must properly disclose such affiliation to its counterparties and provide a quarterly report to NAFMII;
- the net sales amount of credit derivatives of a Core Participant may not exceed 500% of its net capital, while a Normal Participant may not exceed 100% of its net capital or product size;
- a Participant can only buy or sell CRMA/CRMW of a specific reference debt of up to 100% of the reference debt's outstanding amount (CRMAs are calculated on a net basis);
- the aggregate issuance amount of CRMW for a debt may not exceed 500% of such debt's aggregate outstanding amount; and
- for CDS, if the reference entity is a non-financial institution, the reference debts are restricted to NAFMII-registered fixed-income instruments.

Filing and reporting

CRMW and CLN products must be filed with NAFMII before issuance, and they are also subject to ongoing disclosure requirements. The Core Participants are required to file credit derivatives trading with NAFMII before noon on the next trading day (as discussed above, at least one party of a CRMA or CDS must be a Core Participant). Through these mechanisms, NAFMII performs a role of a trade repository for credit derivatives in China.

Outstanding issues

The Revised Rules, the Guidelines and the Definitions together form the larger framework in facilitating market participants to trade in credit derivatives and thereby enrich the financial engineering toolbox in China's inter-bank market.

However, we note that the Revised Rules have intentionally left the following issues unresolved, which are expected to be clarified at a later stage as the onshore credit derivatives market grows:

- how foreign institutional investors may participate in the onshore credit derivatives market;
- how credit derivatives can be submitted for central clearing; and
- when other types of debts can be covered under CDS.

The essential criterion for the long-term development of the credit derivatives market is pricing capability and having a market mechanism for price discovery. The proper functioning of this market component is the key in monetising credit risks and facilitating the pricing of direct financing. The Revised Rules also specify that the NAFMII Derivatives Committee will establish a quotation mechanism based on market demands.

The issue of the Revised Rules is an important step forward for the PRC credit derivatives market. We look forward to working with market participants in exploring further opportunities as the market and the legal framework develop.

Authors and China Contacts

[Yang Tiecheng](#)

Partner

T:86 10 6535 2265

Email:
tiecheng.yang@cliffordchance.com

Ge Yin

Counsel

T: 86 21 2320 7202

Email:
yin.ge@cliffordchance.com

Kimi Liu

Associate

T:86 10 6535 2263

Email:
kimi.liu@cliffordchance.com

Hong Kong Contacts

Francis Edwards

Partner

T: 852 2826 3453

Email:francis.edwards@cliffordchance.com

Terry Yang

Consultant

T: 852 2825 8863

Email: terry.yang@cliffordchance.com