The Cross-border Use of RMB Bonds as Collateral

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Introductory Remarks

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Good morning. Thank you very much to the City of London Corporation and China Central Depository & Clearing Co., Ltd. (CCDC) for organizing this important event and inviting me to deliver welcoming remarks. It's a privilege to address the London RMB Business Monitoring Group, and to speak alongside Madam Jin Mei from the People's Bank of China (PBOC) and Mr Xu Liangdui from CCDC. I'm delighted to be able to share some reflections at this very exciting juncture in the evolution of China's capital markets.

The global margin requirements for non-cleared derivatives have been a major focus for ISDA over the past five years. This was one of the main financial reforms that was put in place after the financial crisis to make the system safer and more resilient. ISDA has worked with members and regulators to implement the margin requirements since the first phase of counterparties came into scope in 2016.

We now have just three months to go until the deadline for phase-five entities to begin posting margin on September 1, and this will be followed by phase six in September 2022. We expect a large number of firms in Asia-Pacific, including many smaller entities, to come into scope of the rules during the course of these final two phases.

By this point, firms should be well advanced in their preparations and will already have been thinking about the collateral they intend to post. Given the rapid growth and liberalization of China's bond market in recent years, many firms are keen to explore the use of Chinese government bonds as initial margin. They need to properly understand the associated legal, regulatory and market structure issues before making a decision on this.

That is why the paper we published in collaboration with CCDC is so important and timely. Now available in English as well as Chinese, the paper provides a detailed analysis of the challenges that arise from the use of Chinese government bonds as collateral and sets out our medium and long-term recommendations. These include improving the collateral enforcement regime and enhancing the role of financial market infrastructures. I'm looking forward to hearing more about these issues and others during the course of today's event.

Now this event comes at an exciting time for China's financial markets. On April 29, the Standing Committee of the National People's Congress of China published a draft Futures Law for consultation. Among its provisions, the draft bill appears to explicitly recognize netting enforceability in over-the-counter derivatives. This is a seminal development, for which we at ISDA have advocated consistently for many years.

In my remarks today, I will explore recent developments in the liberalization of Chinese markets, the role of a robust derivatives market, and why the recent progress on netting is so encouraging.

Chinese market liberalization

The growth of China's financial markets has been one of the defining trends of recent years. As we have lived through a financial crisis, a wide-ranging regulatory reform program and a global pandemic, China's economic growth and the liberalization of its markets have created new opportunities for financial market participants around the world.

China's bond market is now second only to the US, while renminbi is the eighth most traded currency globally. As the world emerges gradually from the grip of the pandemic, China is clearly poised to resume its growth trajectory. The International Monetary Fund has projected that real gross domestic product growth will bounce from 2.3% to 8.4% this year.

Important steps have been taken over the past year to maintain the momentum of liberalization efforts and lower the barriers to international participation. In November, the PBOC, China Securities Regulatory Commission (CSRC) and State Administration of Foreign Exchange combined the flagship Qualified Foreign Institutional Investor and Renminbi Qualified Foreign Institutional Investor schemes and removed constraints on the size of positions international investors can take on Chinese markets. These new rules simplify and streamline the licensing process, allowing investors all over the world to actively participate in the growth of China's economy.

Overseas entities can now choose to use the ISDA Master Agreement for onshore renminbi derivatives transactions, following a joint circular issued in February 2020 by the PBOC and other agencies on accelerating the development of Shanghai as an international financial center. This means derivatives market participants can now enter into renminbi transactions with the contractual certainty provided by ISDA documentation. It also improves operational efficiencies, as internationally active firms can use the same document for all transactions without having to switch to a different document when trading with Chinese entities.

FX hedging rules have also been relaxed so that foreign investors can manage their currency risk when transacting in the bond market, while the PBOC and CSRC have taken joint steps to bring together the interbank bond market and the exchange-traded bond market. Collectively, these measures constitute strong progress in the ongoing liberalization of China's capital markets. This will boost international participation, which in turn leads to deeper liquidity.

Role of derivatives

I often have cause to reflect on the many benefits of safe and efficient derivatives markets, and this is particularly relevant in the context of China. As the Chinese market continues to open up and attract participants from all over the world, it is more important than ever that robust tools are available to enable institutions to effectively manage their risk.

The derivatives market adds fundamental value by allowing companies and individuals to transfer risks appropriately, which creates the certainty that is needed for economies to prosper. In almost every industry and every region of the world where trade takes place, we see derivatives being used to actively reduce and manage risk.

By allowing companies to hedge the risks they face, derivatives create greater certainty and stability, thereby supporting economic growth. A functioning derivatives market also allows banks to manage their risks. In turn, this means they can increase lending to the real economy, thereby supporting liquid capital markets.

Firms are willing to do business with a larger number of counterparties if they know they can hedge the risk of trading with those entities. In short, derivatives are a vital component of the global financial system, allowing risks to be managed and promoting liquidity and transparency.

Netting and collateral enforceability

As the derivatives market has become more complex and interconnected, it has become more important than ever to have a robust and predictable legal framework in place. This must include enforceable rules on close-out netting and related collateral arrangements.

By allowing parties to combine their obligations into a single payment, close-out netting mitigates the credit risk associated with the transaction and promotes financial stability. It also encourages more active participation by both foreign and domestic market participants, supporting liquid and efficient capital markets.

ISDA has worked with authorities all around the world to advance progress on netting enforceability. ISDA’s Model Netting Act has provided a template for legislation that can be applied to markets where netting is not yet recognized. So far, we have published netting opinions on more than 70 countries.

Major progress has been made in China, with a number of significant developments in the years leading up to the publication of the draft Futures Law on April 29. The draft bill expressly recognizes the enforceability of netting in OTC derivatives transactions during bankruptcy proceedings.

Market participants have noted the enormous significance of this legislation as a possible turning point in the development of China’s derivatives markets. In addition to the risk mitigation benefits, close-out netting is recognized as risk-reducing when it comes to setting regulatory capital requirements. Firms can also exchange collateral on a net basis under the margin requirements for non-cleared derivatives. This will reduce costs and create more favorable conditions for international participation. It should also mean firms have greater capacity to provide liquidity and extend credit to local economies.

Last week, ISDA and the Asia Securities Industry & Financial Markets Association submitted a joint response to the public consultation on the legislation, in which we welcomed the progress on netting and recommended additional provisions regarding enforceability of collateral arrangements in OTC derivatives transactions.

Conclusion

Given the growth of China's bond market, the imminent deadlines for the non-cleared margin rules and the recent progress on netting, this is an opportune moment to discuss the use of renminbi bonds as collateral.

Recent developments give me confidence that China's financial markets are headed in the direction of further growth, deeper liquidity and greater legal certainty. We look forward to continuing to work with market participants and policy-makers to address the challenges and tap the opportunities that lie ahead.

Thank you.