ISDA | Safe, Efficient Markets

China's Derivatives Market: Preparing for a New Era
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Opening Remarks
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Hello everyone, and welcome to ISDA's China derivatives conference. Thank you for joining us today, and special thanks to our distinguished keynote speaker, Li Lixia from the China Banking and Insurance Regulatory Commission (CBIRC).

This is a very important moment for China's derivatives market. The country's economy and capital markets have continued to grow rapidly in recent years. China recognizes the need to attract capital to continue this growth. A safe, robust and efficient derivatives market is critical to achieving this goal. By enabling risk mitigation, the derivatives market supports the efficient allocation of resources and encourages investment.

However, China's derivatives market remains relatively small compared to the size of its economy, with average daily turnover representing only around 1% of global turnover. Achieving further growth and development of the derivatives market requires solid legal foundations, a robust market structure and regulatory framework, and resilient risk governance and risk management.

There has been significant progress towards these goals over the past year. In 2021, the draft Futures and Derivatives Law was introduced for first and second reading. This legislation includes provisions on the enforceability of close-out netting, which would dramatically reduce credit risk, lower costs for Chinese firms and remove a major barrier to international participation in Chinese derivatives markets. This will pave the way to deeper liquidity and greater efficiency.

We commend the Chinese authorities for tabling this landmark legislation, and we look forward to working further with them towards the full recognition of netting. But regulators and market participants are also now considering what further steps are needed to promote a safe, robust and efficient derivatives market in China. In December, ISDA published a major whitepaper on this topic, setting out a series of possible policy measures and recommendations.

In my remarks today, I will outline the importance of close-out netting and the benefits it could bring for China's derivatives market. I'll then touch on the key findings and recommendations on next steps.

Netting

I'll start with netting.

ISDA has consistently advocated for the enforceability of close-out netting as the single most important step a country can take to improve the safety and efficiency of its derivatives market. By allowing parties to reduce their obligations to a single net payment due from one party to another, netting drastically decreases credit risk. This reduces the potential for market disruption in the event of a default, while also increasing liquidity and credit capacity.

Over the past 35 years, we have worked closely with authorities around the world to promote netting enforceability and have developed the Model Netting Act to provide a template for legislation. So far, we have published netting opinions for 75 jurisdictions, and six countries have enacted netting legislation since 2020.

Legal enforceability of close-out netting in China would represent a seminal milestone for all market participants. The lack of netting has historically put Chinese entities at a competitive disadvantage as they face higher transaction costs and have to post margin on a gross basis when transacting with foreign counterparties. For international players, it would remove a significant barrier to participation in Chinese markets.

The recognition of netting will unlock the true growth potential of China's derivatives market, just as it has done for other countries. We are grateful to the Chinese regulators for their willingness to engage constructively with all stakeholders on this critical issue. In the months ahead, ISDA will continue to work with authorities, market participants and other industry associations to clarify the draft provisions of the Futures and Derivatives Law and work towards full recognition of netting.

Next steps

While there is no doubt that netting will be a huge step forward, it is not the end of the journey. It is also important to identify what reforms and policy measures may come next, which is why we developed our recent whitepaper, based on more than 50 interviews with domestic and foreign market participants.

The recommendations for policy measures and actions are designed to support the further development of safe and efficient derivatives markets in China. They cover four key areas – risk governance, market structure, risk management and regulatory framework. I'll just briefly highlight some of those recommendations.

On risk governance, the paper proposes promoting the use of derivatives as a risk management tool and increasing the number of professionals with risk management expertise.

Our market structure recommendations include increasing the size and breadth of the market participant base and further improving supporting measures to promote the use of credit derivatives. We also propose that a more comprehensive portfolio of products should be introduced, including government bond futures, which are considered the most effective way of hedging renminbi-related interest rate risk. Permitting greater use of bond futures among banks, insurance companies and foreign investors would increase the resilience of the market.

On risk management, we propose improving credit mitigation through collateral management and strengthening the risk management framework of central counterparties.

The paper also highlights the importance of strong communication of regulatory requirements to market participants. This would include an open consultation process as part of the development of regulations – just as authorities have done with the draft Futures and

Derivatives Law – as well as providing sufficient time for firms to make operational changes that may be needed to comply with new rules.

We have engaged closely with policy-makers and market participants on these proposals and will continue to do so in the months ahead. Today's event is a great opportunity to discuss the provisions of the Futures and Derivatives Law, as well as the next steps for the Chinese derivatives market.

Now I'm delighted to introduce our keynote speaker, Li Lixia, deputy research director in the law and regulation department at the CBIRC. Ms Li is a member of the China-UK Netting Working Group and has worked closely on netting enforceability.

Ms Li, we're honored to have you with us today. The floor is yours.