

Shanghai Launches OTC Derivatives Clearing

Introduction

On 2 January 2014, after much anticipation, Shanghai Clearing House (“**Shanghai Clearing**”) launched the central clearing of RMB interest rate swaps.

As of January 2014, up to 21 financial institutions (including HSBC Bank (China) Company Limited, The Bank of East Asia (China) Limited, and major domestic banks such as Industrial and Commercial Bank of China, Bank of China *etc.*) have signed up as clearing members of Shanghai Clearing. On the first day of launch, a total of 59 RMB interest rate swaps with an aggregate notional amount of over RMB 5 billion were submitted to Shanghai Clearing for central clearing.

Notwithstanding the legal issues discussed below, the central clearing of RMB interest rate swaps, which was launched with the approval of the People’s Bank of China (“**PBOC**”), helps China meet its G20 commitments and represents a significant step in the development of the Chinese derivatives market. At present, only inter-dealer trades are centrally cleared at Shanghai Clearing, and it is expected that client clearing of RMB interest rate swaps will be implemented later this year.

Key Features

Shanghai Clearing’s RMB interest rate swap clearing service has the following key features:

- > **Membership:** only members of Shanghai Clearing can participate in the central clearing of RMB interest rate swaps. Members must sign a central clearing agreement and fill in the requisite registration forms.
- > **Clearable Products:** only interest rate swaps meeting certain standardized specifications are clearable. The transactions must be fixed rate against floating rate, and the reference floating rate has to be one of the following: the overnight Shanghai Interbank Borrowing rate, the 3-month Shanghai Interbank Borrowing rate, or the interbank 7-day repurchase rate.
- > **Novation:** contracting parties to an RMB interest rate swap transaction should have already entered into a NAFMII Master Agreement. Once

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the trade is submitted to Shanghai Clearing for central clearing, a party's rights and obligations towards its counterparty are passed on to Shanghai Clearing by novation, and Shanghai Clearing becomes the central counterparty to the original contracting parties.

- > **Position Limits:** the volume of trades submitted by a particular clearing member to central clearing is limited by the position limits assigned to that member by Shanghai Clearing. Position limits are member-specific, and are determined and adjusted by Shanghai Clearing. A clearing member's position limits also determine its guarantee fund contribution and the initial margin payable.
- > **Margin:** a clearing member has to post initial margin, mark-to-market margin, and over-limit margin. Currently, margin has to be paid in cash. Margin provision is "one-way" only, *i.e.*, Shanghai Clearing will not post margin to a clearing member whose position is in-the-money.
- > **Default Management Resources other than Margin:**
 - **Guarantee fund:** at the time each member joins RMB interest rate swaps central clearing, it must contribute to the guarantee fund. The guarantee fund contribution amount is member-specific, and is determined by Shanghai Clearing on the basis of the position limit assigned to that clearing member.
 - **Reserve fund:** Shanghai Clearing will set aside part of its business income generated from RMB interest rate swaps central clearing service as a reserve fund.
 - **State support?** The clearing rules do not refer to any guarantee from the government. Market participants have queried whether any guarantee or other financial support either from the state or PBOC, would be put in place if such need arises in an emergency.
- > **Default Waterfall:** Clearing participants need to contribute to the guarantee fund, which may be used upon the default of any clearing member. Shanghai Clearing applies funds to meet a default loss in the following order: (1) margin provided by the defaulting member, (2) guarantee fund contributions from the defaulting member, (3) guarantee fund contributions from non-defaulting members, and the reserve fund.

Shanghai Clearing as a Qualifying Central Clearing Counterparty (“CCP”) and Regulatory Capital Treatment

China Banking Regulatory Commission published a set of rules in July 2013 relating to the regulatory capital treatment of banks’ exposure to CCPs (“**CCP Rules**”). The CCP Rules do not specifically refer to Shanghai Clearing, but it is expected that the PBOC will make a public announcement to recognise Shanghai Clearing as a qualifying CCP for the purposes of the CCP Rules. If Shanghai Clearing is so recognised, a clearing member may apply a risk weighting of 2% to its exposure to Shanghai Clearing pursuant to the CCP Rules. This is more favourable than the risk weighting that applies to bilateral settlement or trades cleared with non-qualifying CCPs.

Key Legal Issues

Central clearing of RMB interest rate swaps operates within the limitations imposed by Chinese law.

- > **Legal recognition of finality.** The orderly operation of central clearing and effective implementation of risk management require payment settlement, novation and conclusion of contracts, provision and disposal of margins, and actions taken in the default management process to be final and irrevocable. The clearing rules and clearing agreement for RMB interest rate swaps provide that settlement for centrally cleared RMB interest rate swaps is irrevocable upon completion.

The PRC Bankruptcy Law (the “**Bankruptcy Law**”) allows a bankruptcy administrator to avoid payments and transactions made by a debtor within a statutory suspect period. In relation to securities transactions, the PRC Securities Law specifically provides for settlement finality. However, there is no provision for settlement finality in relation to transactions with a CCP. As the Bankruptcy Law prevails over the clearing rules, if a clearing member becomes insolvent, its bankruptcy administrator can recover settlement funds paid by that clearing member to Shanghai Clearing, or revoke the application by Shanghai Clearing of that member’s guarantee fund contributions.

In order to provide clear and effective legal support to the finality of central clearing of RMB interest rate swaps (and potentially other OTC derivatives in the future), China needs to promulgate appropriate finality legislation.

- > **Will close-out netting be enforceable?** The clearing rules provide that if a clearing member defaults, Shanghai Clearing has a right to mandatorily close out all outstanding positions with the defaulting member, and to settle on a net basis. In the absence of finality legislation, close-out netting serves an even more important function to reduce the risk exposure of Shanghai Clearing.

For a long time, the general view has been that close-out netting is not enforceable under Chinese law in the context of bankruptcy proceedings. With the recent judicial interpretation of the Bankruptcy

Law issued by the Supreme People's Court (please refer to our [bulletin](#) issued in October 2013), the uncertainty regarding the right to net no longer exists.

The right to close-out, however, remains hampered by article 18 of the Bankruptcy Law, which gives the bankruptcy administrator a moratorium power for up to two months following acceptance of a bankruptcy petition by the People's Court to decide whether to affirm or disclaim any executory contract. If the interest rate swaps of an insolvent clearing member are not terminated by the time the People's Court accepts the bankruptcy petition, the right of Shanghai Clearing to close out the positions of such insolvent clearing member pursuant to the clearing agreement and clearing rules will be subject to the moratorium power of that member's bankruptcy administrator.

Uncertainty of the right to close-out in bankruptcy proceedings is not a new issue peculiar to the launch of central clearing for RMB interest rate swaps. The Bankruptcy Law allows the State Council to issue regulations governing the bankruptcy of financial institutions. As most clearing members of Shanghai Clearing are expected to be financial institutions, it would be ideal for such State Council regulations to give clear and express recognition to the right to close-out in respect of OTC derivative transactions.

- > **Shanghai Clearing's rights in respect of collateral.** The ability of a clearing house to promptly use the collateral posted by its clearing members is of paramount importance to the smooth operation and effective risk control of central clearing of OTC derivatives. Normally, a clearing house takes a security interest in the collateral so that its claim in respect of the collateral can benefit from a legally recognized priority; alternatively, the title to the collateral is transferred from the clearing member to the clearing house outright.

This does not seem to be the case for RMB interest rate swaps central clearing by Shanghai Clearing. Pursuant to clearing rules, a clearing member is required to transfer cash into a margin account opened by Shanghai Clearing with a commercial bank, and margins collected from all the clearing members are all deposited into the same margin account. Neither the clearing member nor Shanghai Clearing creates any security interest over cash in such margin account in a way that would be recognized by the PRC Property Law or the PRC Security Law. It is interesting to note that the title to the cash margin does not pass to Shanghai Clearing either.

Being neither a security interest nor a title transfer arrangement, the collateral arrangement for RMB interest rate swaps central clearing appears akin to the "futures transaction deposit fund" (期货交易保证金). The "futures transaction deposit fund" is recognized by the Supreme People's Court and the State Council to be remote from the bankruptcy risk of the futures exchange members. We hope that there

will also be judicial recognition of the bankruptcy remoteness of the collateral mechanism for central clearing in due course.

- > **Will a clearing member be exposed to unlimited liability?** Given the uncertainties relating to close-out netting, margin and finality, clearing members may be concerned about whether Shanghai Clearing would frequently call for replenishment payment be made to cover any shortfall in the guarantee fund, or would increase the guarantee fund contribution amount and expose clearing members to unlimited liability.

Shanghai Clearing noted concerns raised during the consultation process. The published clearing guidelines provide for limitations to the liability of the clearing members.

- Within any 90-day period, the maximum amount of replenishment to the guarantee fund payable by a clearing member will not exceed the guarantee fund contribution amount ascribed to such member.
- If a clearing member wishes to resign its membership, starting from the 10th business day after receiving the resignation application, Shanghai Clearing will not increase the guarantee fund contribution amount for such member.

Client Clearing

The launch of central clearing of RMB interest rate swaps by Shanghai Clearing is an important first step, and we believe that there will be further developments in this area in the months to come.

Many Chinese companies have been entering into RMB interest rate swaps for hedging purposes. We understand that, due to the membership criteria for central clearing, not all companies can directly participate in central clearing as a clearing member. Those companies who are not direct participants and would like to use the central clearing service would need to do so through client clearing.

Shanghai Clearing is still in the course of developing its client clearing infrastructure. Some important questions to be addressed include whether client clearing will be based on an agency model or a principal model, how margin and collateral arrangements can be structured to achieve legal segregation under Chinese law, and how to achieve portability of client positions and margins in the case of a clearing member default.

Mandatory Clearing

The G20 derivatives reform commitments require standardized OTC derivatives to be centrally cleared. We expect PBOC to announce the commencement of mandatory clearing of RMB interest rate swaps later this year. It remains to be seen what specifications (*i.e.*, reference rate, tenor *etc.*) of transactions would become subject to mandatory clearing.

Offshore entities who are approved by the PBOC to invest in the interbank bond market may well need to enter into RMB interest rate swaps. If no exemption is available, those offshore entities may have to clear their trades, either as clearing members or through client clearing, with Shanghai Clearing.

Central Clearing of Other OTC Derivatives

Starting from April 2013, interbank RMB/FX spot transactions have been centrally cleared by Shanghai Clearing. After RMB interest rate swaps became the first OTC derivatives product subject to central clearing in China, it is widely expected that other derivatives transactions will follow suit. In the interbank market, RMB/FX forwards and RMB/FX swaps are two of the most popular derivative transactions by trading volume. Accordingly it is very likely that they will be the next OTC derivatives products in the Chinese market to be subject to central clearing.

Looking Ahead

The launch of central clearing of RMB interest rate swaps opens up a whole new chapter in OTC derivatives reforms in China. In January 2014, the PBOC and China Securities Regulatory Commission called for financial market infrastructure in China (including Shanghai Clearing) to evaluate their compliance with the CPSS-IOSCO Principles for Financial Market Infrastructures, which will be followed by a regulatory audit by the end of March 2014. This shows China's determination to develop world class financial market infrastructure and could spur further developments in the legal framework governing OTC derivatives clearing in China.

** Linklaters is proud to have worked with a group of 22 banks and Shanghai Clearing in preparation for the launch of central clearing of RMB interest rate swaps, and have made presentations on behalf of the industry at meetings with PBOC and other Chinese regulators in this process. Our close involvement in OTC derivatives clearing in the region means we are uniquely positioned to assist market participants to navigate this new world of derivatives clearing.*

Linklaters

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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