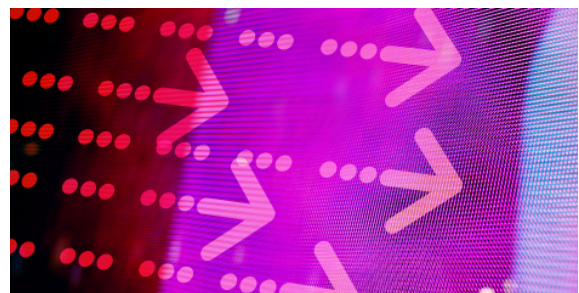


## Swap Connect - Taking Collateral over CGBs

January 2025



### Introduction

On 16 December 2024, the HKEX **announced** that Chinese Government Bonds and Policy Financial Bonds (“**CGBs**”) held through Bond Connect will be accepted by OTC Clearing Hong Kong Limited<sup>1</sup> (“**OTCC**”) as collateral for Northbound Swap Connect transactions effective from 13 January 2025.

This milestone marks the inaugural use of CGBs as offshore collateral, signifying a pivotal moment in the evolution of CGBs as a tool for treasury management and collateral liquidity in the international markets. Amidst the worldwide shortage of high-quality government securities, deploying the vast CGBs resources as offshore collateral has the potential to revolutionise our international financial markets.

### Scope

The eligible Bond Connect securities consist of bonds in the China Interbank Bond Markets (the “**CIBM**”) issued by the Ministry of Finance or various policy banks in the People’s Republic of China (the “**PRC**”), which are held within Bond Connect by international investors.

OTCC will accept such CGBs as collateral for Northbound Swap Connect trades, being the Renminbi interest rate swaps that are cleared through the Swap Connect link between OTCC and Shanghai Clearing House, which improves capital efficiency and reduces liquidity costs for Swap Connect investors.

### Resolving key policy issues for CGBs

Traditionally, Bond Connect securities are subject to non-trade transfer and other restrictions under PRC law and single-custodian requirements imposed by the Central Moneymarkets Unit (the “**CMU**”) in Hong Kong. These limitations have rendered using Bond Connect securities less practical for scalable collateral uses.

#### “Single custodian” requirement

Currently, offshore investors must hold CGBs via members of the CMU. The CMU only permits an offshore investor to appoint a single CMU member as its custodian, and a CMU member may only open one segregated sub-account for each eligible Bond Connect investor in the CMU. These restrictions have made providing Bond Connect securities as collateral difficult and impractical. For example, a Bond Connect investor who is a CMU member

### Contents

Scope	1
Resolving key policy issues for CGBs	1
CGBs collateral for house trades	2
CGBs collateral for client trades	3
Legal opinions	4
The Way Forward	4
About Linklaters Zhao Sheng	5
Key contacts	6

<sup>1</sup> OTC Clearing Hong Kong Limited is a central counterparty established as a subsidiary by HKEX for the purposes of providing clearing and settlement services for OTC derivative transactions.

will have all its bonds in only one account at the CMU and will not be able to segregate bonds which it would like to provide as collateral from those which are not to be subject to collateral arrangement. In any event, a security taker will unlikely be comfortable with taking collateral over Bond Connect securities owned by and custodied with the same collateral provider.

Going forward, the “single custodian” requirement will be relaxed for OTCC to act as an “additional” custodian for the CGBs provided to it as collateral. The Bond Connect investor may also keep its “original” CMU member as custodian for Bond Connect securities that are not provided as collateral to OTCC.

### “Non-trade transfer” restriction

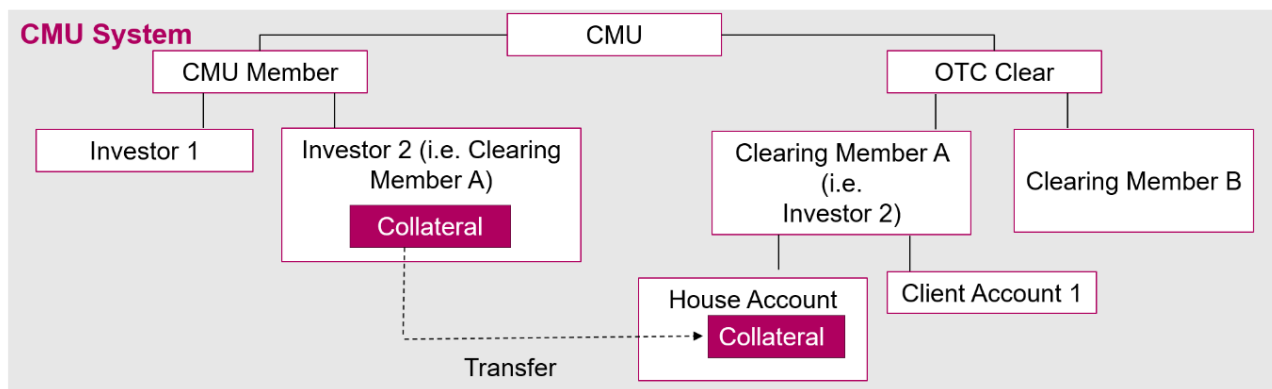
Under the PRC regulations, PRC bonds (including CGBs held via Bond Connect) can only be transferred through trades, subject to certain exceptions (for example, inheritance and court execution). Margin collateral has not currently been included as one of the permitted exceptions for non-trade transfers. This means that any collateral arrangement will have to be carefully structured as not involving transfer. A title transfer collateral arrangement therefore will not be permitted while certain types of security interest arrangement such as charge may be acceptable (if properly drafted) but not a mortgage (which may involve transfer of legal title).

However, for collateral posted to OTCC for Swap Connect purposes transfer by way of security interest or outright transfer will now be permitted.

With the PBOC expressly authorising the use of CGBs as collateral for Swap Connect, any other potential concerns that a collateral taker may have in relation to enforcements (from getting access to the CIBM to sell the collateral bonds to onshore market makers and remitting the enforcement proceeds to offshore) have all been allayed.

## CGBs collateral for house trades

### Structure and documentation

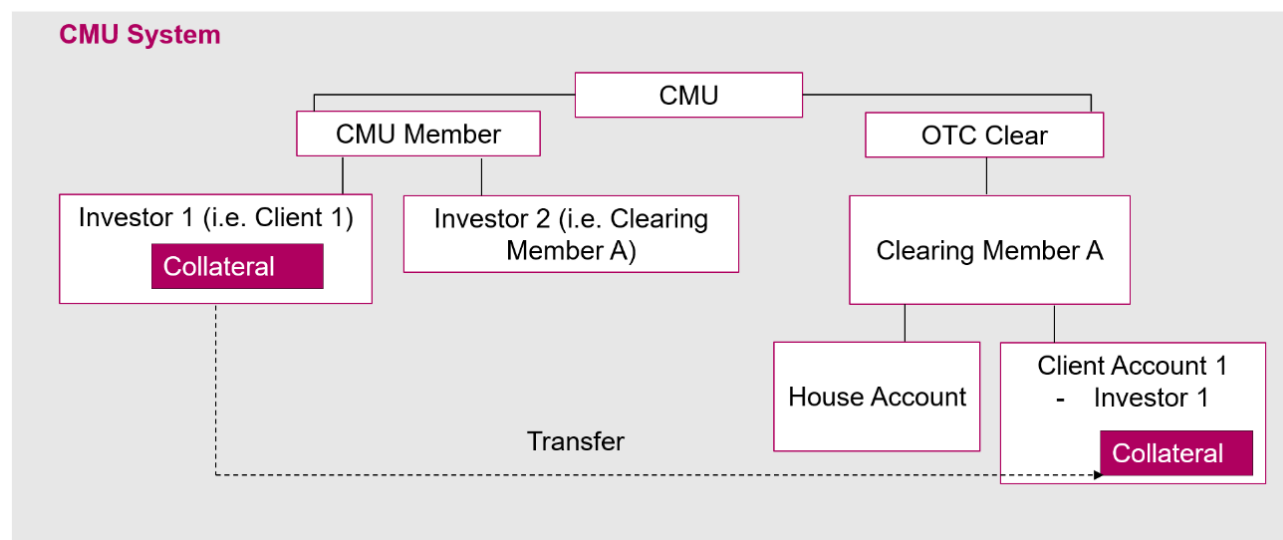


Non-cash collateral for house trades are taken on a security interest basis under a “house” deed of charge in favour of OTCC and held by OTCC. CGBs as collateral for house trades will be taken in a similar manner, which is made possible by the relaxation of the “single custodian” and “non-trade transfer” restrictions.

As non-cash collateral (including CGBs) for house trades is taken over securities held in an account with CMU in Hong Kong, the governing law of the deed of charge will be Hong Kong law, notwithstanding that the CGBs are ultimately housed at securities depository onshore the PRC. To this end, it is helpful to note that as Hong Kong is the place where the security interest is created under the deed of charge, PRC conflicts of law will recognise the security interest created under the Hong Kong law deed of charge.

## CGBs collateral for client trades

### Structure and documentation



For posting non-cash collateral for client trades, there is first a title transfer (i.e. an outright transfer) of the collateral from the client to the clearing member under the client clearing agreement, followed by creation of security interest over such collateral by the clearing member in favour of OTCC pursuant to a “client” deed of charge.

For CGBs as collateral, operationally the CGBs will be transferred within the CMU system directly from the client to OTCC. Legally, there will be a deemed title transfer from the client to the clearing member, and a deemed security interest created by the clearing member over such CGBs in favour of OTCC pursuant to the client deed of charge, upon the operational transfer of CGBs from the client to OTCC, so the overall legal architecture remains unchanged.

#### “Title-transfer” collateral arrangement for CGBs

The regulators’ permission to transfer CGBs held via Bond Connect by way of outright transfer is ground-breaking as it has never been done before, even onshore the PRC in the CIBM. Once this is used and tested for Swap Connect collateral purposes, it may be replicated for wider uses and pave the way for using CGBs more widely in the international treasury and collateral management markets, which operate predominantly on a title transfer basis. In addition, it will also be extremely interesting to see how this development will influence the onshore PRC market where collateral arrangement over securities (such as CGBs) could only be carried out as a pledge at the securities depositories.

Again, such arrangement is made possible following the relaxation of the “single custodian” and “non-trade transfer” restrictions for Swap Connect collateral purposes.

### **Key amendments to client clearing agreements**

Certain updates to the client clearing agreements may be required for a clearing member to take CGBs for Swap Connect collateral purposes from its clients:

- Pursuant to the OTCC rules, a clearing member is obliged to enter into client clearing agreement with the client that contain certain prescribed provisions. Clearing members should include updates to such provisions in the client clearing agreements as necessary.
- Clearing members should check whether non-cash collateral is already permitted as a security-taking option in the client clearing agreement or make any necessary changes.
- ISDA and FIA have published the Swap Connect appendix to the ISDA/FIA addendum in 2024 to facilitate Swap Connect trades, with an expanded definition of “Additional Collateral Amount” to allow a clearing member to obtain Participating Margin contribution from clients. It is important to note that CGBs are accepted only for Swap Connect trades. Updates to the agreement (including the Swap Connect appendix) may be required to ensure that CGBs posted are accounted for exclusively for Swap Connect trades.

### **Legal opinions**

Clearing members and clients may require Hong Kong and PRC legal opinions confirming, among others, bankruptcy remoteness of CGBs as collateral, enforceability of netting and other arrangements, and recognition under PRC law of the collateral arrangements, in order to obtain favourable regulatory capital treatment or for internal approval purposes.

### **The Way Forward**

This transformative use of CGBs as offshore collateral is undoubtedly a defining chapter in the development and internationalisation of CGBs, with wider ramifications beyond the Connect programmes.

For Swap Connect, using CGBs as collateral is expected to achieve cost savings on initial margin and may expand further to the potential use of CGBs for participating margin. CGBs as collateral offers the opportunity for Bond Connect investors to leverage and utilise CGBs which were previously locked up until maturity or sale.

Importantly, this development could pave the way for a further relaxation of the single custodian and title transfer collateral restrictions to outside the Connect programmes, which has the potential to revolutionise treasury management and collateral liquidity in the PRC and beyond. This is most timely as market participants are working with ISDA and China Central Depository & Clearing Co., Ltd. to explore ways to take CGBs as collateral (or regulatory margin) for OTC derivatives conducted in the international market.

This enhancement to Swap Connect, together with these wider developments, heralds the emergence of CGBs as a key driver in the international treasury management and collateral markets, and further revolutionise the internationalisation of Renminbi and assets denominated in Renminbi.

## About Linklaters Zhao Sheng

Linklaters Zhao Sheng have advised the Hong Kong Exchanges and Clearing Limited (HKEX) on the establishment of the China Connect Schemes, including Stock Connect and Bond Connect and Swap Connect, as well as the setting up of OTCC. With dedicated teams in our Hong Kong SAR and Shanghai offices, we regularly advise financial institutions and the buy-side on the full spectrum of issues relating to China Connect Schemes. Recently, we are pleased to have advised HKEX on the establishment of Swap Connect as well as the use of CGBs held through Bond Connect as collateral for Northbound Swap Connect transactions. We would be happy to discuss any questions you may have on the implications of using CGBs held via Bond Connect for Swap Connect collateral purposes. You may also access our previous client materials on Mainland China-Hong Kong access schemes [here](#).

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