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Hong Kong and China Deepen Financial Cooperation:
Bond Connect Securities Available for Certain Repos and Collateral

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Introduction

On 13 January 2025, the Hong Kong Monetary Authority (HKMA) and the People's Bank of China (PBOC) announced new policy measures to deepen the financial market connectivity between Hong Kong and Mainland China[1]. In particular, the new arrangement for offshore RMB repo transactions[2] and proposed measures to use of Northbound Bond Connect bonds as eligible margin collateral for OTC derivatives cleared at OTC Clearing Hong Kong Limited (OTCC) (not just Swap Connect derivatives) are both much anticipated and welcomed by the market.

Other measures announced by the HKMA and PBOC include: (1) a new HKMA RMB Trade Financing Liquidity Facility to support banks in providing RMB trade finance services to corporate customers; (2) enhancements to the settlement time, settlement currencies and scope of eligible Mainland investors; (3) linking faster payment systems in Mainland China and Hong Kong; and (4) the inclusion of new participating banks by the PBOC to offer account-opening by attestation services for Hong Kong residents.

These measures build upon existing infrastructures of cross-boundary investment channels such as Bond Connect and Swap Connect, and will help to both increase offshore RMB liquidity and enhance Hong Kong's position as the global offshore RMB financial centre.

Offshore RMB Repo Transactions under Northbound Bond Connect

Under the new arrangement, Northbound Bond Connect participants can use eligible onshore bonds to conduct RMB repo business in Hong Kong offshore. Although the HKMA press release refers to using Northbound Bond Connect bonds as collateral for offshore RMB repo business, based on the description of the arrangement, it would appear that HKMA is referring to the use of Northbound Bond Connect bonds as the purchased securities under the repo transaction and not only as margin securities. This means that Northbound Bond Connect participants can sell eligible onshore bonds to designated market makers in return for an agreed purchase price in offshore RMB on day one, and repurchase such onshore bonds on the transaction maturity date at the agreed repurchase price in offshore RMB. In this way, Northbound Bond Connect participants can use their Northbound Bond Connect securities holdings to obtain financing from the relevant market makers.

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1. Hong Kong Monetary Authority - New Measures to Deepen Financial Cooperation between Hong Kong and the Mainland
2. Hong Kong Monetary Authority - Arrangement for Offshore RMB Bond Repurchase Business Using Bonds Held under Northbound Bond Connect as Collateral announced by HKMA

While no exact date has been announced, the arrangement is expected to commence soon. Further detailed rules are expected to be published in due course. In the meantime, the following details have been provided:

1. Who Can Enter into Such Repo Transactions?

The eligible participants in the offshore repo arrangement are all Northbound Bond Connect investors[3], including Central Moneymarkets Unit (CMU) members and offshore investors with CMU sub-accounts opened through Hong Kong custodian banks that are CMU members.

Each repo transaction must also involve at least one market maker as a counterparty. In the initial phase, the market makers are the 11 Primary Liquidity Providers designated by the HKMA, namely: 1) Agricultural Bank of China Limited, 2) Bank of China (Hong Kong) Limited, 3) Bank of Communications Co., Ltd., 4) BNP Paribas, 5) China CITIC Bank International Limited, 6) China Construction Bank (Asia) Corporation Limited, 7) Citibank, N.A., 8) Hang Seng Bank Limited, 9) The Hongkong and Shanghai Banking Corporation Limited, 10) Industrial and Commercial Bank of China (Asia) Limited, and 11) Standard Chartered Bank (Hong Kong) Limited.

2. What Types of Bonds are Eligible?

Any onshore bonds traded on the China Inter-bank Bond Market (CIBM) and held by participating institutions under Northbound Bond Connect, regardless of bond type, would be eligible bonds for the repo transactions.

3. How will the Repo Transactions be Documented?

Participants may choose their own form of repo agreement, including the Global Master Repurchase Agreement (GMRA) and National Association of Financial Market Institutional Investors (NAFMII)'s Bond Repurchase Master Agreement. For participants that choose to use GMRA documentation to cover offshore RMB repo transactions, they may wish to consider obtaining bringdown opinions to confirm the industry GMRA enforceability opinions can apply to the new repo arrangement.

4. How will the Repo Transactions be Executed?

The repo transactions may be conducted:

(1) bilaterally over-the-counter (OTC);

(2) in the same manner as existing Northbound Bond Connect transactions, namely via the trading link between offshore access platforms like Tradeweb, Bloomberg and MarketAxess) and China Foreign Exchange Trade System (CFETS) onshore and settled via the Central Securities Depositories (CSDs) linkage between CMU in the offshore market and China Central Depository & Clearing Co., Ltd. (CCDC) and Shanghai Clearing House (SHCH) in the onshore market;

(3) through offshore electronic trading platforms (which may include the existing offshore access platforms for Northbound Bond Connect); and

(4) through the onshore electronic trading platform.

3. The eligible investors for Northbound Bond Connect are those that meet the requirements in the PBOC's Public Notice No. 2 [2016]: Public Notice No. 3 [2016]

5. How will the Repo Transactions be Settled?

Settlement of the initial securities purchase and the subsequent repurchase under the repo transactions are expected be completed under the repo service offered by CMU. While the operational details for bond transfer and settlement will be announced by CMU at a later date, HKMA has indicated that bond ownership will be transferred to the repo buyer during the repo period, but the repo buyer will not be permitted to re-use the bonds during the repo period, as the bonds will be locked up and managed by the CMU platform during such time. This means that the offshore repo arrangements is likely to follow the more commonly seen title transfer arrangements used in the international markets, instead of the pledge repo arrangements commonly used in the Mainland Chinese repo market, but with additional repo services provided by CMU to manage the lock-up of the relevant securities.

Notably, the HKMA press release stated that leverage limits will be introduced during the initial phase. It remains to be seen if the "Margin Ratio" as defined in the GMRA will have to follow prescribed leverage limits for different types of eligible bonds according to the rules of the new repo arrangement, and whether margining requirements following a breach of such leverage limits can follow standard GMRA provisions. We also await further details on how liquidation of the relevant securities will be handled following default by either buyer or seller, whether substitution of securities will be permitted, and if yes, how such substitution will be handled by CMU and the CMU custodians under the repo service provided by CMU.

In the future, the HKMA will review the operation and experience of the offshore repo arrangement and make further adjustments as needed.

6. What Transaction Reporting is Required?

Market makers are required to report transaction data such as: names of the trading institutions (including both the repo party and the reverse repo party), total amount of funds borrowed by the repo party, bond name, bond code, repo term, total face value, repo rate and transaction date. Such data will need to be reported to the HKMA on the same day of the transaction for market monitoring purposes. The HKMA are further communicating with the market makers to finalise the reporting requirements and submission channels.

After the launch of the offshore RMB repo business, the HKMA will continue to closely monitor market conditions to ensure orderly market operations. The HKMA will also maintain communication with the industry and review and adjust the arrangement as appropriate to support the robust and sustainable development of offshore RMB business.

Northbound Bond Connect Bonds as Margin Collateral for OTCC-Cleared Derivatives

The use of Chinese government bonds held through Northbound Bond Connect as eligible margin collateral for Swap Connect derivatives was officially implemented on 13 January 2025. The new measures proposed by HKMA and PBOC extends such margin collateral arrangement to other Northbound Bond Connect securities as collateral for Swap Connect as well as non-Swap Connect derivatives that are cleared at OTCC.

The arrangements as to the posting and holding of such collateral under this extension will likely follow the existing arrangements for Swap Connect. Namely, Northbound Bond Connect securities held by an OTCC member will be transferred from such member's usual CMU custodian to OTCC as an additional custodian for such collateral purposes at CMU, and then made subject to a security interest in favour of OTCC; whereas Northbound Bond Connect securities held by a client of an OTCC member will be transferred from such client to OTCC, with such transfer being legally treated as first an outright transfer of the relevant securities from such client to the relevant OTCC member, followed by the creation of a security interest by such OTCC member over the relevant securities in favour of OTCC.

Other Proposed Measures

Introduction of the HKMA RMB Trade Financing Liquidity Facility

The new facility offered by the HKMA will have a total size of RMB 100 billion. HKMA will offer 1-month, 3-month and 6-month RMB funds, with interest rates referencing onshore interest rates plus a spread. The new facility will operate through repo transactions similar to the existing RMB Liquidity Facility of the HKMA as well as provide currency swaps where banks can swap their HKD funds for RMB funds with HKMA. Launch expected to take place by late February of 2025.

Further enhancement and expansion of Southbound Bond Connect

The HKMA and PBOC will jointly implement a series of enhancement and expansion measures, including: (1) extending the settlement time under the CSDs linkage; (2) supporting the settlement of multi-currency bonds in RMB, Hong Kong dollar, US dollar and euro through the CSDs linkage; and (3) in the longer term, expanding the scope of eligible Mainland investors.

Cross-boundary payment and account-opening facilitation

The measures also include linking the faster payment systems between Mainland China's Internet Banking Payment System (IBPS) operated by the China National Clearing Centre and Hong Kong's Faster Payment System (FPS). Some services are expected to be launched around mid-2025, as well as the inclusion of three new participating banks by the PBOC, namely The Hongkong and Shanghai Banking Corporation Limited, Bank of Communications Co., Ltd. and Standard Chartered Bank (Hong Kong) Limited, to offer account opening by attestation services for Hong Kong residents.

Looking Ahead

Market participants who are looking to make use of these new market initiatives, particularly the new offshore RMB repo arrangement which is due to be launched soon, are advised to review their transaction documentation and operational arrangements together with the new rules when available, and consider whether updates are necessary under the new arrangements.

Our team has extensive experience advising market participants on Bond Connect, Swap Connect, OTCC clearing arrangements and repo transactions generally. Should you have any questions or require further assistance regarding any of the above, please do not hesitate to contact us.

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