# China Briefing

## China's Derivatives Market: All grown up, fast

by Ryan Manuel, Chief Asia Strategist

## Executive Summary


- *China's derivatives market is the missing piece of China's capital markets reforms. China has made rapid progress in improving its derivatives markets in the past few years, and we now await how institutions will react.*
- *Some derivatives are relatively well established in China such as commodities. But on the whole, the major breakthroughs came this year; especially, a new derivatives and futures law means that you can calculate exposure on a net rather than contract-level basis, which makes trading much easier.*
- *The new derivatives law and the ability to buy options from Hong Kong will both force the industry to grow up very fast indeed. However, like any fast-growing adolescent, the final mature product has not fully emerged yet.*
- *China's government seems to believe it can allow far more derivatives while avoiding what it terms "financialisation", and foreign investors are caught somewhat in the middle. While barriers for foreign companies remain, they are being removed cautiously — now that outsiders can participate in China's derivatives markets, it's up to them how to use these tools to extract value.*

# China Briefing

In our final Briefing in this series on China's capital markets, we look at China's derivatives market. This market is changing, and fast.

Part of this change is organic, coming from China's economic growth. China has five domestic derivatives exchanges: agriculture, energy, metals, chemicals, equities and bonds, and the trading volume and turnover of these have increased significantly over recent years.

Another part is that there have been dramatic regulatory changes made to encourage the growth of these markets, which will make it far easier to manage risk and hedge against uncertainty, which has the potential to increase the liquidity of China's other capital markets. It is unclear whether China's government has brought in these changes to release the handbrake on capital markets, or whether it believes it can manage what comes next.

Either way, there are about to be many opportunities to create products for Chinese domestic firms. Foreign investors should also see far better hedging and downside risk protection possibilities. What is less clear is whether these gains will translate into a vibrant derivatives market for China as a whole, one befitting its status as a global economic heavyweight.

## China's Current Derivatives Market

As with many reforming economies, China's derivatives market has waxed and waned, driven largely by government action.

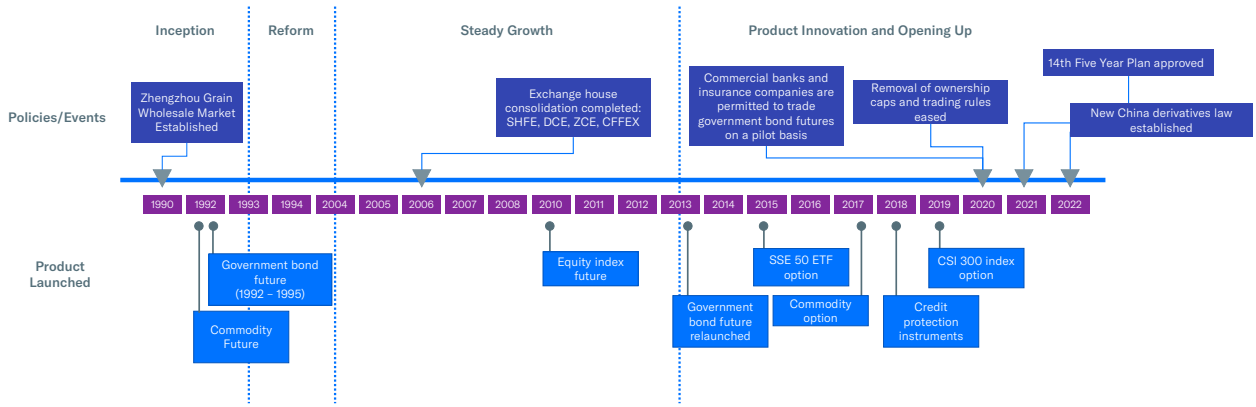
China's commodities markets began with a commodity futures market, the China Zhengzhou Grain Wholesale Market, opening in 1990. After that, a range of new exchanges opened with the main focus being on creating futures contracts to cover major commodities. In 2010, however, futures markets for stocks were launched, and these grew rapidly. Equities futures outtraded commodities by 2013, and flourished, before peaking in 2015.

2015 was a watershed for China's capital markets. A sharp downturn was met by rapid and high-profile government intervention. A particular fear was the use of derivatives. So regulators introduced new rules and fees designed to discourage and reduce margin trading and short selling, and the market experienced a sharp decline in trading volume. It was not until 2020 that regulators let commercial banks and insurance companies begin trading government bond futures on a pilot-basis as a risk mitigation tool for volatility in commodities and energy prices.

2020 saw a range of foreigner-friendly actions. In January, foreign institutional investors had their ownership caps on futures firms removed, while in May of the same year, the trading rules were improved and margin requirements and fees shrunk.

These relaxations happened for two main reasons. Chinese regulators reacted to demands from overseas institutional investors to provide new products as part of a commitment to developing the derivatives market. Consequently, there was a need to put in place further regulations. And, second, there was a need to prevent

**Evolution of the Exchanged-Traded Derivatives Market**




Source: BCG

a similar incident to what had occurred when Bank of China speculated on crude oil in 2020 during the global price drop by issuing a derivatives product to its retail clients, which eventually led to severe losses for them.

This push-and-pull development of the industry is characteristic of other parts of China's capital markets (see our previous three Briefings). In general, perhaps the best way to think of China's derivatives market is as something that has developed cautiously — and its structure represents that steady growth. Most of the over-the-counter derivatives market is foreign exchange derivatives, which is very different from the global market, which consists largely of interest rate products. And the area of most growth is likely to be government bond futures; introducing more of these instruments will help China's leaders manage their pension liabilities, an area of tremendous interest as China's population ages rapidly.

This is the area where China has the most room for improvement, as bond futures still rely on trading happening mainly on the interbank market. Creating a secondary market for government bonds will significantly benefit China's capital markets. A short-term market for government securities would enable market makers to offer a price to clients who are confident in their ability to borrow and deliver the asset at a reasonable price.

Specifically, moving from a "pledge" market system (where the title is not transferred with repurchase, preventing the use of bonds as broader financial instruments) to a "repo" market system (where the bond title can be brought across, and thus used for a variety of extra purposes[1]) would be a vast improvement. It would improve liquidity and enable investors to hedge more effectively. It is unclear why this is the case: it might be a hangover from the Global Financial Crisis, an aversion to "financialisation", or simply a lack of understanding in the capital markets (remember that less than 40 years ago, you could not even tell what type of company would issue shares). However, it has a moderating effect on the bond market.

## Good Times for Derivatives

That said, let us be clear: there has been an extraordinary amount of change from 2020 onwards. And the government has made clear that there yet will be more in the next few years. How do we know that? First, because China's leaders said so. The 14th Five-Year Plan talked about an institutional system and a regulatory model that is linked to international rules.

The second reason is more inductive: China still has a long way to go. Taking into consideration the country's size of economy, China's trading environment is still underdeveloped and has yet to fully open up to overseas investors. Its currency derivatives market is accessible only to approved foreign banks or central banks, while its government bond futures are still closed to trading from offshore.

The question then becomes one of who might benefit from this. There are six main groups of institutional participants present in China's derivatives market: commercial banks, securities companies, futures companies, asset managers, insurance companies, and corporates (non-financial institutions). From this, we can look at firms being either market makers or end users. The main market makers in China's derivatives market are commercial banks, securities companies, and futures companies, whereas all six main groups of institutional participants can be end users in the derivatives market.

In all cases, instrument availability continues to be a significant issue. The biggest shift is in the number of market markers. But, with foreign participation in China's financial system growing at a breakneck pace (and the 2020 reforms described above), there are likely to be more than enough market makers if the terms are favourable — and foreign access will also increase the number of end users, building more network effects. So many of the changes that have recently come about are more targeted at end users.

From that perspective, the last twelve months have been a seminal year for derivatives markets.

First, in 2021, foreign institutional investors[2] were allowed to trade commodity futures, commodity options and stock index options. Previously, they were limited to buying stocks, bonds and warrants, fixed income products in the interbank bond market,

[1] For example: market making, further repos and bond transfers, covering short positions, securities lending or collateral
[2] Under the Qualified Foreign Institutional Investor (QFII) program, i.e. not all institutional investors

securities investment funds and stock index futures — and even then, many of those changes were only allowed in 2020.

Second, capital markets were made a major focus of the Factor Markets Reform initiative, which began in April 2022. They intend to "optimising and upgrading" trading platforms, and "the digital transformation and intelligent upgrading of commodities markets, as well as the...development of comprehensive commodity trading platforms."

These are major shifts, but they do not represent a total release of power to the market. There are some legacies from the 2015 period. The government retains some influence over crucial areas in all changes. They continue to be adamantly opposed to financialisation. To be listed, new futures and option products must be "economically viable and impervious to manipulation." Additionally, chokeholds have been imposed on offshore futures trading, with Article 2 stating that "foreign futures or derivatives trading operations that disturb onshore market order or harm the legitimate interests of mainland investors will face legal repercussions." At the moment, only China's largest 40 or so domestic state-owned corporations can trade, and it is unlikely that foreign firms will be permitted to raise cash. This indicates that China desires money inflows rather than outflows. But either way, it offers considerable money-making possibilities.

The next phase to make these more efficient systems a reality is to improve coordination between different departments, and expand trials of international rules. At present, asset managers are regulated by a minimum of four different bodies.[3] The over-the-counter derivatives markets in China are supervised along different industry sectors, products, and trading venues. To fix this fragmentation, the government has issued a number of orders forcing different players to work together.

This forced integration has been joined by other top-down actions where the government has suddenly opened up. Shanghai, China's designated pilot area for trialling financial sector reforms,[4] allows foreigners to use international agreements to trade with Chinese counterparties onshore. Institutional investors can trade offshore currency in Shanghai's exchange, rather than moving their money into RMB first.

There are more products now entering the market. China's top securities regulator approved two new stock index derivatives, expanding risk management tools available for investors in Chinese mainland-listed equities. Trading in futures and options based on the CSI 1000 Index. Adding derivatives based on the CSI 1000 Index means investors can hedge risks against a broader range of listed companies.

**State of the PRC Derivatives Market**

| | Asset Class | Trade Execution Venue | Clearing & Settlement Venue | Settlement Method |
|---|---|---|---|---|
| China Exchange Derivate Products | T-bond futures | CFFEX | CFFEX | Central |
| | Equity index future/options | SSE/SZSE | SSE/SZSE | |
| | Credit protection contract/certificate | | | |
| | Commodity futures/options | DCE/SHFE/ZCE | DCE/SHFE/ZCE | |
| China OTC Derivative Products | Rates | CEETS | SHCH | Central |
| | | OTC | OTC | Bilateral |
| | FX | CFETS | SHCH | Central |
| | Credit | PBOC approved systems | OTC | Bilateral |
| | Equities | CSIS/OTC | OTC | Bilateral |
| | Commodities (Others) | DCE | SHCH | Central |
| | | | DCE | Bilateral |
| | Commodities (Gold) | SGE | SGE | |

CFETS Exchanges SHCH

Source: BCG

[3] PBOC in conjunction with CBIRC, CSRC, and SAFE

But the biggest change by far was the introduction of the first-ever derivatives law in China. It is much easier for firms to deal with each other directly. Also, it enforces a mechanism used around the world for determining payouts if a derivative counterparty defaults, bringing China's standards in line with those used in other major markets. Based on the new derivative law, China is introducing the application of "close-out netting", which effectively lowers trading cost as this allows for a reduction of funds that need to be put aside to protect against credit risk.

Close-out netting is a method to determine the net obligations of a defaulted counterparty to a derivatives transaction. Close-out netting basically involves terminating individual derivatives transactions documented under a master agreement and reducing them to a single net amount due from one party to the other. This leads to far fewer transaction costs, and more liquidity available, as one has lower margin requirements and any cash that they stand to receive from counterparties to offset their liabilities. Finally, it allows cross-border futures trading.

The legislation establishes a long-awaited legal framework for cross-border futures and derivatives trading, allowing the industry to attract further foreign investors. Any exchange must acquire a regulatory licence before commencing operations under the new rule, but there is no overt discrimination against foreigners. Additionally, the new regulation makes no distinction between who is eligible to be a clearing participant and who is not, potentially allowing a significantly larger number of brokers to participate. It will be tremendously enticing if overseas enterprises may register with the CSRC. Along with brokerage services, futures businesses now offer advising, market-making, and asset management services. This clause is especially appealing to mainland futures companies, which perceive enormous revenue prospects.

The new regulation has a profound effect on China's capital markets. Previously, the absence of guidelines made it difficult to hedge or use risk-management derivatives. This legislation contains rules addressing the enforcement of close-out netting, a practise that enables parties to consolidate their obligations into a single net payment owed from one party to another. Netting considerably minimises credit risk.

Additionally, the ability to prevent profitable transactions from being cherry-picked during a default will significantly boost investor confidence in China and mitigate the impact of domestic political interference. The Civil Code (see Briefing on the Civil Code) and this new legislation will strengthen the country's capacity to provide collateral.

The derivatives law has been requested by banks and foreign institutions for many years.[5] It represents a major milestone.

But it is not a complete opening up to foreigners. Unless approved by CSRC, foreign institutions are prohibited from conducting marketing, promotion, and solicitation activities related to futures (exchanges or brokers) in China (or set up a branch to do so). The legislation further clarifies that "Chinese institutions equally need to be approved by the CSRC to carry out such activities on behalf of a foreign institution. These restrictions must not be violated by any entity or individual."

What can we make of all of this? One, that China is very determined to make a modern financial and capital market system. A derivatives law is a clear sign of intent. Foreigners have gone in the matter of a few years from not being able to own any sort of futures firm to being able to own a firm but being hindered in how they trade to where we are now, which is where foreign firms can freely own and trade futures in a rules-based regulatory environment (albeit one with limited capacity and clear enforcement and local protectionism biases).

But two, China's leaders are determined to ensure that foreigners work with local firms and, one can surmise, in doing so think that they can minimise some of the downsides of financialisation (for more on this, see the first Briefing of this series, China's capital markets: Reforms, but not as we know it).

[4] Feb 2020, Opinions on Further Accelerating the Building of Shanghai into an International Financial Center and Financial Support for the Integrated Development of the Yangtze River Delta.
[5] ISDS report

## Hong Kong's Hope

Perhaps paradoxically, these changes make Hong Kong more important. Why is that? Because the changes to derivatives markets described above are still occurring in a less-well-established regulatory system, and Hong Kong still has far better rules and systems than mainland China.

Mainland authorities have recognised this, it appears, or at the very least have granted Hong Kong a range of perquisites.

First, mainland derivatives products are now available in Hong Kong (and soon, vice versa) through interest rate swaps. Initially, global investors will be able to participate in the mainland interbank financial derivatives market through a Hong Kong trading, clearing, and settlement mechanism. A mechanism that is also already in place for certain mainland equities and bonds — the so-called Northbound trading. In due course, this will then be extended to Southbound trading e.g. allowing mainland investors to participate in the Hong Kong financial derivatives market. Through Swap Connect, links between Hong Kong and the mainland have been extended to derivatives products for the first time. It lets overseas investors trade in the mainland interbank financial derivatives market and hedge their risks.

There is also a range of new tools to hedge risk when investing in mainland China. They include the HuShen300 stock index futures or CSI 300 futures and through CDS (credit default swaps) for bonds. A new instrument, the MSCI China A 50 Connect Index Derivatives Warrants, based on the MSCI China A 50 Connect Index, which tracks 50 key stocks traded on the mainland's Shanghai and Shenzhen stock exchanges, which are accessible through the stock connect programme linking mainland and Hong Kong bourses. So far, the average daily trading volume in this instrument has been nearly three-quarters greater than last year.[6]

While it is clearly in their interests to say so, major Hong Kong institutions appear bullish on these developments. The head of the Hong Kong Stock Exchange, for example, claims that the country's shift from savings to investment in quest of higher returns will quadruple China's capital markets to roughly USD 100 trillion.[7] More derivatives trading appears part of those plans.

## What Comes Next and What Does This Mean for Investors?

The reforms of the past year draft new chapters for China's derivatives markets. At the macro level, they will undoubtedly encourage more domestic and international financial institutions to turn to China's derivatives market to hedge and manage the risks that come with interacting with China's vast economy. China's derivatives market is currently far less developed than China's wider economy.

One may envisage a significantly brighter future. Derivatives and associated financial instruments will play a larger role in supporting China's actual economy. As Chinese corporations extend their international activities and foreign companies strengthen their business contacts with their Chinese counterparts, they can now use China's derivatives markets for more sophisticated FX and related hedging options.

Similarly, domestic and international investors may rely on credit derivatives to manage credit risks associated with Chinese issuers. This is essential for the continued development and internationalisation of China's bond markets, particularly now, when the need to mitigate such risks is increasing. And the development of carbon emissions contracts and other ESG-related derivatives would help China in achieving its climate and other social goals. As more Chinese firms go out, RMB-denominated assets may be used more frequently as collateral, furthering the internationalisation of the Chinese currency.

There is more to be done. Namely, the bond derivatives market should be improved. China now utilises a pledge repo system, and denies short selling on many bonds. Creating a secondary market for government

[6] The MSCI China A 50 Connect Index Futures, which provide an effective hedging tool for investors to manage risks in the A-share market, were also actively traded. Their average daily trading was 71.9% higher than that in 2021.
[7] Nicolas Aguzin at the China Private Equity Summit 2022

bonds will have a huge positive impact on China's capital markets. In conjunction with the new rules, it may allow short selling to occur on many bonds. A short-term market for government assets would allow market makers to give a price to clients who are confident in their abilities to borrow and return the asset at an acceptable cost. If the terms are favourable, there will certainly be an abundance of market makers, as foreign participation in China's financial system is expanding at a dizzying speed. Bonds would then be available for a variety of additional reasons (market making, further repos, covering short positions, securities lending or collateral), and this would be great for China's derivatives market due to increased liquidity and more effective hedging. Given the vast strides made in China's derivatives markets in the past year, one wouldn't put it past China's leaders to make this happen soon, too.

In all cases, the rapid changes make effective forecasting tricky. But it is clear that China's derivatives markets are about to undergo perhaps their most exciting and, one hopes, lucrative period.

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