5 March 2021

The Chief Executive  
All Hong Kong FX Settlement Banks

Dear Sir / Madam,

Enhanced Currency Conversion Arrangement Involving Onshore RMB (CNY) under Northbound Bond Connect

As you may be aware, the China Foreign Exchange Trade System (CFETS) issued a notice on 24 September 2020 on the enhancements to currency conversion and foreign exchange hedging under Bond Connect. In the light of several rounds of market consultation, I write to provide guidance for banks in providing the relevant service.

Background

2. With reference to the Joint Announcement between the Hong Kong Monetary Authority (HKMA) and the People’s Bank of China (PBoC) on 16 May 2017, Bond Connect is an arrangement that enables Mainland and overseas investors to trade bonds tradable in the Mainland and Hong Kong bond markets through connection between the Mainland and Hong Kong financial infrastructure institution. To ensure sound supervisory cooperation and effective implementation of Bond Connect, the HKMA and the PBoC have entered into a Memorandum of Understanding on supervisory cooperation under Bond Connect (referred to as “the MoU” hereafter). Under the MoU, the HKMA and the PBoC should provide each other with supervisory assistance, with a view to ensuring effective operation of Bond Connect, and meet each other’s request for information for supervisory purposes as far as possible.

3. Pursuant to PBoC Order [2017] No. 1, Bond Connect investors are allowed to conduct currency conversion (CNY/FX) or foreign exchange hedging with the designated settlement banks in Hong Kong. The said banks may square their positions arising from the aforementioned transactions in the onshore interbank foreign exchange market in accordance with the relevant rules and regulations. The notice issued by the CFETS on 24 September 2020 stipulated a new arrangement where Bond Connect investors may choose to engage up to three designated settlement banks in Hong Kong

1 The text of the Notice can be found at http://www.chinamoney.com.cn/english/rarfmrudrgl/20200924/1785566.html
to conduct currency conversion and foreign exchange hedging for their RMB exposure in respect of their Bond Connect investments (referred to as “Enhanced CNY Conversion Service” hereafter). In order to maintain access to the onshore interbank foreign exchange market to conduct the permitted position squaring transactions, Hong Kong banks should have proper internal controls in place to ensure compliance with the requirements in this circular and other relevant requirements.

Scope

4. Banks that can offer the Enhanced CNY Conversion Service include the RMB Clearing Bank and overseas RMB participating banks in Hong Kong which have been approved by the Mainland authorities to take part in the onshore interbank foreign exchange market (collectively referred to as “Hong Kong FX Settlement Banks” hereafter). Hong Kong FX Settlement Banks shall only provide the Enhanced CNY Conversion Service to investors who are eligible to participate in the Northbound Bond Connect (collectively referred to as “Eligible Investors” hereafter).

5. Each Eligible Investor should appoint one Hong Kong FX Settlement Bank as its Primary FX Settlement Bank and up to two as General FX Settlement Bank(s). Upon the appointment, the Eligible Investor should inform the HKMA of its appointment through its Primary FX Settlement Bank. The Primary FX Settlement Bank must concurrently be the bank that executes the related money settlement of the Northbound Bond Connect transactions with the Central Moneymarkets Unit (CMU). Only the Primary FX Settlement Bank should deposit CNY funds to and receive CNY funds from the CMU for an Eligible Investor’s Northbound Bond Connect transaction settlement. The General FX Settlement Bank(s) should only undertake CNY funds transfer to and from the Eligible Investor’s designated Bond Connect settlement account at its Primary FX Settlement Bank.

6. If an Eligible Investor does not file any appointment of Primary and General FX Settlement Banks, it will be assumed that the said investor will continue to engage its incumbent settlement bank alone to obtain CNY under the regulatory requirements that have been in place since the launch of Bond Connect.3

Principle

7. In providing the Enhanced CNY Conversion Service, the Hong Kong FX Settlement Banks should ensure that the currency conversion and foreign exchange hedging transactions (collectively referred to as “CNY Transactions” hereafter) arise from genuine and reasonable needs from Bond Connect investments. In order to ensure continued access to the onshore interbank foreign exchange market, the Hong Kong FX Settlement Banks should ensure continued compliance with the relevant Mainland regulations, and have proper internal control in place to monitor the following:

---

3 The requirements are set out in the letter and FAQs issued to Hong Kong FX Settlement Banks at the launch of Bond Connect or when a Hong Kong Settlement Bank acquires the relevant license from the Mainland authorities.
i. the genuineness of the Eligible Investors using the Enhanced CNY Conversion Service;

ii. the genuineness and reasonableness of the Bond Connect investments underpinning the CNY Transactions as confirmed by the Eligible Investors; and

iii. the CNY converted for the Eligible Investors is properly ring-fenced and is only used for settling Bond Connect.

8. The Hong Kong FX Settlement Banks are not expected to share the transaction data relating to the Enhanced CNY Conversion Service with each another; they are required to report the investor-level data relating to the Enhanced CNY Conversion Service to the HKMA. The HKMA will make use of the data collected as well as the data available from the CMU to conduct ex post spot checking over the Enhanced CNY Conversion Service obtained by each Eligible Investors across different Hong Kong FX Settlement Banks. If any irregularities are found, the HKMA may ask investors to provide supporting documents, through their Primary FX Settlement Banks, to clarify that their CNY Transactions are conducted based on genuine and reasonable Bond Connect investment needs.

Monitoring Responsibilities

9. To facilitate the control and monitoring work by the Hong Kong FX Settlement Banks, the expectations of each party in monitoring the “genuineness and reasonableness” of CNY Transactions are set out as follows.

i. General FX Settlement Bank: While the Eligible Investors shall bear the responsibility of ensuring that their CNY Transactions are commensurate with their underlying Bond Connect investments, the Hong Kong FX Settlement Banks who provide the Enhanced CNY Conversion Service in the capacity of General FX Settlement Banks should obtain confirmation from the Eligible Investors that the CNY Transactions are underpinned by genuine and reasonable Bond Connect transactions.

For currency conversion, the banks should implement a closed-loop fund flow arrangement for the CNY funds obtained under the Enhanced CNY Conversion Service. Specifically, the banks should properly ring-fence an account under each Eligible Investor so that the funds in that account can be properly monitored and are only used for settlement of Bond Connect transactions via the Primary FX Settlement Bank.4

Besides the reporting obligation to the HKMA (see section below), the banks should monitor and notify the HKMA if the difference between (1) the net

---

4 For the avoidance of doubt, CNY funds in an Eligible Investor’s designated account at General FX Settlement Banks should only be transferred to the designated Bond Connect settlement account at the said investor’s Primary FX Settlement Bank.
amount of CNY conversion conducted by an Eligible Investor and (2) the net remittance\(^5\) to the said investor’s designated Bond Connect settlement account at the Primary FX Settlement Bank exceeds 15% for a period longer than 10 working days.

ii. **Primary FX Settlement Bank:** While the Eligible Investors shall bear the responsibility of ensuring that their CNY Transactions are commensurate with their underlying Bond Connect investments, the Hong Kong FX Settlement Banks who provide the Enhanced CNY Conversion Service in the capacity of Primary FX Settlement Banks should obtain confirmation from the Eligible Investors that the CNY Transactions are underpinned by genuine and reasonable Bond Connect transactions.

For currency conversion, the banks should implement a closed-loop fund flow arrangement for the CNY funds obtained under the Enhanced CNY Conversion Service. Specifically, the banks should properly ring-fence an account under each Eligible Investor so that the funds in that account can be properly monitored and are only used for settlement of Bond Connect transactions with the CMU. Remittance by General FX Settlement Banks for the purpose of settling Bond Connect transactions should also be deposited in this designated account before onward remittance to the CMU.

Besides the reporting obligation to the HKMA (see section below), a Primary FX Settlement Bank should bear the following monitoring responsibilities:

(a) Notify the HKMA if the difference between (1) the sum of net amount of CNY conversion it provides to an Eligible Investor and the net remittance\(^6\) it receives from the said investor’s designated account(s) at the General FX Settlement Bank(s), and (2) the net money settlement of Bond Connect transactions with the CMU\(^6\) exceeds 15% for a period longer than 10 working days.

(b) Notify the HKMA if the difference between (1) the outstanding CNY hedging instruments it provides to an Eligible Investor and (2) the net money settlement of Bond Connect transactions with the CMU\(^7\) (which serves as a proxy for the amount of the said

---

\(^5\) The regulatory focus of this requirement is CNY. If a General FX Settlement Bank has put in place adequate systems and control to distinguish CNY funds from CNH funds it transfers to and receives from Primary FX Settlement Banks, it should monitor the net CNY remittance. However, if a General FX Settlement has difficulty in singling out CNY remittance from the total RMB remittance, it may monitor the net remittance in its entirety.

\(^6\) The regulatory focus of this requirement is CNY. If a Primary FX Settlement Bank has put in place adequate systems and control to distinguish CNY funds from CNH funds it transfers to and receives from the General FX Settlement Banks and the CMU, it should monitor the net CNY remittance. However, if a Primary FX Settlement has difficulty in singling out CNY remittance from the total RMB remittance, it may monitor the net RMB remittance in its entirety.

\(^7\) A Primary FX Settlement Bank may also monitor the outstanding CNY hedging instruments it provides to an Eligible Investor against the nominal value of the bond holding of the said investor, if the latter
investor’s bond holdings) exceeds 15% for a period longer than 10 working days.

For more detailed guidance, please refer to the FAQ in Annex 1.

Reporting Requirements

10. The Hong Kong FX Settlement Banks are required to submit to the HKMA investor-level transactions under the Enhanced CNY Conversion Service they provide, including both currency conversion and foreign exchange hedging. Banks should match each transaction with an Eligible Investor using the latter’s CMU sub-account number as the identifier.

11. Authorized Institutions are currently required to report over-the-counter foreign exchange derivatives transactions (including those arising from Bond Connect investments) to the Trade Repository of the HKMA (HKTR). To avoid duplicate reporting, we will require the Hong Kong FX Settlement Banks to report the Enhanced CNY Conversion Service transactions to the HKTR. To allow sufficient time for system adjustments, there will also be a twelve-month transitional period starting from 8 March 2021, during which banks may report transactions under the Enhanced CNY Conversion Service using other specified channels. For detailed reporting requirements, please refer to Annex 2.

Pre-existing Positions

12. An Eligible Investor may obtain the Enhanced CNY Conversion Service for its Bond Connect transactions settled prior to the date when it appoints its Primary and General FX Settlement Banks (referred to as “Effective Date” hereafter), provided that its Primary FX Settlement Bank is able to report to the HKMA the said investor’s (1) total net amount of CNY conversion prior to the Effective Date and (2) the outstanding CNY hedging instruments prior to the Effective Date (collectively referred to as “Pre-existing CNY Positions” hereafter). The Primary FX Settlement Bank should then take into account the Pre-existing CNY Positions when they are carrying out the monitoring responsibilities set out above.

13. If a Hong Kong FX Settlement Bank has difficulty in reporting the Pre-existing CNY Positions of its Eligible Investors, it can continue to provide CNY Conversion Service to the Eligible Investors for their Bond Connect transactions settled prior to the Effective Date. The said Hong Kong FX Settlement Bank should however continue to carry out the monitoring responsibilities of the Pre-existing CNY positions in accordance with the requirements that have been in place since the launch of Bond Connect.

---

8 Where an Eligible Investor does not choose to use the Enhanced CNY Conversion Service, the issue of pre-existing positions does not arise.

9 The Primary Hong Kong FX Settlement Bank may use the investor’s net RMB remittance to CMU as a proxy of its Bond Connect transactions settled prior to the Effective Date.

10 As opposed to the Enhanced CNY Conversion Service
Way Forward

14. The Hong Kong FX Settlement Banks may start to provide the Enhanced CNY Conversion Service after the issuance of this circular and after they have the necessary control and system in place to discharge the abovementioned requirements.

15. Please nominate a staff member as the contact person in your bank for further communication with the HKMA on matters relating to Bond Connect currency conversion. Please submit relevant details by email to bcreporting@hkma.gov.hk.

16. Should you have any question, please contact Mr Edmund Lee at +852 2878 1239 or Ms Andrea Chen at +852 2597 0605.

Yours faithfully,

Donald Chen
Senior Advisor (External)

Encl.