Annex 1

Frequently Asked Questions in Relation to The Enhanced Currency Conversion Arrangement under Bond Connect

I. Appointment of the Hong Kong FX Settlement Banks

Q1 Can Global Custodian (GC) or other financial intermediaries appoint the Primary and General FX Settlement Banks on behalf of Eligible Investors?

A1 The appointment of Primary and General FX Settlement Banks is at the discretion of the Eligible Investors. However, the Eligible Investors may choose to complete appointment procedures (please refer to FAQ3 for details) through its GC or other financial intermediaries.

Q2 Should the Primary FX Settlement Bank be the GC of the Eligible Investors?

A2 The appointment of Primary and General FX Settlement Banks is at the discretion of the Eligible Investors. However, the Primary FX Settlement Bank must concurrently be the bank that executes the related money settlement of the Northbound Bond Connect transactions with the CMU. Therefore, the Primary FX Settlement Bank of an Eligible Investor has to be the settlement bank of the investor's CMU member (in many cases, CMU members serve as their own settlement banks). Subject to its account structure and payment arrangement, an Eligible Investor may designate its GC as the Primary FX Settlement Bank.

Q3 How should a Hong Kong FX Settlement Bank inform the HKMA that it is appointed by an Eligible Investor?

A3 Upon the appointment of Primary and General FX Settlement Bank(s), the Primary FX Settlement Bank should inform the HKMA (via email: bcreporting@hkma.gov.hk) on behalf of the Eligible Investor and with a copy to the General FX Settlement Bank(s): (1) The name of the Eligible Investor and its CMU sub-account number, and (2) the names of the Primary and General FX Settlement Banks appointed by the Eligible Investor. The Primary FX Settlement Bank may also choose to submit the CFETS filing form (dated 24 September 2020) to bcreporting@hkma.gov.hk. The Hong Kong FX Settlement Banks may start to provide Enhanced CNY Conversion Service if the HKMA has not raised any enquiries or objections after five business days.

II. Account Structure And Fund Flow

Q4 Can Hong Kong FX Settlement Banks maintain an omnibus account for multiple Eligible Investors at the same custodian bank? Or does each Eligible Investor need to set up a physical account?

A4 The HKMA does not intend to prescribe the operational arrangement, so long as the Hong Kong FX Settlement Banks can implement the closed-loop fund flow arrangement and fulfil the reporting obligations at the investor-level (or the CMU sub-account level) as set out in this circular.

Q5 Can GC execute currency conversion and foreign exchange hedging with the Hong Kong FX Settlement Banks on behalf of Eligible Investors?

A5 The Hong Kong FX Settlement Banks may provide Enhanced CNY Conversion Service to GCs acting on behalf of the Eligible Investors, so long as they can implement the closed-loop fund flow arrangement and fulfil the reporting obligations at the investor-level (or the CMU sub-account level) as set out in this circular.

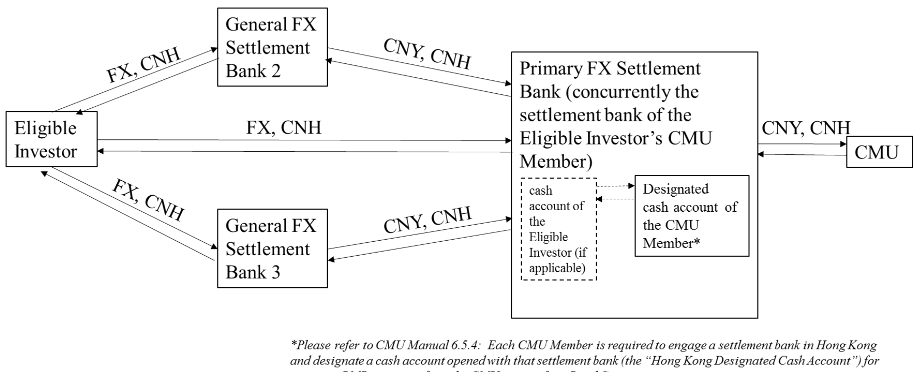
Q6 Is pre-funding allowed? Can the Eligible Investors keep their CNY proceeds (either from bond sale or coupon payment) in their ring-fenced account for future refinements under Bond Connect?

Q6 Eligible Investors are allowed to conduct currency conversion and foreign exchange hedging transactions as long as these transactions are underpinned by genuine and reasonable Bond Connect transactions. In practice, we do not require the Hong Kong FX Settlement Banks to take any actions if the difference between the net CNY conversion and the net Bond Connect settlement of an Eligible Investor does not exceed 15% over a period of 10 working days. Further details on the calculation methodology are set out in FAQ 10 below.

Even if the difference between the net CNY conversion and the net Bond Connect settlement exceeds 15%, it does not necessarily imply that there is a breach of the requirement. Under such circumstances, the responsibility of the Hong Kong FX Settlement Banks is to notify the HKMA in accordance with the circular. We will review the actual circumstances of the case to assess whether the CNY conversion arises from genuine and reasonable Bond Connect investment needs.

Q7 What will be the standard payment flow look like under the enhanced currency conversion arrangement?

A7 A standard payment flow is depicted in the figure below:



**Please refer to CMU Manual 6.5.4: Each CMU Member is required to engage a settlement bank in Hong Kong and designate a cash account opened with that settlement bank (the "Hong Kong Designated Cash Account") for receiving RMB payments from the CMU arising from Bond Connect transactions.*

Q8 Can wire transfer be made from an Eligible Investor's account at its Primary FX Settlement Bank to CMU directly? Or should it be routed via CMU member's account at the Primary FX Settlement Bank?

A8 It should be routed via CMU member's account at the Primary FX Settlement Bank.

III. Monitoring Responsibilities

Q9 How often should the Hong Kong FX Settlement Banks obtain confirmation from the Eligible Investors that the CNY Transactions are underpinned by genuine and reasonable Bond Connect transactions? Do banks have to obtain such confirmation on a deal-by-deal basis?

A9 It is up to the Hong Kong FX Settlement Banks to decide the format and frequency of such confirmation. Depending on the relationship with the Eligible Investors, the Hong Kong FX Settlement Banks may choose to accept periodic confirmation rather than deal-by-deal confirmation.

Q10 Could the HKMA illustrate with some examples how the Hong Kong FX Settlement Banks calculate the 15% difference when carrying out their monitoring responsibilities? Should they use the notional value of bond purchases, or mark-to-market value?

A10 Consider the following scenarios:

<u>Scenario 1</u> (currency conversion)

On Day 1, an Eligible Investor (Investor A') buys CNY50 from its Primary FX Settlement Bank (Bank A) and CNY55 from its General FX Settlement Bank (Bank B). Investor A' instructs Bank B to remit CNY55 to Bank A for settling its Bond Connect transactions. On Day 2, upon instructions of Investor A', Bank A remits CNY100 from its account to CMU for settling its Bond Connect transactions. So, for Bank A:

Net Bond Connect Settlement = CNY100

Net CNY Conversion = CNY50

Net Remittance from Bank B = CNY55

Net CNY Conversion + Net Remittance from Bank B - Net Bond Connect Settlement = CNY 5

Since the difference is only 5% of net Bond Connect settlement, Bank A does not need to notify the HKMA.

For Bank B:

Net Bond Connect Settlement via Bank A = CNY55

Net CNY Conversion = CNY55

Net CNY Conversion - Net Settlement via Bank A = CNY 0

Since there is no difference between the conversion and settlement, Bank B does not need to notify the HKMA.

On Day 11, upon selling its bond, Investor A' receives CNY 120 from CMU; it sells CNY 140 to Bank A. So, For Bank A:

> Net Bond Connect Settlement = CNY100 – CNY120 = -CNY20
>
> Net CNY Conversion = CNY50 – CNY140 = -CNY90
>
> Net Remittance from Bank B = CNY55
>
> Net CNY Conversion + Net Remittance from Bank B - Net Bond Connect Settlement = -CNY 15

The difference exceeds 15% of the net Bond Connect settlement, Bank A should notify the HKMA if the difference continues to exceed 15% after 10 working days.

<u>Scenario 2</u> (hedging)

On Day 1, an Eligible Investor (Investor X') buys CNY100 from its Primary FX Settlement Bank (Bank X) and CNY50 from its General FX Settlement Bank (Bank Y). Investor X' instructs Bank Y to remit CNY50 to Bank X for settling its Bond Connect transactions. On Day 2, upon instructions of Investor X', Bank X remits CNY150 from its account to CMU for settling its Bond Connect transactions. Investor X' also enters into a short CNY deliverable forward, with a notional value of CNY160 with Bank X. So, for Bank X:

> Net Bond Connect Settlement = CNY150
>
> Outstanding Short CNY positions = CNY160
>
> Outstanding Short CNY positions - Net Bond Connect Settlement = CNY 10

Since the difference is only 6.67% of net Bond Connect settlement, Bank X does not need to notify the HKMA.

Q11 How should the Hong Kong FX Settlement Banks inform the HKMA if Eligible Investors' currency conversion or hedging transactions exceeds the 15% prescribed in the circular for a period longer than 10 working days?

A11 The Hong Kong FX Settlement Banks should inform the HKMA by emailing to bondconnectcny@hkma.gov.hk. The banks may continue to provide Enhanced CNY Conversion Service to the Eligible Investor, unless otherwise instructed by the HKMA.

Q12 It is mentioned in the circular that the HKMA may ask for supporting documents. Can the HKMA provide examples of the acceptable supporting documents?

A12 The HKMA will compile the investor-level CNY transactions data provided by the Hong Kong FX Settlement Banks and cross check the investors' bond settlement and positions. If any irregularities are found, the HKMA may ask investors to clarify, through their Primary FX Settlement Banks, that the currency conversion and/or foreign exchange hedging are conducted based on genuine and reasonable Bond Connect investment needs. The type of clarifications and supporting documents will vary depending on the circumstances of the case. Generally speaking, records of fund remittance, Bond Connect transactions, and/or coupon payments (or other applicable payments) are supporting documents that we may ask for.

Q13 Do Hong Kong FX Settlement Banks need to keep track of CNH fund flows?

Q13 No.

IV. Reporting Requirements

Q14 If long and short positions are netted out at the end of trading day among different Eligible Investors engaging the same Hong Kong FX Settlement Bank (i.e. not squared in the onshore FX market), does the bank still need to report the transactions to the HKMA?

A14 All CNY Transactions with Eligible Investors for the purpose of Bond Connect investments are subject to reporting, irrespective of whether the positions are ultimately squared in the onshore FX market. If the Hong Kong FX Settlement Bank chooses not to conduct any transaction in the onshore FX market after selling 100 CNY to Investor A and buying 100 CNY from Investor B, the bank should still report the two currency conversion transactions to the HKMA.

Q15 When should the Hong Kong FX Settlement Banks report different types of hedging and currency conversion transactions? Could HKMA illustrate with examples?

A15 The Hong Kong FX Settlement Banks should observe existing HKTR reporting requirements and complementary requirements set out in Annex 2 of the circular in reporting CNY Transactions to the HKMA via HKTR. Some examples are provided below for the sake of clarity. For the avoidance of doubt, the following examples also apply to reporting using the CFETS template and interim template during the transitional period.

Scenarios	Reporting requirements[1]
Hong Kong FX Settlement Bank A enters into a spot transaction contract with Eligible Investor A' on Day 0. The contract is settled on Day 1.	Hong Kong FX Settlement Bank A should report a currency conversion transaction by Day 2.

[1] The reporting timeline set out in this table refers to the requirements in place after the transitional period. For details on the transitional arrangement, please refer to Annex 2.

Hong Kong FX Settlement Bank A enters into a 5-day physically-settled short CNY forward with Eligible Investor A’ on Day 0. The contract is delivered on Day 5.	Hong Kong FX Settlement Bank A should report a hedging transaction (short CNY forward) by Day 2 .
Eligible Investor A’ enters into a 5-day cash-settled short CNY forward with Hong Kong FX Settlement Bank A on Day 0. On Day 5, the contract is cash-settled; on the same day, Eligible Investor A’ enters into a spot transaction contract with Hong Kong Settlement Bank A to sell CNY at the market price.	Hong Kong FX Settlement Bank A should report a hedging transaction (short cash-settled CNY forward[2]) by Day 2 and a spot transaction (sell CNY) by Day 7.
Hong Kong Settlement Bank A enters into a 5-day cash-settled short CNY forward contract with Eligible Investor A’ on Day 0. On Day 5, Eligible Investor A’ rolls over the position by closing the existing position and re-entering a 5-day cash-settled short contract.	Hong Kong FX Settlement Bank A should report a hedging transaction (short cash-settled CNY forward[2]) by Day 2 and a hedging transactions (short cash-settled CNY forward[2]) by Day 7.
Hong Kong FX Settlement Bank A enters into a swap contract with Eligible Investor A’ on Day 0, which involves CNY purchase on Day 1 and CNY sale on Day 5. The contract is settled on day 5.	Hong Kong FX Settlement Bank A should report a hedging transaction (swap) by Day 2. The transaction should be reported in the form of two forwards: a near-leg long CNY forward and a far-leg short CNY forward.
Hong Kong FX Settlement Bank A on Day 0 sells a put option to Eligible Investor A’ that expires on Day 5. The option is not executed. On Day 5, Eligible Investor A’ enters into a spot transaction contract with Hong Kong FX Settlement Bank A to sell CNY at the market price.	Hong Kong FX Settlement Bank A should report a hedging transaction (short CNY option) by Day 2 and a spot transaction (sell CNY) by Day 7.
Hong Kong FX Settlement Bank A on Day 0 sells a put option to	Hong Kong FX Settlement Bank A should report a hedging transaction

[2] Hong Kong FX Settlement Banks may choose to report a cash settled forward as either a forward or a non-deliverable forward (NDF) to HKTR, following their existing practice. If a bank chooses to report the aforementioned transaction as a forward, it should use the optional data field of “FX Delivery Type” (Item 179) to denote cash settlement. When the data field is left blank, the reporting entry will be treated as a physically settled forward contract and recorded as a spot transaction on the value date.

Eligible Investor A' that expires on Day 5. The option is executed on Day 4.	(short CNY option) by Day 2 and a currency conversion transaction (sell CNY) by Day 6.

Q16 For the Hong Kong FX Settlement Banks that employs a centralised settlement model pursuant to PBoC's Notice 159 (i.e. all offshore banks under the same banking group square their CNY positions in the onshore Interbank FX Market through its Hong Kong affiliates), what would be the reporting requirements?

A16 The reporting requirements set out in this circular apply to all Enhanced CNY Conversion Service provided by the Hong Kong FX Settlement Banks. So for the Hong Kong FX Settlement Banks that centrally square the Bond Connect-related CNY Transactions on behalf of their banking groups, Hong Kong FX Settlement Banks should include the CNY Transactions conducted by their offshore affiliates in the reporting.

For the avoidance of doubt, the Hong Kong FX Settlement Banks adopting a centralised settlement model do not need to report both the client-facing transaction and the related back-to-back internal transaction. A report of either one in compliance with the reporting requirements set out in this circular and the existing HKTR requirements will do.

Q17 Can the Hong Kong FX Settlement Banks provide multiple CMU sub-account numbers in Remarks 2 for a single reporting entry?

A17 No. Each HKTR reporting entry should correspond to one CMU sub-account number. If the Hong Kong FX Settlement Banks conduct block trades with multiple investors (i.e. via GC's omnibus account) , the banks should put in place proper bookkeeping measures to make sure transactions can be traced to and reported at an investor level.

Q18 Can multiple CNY hedging reporting entries share the same Unique Trade Identifier Indicator?

A18 The Hong Kong FX Settlement Banks should observe existing HKTR requirements in reporting CNY hedging transactions, and each reporting entry should carry a unique trade identifier.

V. Others

Q19 Could there be some examples to show how Hong Kong FX Settlement Banks calculate the 15% difference when taking into account pre-existing CNY and bond positions?

A19 Consider the following scenario for an Eligible investor who chooses Option (b) in paragraph 12 of the covering circular.

Scenario 1 (Conversion):

An Eligible Investor (Investor A') has bought a net of CNY100 from a FX Settlement Bank (Bank A) and settled a net of CNY 100 Bond Connect transactions via Bank A prior to appointing Bank A as its Primary FX

Settlement Bank. After the appointment, it buys CNY 50 from Bank A. It also buys CNY55 from its General FX Settlement Bank (Bank B). Investor A' instructs Bank B to remit CNY55 to Bank A for settling its Bond Connect transactions. Upon instructions of Investor A', Bank A remits CNY100 from its account to CMU for settling its Bond Connect transactions. So, for Bank A:

Net Bond Connect Settlement = CNY100

Net CNY Conversion = CNY50

Net Remittance from Bank B = CNY55

Net CNY Conversion + Net Remittance from Bank B - Net Bond Connect Settlement = CNY 5

Since the difference is only 5% of net Bond Connect settlement, Bank A does not need to notify the HKMA.

Meanwhile, Bank A should monitor the pre-existing CNY conversion of CNY 100 following instructions set up in the letter and FAQs issued to Hong Kong FX Settlement Banks at the launch of Bond Connect or when a Hong Kong FX Settlement Bank acquires the relevant license from the Mainland authorities.

Scenario 2 (hedging):

An Eligible Investor (Investor X') has entered into short CNY hedging contracts with a notional value of CNY 100 with a FX Settlement Bank (Bank X) and settled a net of CNY 100 Bond Connect transactions via Bank X prior to appointing Bank X as its Primary FX Settlement Bank. After the appointment, Investor X' buys CNY100 from Bank X and CNY50 from its General FX Settlement Bank (Bank Y). Investor X' instructs Bank Y to remit CNY50 to Bank X for settling its Bond Connect transactions. Upon instructions of Investor X', Bank X remits CNY150 from its account to CMU for settling its Bond Connect transactions. Investor X' also enters into a short CNY deliverable forward, with a notional value of CNY160 with Bank X. So, for Bank X:

Net Bond Connect Settlement = CNY150

Outstanding Short CNY positions = CNY160

Outstanding Short CNY positions - Net Bond Connect Settlement = CNY 10

Since the difference is only 6.67% of net Bond Connect settlement, Bank X does not need to notify the HKMA.

Meanwhile, Bank A should monitor the pre-existing short CNY hedging positions of CNY 100 following instructions set up in the letter and FAQs issued to Hong Kong FX Settlement Banks at the launch of Bond Connect or when a Hong Kong FX Settlement Bank acquires the relevant license from the Mainland authorities.

Q20 Can Eligible Investors continue to engage only one Hong Kong FX Settlement Bank?

A20 Yes. In such cases, the incumbent Hong Kong FX Settlement Banks may choose to monitor their investors' CNY Transactions under the regulatory requirements that have been in place since the launch of Bond Connect, or under the requirements set out in this circular. In the latter case, the Eligible Investor will need to designate the incumbent Hong Kong FX Settlement Bank as its Primary FX Settlement Bank.