

ASSOCIATION OF GLOBAL CUSTODIANS

Communication of the Association of Global Custodian's Asia Focus Committee

17 July 2017

VIA REGISTERED MAIL AND E-MAIL

Hon Mr Eddie Yue Wai-man, JP
Executive Director,
Deputy Chief Executive,
Hong Kong Monetary Authority

Dear Mr. Yue,

Bond Connect

This letter is submitted on behalf of the members of the Association of Global Custodians (AGC) ^[1] through its Asia Focus Committee (Committee), in response to certain operational difficulties that AGC member banks and their clients have faced since the launch of the China/Hong Kong Bond Connect on the 3rd July 2017.

In their "Joint Announcement of the People's Bank of China and the Hong Kong Monetary Authority" on the 16th May 2017, under item "5", both regulators have agreed that:

"The Hong Kong and Mainland Financial Infrastructure Institutions should actively take forward preparations for Bond Connect in an orderly manner and with prudent risk management. Bond Connect will be formally launched after relevant rules and system development have been finalised, market participants' practical needs have been suitably addressed, relevant regulatory approvals have been granted and all other necessary preparations have been completed."

Matters were progressed along those lines and the operating model was readied for the implementation of Bond Connect by market participants,

^[1] *The Association of Global Custodians is an informal group of 12 financial institutions that provide securities safekeeping services and asset-servicing functions to primarily institutional cross-border investors worldwide. As a non-partisan advocacy organization, the Association represents members' common interests on regulatory and market structure matters through comment letters, white papers and interaction with legislative and regulatory authorities and financial industry organizations around the globe. The members of the Association of Global Custodians are: BNP Paribas; BNY Mellon; Brown Brothers Harriman & Co; Citibank, N.A.; Deutsche Bank; HSBC Securities Services; JP Morgan; Northern Trust; RBC Investor & Treasury Services; Skandinaviska Enskilda Banken; Standard Chartered Bank; and State Street Bank and Trust Company. For more information visit www.theagc.com.*

including custodian banks which have a key role to play in the success of Bond Connect as they have had with the two equity links with the Mainland.

However, a very key risk management component of the operating model was changed very late which has given rise to settlement and counterparty risk for our foreign institutional investor (FII) clients. An essential aspect of the model was that the Hong Kong Central Moneymarkets Unit (CMU) had in place for cash settlement omnibus accounts with the Shanghai Clearing House (SCH) and the China Central Depository & Clearing Co., Ltd (CCDC). Whereas an account is in place with SCH and operating, we now understand CCDC had not committed to the announced model and unfortunately this was only confirmed to market participants one day prior to the launch date. Instead payment is now to be made to the market maker's settlement bank. Investors will then be exposed to a different counterparty. This is where the settlement and counterparty risk arises, as securities are moving independently of cash. In this situation neither CMU nor CCDC has control over the cash settlement process to mitigate the counterparty/principal risk of this exchange-of-value settlement system for CMU participants and/or FII's with the market maker in China. A major concern is whether CMU participants will be able to recover the cash payment made to a counterparty if a Bond Connect transaction fails to settle.

Principle "12" of the "CPSS-IOSCO Principles for financial market infrastructures" White paper (published by Bank for International Settlements/ BIS and IOSCO, with HKMA/PBOC/CSRC as members of the Steering/Editorial team) requires Central Securities Depositories and exchange-of-value settlement systems, to eliminate principal risk by linking and conditioning the final settlement of one obligation upon the final settlement of the other.

FII's and their custodians which had readied themselves for the previously communicated operating model, were suddenly faced with having two different operating models when using Bond Connect. There was insufficient time for our member banks to communicate the revised settlement process to FII's prior to the launch of Bond Connect.

Furthermore, many major FII's who are subject to home country jurisdictional oversight as well as their own internal investment and compliance rules, may now be unable to participate in Bond Connect where CCDC is the depository due to the increased counterparty risk exposure.

It is assumed that Mainland laws on the establishment and operation of Bond Connect apply equally to both SCH and CCDC. However, whereas the SCH has not had any issue in opening an omnibus cash account for the CMU, the CCDC has.

The AGC, on behalf of our FII clients, would be most grateful if the Hong Kong Monetary Authority could take this matter up with the People's Bank of China as a matter of urgency.

AGC member banks and its clients had looked forward to the implementation of Bond Connect with enthusiasm as the opening-up of the Mainland bond market was seen as a major boost for both Hong Kong and the Mainland markets. We are sure it will be if the hurdle outlined in this letter can be overcome.

Thank you.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'R. Edwards', written over a horizontal line.

Robert Edwards, (as attorney in fact)
For and on behalf of Rudy Ingkiriwang
Chairman Asia Focus Committee,
The Association of Global Custodians