Swap Connect Series: China’s Interest Rate Derivatives Market

On February 17, 2023, the People's Bank of China (PBC) published a consultation draft of Interim Administrative Measures for the Interconnection and Cooperation in the Interest Rate Swap Markets between China’s Mainland and Hong Kong SAR.

Swap Connect is a new mutual access program between China’s Mainland and Hong Kong's interbank interest rate swap markets. It solves the challenge of hedging RMB interest rate risk, allowing global investors to better participate in the onshore derivatives market to hedge their interest rate exposures.

In its initial stage, Swap Connect will be open for “Northbound Trading” only, allowing Hong Kong and international investors to participate in China’s Mainland interbank interest rate swap market.

CICC FICC will continue to focus on the specific trading and settlement rules of the Swap Connect and launch a series of the introduction to China's interest rate derivatives market and the Swap Connect. The first episode will introduce China’s interest rate derivatives market.

I. China’s Interest Rate Derivatives Market

China's interest rate derivatives market has experienced more than a decade of development, and the products of interest rate derivatives have been constantly enriched and the transaction scale has grown rapidly.

In 2005, bond forwards were introduced in the interbank market, starting a new process of interest rate derivatives market development. Since then, interest rate swaps (IRS) and forward rate agreements (FRA) have been introduced one after another, with an increasing variety of products and a rapid growth in trading scale. In March 2020, interest rate options linked to LPR were introduced, and in March 2021, interest rate options linked to FDR001/FDR007 were further introduced. In the futures market, China Financial Futures Exchange (CFFEX) launched 5-year CGB futures in 2013, followed by 10-year and 2-year CGB futures in the following years. The trading mechanism was further enriched with the introduction of market maker system and future-to-spot transactions. At the same time, the types of market participants were expanded to allow pilot banks and insurance companies to participate in the CGB futures market.

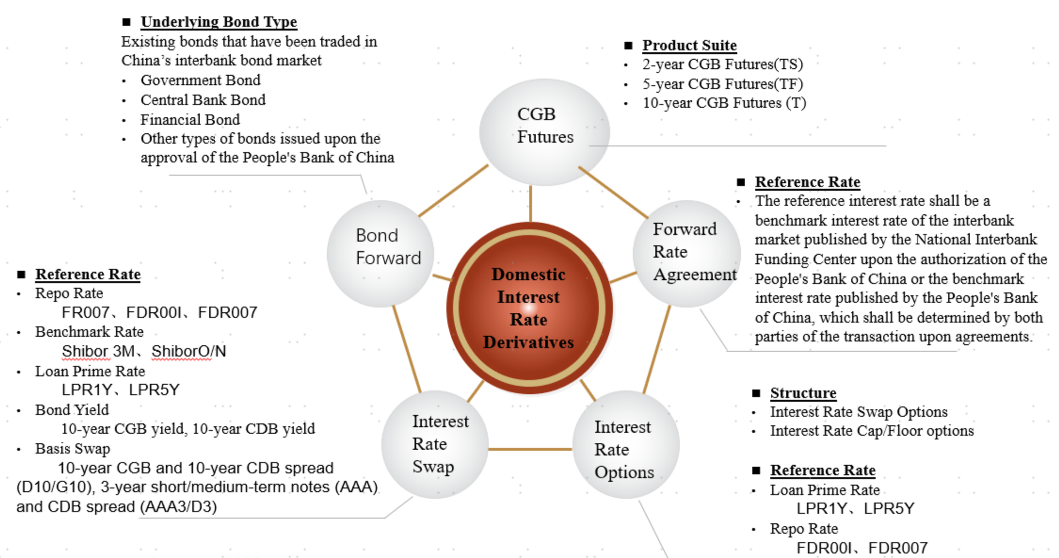
The development of China's interest rate derivatives market	
December 1992	The Shanghai Stock Exchange was the first to launch CGB futures trading on a pilot basis.
June 2005	The People's Bank of China issued the announcement "Provisions Governing the Forward Transactions of Bonds in the National Inter-bank Bond Market", which officially took effect on June 15, 2005, marking a new development of the interest rate derivatives market.
January 2006	The People's Bank of China issued the "Notice of the People's Bank of China about the Relevant Matters concerning the Pilots of RMB Interest Rate Swap Transaction". Subsequently, China Development Bank and Everbright Bank completed the first RMB 5 billion interest rate swap transaction.
November 2007	The People's Bank of China issued the announcement "Administrative Provisions on Forward Rate Agreement Business" and officially launched the forward rate agreement in November 2007.
January 2008	The People's Bank of China issued the "Notice of the People's Bank of China on Operating RMB Interest Rate Swap Business", and the RMB Interest Rate Swap business was officially launched.
October 2017	The short/medium-term notes (AAA) and CDB spread (AAA3/D3) and other 3 reference rates increased the diversity of interest rate swap market underlying.
March 2020	National Interbank Funding Center piloted interest rate options linked to LPR and related services since March 23, 2020. The main trading varieties are interest rate swap options linked to LPR1Y/LPR5Y, interest rate cap/floor options, and the option type is European option.
March 2021	National Interbank Funding Center listed interest rate swap options linked to FDR001 and FDR007 and interest rate cap/floor options.

Source: CICC

According to Wind, the Interbank RMB derivatives market traded a total of RMB 21.3 trillion in 2022, basically unchanged from 2021. In terms of interbank interest rate derivatives, the total notional principal amount of interest rate swaps was RMB 21.0 trillion. Standard bond forwards was traded for RMB 260 billion. In the futures market, CGB futures were traded for a total of RMB 46.4 trillion, up 68.7% year-on-year.

II. Major Interest Rate Derivatives in China

Currently, the RMB interest rate derivatives include bond forwards, interest rate swaps (IRS), forward rate agreements (FRA), CGB futures, standard bond forwards and interest rate options. Among them, IRS and CGB futures are the most dominant and actively traded interest rate derivatives.



Source: CICC

III. How financial institutions utilize interest rate derivatives

The trading price of interest rate derivatives reflects the behavior of various participants, including hedgers, arbitrageurs and speculators, etc. It contains expectations for future money market interest rates, bond market interest rates and the monetary policy, and has a substantial price discovery function.

Interest rate derivatives include three basic functions:

1. Risk Hedging

Hedging interest rate risk is the most basic function of interest rate derivatives. For bond investors, they can properly use derivatives to reduce the risk of interest rate fluctuations, thus locking in the holding period yield and to some extent avoiding the situation of selling bonds due to stop loss or liquidity needs.

2. Duration adjustment

Interest rate derivatives have the advantage of lower cost and higher flexibility and liquidity. For commercial banks and other institutions, interest rate derivatives can flexibly adjust the duration gap without significantly changing the asset and liability structure and effectively reduce costs.

3. Spot-market replacement

Through a combination of various types of interest rate derivatives, it is also possible to create a portfolio with specific yield and risk to achieve the same purpose of holding the underlying asset or participating in the spot market.