Derivatives Trading as an Outgrowth of Connect Programme

Keynote speech at ISDA Derivatives Trading Forum

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Honourable guests, ladies and gentlemen, good afternoon. It is my pleasure to speak at the ISDA Derivatives Trading Forum today.

Over the past decades, Hong Kong has risen as the premier global financial centre to facilitate the opening-up of Mainland markets to investors worldwide. As the Chinese economy sprints ahead and markets modernise, the city plays a pivotal role as an offshore fund-raising centre and a bridge enabling cross-border market access. Here in Hong Kong, investors and industry players alike are blessed with the free flow of capital, sound market infrastructure, the rule of law, effective regulation, as well as international standards and practices. For years, our premier platform has allowed global investors to share in the fruits of China's economic growth.

Today, I will speak to you about derivatives trading as an outgrowth of the Connect schemes. Let me first talk about the evolution of Mainland-Hong Kong mutual market access, before turning my focus to how greater connectivity underpins derivatives market developments.

A unique offshore fundraising centre

Hong Kong has a stellar track record in connecting Mainland firms with international investors. The city's stock market serves as an efficient fund-raising platform, and it has been agile enough to adapt to the changing times and emerging opportunities. For instance, we revised the listing rules in recent years to attract the listings of more Mainland firms, especially new-economy enterprises.

As a result, Mainland companies have become integral to the Hong Kong stock market, accounting for 77% of our market capitalisation and 88% of equity turnover. These represent a giant leap from 16% and 38% in 1997, respectively. This feat is unmatched by any other markets and demonstrates the confidence to leverage our platform to reform Mainland companies.

Expanding mutual market access through Connects

As the mother of all Connect schemes, Stock Connect has truly moved the needle. Its success has entrenched Hong Kong's unique role in the opening-up of Mainland markets.

Note: This is the text of the speech as drafted, which may differ from the delivered version.

Since its introduction in 2014, Stock Connect has become the major channel for global investors to directly access the Mainland's A-share market and for Mainland investors to easily tap into ours.

Northbound trading of Stock Connect has been active. The average daily turnover is now over RMB100 billion, equivalent to 70% of Hong Kong's equity turnover. International investors have increasingly leveraged the city's platform to tap into A-share market opportunities. Cumulative inflow into the A-share market has reached RMB1.9 trillion (or US$260 billion) since the launch of Stock Connect. We have seen an upward trend in A-share investing through Stock Connect over the past nine years.

For one thing, Stock Connect indeed blazed a trail. After its launch, the Connect family has continued to welcome new members that cover bonds, swaps, ETFs and wealth management products. In particular, Bond Connect was launched with northbound trading in 2017. It has been a huge success, as Mainland bond holdings by international investors tripled from RMB1 trillion in 2017 to more than RMB3 trillion currently.

This year, the Connect train has moved into new territory, that is, the derivatives market. We launched Swap Connect in May to enable global investors to trade onshore renminbi (RMB) interest rate swaps. Offshore investors holding Mainland bonds can use this to hedge RMB interest rate risks. As of end-June, 540 Mainland interbank interest rate swap contracts were traded under Swap Connect, with a gross notional amount of RMB129 billion, or a daily average of RMB3.9 billion. With this new milestone, we believe Hong Kong has further evolved as a one-stop shop for RMB investment and risk management.

Accessing Mainland markets through OTC derivatives market in Hong Kong

Now, let's move from Connect to what may interest you most, that is, the OTC derivatives market. Interestingly, the launch of various Connect schemes has driven the growth of Hong Kong's derivatives market. This is an outgrowth that the architects of Stock Connect may not have foreseen. I will highlight two developments in this regard:

First, Stock Connect has catalysed the growth of Hong Kong's OTC derivatives market. With Stock Connect, investment banks can more efficiently manage the risks from their OTC derivatives transactions with counterparties. This allows international investors to gain exposure to the A-share market through OTC derivatives transactions on Mainland equities.

Both the depth and breadth of the OTC derivatives market in Hong Kong have increased thanks to Stock Connect. Currently, about 1,200 counterparties trade OTC derivatives products on A shares, including asset managers, hedge funds and other financial institutions. Equity swaps account for the majority of OTC derivatives transactions on A shares, followed by Contract for Differences and options. The product types for OTC derivatives transactions on A shares were relatively uniform and simple. Investors use them as a cost-effective means to gain A-share market exposure.

An analysis of northbound capital flow data will provide more insights into the impact of Connect on derivatives transactions. Northbound capital flows now mainly comprise two parts: first, investment from overseas long-term investors, and second, rebalancing of A-share portfolios held by investment banks for hedging their OTC derivatives transactions on A shares. We noted that the outstanding notional value of OTC derivatives on A shares is now about 60% of the northbound cumulative net buy since the launch of Stock Connect. The two numbers have grown largely in sync. So, clearly, Stock Connect delivers a win-win situation: it enables global investors to share in Mainland China's growth story on one hand, and also powers the growth of our OTC derivatives market on the other.

Better still, we believe strong growth potential lies ahead. By our estimation, the gross notional value of OTC derivatives on A shares is about 1.5% of the A-share market capitalisation. This is far lower than the 9-14% for major developed markets and implies ample headroom.

Managing risks with derivatives products in Hong Kong

Let me now talk about the second development. Overseas investors have now accumulated substantial amounts of Mainland investments through various Connect schemes, so their demand for risk management tools has surged.

To meet this demand, we delivered a key product in 2021, that is, the MSCI China A50 Connect Index futures (or A50 futures). As a complement to Stock Connect, A50 futures provides an effective tool to manage risks of A-share exposure and has since become a major Mainland-related derivatives product in the Hong Kong market.

As part of our long-term strategy to reinforce the Connect schemes and expand market access, we are pulling our weight to launch more Mainland-related derivatives, to build on the success of A50 futures. The China Securities Regulatory Commission has recently expressed support for the launch of an A50 options contract in Hong Kong. With a lot of preparations done, we believe the options contract can supplement the existing futures contract and enable market participants to implement more tailored trading and hedging strategies. This may also encourage more A-share based investment products to be issued and therefore boost ecosystem vibrancy. Besides, a broader suite of offshore hedging tools may increase investors' participation in the A-share market.

In the fixed income market, you may be aware that the Mainland authorities support the launch of Treasury bond (T-bond) futures in Hong Kong. T-bond futures will complement Swap Connect as another effective offshore risk management tool and further encourage foreign investors to participate in the Mainland bond market. We hope to bring you the good news soon for both A50 options contract and T-bond futures.

Let's not forget the Connect train goes both ways. Southbound investors are also showing keener demand for tools to manage risks in the Hong Kong market. They currently hold HK$2.7 trillion worth of Hong Kong stocks, but hedging tools available to them are relatively limited. With the right hedging tools during high market volatility, investors could avoid big losses from unwinding positions. Therefore, it is one of our priorities to develop suitable hedging tools with Mainland authorities to meet the needs of southbound investors.

Why not a Futures Connect?

So now, you may ask: with so many Connects in Hong Kong, why don't we have a Futures Connect? My answer is that, compared with other products, the regulatory and trading requirements on futures are more different between the Mainland and Hong Kong markets. So, it is not straightforward to set out a Futures Connect model acceptable to both the

Mainland authorities and overseas investors in the immediate future. In addition, capital flows under Futures Connect could be tremendous if trading activities or the demand for margin calls suddenly surge in times of high volatility. We will examine these issues closely in further discussions and welcome your views.

Based on other markets' experience, the listing of foreign futures contracts in a local marketplace is straightforward and does not require infrastructural linkage to the home market. Trading and settlement of futures contracts can also follow the host market's rules and practices. A case in point is the A50 futures in Hong Kong. The SFC will continue to work with all stakeholders to explore ways to enhance Hong Kong's derivatives product offering and strengthen its role as a risk management centre.

RMB bond as collateral

Apart from broadening our derivatives product range, let's not lose sight of other important infrastructural issues. Collateral management for derivatives is one of these, and we are discussing with Hong Kong Exchanges and Clearing Limited (HKEX) on how to enhance it. I noticed one of the panel discussions today will be about the Mainland markets' journey to collateralisation, with a focus on using RMB bonds as collateral. This is timely given the rising interest rates and growing RMB bond holdings by global investors. I'm confident the discussion will crystalise our ways to improve market efficiency in accepting non-cash collateral, particularly RMB bonds, as initial margin from clearing participants.

Closing remarks

On a final note, let me emphasise Hong Kong always keeps its door open to the world. This hasn't changed and will not change in the years to come. Global investors are welcome as ever to participate in the local and Mainland markets, and take advantage of our expanding Connect services and provision of a variety of risk management tools. As the saying goes, "coming together is a beginning; keeping together is progress; working together is success". We look forward to closer collaboration with ISDA and the industry to further develop Hong Kong as a leading financial centre and contribute to Mainland markets' opening-up.

I wish today's forum a great success. Thank you very much.