

CHINA BANKING REGULATORY COMMISSION

Provisional Measures on the Business Management of Derivative Product Transactions of Financial Institutions

(China Banking Regulatory Commission No. 1 Decree of 2004 for issuance and implementation; revised from “Decision Regarding the Revision of ‘Provisional Measures on the Business Management of Derivative Product Transactions of Financial Institutions’” of the 55th Chair’s Meeting of the China Banking Regulatory Commission on December 28, 2006)

Section 1. General Provisions

Article 1. These measures have been formulated based on the “Banking Regulation Law of the People’s Republic of China” and the “Commercial Banking Law of the People’s Republic of China” to undertake standardized management of the derivative product transactions of financial institutions and effectively control the risk of derivative product transactions carried out by financial institutions.

Article 2. In these measures, “financial institutions” refers to banks, trust companies, finance companies, financial leasing companies, and automobile financing company persons legally established within the People’s Republic of China and Chinese branches of foreign banks (“Branches of Foreign Banks”).

Article 3. In these measures, “derivative products” are a type of financial

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contract whose value is determined by one or more underlying assets or indicators. The basic types of these contracts include forwards, futures, swaps, and options. Derivative products also include structured financial instruments with one or more features of forwards, futures, swaps, and options.

Article 4. In these measures, the derivative product transaction business of financial institutions can be divided into two types:

1. Derivative product transactions undertaken by financial institutions to avoid risk of their own assets and liabilities or for profit making. When financial institutions engage in this type of business, they are considered the end users of the derivative product.

2. Derivative product transaction services provided by financial institutions to clients (including financial institutions). When financial institutions engage in this type of business, they are considered traders of derivative products, and those who can provide derivative product quoting and transaction services for other traders and clients are considered derivative product market makers.

Article 5. The China Banking Regulatory Commission is a supervisory organization for financial institutions engaged in the business of derivative product transactions. Financial institutions starting the business of derivative product transactions must obtain approval from the China Banking Regulatory Commission and must accept the supervision and inspections of the China Banking Regulatory Commission.

Financial institutions that obtain qualifications to start the business of derivative product transactions must engage in business activities that correspond to their own ability for risk management. Before making their first offering of complex derivative product transactions within China, financial institutions must submit the relevant materials to the supervisory authorities and solicit their written opinions.

Article 6. Financial institutions engaging in derivative product transactions related to foreign exchange, stocks, and commodities and exchange-traded derivative product transactions must follow national regulations on foreign exchange management and other related regulations.

Section 2. Market Access Management

Article 7. Financial institutions applying to start the business of derivative product transactions must meet the following conditions:

1. have a sound risk management system and internal control system for derivative product transactions;

2. have a perfect business processing system that automatically connects the front, middle, and back offices for derivative product transactions and a real-time risk management system;

3. have managers of derivative product transactions with at least five years of experience in direct participation in derivative transaction activities and risk management and a good record;

4. have at least two traders with at least two years of experience dealing with derivative products or related transactions and at least half a year of specialized training in trading techniques for related derivative products, at least one related risk manager, and at least one risk model researcher or risk analyst; the aforementioned personnel must be assigned to individual posts, their duties may not overlap, and they must have good records;

5. have suitable trading sites and equipment;

6. Branches of Foreign Banks applying to start the business of derivative product transactions must obtain official authorization from their headquarters (regional headquarters), their parent country must have a legal framework for supervising the business of derivative product transactions, and the supervisory authorities in their parent country must have the corresponding supervisory capacity;

7. Other conditions provided by the China Banking Regulatory Commission.

Branches of Foreign Banks applying to start the business of derivative product transactions must meet the above listed conditions. If they do not meet the above conditions (1) through (5), their headquarters (regional headquarters) must meet the above conditions, and the branch must also meet above conditions (6) and (7) as well as the following conditions:

1. Official authorizations from the headquarters (regional headquarters) of said branches for engaging in derivative product transactions must clearly state the transaction types and limits involved.

2. Unless otherwise clearly stipulated by headquarters, all derivative product transactions of said branches are to be uniformly traded in real time on the systems of the authorizing headquarters (regional headquarters), and the headquarters (regional headquarters) are to carry out centralized square-off trading, exposure management, and risk control.

Article 8. Policy banks and Chinese-invested commercial banks (not including urban commercial banks, rural commercial banks, and rural cooperative banks) starting the business of derivative product transactions must uniformly apply to the China Banking Regulatory Commission through their person legally designated for examination and approval.

Trust companies, finance companies, financial leasing companies, and automobile financing companies starting the business of derivative product transactions must uniformly submit their applications and materials to their local banking regulatory bureaus through their person legally designated

and, upon examination and consent, report to the China Banking Regulatory Commission for examination and approval.

Urban commercial banks, rural commercial banks, and rural cooperative banks starting the business of derivative product transactions must uniformly submit their applications and materials to their local banking regulatory bureaus through their person legally designated and, upon examination and consent, report to the China Banking Regulatory Commission for examination and approval.

Operating institutions of foreign banks starting the business of derivative product transactions must submit their application materials signed by an authorized signatory to their local banking regulatory bureaus and, after examination and consent, report to the China Banking Regulatory Commission for examination and approval. Foreign banks planning to have at least two branches within China starting the business of derivative product transactions may uniformly submit their application materials to the local banking regulatory bureau from their foreign-invested person legally designated to institution headquarters or foreign bank main reporting branch and, upon examination and consent, report to the China Banking Regulatory Commission for examination and approval.

Article 9. Financial institutions applying to start the business of derivative product transactions must submit the following documents and materials (in triplicate) to the China Banking Regulatory Commission:

1. application to start the business of derivative product transactions, feasibility report, and business plan or trading development plan;
2. system of internal management rules for the business of derivative product transactions;
3. accounting system for derivative product transactions;
4. list of names and resumes of managers and main transaction personnel;
5. an authorization management system for risk exposure quantization or limits;
6. safety test reports for trading sites, equipment, and systems;
7. other documents and materials required by the China Banking Regulatory Commission.

In addition to the aforementioned documents and materials that must be submitted to their headquarters (regional headquarters), Branches of Foreign Banks applying to start the business of derivative product transactions that do not meet conditions (1) through (5) of Article 7 must also submit the following documents to their local banking regulatory bureaus:

1. official written authorization documents from headquarters (regional headquarters) for the types and limits of derivative product transactions undertaken by the branch;

2. unless otherwise clearly stipulated by headquarters (regional headquarters), a letter of commitment issued by headquarters (regional headquarters) ensuring that all the branch's derivative product transactions are carried out in real time on the trading system of the authorizing headquarters (regional headquarters) and that headquarters (regional headquarters) is responsible for square-off trading and exposure management and risk control.

Article 10. The accounting systems for derivative product transactions submitted by financial institutions must conform to relevant Chinese accounting standards. If there are no relevant Chinese standards, they must conform to relevant international standards. Branches of Foreign Banks may follow the accounting standards of their parent country/bank.

Article 11. In principle, safety test reports for trading sites, equipment, and systems provided by financial institutions as stipulated in these measures must be safety test reports for trading sites, equipment, and systems issued by third parties.

Article 12. Internal management rule systems of financial institutions starting the business of derivative product transactions must at least include the following contents:

1. guiding principles for the business of derivative product transactions, business operating rules (business operating rules must embody the principle of separation of transactions in front, middle, and back offices), and emergency response plans;

2. risk model indicators and quantification management indicators for derivative product transactions;

3. transaction types and the risk control system;

4. risk reporting system and internal auditing system;

5. research and development management system and ex post evaluation system;

6. code of conduct for traders;

7. professional responsibility system for transaction managers and accountability system and incentive and restraint mechanism for managers and traders at all levels;

8. training plan for front, middle, and back office managers and employees;

9. other content stipulated by the China Banking Regulatory Commission.

Article 13. The China Banking Regulatory Commission must issue an official reply within sixty days of receiving all the application materials submitted by financial institutions in accordance with these measures.

Article 14. The financial institution person legally in China who authorizes his or her branch organizations to undertake the business of derivative product transactions must rigorously examine risk management capacity and issue

official written authorization documents for relevant transaction types and limits; subbranch organizations undertaking the business of derivative product transactions must uniformly carry out real-time trades on their headquarters' (regional headquarters) system, and their headquarters (regional headquarters) must uniformly carry out square-off trades, exposure management, and risk control.

The aforementioned branch organizations must bring their authorization documents from their headquarters (department) to the local banking regulatory bureau within thirty days of receiving authorization from their headquarters (department) and when there are changes in authorization.

Section 3. Risk Management

Article 15. Financial institutions must determine whether they can engage in derivative product transactions and the types and sizes of the derivative product transactions to undertake based on their own operating targets, capital strength, management abilities, and derivative product risk characteristics.

Article 16. Financial institutions must establish a risk management system, internal control system, and business processing system that corresponds to the nature, size, and degree of complexity of the derivative product transaction business they are conducting based on the types of derivative product transaction business listed in Article 4.

Article 17. Boards of directors of financial institutions must evaluate their current derivative product management policies and procedures at least once a year to ensure that they are consistent with their institution's capital strength and management level. When there are frequent new product offerings or major system changes, they must increase the frequency of the evaluations.

Article 18. Senior management of financial institutions must understand the risk of the derivative product transactions undertaken; examine, approve, and evaluate frameworks that incorporate the principles, procedures, organization, and authorities of the operation and risk management of their derivative product transaction business; and obtain information related to the risk status of derivative product transactions at any time through independent risk management departments and perfect inspection and reporting systems, and on this foundation perform the relevant supervision and guidance.

Article 19. The senior management of financial institutions must determine the indicators and methods that correspond to their institution's business to be used in measuring and calculating the risk exposure of derivative product transactions and, based on their institution's overall strength, equity capital, profit-making ability, business orientation, and market risk forecasts, formulate and periodically review and update risk exposure limits, stop-loss limits, and

emergency plans for derivative product transactions and formulate procedures for supervising and handling the limits.

The senior management of financial institutions responsible for the risk management and control of derivative product business must be separate from the senior management responsible for the trading or marketing of derivative products, and their duties may not overlap.

Article 20. Risk measurement, monitoring, and control personnel of financial institutions must be separate from personnel engaged in derivative product transactions or marketing, and their duties may not overlap; risk management, monitoring, and control personnel may directly report on risk status to senior management.

Article 21. Financial institutions must establish and strictly implement authorization and stop-loss systems. When undertaking derivative product transactions, financial institutions must strictly implement their authorization level and exposure management systems, and any major transactions or new derivative product business must be approved by the board of directors or have the consent of senior management designated by the board of directors. When floating losses occur in the books due to market changes or decision errors, the stop-loss system must be strictly implemented.

Article 22. Financial institutions must formulate clear qualification determination standards for employees such as traders and analysts and train sales personnel and other relevant employees based on the complexity of the derivative product transactions and risk management to ensure they have the necessary technical abilities and qualifications.

Article 23. Financial institutions must formulate relevant policies to evaluate the appropriateness of counterparties. This includes evaluating whether the counterparties fully understand the contract terms and carry out their contract responsibilities, identifying whether planned derivative transactions conform to the counterparty's own objectives for undertaking the derivative transaction, and evaluating the counterparty's credit risk.

For high-risk derivative product transactions, financial institutions must make special rules for the qualifications and conditions of counterparties.

When carrying out the requirements of this article, financial institutions can reasonably rely on the official written documents provided by the counterparties based on the principle of good faith.

Article 24. Financial institutions that handle derivative product transactions for organizations and individuals in China must fully disclose the risk of such derivative product transactions to said organizations or individuals and obtain letters of confirmation from said organizations or individuals to confirm that they understand and are capable of bearing the risk of the derivative product transactions.

The information disclosed by the financial institutions to the organizations or individuals must at least include:

1. the content of the derivative product contract and summary of the inherent risks;

2. important factors affecting the potential losses of the derivative product.

Article 25. Financial institutions must suitably and reasonably make use of various measures such as guarantees to mitigate credit risk and reduce the credit risk of counterparties, select suitable methods and models for evaluating credit risk, and adopt corresponding risk control measures.

Article 26. Financial institutions must use suitable risk evaluation methods or models to evaluate the market risk of derivative product transactions, manage market risk, and make adjustments in transaction sizes, types, and risk exposure levels based on market prices.

Article 27. Financial institutions must make adequate liquidity arrangements based on the sizes and types of derivative product transactions to ensure that they are sufficiently capable of performing their contracts during abnormal market trading conditions.

Article 28. Financial institutions must establish a sound mechanism and system for controlling operational risk to strictly control their operational risk.

Article 29. Financial institutions must make written confirmation of the authority limits and responsibilities of derivative product managers and traders, strictly implement accountability systems, and have a clear punishment system for traders (and their managers) who violate their authorization or regulations during trading activities.

Article 30. Financial institutions must formulate reasonable cost and capital analysis and measurement systems and incentive and restraint mechanisms, and must not simply link the salaries of derivative product transaction and risk management personnel with profits from derivative product transactions to avoid increased transaction risk as a result of excessive profit seeking.

Article 31. Financial institutions must implement scheduled post rotations and mandatory paid leave for derivative product managers and traders.

Article 32. Financial institutions must establish sound mechanisms and systems for controlling legal risk and rigorously investigate the legal status and trading qualifications of counterparties. When financial institutions sign derivative product transaction contracts with counterparties, they must refer to international practices, sufficiently consider factors such as the actionability of recourse and preservation by legal means adopted after a default, and adopt effective measures to guard against legal risk during the process of drafting, negotiating, and signing transaction contracts.

Article 33. Financial institutions must follow China Banking Regulatory

Commission regulations in reporting accounting and statistical forms and other reports related to derivative product transactions to the China Banking Regulatory Commission.

Financial institutions must follow China Banking Regulatory Commission regulations on information disclosure and disclose the risk status, loss status, changes in profit, and abnormal situations for the derivative product transactions they engage in.

Article 34. Internal auditing departments of financial institutions must periodically investigate the implementation status of risk management systems for the business of derivative product transactions. When major risks occur in the business of derivative product transactions, they must rapidly adopt effective measures to stop the losses from continuing to grow and promptly make a report on the situation to their supervisory organizations.

Article 35. The China Banking Regulatory Commission has the right to inspect materials and reports of financial institutions related to the business of derivative product transactions at any time and make scheduled inspections to determine whether the financial institution's risk management system, internal control system, and business processing system are suitable for the types of derivative product transactions being conducted.

Article 36. When major business risk or major business losses occur in the derivative product transactions conducted by financial institutions, the institutions must promptly report to the China Banking Regulatory Commission and submit the measures being taken.

When there are major changes in a financial institution's derivative product transactions, operating system, and risk management system, they must promptly report the specific situation to the China Banking Regulatory Commission.

When there are changes in the authorization of a foreign bank branch ordered by its overseas headquarters (regional headquarters), the branch must promptly report to the China Banking Regulatory Commission.

Article 37. Financial institutions must properly store all transaction records and transaction-related materials such as documents, accounts, original receipts, and telephone recordings for their derivative product transactions. Telephone recordings must be stored for at least half a year, and other materials must be stored for three years after the transaction contract expires to be available for examination unless otherwise specially required by the accounting system.

Section 4. Penalty Provisions

Article 38. If the operations of derivative product traders of financial institutions violate these measures and the relevant rules of their institution, resulting

in major economic losses for the institution or client, said financial institutions must take disciplinary action ranging from making a record of misconduct to dismissal for senior managers directly responsible, other managers directly responsible for said item of business, and personnel directly responsible; if the actions constitute a crime, the case is to be handed over to the judicial authorities and is subject to criminal prosecution.

Article 39. Financial institutions that start the business of derivative product transactions without approval are to be penalized by the China Banking Regulatory Commission as stipulated in the “Measures for Penalizing Illegal Financial Conduct.”

Article 40. Financial institutions that do not report the relevant reporting tables and materials and disclose the status of derivative product transactions as required by these measures and the China Banking Regulatory Commission are to be penalized by the China Banking Regulatory Commission based on the nature of the financial institution in accordance with the respective laws, regulations, and financial rules of “Banking Regulation Law of the People’s Republic of China,” “Commercial Banking Law of the People’s Republic of China,” and “Administrative Measures for Foreign Banks of the People’s Republic of China.”

Financial institutions that provide derivative product transaction information that is false or omits material facts are to be penalized by the China Banking Regulatory Commission as stipulated in “Measures for Penalizing Illegal Financial Conduct.”

Article 41. If the China Banking Regulatory Commission discovers that a financial institution cannot effectively implement the risk management and internal control systems needed for the derivative product transactions they are conducting, they may suspend or terminate the institution’s qualifications to conduct derivative product transactions.

Section 5. Supplementary Provisions

Article 42. The China Banking Regulatory Commission is responsible for interpreting these measures.

Article 43. These measures are effective as of March 1, 2004. If there are conflicts between relevant regulations for derivative product transactions of financial institutions previously issued and these measures, these measures have priority.

If there are other laws or administrative regulations that cover the content of these measures, said laws or regulations have priority.

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