



HONG KONG MONETARY AUTHORITY
香港金融管理局

21 June 2019

The Chief Executive
All Hong Kong Settlement Banks

Dear Sir / Madam,

Currency Conversion Arrangement Involving Onshore RMB under Northbound Stock Connect

As you may be aware, the People's Bank of China (PBoC) issued a notice in May 2018 approving in principle the enhancement of the currency conversion arrangement under the Northbound Stock Connect¹. In the light of several rounds of market feedback and discussions with the PBoC, I write to provide guidance for banks in providing the relevant service.

Background

The PBoC Notice stipulated that overseas investors will be allowed to use offshore RMB (CNH) or foreign currencies to invest under Northbound Stock Connect. Those who use foreign currencies for investment may, through eligible brokers (see definitions below), conduct currency conversion (RMB/FX) or foreign exchange hedging with one of the designated settlement banks (referred to as “**CNY Conversion Service**” hereafter). The said banks may square their positions arising from the CNY Conversion Service in the onshore interbank foreign exchange market in accordance with the relevant PBoC rules and regulations.

Scope

Banks that can offer the CNY Conversion Service include the RMB Clearing Bank and overseas RMB participating banks in Hong Kong which have been approved by the PBoC to take part in the onshore interbank foreign exchange market (Collectively referred to as “**Hong Kong Settlement Banks**”). They must concurrently be the banks that execute the related money settlement of the Northbound Stock Connect transactions with the Hong Kong Securities Clearing Company (HKSCC).

¹ See Notice of the General Office of PBoC (Yinbanfa [2018] No. 96):
<http://www.pbc.gov.cn/zhengwugongkai/127924/128038/128109/3541005/2018051815570080622.pdf>

Hong Kong Settlement Banks shall only provide CNY Conversion Service to Exchange Participants of the Stock Exchange of Hong Kong (SEHK) and/or Clearing Participants of the HKSCC which are eligible to participate in the Northbound Stock Connect (collectively referred to as “**Eligible Brokers**”). Investors under the Northbound Stock Connect obtain access to the CNY Conversion Service indirectly through these Eligible Brokers.

Principle

In providing the CNY Conversion Service, the Hong Kong Settlement Banks should ensure that the currency conversion and foreign exchange hedging transactions arise from genuine and reasonable need from Stock Connect investments. In order to ensure continued access to the onshore interbank foreign exchange market, the Hong Kong Settlement Banks should ensure continued compliance with the relevant Mainland regulations, and have proper internal control in place to ascertain:

- i. the genuineness of the Eligible Brokers using the CNY Conversion Service;
- ii. the genuineness and reasonableness of the Stock Connect investments underpinning the currency conversion and foreign exchange hedging transactions; and
- iii. Eligible Brokers who convert foreign currencies into CNY for Northbound Stock Connect investments should in principle convert the proceeds back into foreign currencies when they exit the investments and withdraw the funds from the Hong Kong Settlement Banks.

Expectations

To facilitate the control and monitoring work by the Hong Kong Settlement Banks, expectations in implementing the “genuineness and reasonableness” checking are set out in the following –

- i. Closed-loop Fund Flow: The Hong Kong Settlement Banks shall only provide CNY Conversion Service to the Eligible Brokers. Each Eligible Broker must engage the same bank for both the CNY Conversion Service and the related money settlement with the HKSCC for Northbound Stock Connect trading, as the relevant PBoC regulation stipulates². According to the current requirement of the HKSCC, each Eligible Broker may only engage one bank for money settlement of Stock Connect trades, i.e., effectively, the Eligible Broker may only engage the same bank for CNY Conversion Service. The Hong Kong Settlement Banks should ring-fence the account

² See Notice of the PBoC (Yinfa [2018] No. 159):
<http://www.pbc.gov.cn/tiaofasi/144941/3581332/3730217/2018122910542929730.pdf>

under each Eligible Broker so that they can be properly monitored and so that the funds in the accounts are only used for settlement of Stock Connect trades with the HKSCC.

- ii. Aggregate Level Monitoring: It is not a requirement for the Hong Kong Settlement Banks to monitor and match, on a deal-by-deal basis, individual Stock Connect trades with the corresponding conversion and foreign exchange hedging transactions under the CNY Conversion Service.

For currency conversion, the Hong Kong Settlement Banks are expected to monitor over a period of time the net amount of conversion with the Eligible Brokers on one hand, and the net amount of Stock Connect money settlements conducted on behalf of those Eligible Brokers on the other. The two figures should reasonably match over a period of time.

For foreign exchange hedging, the Hong Kong Settlement Banks are expected to monitor over a period of time the notional value of the outstanding hedging instruments held by the Eligible Brokers on one hand, and the Stock Connect holdings by those Eligible Brokers on the other. The two figures should reasonably match over a period of time.

- iii. Ex Post Monitoring and Record Keeping: It may not be feasible in some cases to carry out ex ante checking on each transaction under the CNY Conversion Service (e.g. pre-funding needs). Nevertheless, it is expected that the Hong Kong Settlement Banks shall keep proper record of transactions under the CNY Conversion Service for each Eligible Broker and obtain its trading and holding data under the Northbound Stock Connect where necessary. The Hong Kong Settlement Banks are expected to, on an ex post basis, monitor and identify irregularities³ in respect of each Eligible Broker and furnish the relevant information when called upon by the authorities. Should there be misuse of the CNY Conversion Service for purposes other than conducting/hedging Stock Connect investments, the cases should be reported to the HKMA and the PBoC as appropriate.

For more detailed guidance, please refer to the FAQ in [Annex 1](#).

Modus Operandi

The operating model for the Hong Kong Settlement Banks in providing the CNY Conversion Service under Stock Connect is set out in [Annex 2](#) for reference.

³ For example, the net buy of CNY by an Eligible Broker far exceeds the aggregate net Stock Connect settlement by that Eligible Broker for an extended period of time.

Quarterly Tally

The Hong Kong Settlement Banks are required to produce and submit to the HKMA at the end of each quarter (a) the net amount of CNY conversions conducted by the Bank with the Eligible Brokers; and (b) the net amount of Stock Connect money settlements made on behalf of the Eligible Brokers using the CNY Conversion Service. In the case of foreign exchange hedging, the Hong Kong Settlement Banks should produce and submit (a) the notional value of outstanding hedging tools provided to the Eligible Brokers; and (b) the underlying Stock Connect holdings of the Eligible Brokers⁴. A data template will be provided to you separately. For avoidance of doubt, it is not a requirement for the Hong Kong Settlement Banks to differentiate the CNH and CNY funding in dealing with the Eligible Brokers.

Way Forward

Please nominate a staff member as the contact person in your bank for further communication with the HKMA on related matters. The Hong Kong Settlement Banks may start to provide the CNY Conversion Service after they have the necessary control and system in place to discharge the abovementioned requirements.

Should you have any question, please contact Mr Edmund Lee at +852 2878 1239 or Ms Jacqueline Zhang at +852 2878 1428.

Yours faithfully,

Eddie Yue
For Monetary Authority

Encl.

⁴ For avoidance of doubt, the Hong Kong Settlement Banks should report all the underlying Stock Connect holdings of relevant Eligible Brokers, regardless of whether they were originally transacted using CNH or foreign currencies.

Frequently asked questions in relation to the responsibilities of Hong Kong Settlement Banks in providing currency conversion under Northbound Stock Connect

Q1.	Should pre-existing holding and trading positions of the Eligible Brokers be taken into account in the monitoring by the Hong Kong Settlement Banks?
A1.	The Hong Kong Settlement Banks should take into account transactions of the Eligible Brokers starting from the date when they provide the CNY Conversion Service.
Q2.	Do the Hong Kong Settlement Banks need to monitor the CNH fund flows of the Eligible Brokers?
A2.	It is not a requirement per se for the Hong Kong Settlement Banks to monitor the CNH fund flows of the Eligible Brokers. However, the Banks should be able to differentiate the CNY and CNH fund flows so that they can effectively carry out the monitoring requirement for the CNY Conversion Service. It should be noted that the Banks are also responsible for money settlement of Stock Connect transactions for the Eligible Brokers, be it in CNY (converted from foreign currencies by the Banks) or CNH.
Q3.	What is the yardstick in carrying out aggregate level monitoring of the Eligible Brokers' activities?
A3.	For currency conversion, the Hong Kong Settlement Banks should look at the net amount of CNY an Eligible Broker has converted (for avoidance of doubt, they should also look at the relevant hedging activities that have a similar effect as buying CNY, such as using FX or currency swaps) and the net amount of Stock Connect settlement made on behalf of that Eligible Broker to HKSCC. In principle, these two figures should largely match over a period of time. Should there be significant deviation, the Banks should request the relevant Eligible Brokers to provide explanation. The Banks should exercise judgment whether explanation is satisfactory. Should there be consistent and significant mismatch of conversion and settlement figures over multiple quarters without satisfactory explanation, the cases should be reported to the HKMA and the PBoC as appropriate.

	For foreign exchange hedging, the Hong Kong Settlement Banks should look at the notional value of the outstanding hedging instruments held by the Eligible Brokers, and the Stock Connect holdings by those Eligible Brokers. The Banks should obtain from the Eligible Brokers the stock holding figures regularly for this purpose. In principle, Eligible Brokers should not have an open position in FX hedging unreasonably larger than their stock holdings under Stock Connect.
Q4.	Should the Hong Kong Settlement Banks open new and designated accounts for Eligible Brokers in order to carry out the ring-fencing requirement?
A4.	The Hong Kong Settlement Banks are expected to put in place proper bookkeeping arrangements, including but not limited to opening a designated account for each Eligible Broker for the purpose of holding the CNY and settling the related Stock Connect transactions.
Q5.	How to implement the requirement that the Eligible Brokers should convert funds back into foreign currencies when they exit the investments?
A5.	A proportionate amount of funds that had been converted into CNY from foreign currencies should be converted back into foreign currencies when withdrawn by an Eligible Broker from a Hong Kong Settlement Bank. The amount of funds to be converted back into foreign currencies can be determined by the proportion of CNY and CNH funding used by the Eligible Brokers in settlement of stock purchases (please refer to A2). While it is not a requirement per se to differentiate the CNY and CNH funding for each stock trade on a deal-by-deal basis, the Hong Kong Settlement Banks should ensure that at an aggregate level the net CNY conversion amount and net amount of stock settlement reasonably match with each other over a period of time. By the same token, for foreign currency hedging, any open position should be closed as soon as practicable when an Eligible Broker liquidates its stock holdings.
Q6.	Can the Hong Kong Settlement Banks rely on a “signed declaration” from an Eligible Broker to conclude the genuineness and reasonableness of a transaction? For currency conversion transactions

	conducted under Standing Instruction, can Hong Kong Settlement Banks depend on a one-off “signed declaration”?
A6.	In addition to the requirements set out in this FAQ and the circular dated 21 June 2019, the Hong Kong Settlement Banks may ask the Eligible Brokers to declare the purpose and use of the CNY funds so converted as an extra safeguard to ensure the “genuineness and reasonableness” requirement is satisfied. Subject to that, it is at the Hong Kong Settlement Banks’ discretion to decide the format and frequency of such declaration.
Q7.	May Hong Kong Settlement Banks enter into currency conversion contracts with end investors directly?
A7.	Investors should obtain the CNY Conversion Service via their brokers, which, in the context of this circular, refer to the Eligible Brokers.
Q8.	Can investors hedge Stock Connect investments made in CNH at the CNY rate or use CNH to settle CNY-denominated derivatives contracts?
A8.	A Hong Kong Settlement Bank may offer the Eligible Brokers hedging service for their Stock Connect holdings that are settled by the Bank itself. Please refer to A3 on the monitoring requirement for the Banks on foreign exchange hedging, i.e. that the open position in foreign currency hedging of an Eligible Broker should reasonably match with its underlining stock holdings at an aggregate level. There is no requirement other than that.

Annex 2: Operating Model under Stock Connect

- Currency conversion
- Hedging
- Remittance
- Bank's funding source

