CHINA Insights

OCBC Bank

Bye foreign debt quota, hello foreign debt limit

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Highlights:

- **Effective from today, the foreign debt quota system will withdraw from the historical stage.**
- **All China incorporated enterprises (excluding government funding vehicles and real estate company) and financial institutions are allowed to borrow RMB or foreign currency from offshore market under new foreign debt limit in place of existing foreign debt quota.**
- **The new foreign debt limit will be subject to weighted risk balance limit which depends on borrower's core capital (for financial institutions) or net assets (for enterprises).**
- **The impact on banks' cross border business is mixed given the risk ratio for off balance sheet financing was increased to 1. We see five implications from the new MPA rules.**

Corporate FX & Structured Products
Tel: 6349-1888 / 1881

Fixed Income & Structured Products
Tel: 6349-1810

Investments & Structured Product
Tel: 6349-1886

Interest Rate Derivatives
Tel: 6349-1899

Treasury Research & Strategy
Tel: 6530-4887

Tommy Xie Dongming

+(65) 6530 7256

xied@ocbc.com

PBoC announced to expand its pilot program for Macro Prudential Management of cross border financing in four free trade zones, launched on 25 January 2016 to nationwide. With effective from 3 May 2016, the foreign debt quota system will withdraw from the historical stage.

All China incorporated enterprises (excluding government funding vehicles and real estate company) and financial institutions are allowed to borrow RMB or foreign currency from offshore market under new foreign debt limit in place of existing foreign debt quota.

The new foreign debt limit will be subject to weighted risk balance limit which depends on borrower's core capital (for financial institutions) or net assets (for enterprises). The formula for weighted risk limit is: core capital (bank) or net asset (enterprise) * financing leverage ratio *macro prudential raito.

For each cross border financing, the weighted risk balance will be calculated and the sum of weighted risk balance should not be higher than weighted risk limit. The formula for weighted risk balance is Σ RMB or foreign currency financing balance * tenor risk ratio * class risk ratio + Σ foreign currency financing balance * exchange rate risk ratio.

The key difference is that the risk ratio for off balance sheet financing (or contingent liability) such as, 内保外贷 onshore guarantee to secure an offshore debt and derivative transaction entered by financial institutions with their offshore counterparty to hedge client's currency and tenor risks, will be increased to 1 from previously 0.2 and 0.5.

To conclude: we think the expansion of the pilot scheme for macro prudential management of cross border financing to nationwide effectively broadened the financing channel for all solvent Chinese companies. In theory, all Chinese companies can borrow from the offshore market. The limit of their offshore borrowing will depend on their own financing position such as core capital for banks and net asset for enterprises.

The new rules will have five implications in our view. First, the demand for medium to long term offshore RMB or foreign currency is likely to increase given the risk ratio for weighted risk balance is lower for loan tenor more than 1-year. Second, the impact on offshore RMB funding cost is unlikely to be imminent given the onshore RMB cost is lower currently. However, the risk for offshore RMB funding cost to be driven higher cannot be ruled out should Chinese companies divert their funding needs from onshore to offshore. Third, in the medium term, the offshore RMB funding cost will be reference to the onshore RMB funding cost. Fourth, the increase of risk ratio for derivative transaction to 1 may dampen the cross border derivative transactions. Last but not least, the increase of risk ratio for neibaowaidai to 1 will also negatively impact on banks' cross border business.

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