Summary

The data-light week was swamped by a number of regulatory changes ahead of Labor Day holiday. China's central bank decided to expand its pilot program for macro prudential management of cross border financing from free trade zone to nationwide with effective from 3rd May. This declared that foreign debt quota system will withdraw from the historical stage. Despite the expansion of eligible borrowers, the adjustment of risk ratio for off balance sheet activities implies the mixed impact on bank's cross border business. Meanwhile, China's currency regulator also granted the bigger limit to banks to short sell the dollar. Both regulatory changes served the similar purpose, which is to attract more capital inflows. China's bond market was sold off further last week due to concerns about the change of tax regime on interest income from the financial transaction. However, the last minute announcement from the Ministry of Finance to add interest income from repo and policy bank bond to the VAT exemption list is likely to correct the excessive concern about the negative impact of VAT system on the bond market. As such, sentiment may improve this week in China's onshore bond market. On RMB front, China continued to take advantage of weak global dollar to adjust its basket currency lower but maintaining the USDCNY relatively stable. The stronger CNY last Friday failed to support the CNY spot, signalling market is still cautious on the CNY outlook despite weakening dollar.

Key Events and market talk	
Facts	**OCBC Opinions**
▪ 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.
▪ The SAFE allowed banks to have bigger negative synthetic positions in settlement and sales of foreign exchange, signalling that the regulators allowed banks to short sell more dollars.	▪ China's regulator did not allow banks to short sell dollar until 2012 to promote price discovery of its exchange rate. The limit has been expanded gradually in the past few years. According to the estimation from the SAFE, the aggregate lower limit for banks' synthetic position will be increased to US$100 billion.
▪ China may launch the platform for SDR borrowings by Chinese and foreign entities in China's onshore capital market as early as July to promote the use of SDR according to MarketWatch. PBoC Governor Zhou Xiaochuan said in March that China plans to issue SDR denominated bonds.	▪ The SDR denominated securities in the private market were first issued in 1975 ranging from commercial bank deposits and CDs etc. Sweden issued an SDR denominated credit in 1981. However, the private SDR bond market failed to take off due to the coordination problem that "many prospective issuers were reluctant to issue SDR-denominated claims in the absence of evidence that others were prepared to likewise" according to Professor Eichengreen. ▪ The benefits of SDR-denominated securities are significant. The research reports showed that SDR denominated securities had a role to play in the construction of efficient portfolio and can serve as a diversification as well as partial hedge against the currency risk. ▪ We see two benefits from China's motivation to push the issuance of SDR denominated bonds. First, it will increase the use of SDR. Second, it will give investors the opportunity to hedge against the RMB risk in the onshore market, which will also help alleviate capital outflow risk.
▪ Both Bank of China and ICBC breached the minimum regulatory bad loan provision ratio, which currently is at 150%, in the first quarter. The bad loan provision ratio for ICBC dropped to 141.21%.	▪ ICBC managed to clock a small increase in net profit in 1Q after it allowed the bad loan provision ratio to break below 150%. This signals that there has been increasing pressure for Chinese banks to balance between profit and bad loan coverage amid deteriorating credit quality. Nevertheless, it does not imply any imminent crisis given the bad loan provision remains high. Meanwhile, there has been increasing market talk that China's regulator may lower the minimum provision ratio to 120%-130% to alleviate the pressure for banks.
▪ China completed its largest tax overhaul in two decades. With effective from May, value added tax (VAT) has replaced gross revenue based business tax in construction, real estate, finance and consumer services sectors. The tax reform is expected to save CNY500 billion this year. ▪ The Ministry of Finance fine-tuned the new VAT system to allow the interest income from repo transaction and holding of policy bank bond to be exempted from the VAT.	▪ China's bond market has reacted negatively in the past weeks due to concerns about the rising holding and transaction cost for bond and money market as a result of the change of tax regime. The last minute announcement from the Ministry of Finance to add interest income from repo and policy bank bond to the VAT exemption list is likely to correct the excessive concern about the negative impact of VAT system on the bond market. As such, sentiment may improve this week in China's onshore bond market.

Key Economic News	
Facts	**OCBC Opinions**
▪ **Foreign currency sale and purchase data:** China's official PMI fell to 50.1 in April, down slightly from 50.2 in March. ▪ Both new export orders and new orders fell to 50.1 and 51 respectively from 50.2 and 51.4. ▪ Input prices rebounded further to 57.6 from 55.3 on the back of rising commodity prices. ▪ Raw material and finished goods inventory also fell to 47.4 and 45.5 respectively from 48.2 and 46.	▪ Most of the sub-index softened slightly in April with the exception of input prices, which is driven by rising commodity prices. This will further narrow the gap of PPI. The contraction of PPI is expected to moderate to 3.6%. ▪ Overall speaking, the April PMI data is still supportive of China's recovery story. However, the decline of both raw material and finished goods inventory shows that companies remain cautious due to uncertain prospect.

RMB	
Facts	**OCBC Opinions**
▪ RMB Index fell further to 97.12 from 97.22 taking advantage of weak global dollar.	▪ China continued to take advantage of weak global dollar to adjust its basket currency lower but maintaining the USDCNY relatively stable. The stronger CNY last Friday failed to support the CNY spot, signalling market is still cautious on the CNY outlook despite weakening dollar.

Liquidity	
Facts	**OCBC Opinions**
▪ PBoC net withdrew CNY290 billion via open market operation last week.	▪ It shows PBoC is still cautious on liquidity management despite the correction of bond market.

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