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CNY – Relaxing Cross-Border Financing and Flows[1]

8 February 2018

Key Points:

- **In limited but noticeable steps, Chinese authorities are signaling discomfort with pace of renminbi strengthening thus far this year, by tweaking knobs on capital controls to permit some more outflows**
- **In an initially low-key announcement, PBOC broadened a bit the scope for onshore banks to conduct more offshore yuan financing**
- **This is likely tied to future hopes for the One Belt, One Road effort**
- **In principle this may increase the size of CNH pools offshore; that USD/CNH forward points have traded to a discount to onshore is a hint**
- **Both the new announcement and subsequent developments should be taken as signs of some official relaxation of capital outflows**
- **Perhaps, that means onshore authorities have not been completely comfortable with the degree of renminbi appreciation seen YTD**
- **But there have been *no* herd effects nor does this have much to do with the FSB, IMF or major nations**

Introduction

In our experience, Chinese capital controls are always directional; this one favors outbound

In our experience, Chinese capital controls are **always** directional, so instinctively we wanted to first ask, re a little-noticed change in what China calls its **countercyclical coefficient,** in what direction are Chinese authorities favoring and has it changed?

The answers are **out and yes,** as in relaxing a bit the scope for yuan to flow offshore. **This is a signal onshore authorities have not been entirely comfortable with the pace of RMB strengthening thus far this year.**

What Happened

PBOC adjusts rules for its *countercyclical coefficient* (not to be confused with the *countercyclical factor*)

PBOC, on its micro-blog on 19 January 2018, announced for commercial banks, the upper permissible limit for yuan-denominated cross-border financing would be determined by a bank's yuan deposits multiplied by a *countercyclical coefficient* (CCC; *逆周期系数*) which currently stands at 3% and which will remain unchanged.[2] Perhaps not coincidentally, the announcement was the same day when CFETS, a sub-institution under PBOC, confirmed a *countercyclical factor* (CCF) had been set to neutral (we discussed the latter in *Asia Cross Current: CNY – R.I.P. Countercyclical Factor*, 10 January 2018). **The CCC is not the CCF**, with the CCC meant to be applied to cross-border yuan financing outflows instead of the daily CNY fixing model. We provide full details of the PBOC policy change in the Appendix.

Initially the microblog announcement flew under most people's radars, till Bloomberg and Reuters both reported it 31 January 2018, giving the CCC some multilateral institution cachet in the process. Eg,

> *PBOC adopts* ***counter-cyclical coefficient*** **(CCC)** ***in commercial banks' yuan cross-border financing*** *to hedge the fluctuations when there is* ***"herd effect" in market****. And the counter-cyclical management is in line with agreements made by* ***FSB, IMF and major nations.*** *(Bloomberg)*

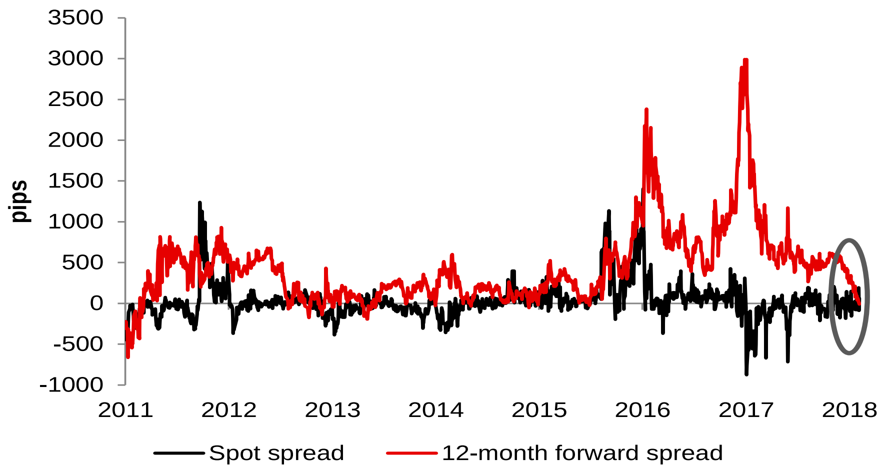
[1] Special thanks to trading colleagues who provided valuable insights.
[2] PBOC *Weibo* announcement on 19 January 2018 (simplified Chinese)

Market Impact

USD/CNH forwards in discount to USD/CNY for the first time since 2014

Since the microblog announcement the immediate impact on CNH rates may have been masked by abundant CNH funding ahead of the Chinese New Year holidays (15-21 February 2018 on the Mainland and 16-19 February 2018 in Hong Kong).

12-MONTH FORWARD POINTS SPREAD: USD/CNH AND USD/CNY

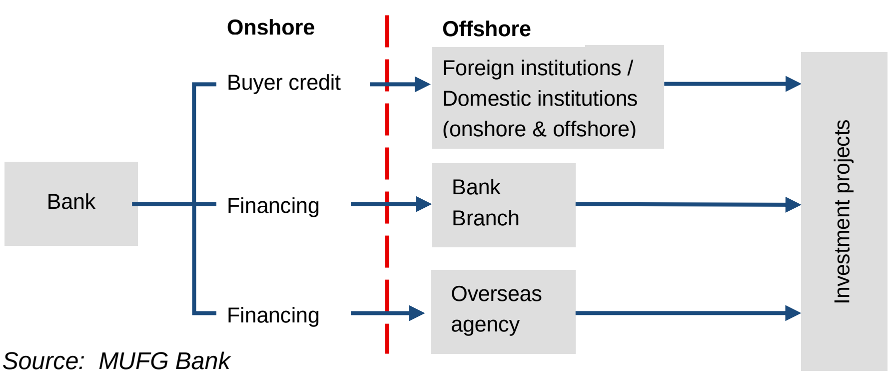


Source: Bloomberg, MUFG

Possibly in anticipation of future OBOR-related yuan outflows

But it is also worth noting 12-month forward point spreads between USD/CNH and USD/CNY has been narrowing noticeably (since late November). In practice, it takes time to match investment appetite between the supply side of finance (Chinese banks onshore) and the demand side (overseas Chinese bank branches, overseas agencies, domestic institutions and foreign institutions) and there may be the possibility markets have started to tighten CNH-CNY spreads in forward markets in anticipation of a future increase in yuan cross-border flow, against a backdrop of SAFE's declared neutral yuan cross-border capital flow policy and OBOR. That said, SAFE has also mentioned explicitly (on 7 February 2018) that two-way Chinese yuan floating characteristics will become more noticeable (*人民币汇率双向浮动的特征将更加明显*),[8] possibly implying a turnaround in the so-far one-way appreciation of the Chinese yuan against USD.

CHINESE COMMERCIAL BANKS YUAN CROSS-BORDER FINANCING



Source: MUFG Bank

The CCC and subsequent policy announcements are a sign of relaxed controls on capital outflows

A Neutral Macroprudential Policy

On 7 February 2018, **SAFE Administrator Pan said all macroprudential policies has returned to *neutral*** (*宏观审慎政策已全部恢复中性*) and **future management of cross-border capital flows would also adhere to the *neutral principle*** (*未来的跨境资本流动管理上，坚持政策中性原则*), according to Caixin.[3] As such, a CCC of 3% might be interpreted as a neutral rate and when CCC is bigger (smaller) than 3%, yuan cross-border financing policy is more (less) accommodative (tighter).

Today, Chinese authorities further announced the resumption of the Qualified Domestic Limited Partnership program – suspended for two years during the recent era of capital controls (which was, after all, about limiting outflows) – by granting license to a dozen well-known foreign fund managers to come onshore to gather domestic funds which would then be invested *offshore.* USD/CNH vols gapped up significantly (our traders said the market was short gamma) and 1-month riskies jumped 0.57 vols in favor of calls as folks positioned for future USD demand. **Both the CCC announcement and these subsequent developments should be, we think, taken as signs of official relaxation of some further capital outflows allowed. Perhaps, that means onshore authorities have not been completely comfortable with the degree of renminbi appreciation seen YTD.**

Impact on Chinese Commercial Bank Cross-Border Yuan Financing

OBOR-related yuan outflows may help revive the CNH market

Per previous PBOC guidance (PBOC Document No. 168 [2013]),[4] which stipulated that a bank's cross-border yuan financing could not exceed 3% of its total yuan deposit balances **as of the previous year-end** and updating formulae for permissible cross-border financing in PBOC Document No. 9 [2017] (details in our Appendix), the latest announcement could appear, at the first glance, "old wine in a new bottle." But old wine –**cross-border yuan financing activity** – c**ould be revived in the context of the Belt and Road Initiative** (or One Belt, One Road; OBOR). Some OBOR projects can be done **in conjunction with the going-out strategy for Chinese enterprises**, in particular state-owned enterprises, and financed in Chinese yuan. As such, the so-far low international usage of the Chinese yuan,[5] despite its inclusion in the IMF's SDR basket, could be boosted. Because the base against which can be calculated the upper bound of permissible cross-border yuan financing is no longer a fixed number set at the end of a year, conceivably banks will be allowed to take on more such activities in the subsequent year. (Again, please see our Appendix.) We discussed this possibility in our last *The Global Renminbi,* February 2018.

The more vibrant the yuan cross-border financing activity, the larger and the more liquid the CNH pool

The diagram above implicitly suggests the very real possibility that Chinese commercial banks, in their offshore yuan financing activities, could possibly increase (or decrease) the size and liquidity of the offshore CNH pool in various offshore CNH centers (most prominently Hong Kong).

Is There a Herd Effect? No

2-in-1 capital flow management

Two separate press releases[6] issued by SAFE and PBOC on 6 February 2018, regarding their 2018 working conference in Beijing, emphasized the importance of

[3] Caixin. 7 February 2018. (simplified Chinese)

[4] PBOC Document No. 168 [2013] (simplified Chinese)

[5] According to SWIFT data in December 2017, the yuan ranked #8 in terms of cross-border payments (0.98% of total activity), while USD remained the predominant currency (41.27%), followed by EUR (39.45%), GBP (3.84%) and JPY (3.56%).

[6] 2018 PBOC working conference held in Beijing, released on 6 February 2018. (simplified Chinese):

2018 SAFE working conference held in Beijing, released on 6 February 2018 (simplified Chinese) preventing financial risks, with the implementation of macroprudential management in cross-border financing, so as to promote the balanced flow of cross-border capital. Specifically, SAFE mentioned that macroprudential policy would countercyclically manage cross-border capital flow (*宏观审慎政策逆周期调控跨境资本流动*) in the two-in-one cross-border capital liquidity management system that consists of macro-prudential management and micro-market supervision.

But there is no herd effect, not even in official statements

That's the official framework (repeated from time to time in the onshore financial markets) but you won't find mention of herd behavior. Not even in official statements. Neither have herd effects occurred nor is expected to occur this year, as SAFE said **cross-border capital flows would probably remain generally stable** (*总体稳定*) **in 2018**, after such flow changed from net outflows to basic equilibrium in 2017 (*跨境资金流动从净流出走向基本平衡*). At the same time, SAFE expects **cross-border financing would probably continue to increase at a stable rate, with an orderly decline in foreign investment and personal foreign exchange purchases** (*跨境融资继续增加而且增幅更加平稳，对外投资和个人购汇有序回落*), according to its press conference on the 2017 foreign exchange balance[7]. In its latest statement related to foreign reserves for January,[8] SAFE again confirmed the *generally stable* cross-border capital flow and a projection for *balanced* cross-border capital flows in 2018.

What Does This Have to Do with the FSB, IMF or major nations? Nothing

The FSB (Financial Stability Board), IMF and major nations have promoted and implemented a *countercyclical capital buffer* (CCYB)[9] as a part of the Basel III regulatory capital framework, in which "*banks are required to build up a capital buffer during the upturn of a credit cycle which can be used in the subsequent downturn to help maintain an adequate supply of credit to the real economy.*"[10]

CCC has nothing to do with a countercyclical capital buffer

The CCC seems to have nothing to do with the CCYB; the CCYB is a stock concept while the CCC seems to deal with flows. There are no capital buffer requirements under the latest PBOC CCC arrangement. In principle CCC could be adjusted by PBOC in anticipation of upcoming macrofinancial and yuan cross-border capital flows, as part of macroprudential policy. **The higher (lower) the volatility of yuan cross-border capital flow is, the lower (higher) the CCC is likely to be adjusted by PBOC**. It is possible PBOC will closely monitor the ratio of the upper limit of the yuan cross-border financing amount or actual yuan cross-border financing amount of Chinese banks to their corresponding Tier 1 capital as part of its quarterly macroprudential assessment (MPA).

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[7] SAFE 2017 Foreign Exchange Balance Press Conference, released on 18 January 2018. (simplified Chinese)

[8] SAFE statement related to foreign reserves for January, released on 7 February 2018. (simplified Chinese)

[9] CCYB *is calculated as the weighted average of the buffers in effect in the jurisdictions to which banks have a credit exposure*, and *consists entirely of Common Equity Tier 1 capital*. (Source: Bank for International Settlements (BIS)'s Basel Committee on Banking Supervision: Counter-cyclical capital buffer, updated on 11 September 2017)

[10] Source: Frequently Asked Questions on the CCyB, Hong Kong Monetary Authority.

Appendix

PBOC Document No. 9 [2017]

On 11 January 2017, PBOC released Document No. 9 [2017] concerning the macro-prudential management of full-covered cross-border financing,[11] with three key objectives and formulae.

(i) To calculate the **risk-weighted outstanding cross-border financing (RWOCBF)** for an enterprise or for a financial institution:

$$\boldsymbol{RWOCBF} = \sum outstanding\ amount\ of\ total\ cross\ border\ financing\ \ (both\ yuan\ and\ foreign\ currency) \times maturity\ risk\ conversion\ factor\ \times categorized\ risk\ conversion\ factor + \sum outstanding\ amount\ of\ foreign\ currency\ \ cross\ border\ financing \times exchange\ rate\ risk\ coversion\ factor$$

where

$$maturity\ risk\ conversion\ factor = \begin{cases} 1\ \ for\ financing\ with\ term \geq 1\ year \\ 1.5\ for\ financing\ with\ term < 1\ year \end{cases}$$

$$categorized\ risk\ conversion\ factor = \begin{cases} 1\ \ for\ on\ balance\ sheet\ finacing \\ 1\ (tentatively) for\ off\ balance\ sheet\ financing \end{cases}$$

$$exchange\ rate\ risk\ conversion\ factor = 0.5$$

(ii) To calculate an upper limit for RWOCBF (URWOCBF) for either an enterprise or a financial institution:

$$\boldsymbol{URWOCBF} = \ capital\ or\ net\ assets \times cross\ border\ financing\ leverage\ ratio \times macro\ prudential\ adjustment\ coefficient$$

where

$$cross\ border\ financing\ leverage\ ratio\ = \begin{cases} 2\ for\ enterprises \\ 1\ for\ non\ bank\ financial\ institutions \\ 0.8\ for\ banks \end{cases}$$

$$macro\ prudential\ adjustment\ coefficient = 1$$

[We think capital is meant to apply to financial institutions and net asset for non-financials.]

(iii) $\boldsymbol{RWOCBF} \leq \boldsymbol{URWOCBF}$

This was intended as the binding limit for cross-border yuan financing.

PBOC Announcement 19 January 2018

The announcement implies modifications to formulae (i) and (ii) **for commercial banks (only),** *viz.*, (iv) and (v); (vi) is the new rule.

(iv) $\boldsymbol{RWOCBF}_{yuan_{new}} = \sum outstanding\ amount\ of\ yuan\ cross\ border\ financing \times maturity\ risk\ conversion\ factor\ \times categorized\ risk\ conversion\ factor$

(v) $\boldsymbol{URWOCBF}_{yuan_{new}} = f(bank's\ yuan\ deposit\ balance,\ \ counter\ cyclical\ coefficient) \approx bank's\ yuan\ deposit\ balance\ \times 3\%$

where

$$counter\ cyclical\ coefficient\ (CCC) = 3\%$$

(vi) $\boldsymbol{RWOCBF}_{yuan_{new}}\ \leq \boldsymbol{URWOCBF}_{yuan_{new}}$

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[11] PBOC Document No. 9 [2017] (simplified Chinese).

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