CHINA Insights

OCBC Bank

The quarter-end drama: crossing the river by feeling the stone

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Highlights:

- **Offshore overnight CNH money market rate fell to negative territory for the first time, while onshore CNY money market rate spiked due to tight liquidity. But, sorry, there is no new juicy story for China bear.**
- **The divergent liquidity trend in two RMB market was mainly driven by separate regulatory changes.**
- **In the onshore market, banks are trying to be adaptable to the newly launched macro prudential assessment framework, which resulted in reluctance to lend to non-bank financial institutions.**
- **In the offshore market, banks are still exploring the implications of RRR. But banks have the incentive to lend out to reduce their deposit balance at quarter-end, which will be used to calculate amount of reserve needed to be locked up for 3 months. Between negative interest rate for one day and freeze of liquidity for three months, market has done their calculation.**
- **Those are temporary factors. Business is expected to be as usual when new quarter starts today.**

The passing quarter-end is remarkable for Chinese investors after watching the divergent RMB liquidity trend in onshore and offshore markets. In the offshore market, CNH overnight interbank rate fell into negative territory with the negative interest rate implied by swap travelled to as low as double digit after overnight CNH HIBOR being fixed at minus 3.725% as a result of super flush liquidity. However, in the onshore market, liquidity remained tight with 1-day repo in the Shanghai Exchange hitting a high of 12.6% intraday.

So, what's the story behind this divergent RMB liquidity trend? Unfortunately, there is no juicy story for China bear here. There is no structural change in the market or rise of negative sentiment due to particular event. The divergent liquidity trend in both markets was mainly distorted by separate regulatory changes including the quarter-end macro prudential assessment in the onshore market and quarter-end reserve requirement ratio calculation in the offshore market.

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The impact of MPA on onshore liquidity

Since the beginning of 2016, PBoC has introduced a new macro prudential assessment (MPA) system to contain risks in the financial system. The new MPA system covers seven areas including banks' capital adequacy, leverage ratio, assets and liabilities, pricing, asset quality, foreign debt risk and implementation of credit policy. Instead of previous simple loan management, the credit assessment will be expanded to a broader range of credit products including loan, bond investment, equity investment, alternative investment, buying back the sale of financial assets and deposits in non-bank financial institutions.

Given this is the first quarter for the MPA assessment, extra caution has been exercised by banks. As such, banks were reluctant to lend to non-bank financial institutions as this is the easiest way to control the credit expansion to meet regulatory requirement. The tight liquidity for non-bank financial institutions led to the spike of 1-day repo rate in the Shanghai Exchange.

The impact of RRR on offshore liquidity

In contrast to the tight RMB liquidity in the onshore market, which is not uncommon at quarter-end, the extreme flush RMB liquidity in the offshore market is more dramatic. Despite concerns about the negative impact of breach of Keepwell deed by Guosen Securities on offshore RMB demand, we think the negative interest rate was mainly the result of newly imposed reserve requirement ratio for offshore RMB deposits.

The reserve requirement, which depends on the balance of quarter-end, will be locked up for three months. As such, there is incentive for banks to lend out to reduce their quarter-end balance. Between interest rate paid to park the money outside for one day and 3-month lockup of funds with low interest rate, market has done their calculation.

To conclude, we think the drivers behind the dramatic divergent liquidity trend on 31 March was nothing fancy but mainly the result of regulatory changes. In the onshore market, banks are trying to be adaptable to the new MPA system while in the offshore market, banks are still exploring the impact of RRR on the offshore RMB deposits. The distortion on both money market rate is likely to be temporary and business is likely to go back to usual when the new quarter starts.

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