CHINA Insights

OCBC Bank

An innovative RRR cut with debt swap feature

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Highlights:

- **The RRR cut is close to a universal cut, which will unfreeze about CNY1.3 trillion. However, CNY900 billion out of CNY1.3 trillion will be used to pay off the existing Medium-term lending facility (MLF). As such, the net liquidity injection is about CNY400 billion.**
- **The RRR cut with innovative debt swap feature to replace the MLF shows that China is unlikely to deviate from the path of prudent monetary policy. Nevertheless, the cut reinforced the consensus that China is unlikely to tighten further.**
- **It is supportive of risk sentiment as banks profit is expected to improve with lower funding costs.**
- **The RRR cut will unfreeze more liquidity for those smaller banks with no direct access to the central bank liquidity facility, which may in turn better support the funding demand from SMEs.**
- **The RRR cut will also play a pre-emptive role in stabilizing China's credit expansion to ease the tighter monetary condition. More cuts with similar feature may come.**

PBoC announced to cut reserve requirement ratio for most Chinese banks by 1% effective from 25 April. Only those small rural commercial banks with already low RRR will not be affected. RRR for big commercial banks will be lowered to 16% from 17%.

The RRR cut will unfreeze about CNY1.3 trillion according to the PBoC estimation. However, CNY900 billion out of CNY1.3 trillion will be used to pay off the existing Medium-term lending facility (MLF). As such, the net liquidity injection is about CNY400 billion.

The RRR cut with innovative debt swap feature to replace the MLF shows that China is unlikely to deviate from the path of prudent monetary policy. As such, there is no turn of monetary policy at the current junction. **Nevertheless, we see three possible impact of this RRR cut.**

First, the almost universal RRR cut will help lower the banks' funding costs as the 1.62% opportunity cost for RRR is much lower than 3.3% 1-year MLF cost. This will help banks improve its profit outlook.

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Second, it may promote banks lend more to SMEs. Smaller city commercial banks are expected to benefit from the RRR cut as majority of those banks are unable to tap the MLF. The RRR cut will unfreeze more liquidity for those smaller banks with no direct access to central bank liquidity facility, which may in turn support the funding demand from SMEs.

Third, ever since China's top economic policy body came out the idea of structural de-leverage targeting at local government and SOE debt, market has formed expectation that the central bank is unlikely to tighten further. This has been one of the key drivers to recent mini bull market in China's bond space. The latest RRR cut reinforced this expectation that China may move away from tight bias.

In addition to those three possible implications, we think tighter monetary condition and recent RMB appreciation may also be two factors taken into account by the central bank. The deceleration of aggregate social financing and money supply growth may have caught PBoC's attention. The RRR cut will also play a pre-emptive role in stabilizing China's credit expansion. As such, we think PBoC is likely to conduct similar operation in future.

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