OCBC Bank

Half step towards interest rate liberalization

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- **China's new loan rate will be benchmarked to the LPR, which will be referenced to the open market operation rate namely 1-year and 5-year MLF rates.**
- **We believe it will help lower the funding costs to the real economy.**
- **The immediate focus will be whether China will lower its MLF rate to guide the LPR lower. We see no urgency for China to do that.**
- **We think the chance of a universal RRR cut is slimmer.**
- **MLF rate is unlikely to be the permanent anchor for LPR and it could only be the transitory arrangement due to two drawbacks of MLF including higher funding costs and limited access.**

The PBoC announced to further liberalize China's lending rate via the reform of loan prime rate (LPR) on 17 August. The central bank introduced four new features to lending rate as below.

Pricing mechanism	Instead of being referenced to the benchmark lending rate, the new loan rate will be benchmarked to the LPR, which will be referenced to the open market operation rate namely 1-year MLF rate. This is designed to help unblock the transmission mechanism from the interbank funding cost to the real economy. Going forwards, China's funding cost to the real economy will depend on two parameters including the LPR (which reflect bank's funding cost) and credit spread (which reflect the credit premium, market supply and demand matrix and risk appetite etc).
Tenor	Other than the 1-year LPR, PBoC will introduce the 5-year LPR as the benchmark for the longer-term loan such as mortgage. However, as there is no 5-year MLF rate, it remains unclear how the 5-year LPR to be priced.
Contributing banks	The number of LPR contributing banks will be increased from previously 10 big national banks to 18 banks including city commercial banks, rural commercial banks, foreign banks and private owned banks to better reflect the funding costs.
Frequency	The publishing frequency of LPR however will be reduced to only once a month from previously daily rate. The LPR will be decided on the 20th of each month. According to the PBoC, the reduction of frequency will improve the quality of LPR and make banks more serious when contributing the LPR.

Impact on the real interest rate

With effective from this week, China's new lending will be encouraged to be priced in LPR. The current 1-year LPR was at 4.31%, which was 101bps above the 1-year MLF rate. We expect the LPR to decline gradually to reflect the lower funding costs in the interbank market.

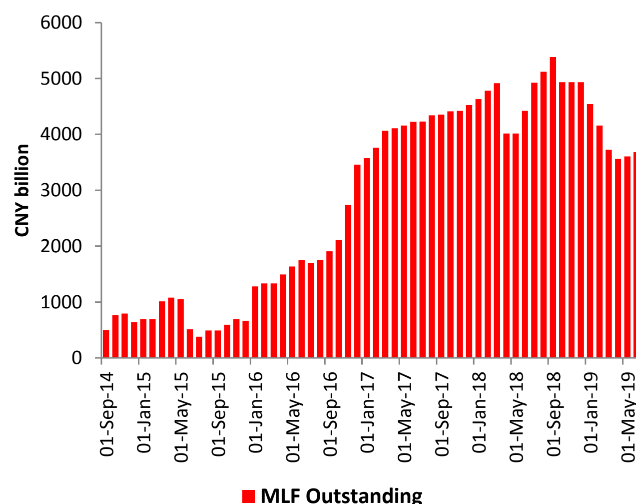
In addition, PBoC will include the use of LPR and setting of loan rate in the macro prudential assessment (MPA), as such, we think banks are likely to keep the credit spread in check to lower the funding costs to the real economy. This may help China to achieve its target to lower the funding costs to the small and micro companies by 100bps in 2019.

What's next?

The immediate focus will be whether China will lower its MLF rate to guide the LPR lower as a way to reduce the funding costs to the real economy. We see chances for China to lower its MLF rate in the coming months. However, we don't see the urgency for China to cut its MLF rate in August as China may want to take a wait-and-see approach to see how market react and digest the latest liberalization.

Nevertheless, we think the chance of a universal RRR cut is slimmer. Given the universal RRR cut is previously to be used to replace the MLF, the increasing role of MLF in the latest interest rate liberalization suggests that the replacement of MLF by RRR cut may pause for now.

Chart: The outstanding of MLF has been shrinking replaced by the RRR cuts.



Source: Bloomberg, OCBC Bank

In the medium term, we think the current liberalization is only half step towards interest rate liberalization for two reasons.

First, MLF rate is unlikely to be the permanent anchor for LPR and it could only be the transitory arrangement due to two drawbacks of MLF including higher funding costs for banks as compared to interest rate on RRR as well as limited access for smaller banks which are not the primary dealers.

Second, the current liberalization focuses only on the lending rate while deposit rate was left untouched. This is probably to protect banks' margin to ensure a smooth transition for lending rate. In the longer run, China may also need to loosen the setting of deposit rate.

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