Economic Analysis

China's banking regulator redefined the loan-to-deposit ratio (LDR) to spur lending

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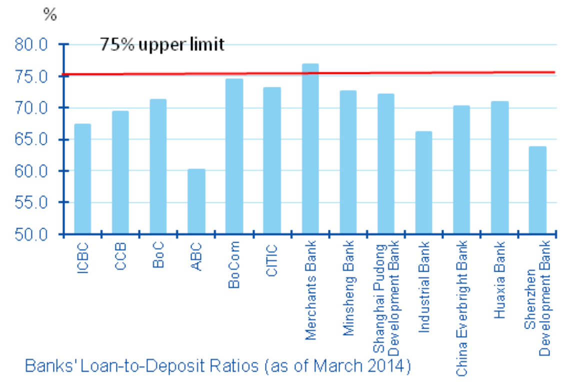
On June 30th, the China Banking Regulation Committee (CBRC) announced a revision to the calculation method for banks' regulatory loan-to-deposit ratio (LDR). The new calculation method, effective from July 1st, is expected to stimulate banking lending to the real economy, in particular to small-and-medium-sized-enterprises (SMEs). Moreover, the new calculation method reflects the authorities' resolution to push forward interest rate liberalization and open the banking sector to foreign capital.

Why did regulators need to redefine the LDR?

The LDR used to be defined as a bank's total loans to its total deposits, in which only a few items could be deducted from the numerator (total loans), including some loans to the agricultural sector. According to China's Commercial Bank Law, a 75% upper limit of the LDR is stipulated for the purpose of risk management. Although the upper limit played an important role in preventing excessive credit growth, some fundamental changes in the macroeconomic environment have indeed rendered it obsolete. First of all, China's current account surplus and capital inflows have significantly slowed amid a notable moderation of the region's growth. This leads to a slower pace of deposit growth in the banking sector, which has effectively pushed many banks' LDRs close to the upper limit (Figure 1 and 2), constraining their capability to lend despite the authorities are seeking to boost credit supply to support growth. The only way to relax the binding constraint on bank's lending in order to circumvent the Commercial Bank Law was to introduce a revision to the LDR's calculation method.

Figure 1

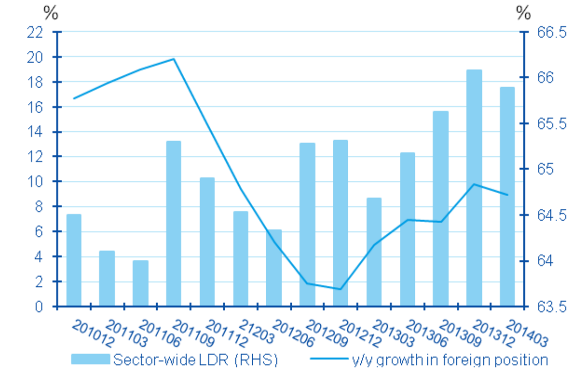
The 75% upper limit of LDR has put a binding constraint on banks' lending



Source: Wind and BBVA Research

Figure 2

The upward pressure on banks' LDR stems from the slowed pace of capital inflows



Source: Wind and BBVA Research

What's in the new calculation method?

Under the new calculation method, three additional items can be deducted from the LDR's numerator (total loans), including: (i) loans financed by bond issuance with a maturity beyond one year and without prepayment clause; (ii) SME loans financed by the central banks' refinancing program; and (iii) loans financed by international financial institutions and foreign governments. Additionally, two items will be added to the denominator (total deposits): (i) negotiable CDs issued by banks to corporates and individuals; and (ii) net deposits from foreign parent banks, which is only applicable to foreign banks incorporated in China.

Several points are noteworthy. First, the revision of the LDR calculation method will encourage banks' lending to their SME customers, which is consistent with the authorities' policy stance revealed by two targeted cuts in banks' reserve requirement ratio (RRR) in April and June. (See our previous China Flash) Second, the new LDR definition takes into account the stability of fund sources (for example, the loans financed by bond issuance can be deducted from the numerator), which bears great resemblance to some regulatory liquidity indicators under the Basel III framework, such as the net stable funding ratio and liquidity coverage ratio. Given that China will start to implement the Basel III regulatory framework in 2016, it is very likely that the traditional LDR ratio will be replaced by these new regulatory liquidity indicators. Third, so far there have been no negotiable CDs being issued to corporate or individuals; however the new revision has permitted these CDs to be included in the calculation method for the LDR. It conveys a clear message that the issuance of these CDs is soon to be expected, which many perceive is an important step towards a fully liberalized interest rate system (see our Banking Watch on financial liberalization). Finally, the new LDR calculation can also benefit local incorporated foreign banks by including net deposits from their parent banks in the denominator. However, this will not affect the RMB LDR of foreign banks because net deposits from their parent banks are generally denominated in foreign currencies.