Economic Analysis

China will scrap banks' loan-to-deposit ratio requirement: a welcome step but with limited short-term impact

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Yesterday, China's State Council --- the country's cabinet---passed a draft amendment to the 20-year old Commercial Banking Law, seeking to scrap the law-based 75% cap for commercial banks' loan-to-deposit ratio (LTD). Still the banking regulator will require banks to report their LTDs as a reference indicator gauging banks' liquidity risk. The amendment to the Law is expected be approved by the parliament next July 2016 and to become effective thereafter. Therefore, the amendment is widely deemed to be a new measure to boost bank lending and to stimulate growth. It is also among a series of financial liberalizing steps undertaken by the authorities, including the widening of banks' permissible range of deposit rates, the instalment of the bank deposit insurance scheme as well as the introduction of CDs issuance for corporate and individual investors (see our recent China Flash). Nevertheless, we believe that the short-term impact of scrapping the LTD cap is limited in the short run.

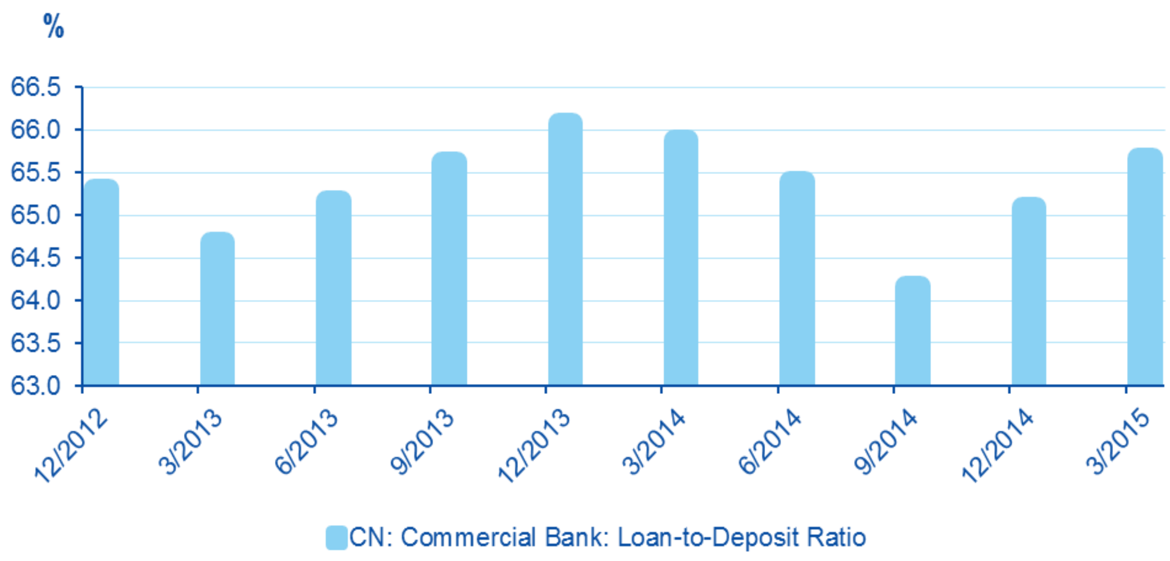
- **Controversies around the LTD cap…**

Having been introduced to the Law since 1995, the 75% LTD cap has been contentious. On the one hand, the cap, as one of key regulatory indicators, has forced banks to guard off liquidity risks and therefore helps to maintain the stability of the entire banking sector. On the other hand, it has also increased the seasonal variability of interbank interest rates because banks tend to boost short-term deposits at the ends of the quarters to meet the regulator's LTD requirement. Indeed, banks' actions of meeting LTD cap (through vying for short-term deposits) was one of catalysts which caused the interbank liquidity squeeze in June 2013 when the entire banking sector once teetered on the brink of collapse. Moreover, some people argue that the stiff LTD cap has prevented banks from extending more credit to the economy, aggravating the on-going economic downturn.

- **…whereas the impact of its scrapping is not significant for the short run**

Our conclusion about its ineffectiveness is based on two facts: first, the recently weak credit growth has been largely attributed to the demand side rather than the stiff LTD cap. Indeed, the sector-wide LTD ratio stood at 65.57% as of end-March (Figure 1), way below the 75% cap. That being said, the LTD cap currently is not a binding constraint of curtailing bank lending. Consequently, the removal of the cap can not have immediate and significant effects on credit growth. Second, we anticipate that many banks will continue to use the LTD ratio as one of important indicators for internal risk control. Indeed, the authorities have already made some adjustments for the LTD regulation over the past several years (for example, banks were asked to report the daily average LTDs instead of end-of-quarter LTDs in 2011 and were also to include more deposit items in the denominator). However, these adjustments haven't eliminated the seasonal variability of interbank interest rates yet. We therefore expect that such a case will not change in the short term until banks overhaul their internal management system for liquidity risk.

Figure 1
The sector-wide LTD ratio is way below the 75% cap in the past years



Source: CEIC and BBVA Research