

## China: Market Liberalization Measures Update

China's financial market and capital account liberalization continues to quicken, with a slew of news and data releases in recent days. On Tue (2 Jun), PBoC released details on its PSL (pledged supplementary lending) program, as well as announced the launch of large-denomination, floating-rate tradable certificates of deposit (CD) to individuals and companies, as it moves towards full interest rate liberalization. Late Wed (3 Jun), PBoC also announced further opening of the capital account and RMB internationalization, by allowing offshore RMB clearing and-settlement banks to participate in China's interbank bond market's repurchase facilities, and the funds raised can be used outside of mainland China.

All these developments are aimed at strengthening the financial sector: the PSL as one of the tools to manage financial sector's liquidity condition, CDs to improve the banks' funding requirements and liability management, and participation of offshore institutions in domestic bond markets to see increased inflows and outflows of funds, and ultimately full RMB internationalization.

### More Details on PSL

China's central bank PBoC late Tue (2 Jun) released more information on its PSL (pledged supplementary lending; 抵押补充贷款) program. PSL was first mooted in Apr 2014, and was reported in July 2014 that PBoC has pledged RMB1tn at low interest rates for 3 years, to China Development Bank (CDB) to facilitate rebuilding of slum areas (棚户区改造). The aim of PSL is provide stable, longer term funding at reasonable costs to financial institutions for long term development projects, backed by high quality collaterals.

Based on data released on 2 Jun by PBoC, the funds released under PSL amounted to RMB383.1bn in 2014, and RMB262.8bn so far in 2015, thus the outstanding amount under the PSL program is RMB645.9bn as at end-May 2015. Equally important, interest rate on the PSL was lowered from 4.5% in 2014 to 3.1% so far in 2015, reflecting PBoC's three consecutive interest rate cuts over the past 6 months. The data confirmed that CDB is the only borrower under this program so far. From June onwards, PBoC will be releasing data on PSL on a monthly basis.

The latest statement further reaffirmed the role of PSL, which is one of the instruments among PBoC's monetary policy "toolbox". These include an alphabet soup of acronyms such as MLF (Medium-term Lending Facility, 中期借贷便利), SLO (Short-term Liquidity Operations, 公开市场短期流动性调节工具), SLF (Standing Lending Facility, 常备借贷便利) created only in recent years as PBoC refined its liquidity and interest rates management just as financial markets are further liberalized and increasingly becoming more complex and sophisticated.

Unlike other instruments, which are short term tools to manage liquidity conditions ranging from short term operations of 1 day to 3 months (for SLO and SLF/MLF), PSL is of medium term duration of 3 to 5 years. This means that PBoC can now employ a range of tools to influence short term to medium term liquidity conditions and interest rates.

### PSL and Local Government Debt Swap

The release of details on PSL also coincided with the recent developments on the local government debt swap program, with speculation that the total amount planned for this year to double to RMB2tn from the original RMB1tn. This speculation no doubt was encouraged by the successful placement of Jiangsu province's RMB10.9bn worth of bonds on Mon (1 Jun), as part of the debt swap program.

The swap program is one of the key planks in resolving China's local government debt burden, which the National Audit office estimated to stand at RMB17.9tn at end-Jun 2013 (some recent analyses suggested the outstanding balance may have risen to more than RMB20tn since then), with an estimated RMB1.86tn coming due in 2015, in addition to contingent liabilities of RMB919.3bn, data from the same 2013 audit report show. Based on the 2013 audit report, more than 56% of the local government debt was in the form of bank loans. As such, banks play a crucial role in this restructuring exercise to rehabilitate local governments' finances.

As these loans owed by local governments are swapped and restructured into bonds with longer duration and lower interest rates, the upside is that banks will be able to free up capital/boost capital ratios, reduce the loan-to-deposit (LD) ratios, slowdown the formation of non-performing loans (NPLs) and provisions, and otherwise improve the overall asset and credit quality of the banking sector as a whole. It is therefore no surprise that restructuring could be expanded from the current RMB1tn size.

However, up to this point, a necessary condition is being created for banks to improve their asset quality and capacity to lend. However, this condition is not sufficient to spur local banks to increase their lending activities. This is where the PSL could potentially play a role, even though it is not explicitly stated as such. As these privately placed, restructured local government bonds are not tradable in the open market, the only way to obtain stable and low cost funding is to pledge them to the central bank, via such program as the PSL. This will be in line with Premier Li Keqiang's earlier exhortation of targeted use of increased quantity and existing resources ("用好增量 盘活存量").

This may sound like a China version of "Quantitative Easing" or QE. However, it is only true to the extent that PSL, MLF, QE, and others are "quantitative" in nature, i.e. the creation of new money. But unlike the QE of the US Fed, European Central Bank (ECB), and Bank of Japan, with a prescribed size of large scale asset purchase (LSAP) program over a set calendar period to expand the central bank's balance sheet. In this instance, PSL and the likes are closer to refinancing programs such as ECB's Long Term Refinancing Operations (LTRO), than to QE.

### **Large Denomination Certificates of Deposit (CDs)**

On Tue (2 Jun), PBoC also announced the launch of Large Denomination Certificates of Deposit to both individuals and institutional investors, which will help to improve funding for banks and liability management, and to reduce the attractiveness of wealth management products. Previously, only depositary financial institutions were allowed to issue and trade in CDs.

The minimum amounts for large denomination CDs are set at RMB300,000 for individuals and RMB10mn for institutional investors, and will be sold among core members in a self-regulated system as a trial at initial stage. More importantly, CD interest rate to be decided by market with the floating-rate CD using Shibor as a benchmark, as China moves towards full liberalization of interest rate, which is likely before end-2015. Making CDs attractive to investors are that they can be transferred, pledged, redeemed and withdrawn early, and will be included in deposit insurance system.

With the recent increased deposit rate ceiling to 1.5x of benchmark rates and the introduction of deposit insurance from 1 May, commercial banks have increased flexibility to price their deposits, especially with larger denominations being involved. This will certainly make CDs an attractive alternative to wealth management products (WMPs), after taking into account features such as deposit insurance, tradability, ability to pledge, early withdrawal, among others.

### **Capital Account Opening Measures**

On Wed (3 Jun), China announced further opening of the capital account, by allowing offshore RMB offshore RMB clearing-and-settlement banks to participate in China's interbank bond market's repurchase facilities, and the funds raised can be used outside of mainland China.

This latest move is to address the last few remaining major restrictions of China's capital account, i.e. the inability of foreign institutions to raise funds in China's bond and equity markets, and individuals from China to move funds offshore. The further opening of China's capital account will help to lower offshore RMB funding costs and improve offshore liquidity conditions, as China keep its eye on the prize of being included in IMF's Special Drawing Rights (for further details on SDR, please refer to our report "China: Aiming for the SDR Basket, dated 30 Apr 2015).

Source:

PBoC's PSL Operations Details

人民银行开展抵押补充贷款操作2 Jun 2015

<http://m.weibo.cn/3921015143/Ckicit8gm>

PBoC's Guidelines for Large Scale Certificates of Deposit

大额存单管理暂行办法 2 Jun 2015

[http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2015/20150602161842756366076/20150602161842756366076\\_.html](http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2015/20150602161842756366076/20150602161842756366076_.html)

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