



EQUITIES RESEARCH

CHINA BANKS

THE LDR HURDLE

Talk of China's banking regulator scrapping loan-to-deposit ratio (LDR) requirements (capped at 75%) has been around a while and recently made headlines again. While we believe administrative liquidity requirements like LDR do not fit the rapidly evolving landscape of China's financial sector and should ultimately disappear, CBRC is unlikely to remove the LDR requirement within 2012. We think near term we are more likely to see a loosening of the requirement, to ease operating pressures on smaller banks.

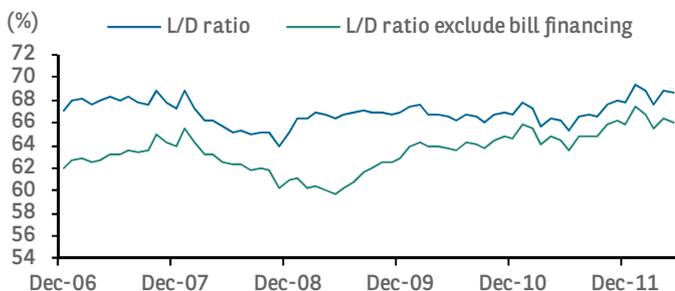
To recap, the purpose of setting a LDR requirement is to limit banks from rampant credit growth. However, the rule was created when banks enjoyed ample sources of deposits, which does not seem to fit today's trend of disintermediation. 2012 is the first year in most China observers' memory that banks might fail to fill the new loan target set by the monetary authority, due to constraints in funding sources as well as weak credit demand from broad-based enterprises. Also, as China is moving to a BASEL III framework, which does not stipulate LDR as a risk management parameter, now looks like a good time to make the change.

However, we think technical difficulties mean we are unlikely to see the removal of the LDR requirement in 2012. The 75% maximum LDR is stipulated by China's Commercial Banks Law. This puts it beyond CBRC's authority to change or abolish. To change the Commercial Banks Law requires hearing and approval at People's Congress level, which means the soonest possible time is March 2013 if CBRC proposes removal now. To change the law without going through People's Congress would be illegal.

In practice, there is no need for CBRC to go against the Commercial Banks Law if it wants to help banks facing constrained funding sources. History suggests CBRC does have a few options to create breathing room for banks, such as: 1) excluding discount bill loans when calculating total loan balance. This would immediately lower the sector's LDR from 68.7% to 65%, helping smaller banks that struggle to make the 75%; 2) temporarily allow smaller banks to lever up to higher levels. After the financial crisis in 3Q08, smaller banks were allowed to lever up to 85%; 3) stop implementing penalty measures on banks whose LDR is above 75%, such as prohibiting them from adding new branch or sub-branch networks.

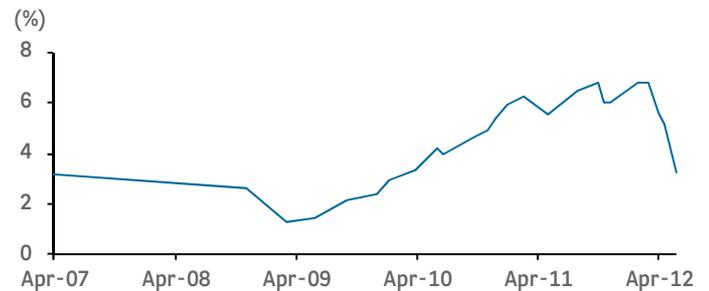
Overall, we believe weakened credit demand is a bigger constraint than tight funding for banks to regain growth momentum. The recent six month fiscal deposit auction saw the rate drop from 6.8% (beginning 2012) to 3.2%, implying pressure to compete for deposits is dropping, as a reaction to declining credit demand in a decelerating economy. Even if smaller banks are allowed to lever up to 85%, the impact will be limited to easing operating pressure, rather than immediate upside in credit growth throughout the system.

EXHIBIT 1: Sector LDR lowered, excluding discount bill loans



Sources PBOC; BNP Paribas

EXHIBIT 2: Auction rate for six-month fiscal deposits dropped



Sources: WIND; BNP Paribas



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