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ABCI Policy Insight

Establishment of new interest rate transmission mechanism and the subsequent rate cut

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Establishment of new interest rate transmission mechanism and the subsequent rate cut

Summary

A new lending rate transmission mechanism has been established. PBC has adjusted interest rate of MLF to affect the LPR of commercial banks. LPR has become the benchmark reference for banks in determining the lending rate for borrowers.

The market expects the interest rate to decline further. Since the outbreak of COVID-19 in Jan 2020, the capital market has been expecting PBOC to lower interest rates to support the economy. As expected, PBOC lowered the interest rate of the latest batch of MLF by 10bps, while the commercial banks also lessened the 1-yr LPR by 10bps on Feb 20. However, the bond market expects a more aggressive rate cut. Between Jan 23 and Feb 20, the yield curve of China's government bonds shifted downward, reflecting the anticipation of a 20 bps rate cut. Hence, the 10bps cut in LPR this week is milder than expected. The bond market is expecting further rate cut after the lowering of LPR this week.

Interest rate gaps are affecting banking business and risk appetite. Our analysis suggests the emergence of various interest rate gaps. The rate differential between 1-yr LPR and 1-yr MLF is narrowing, while the one between 5-yr LPR and 1-yr LPR is expanding. These discrepancies will affect business preference and risk appetite of banks.

Mounting expectations of RRR cuts. We believe PBOC will lower RRR to support the economy; furthermore, the authority is gradually changing its management philosophy to one that allows for more autonomy in banks in determining its allocation of financial resources. PBOC is enabling banks to play a bigger role in resource allocation in the economy.

Balance sheet management of central banks in major economies may undergo significant changes in 2020. For the last two years, the Fed has been shrinking its balance sheet; meanwhile, PBOC, ECB, and BOJ have slowed the expansion. Since 4Q19, the Fed has been growing its balance sheet. Central banks of other major economies are unlikely to reduce their balance sheets in 2020 **-** in contrast, they will expand at a faster pace. It is advisable to lock in some high-yield medium-risk assets in early 2020.

Increased exposure to personal mortgage loans business has driven up systemic risk in the economy. The 5-yr LPR fell 5bps this week. We expect the weighted average interest rate of mortgage loan to lower by 5bps to 5.50% or 75bp higher than the 5-yr LPR. Our concern lies on the growth in the supply of mortgage loans, which is approaching its peak; such sharp increase would need to be quelled. The proportion of personal mortgage loans in total RMB loans increased from 13% in 2013 to 20% in 2019. Increased concentration on personal housing loan business will elevate systemic risk – and we believe the central bank and regulatory bodies are aware of such elevation. Considering the unusual circumstances this year, China may take action in the following year to manage such risk.

"Gray Rhino" risk: We are not ruling out that banks may slash growth in home mortgage loans significantly in coming years to reduce concentration risk. If banks reduce the supply of home loans, property sales could be adversely affected, and developers would need to deduce ways to manage the probable risk.

Formation of a new lending interest rate transmission mechanism

Previously, PBOC was responsible for setting the benchmark lending rates. Under the new mechanism, the LPR has become the lending reference rate. LPR is determined by the bank, but the formation of the bank's LPR is based on the interest rate of MLF. In another word, PBOC can influence the LPR of commercial banks by adjusting in interest rate of MLF.

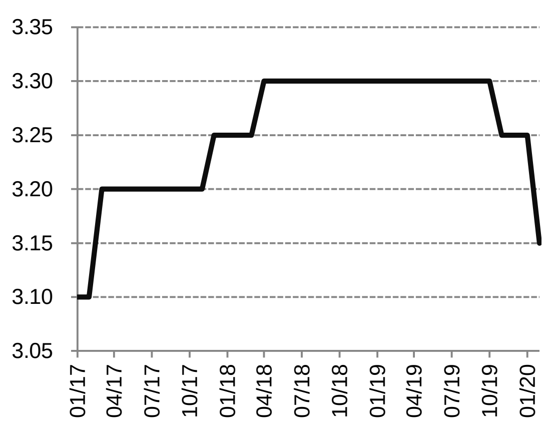
According to PBOC, LPR quotations are formed by adding basis points (bps) to the rates of open market operations (mainly the MLF interest rate). It is calculated by the national interbank lending center to provide pricing reference for bank loans. At present, LPR includes two duration terms: 1-yr and 5-yr. LPR quotation banks currently include 18 banks. Before 9:00 am on the 20th in each month (postponed in case of holidays), each quoting bank would submit its quotation to the national interbank lending center with 0.05ppt as step length. The national interbank lending center derives the LPR by obtaining the arithmetic average after removing the highest and lowest quotations and rounding it to the nearest integer multiple of 0.05%. The LPR will be announced at 9:30am on the same day and be published on PBOC's website.

MLF interest rate and LPR trend

PBOC provides MLF to major banks to increase liquidity in the banking system, and MLF is repaid to withdraw liquidity from the market. Since MLF is one of the money market operation tools, its interest rate contributes to the banks' financing cost, which in turn affects the latter's determining of LPR every month. Aside from the interest rate trend, we should also consider the changes in the interest rate gap that incentivize profit-oriented banks to adjust their business and risk appetite.

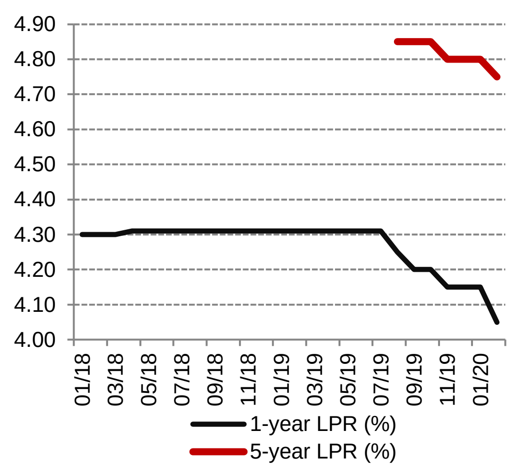
A downtrend in interest rates is expected. The 1-yr MLF rate has fallen by 15bps since 4Q19. The latest 1-yr MLF rate offered by the central bank in Feb was 3.15%. On Feb 20, the 1-yr and 5-yr LPR decreased by 10bps and 5bps to 4.05% and 4.75%. 1-yr LPR fell 25 bps from July 2019 to Feb 20, while the 5-yr LPR fell by 15bps during the same period. The uneven decline has led to differential changes in interest rate gaps.

Exhibit 1: 1-yr MLF interest rate (%) - since 4Q19, the rate has declined by 15bp



Source(s): PBOC, ABCI Securities

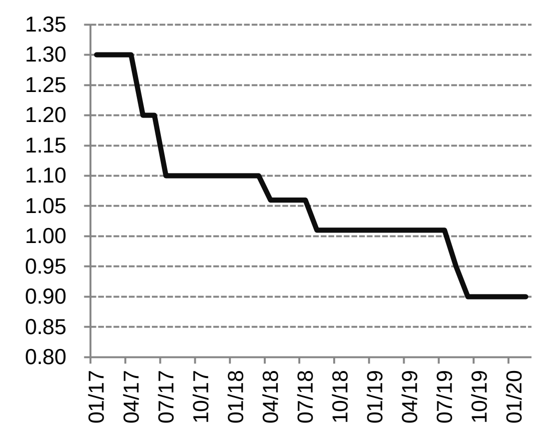
Exhibit 2: 1-yr LPR has declined by 25bps since Jul 2019; 5-yr LPR has declined by 15bps since Aug 2019



Source(s): PBOC, ABCI Securities

Different interest rate gaps are forming, leading banks to adjust business direction and risk appetite accordingly. PBOC instructs banks to set the LPR according to the direction of the MLF interest rate. The LPR-MLF interest gap is narrowing, curbing the profitability of the loan business in banks. The interest gap between the 1-yr LPR and the 1-yr MLF narrowed from 130bps at the beginning of 2017 to 90bps in Feb 2020. To compensate for the narrowed LPR-MLF gap, banks can increase the credit spread to loan customers or increase the maturity mismatch of assets and liabilities to improve profitability. On the other hand, the interest gap between the 5-yr LPR and 1-yr LPR expanded from 60bps in Aug 2019 to 70 bps in Feb 2020. Expanding the interest rate gap will encourage profit-oriented banks to increase the proportion of long-term loan business.

Exhibit3: Interest rate gap（1 yr LPR – 1 yr MLF）



Source(s): PBOC, ABCI Securities

Exhibit4: Interest rate gap（5yr MLF – 1 yr MLF）

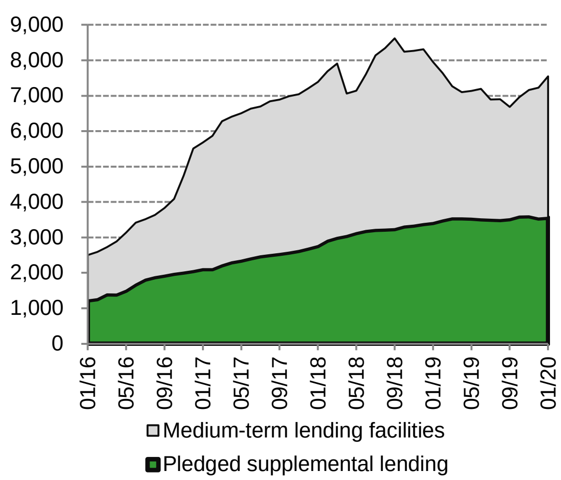
Source(s): PBOC, ABCI Securities

MLF and balance sheet management of PBOC

At present, two major money market operation tools are affecting the economy - the medium-term lending facilities (MLF) and the pledged supplemental lending (PSL). These tools are utilized by PBOC to inject medium-to-long-term liquidity into the banking system and, subsequently, the real economy. Due to the vast outstanding balances, these are considered to be the major money market operation tools. By the end of Jan 2020, the outstanding balances of MLF and PSL were RMB 3,990bn and RMB 3,574bn; the total balances accounted for ~20% of the total assets of PBOC. PBOC is required to manage their balance sheet just like the commercial banks do

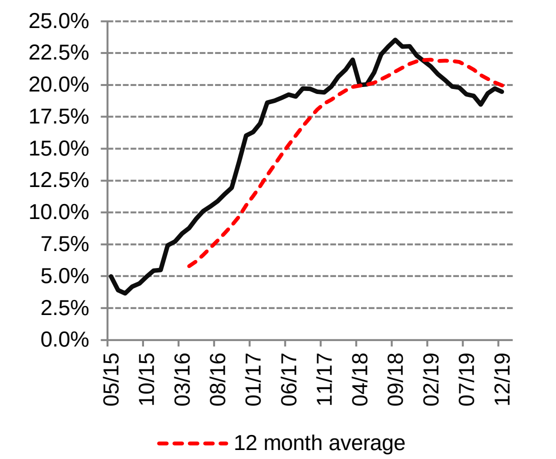
Since 4Q19, PBOC has increased its MLF supply to the banking system, and we expect such increases to extend to 1H20. Since 2019, PBOC has begun to slow down the growth of PSL to policy banks. So far, there have not been signs indicating that the central bank would reduce PSL.

Exhibit 5: MLF and PSL balance, (RMB bn)



Source(s): PBOC, ABCI Securities

Exhibit 6: Proportion of MLF and PSL balances in total assets of PBOC increased from 5% in 2015 to 20% in 2019

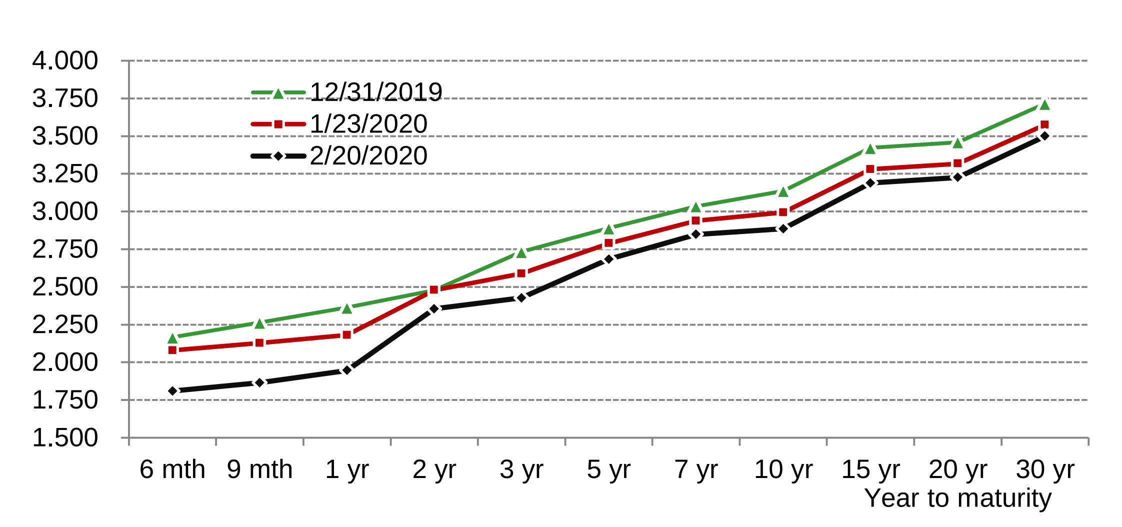


Source(s): PBOC, ABCI Securities

Bond market expects further rate cuts

Between Jan 23 and Feb 20, the yield curve in China's government bond market shifted downward, with the yield of 1-yr and 2-yr national debts dropping by 24bps and 13bps. Yields of 6-mth and 9-mth bonds fell 27bps and 26bps over the same period. The bond market expects interest rates to be slashed by ~20bps as a whole. As a result, LPR rate cut this week was less than the market had anticipated. In other words, after this week's LPR cut, the market is expecting further rate cut shortly.

Exhibit7: China's government bond yield curve (%YTM) – Shifting downwards

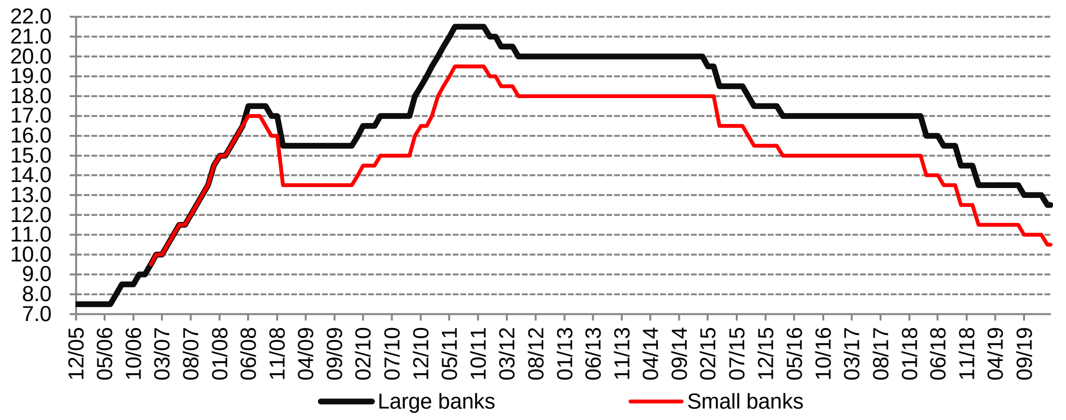


Source(s): Chinabond, Bloomberg, ABCI Securities

RRR trend

We believe PBOC has lowered the RRR to allow for greater flexibility and efficiency in banks to manage their deposit resources. Aside from stabilizing the economy, the adjustment reflects a change in management philosophy and increased trust in commercial banks that enable them to play a more important role in the allocation of financial resources. However, the continuous or substantial reduction in RRR will pose challenges to PBOC's balance sheet management. E.g., when RRR is slashed substantially or continuously within a short period, PBOC would need to reduce the size of its assets (such as reducing MLF or SLF), which will offset the positive effect of the RRR cut.

Exhibit8: RRR (%) trend

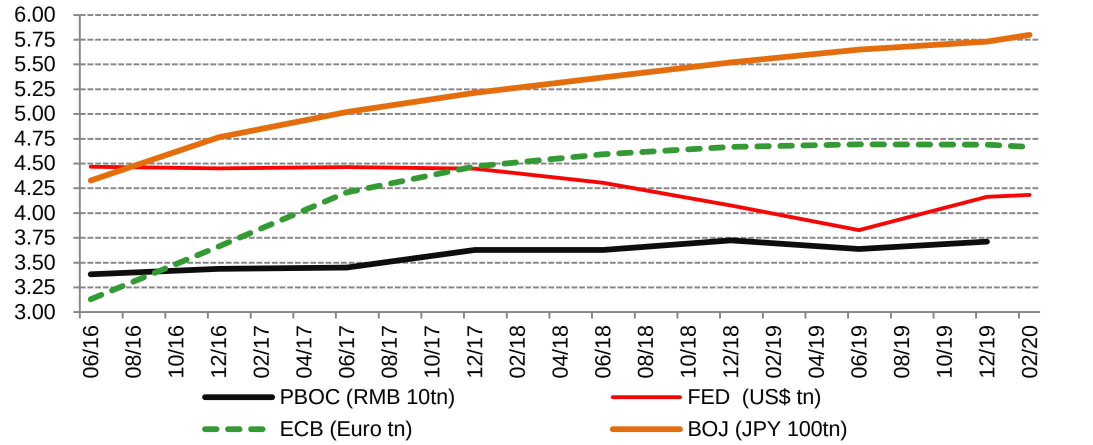


Source(s): PBOC, ABCI Research

Balance sheet management of central banks in major economies may undergo significant changes.

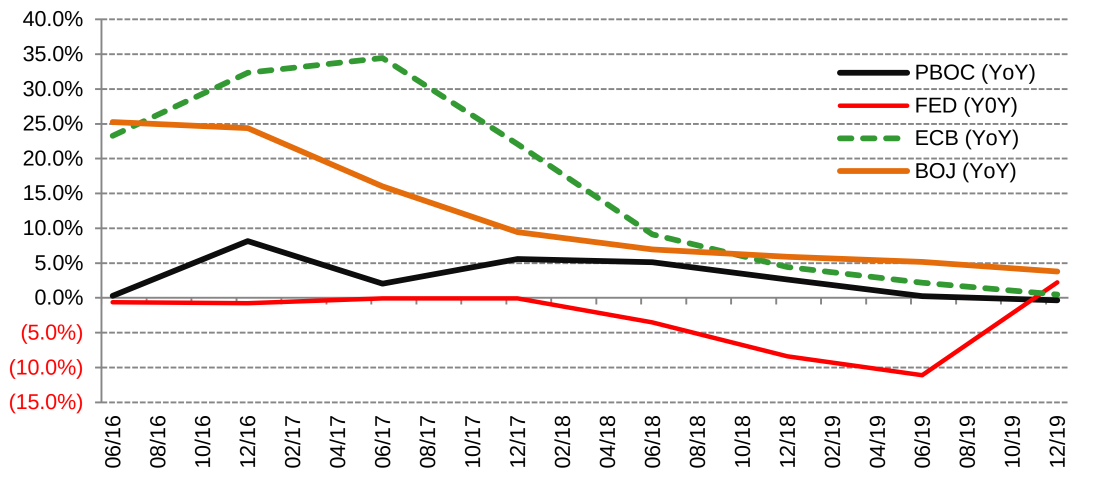
Balance sheet management of central banks in major economies could undergo significant changes in 2020. Over the past two years, the Fed has scaled down its balance sheet. PBOC, ECB, and BOJ have slowed their balance sheet growth. The Fed has begun to expand its balance sheet in 4Q19; in 2020, the central banks in other major economies may follow suit - or at the very least, not shrink it. In short, the likelihood of a sharp rise in global liquidity supply will be increasing in 2020, and it is advisable to lock in the high-yield and medium-risk assets early this year.

Exhibit 9: Total assets of major central banks



Source(s): PBOC, FED, ECB, BOJ, ABCI Securities

Exhibit10: Total assets of central banks (%YoY) – the Fed is resuming balance sheet expansion



Source(s): PBOC, FED, ECB, BOJ, and ABCI Securities

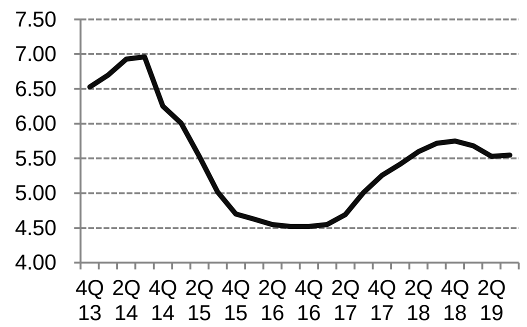
Impact on the housing market

The 5-yr LPR decline was small, so the interest rate of personal mortgage loans is expected to fall by 5bps, and the weighted average interest rate of personal mortgage loans may drop to 5.50%, 75 bps higher than the 5-yr LPR. We are not as concerned about the level of interest rate as we are about the supply growth of personal mortgage loans, which is approaching the limit, meaning that a substantial reduction could be in sight.

For years, the growth in personal housing loan balance has been much higher than the growth in total loan balance; rising exposure to the housing loan market has led to an increase in the concentration risk for banks. The proportion of personal housing loan balance in the RMB loan balance of FIs rose from 13% in 2013 to ~20% in 2019. The increase in business concentration risk will inevitably elevate the systemic risk; hence, the central banks and regulators would need to take preemptive measures to avoid further increase in concentration risk.

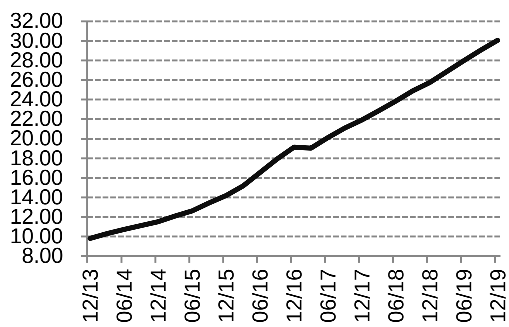
Gray Rhino Risk: From a risk management perspective, we reckon that banks would keep the ratio of personal mortgage loans to below 20% of total loans in the foreseeable future. We are not ruling out that banks might reduce such ratio in the near future (that is, the growth of personal mortgage loan balance will be much lower than the growth of total loan balance). If banks are reducing the growth of personal mortgage loans to a level below that of the total RMB loans, housing sales of real estate developers will be negatively impacted in coming years. The risk of a major adjustment in the property market will increase; subsequently, the repayment ability of developers will decline - a risk that would need to be addressed as soon as possible.

Exhibit 11: Quarterly weighted average interest rate of personal mortgage loans (%) – we expect the rate to decline by 5bps in 1Q20



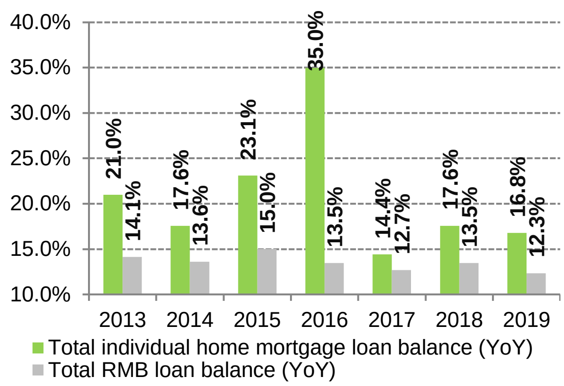
Source(s): PBOC, ABCI Securities

Exhibit12: Balance of personal mortgage loans（RMB tr）increased by 16.8% YoY to RMB 30.07 tr at end-2019



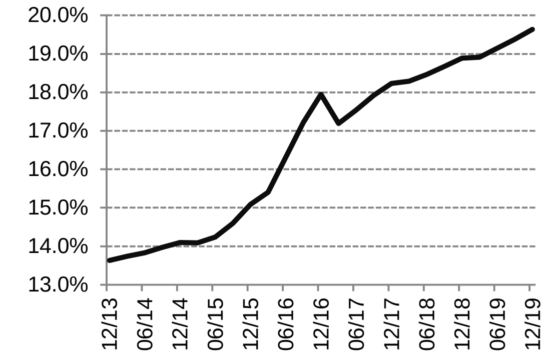
Source(s): PBOC, ABCI Securities

Exhibit 13: Growth of home mortgage loan balance and total RMB loan balance



Source(s): PBOC, ABCI Research

Exhibit 14: The proportion of home mortgage loan in total RMB loan increased to ~20%, indicating an increase in concentration risk and systemic risk



Source(s): PBOC, ABCI Research

The Fed's rate cut - its impact on the U.S. housing market

Following the Fed's substantial interest rate cut in 2H19, the capital market generally expects a rate cut cycle to begin in China in 2020. We believe the impact of the rate cut on the US housing market would provide a reference for the potential changes that may emerge in China's.

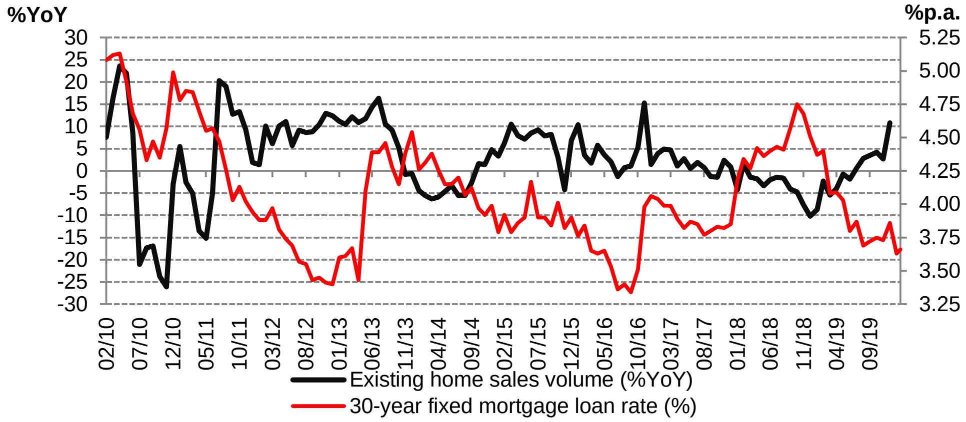
Since the end of 2018, risk aversion and expectations of rate cuts by the Fed have driven down the US home mortgage rates. Since the end of 2018, concerns over the economic slowdown have led global investors to purchase high-grade bonds to hedge risks. In 2H19, the Fed slashed the fed fund rate range three times from 2.25-2.5% in June to 1.50-1.75%, a decrease of 75 basis points. These factors have led to lower yields on government bonds issued by government agencies and lower yields on mortgage-backed securities. Homebuyers, therefore, enjoyed a lower mortgage interest rate.

Falling mortgage interest rates are prompting homebuyers to purchase properties. The 30-year fixed home loan interest rate began to fall after reaching a 7-year high of 4.82% in early Nov 2018, and fell to 3.64% in early Feb 2020, a decrease of 118 bps that is deeper than the Fed's rate cut. The U.S. existing home sales growth (YoY) bottomed to -10.23% in Dec 2018 and rebounded to 10.8% in Dec 2019.

The recovery in existing home sales has encouraged home builders to construct new homes. In Dec 2019, the number of applications for building permit increased by 40.8%YoY. Construction spending growth started to recover in 4Q19. Given the sharp increase in applications for building permits in late 2019, we expect home construction activities to ramp up in 2020.

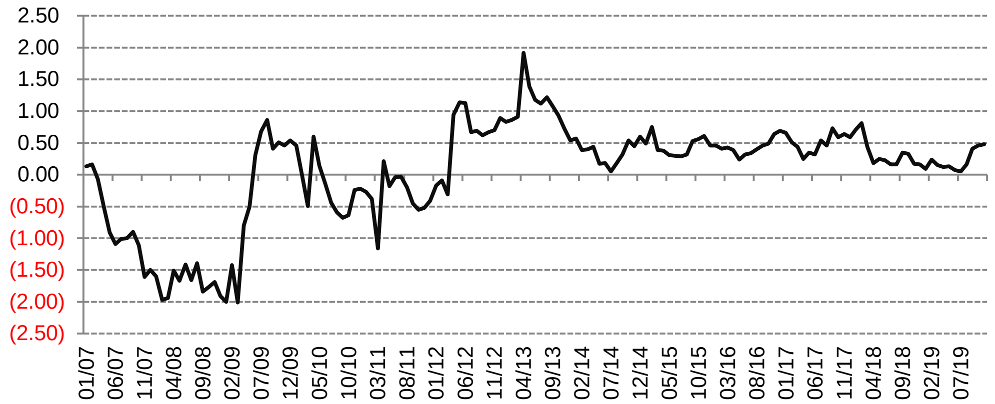
Global bond investors and the Fed may have unintentionally stimulated the U.S. housing market. Still, homebuyers nonetheless respond to the drop in interest rates by purchasing properties, and home builders respond to the increase in real estate transactions by ramping up construction to fulfill the rising demand.

Exhibit 15: US existing home sales (%YoY) vs. Home mortgage loan rate（%pa）-The decline in mortgage loan rate has driven up home sales since 2H19



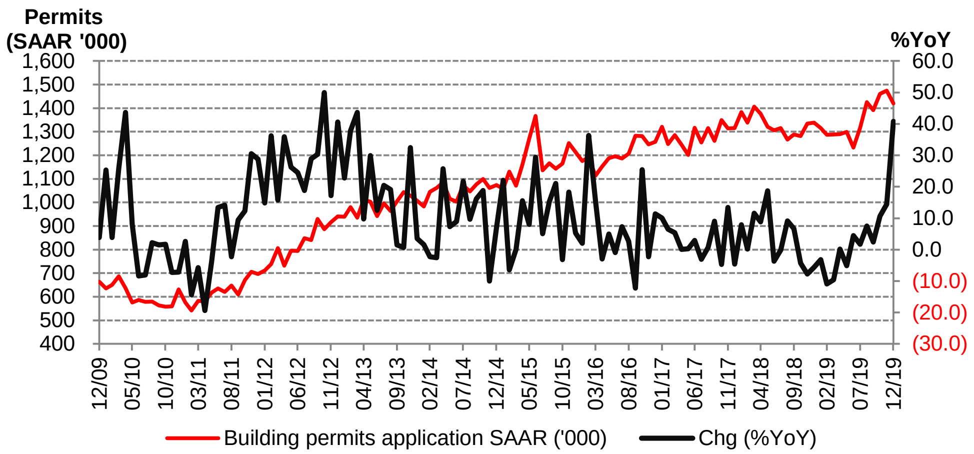
Source(s)：US Census Bureau, Bloomberg, ABCI Securities

Exhibit16: US home prices in 20 major cities（%MoM）- Since Apr 2012, home prices have recorded 92 consecutive months of MoM increase



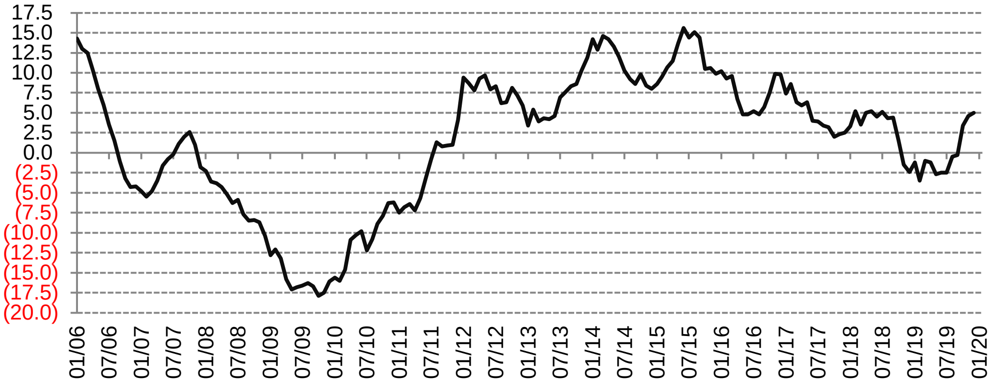
Source(s)：S&P/Case-Shiller 20-City, Bloomberg, ABCI Securities

Exhibit 17: Building permits application - Substantial growth of application in 4Q19 will lead to strong growth in construction activities in 2020



Source(s)：US Census Bureau, Bloomberg, ABCI Securities

Exhibit 18: US construction spending growth (%YoY) - Construction spending has begun to recover since 4Q19



Source(s)：US Census Bureau, Bloomberg, ABCI Securities

Disclosures

Analyst Certification

I, Chan Sung Yan, Philip, being the person primarily responsible for the content of this research report, in whole or in part, hereby certify that all of the views expressed in this report accurately reflect my personal view about the subject company or companies and its or their securities. I also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report. I and/or My associates have no financial interests in relation to any listed company (ies) covered in this report, and I and/or My associates do not serve as officer(s) of any listed company (ies) covered in this report.

Definition of equity rating

Rating	Definition
Buy	Stock return rate≥ Market return rate (10%)
Hold	- Market return rate (-10%) ≤ Stock return rate < Market return rate (+10%)
Sell	Stock return < - Market return (-10%)

Notes: Stock return rate: expected percentage change of share price plus gross dividend yield over the next 12 months

Market return rate: average market return rate since 2008 (HSI total return index 2008-19 CAGR at 10%)

Time horizon of share price target: 12-month

Stock rating, however, may vary from the stated framework due to factors including but not limited to: corporate governance, market capitalization, historical price volatility relative to corresponding benchmark index, average daily turnover of the stock relative to market capitalization of the stock, competitive advantages in corresponding industry, etc.

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