BEIJING (MNI) - Traders in China's interbank market are on edge. The regulatory storm unleashed by the country's banking watchdog over the past month to rein in financial risks, strengthen supervision and curb arbitrage is exacerbating the already tight liquidity conditions in the money markets. Big banks, who provide most of the oil that lubricates the wheels of the interbank market, are reluctant to lend out their excess funds, while small banks who are crying out for money are having to pay more for the scraps their bigger brothers are prepared to throw them. Non-bank financial institutions are also suffering as the tighter liquidity makes it harder to refinance the debt they've taken on to undertake leveraged investments. The People's Bank of China, while standing firm on its deleveraging stance, is desperate to prevent a potentially destabilizing liquidity crunch and a spike in money-market rates. Traders say the PBOC is gauging the pulse of the market with increasing frequency so that it can inject funds in a timely manner when the need arises. In a sign of how fragile market stability has become, traders say the big banks are under orders to keep their lending taps open to the interbank market even as they are forced to obey the China Banking Regulatory Commission's (CBRC) order to unwind their investments in wealth management products (WMPs) and break the increasingly risky chain of financial institutions investing in each other's WMPs. The gloom is reflected in the latest Market News International China Interbank Survey, which shows just over two thirds of traders saying liquidity conditions have deteriorated over the past month. That's up from 35% in the previous survey and the highest percentage for an April since the survey began in May 2014. The survey gauged the opinions of 19 traders with financial institutions operating in the Chinese interbank market, the country's main platform for trading money market, bond and currency instruments, and the main funding source for financial institutions. Interviews were conducted from April 20 to 24. "Banks have been redeeming their investments in asset management products because of the CBRC directives and that's really squeezed liquidity, which is killing us," said a trader with a small commercial bank in eastern China. Large banks have been reluctant to lend for several months for a combination of reasons, including meeting the criteria in the PBOC's quarterly Macro-Prudential Assessment, but have become increasingly unwilling to provide liquidity to the market over the past month due to the CBRC's regulatory storm. "But they are under administrative orders to lend because regulators are trying to prevent a crunch that could be triggered by a liquidity shortage among smaller banks," said a trader with a state-owned bank in Beijing. "The central bank conducts 'window guidance' from time to time, but usually they talk to the heads of asset management department, so people like us don't know much of the details." Smaller banks have been among the biggest players in the interbank market seeking funds to expand their loan books and to invest in wealth management products through the issuance of negotiable certificates of deposit (NCDs). But as money-market rates have risen and liquidity has tightened as a result of the PBOC's reluctance to inject funding via open-market operations (OMO), it's become increasingly expensive and difficult for the smaller banks to roll over these short-term debt instruments let alone issue new ones. The latest CBRC rules are adding to the pain but traders sense disagreement among the regulators about just how much deleveraging pressure should be put on the market, which is also creating uncertainty. "The PBOC and CBRC don't seem to have reached a consensus on the strength of financial deleveraging," a trader in eastern China told MNI. He said news media reports that the central bank was unhappy about the impact the banking regulator's directives had had on the markets and didn't want the situation to continue, had gained a lot of attention. "We are guessing the two regulator are arguing with each other," the trader said. "So it's really hard to predict how much more forceful this regulatory storm will get and how long it will last. It seems that for the PBOC, maintaining stability is the priority." In the meantime, traders are complaining about the cost of borrowing in the interbank market. "It's really expensive now, but we have no choice, we have to borrow," said the trader in eastern China. "We just hope the big banks will lend to us. At least it's not as bad as last month when we were kneeling down to beg for money, but I am worried." The volume-weighted average rate of the benchmark seven-day interbank repo stood at 2.9721% on April 25 and has averaged 2.7389% so far this month. The rate has crept up each month from an average of 2.4914% in January. The daily fixing of the seven-day repo jumped from 2.65% on April 5 to 3.44% on April 25. The central bank has also imposed two increases in the rates on every maturity of reverse repos offered at open-market operations -- one in February and one in March -- which has taken the rate on the benchmark seven-day reverse repo to 2.45%. Sensing stress in the market, the PBOC went into overdrive last week. It added CNY170 billion via open-market operations, the second straight weekly net injection and most since mid-January. Another net addition is likely this week as CNY250 billion of reverse repos mature and banks get ready to make their end-month deposit of required reserves with the PBOC. As of Thursday, the PBOC has made a further net addition of CNY70 billion via its OMOs this week. The central bank also offered CNY495.5 billion of loans to banks via its Medium-term Lending Facility (MLF) on April 17, after a total of CNY217 billion in MLF instruments matured on April 13 and another CNY234.5 billion matured on April 18. This has resulted in a net injection of CNY44 billion via the MLF so far this month. Traders in the MNI survey were evenly split between those expecting the seven-day repo rate to rise further over the next two weeks and those seeing rates staying at the same level, with 47% in each camp. Only one respondent saw rates falling, the same number as in the March survey, the lowest number since December when no traders expected an increase. The central bank has been watching the market carefully for any signs of distress as the CBRC has dived headlong into the campaign to squeeze leverage out of financial institutions. "Communication between the PBOC and (financial) institutions is much more frequent these days to find out our demand for reverse repos," said a Shanghai-based trader with one of the Big Five commercial banks. "But the PBOC is only injecting money to avoid any big volatility as it pursues its deleveraging agenda." Another trader with a state-owned bank in Beijing added: "The PBOC's priority is to stabilize expectations so when liquidity is too tight it will add funds but the overall direction is a moderate tightening. "The outlook is gloomy for the bond market, too. The results of treasury bond auctions have not been very satisfactory due to more local bond issuance, and banks are changing their asset allocations by selling the most liquid assets first because of the CBRC's directives," he noted. Out of the 19 respondents to the MNI survey, 15, or 79%, said they expect the yield on 10-year government bonds to rise over the next three months, the most since January. Prices of government bonds have plunged over the past two weeks as financial institutions reacted to the CBRC's directives by selling their most liquid assets first. The yield on the most-active 10-year government bond stood at 3.505% on April 24, a jump of more than 21 basis points in 10 trading days. The strain on the smaller banks has led to increasing talk in the market about the need to reduce banks' reserve requirement ratio (RRR) to provide a permanent injection of liquidity to the whole financial system. An RRR cut would spread the benefit among all banks rather than just the few selected large banks who gain most from injections via the MLF, which has become the tool of choice for the central bank in its liquidity management. The PBOC hasn't cut the RRR since February 2016 partly out of concern that the liquidity released would find its way into speculative financial activities and into the hands of non-bank financial institutions, thwarting the deleveraging campaign. Even so, with the ratio now standing at 17% of total deposits for the largest banks, and less for smaller banks and those who meet certain central bank conditions, there is plenty of room for a cut. "I really hope the PBOC will cut the RRR because the current injections of liquidity just favor the big banks," said the trader in eastern China. "We small banks are thirsty too." --MNI Beijing Bureau; +86 (10) 8532 5998; email: marissa.wang@marketnews.com --MNI Beijing Bureau; +44 203-586-2244; email: nerys.avery@marketnews.com --MNI BEIJING Bureau; +1 202-371-2121; email: john.carter@mni-news.com How scared should I be?