The final version of the new rules for China’s CNY 100tn asset management industry has now been published by the Chinese financial regulators. In this Executive Interview, Aidan Shevlin, Head of Asia Pacific Liquidity Fund Management, J.P. Morgan Asset Management, explains the implications of the new rules for the industry, and for corporate treasurers, whilst outlining practical steps for rethinking liquidity management practices in the country.

What are the new asset management industry rules? When do they come into force in China, and what will their broad impact be?

Officially known as the ‘Guiding Opinions on Regulating the Asset Management Business of Financial Institutions’, the new regulations represent a comprehensive restructuring of China’s asset management industry. Introduced by the new Financial Stability and Development Committee.
China’s AMP rules: need to know

At a glance, what are the new AMP rules looking to achieve?
In brief, the new rules are designed to: limit shadow banking activities; ban expected return and principal guarantees; harmonise regulatory standards; and reduce regulatory arbitrage.

What constitutes an ‘Asset Management Product’ according to the rules?
Historically, shadow banking was the broad term for all non-time deposit products issued and managed by commercial banks and financial institutions, including wealth management products (WMP), trust products (TP), asset management plans and so on. The new regulations specifically define Asset Management Products (AMPs) as an umbrella term for all these instruments (with a few exceptions such as private funds and pension products).

Under the new rules, all public AMPs must be managed on a mark-to-market net asset value (NAV) basis (there are some exceptions for amortised NAVs) without offering expected returns or implicit guarantees. AMPs will have strict rules on leverage, layering and risk reserves; in addition they must be managed by a segregated asset management business and have a separate custodian.

How does the regulator define standard assets and non-standard assets?
The new rules stipulate that publicly-offered AMPs, which make up the majority of existing products, can only invest in standard assets (SAs). Typical standard assets are tradable fixed income instruments or equity shares. Non-standard assets (NSAs) are essentially all other assets.

According to the new rules, qualified investors can still buy privately offered AMPs that invest in NSAs, but there are strict rules regarding the type of investors, pricing of the NSAs and type of investments that private AMPs can put money into. As such, it is worth seeking specialist advice on this topic where appropriate.

Why were new regulations needed for the shadow banking sector and what were the Chinese authorities looking to achieve?
A confluence of factors has led to the introduction of these new rules – but clamping down on China’s shadow banking industry has been one of the major drivers. Shadow banking in China is a by-product of past financial regulations and interest rate liberalisation, as borrowers and lenders sought to circumvent rules to achieve access to capital at more market-driven interest rates.

It is not hard to see why shadow banking became so popular: investors benefited from very attractive and stable yields with principal guarantees, while financial intermediaries like commercial banks were able to take assets off-balance sheet and generate profitable fee income; and finally these products offered financing to issuers who were perhaps unable to access other sources of funding. Between March 2015 and September 2017 the amount of shadow banking products outstanding doubled from CNY54.2trn to CNY107.6trn. At their peak in Q4-2015 wealth management products – the largest individual asset class, representing a quarter of assets - grew by 56%/y/y.

But in some ways, these benefits were too good to be true. There was a distinct lack of transparency around the underlying assets in many shadow banking products, and in recent years some of these opaque assets turned out to be very poor quality. In addition, the use of leverage and layering created a complex web that touched almost every part of China’s financial industry. While certain banks performed bail-outs where necessary, this only fuelled further investor interest, since they assumed that their WMPs were ‘safe’ – triggering concerns about moral hazard.

By the end of 2017, the shadow banking sector had ballooned to US$12.3trn, representing approximately 39% of China’s GDP and approximately 63% of all bank loans. The Chinese authorities realised this behemoth need to be contained while also eliminating misconceptions about principal guarantees and establishing stronger links between risk and return. To this end, the...
new rules are a big step in the right direction. In fact, the AMP rules are one of the most significant changes ever in the history of China’s shadow banking industry.

What other drivers led to the issuance of these new rules?

Even as economic growth has slowed (from an average of 11% y/y between 2006 and 2011 to 6.8% in Q1-2018⁴), debt outstanding has sky-rocketed. In fact, the country’s percentage of debt to GDP has increased from 164% in 2007 to 266% at the end of 2017⁵. Although this is still significantly lower than many developed markets like the USA (253%) and the UK (280%), it is substantially higher than the average for other emerging market countries (circa 140%) and has been growing rapidly⁶. Additionally, the number of credit defaults in China has increased in recent years, with 72 issuers defaulting year-to-date in 2018 compared with none prior to 2014 and 65 for the whole of 2017⁷. This is a significant risk and a key concern for the government. The majority of this growth emanated from the corporate and state-owned enterprise (SOE) sectors — and is widely considered unsustainable, with the potential to trigger a financial crisis if it continued to increase unchecked. While the term SOEs suggests financial strength and solid government links, it is a misnomer, as China’s SOEs vary widely in terms of credit quality and have never been guaranteed by the central government. One of the government’s three main aims for 2018 is to reduce financial risk in the market. To that end, they want to focus on the quality of growth rather than the quantity, and therefore want to put a brake on the proliferation of debt; the new AMP rules represent a key step on the path to deleveraging and debt reduction.

These new AMP rules also serve to harmonise the regulatory landscape in China. Historically there were four financial market regulators: the central bank – the People’s Bank of China (PBoC); the China Banking Regulatory Commission (CBRC); the China Insurance Regulatory Commission (CIRC); and the China Securities Regulatory Commission (CSRC). Splitting regulatory oversight in this way led to different focuses in the rules between sectors and regulatory arbitrage could happen. To put an end to this, a new super financial regulator has been created: the Financial Stability and Development Committee (FSDC). In tandem, the CIRC and CBRC have recently merged to form the China Banking and Insurance Regulatory Commission (CBIRC), while the PBoC and CSRC remain unchanged.

The FSDC is tasked with formulating the regulatory structure and coordinating regulatory workflows. Since the new regulations are based on product lines rather than sectors, the hope is that these unified regulations will reduce regulatory arbitrage.

Surely these new rules will have a significant impact on commercial banks? How will this change their business models?

As alluded to, commercial banks have historically played a critical role in shadow banking - both as major issuers and investors in asset management products. Under the new rules, however, the requirement to provide NAVs, the exclusion of NSAs from public AMPs and the removal of guarantees will likely lead to a dramatic reduction in shadow banking activity. The initial result for commercial banks will be a negative impact on fee income and profitability; subsequently banks will need to increase loan loss provisions and potentially face higher non-performing loans and impairments as they take some NSAs back onto their balance sheets.

It is not all bad news for the banks, though. On a more positive note, some of the funds currently invested in shadow banking products may well be re-invested in bank time deposits and certificate of deposits. In addition, the new rules allow banks to set up their own asset management subsidiaries to manage their legacy WMPs and new AMPs.

What might this mean for the competitive landscape? Which banks will be the winners? And where will all the money from AMPs actually end up?

Taking everything into account, it seems that banks with stronger traditional loan/deposit franchises and capital bases will be better positioned to withstand the impact of the new rules, at least in the short term. Looking longer-term, the reduction in systemic risk and the ability for banks to

In a nutshell

- The new rule is a positive move to reduce shadow banking, reduce systemic risks and avoid regulatory arbitrage
- However during transitions, commercial banks will suffer from negative impacts on fee income and profitability, credit conditions are likely to tighten, leading to greater uncertainty and volatility
- Investors will need to rethink their investment and liquidity to search for yields, encouraging financial innovation
establish asset management businesses should be supportive for the industry. Within these new subsidiaries, banks will need to get creative to attract new assets – launching a range of more transparent, and clearly delineated investments to appeal to different investors with varying risk and return requirements. But the good news is that encouraging banks to diversify their business models and embrace innovation, whilst spurring competition, should be a long-term positive for the banking industry.

How will fund managers in China be affected by the new rules? Is the future bright?
By and large, the new rules are positive for the onshore asset management industry, which already has a strong track record of offering a wide range of funds with good disclosure, clear pricing and independent custodians. What’s more, with mutual funds only representing 10% of the entire asset management industry in China today, there appears to be substantial room to grow further. This is especially true since the reduced availability of WMPs and TPs should spur growth of existing funds and innovation of new funds.

Will RMB money market funds (MMFs) be impacted by the new rules, then?
MMF assets in China continue to trend upwards. While RMB MMFs fall within the scope of the new rules, the CSRC had already introduced detailed new MMF rules in September 2017 – which have already derisked the MMF sector by improving liquidity, security and disclosures.

That said, the CSRC may issue further clarification for the entire mutual fund industry following the publication of the AMP rules. But it is unlikely that any significant, or even minor, changes will be made.

All in all, we see the rules being largely positive for MMFs as these products typically offer good disclosure, strict regulations and competitive returns – which should appeal to investors focused on security, liquidity and yield. Moreover, opinion in the market suggests that RMB MMFs will continue to operate at a stable NAV.

In your view, what will the impact of the AMP rules be on asset classes and market-driven yields?
Assets deemed ‘non-standard’ will likely see significantly lower demand, even if returns increase. Issuers of these NSAs may struggle to get funding – especially if banks are unwilling to take these debts back on balance sheet. This could push corporate bond spreads wider and trigger an increase in credit events.

Meanwhile, demand for standard assets will increase. This is potentially a positive for bond and equity prices, although this will be a longer-term trend.

What does all of this mean for corporate treasury functions and their liquidity management practices in China?
While the new rules represent a significant change in the market, corporate treasurers’ core investment goals should remain the same: security, liquidity and yield.

Where treasurers may need to rethink their investments is if they currently use any WMPs or TPs. Under the new rules, the benefits that some, more adventurous, treasurers have become accustomed to, in particular higher returns and principal guarantees, will no longer be available. This will require treasury professionals to reassess the risks they are comfortable with.

On the other hand, little will change for more conservative corporates, who will likely continue to invest in time deposits and MMFs. Nevertheless, they should also benefit from a greater range of products as the banks and fund managers innovate in reaction to the new rules. The choice of investments in China may soon rival that of Western markets.

Any other useful tips you could offer treasurers with liquidity in China around preparing for the new rules?
All treasurers will need to consider their credit and bank counterparty risks. Which banks are more exposed to the loss of income from WMPs, for example? And which banks will need to take more of these loans back on to their balance sheet in the future, thereby reducing the quality of the bank itself? These are important points to consider – sooner rather than later.

Elsewhere, the momentum generated by the new rules could be harnessed by local corporates to further embrace global best practice in cash and liquidity management. Local methods will no longer stand up to scrutiny. This is a great opportunity to internationalise.

Finally, how would you summarise the impact of the new rules? And what next steps should corporate treasurers take to embrace this change?
Overall, the new rules are a positive move by the regulators. While the rules may well tighten liquidity conditions and slow economic growth, they offer major benefits including the ability to reduce systemic risk and moral hazard. Their introduction brings an end to an era of regulatory uncertainty in the asset management sector, while the long grace period should allow for a smooth transition.

As well as continuing to focus on their three core investment goals, treasurers would do well to make sure their investment policies are kept up to date and that they have enough flexibility built-in to deal with the changes that may happen to the products they use. Another important next step is education. Treasurers ought to make internal stakeholders aware of the changes, the risks, and why more clarity around investments will be required going forward. In short, this is an exciting opportunity for treasurers to question existing set-ups and ensure they have a liquidity structure in place that is truly fit-for-purpose.

Notes
1 Source: JPMorgan as at 31st March 2018
2 Source: Bloomberg Data as at 31st March 2018
3 Source: IBIS report as at 30th April 2018
4 Source: Bloomberg Data as at 31st May 2018
5 Source: Bloomberg Data as at 31st Dec 2017
6 Source: JPMorgan as at 30th Apr 2018
7 Source: Moody’s Investor Services as at 31st May 2018
8 Source: JPMorgan as at 30th Apr 2018