BUILDING STRONGER LIQUIDITY STRATEGIES

THE IMPACT OF CHINA’S COMPREHENSIVE 2018 REGULATION OF ASSET MANAGEMENT PRODUCTS
INTRODUCTION

In April 2018, China announced major new asset management product (AMP) rules designed to curtail shadow banking activity, increase investor protection and reduce systemic risks. While the changes were widely regarded as necessary and important for the long-term stability and safety of the Chinese financial system, the unprecedented breadth and depth of the rules have propelled China into the most significant period of regulatory reform in over two decades, with momentous implications for banks, borrowers and investors.

BACKGROUND: BORROWING SURGE

As the global financial crisis engulfed Western economies, the Chinese government initiated an extraordinary period of borrowing to help support domestic economic growth. The unconstrained debt surge by local governments and state-owned enterprises temporarily boosted GDP, but continued investment in increasingly unproductive economic activity failed to prevent a long-term decline in China’s growth.

The pace and absolute size of debt outstanding have now become major concerns, with soaring debt levels raising the specter of a liquidity or credit crisis and leading some to question the stability of China’s financial system.

IN BRIEF

- The rapid increase in shadow banking—off-balance-sheet financial activities funded by largely unregulated asset management products—has helped push China’s debt-to-GDP ratio to potentially unsustainable levels.
- Asset management product rules introduced in April 2018 represent a concerted attempt by China’s regulators to curtail the shadow banking sector and reduce financial risks.
- The new rules herald major, positive changes in how financial institutions operate in the longer term, with significant positive implications for investors, issuers and financial markets, but they are likely to increase volatility and uncertainty.
- These new rules should benefit corporate treasurers by increasing innovation and choice; however, treasurers should not forget their key goals of liquidity and security.

In the past decade, China’s debt-to-GDP ratio has vaulted from 150% to over 260%, surpassing other emerging markets and approaching elevated developed market levels.
SHADOW BANKING

Bank loans were a major source of funding for China’s debt spree. Enabling this was the rapid increase in total social financing—a euphemism for shadow banking activities.

Conventionally, shadow banking is defined as all financial activity beyond basic bank borrowing and lending. In China, the shadow banking sector originally evolved following the liberalization of domestic interest rates2, which allowed borrowers and lenders to operate outside normal banking channels, through activities such as fund management and corporate bond issuance.

More recently, growth in shadow banking activities focused on moving assets off commercial banks’ balance sheets and repackaging them as AMPs3. These products experienced phenomenal growth due to a combination of very attractive yields and implicit guarantees.

Unregulated, and with no requirement to disclose holdings or mark to market, AMPs were free to invest in a broad range of opaque and illiquid securities, while using leverage to boost returns. With multiple financial institutions creating, distributing and investing in each other’s products, a complex web of interconnectedness emerged, underpinned by principal and return guarantees that created a moral hazard and magnified systemic risks.

China’s shadow banking sector doubled in size, reaching CNY100 trillion, in the past three years, nearly equivalent to China’s GDP.

SHADOW BANKING’S GROWTH:
UNINTENDED CONSEQUENCE OF DEREGULATION AND INTEREST RATE LIBERALIZATION

- Regulatory arbitrage
  Multiple, sector-specific regulatory bodies encouraged the financial industry to circumvent inconvenient rules

- Central bank interest rates
  Artificially low official interest rates encouraged investors to seek superior returns elsewhere

- Investors seeking yields
  AMPs offered investors high returns and implicit guarantees

- Complacent rating agencies
  Domestic rating agencies prioritized lenders’ government links over financial soundness

- Misaligned incentives for commercial banks
  Shadow banking proved a profitable way to grow assets and boost revenue, while circumventing regulation by moving assets off balance sheets

- Borrowers seeking funds
  Borrowers unable to access traditional investment sources obtained funding via shadow banking channels, albeit at higher cost

2. Asset management products (AMPs) are public investment vehicles for a broad range of assets including loans, receivables, etc. Wealth management products were sold by commercial banks, trust products were sold by trust companies and asset management plans were sold by securities companies.
**SIGNIFICANT CHANGES**

The enormous size and complexity of the shadow banking sector meant that a crisis, should one occur, would be painful. As the downside risks became more evident, the government committed to reform. It created the Financial Stability and Development Committee (FSDC)—a new senior regulatory agency headed by China’s Vice Premier and tasked with coordinating regulatory agencies, standardizing regulations and, ultimately, eliminating regulatory arbitrage.

Five months later, the FSDC published a comprehensive set of new rules to regulate China’s disparate AMPs and encourage the development of more prudent asset management businesses. Existing products will have a grace period until December 2020 to comply with the rules. All new, public AMPs will have to comply from the start.

**GOALS OF APRIL 2018 AMP RULES**

**PROTECT**
- Protecting investors, financial system
  - Distributors and asset managers must be separate to reduce conflicts of interest
  - Independent custodians and improved product disclosures are required
  - Stricter rules passed on structure, leverage and duration to reduce product risks
  - Asset manager risk reserves are increased

**SIMPLIFY**
- Simplifying products and rules
  - Official definitions enacted for AMPs, standard assets and qualified investors
  - Limitations placed on mismatches of investment maturities and asset maturities
  - Reduction in number of intermediaries (layers) between fund managers and final investors

**BAN**
- Banning questionable practices
  - Principal and return guarantees are banned
  - Public AMP cannot use amortized accounting or invest in nonstandard assets
  - Fund pooling and channel business are banned

**TIMELINE OF APRIL 2018 AMP RULES**

- **15 July, 2017**: President Xi Jinping ordered creation of new regulatory agency to tackle financial risk
- **8 November, 2017**: FSDC officially established
- **17 November, 2017**: Draft AMP rules introduced
- **27 April, 2018**: New AMP guidelines formally introduced; all new products must comply
- **20 July, 2018**: PBoC, CBIRC and CSRC announced implementation details
- **31 December, 2020**: All existing products must comply with new guidelines

---

1. Public AMPs are advertised and sold to the public. Private AMPs are those that only sophisticated, qualified investors can buy and which may invest in nonstandard assets. Strict rules define these qualified investors and private products.

2. Standard assets are defined as tradeable fixed income instruments or equities. All other assets are classified as nonstandard.

3. Fund pooling practices included rolling issuance and combining assets across separate products.

4. Channels, such as trust and securities companies, were used to mask and transform underlying assets.
SUBSTANTIAL IMPLICATIONS

The new rules bring about a major change in how commercial banks and financial institutions operate. While the rules should substantially lessen systemic risks and moral hazards, their onerous restrictions and ban on guarantees will greatly reduce the desirability of new AMPs.

Commercial banks will be hardest hit—initially by a loss of fee income from issuing AMPs. They will also need to source alternative funding, set aside larger credit provisions and potentially face higher numbers of nonperforming loans as residual nonstandard assets return to their balance sheets. Such negative repercussions will likely be borne disproportionately by smaller commercial banks with lower deposit bases and higher reliance on AMPs. The prospects for trust companies and securities companies will also dim as their key distribution businesses decline.

The challenge of replacing maturing products and attracting new investment will intensify as banks and financial institutions scramble to establish separate asset management businesses, appoint independent custodians and develop suitable new products. However, eventually, new entrants should bring more competition and innovation.

Investor demand for standard assets and mutual funds will likely increase, benefiting the already well-regulated mutual fund industry. Simultaneously, demand for nonstandard assets will likely decline sharply, increasing the costs and reducing the availability of funding for borrowers who had previously relied on AMPs as their main funding source—very likely triggering increasingly frequent credit events.

THE IMPACT OF THE 2018 AMP RULES ON MONEY MARKET FUNDS

- Mutual fund management products already comply with the majority of the new rules, offering good disclosure, clear pricing and independent custodians.
- Money market funds (MMFs) were already among the most heavily regulated Chinese financial products; rules issued in February 2016 and September 2017 further improved their liquidity, security and disclosures.
- Since 2017, MMFs have not been subject to any further regulation.

Comparison of MMFs vs. traditional AMPs and AMPs after passage of 2018 rules

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>MMFs</th>
<th>Traditional AMPs</th>
<th>AMPs after 2018 Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net asset value (NAV)</td>
<td>Stable</td>
<td>No</td>
<td>Variable NAV for majority of public AMPs</td>
</tr>
<tr>
<td>Bank guarantee</td>
<td>No</td>
<td>Implicit yield and principal guarantee</td>
<td>No</td>
</tr>
<tr>
<td>Maximum underlying investment maturity</td>
<td>1 year</td>
<td>Unlimited</td>
<td>Must more closely match assets and liabilities</td>
</tr>
<tr>
<td>Maximum duration</td>
<td>120 days</td>
<td>N/A</td>
<td>Closely match duration</td>
</tr>
<tr>
<td>Minimum credit quality</td>
<td>AAA</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Minimum liquidity</td>
<td>Minimum 5% overnight and 10% weekly</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Investment universe</td>
<td>Well-defined, including time deposits (TD), commercial paper (CP), certificate of deposits (CD), high-quality bonds</td>
<td>Undefined: Typically loans, structures, receivables, equities, bonds, etc.</td>
<td>Public AMPs can only invest in standard assets</td>
</tr>
<tr>
<td>Concentration</td>
<td>30% per bank, 10% per corporate issuer</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>
RAPID REPERCUSSIONS

The impact of the new rules is already evident in investor behavior, market movements and economic data.

Traditional AMP issuance has dwindled rapidly since the draft rules were announced in November 2017. Meanwhile, maturing AMPs are being reinvested in other asset classes, shrinking the shadow banking sector. As commercial banks have started taking nonstandard assets back onto their balance sheets, competition for deposits and alternative sources of funding has increased sharply.

The onshore credit markets have diverged: On one side, high-quality, AAA-rated securities unaffected by the new rules are in demand. On the other, demand has declined for lower-rated bonds. Highly indebted companies with weaker profitability have suffered a major upheaval in perceptions as investors re-price credit risk and concerns about downgrades and defaults intensify.

Finally, domestic economic growth has slowed as the pace of fixed-asset investment—a key beneficiary of shadow banking loans and sizable portion of recent economic growth—approaches a record low.

Shadow banking activity had already slowed sharply in anticipation of new rules

THE RISE AND FALL OF STRUCTURED DEPOSITS

- Structured deposits combine a bank deposit with an embedded financial product—typically, a derivative linked to an interest rate, exchange rate or stock price—and give investors higher yields than standard deposits for accepting the structure’s risk.
- Structured deposits saw a resurgence in growth in early 2018 as commercial banks created more to boost deposits and circumvent AMP rules.
- Subsequent CBIRC regulations clarified that structured deposits must be held on a bank’s balance sheet, be properly linked to derivatives products and have a genuine transaction counterparty.
- These subsequent regulations will likely curtail the use of structured deposits.

FINE-TUNING THE RULES

Less than three months after the 2018 AMP rules were introduced, supplementary documents from the PBoC, CBIRC and CSRC offered further clarification. They reiterated the key principles of the original AMP rules. However, they also emphasized the need for flexibility concerning the use of nonstandard assets and amortized pricing during the grace period. Cognizant of the risks an instant cessation of all shadow banking could cause, they allowed commercial banks, investors and issuers time to adjust.

To help alleviate pressure on commercial bank balance sheets, the PBoC has also cut the reserve requirement ratio twice and increased the supply of funds via its medium-term lending facility. The central bank also confirmed it will adjust its macro prudential assessment to take into account nonstandard assets returning to commercial bank balance sheets, while supporting the issuance of secondary capital bonds to replenish bank capital.

---

9 PBoC cuts to the reserve requirement ratio: 100bps cut on 17 April, 2018 and a 50bps cut on 24 June, 2018.
CONCLUSION: DESPITE DISRUPTION, A FOUNDATION FOR FUTURE GROWTH

- The 2018 AMP rules mark a significant and positive change in how China regulates its shadow banking sector. Sweeping away implicit guarantees, opaque holdings and complex structures should reduce moral hazard and lessen the threat of a systemic crisis. Meanwhile, the establishment of independent asset management businesses, transparent pricing and simplified structures should establish a solid foundation for China’s future financial growth.

- Nevertheless, in the short term, the changes have triggered significant disruption, uncertainty and volatility—and will require further fine-tuning and clarification to ensure deleveraging continues without provoking a seizing up of the financial system.

- Fortunately, cash investors are well placed to take advantage of these changes. The removal of implicit guarantees and artificially magnified returns creates a level playing field between deposits, mutual funds and AMPs. Increased competition among banks for deposits, and among asset managers for investments, should reduce costs, increase returns and spur innovation.

- Amid the transformations, cash investors should remember that their core goals of liquidity, security and yield remain unchanged. By exercising proper due diligence and conducting rigorous counterparty risk analysis, they are likely to achieve better cash investment solutions.
Building Stronger Liquidity Strategies with J.P. Morgan

J.P. Morgan Global Liquidity was a pioneer of triple-A rated money market funds in China. In 2005, we launched the CIFM RMB Money Market Fund in partnership with China Investment Fund Management Co., Ltd (CIFM), creating the first top-rated institutional RMB money market fund for corporate and institutional RMB investors.10

J.P. Morgan Global Liquidity applies the same rigorous investment process, relentless risk management and commitment to provide the highest quality client support to all its liquidity investment solutions around the world.

By investing directly with J.P. Morgan Global Liquidity China,11 the fund distribution team of J.P. Morgan Chase Bank (China), corporate and institutional cash investors in China can benefit from a liquidity manager with the ability to provide clients with streamlined investment capabilities and around-the-clock, multilingual client support.

For more information, contact your local J.P. Morgan Global Liquidity representative.

www.jmpgloballiquidity.com

NOT FOR RETAIL DISTRIBUTION: This communication has been prepared exclusively for institutional, wholesale, professional clients and qualified investors only, as defined by local laws and regulations.

This is a promotional document and is intended to report solely on investment strategies and opportunities identified by J.P. Morgan Asset Management and as such views contained herein are not to be taken as advice or a recommendation to buy or sell any investment or interest therein. This document is confidential and intended only for the person or entity to which it has been provided. Reliance upon information in this material is at the sole discretion of the reader. The material was prepared without regard to specific objectives, financial situation or needs of any particular investor. Any research in this document has been obtained and may have been acted upon by J.P. Morgan Asset Management for its own purpose. The results of such research are being made available as additional information and do not necessarily reflect the views of J.P. Morgan Asset Management. Any forecasts, figures, opinions, statements of financial market trends or investment techniques and strategies expressed are those of J.P. Morgan Asset Management, unless otherwise stated, as of the date of issuance. They are considered to be reliable at the time of production, but no warranty as to the accuracy and reliability or completeness in respect of any error or omission is accepted, and may be subject to change without reference or notification to you.

Investment involves risks. Any investment decision should be based solely on the basis of any relevant offering documents such as the prospectus, annual report, semi-annual report, private placement or offering memorandum. For further information, any questions and for copies of the offering material you can contact your usual J.P. Morgan Asset Management representative. Past performance and yields are not reliable indicators of current and future results. There is no guarantee that any forecast will come to pass. Any reproduction, retransmission, dissemination or other unauthorized use of this document or the information contained herein by any person or entity without the express prior written consent of J.P. Morgan Asset Management is strictly prohibited.

J.P. Morgan Asset Management or any of its affiliates and employees may hold positions or act as a market maker in the financial instruments of any issuer discussed herein or act as the underwriter, placement agent or lender to such issuer. The investments and strategies described herein may not be suitable for all investors and may not be authorized or its offering may be restricted in your jurisdiction, it is the responsibility of every reader to satisfy himself as to the full observance of the laws and regulations of the relevant jurisdictions. Prior to any application investors are advised to take all necessary legal, regulatory and tax advice on the consequences of an investment in the products.

Securities products, if presented in the U.S., are offered by J.P. Morgan Institutional Investments, Inc., member of FINRA.

J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide.

To the extent permitted by applicable law, we may record telephone calls and monitor electronic communications to comply with our legal and regulatory obligations and internal policies. Personal data will be collected, stored and processed by J.P. Morgan Asset Management in accordance with our privacy policies at https://am.jpmorgan.com/global/privacy.

This communication is issued by the following entities:

In the United States, by J.P. Morgan Investment Management Inc. or J.P. Morgan Alternative Asset Management, Inc., both regulated by the Securities and Exchange Commission, in Latin America, for intended recipients’ use only, by local J.P. Morgan entities, as the case may be; in Canada, for institutional clients’ use only, by JPMorgan Asset Management (Canada) Inc., which is a registered Portfolio Manager and Exempt Market Dealer in all Canadian provinces and territories except the Yukon and is also registered as an Investment Fund Manager in British Columbia, Ontario, Quebec and Newfoundland and Labrador. In the United Kingdom, by JPMorgan Asset Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority; in other European jurisdictions, by JPMorgan Asset Management (Europe) S.A.r.l. in Asia Pacific ("JPMAPC"), by the following issuing entities and in the respective jurisdictions in which they are primarily regulated: JPMorgan Asset Management (Asia Pacific) Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited, each of which is regulated by the Securities and Futures Commission of Hong Kong; JPMorgan Asset Management (Singapore) Limited (Co. Reg. No. 197602566K), which this advertisement or publication has not been reviewed by the Monetary Authority of Singapore; JPMorgan Asset Management (Taiwan) Limited, JPMorgan Asset Management (Japan) Limited, which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association, Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number “Kanto Local Finance Bureau (Financial Instruments Firm) No. 330”), in Australia, to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Commonwealth), by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919).

Malaysia, Philippines, Brunei, Thailand, Indonesia, India, Vietnam and Korea: This document is provided in response to your request. This document is for informational purposes only and does not constitute an invitation or offer to subscribe to the public. This document including any other documents in connection are for intended recipients only and should not be distributed, cause to be distributed or circulated to the public. This document should not be treated as a prospectus or offering document and it has not been reviewed or approved by regulatory authorities in these jurisdictions. It is recipient’s responsibility to obtain any regulatory approvals and complying with requirements applicable to them.

People’s Republic of China: This document is private and confidential and is issued to you upon your specific request and is provided for your internal use and informational purposes only. It may not be photocopied, reproduced, circulated or otherwise distributed or redistributed to others. This document does not constitute an offer, whether by sale or subscription, in the People’s Republic of China (the "PRC"). Any interests stated in this document are for the PRC only and are not the interests of any other jurisdiction, unless otherwise stated. The PRC has not reviewed, approved or otherwise endorsed any of the information contained herein.

For materials distributed to wholesale clients in Australia, please note the following: Pursuant to ASIC Class Order 03/102 and ASIC Class Order 03/103 applicable to JPMorgan Asset Management (Singapore) Limited ("JPMAMSL") and JPMorgan Funds (Asia) Limited ("JPMFAL") respectively, JPMAMSL and JPMFAL are exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Commonwealth) in respect of the financial services provided by JPMAMSL or JPMFAL in Australia to wholesale clients. A copy of which may be obtained at the website of the Australian Securities and Investments Commission www.asic.gov.au. The class order exempts JPMAMSL and JPMFAL respectively from the need to hold an AFSL for financial services provided to Australian wholesale clients on certain conditions. Please note that JPMAMSL is regulated by the Monetary Authority of Singapore (MAS) under the laws of Singapore, which differ from Australian laws. Similarly, JPMFAL is regulated by the Securities and Futures Commission (SFC) of Hong Kong under the laws of Hong Kong, which also differ from Australian laws.

Copyright 2020 JPMorgan Chase & Co. All rights reserved.

0993250a5237ac

10 J.P. Morgan Global Liquidity China is the brand for the fund distribution business of JPMorgan Chase Bank (China) Company Limited, a local incorporated bank in China with a fund distribution business qualification. JPMorgan Chase Bank (China) Company Limited is a subsidiary of JPMorgan Chase & Co. regulated by the China Banking Regulatory Commission (CBRC), and its fund distribution business is also regulated by the China Securities Regulatory Commission (CSRC).

11 J.P. Morgan Global Liquidity is a pioneer of triple-A rated money market funds in China.