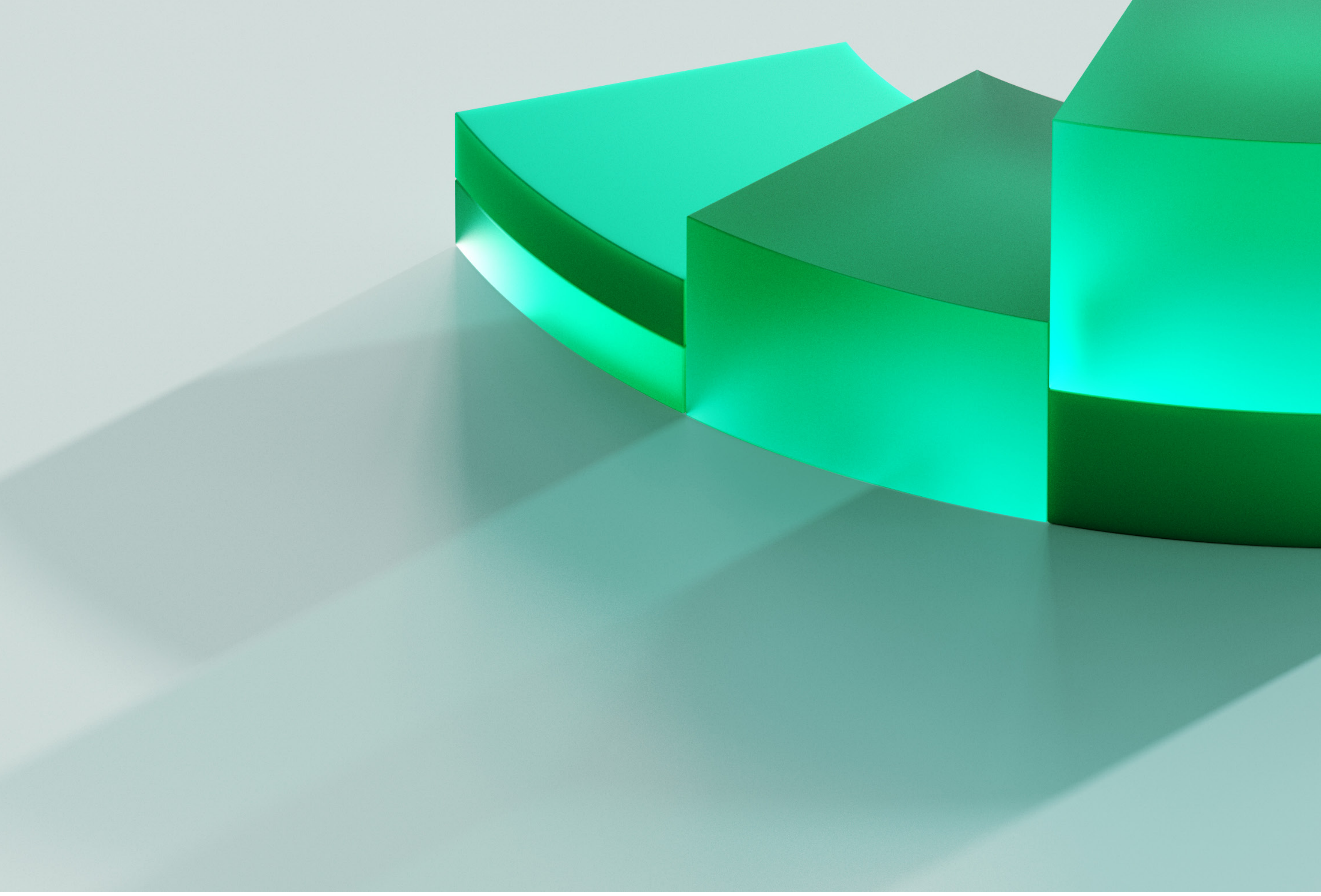


The impact of China's comprehensive 2018 regulation of asset management products

J.P.Morgan
ASSET MANAGEMENT

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.

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[1]. 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.

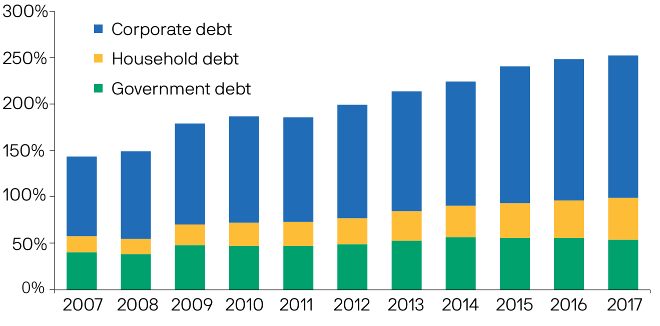
Background: Borrowing surge

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.

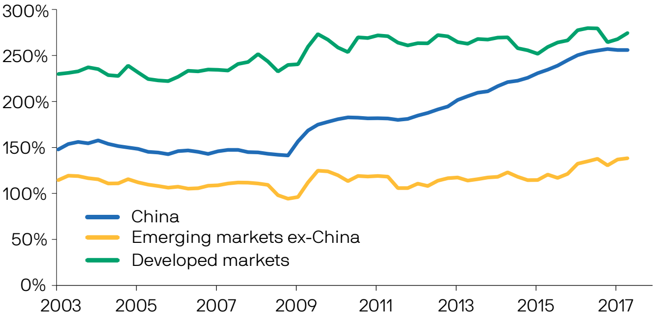
In the past decade, China's debt-to-GDP ratio has vaulted from 150% to over 260%, surpassing other emerging markets and approaching elevated developed market levels

China's Debt-to-GDP ratio



Source: J.P. Morgan; data as of 30 June, 2018

Debt-to-GDP country comparisons



Source: J.P. Morgan; data as of 30 June, 2018

[1] "Guiding Opinions on Regulating the Asset Management Business of Financial Institutions," Financial Stability and Development Committee, 27 April, 2018.

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 euphuism for shadow banking activities.

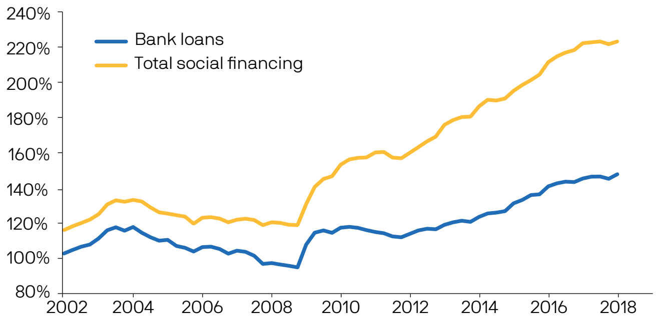
Conventionally, shadow banking is defined as all financial activity beyond basic bank borrowing and lending. In China, the shadow banking sector originally evolved following the liberalization of domestic interest rates[2], which allowed borrowers and lenders to operate outside normal banking channels, 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 AMPs[3]. 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.

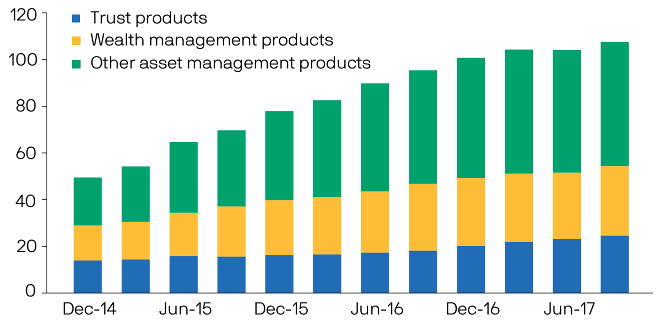
China's shadow banking sector doubled in size, to approximately CNY100 trillion, in the past three years, nearly equivalent to China's GDP

Credit to GDP



Source: J.P. Morgan; data as of 30 June, 2018

Shadow banking (CNY bn)



Source: HSBC, Wind Financial Data; data as of 30 June, 2018

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

Source: J.P. Morgan Asset Management

[2] Aidan Shevlin and Lan Wu, "Liquidity Insights: China: The path to interest rate liberalization," J.P. Morgan Asset Management, September 2014, https://am.jpmorgan. com/blob-gim/1383216432861/83456/WP-GL-China-The-path-to-interest-rate-liberalization.pdf.
[3] 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[4] AMPs will have to comply from the start.

China's new financial regulatory structure established a new senior agency, while merging the banking and insurance regulators

New financial regulatory structure

Source: J.P. Morgan Asset Management

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[5] 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[6] and channel business[7] are banned

Timeline of April 2018 AMP rules

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

Source: J.P. Morgan Asset Management

[4] 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.
[5] Standard assets are defined as tradable fixed income instruments or equities. All other assets are classified as nonstandard.
[6] Fund pooling practices included rolling issuance and combining assets across separate products.
[7] 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 disproportionally 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

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

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.

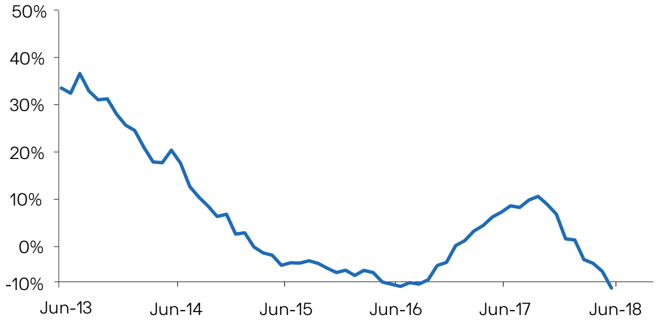
Fine-tuning the rules

Less than three months after the 2018 AMP rules were introduced, supplementary documents from the PBoC, CBIRC and CSRC offered further clarification[8]. 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.[9] 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.

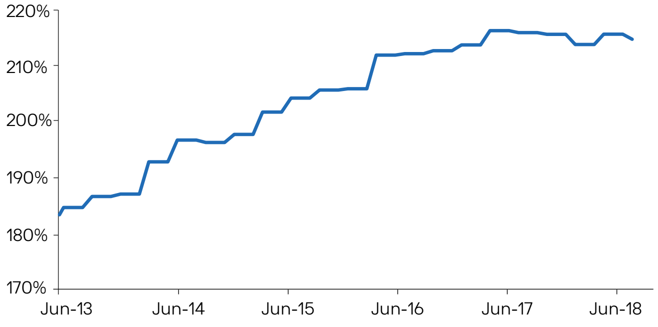
Shadow banking activity had already slowed sharply in anticipation of new rules

Shadow banking growth rate



Source: J.P. Morgan; data as of 30 June, 2018.

Shadow banking as a percentage of GDP



Source: HSBC, Wind Financial Data; data as of 30 June, 2018.

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.

[8] On 20 July, 2018.
[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.

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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]

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[10] China Investment Fund Management Co., Ltd (CIFM) is a joint venture between Shanghai International Trust Co. Ltd. and J.P. Morgan Asset Management (UK) Ltd.

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