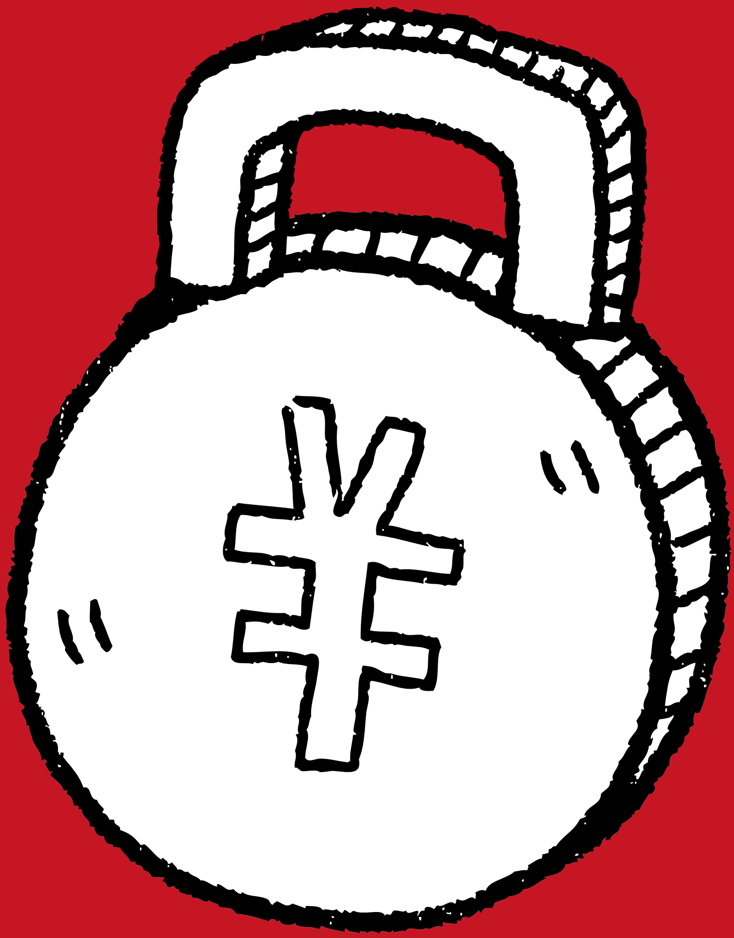
Money market funds in China



SHUTTERSTOCK

REGULATORY CHANGE AND THE QUICKENING PACE OF INTEREST-RATE LIBERALISATION ARE SIGNIFICANT FORCES IN THE CHINESE MARKET, AS KHENG LEONG CHEAH EXPLAINS

Since renminbi money market funds (MMFs) were first introduced in China in 2004, the sector has been transformed, growing in both size and significance. As of June 2015, there were 190 registered MMFs in China, with RMB 2.4 trillion in assets under management.[1] Serving as an intermediary between borrowers seeking short-term funding and investors searching for a low-risk cash management solution, MMFs perform a vital role in short-term, fixed-income capital markets. The sector's growth largely reflects investors' desire for daily liquidity, credit-risk management and competitive returns. A niche AAA-rated MMF sector addresses the needs of more risk-averse investors who want market-driven yields without compromising liquidity and security.

Although there is a large number of MMFs in China, the industry is highly concentrated, with the top 15 funds accounting for over 65% of assets.[2] In the past, retail investors invested in wealth-management products and bank deposits, whereas institutional investors were limited to products offered by banks. Retail investors have a growing interest in non-rated MMFs, such as Tianhong's Cash Income Fund. At the same time, AAA-rated MMFs are increasingly popular with institutional investors for their preservation of security, as well as their liquidity and market-yield characteristics. In addition, institutional investors also enjoy beneficial tax savings, as mutual funds are exempt from the local corporate income tax.

MMF investors

The differences between retail and institutional MMFs fall into two categories: investor behaviour and product characteristics. Retail investors tend to be attracted by higher yields, whereas institutional investors are likely to be more conservative, prioritising liquidity and capital preservation. In addition, institutional investors are usually bound by their company's investment policies to invest in AAA-rated funds. On the product side, institutional MMFs typically have AAA ratings that set the investment parameters of the fund (for example, credit quality, average maturity and liquidity). Retail MMFs must conform to China Securities Regulatory Commission (CSRC) requirements, but they do not need to meet the requirements of international rating agencies.

Ratings are an important consideration for an MMF

investor. They allow for an independent evaluation of an MMF's parameters for liquidity and capital preservation. The global investment policies of many corporations limit MMF investment to funds with AAA ratings from international rating agencies. It's also interesting to note that because China currently only acknowledges fund ratings provided by domestic rating agencies, certain international rating agencies have collaborated in joint ventures with domestic rating agencies. For example, Moody's has a 49% stake in China Chengxin International Credit Rating Company Ltd.[3]

In May 2015, the CSRC published proposed new guidelines for MMFs, seen as the most significant and comprehensive since MMFs were first introduced in 2004. The guidelines are still a work-in-progress, but here's the big picture: they bring Chinese MMFs more in line with their Western counterparts. The guidelines focus on tighter duration limits, better liquidity management, improved diversification of assets and a broader range of issuers and instruments. The proposed rules also improve MMF standardisation and disclosure. Overall, the guidelines encourage fund managers to innovate and exercise more proactive credit control while maintaining effective risk and liquidity management.

> Critical to the success of the renminbi MMF has been its ability to invest in repo. As the largest, most liquid money market instrument in Chinese markets, repo is a major holding for renminbi MMFs

More frequent and extensive disclosure

In all global markets, JPMorgan supports regulatory reforms that address structural vulnerabilities and decrease systemic risk in MMFs. Among our specific recommendations to the CSRC, we called for more frequent and extensive disclosure. All MMFs should be required to disclose assets under management, yield, average residual maturity and average residual duration on a daily basis. Furthermore, all MMFs should be required to disclose detailed portfolio constituents and the maturity profile of the portfolio on at least a monthly basis. We also think same-day settlement should be an explicit right of MMFs and should be permitted at the discretion of the fund manager.

Other regulatory changes on the international stage are set to have an impact on the MMF industry. In the US, two key regulatory changes will take effect in October 2016, following a two-year transition period. Institutional prime and municipal MMFs must float their market-based net asset value. And an MMF board may impose a liquidity fee or redemption gate if the fund's weekly liquidity assets fall below 30% of total assets (government MMFs are not required to be subject to the fee and gate provisions). Basel III regulations, which redefine global standards for bank capital, liquidity and leverage, are changing how banks manage their balance sheets. The new rules will have a significant impact on the relative attractiveness of MMFs as compared with bank deposits.

Meanwhile, interest-rate liberalisation, a long time coming, has finally begun. When a deposit-protection insurance scheme was introduced in May 2015, it was a critical step on the path to interest-rate liberalisation. It transforms the unlimited, implicit guarantee that all Chinese bank products had enjoyed into a limited, explicit guarantee on deposits only.

So what are the implications for investors? Interest-rate liberalisation will spur a move from government-regulated rates to risk-adjusted market yields. This means that investors need a keener focus on credit and risk analysis. We recommend that investors promptly establish and/or review all their counterparty and credit-risk procedures. Without question, it's a more challenging environment for Chinese cash investment.

Investment in repo

Critical to the success of the renminbi MMF has been its ability to invest in repo. As the largest, most liquid money market instrument in Chinese markets, repo is a major holding for renminbi MMFs. Repo offers good liquidity and timely settlement of short-term cash balances. These are valuable benefits.

We favour stock exchange repo. Its yields are more volatile than interbank repo, but stock exchange repo offers quasi-sovereign counterparty risk, which is very important. Another critical consideration is liquidity; stock exchange cash is returned to the buyer at the start of the day, whereas interbank cash can be returned at any time prior to market close. Regulations prohibit intraday and overnight overdrafts, so this is a big distinction.

In a AAA-rated MMF, stock exchange repo typically constitutes 20% to 60% of the holdings of a AAA-rated MMF.[4]

Of course, market volatility has been a concern for some MMF investors. China is in the early stages of its financial sector reform and volatility is always a concern when a market is opening up. As a market matures, volatility should decrease. We'd note that this applies to the equities market as well as MMFs.

1 Source: WIND; as of 30 June 2015
2 Source: WIND; as of 30 June 2015
3 Source: *China Chengxin (Asia Pacific) Credit Ratings Company Limited* – About us, www.ccxap.com/About.aspx#; as of 4 August 2015
4 Source: WIND; as of 31 May 2015

Kheng Leong Cheah is managing director, head of Greater China sales, global liquidity China, JPMorgan Chase Bank (China) Company Ltd **www.jpmgloballiquidity.com**

J.P.Morgan Asset Management