Liquidity Perspectives—2Q18

Chinese money market reform: Challenges present opportunities

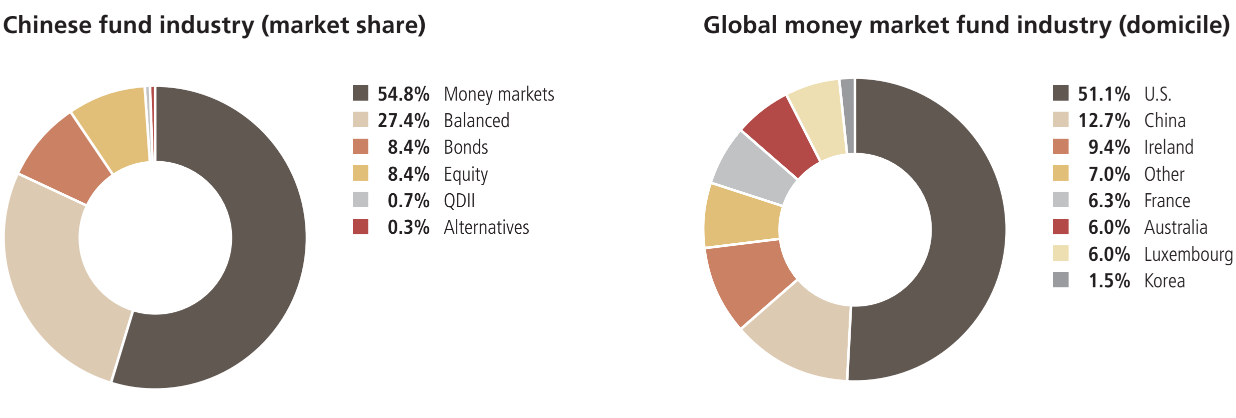
Overview

- China's money market fund sector has experienced rapid growth in the past several years and is now the second largest in the world.
- Money market funds (MMFs) are now considered "systemically important" to the Chinese economy as The People's Bank of China (PBOC) now includes public MMFs as part of the broad money supply (M2). As a result, the Chinese Securities Regulatory Commission (CSRC) started strengthening MMF regulations to contain systematic risk and bring them closer in line with international standards.
- In an effort to protect retail investors from a run on MMFs, the CRSC instituted higher liquidity requirements for domestic public funds, putting pressure on yields.
- New regulations make it difficult to mix institutional and retail clients in the same fund, making a private fund structure appealing for institutional investors.

The first money market funds (MMF) in China launched in 2003–2004, but despite being a relatively new player to the mutual fund industry, the MMF industry has experienced rapid growth in recent years. According to the Asset Management Association of China, the total value of MMFs in China nearly doubled from $680 billion in 2016 to almost $1.1 trillion by the end of 2017.[1] While equity and bond mutual funds are typically the dominate investments in other large markets, MMFs comprise the largest share of China's mutual fund industry and now account for more than half of China's mutual fund market, compared to a 14 percent share in the US.[2]

China's money market fund sector has become the second largest globally behind the US and is now considered "systemically important" to the Chinese economy. In 2016, the Chinese Securities Regulatory Commission (CSRC) started on the road to reform, strengthening MMF regulations to bring them closer in line with international standards.

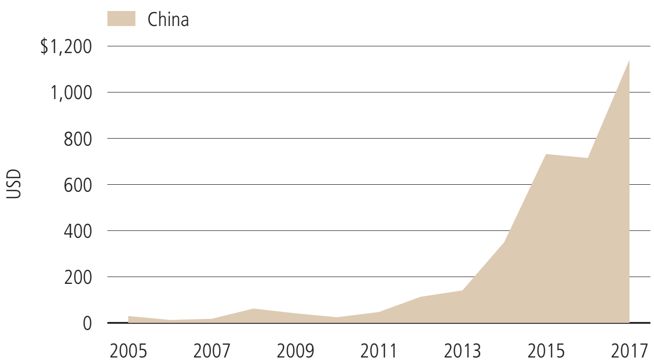
Figure 1. Money market funds dominate mutual fund investments in China



Source: Crane Data, ICI, J.P.Morgan Asset Management; data as of June 30, 2016.

[1] China Plans Curbs on $1 Trillion in Money-Market Funds, Bloomberg.com, February 28, 2018.
[2] China's giant Yu'e Bao money market fund riskier than US rival, Fitch says, South China Morning Post, December 15, 2017.

Figure 2. Growth of assets under management in Chinese money market funds



Source: Wind Financial Terminal. For illustration purposes only. August 2017.

A brief history: The rise of China's money market industry

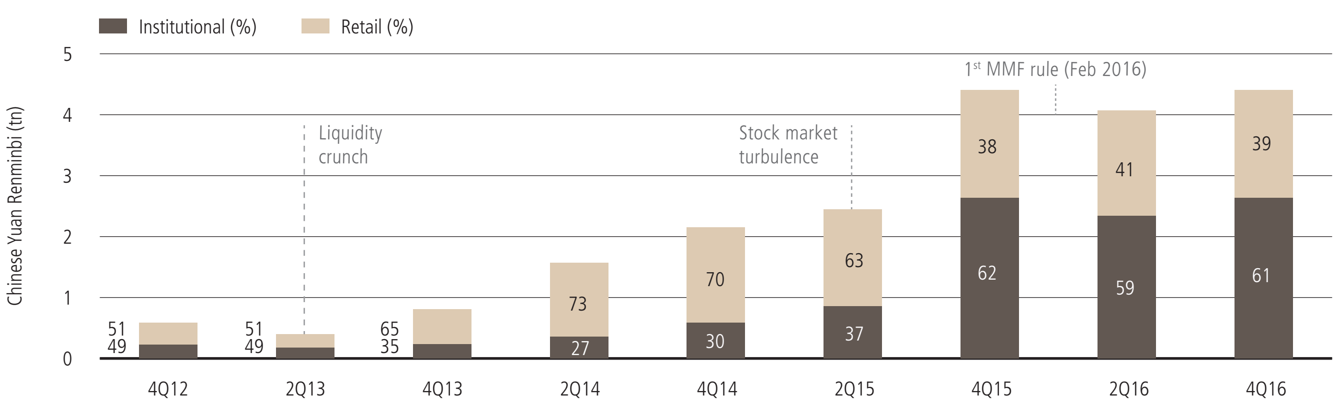
The first Chinese MMF funds were originally marketed to wealthy individuals and institutions to take advantage of higher yields and good liquidity in the interbank market versus bank deposits.[3] However, a significant part of the recent growth in China's MMFs has been driven by retail investors, thanks in part to the 2013 launch of Yu'e Bao, a money market fund created by Ant Financial, an affiliate of China's Alibaba Group. Yu'e Bao, whose name means "leftover treasure" in Mandarin, was created as a way for users of the popular Chinese payments network, Alipay, to earn returns on the "leftovers" from online payments. The concept was that retail clients could easily invest this excess cash into a MMF via their mobile phones. Along with easy access, retail investors were also drawn to the attractive yields. While global investors tend to invest in MMFs for capital preservation and daily liquidity, many Chinese retail investors expect attractive yields from their MMF investments, which can offer yields up to 4%, well above the current 1.5% they can earn in a one-year Chinese bank deposit. Yu'e Bao was a dramatic success and became the biggest money market fund in the world reaching USD 251 billion in assets under management as of December 31, 2017.[4]

Shift toward institutional investors

By the end of 2014, the rapid growth of the retail-dominated MMF industry also caught the attention of institutional investors who comprise approximately two-thirds of the MMF market. The institutional client base was mostly comprised of banks and other financial institutions seeking both liquidity and a way to arbitrage yields between issuers. Many of these banks and financial institutions issued negotiable commercial deposits (NCDs) with low yields and used them as funding instruments. These issuing banks/financial institutions then used the funding proceeds to invest in low risk and higher yielding MMFs, generating a positive return. Given the taxable nature of NCDs, some banks also invested in domestic public MMFs because of their tax-free status.

As NCD issuance increased, Chinese authorities began to take note. In a broader drive to curb financial risks, China's central bank instituted a ban on new issues of NCDs as of September 1, 2017. The regulator went further in 2018 and changed the accounting treatment for NCDs. Previously, banks were permitted to book NCDs as investable assets, but new regulations require them to be booked as liabilities. As a result, NCDs became less appealing for banks to issue, and the supply began to dry up. Furthermore, given that NCDs were also an integral part of MMF holdings, the decreased supply put further pressure on fund yields.

Figure 3. Composition of money market fund investors



Source: Fitch. For illustration purposes only. August 2017.

[3] Meet the Earth's Largest Money-Market Fund, The Wall Street Journal, September 13, 2017.
[4] Asset Growth in the World's Largest Money-Market Fund Slows Sharply, The Wall Street Journal, February 5, 2018.

Seeds of reform

While the CSRC drew up a list of guidelines relating to money market funds as early as 2004 using international guidelines and regulations as a blueprint, they have not kept up with ongoing international regulatory reforms. As a result, there is a clear divergence between international and Chinese money market funds. The CSRC stepped in again in 2016 given fears that the market could overheat, resulting in potential liquidity problems for some MMFs. In an attempt to protect retail investors from a run on MMFs, the CSRC instituted new regulations for higher liquidity requirements for domestic public funds. In August 2017, the CRSC announced additional regulatory reforms including, new reserve capital limits, constant-NAV client (single investor) limits and new restrictions on investment instruments. However, one of the unintended consequences was that the requirements caused the yields to drop, leading to slower growth and signs that retail investors could begin to move out of public MMFs and look for other, higher-yielding alternatives.

With the level of cash pouring into MMFs from both retail and institutional investors, the number of MMFs has more than doubled since 2014. While there are now over 400 money market funds, most of the assets are concentrated among a small number of asset managers, including Yu'e Bao's manager, Tianhong Asset Management. Still, competition has increased, and with Chinese retail investors primarily focused on yield, some fund managers adopted aggressive investment strategies, such as buying less liquid or lower-quality bonds.

With retail investors beginning to move out of public funds, institutional investors became forced sellers to remain in compliance with their internal guidelines, such as limiting holdings to a certain percentage of a fund's total assets under management. MMF assets under management contracted further, leading to a higher need for liquidity, thus starting the vicious circle of lower yields and slower growth in assets under management.

Considering a private alternative

China's attempt to bring more stability and safety into the domestic and public MMF space also simultaneously presents the funds with additional challenges. Under the new regulatory reforms for domestic public MMFs, it will become more difficult to mix institutional and retail clients in the same fund. Going forward some fund managers likely won't even accept institutional clients. With diminishing investment opportunities, institutional investors could consider a private fund structure that could provide a stable investment framework and could better align with global MMF standards. A private fund structure could involve a pool of assets managed by a fully licensed, offshore asset manager and could offer several advantages including:

- Attractive yield and greater diversification in asset allocation.
- Flexible structure designed to take advantage of liquidity within a pooled fund to meet clients' liquidity needs.
- Ability to apply the fund manager's own risk framework for risk control at both fund and investment instrument level.
- No redemption constraints on settlement.

Furthermore, many multi-national corporations have internal investment guidelines that require their MMF investments to have a AAA MMF rating from an international rating agency such as Fitch. However, ratings agencies have tightened restrictions required to garner an international AAA MMF rating. For example, in order to receive a AAA rating from Fitch, the rating agency requires Chinese MMFs to invest only in a narrow list of securities rated by Fitch, which could increase liquidity risk. As a result, one could argue that a non-rated fund that can invest in a broader investment universe provides wider diversification and better access to liquidity, less issuer concentration and possible yield pick-up. These attributes come without increasing the fund's intrinsic risk by maintaining a AAA rating.

Conclusion

In the relatively short period of time since the first MMFs were launched in China, they have become a crucial asset class. Given the increase in the number of MMFs and the rapid growth of assets in them, China's new guidelines sought to provide better protection for retail investors. However, institutional investors are left with far fewer options. As the guidelines evolve and become clearer, it will be important for cash managers with significant holdings in China to become familiar with options for investing their cash.

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