Asset
Management

Global Liquidity Management

China Insights:

China's Money Market Fund Regulation in a Global Context

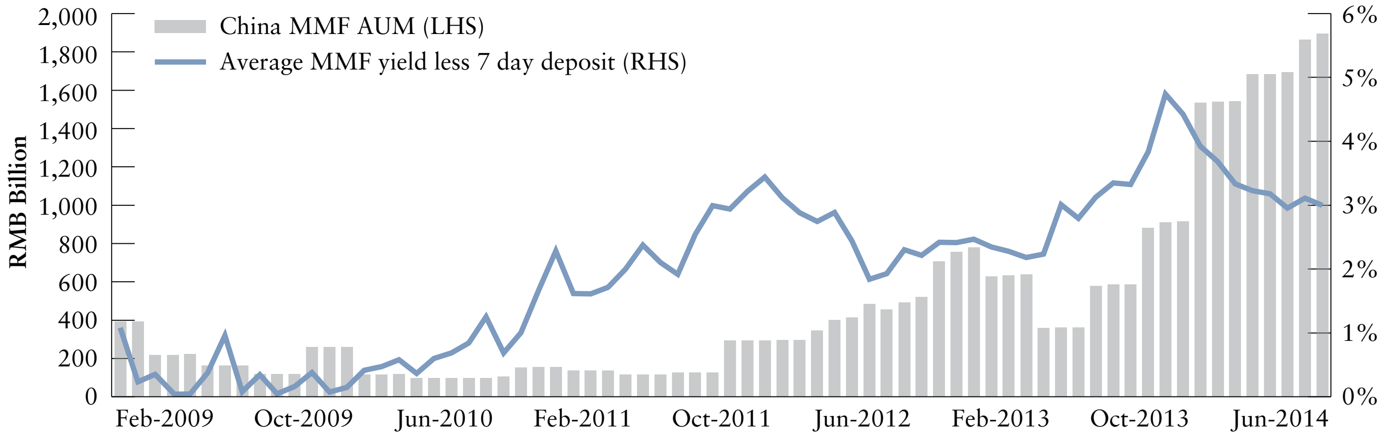
The money market fund (MMF) industry in China has experienced notable growth given the relative security, diversification and yield it provides. As a consequence, financial market regulatory changes over recent years have had the effect of opening the local fund industry to further expansion.

Regulatory Framework and Function

China's MMF industry is barely a decade old, but assets under management (AUM) have grown nearly fifteen-fold in the past four years alone to around RMB 1.9 trillion as of October 2014.

Figure 1: China's Growing MMF Industry

With a large and consistent yield pickup vs deposits, MMF AUM has grown rapidly in recent years.



Source: WIND, as of October 31, 2014

The industry operates within a formal regulatory framework that has itself come together quickly since the early 1990s, with the China Securities Regulatory Commission (CSRC) as the leading oversight and enforcement authority for MMFs. Overall, the CSRC's responsibilities include:

- Formulating policies, laws and regulations concerning markets in securities and futures contracts.
- Overseeing issuing, trading, custody and settlement of equity shares, bonds, investment funds.
- Supervising listing, trading and settlement of futures contracts; futures exchanges; securities and futures firms.

Regulatory oversight of money market funds varies globally. In the European Union (EU), there are a number of important regulatory and legislative bodies. National legislators and the European Council, European Parliament and European Commission develop MMF regulation, while national regulators are responsible for oversight. In the US, the Securities and Exchange Commission (SEC) is the primary regulator with discretion over MMF rules, similarly to the CRSC.

Like its international peers, the CSRC is developing policy to address the oversight challenges of a sizeable industry at the core of the financial system. However, the priorities for China's policymakers at this stage of the MMF industry's evolution are different from those in longer-established markets. For instance, the SEC and EU institutions are addressing perceived shortcomings as a legacy of the financial crisis, including more restrictions on existing, standardized investment requirements for MMFs. The CSRC, meanwhile, is focusing on ensuring that there is proper oversight of new entrants in a market with many different types of funds—particularly given the ascendance of online funds in the retail space.

CSRC spokesman Zhang Xiaojun underscored this priority in a press conference on February 28, 2014. Zhang noted that the CSRC is working to adopt relevant rules on further enhancing risk management for money market funds and supervision of internet-based offers and sales of funds.

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Points of Difference

Like its peers in the US and Europe, the CSRC sets risk management requirements for MMFs that limit the duration exposure, credit risk, liquidity risk and concentration of assets in portfolios. The main difference is that CSRC standards allow MMF managers more flexibility than the US and European regulations, particularly given the tightening in SEC and European rules since the crisis. US and European managers are further constrained from a yield standpoint by the historically low interest rates and shortage of high-quality assets in developed markets. The following are key distinctions between the CSRC’s guidelines and international standards:

- **Duration exposure:** Money market funds typically comprise very short-dated securities, in order to limit the potential impact of rising interest rates on the value of the investments. The CSRC’s requirements for MMFs allow for greater interest rate management flexibility, both in the overall average maturity and individual investments, than US and European requirements.
  In the US and Europe, regulators impose restrictions on the maturity of each instrument as well as the weighted average maturity (WAM) and weighted average life (WAL) of the portfolio in total. In the US, the SEC limits the maturity of any fixed- or floating-rate security to 397 days, with the exception of government floating-rate notes, for which there is no maximum (other than those resulting from the overall portfolio WAL limit of 120 days). The CSRC similarly sets a maximum maturity of 397 days for fixed-rate notes, but does not set a limit for floating-rate securities (no overall WAL limit) although holdings for those floating-rate securities with a maturity that is longer than 397 days may not be more than 20% of the MMF’s assets. As for the portfolio’s average maturity, the SEC and ESMA each impose a maximum WAM of 60 days, while the CSRC’s limit is 180 days.
- **Net asset value (NAV):** Changes to the accounting regime for MMFs were a big feature of the latest US amendments as well as those being contemplated in Europe and they affect how a fund’s NAV (or price at which an investor transacts) is reported. A fund with a “stable NAV” traditionally uses amortized cost accounting methodology, where the price of a unit/share is held constant at 1.00 by amortizing the underlying investments while the actual underlying market prices of investments in the portfolio may be very slightly higher or lower than the amortized price. A NAV calculated using market value prices is commonly referred to as a market-value or shadow NAV.
  China’s MMFs generally use amortized cost accounting methodology to offer stable NAVs, and managers are required to calculate their market-value NAV and publish their maximum deviation during any calendar quarter following the end of that quarter. By contrast, in the US, within a couple of years, US institutional prime funds will fully switch to a floating NAV, and MMFs that transact at a stable NAV, including government funds and retail funds, will be required to report market-value NAVs on a daily basis.
- **Credit risk:** China’s MMFs are permitted to hold a range of assets across government, quasi-government, bank- and corporate-issued securities. While US MMFs can invest in corporate issuance, the US money market regulations specify that no more than 5% of corporate investments can be from a single issuer. In China, the maximum concentration is 10%.
- **Leverage:** International MMFs generally do not permit explicit leverage, meaning borrowing for purposes of creating more than 100% asset exposure. In China, the CSRC allows up to 20% leverage via borrowing cash/lending securities in repurchase (repo) markets.

Eligible Assets

Eligible assets for China’s MMFs include the following:

- **Treasury paper**, which is issued by the Ministry of Finance and the People’s Bank of China.
- **Policy bank bonds** are the largest segment of the fixed income market. These securities are issued by three 100% government-owned policy banks, the Agricultural Development Bank of China, Export Import Bank of China and the China Development Bank. Policy bank bonds are similar to Agency paper in the US and Europe.
- **Time deposits** with which MMFs can invest in interbank negotiated deposits with banks.
- **Corporate securities** are available in a variety of structures, including commercial paper and medium-term notes. Typically these instruments have variable liquidity.
- **Repos** including interbank and exchange-traded repos typically with high grade collateral.

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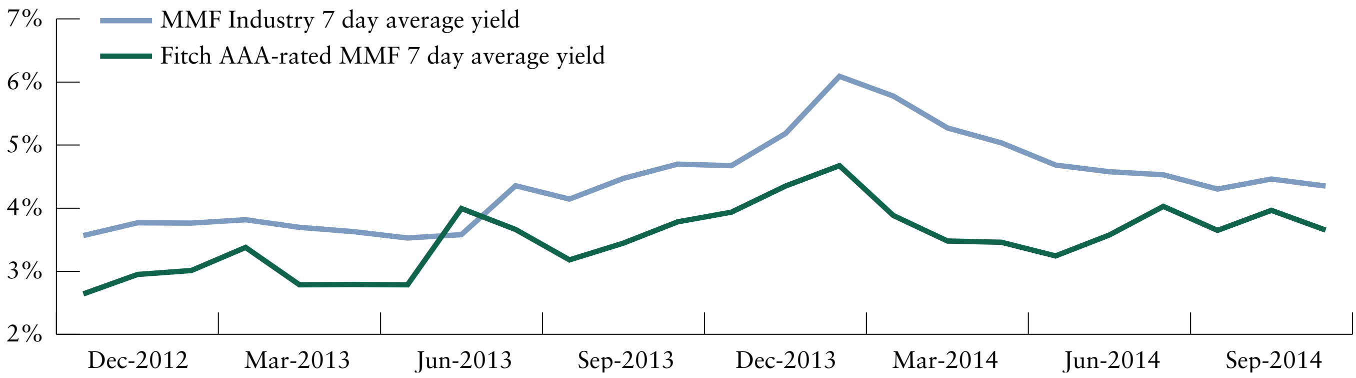
Role of Rating Agencies

China's standards are similar to international conventions in that the securities in MMFs are required to have top-shelf ratings. In the US, money market fund rules from leading rating agencies such as Standard & Poor's, Moody's Investors Service and Fitch Ratings stipulate that 100% of triple-A rated funds must generally be invested in first tier securities that are rated at least A-1/P-1/F-1.

However, triple-A criteria for China's local ratings agencies vary. When it comes to ratings of the funds themselves, the local agencies' standards for MMFs are typically no more stringent than the CSRC guidelines. Fitch, the main international rating agency operating in China, sets tighter restrictions in line with global standards, but its triple-A rated funds account for just around 3% (as of September 30, 2014) of China's MMF industry. Fitch's[1] criteria on factors such as leverage, liquidity and portfolio concentration are consistent with, though not identical to, triple-A guidelines in the US and Europe. For instance, Fitch's maximum WAM of 75 days is well below the CSRC maximum of 180 days, but still above the global norm of 60 days.

The potential benefit in terms of risk management does entail some sacrifice when it comes to yield. Fitch's funds exhibit a material difference in risk and return versus non-Fitch triple-A rated funds that use the full flexibility allowed under CSRC guidelines. Historically, non-Fitch triple-A rated funds have substantially outperformed, albeit in an environment where corporate defaults are still very rare.

Figure 2: Average yield of non-Fitch MMF and Fitch rated MMF/MM CIS[2]



Source: WIND, as of October 31, 2014

Manager Discretion

While MMFs in China have the flexibility to access higher yields, the risks to capital preservation and liquidity can also be higher. This is where the expertise of the fund manager comes in, and risk management is a distinguishing factor in China's increasingly crowded MMF space. The following are key areas in which a manager's philosophy can make a difference in this regulatory environment:

- **Independent assessment of credit risk** for various issuers, rather than relying solely on issuers meeting the minimum requirements of credit rating agencies.
- **Ensuring sufficient liquidity** is maintained in the fund relative to the amount and variety of shareholders.
- **Calibrating duration**, whereby some managers will voluntarily restrict WAM even further—down to 60 days—to be more consistent with global practice. This is very pertinent considering the pronounced interest rate volatility in China's money markets.

This expansionary phase of the MMF industry's development in China is a boon for the growing population of corporate and retail clients seeking alternatives to bank deposits and help in navigating the domestic securities markets. However, investors should also exercise discernment in their choice of manager, given the range of relatively new entrants and the variation in their risk management expertise. In a growth industry so far untested by crisis, it pays to focus on the risks as much as the returns, in line with standards shared by a global community attuned to the challenges of today's investment environment.

[1] Fitch triple-A rated funds: include all Fitch triple-A rated money market public funds and collective investment schemes.
[2] Fitch triple-A rated MMF/MM CIS: includes Fitch triple-A rated money market public funds and collective investment scheme ("CIS") in the China market, altogether four of them.

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* Gao Hua is the strategic partner of Goldman Sachs in China

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