SETTING THE STAGE FOR PRUDENT GROWTH IN CHINA

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Summary

China's asset management industry is going through a sea change, triggered by regulations focussing on financial stability and market liberalization. Probably the most far-reaching yet is the super guidance, introduced in April 2018, with the potential to alter various market segments in the coming years. Relaxation of rules on foreign ownership of financial services companies, as well as pension reforms, will also create opportunities for positive change. We examine the key market trends these reforms are igniting.

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Moves to revamp China's financial industry gained momentum in the first half of 2018. In March, banking and insurance regulators were merged in a bid to tighten oversight. Besides transferring policy-making functions to the People's Bank of China (PBOC)—effectively giving it more regulatory powers—the new China Banking and Insurance Regulatory Commission (CBIRC) promised to deepen reform and crack down on financial risk, notably in the shadow banking sector.

This was followed soon after with guidelines issued on individual tax-deferred commercial pension insurance products by the new regulatory body. In April, a pilot scheme for these products—the first ones planned for third-pillar pensions—was launched in Shanghai, Fujian Province, and Suzhou Industrial Park.

But perhaps the most significant reform so far is the release of a "super guidance" in April. The first integrated guideline for the industry in 20 years, it unifies standards for asset management products issued by all financial institutions, and will be the most important rule for industry players to follow in the next few years. Firms have until end-2020 to comply.

Key Points

- The "super guidance", introduced in April 2018 with an emphasis on financial stability, will be the most important rule for players to follow in the next few years. It is expected to impact various segments of the asset management industry.
- In line with efforts to liberalize the market, regulators have raised the cap on foreign ownership of financial services companies, and issued new quotas for cross-border schemes.
- Pension reforms are likely to spur growth in retirement savings and offer outsourcing

The guidance is expected to significantly impact the asset management industry, shaping the behaviors of market players as well as the form of products. For example, under the guidance, banks will have to limit the number of wealth management products (WMPs) with "guaranteed" returns, and instead launch more WMPs using the net asset value model. Small and mid-sized banks will suffer, due to the competitive market, their lack of asset management expertise, and retail investors' continued appetite for "guaranteed" returns.

With financial stability now a top regulatory priority, regulatory reform in China is likely to continue at its current pace in the near term.

Key Trend 1: FMCs look for long-term assets as institutional business struggles

With the "channel business" suffering from curbs on the shadow banking business, segregated accounts (SAs) and subsidiaries of fund management companies (FMCs) are facing increasing competition, and have to look for ways to differentiate themselves. The insurance and pension businesses are particularly promising in terms of the potential to boost FMCs' long-term assets.

Pension reforms offer outsourcing opportunities, especially for FMCs eligible to manage National Social Security Fund (NSSF) assets. FMCs manage nearly 80% of NSSF mandates, and inflows to SAs are expected to increase further with a pilot plan that will see the NSSF receiving 10% of the shares in selected state-owned enterprises. As for insurance, mandated assets to SAs increased nearly 22% last year. Growth is likely to continue as long as insurance assets expand and FMCs maintain their track records.

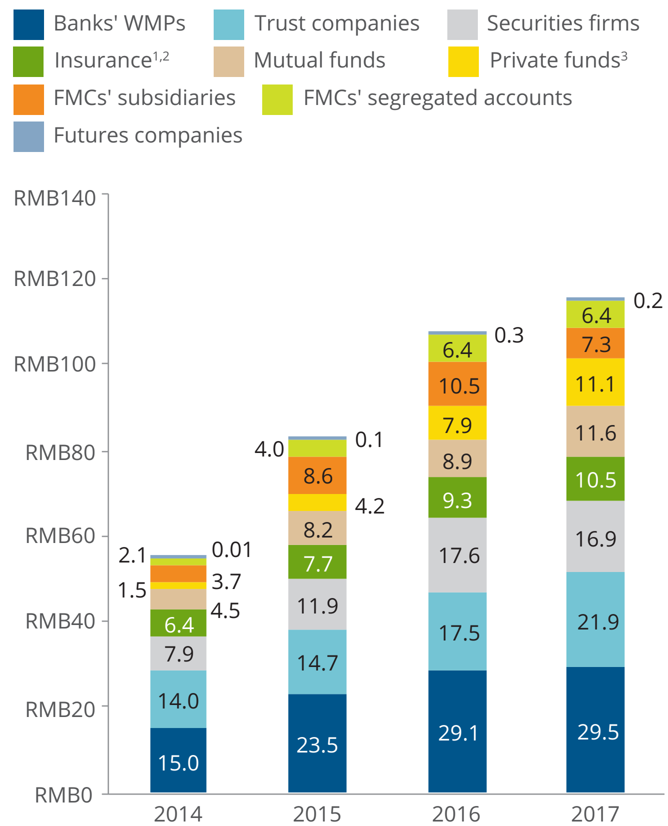
Another strategy for some FMCs is venturing overseas, mostly to Hong Kong, despite the keen competition there. Those looking further afield have been entering into product and distribution partnerships with overseas firms, and more of such tie-ups can be expected. As of end-2017, 23 FMCs have established overseas subsidiaries. Four—Harvest, China AMC, GF, and China Post—have presence in the United States or the United Kingdom, mostly formed in recent years. Nine FMCs have launched UCITS funds.

EXHIBIT 1

Snapshot of China's Asset Management Industry, 2014–2017 (RMB trillions)

Sources: Asset Management Association of China, Cerulli Associates

Analyst Note: [1]Estimated. [2]Life insurance investable assets only. [3]Funded assets only.



Key Trend 2: Building relationships with distributors

Another effect of the continued regulatory tightening on shadow banking is the decline in the institutional business. With many managers generally pessimistic about the prospects for this business, they are starting to pay more attention to developing their retail investor base this year, and diversifying their distribution channels accordingly.

Banks are still the most common and effective way for managers to reach retail investors. In a 2017 survey conducted by the Asset Management Association of China (AMAC), 28.4% of respondents named banks' wealth managers as their main providers of investment information. However, Cerulli's survey findings show that managers are looking to develop securities companies and online platforms this year. They are even looking to expand their use of these channels over direct sales, which include sales generated through in-house institutional teams. These used to be the focus of most managers' distribution strategies, during the heyday of institutions' outsourcing activities.

Although accounting for only around 10% of most managers' assets, third-party online platforms are becoming important channels to reach retail investors. Several managers told Cerulli that most of their new investor accounts were acquired through online platforms, and they see further growth in this channel.

Not many distributors disclose their sales volumes publicly, but available data shows that Tiantian Fund, a leading fund distribution platform under Eastmoney, has already overtaken the Agricultural Bank of China in terms of fund sales. Alibaba-owned Ant Wealth is a strong competitor to Tiantian, given the 450 million active users on Alipay, Alibaba's third-party payment platform. Tech giant Tencent—which operates China's largest messaging and social network mobile app, WeChat—has also entered the fray, receiving a fund sales license in January 2018. Its platform, Li Caitong, allows fund managers to set up their own shops on it.

EXHIBIT 2

Selected Distributors' Mutual Fund Sales Volume,1H 2015–1H 2017 (RMB billions)

Source: Cerulli Associates

<table>
<tr><th>Distributor</th><th>1H 2015</th><th>2H 2015</th><th>1H 2016</th><th>2H 2016</th><th>1H 2017</th><th>2H 2017</th></tr>
<tr><td>Industrial and Commercial Bank of China</td><td>713.1</td><td>324.8</td><td>243.5</td><td>245.4</td><td>372.8</td><td>550.4</td></tr>
<tr><td>China Merchant Bank</td><td>414.2</td><td>191.5</td><td>242.1</td><td>253.1</td><td>321.9</td><td>383.6</td></tr>
<tr><td>Tiantian Fund (Eastmoney)</td><td>430.6</td><td>312.7</td><td>164.3</td><td>141.8</td><td>158.6</td><td>253.8</td></tr>
<tr><td>Agricultural Bank of China</td><td>262.5</td><td>143.0</td><td>93.1</td><td>163.9</td><td>131.6</td><td>205.7</td></tr>
<tr><td>Postal Saving Bank of China</td><td colspan="2">99.4</td><td>17.9</td><td>20.4</td><td>30.0</td><td>58.9</td></tr>
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MMFs and equity funds preferred online

Money market funds (MMFs) are the most popular funds purchased online, largely due to Tianhong Asset Management's Yu'e Bao, the world's largest MMF by assets. MMFs attract retail investors with their stable returns, and when Yu'e Bao started limiting subscriptions due to tighter regulations, some assets flowed to other MMFs on Ant Wealth.

The question for managers, however, is whether MMFs will continue to attract inflows following regulatory measures addressing liquidity management. Also, how long can managers bear the squeeze on margins with the sales of low-fee products? Tianhong has taken heed of this already and is looking to create alternative revenue streams instead of relying only on Yu'e Bao. The firm is now planning to launch index funds tracking overseas indices to meet the diversification needs of Chinese investors, and has plans to build smart beta strategies.

It is well known that Tianhong's tie-up with Alipay resulted in the explosive growth of MMFs in China, prompting others to follow. Now, as it plans to revive its product range, it is expected that others will also follow suit, sooner or later.

Other than MMFs, equity funds are the most popular funds purchased online, which could also be attributed to their high returns. Cerulli notes that many managers plan to launch more equity or equity-biased balanced funds in 2018, following a bull year for blue-chip stocks and the regulatory curbs on MMFs.

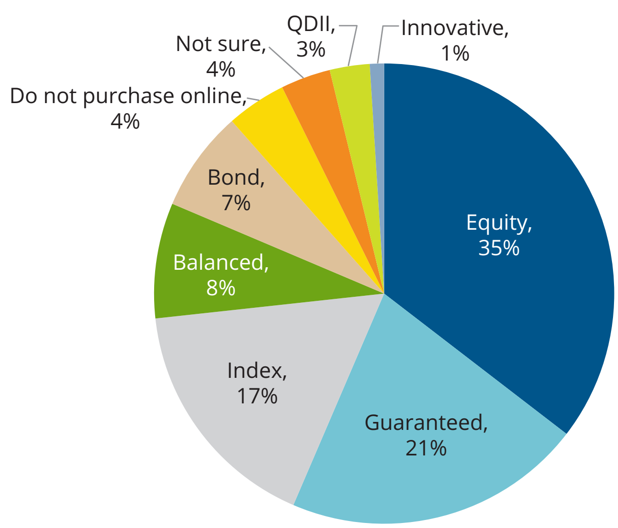
Managers who want to tap into established banks' or platforms' distribution networks should be aware of the high costs of doing so, as trailer fees can reach 70%. Long-term and in-depth relationships with key distributors are crucial for managers to make these partnerships cost-effective, with consistent and outstanding performance providing extra bargaining power.

EXHIBIT 3

Most Popular Categories of Funds Purchased Online

Sources: Asset Management Association of China, Cerulli Associates

Analyst Note: More than 76,000 individual investors were asked what the main types of funds (except money market funds) they purchased online were. The survey was conducted in 2Q 2017.



Key Trend 3: Market liberalization and foreign participation

In a game-changing move, the People's Bank of China in April 2018 said it would relax the foreign ownership cap on financial services companies—including securities, futures, and fund management companies—to 51% from 49%. This was targeted for the middle of the year, and the government also aims to fully lift the foreign ownership limit within the next three years.

The move is expected to add another avenue for foreign fund firms to raise assets in China. J.P. Morgan was the first to publicly announce intentions to capitalize on the 51% rule change. In May 2018, it applied to acquire a majority stake in a new securities joint venture (JV), and also announced plans to raise its 49% stake in China International Fund Management, its JV with Shanghai Pudong Development Bank, subject to agreement with the latter and regulations.

Cross-border schemes

Other liberalization moves have been announced this year. For example, many cross-border schemes for overseas investments, including Qualified Domestic Institutional Investor (QDII), Qualified Domestic Limited Partnership (QDLP), and Qualified Domestic Investment Enterprise (QDIE), have been issued new quotas after being suspended for some time.

Among these, QDLP is the most popular scheme among foreign managers, with Shanghai still the main city issuing such licenses. From 2013 to 2015, the Shanghai Finance Office (SFO) granted three batches of QDLP licenses to 15 asset managers—14 foreign and one JV—allowing them to raise funds from China's onshore investors and invest in overseas assets, including alternative assets such as hedge funds and real estate investment trusts. A total of US$1.2 billion of initial quotas was given to these managers.

No licenses were issued between September 2015 and late 2017, but Cerulli understands that many foreign managers have been keen to participate in the scheme, and continued to prepare for applications during this time. When the doors re-opened, a dozen managers seized the opportunities to apply for licenses. Consequently, the number of QDLP holders almost doubled to 27 in the first five months of 2018, from 15 previously.

In April 2018, the State Administration of Foreign Exchange (SAFE) in April 2018 raised the total QDLP quota to US$5 billion, from US$2 billion previously, which had been used up as of end-February 2018. New QDLP licenses might continue to be issued, and existing licensees can expect quota top-ups in the future. Outstanding fund performance and fundraising capabilities will be key factors to win extra quotas.

Private funds management

Private securities fund (PSF) management is one avenue for wholly foreign-owned enterprises (WFOEs) looking to expand onshore. Since the China Securities Regulatory Commission gave the green light, 11 WFOEs have registered with AMAC as PSF managers, as of May 2018. At the time of writing, Schroders was the latest firm to launch an onshore private fund—an equity product investing in A-shares—joining the other eight managers, which have each launched at least one product.

To succeed in the market, foreign managers have been building their networks and familiarizing themselves with the regulations, both of which are crucial to running a business in China. They face keen competition from domestic managers, which generally are stronger in terms of their client base, knowledge and investment track records. So far, foreign PSF managers have appeared to be united and not really competing with each other yet, since there are only a handful of them in a huge market.

Despite the initial challenges facing foreign asset managers, Cerulli believes that the ground is gradually becoming more fertile for them to set up private fund firms. Not only is AMAC conducting stricter surveillance of the industry and sieving out unqualified players, Chinese investors are also gradually becoming more sophisticated and aware of foreign managers' products.

EXHIBIT 4

Private Fund Assets Under Management, December 2014–May 2018 (RMB billions)

Sources: Asset Management Association of China, Cerulli Associates

Analyst Note: Based on public information, and might be non-exhaustive. [1]Joint venture between GF Asset Management and Hong Kong-based Persistent Asset Management.

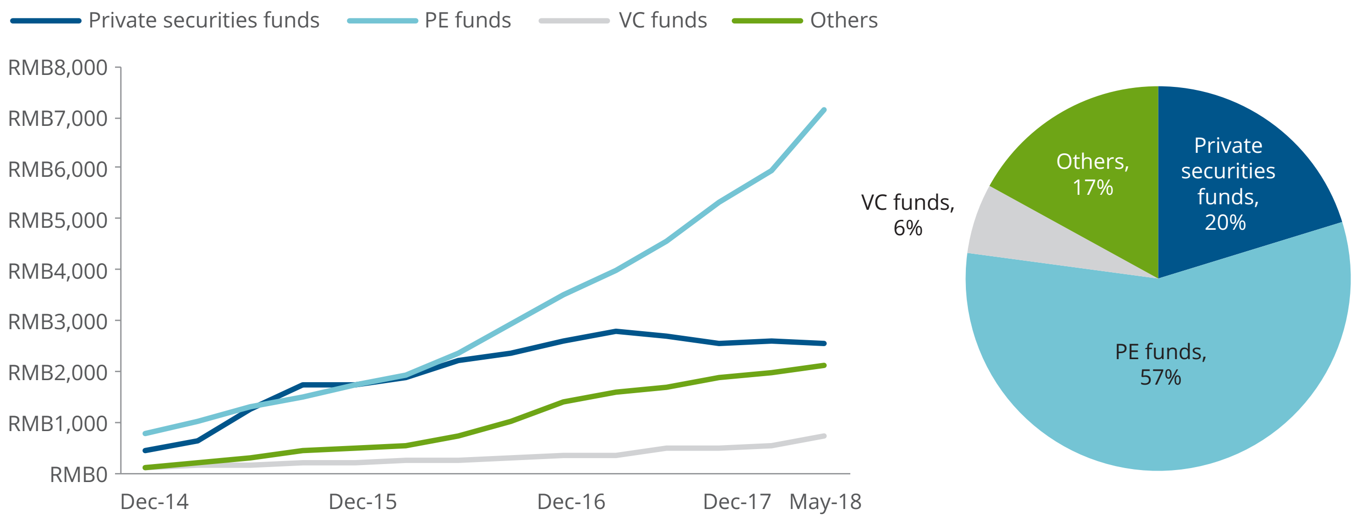
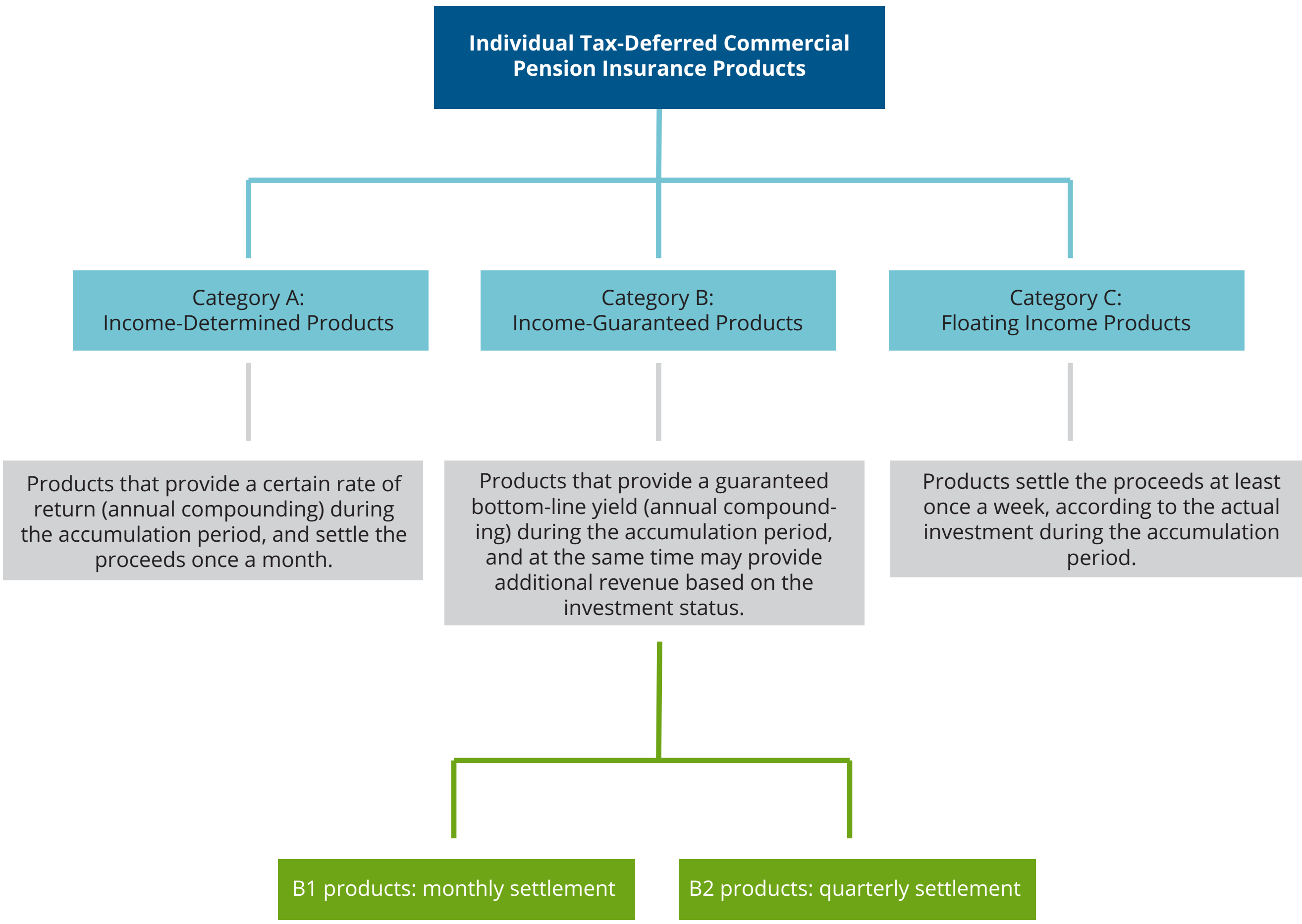


EXHIBIT 5

Individual Tax-Deferred Commercial Pension Insurance Product Types, May 2018

Sources: China Banking and Insurance Regulatory Commission, Cerulli Associates



Key Trend 4: Speeding up pension reform

China has so far been relying heavily on the first pillar to fund retirement. However, the government has been making good progress on overall pension reform; for example, by centralizing the basic pension management mechanism, implementing occupational annuities at the provincial level, and designing a top-level system for the third pillar, which is expected to spur significant growth in retirement savings. These moves bode well for the industry.

To support the development of the third pillar, the newly formed CBIRC has published Guidelines on Developing Individual Tax-Deferred Commercial Pension Insurance Products. Under the plan, individuals are allowed to defer tax on part of their income used to buy commercial pension insurance until they retire. Twelve insurers have been licensed to offer such products—China Life, China Pacific Life, Ping An Annuity, New China Life, Taiping Pension, Taikang Pension, Taiping Life, Taikang Life, Sunshine Life, CITIC-Prudential, Generali China, and Yingda Life. Six of them started selling 19 products since June 7 this year.

The government also announced a pilot scheme on tax-deferred commercial pension insurance in April 2018. Shanghai, Fujian Province (including Xiamen City), and Suzhou Industrial Park began to pilot the one-year scheme in May. Though it was announced four months later than earlier committed to, the pilot tax relief program is a significant step toward China's ambition to develop its potentially lucrative third-pillar pensions. If it proves successful, the pilot may be rolled out to other provinces.

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Cerulli **Lodestar**
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