

# China: The path to interest rate liberalization

Investors will need a keener focus on credit and risk analysis in a challenging new terrain

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# EXECUTIVE SUMMARY

## EXECUTIVE SUMMARY



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LAN WU

**FINANCIAL SECTOR REFORM IS A** key component of China's multi-decade economic restructuring plan, designed to shift from a centrally planned, government-controlled economy to a unique Chinese hybrid best described as a socialist market system.

Historically, the People's Bank of China (PBoC) has dominated China's banking and financial sectors, but gradual liberalization has allowed commercial banks to establish operations, bond markets to actively trade, money markets to determine the price of liquidity and a shadow banking system to evolve. Still, China's largest commercial banks have continued to dominate financial intermediation, while the PBoC's prescribed deposit rates and other monetary policy controls have created vast distortions and overcapacity in many industries.

The next major step in China's financial reform—interest rate liberalization—is about to occur. This fundamental change in how Chinese financial institutions price interest rates and manage risk will have significant implications for investors.

Central elements of the proposed liberalization include the introduction of a deposit guarantee scheme and a legal framework by the government to remove the implicit guarantee all financial institutions enjoy, allowing failing banks to default. In addition, deposit rates will be liberalized and PBoC capital allocation controls will be removed.

These reforms should ensure more accurate, market-driven interest rates, a broader range of financial products and more competition. But they will also create greater uncertainty, risk and instability. More rigorous risk and credit analysis is critical for institutional investors to confidently invest in this new regime.

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## INTRODUCTION

**IN 1978, CHINA TOOK ITS** first steps toward economic reform, beginning a gradual shift from a centrally planned, government-controlled economy to a Chinese hybrid best described as a socialist market system. The government aimed to build a stronger, more powerful economy and improve living standards in a society that was still overwhelmingly rural.

More than 35 years later, China's progress has been astonishing and the success of its reforms unmistakable. After many years of double-digit growth, a massive migration to cities and an extraordinary decline in poverty, China ranks as the world's second-largest economy.

Financial sector reforms have been critical to this transformation. From a single bank economy, in which the PBoC acted as both the central bank and a commercial bank, the sector has evolved into one characterised by publicly traded companies driven by market fundamentals.

But China's large commercial banks continue to dominate financial intermediation, while the PBoC exerts strong control over interest rates and markets. This has created pervasive distortions throughout the financial system, subsidizing borrowers, limiting private enterprise credit and curtailing the impact of other social reforms. In addition, the limitations of China's current investment- and export-focused economic model have become apparent, with slower GDP growth and spiraling borrowing required to maintain the government's avowed pace of expansion.

Today, China stands on the brink of a major financial reform—interest rate liberalization. The Chinese government and the PBoC are committed to fundamental changes that will move the Chinese economy from an investment-driven to a more sustainable, domestically driven, consumption-based growth model. Recent comments by the PBoC suggest that it expects full interest rate liberalization within a medium-term horizon of three to five years.

## INVESTOR IMPACT

How might interest rate liberalization impact investors? Though much will depend on the government's final policy, we believe that interest rate liberalization will create significant and widespread uncertainty. It will dispel investor complacency and force a new attention to risk in all bank and financial products.

The major elements of the proposed interest rate liberalization include:

- A new deposit protection scheme
- The establishment of a legal structure that allows banks to default
- The introduction of market-driven, competitive deposit rates

In the 65-year history of the People's Republic of China, no bank has ever defaulted, creating a widespread belief that all banks enjoy an implicit government guarantee. This has muted natural investor caution and encouraged injudicious investments in a wide range of high-risk, opaque financial instruments.

Removal of this moral hazard will stimulate the need for more accurate and insightful counterparty risk analysis. Even before interest rate liberalization takes full effect, investors will have to shift their perspective, carefully considering risk-reward trade-offs as they have never done before.

# Chinese banks: History and structure

A brief review of the history and structure of China's increasingly complex financial system provides a useful context for understanding the potential impact of interest rate liberalization.

Following the creation of the People's Republic of China in 1949, all commercial banks were nationalized and amalgamated into the People's Bank of China. For the next 30 years, the PBoC was the only bank operating in China. Unlike most developed market central banks, which have a considerable measure of independence, the PBoC has always been an integral part of the government. From the beginning, it focused on financing state-owned enterprises, controlling monetary policy, managing foreign exchange and accepting customer deposits, but it did not engage in lending to individuals. During this period there were no other financial markets in China.

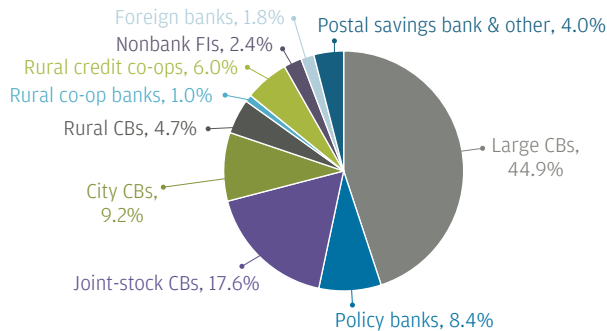
In 1979, as part of Deng Xiaoping's broader economic reforms, the commercial functions of the PBoC were separated into a number of different banks. Over the subsequent decade, the Chinese government also allowed several joint-stock commercial banks, city commercial banks and rural and urban credit cooperatives to establish operations.

Currently, China's banking sector includes about RMB 140 trillion of deposits, one billion customers and 2,500 banks, classified as large commercial banks, joint-stock banks, city commercial banks, rural commercial banks, rural cooperative banks, rural credit cooperatives and foreign banks (**EXHIBIT 1**, next page).

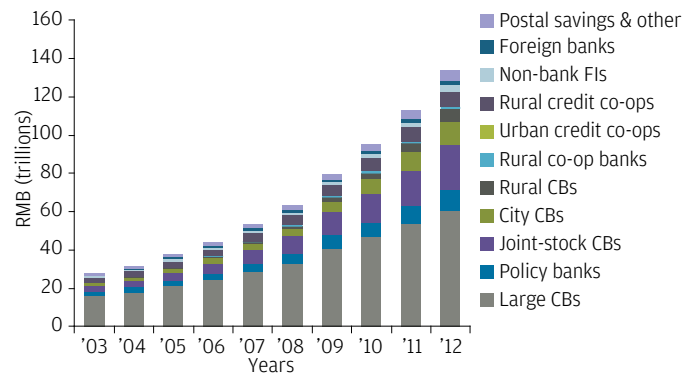
Sustained financial reform and development have been hampered by the absence of a clear legal and regulatory framework. As a result, China's largest banks continue to dominate financial intermediation and the commercial banking sector remains heavily influenced by the government.

EXHIBIT 1: CHINESE BANKING SECTOR

1A: SHARE OF 140 TRN RMB DEPOSIT BASE AMONG CHINA'S BANKS



1B: SHARE OF ASSETS BY BANK TYPE



Source: CLSA; data as of December 31, 2012.

Note: CBs = commercial banks.

In addition, high savings rates, a limited range of products and strict capital controls allow Chinese commercial banks to benefit from huge, low-cost deposit bases. Meanwhile, the PBoC's prescribed deposit and lending rates have exacerbated the commercial banks' natural preference for lending to low-risk state-owned enterprises while severely limiting the availability of credit to higher-risk private individuals and companies. This has created vast distortions and overcapacity in many industries and inflated property markets and allowed the banks to enjoy wide net interest margins, strong revenue growth and excellent profitability.

RESERVE REQUIREMENT RATIO

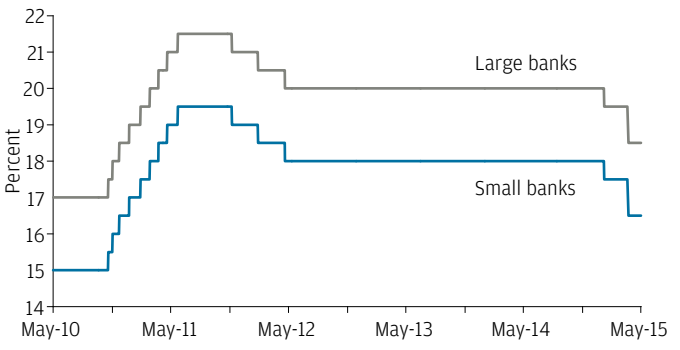
The PBoC's reserve requirement ratio (RRR) specifies the percentage of customer deposits that must be placed with the central bank (EXHIBIT 2). While most central banks impose an RRR to improve financial stability, the PBoC also uses the RRR as a monetary policy tool. Recognizing the importance and unique risks of smaller, rural banks, in 2008 the PBoC established a separate RRR for these banks. Recently, the PBoC has favored targeted rather than general movements in the ratio to tactically influence specific types of banks and regions.

THE PEOPLE'S BANK OF CHINA

The PBoC exerts enormous control and influence over China's interest rates and financial markets. Reform of its structure and rate-setting mechanisms will be a critical part of interest rate liberalization.

The Law on the People's Bank of China, introduced in 1995, formally established the PBoC as China's central bank and listed its functions and responsibilities. The three key responsibilities of the bank are to implement monetary policy, eliminate financial risks and maintain financial stability. Currently, the PBoC controls China's monetary policy mechanisms, including benchmark interest rates, reserve requirement ratio and open market operations. It also exerts influence via guidance, loan quotas and targets for the M2 money supply.

EXHIBIT 2: CHINA'S RESERVE REQUIREMENT RATIO



Source: Bloomberg; data as of May 20, 2015.

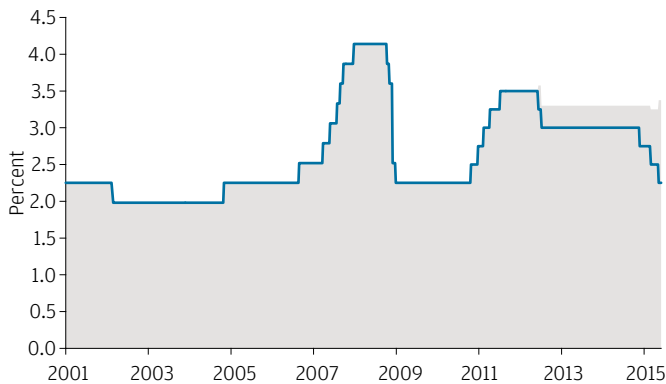
## BENCHMARK DEPOSIT AND LENDING RATES

The PBoC sets the benchmark deposit and lending rates for all financial institutions in China. Unlike other central banks, which only set the overnight rate, the PBoC sets rates for multiple maturities, extending from overnight to five years (**EXHIBIT 3A**). The central bank does not have a published calendar of rate-setting dates and instead changes rates at its discretion.

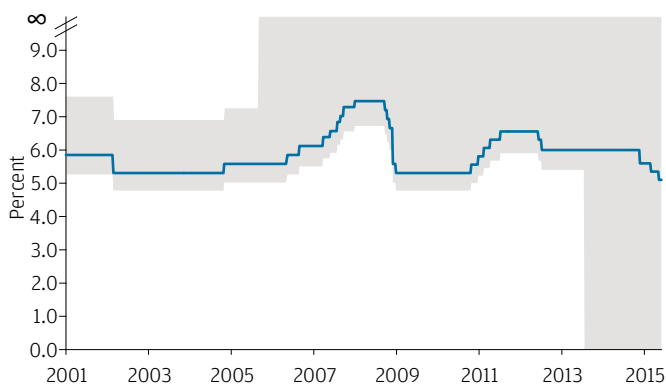
Originally, banks were obliged to apply these rates to all deposits and loans. This created large distortions, as banks favored loans to low-risk, government-linked entities while depositors favored large low-risk banks. To address this problem and allow some flexibility to price credit risks, the PBoC permitted banks to offer a range of borrowing and lending rates within narrow bands (**EXHIBIT 3B**). For the lending rates, the ceiling and floor were widened several times before being completely removed in 2013, effectively fully liberalizing bank lending. However, for the much more important deposit rates, the floor has been removed, but a quite restrictive ceiling still remains.

**EXHIBIT 3: CHINA'S OFFICIAL DEPOSIT AND LENDING RATES**

**3A: PBOC ONE-YEAR DEPOSIT RATE (AND RANGE)**



**3B: PBOC ONE-YEAR LENDING RATE (AND RANGE)**



Source: J.P. Morgan Asset Management, PBoC; data as of May 20, 2015.

Despite banks' newfound flexibility to price loans above and below the benchmark rate, approximately 90% of all loans are still priced very close to the benchmark as banks struggle to identify a suitable market-driven reference rate. The majority of deposits are currently priced at the ceiling. Both decisions suggest a conflict between weak bank pricing power and a desire to maintain net interest margins.

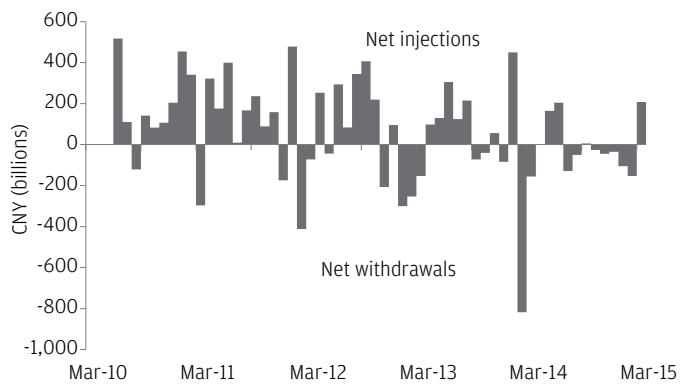
## OPEN MARKET OPERATIONS

The PBoC's open market operations (OMO) include the ability to issue and redeem central bank Treasury bills (T-bills) and to conduct repurchase (repo) operations to adjust the quantity and price of liquidity in the market.

The issuance and redemption of PBoC T-bills is more closely linked to an effort to sterilize foreign exchange flows rather than to control monetary policy. The recent decline in Treasury bill issuance is inversely related to the strengthening of the renminbi.

The PBoC adjusts market liquidity conditions by using repo operations, conducted twice a week to inject or withdraw liquidity based on demand information from the largest banks (**EXHIBIT 4**). Usually, the PBoC injects liquidity ahead of holidays and quarter-ends, and when interest rates deviate from its target. Yet standard open market operations can be slow to react to any spike in liquidity requirements, and the PBoC is unable to direct liquidity precisely where it is needed—two failings that were quite apparent during China's liquidity crisis in June 2013.

**EXHIBIT 4: COMPLETED OPEN MARKET OPERATIONS**



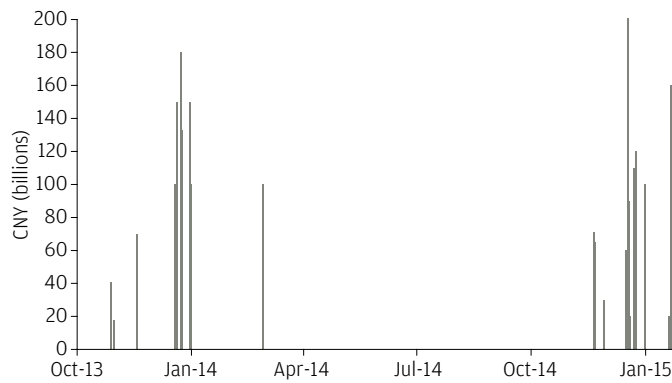
Source: J.P. Morgan Asset Management, Bloomberg; data as of March 31, 2015.

In an effort to address these shortcomings, in early 2013 the PBoC introduced the short-term liquidity operations (SLO) facility, which enables select banks to approach the central bank for funding on days when liquidity conditions tighten and open market operations are not available. But the SLO has not been used very often (**EXHIBIT 5A**), having plainly failed to fully address the root cause of liquidity rate volatility, which is chiefly the result of cash shortages at medium-sized and small banks.

The standing lending facility (SLF) is the mechanism most recently introduced by the PBoC to help reduce interest rate volatility and ensure adequate liquidity. In contrast to the SLO, this scheme is open to almost all banks in China and can be initiated by the banks themselves. Although lending rates are significantly higher than typical funding costs, the SLF has at least put a theoretical cap on interest rate spikes in the repo market. To date, the SLF has been tapped on numerous occasions to help banks manage their liquidity, and repo volatility has declined significantly since its introduction (**EXHIBIT 5B**).

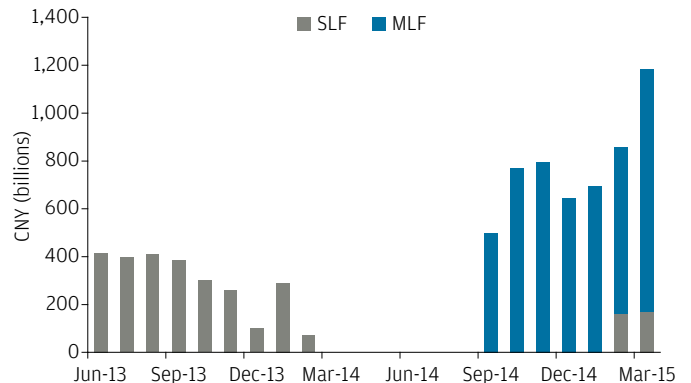
**EXHIBIT 5: RECENTLY INTRODUCED PBOC TOOLS**

**5A: COMPLETED SHORT-TERM LIQUIDITY OPERATIONS**



Source: Bloomberg, Citibank, PBoC; data as of May 20, 2015.

**5B: STANDING LENDING FACILITY OUTSTANDING**



Source: Bloomberg, Citibank, PBoC; data as of May 20, 2015.

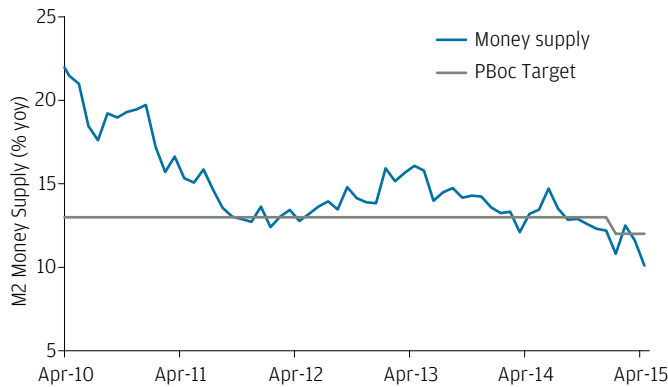
## NEW LOANS AND M2 GUIDANCE

On an annual basis, the government sets targets and objectives for new loan growth and money supply growth (**EXHIBIT 6**). The PBoC frequently meets with large financial institutions to ensure that their monetary decisions align with PBoC and government objectives. This informal, opaque method for managing and directing credit allows the PBoC to exert a great deal of control over the banking sector and the economy as a whole.

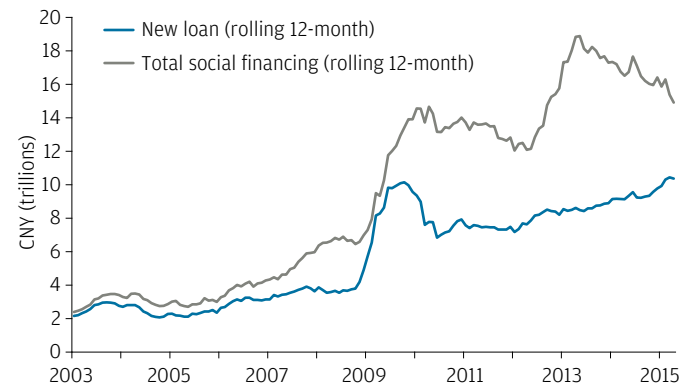
Rapid financial innovation has reduced the importance of M2 money supply; its successor, total social financing (TSF), is a broader measure of credit and liquidity growth, designed to better monitor the growing importance of shadow banking. But TSF has problems tracking the true growth of the financial system.

**EXHIBIT 6: CHINA'S MONEY SUPPLY, NEW LOAN AND TOTAL SOCIAL FINANCING**

**6A: M2 MONEY SUPPLY**



**6B: NEW LOAN AND TOTAL SOCIAL FINANCING**



Source: J.P. Morgan Asset Management, Bloomberg; data as of May 20, 2015.

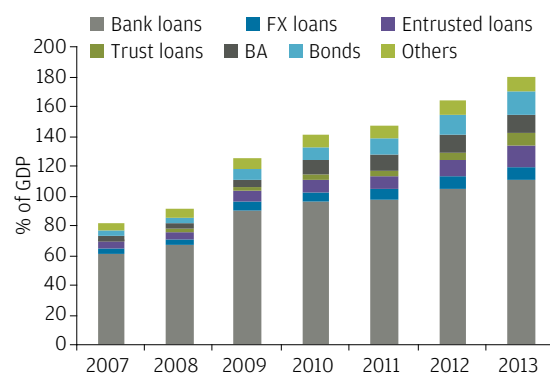
# The shadow banking sector

Even as economic growth has slowed in recent years, the pace of credit growth in China has risen sharply. The shadow banking sector has been one of the important drivers of this growth.

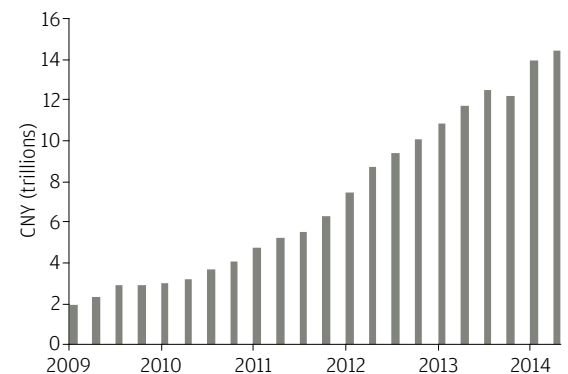
Shadow banking is commonly understood to encompass all credit outside the formal banking sector, including wealth management products (WMP), trust loans and the bond market (**EXHIBIT 7**). The label “shadow banking” is misleading in the Chinese context because the government and existing financial institutions control the vast majority of the entities offering shadow banking services. In addition, many of the sectors that make up shadow banking are well regulated and transparent. The lack of control of some underlying assets, poor liability matching and riskier informal lending have hurt the reputation of the entire industry.

## EXHIBIT 7: CHINA SHADOW BANKING INDUSTRY

7A: CHINA'S OUTSTANDING CREDIT



7B: TRUST ASSETS



Source: Goldman Sachs, HSBC, PBoC, UBS; data as of May 31, 2015.

Shadow banking is a central part of the government's efforts to broaden financial channels beyond the banks and reduce dependence on bank loans. The ultimate goal of shadow banking activities is to circumvent official interest rates and regulations in order to achieve better, more market-driven interest rates for borrowing and lending and to gain access to funding.

Over the past six years, shadow banking has grown four times faster than traditional banking. Today it accounts for most of the private lending in China.<sup>1</sup> Shadow banking products offer very attractive returns to investors with little extra perceived risk. At the same time, they offer borrowers vital access to capital not available elsewhere. Despite their explicit or implicit government guarantees, many shadow banking products carry considerable risks, which local investors are unlikely to fully appreciate.

Notwithstanding widespread concerns about rapid growth, transparency and unquantifiable risks, the shadow banking sector is now an integral part of the Chinese financial system. It is an important element in the ongoing process of interest rate liberalization. We believe the government's focus will be on regulating and controlling shadow banking, rather than shutting it down. At the same time, further liberalization should improve transparency and reduce the economic need for the less desirable elements of the shadow banking sector.

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<sup>1</sup> "China Inside Out," HSBC. (January 3, 2014).

## LIBERALIZED FINANCIAL MARKETS

Surprisingly, many financial markets in China already enjoy a large degree of freedom—the effect of previous economic reforms and investor ingenuity. Innovation, market-driven interest rates and more detailed risk analysis are characteristics of these markets. While the majority of these investments are only available to professional investors, they serve as important test beds for trading, the development of risk management and the understanding of economic liberalization.

### Chinese fixed income markets

Indirect financing by banking intermediaries dominates China’s financial system. The recent growth of direct financing via the bond market and shadow banking sector is the result of recently implemented reforms designed to reduce this dominance.

China’s onshore bond market is the world’s third largest, with total bonds outstanding of CNY 29.6 trillion at the end of 2013. It is growing at a rapid pace, increasing by over 40% in the past three years.<sup>2</sup> The Ministry of Finance,

the PBoC and policy bank bonds dominate the market, although corporate bond issuance has grown quickly.

Primary issuance yields for government, PBoC and policy bank bonds are controlled by the authorities to help guide domestic rates, but secondary market trading is fully liberalized. Recently, the government’s ability to influence market yields has declined, with market participants less willing to buy if they judge the yields offered to be too low.

Bond market reform and liberalization have centered on the introduction of new instruments and trading methods (**Exhibit A**). As the market has become more established, the range of issuers and investors has increased substantially. All these market-oriented reforms should increase financial disintermediation and help broaden and deepen China’s domestic bond markets. We believe this will allow for increased bond market transparency, improve market-based pricing and strengthen market discipline.

**EXHIBIT A: CHINESE BOND STRUCTURES AND CHARACTERISTICS**

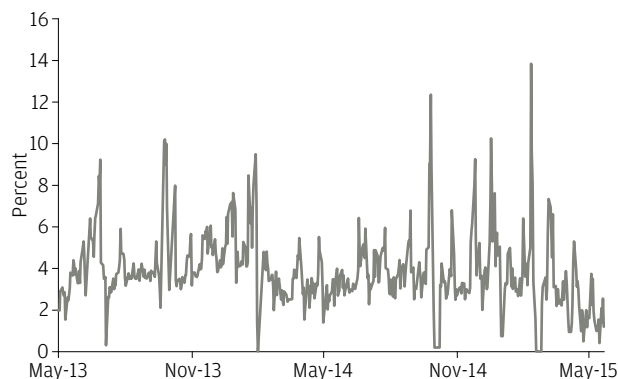
	Type	Issuer	Regulator	Market	Rating	Maturity
GOVERNMENT	Sovereign bond	MOF	MOF, CSRC	Exchange, interbank	Sovereign	3 months-50 years
	PBoC bill	PBoC	PBoC	Interbank	Sovereign	3 months-3 years
	Financial bond	Financial institute	PBoC, CBRC, CIRC	Interbank	Sovereign/AAA	1 year-30 years
CORPORATE	Commercial paper	Corporate	PBoC, NAFMII	Interbank	AAA-AA	1 month-12 months
	Medium-term note	Corporate	PBoC, NAFMII	Interbank	AAA-AA	3 years-30 years
	Listed corporate bond	Listed company	CSRC	Exchange	AAA-AA	3 years-30 years
	Unlisted corporate bond	Non-listed company	NDRC, CSRC	Exchange, interbank	AAA-AA	3 years-30 years
	Quasi-municipal bond	LGFV	NDRC, CSRC	Exchange, interbank	AAA-AA	3 years-30 years
	Negotiable certificate of deposit	Financial institute	PBoC	Interbank	AAA-AA	1 month-3 years

<sup>2</sup> Asian Development Bank website; as of July 31, 2014

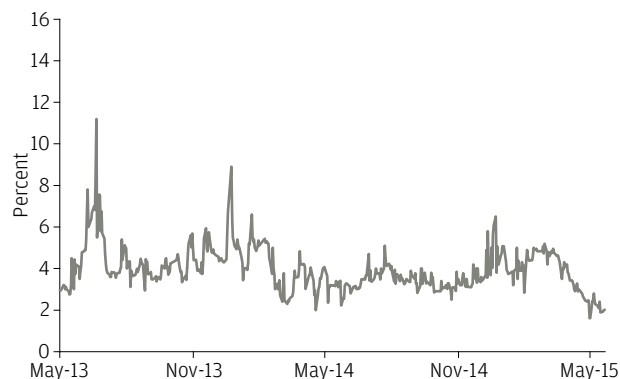
## LIBERALIZED FINANCIAL MARKETS

## EXHIBIT B: SHANGHAI STOCK EXCHANGE REPO RATES AND INTERBANK REPO RATES

B1: SEVEN-DAY SHANGHAI STOCK EXCHANGE REPO RATE



B2: SEVEN-DAY INTERBANK REPO



Source: Bloomberg; data as of May 20, 2015.

### Repo and reverse repo markets

Repos represent the largest, most efficient and most liquid segment of Chinese financial markets. The ability to execute repos is particularly important to smaller Chinese banks and non-bank financials that do not have access to large deposit bases. In addition, repos allow for secured funding that circumvents the dominance of large Chinese banks.

There are two types of repo markets in China: the stock exchange market, which started trading repos in 1991, and the interbank market, which began trading them in 1997. The Shanghai Stock Exchange (SSE) has emerged as the dominant market for repo trading. Intra-day interest rate movements in SSE repo are dependent upon changes in liquidity, PBoC open market operations and investor sentiment.

The SSE seven-day repo rate (**EXHIBIT B**) is widely recognized as the best and most important measure of funding costs, liquidity conditions and market stresses in the Chinese economy. Historically, rates are higher and more volatile at quarter-end and ahead of major holidays as banks struggle to estimate funding needs due to a higher demand for cash and liquidity.

Recently, the combination of new PBoC liquidity tools, new methods of bank funding and the beginning of interest rate liberalization has reduced the volatility of SSE repo. Even with further interest rate liberalization, repo markets will remain very important, both as a source of funding and as a measure of liquidity conditions.

### Commercial paper

The commercial paper (CP) market began in China in 2005, when securities brokers and non-financial companies were allowed to issue CP in the inter-bank market with tenors of up to 365 days. Banks are the main underwriters for CP issuance. But in China, unlike in most developed markets, issuance frequency, size, tenor and yield are determined by the distributing broker rather than investors. Though secondary trading has been liberalized, the market remains relatively small and peripheral. We believe that market expansion will require broadening the range of issuers and increasing issuer flexibility regarding outstanding volumes, tenors and yields.

## LIBERALIZED FINANCIAL MARKETS

### Negotiable certificates of deposit

In December 2013 the PBoC launched the negotiable certificates of deposit (NCD) program. It was an important step towards interest rate liberalization, allowing banks to broaden their funding bases and price borrowings using market-driven Shibor interest rates (the Shanghai Interbank Offered Rate).

NCDs are money market instruments issued in the market by deposit-taking financial institutions. They are transferrable and can be used as collateral for repo transactions. Initially, the NCD program included a limited number of eligible issuers and investors, but the range of issuers is likely to grow as the program matures.

NCDs are priced against Shibor, which is a simple arithmetic average of the uncollateralized wholesale lending rates offered by a group of highly rated Chinese banks in the interbank market. Theoretically, as an uncollateralized rate, Shibor should be higher than similar collateralized repo rates of similar maturity. However, low volumes and limited usage have historically undermined Shibor's usefulness as a gauge of liquidity and funding costs. Nevertheless, as NCD issuance increases and banks are required to price NCDs at market rates, Shibor rates will likely become more accurate. Although this will probably lead to higher bank funding costs, the appeal of the NCD—as an alternative funding source that offers better liquidity management and increased financial flexibility—will be very attractive to many banks.

As the NCD scheme is expanded to include more banks and a broader range of approved investors, these instruments are expected to become a major source of bank funding, making up a very liquid market and serving as an excellent barometer for short-term interest rates in China.

### Shadow banking products

Excluding the bond market, the two largest components of the shadow banking sector are wealth management products and trust products.

WMP are packaged loans or investments that offer higher yields than bank deposits, including either a principal guarantee or a non-principal guarantee by the originating bank. They are conceptually similar to funds sold by asset managers, but in China the WMP business is largely dominated by banks due to their strong retail distribution channels. Although banks prefer to issue non-principal guaranteed products, as these can be kept off-balance sheet, all WMPs are still widely perceived as having an implicit bank guarantee.

Trust products are similar to private, short-maturity bond issues. The trust company gives a high-interest loan to a corporate borrower, and a bank intermediary distributes the trust company's debt to investors, who enjoy the higher returns but ultimately bear the credit risk of the corporate borrower. Investors generally assume that the trust company and the distributing bank are offering an implicit guarantee on the debt. Trust products may be repackaged and sold through the same distribution channels used to sell WMPs.

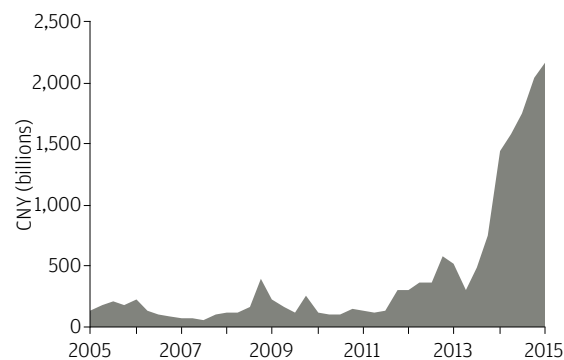
Though WMPs and trust products may offer implicit or even explicit guarantees, many are risky investments. We estimate that the vast majority of local investors underestimate these embedded risks.

# The Chinese fund industry

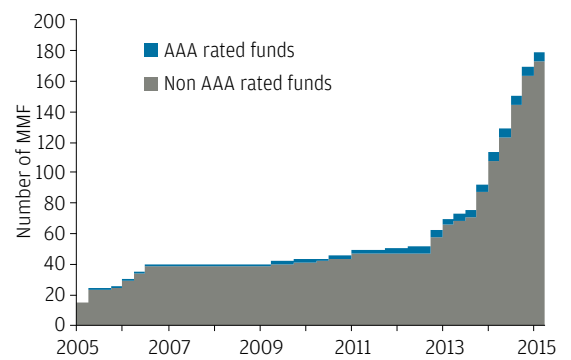
The bond and money market sectors of the Chinese retail fund industry have served as leading channels for retail and corporate investors to take advantage of the higher yields offered in liberalized financial markets. Money market funds in particular have been major beneficiaries of retail investors' desire for more-competitive, market-driven returns. As of mid-2014, there were 129 money market funds available, with record assets under management (AUM) of CNY 1.6 trillion (**EXHIBIT 8**).

## EXHIBIT 8: GROWTH OF CHINA MONEY MARKET FUND INDUSTRY

8A: INDUSTRY SIZE



8B: NUMBER OF MONEY MARKET FUNDS



Source: Wind; quarterly data as of March 31, 2015

The money market fund industry is highly concentrated, with the top 15 funds accounting for 83% of the market. Asset growth is largely driven by attractive yields, strong distribution channels and the promotion of additional investor benefits and services.

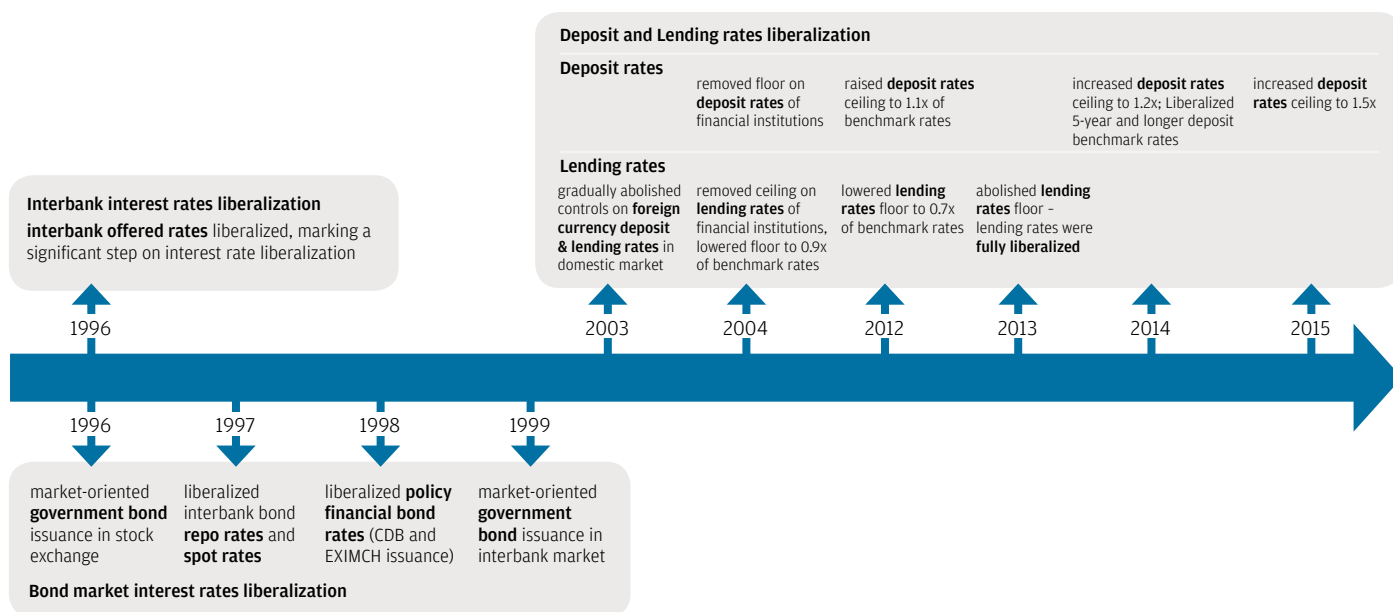
A niche AAA rated money market fund industry has also developed to serve the needs of more-risk-averse investors. These primarily include local companies and multinationals operating in China, which appreciate the benefits of higher, market-driven yields but do not want to compromise liquidity and security. Both Fitch Ratings and CCXI (China Cheng Xin International Credit Rating Co Ltd., a joint venture partner of Moody's Investors Service) offer domestic-scale money market fund ratings based on more rigorous guidelines than the standard regulator guidelines.

Future money market fund growth is dependent on the attractiveness of fund returns relative to other asset classes and on the availability of other investment options. Higher, liberalized bank deposit rates will likely reduce the appeal of funds and increase competition from banks.

# The path to interest rate liberalization

The modest interest rate liberalization implemented by the government, after more than two decades of financial market reforms, has benefitted only a small minority of Chinese investors. The majority of China's 1.4 billion population find themselves with few investment and interest rate choices beyond time deposits (EXHIBIT 9). This is by design: The slow pace of adoption reflects the government's preference for taking small steps and not introducing a major change in one big bang.

EXHIBIT 9: HISTORY OF INTEREST RATE LIBERALIZATION



Source: J.P. Morgan Asset Management, PBoC.

Nevertheless, the government, the PBoC and regulators are clearly committed to interest rate liberalization. They see it as a major step on the path to full economic liberalization and a critical element of the structural economic reform necessary to realign the Chinese economy towards a consumption-based growth model. As they have done in the past, the authorities will likely continue to implement change slowly.

## POTENTIAL CHANGES TO GOVERNMENT POLICY

The Chinese government is currently considering two critical pieces of legislation to enable further liberalization. First, the introduction of a formal deposit protection scheme will remove the pervasive assumption that all banks and financial products are implicitly guaranteed by the central government. This should force investors to diversify and encourage banks to clarify the credit risks embedded in their products. Second, the establishment of a legal framework to allow bank defaults to occur in an orderly and structured manner will eliminate the potential panic of a bank collapse. It will also enable relevant parties to create policies and procedures to handle the bankruptcy of financial institutions.

## POTENTIAL CHANGES TO PBOC MONETARY POLICY

Changes to PBoC policies and regulations will lay the groundwork for the establishment of a stable and functional market-driven interest rate regime. Switching from administrative and quantitative measures to price and market-based controls will have major implications for the cost and quantity of market liquidity.

Many observers believe that the PBoC should introduce a monetary policy framework similar to those adopted by developed countries, in which the central bank does not directly control the cost of credit but influences it by manipulating the short-term interest rate. To achieve this, the PBoC must identify a credible benchmark that is linked to both the interbank market and the real economy, allowing price signals to be effectively transmitted.

In this regard, the PBoC's likely first steps will include further increases in the deposit rate ceiling and liberalization of longer tenor deposit rates. In a further step, credit quotas and new loan growth targets should be phased out, as these will no longer be necessary when interest rates rise to a level at which loan demand becomes elastic to price signals.

Finally, modifications to the PBoC's reserve requirement rates will enable banks to more accurately and efficiently control their funding and liquidity conditions. These potential changes include lowering the excess reserves held by banks, allowing banks with temporary reserve deficits to borrow funds at penalty rates and reducing interest rates paid on required and excess reserves.

## POTENTIAL CHANGES TO REGULATOR POLICY

Bank and financial market regulators<sup>3</sup> need to encourage the broadening and deepening of bond and shadow banking sectors with more market-based pricing and better liquidity. Harmonizing policies, simplifying issuance requirements and extending the range of issuers and investors allowed to access the market will all help achieve this goal.

By allowing commercial banks to increase their liabilities in the wholesale markets, regulators can better prepare them for the challenges associated with deposit liberalization by diversifying their source of funding beyond deposits.

The regulators should also encourage the banking sector to improve its credit analysis and risk scoring to ensure that lending risks are properly aligned with potential returns. Better, more accurate domestic rating agency information would also be helpful in identifying and pricing risks.

Finally, improved coordination of supervision and control among the different regulators will be important to ensure consistency and avoid unsustainable competition between banks and other financial providers.

<sup>3</sup> The China Securities Regulatory Commission and the China Banking Regulatory Commission.

## HOW INTEREST RATE LIBERALIZATION MIGHT UNFOLD

### Implications for markets

Over the past decade, China's benchmark one-year lending and deposit rates have been significantly lower than the country's nominal annual GDP growth rate.<sup>4</sup> This breaches the "golden rule of interest rates," which suggests a country's nominal interest rate should be equal to or higher than its nominal GDP growth rate. In addition, high inflation has created negative real rates, subsidizing borrowers at the expense of savers. To correct these imbalances, interest rates will likely rise once deposit rates are liberalized. The high interest rates observed in the shadow banking sector are a portent of liberalized deposit interest rates. This rise will not be confined to current regulated rates, but will also affect market-based rates.

Deregulation of deposits will lead to increased competition among banks for funding and a sharp reduction in their net interest margins. Large banks with huge branch networks and more-secure deposit bases may be less impacted by deregulation. But smaller banks will need to innovate—increasing the range and variety of deposits, in addition to introducing new financial instruments to attract retail funds.

Issuance of NCDs will rise as banks seek alternative funding sources in the wholesale markets. Shibor as an NCD pricing reference rate will become more important and a more accurate reflection of funding costs. Bond yields for governments, policy banks and credit bonds will all rise due to increased issuance and higher competition for funding. This will promote increased secondary trading, liquidity and pricing transparency.

The introduction of a deposit protection scheme and bankruptcy legislation will remove the implicit guarantee assumption that all banks now enjoy. Investors will be forced to develop a better appreciation of the link between risk and return. In addition, domestic rating agencies, which currently rate 60% of all corporate issuers AAA<sup>5</sup>, will have to improve their research, remove the rating uplift from implicit government support and broaden the range of ratings that they issue.

For money market funds, increasing deposit rates will push fund yields higher, but the spread that funds currently enjoy over time deposits will decline.

### Implications for investments

Direct or indirect investment in government, government-guaranteed and major central government-owned entities will continue to offer the highest credit quality in China. Despite the potential for increased bad debts and reduced net interest rate margins, the Big Five banks will remain systemically important. (As always, investors are well advised to diversify holdings across the banks.) Investments in lower-tier banks, wealth management products and other structures should be subject to more rigorous analysis, with a focus on the credit quality and downside risk.

Indirect investments via fund management companies (money market funds or separately managed accounts) should be reviewed on the basis of fund ratings, track record, size and diversification. In addition, the fund manager's investment capabilities, operational controls and financial resource commitments must be carefully evaluated.

<sup>4</sup> Bloomberg; as of July 31, 2014. Average lending rate has been 6.0%; average deposit rate has been 2.8%. Average nominal growth rate has been 15%.

<sup>5</sup> "China Onshore Bond Compendium 2014," Standard Chartered Bank (April 29, 2014).

### Implications for institutional investors

Although China’s financial borders have become more porous, institutional renminbi cash balances continue to grow, thanks to higher interest rates and promising investment opportunities. Institutional investors already invest in a broad array of products (including simple time deposits, entrusted loans, wealth management products, money market funds and separately managed accounts), all benefitting from an implicit government guarantee (**EXHIBIT 10**).

The guarantee will disappear with interest rate liberalization. This profound change in the market environment will dispel investor complacency, create uncertainty and force the re-evaluation of counterparty risk and credit risk, as well as the myriad risks inherent in investment policies. We expect that the implementation of new interest rate policies will be gradual, giving investors ample time to decide on a strategic approach and introduce necessary controls and procedures. We also anticipate that most institutional investors will become more conservative, at least initially, in their investment choices.

**EXHIBIT 10: IMPACT OF INTEREST RATE LIBERALIZATION ON DIFFERENT ASSET CLASSES**

<p><b>Government bonds</b></p> <ul style="list-style-type: none"> <li>• Government bonds</li> <li>• PBoC T-bills &amp; policy banks</li> <li>• Remain highest credit quality</li> </ul>	<p><b>Lower-tier bank products</b></p> <ul style="list-style-type: none"> <li>• Weak government support</li> <li>• Poor profitability &amp; fundamentals</li> <li>• Very low credit quality</li> </ul>
<p><b>Big Five banks products</b></p> <ul style="list-style-type: none"> <li>• Strong government links</li> <li>• Still systemically important</li> <li>• Will retain high credit quality</li> </ul>	<p><b>Shadow banking products</b></p> <ul style="list-style-type: none"> <li>• Significantly higher risk</li> <li>• Assess issuer quality</li> <li>• Assess underlying asset quality</li> </ul>
<p><b>Second-tier bank products</b></p> <ul style="list-style-type: none"> <li>• Lower government support</li> <li>• Weaker fundamentals</li> <li>• Lower credit quality</li> </ul>	<p><b>Money market funds</b></p> <ul style="list-style-type: none"> <li>• Assess fund rating &amp; track record</li> <li>• Assess fund manager capabilities</li> <li>• Transparency of holdings</li> </ul>

Source: J.P. Morgan Asset Management. For illustrative purposes only.

## Conclusion

The Chinese government is committed to further financial sector reform, believing that market-driven interest rates and profit-minded institutions are central pillars of efficient capital allocation and continued economic growth. But the next phase of reform, full interest rate liberalization, will present fresh challenges. The government, regulators and banks will all look to strike a balance between free markets and government control, aiming to spur economic growth while restraining unhealthy financial risk.

Interest rate liberalization has begun gradually, and we expect that its evolution will continue at a fairly steady pace. However, in a centrally planned market, in which many investors do not fully understand or acknowledge counterparty and credit risks, the process could derail, at least temporarily. In addition, vested interests – including local governments and state-owned enterprises that benefit from cheap borrowing, as well as large commercial banks that enjoy attractive interest rate margins – could present roadblocks to liberalization. Finally, the recent slowdown in economic growth and rise in leverage will create further challenges.

Despite the various obstacles and complications, two powerful forces are at work: the government's push to create a sustainable domestic growth model and the desire of investors to benefit from the higher yields of liberalized markets. Together they demonstrate China's aspiration for more market-driven interest rates, better access to capital and greater investment choice.

## Update: June 2015

The pace of economic and financial reform has quickened since our white paper on Chinese interest rate liberalization was first published in November 2014. Several of the developments we anticipated have occurred, deepening market liquidity, increasing flexibility and introducing the concept of bank counterparty risk. In the following pages we highlight the most important changes in the landscape for liquidity investment.

### THE PEOPLE'S BANK OF CHINA (PBOC) HAS PROACTIVELY COMBINED A DOVISH MONETARY POLICY WITH FURTHER STEPS TO LIBERALIZE INTEREST RATES

- The PBoC introduced large denomination negotiated certificates of deposit (CDs) in late May 2015. These new instruments constitute a major change in how Chinese banks fund themselves and how non-financial corporations and retail clients invest. The CDs offer enhanced liquidity, as well as attractive, market-driven yields, and they represent an important step towards passing on the pricing of risk from China's central bank to the market.
- The PBoC no longer quotes lending rates for >5-year tenors. It has consolidated other lending rates into ranges of 0-1 year, 1-5 years and 5+ years. This has given banks the freedom to set their own lending rates for any chosen tenor.
- In November 2014 the PBoC raised the ceiling for deposit rates from 1.1x to 1.2x; in February the ceiling was raised to 1.3x and in May it was hiked once again, to 1.5x. As a result, banks have much more flexibility to price deposits closer to market-driven rates, allowing them to compete more effectively with shadow banking products.
- Between February and April 2015, the PBoC cut the reserve requirement ratio on two occasions, by a total of 150bps. These cuts were triggered by slower-than-expected economic data, but they have the secondary effect of aligning this ratio more closely with Western standards and freeing up Chinese bank lending.

## THE GOVERNMENT IS FOSTERING GREATER AWARENESS OF CREDIT RISK

- In December 2014, the State Council published draft regulations for a deposit protection insurance scheme. The scheme was formally announced in late March 2015 and introduced in early May. A critical step on the path to interest rate liberalization, it transforms the current unlimited, implicit guarantee that all Chinese bank products enjoy into a limited, explicit guarantee on deposits only.
- The government has also unveiled a series of policies to simplify the complexities of municipal and local government financing vehicles (LGFV). The goal is to reduce inefficient borrowing and remove the implicit central government guarantee these entities enjoy.
- Finally, the State Council has clarified the mandates of the three policy banks, reducing their commercial role while confirming their policy mandate. This will further differentiate government and non-government risks.

## REGULATORS ARE ENCOURAGING INNOVATION AND STRONGER RISK CONTROLS

In mid-May, the China Securities Regulatory Commission (CSRC) published its new guidelines for Chinese money market funds (MMF). These are the most significant and comprehensive changes to the rules governing the sector since money market funds were introduced in China in 2004.

The guidelines focus on tighter duration limits, better liquidity management, improved diversification of assets and a broader range of issuers and instruments. The new rules also improve MMF standardization and disclosure, and bring Chinese money market funds more in line with their Western counterparts. Overall, the guidelines encourage fund managers to innovate and exercise more proactive credit control while maintaining effective risk and liquidity management.

### INVESTMENT IMPLICATIONS

The main conclusions of our white paper remain very much intact: Interest and deposit rates will become more market-driven, bond markets will become deeper and more important and investors will develop a heightened awareness of risk. A quickening pace of liberalization suggests that investors need to promptly establish and/or review their counterparty and credit risk procedures. A host of powerful forces—the introduction of a limited deposit protection scheme, the government’s desire to sever the implicit assumption of a broad government guarantee and a dramatic slowdown in the pace of economic growth—have created a more challenging environment for Chinese cash investment. With the correct controls and procedures, those challenges can be met, and investors can benefit from a broader range of market-driven solutions to their investment needs.

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## LIQUIDITY INSIGHTS

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