At the end of the last quarter, the People’s Bank of China (PBOC), together with China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), China Insurance Regulatory Commission (CIRC) and State Administration of Foreign Exchange (SAFE), issued the Guiding Opinions on Regulating the Asset Management Business of Financial Institutions (Consultation Paper) (Guiding Opinions), formally soliciting public comments on this subject.

The Guiding Opinions consolidated a number of regulations previously issued by PBOC, CBRC, CSRC, CIRC and SAFE, aiming to unify regulations over various current issues of the asset management industry, especially multi-level investment products, the unclear extent of leverage, pervasive use of regulatory arbitrage, excessive speculation, among various others. The period prior to 30 June 2019 has been set as the transitional period before the regulations become effective; during this period, grandfather provisions would apply and new transactions need to be segregated from existing transactions.

The Guiding Opinions comprise a total of 29 articles, and the main contents include:

- **Formulation of unified regulations for cross-market and cross-industry businesses in the asset management industry:** This clarifies the scope of financial institutions, that are regarded as participants of the asset management industry and the substance of asset management products (AMPs) that would be regulated. It requires AMPs to be clearly categorized and matched with appropriate qualified investors. Moreover, it contains the investment scope and information disclosure guidelines according to the different categories of AMPs, with emphasis on management, with regard to the suitability for investors.

- **Strengthen the supervision of shadow banking and channel businesses:** It has been clarified that non-standard products issued by financial institutions would need to comply with certain regulatory standards, such as risk reserves, liquidity ratio and concentration ratio requirements. They may also not directly or indirectly invest in credit assets of a commercial bank. In addition, AMPs can only have two layers at maximum and multi-tranche products will no longer be allowed.
Emphasize risk isolation and mitigation of liquidity risk: This advocates the setup of a third-party independent custodian and regulating the management of investment portfolios for different AMPs. The roll forward of AMPs via new issuance and the management of AMPs on a pooling basis with maturity mismatch would be prohibited. Capital and risk reserves requirements would also be tightened.

Banish implicit guarantee and promote the use of net asset value (NAV) for management of AMPs: Financial institutions shall not provide any form of guarantee or repurchase commitments for AMPs, including the rolling forward of AMPs to a new issue. It also disallows the use of own funds or to entrust other entities to repurchase AMPs. Punishment and measures for breach of this policy under various scenarios are also provided in the Guiding Opinions.

Reduce the use of leverage: There is a requirement to manage the corresponding liability of AMPs by types, clearly prohibiting public mutual funds adapting multi-tranche arrangements. Meanwhile, regulators have drawn a clear line on the product types that can have stratified structure. For private funds that can be stratified, guidance on limits and proportion for each strata is also stipulated.

Regulate the application of robo-advisors: It has been clearly stipulated that artificial intelligence technology applied by financial institutions needs to be approved by the regulatory authorities. In addition, a risk management system specific to its use needs to be set up. Financial institutions are also prohibited from extensively publicizing their use of robo-advisors.

Our points of view

The Guiding Opinions formulated by PBOC, CBRC, CSRC, CIRC and SAFE constitute an effective response following the establishment of the State Council’s Financial Stability Development Committee and is a clear indication of regulators’ efforts to strengthen the coordinated development of the asset management industry. The regulatory environment of financial institutions will be gradually transformed from a diverse decentralized management model into one led by the PBOC, with support and coordination from various other regulatory authorities. Thus, the possibility of regulatory arbitrage by financial institutions will be reduced.

The Guiding Opinions set a transitional period of up to one and a half years. Although specific details and implementation guidelines are awaiting further clarifications from the regulators, we believe that the persuasive tone used throughout the text of the Guiding Opinions will remain unchanged, namely to push standardization in the regulations of the asset management industry, the strengthening of information transparency and overall risk management.

Bank wealth management products (BWMPs) are a key focus for the regulators and the growth and size of these will suffer.

The size of BWMPs’ assets under management (AUM) is about RMB 30 trillion, which constitutes the largest proportion of the asset management industry. Breaking up implicit guarantee arrangements and the implementation of NAV management will probably result in BWMPs losing favor with investors. In addition, BWMPs that invest in credit securities may face higher liquidity risk as a result of the requirement to manage BWMPs on an NAV basis.

Related regulations to regularize non-standard businesses, the ban on the rolling forward of products with new issuance, maturity mismatch, etc., may also affect the issuance and management of BWMPs. Those products with a term of less than three months will be gradually phased out and those with illiquid assets can also no longer rely on the launching of short-term products to cover the mismatch. It is, however, unclear how this requirement would be applied to existing medium- and long-term non-standard businesses after the transitional period.

BWMPs are likely to be most affected by the new regulations in the short-term. We believe that the overall size of BWMPs may shrink significantly in 2018. However, in the long run, the proper management of BWMPs is necessary to reinstate the nature and properties of AMPs.

The importance of custody business has been further underlined. Continuous improvement of professional services is needed.

The Guiding Opinions specify that asset management products issued by financial institutions have to be independently managed by third-party institutions with custody qualifications, further emphasizing the importance and independence of the custody business. This will facilitate and promote the growth of the custody market.

The Guiding Opinions, while emphasizing the importance and independence of the custody function, also impose new challenges for the professional development of custody business. The full implementation of NAV management would likely require the custodian banks to invest in technology relating to this business process and increase the level of automation. At the same time, the Guiding Opinions stress that after the new regulations come into effect, supervision with thorough permeation and real-time supervision would be strengthened. This requires custodian banks to upgrade processes related to the supervision of investments by enhancing the level of accuracy and details and specialization in order to satisfy regulators’ expectations.
Main channel business of fund subsidiaries remains restrictive. The launch of new products requires greater caution.

AUM for fund subsidiaries have experienced explosive growth since 2015. AUM of approximately RMB 11 trillion at one stage had surpassed those of public mutual funds. However, due to regulations relating to net capital requirements, the size of fund subsidiaries has reduced by nearly 30% in the past year. The Guiding Opinions clearly prohibit the conduct of multi-tranche channel business and emphasizes that managers cannot avoid the responsibilities they have to bear on the basis that the business had been conducted through channels.

The issuance of the Guiding Opinions may exert liquidity pressure on non-standard debt products of fund subsidiaries. Prohibition of maturity mismatch and multi-tranche products will further dampen the launch of new products by fund subsidiaries. Meanwhile, stress that managers will be more cautious in their expansion of channel business as managers will no longer be able to avoid liabilities. Overall, the business scale of fund subsidiaries may experience further reduction.

Asset management business of securities companies has slowed. Access to short-term financing resources may be restricted.

The size of securities companies' asset management has exceeded RMB 17 trillion, but active management products make up less than 30% of the same. Most of the remaining products are from channel business or non-standard products financed by assignment of debt.

The regulations in the Guiding Opinions governing restricting channel business, regulating capital pool and reducing leverage will hinder securities companies from continuing the issuance of AMPs via channel-oriented business. This includes the transfer of nonstandard products via the assignment of debts with maturity mismatch. The scale and growth of securities companies’ asset management plans may slow, and securities companies would also need to start reviewing and clearing its existing capital pool businesses, especially those long-term plans financed by mid-term and short-term products.

However, as the asset management business of securities companies are still at a developing stage, its contribution to the securities companies' overall revenue is not very significant. Therefore, slowdown in this area may not have a significant impact on the overall development of securities companies. In the long-term, a clearer regulatory environment may even be more conducive for securities companies, allowing them to set directions for the development of their asset management business.

The extent of leverage at trust companies is restricted, but it is hoped that the pressure to hold adequate capital may be relieved.

The AUM of products developed by trust companies has reached RMB 24 trillion, second to BWMPs in the asset management industry. The channel business accounts for more than 60% of current product structure, and most of the products are multi-tranche structured products. Again, the Guiding Opinions which prohibit multi-tranche structures in products may cause further decline in the scale of trust products.

Meanwhile, the Guiding Opinions which disallow the notion of implicit guarantee is consistent with trust companies' developments in recent years, which alleviates the pressure on trust companies to redeem products to a certain extent, and would spur them to establish and strengthen their own risk management system. In addition, the Guiding Opinions state that all financial institutions are obliged to set aside risk reserves, calculated on the basis of 10% of the management fee from asset management. In this regard, trust companies are already required to make provision for risk reserve security funds as part of industry requirements. On top of this, they are also required to satisfy certain net capital requirements at the same time, i.e., they are currently subject to a double reserve mechanism. If the implementation of the Guiding Opinions follow the idea of unified supervision, trust companies may only need to set aside risk reserve once, without further capital adequacy requirement, resulting in less pressure for funds.

Entry threshold of private funds products is increased. Innovative technological products with venture capital investment win regulatory support.

With regard to non-public offerings issued by licensed institutions, the Guiding Opinions raised the entry threshold for qualified investors from the previous minimum household financial assets of a RMB 3 million benchmark to RMB 5 million. This increase in threshold may directly result in a reduction of potential customers, further increase client acquisition costs and compress profit margins. Meanwhile, at the product level, the requirements of the Guiding Opinions on implicit guarantee, multi-tranche, extent of leverage, etc., may also restrain the issuance and growth of private products in the short term.

In contrast, the Guiding Opinions encourage and support national priority initiatives and major infrastructure projects, technology and innovation, and strategic emerging industries, the "Belt and Road" construction, the coordinated development of Beijing-Tianjin-Hebei province, and related fields. Private funds investments in these areas are likely to receive support from regulators.
Public mutual funds will be less affected by new regulations. It may gain popularity with mature investors.

Public mutual funds with a scale of RMB 11 trillion benefits from having a transparent and complete regulatory system with product structures that are also clear and concise comparatively. It seems to be least affected by the relevant regulations in the Guiding Opinions. Although the Guiding Opinions prohibit public mutual funds from having multi-tranche structure, the size of structured funds of public mutual funds has greatly reduced after the 2015 stock market crash. Therefore, the new regulations have less impact on public mutual funds.

The size of public mutual funds may reduce in the short-term along with the shrinkage of upstream AMPs such as banks’ financial management products. However, in the medium- to long-term, with the removal of implicit guarantees and the implementation of NAV management for BWMPs and trust products, investors are more likely to favor public mutual funds, characterized by outstanding active management ability, clear historical performance and transparent post-investment disclosure. In addition, with the implementation of regulatory initiatives and the gradual improvement of investor education, investors will become more familiar with AMPs. The public mutual funds market provides extensive product lines with various risk return, which would probably gain broader customer acceptance and be favored by the investors. Therefore, we expect that the public mutual funds may benefit from the new policy, and the size of this market will further expand as investors' cognitive sophistication increases.

Conclusion

Overall, the issuance of the Guiding Opinions herald the arrival of the "big asset management" era, with enhanced regulations in this area that are well coordinated and complete. The setting of the transitional period will allow sufficient space for adjustment and clearance of existing products, while setting development directions for incremental products. The relevant detailed regulations of the Guiding Opinions may be adjusted, and more detailed rules to achieve implementation of regulations need to be issued. On the whole, in the short- to medium-term, the issuance of the Guiding Opinions is likely to lead to a slowdown in the scale and growth of AMPs and pressure from structural adjustments will increase. However, in the long term, the issuance of the Guiding Opinions will accelerate asset management institutions' efforts to transform their operating models, promote the development of differentiated business models, and effectively drive the overall development of the industry in an orderly and controlled manner.