In Case You Missed It: CSOP's Weekly China Wrap Up

CSRC issues "window guidance" limiting hostile takeovers via leveraged buyouts
In a move to restrict hostile takeover attempts, the China Securities Regulatory Commission (CSRC) has issued "window guidance" that prohibits existing major shareholders (>5% of holding) from using borrowed money or newly raised funds to participate in share placements by listed firms, according to South China Morning Post.[1]

Although not *officially* a rule change, the guidance allows the CSRC to modify existing rules without further revision. The announcement comes in response to the ongoing and controversial struggle for control over China Vanke, the world's largest homebuilder. In an open letter to the CSRC, Vanke charged Baoneng Group, its largest shareholder, with illegally raising funds to fuel a takeover attempt. In issuing the guidance, the CSRC aimed to establish more decisive rules to help fend off similar attempts in other market sectors.

Most market players expect additional de-leverage and risk control policies announced in the coming weeks.

CBRC suggests tightening regulation on Wealth Management Products to improve financial system transparency
The China Banking Regulatory Commission (CBRC) suggested tightening regulation on wealth management products (WMPs), instruments that have increasingly come to serve as banks' off balance sheet funding channel of choice.[2]

By employing the products, banks are able to sidestep capital requirements and extend loans to subprime borrowers. Investors too benefit—WMP's average 6%-10% interest rates are a windfall compared to the 2%-4% returns found in traditional savings accounts. A problem arises, though, because investors in WMPs often consider the products risk-free, akin to plain vanilla deposits. This is a misconception. WMP capital is invested in riskier assets classes like equities and non-standard fixed income assets, allowing banks to record the income as fee-based (rather than interest-based), and subsequently enjoy a higher market capitalization.

Although no definitive rules have been set, the CBRC's announcement serves as a warning signal for banks and investors alike. Because the shadow banking system that has resulted from the rise of WMPs strongly resembles the off-balance sheet special purpose vehicles (SPV) that helped incite the 2008 global financial crisis, the announcement aims to inspire a return to good old fashioned lending vehicles-- mutual funds and savings accounts. The rules also intend to prepare markets for potential defaults of the WMPs-- widely considered a necessary move for market maturation.

In response to the news, small and medium-cap companies' stocks plummeted 5.45%; they are the primary beneficiaries of WMP loans. They are also seen as the most impacted if regulation is to pass.

State-Owned Enterprises see profits drop 8.5% YoY
China's Ministry of Finance reported that overall SOE profit decreased to RMB 1.13 trillion in 1H2016, an 8.5% drop YoY.[3,4,5] Although significant, the figure represents a slowing pace of decline; profits from January to May of this year were 9.5% YoY.

The results of the downturn were disproportionately concentrated in the steel, oil, and chemicals sectors, reflecting weaker-than-expected global demand resulting from Brexit and ensuing market uncertainties. Providing a glimmer of good news, the healthcare and real estate sectors both recorded significant profit increases. The coal sector broke-even for the period.

What to watch for moving forward? Slowing economic growth has put pressure on leaders to accelerate SOE reform efforts as a means of reducing overcapacity.

Report reveals progress in RMB internationalization over past 5 years

The RMB Internationalization Report showed that RMB Internationalization Index (RII) reached 3.6, ten times that of 5 years ago. In 2015, the RII increased dramatically thanks to the demand from RMB direct investment and overseas loans. At the current stage, RMB-denominated assets account for 1.1% of global foreign reserves.

In a related report, the Society for Worldwide Financial Telecommunications (SWIFT) reported that China slipped back to the sixth most transacted currency, falling behind the Loonie. The trend is largely attributed to speculation that China's central bank will continue depreciation measures in its effort to spur economic growth. Despite the setback, medium and long term signals point to continued acceptance of the RMB; the number of financial institutions using the RMB for payments has increased 12% YoY. Analysts reference initiatives such as China's cross border Inter-Bank Payments System and the appointment of offshore clearing centers in more than twenty countries as evidence. The most critical event will occur October 1, 2016, when the IMF includes the RMB as the fifth currency in the SDR basket, joining the dollar, euro, yen, and pound sterling as global reserve currencies.[6,7]

Notes:

1. CSRC: China Securities Regulatory Commission
2. CBRC: China Banking Regulatory Commission
3. YoY: Year over year
4. SOE: State-owned enterprise
5. RMB: Renminbi, the national currency of China
6. IMF: International Monetary Fund
7. SDR: Special Drawing Right, an international reserve asset