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

Regulators in Hong Kong and China formally approve Bond Connect scheme

The People's Bank of China (PBOC) and Hong Kong Monetary Authority (HKMA) announced their joint approval of the long-anticipated Hong Kong-China Bond Connect scheme. Initially, the program will solely permit Northbound transactions, allowing overseas market participants to invest in China's onshore bond market; the Southbound link will be developed at a later date. Although no official launch date has been provided for the Connect scheme, some speculate that it will open for business on July 1, 2017, the 20th anniversary of Hong Kong's handover to China.

An important milestone for China's capital market

Following on the heels of the 2014 Shanghai and 2016 Shenzhen-Hong Kong Stock Connect schemes, the Bond Connect program represents another key milestone in the evolution of China's capital market. Although China's USD 9.6 trillion bond market is the world's third largest, foreign investors own less than 2% of outstanding debt.[1] This imbalance is partially due to the fact that, in recent history, only RQFII investors and select foreign central banks could participate in China's onshore inter-bank bond market.[2]

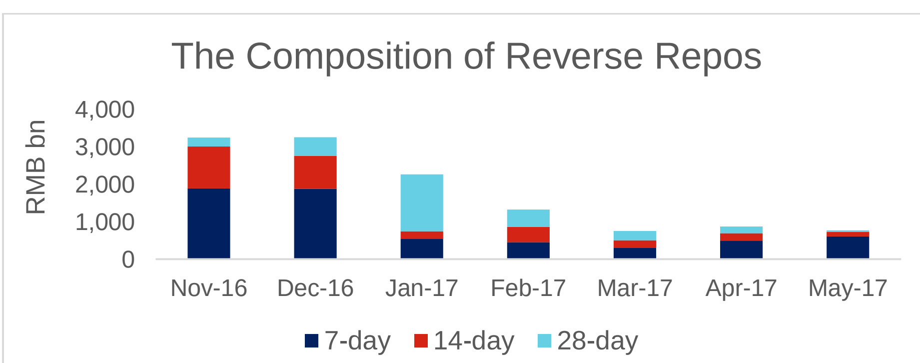
The new Connect initiative will expand the scope of eligible participants to include institutional investors, international financial companies, and sovereign wealth funds. Moreover, through the Connect scheme, international investors can avoid settling trades on the mainland, a convoluted process that many try to avoid. These enhancements increase the chance that China's bonds will secure entry into key global fixed income benchmarks, which could resultantly provide more than USD 200 billion of inflows in the coming years. Capturing such flows would be a boon for China's foreign exchange reserves, offsetting several months of outflow pressure.

PBOC renews cash injections to relieve liquidity stress

China's central bank injected USD 24.7 billion into the country's financial system last week, the largest single-day injection in nearly four months. The move is welcome news for downtrodden investors who have seen $250 billion erased from markets in the recent deleveraging campaign, according to Bloomberg.

What's behind the injection?

In their continued quest to curb the use of short-term borrowing, the PBOC employed their favorite tool: the reverse repo. The PBOC conducted reverse repos worth RMB 630 billion (USD 90 billion) in May, 79.4% of which were 7-day maturity.[3] The prevalence of shorter maturity instruments has increased in recent months--35% in February, 41% in March, and 57% in April-- while 28-day maturity reverse repos fell from 30% in January to 6.3% in May. Analysts argue that the use of shorter-term instruments indicates the PBOC's desire to deleverage cautiously. The weeklong maturities allow for concentrated fine-tuning of the monetary supply.



Source: Bloomberg, as of May 18, 2017

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CIRC bans Universal Life Insurance, Forsea Life quivers

The China Insurance Regulatory Commission banned life insurers from selling Universal Life Insurance (ULI) products, the insurers' favored method of inexpensively funding acquisition sprees. As a result of the ban, Foresea Life Insurance, which relied on the funding mechanism to acquire listed companies like Vanke, has suffered a major blow to company cash flows and is reportedly on the brink of bankruptcy.

What is Universal Life Insurance?

Invented in the United States in 1979, ULI is a hybrid life insurance/wealth management product. It both protects investors like traditional life insurance, while allowing them to share in the profits and losses from insurer investments. The products have become popular in China in recent years due to their guaranteed minimum return (between 1.75% to 2.5%), adjustable notional amounts, non-compulsory contribution frequency, and flexible surrender terms.

How Foresea used the products

Established in 2012, Foresea Insurance's stellar debut impressed its competitors: the company sold USD 1.2 billion of insurance policy premiums in its first year alone. Foresea grew rapidly through selling ULI; premium income reached USD 5 billion by the company's second year.
This formidable income stream was funneled into the war chest of parent company Baoneng Group, who embarked on a purchasing spree to secure stakes in real estate and A-Share listed companies.
Foresea/Baoneng's success soon attracted copycats. The lax attitude of then-CIRC chairman Xiang Junbo implicitly encouraged the practice. However, Foresea's fortunes reversed after Xiang's recent ouster. Forced to suspend their ULI business, they witnessed a rapid decline in premium income. In fact, the ensuing loss of market confidence has cost the company an estimated USD 560 million in insurance policy cancellations since 2016.

In light of the deteriorating situation, some onlookers are predicting bankruptcy. Critics allege the firm's duration mismatch is too severe to be remedied.

Plans floated to replenish China's pension system with state-owned enterprise capital

China may replenish its pension fund system with SOE capital this year, according to National Council for Social Security Fund (NCSSF) chairman Lou Jiwei.[4] Two key issues remain under discussion, however: 1) whether to transfer equity or profit; 2) whether to replenish pensions at the national level or provincial level.

The problem with China's current system

Mr. Lou's comments attracted wide attention from onlookers hoping that the plan will address deficiencies in China's underfunded social security system. According to the Ministry of Human Resources and Social Security, the situation has deteriorated in recent years. Whereas three provinces had underfunded pensions in 2014, that number grew to six in 2015. Although the 2016 data has not yet been reported, onlookers allege the problem continues to worsen as China's population ages into a low interest rate environment.

A capital transfer program in northeastern Shandong Province was the first provincial program to replenish a social security system with state assets. The industrial region transferred 30% of state-owned equity (RMB 18 billion) to the local social security fund in 2015. Although the ultimate success of the program has yet to be determined, it indicates that transfer schemes are technically feasible at the local level.

Lingering questions

Problematically, however, China’s pension imbalance might be more equitably resolved at the national level-- by transferring assets from central government SOEs to China’s national pension system. Because of the country’s development imbalance, the highest quality state-owned assets are located in wealthy coastal provinces with healthier social security systems. As such, although infusing provincial pension systems with provincial-level assets would suffice in well-developed regions, it would be inadequate in China’s less-developed inner regions, where the local assets are low quality and the funding gaps more severe. Accordingly, a growing chorus is arguing for the transfer of national SOE assets to the National Social Security Fund, although the logistical feasibility of this arrangement remains uncertain.

Also at issue is the question of profit transfer versus equity transfer. The former involves shifting a certain percentage of state-owned enterprise profits to social security funds, whereas the later entails transferring company ownership stakes. So far, the equity transfer option has emerged as the preferred scheme; the impact appears less burdensome on SOE operation.

Prospective launch of new mutual fund type offers encouraging sign of pension system reform

China’s securities regulator is collecting feedback from domestic managers about a new financial product catering to China's aging population: pension mutual funds. By introducing the instrument, China’s leadership is demonstrating concern for the needs of retail pensioners and spurring maturation of China’s underdeveloped social security system.

Pension mutual funds: a primer

Pension funds differ from traditional mutual funds because they operate with a specific objective: use mature assets to preserve and grow capital over the long term while maintaining low volatility and limited downside risk. According to the proposed rules, mutual fund managers with assets under management exceeding RMB 30 billion (excluding money market funds) will be eligible to establish pension mutual funds. The funds will be allowed to invest a maximum of 30% in equity or equity funds and are permitted to operate using a Fund of Funds model.

Why it matters

Unlike the robust 401k industry in the United States, China largely lacks individualized, market-based mechanisms to aid in retirement preparation. On the contrary, most pension investment is undertaken on the provincial or national level; IRAs do not exist. As such, not only will the funds provide aging retail investors a new vehicle for preparing for retirement, they will also bring an infusion of much-need capital into China’s thirsty domestic equity market.

Notes:
1. USD: USD Dollar, the official currency of the United States
2. RQFII: Renminbi Qualified Foreign Institutional Investor
3. RMB: Renminbi, the official currency of the People’s Republic of China
4. SOE: State-owned enterprise