SUMMARY

President Xi hosts the five yearly National Financial Work Conference with “financial security” taking centre stage. A new State Council committee above China’s regulators should bring much needed coordination and harmonisation of rules. The regulatory ‘storm’ continues in the banking and insurance sectors with a deepening anti-corruption purge snaring the chairmen of the insurance regulator and Anbang Insurance. Liquidity tightens and deleveraging ticks up, but a huge overhang remains. Liberalisation inches along with MSCI inclusion and bond connect but tensions rise in the run up to Congress with Governor Zhou blasting vested interests obstructing reform.

Road to Congress

The five-yearly National People’s Congress will cast a long shadow over the coming quarter for China’s financial markets but July’s National Financial Work Conference gave a glimpse of things to come. The Conference meets every five years and previous meetings have heralded substantial reforms in China’s financial markets including the creation of the securities, insurance (1997) and banking regulators (2002), recapitalisation of the large four banks (1997), and creation of China Investment Corporation (2007).

Unsurprisingly, ‘financial security’ took centre stage with President Xi himself chairing the meeting. In April and for this first time in his tenure, President Xi convened the Politburo (the Communist Party’s top decision making body) to discuss financial security, signalling an unprecedented degree of political attention on China’s financial system. Xi followed up at the Work Conference by calling finance the “life blood” of the economy and stressing greater party interest, attention and education on financial matters. He stressed three major priorities: making the financial sector better serve the real economy, containing financial risks, and deepening financial reforms. Deleveraging will gain renewed focus with Xi emphasising the need to tackle zombie companies in the state owned sector.

As expected, a root and branch overhaul of the regulatory system was off the table. Instead a new committee to oversee financial stability will be created at the State Council addressing a longstanding need to increase coordination, and overcome competition, between the regulators. The new committee will also be tasked with increasing focus on regulation by ‘function’ and harmonise rules and regulations across the system to tackle arbitrage.

The Conference was silent on shifting top jobs. It’s not clear what the makeup of the new committee will be. Nor are we any clearer on who will be new Chairman of the CIRC, or new Governor of the PBOC.
President Xi reiterated that up will continue in a stable and steady manner with authorities promoting Belt & Road initiative as a way to increase financial innovation. In February this year, the State Council set out a seemingly ambitious agenda for liberalisation through “Circular No.5” promising updated national and FTZ negative lists, and easing constraints on credit rating, accountancy and auditing business. Whilst interim results to the US-China 100 day trade plan have borne fruit, the upcoming US-China Comprehensive Economic Dialogue will be an early litmus test of China’s ambition for significant opening up.

Regulators tighten the noose

Tasked by the President, China’s regulators have continued to fan the ‘storm’ that has hit China’s financial sector since the turn of the year. The China Banking Regulatory Commission and Chairman Guo have led the charge, issuing a wave of new regulatory requirements to rein in legal violations, regulatory arbitrage and misconduct, with China’s banks also required to report self-assessments on exposures to shadow banking sector products. Reflecting wider concerns over ODI, the CBRC has also asked all banks to report their lending in support of outbound capital investment by clients.

China’s insurance sector has come under intense scrutiny in the first half of the year. The sector has been fertile territory in recent years with insurance premiums growing an annual average 16.8% from 2011 to 2016 to RMB3.1 trillion, and assets growing at a compound rate of 20.2% over the last five years (Figure 1). Now however, the tables have turned with the chairman of security regulator Liu Shiyu calling for “hunting” of the “barbarians” and “crocodiles” in the insurance sector manipulating the stock market.

![Image](image.png)

**Figure 1 Insurance Asset Growth**

Anbang has been the most high profile target of the regulatory clampdown. Founded in 2004 with $72.7m in assets, Anbang hoarded licences and grew rapidly to become the third largest insurers with $285bn in assets this year. Earlier this year the regulator banned Anbang from selling certain products because they were causing ‘havoc’ in the market. Anbang Life Insurance's business has since suffered sharply, but the pain is shared across the sector with premium incomes halving across the board over the last five months.

The Chairman of Anbang, Wu Xiaohui, but also CIRC Chairman, Xiang Junbo, both fall to the anti-corruption purge with the latter carrying the blame for excessive risk build up in the sector. Both figures are the most high profile to fall in the financial sector to date and with the President pressing for greater attention on appropriate behaviour in the financial system, further casualties are likely.
Draining the money markets

In parallel to the regulatory crack down, the People’s Bank of China has continued to tighten liquidity in the money markets. The PBOC’s ‘neutral money policy’ in effect means tightening with M2 growth dipping to 9.6% in May, and 9.4% in June against a trend rate of 10.5% for most of the past year. The squeeze has caused the 7-day interbank repo rate to spike, hitting 5% in late March.

The PBOC has been careful to fine tune its approach and prevent any excess volatility. Significant short term liquidity injections by the central bank ($91bn in June, the largest since January, $10bn in July to date) gas stymied volatility and maintained steady interbank lending rates. The 7-day interbank rate (DR007), peaked between 3% and 3.3% in June (Figure 2) falling thereafter.

Leverage is falling nonetheless in the shadow sector. May was the second consecutive month of declining new credit shrinking to RMB1.06 trillion ($156bn) from RMB1.39 trillion ($204.6bn) in April. However, with a lending rate around 12%/year in recent years, almost two times of the GDP growth rate, the debt overhang remains significant. Concerned over the debt trajectory, in May Moody’s downgraded China’s debt from A1 to Aa3 in May and moved from neutral to negative outlook.
Small and middle sized banks have suffered the most from the de-leveraging campaign with the clampdown hitting their easy access to shadow finance. In May, net funds raised in the shadow-banking system stood at RMB28.9 billion, a fraction of the RMB1.2 trillion recorded in January (Figure 3). Whilst according to official accounts there have not been bank bankruptcy or bailouts to date (some analysts disagree) there is growing acceptance that the risk is growing, and small bank bankruptcies could happen, and be tolerated, over the coming year.

The central government has also tightened the net on its profligate provinces. In May and June the Ministry of Finance (MOF) issued policy Circulars 50 and 87 to reign in local government debt which stands at around RMB15.3 trillion (central government debt is RMB13 trillion). The Circulars seek to bar local governments from using borrowed money to set up investment funds, from issuing excessive debt through PPP projects, and from offering any implicit guarantee to their financing vehicles. Fully implemented, the long term impact could be significant but won’t come at the cost of short term stability.

Opening up vs “Rent-Seeking”

At this year’s LujiaZui Forum, the Governor of the People’s Bank of China, Zhou Xiaochuan, lashed out at ‘some’ that have argued against liberalisation out of self interest, warning that protection leads to ‘laziness’ and ‘rent-seeking’. With many expecting Governor Zhou to retire by the end of this year, the speech was seen by some as a parting shot that have sought to stifle an ambitious and progressive agenda under his tenure. Equally, following the Financial Conference others are speculating that Zhou make take on an elevated role through the new State Council Committee.

There were nonetheless significant landmarks this quarter for China’s opening. In June, the MSCI Index finally included a handful of Chinese stocks into its flagship emerging markets index. With $1.6tn in funds tracking the index, the decision means some investors will turn to China for the first time. Whilst only 5% of Chinese stocks are currently included in the index, securities regulator Vice Chairman Fang has publicly targeted 30% inclusion, and has committed to further liberalisation of inward investment schemes in order to meet MSCI’s requirements.

Perhaps more significant, though to less fanfare, was the launch of the northbound channel of the Mainland-Hong Kong Bond Connect. Whilst the Chinese interbank bond market is largely open to foreign investors, the foreign share of the third largest bond market in the world remains less than 2% (the share in the US is 29%, UK 41%). The new Bond Connect scheme substantially reduces the bureaucratic and infrastructure barriers to direct investment from Hong Kong and should facilitate substantially greater inflows.

A strong bias remains nonetheless to any reform initiative that brings greater inward capital flows. A tighter capital account remains in place and in May, China Foreign Exchange Trade Systems adjusted the mechanism for setting the RMB’s exchange rate by adding a “countercyclical” component to help prevent large fluctuations. Foreign Exchange reserves have regained ground in the second quarter of this year reaching $3.22 trillion having fallen below the $3 trillion level last year.