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Regulatory responses to the Chinese shadow banking development

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Abstract

Shadow banking systems were developing rapidly in the Western economies during the last two decades. Research from recent years show that within the last years equally important process of shadow banking development occurs in some emerging markets, and among others, in China. The system was not only a sophisticated part of China's financial market, but played very important role in the development of the Chinese economy. The aim of this article is a description of the mechanisms of shadow banking development in China, characteristics of the main threats of this system and the regulatory approach in the country. Despite many threats, the shadow banking system plays an important role in the Chinese economy. There is a need for its regulation and support for further development.

Paper type: review article

Keywords: Chinese financial market, shadow banking, trust companies, wealth management products

Introduction

Shadow banking is evolving mainly in developed countries. The Financial Stability Board estimates that in 2014 more than 80% of global shadow banking assets reside in advanced economies (FSB Financial Stability Board, 2015, p. 2). Despite that there are several countries classified as an emerging economy or developing country, where the system is growing very rapidly. Among them is China. The country

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belongs to 26 jurisdictions which the FSB is monitoring the development of shadow banking and treating the sector as an important part of country's financial market. China is the leading emerging country where shadow banking is developing rapidly. Actually the Chinese share of global shadow banking assets is 8% (the end of 2014) and it is very rapidly developing (in the 2010 it was only 2% of the global shadow banking) (Canuto, 2015). The article concerns the issue of the Chinese shadow banking development and the regulatory responses to the threats stemming from the system. The main motive was to synthesize the issues and assess the introduced regulatory changes.

1. The importance and characteristics of Chinese shadow banking

The shadow banking in China is similarly defined as in another countries. The People's Bank of China defines it as "a credit intermediation involving entities and activities outside the regular banking system, that provides liquidity and credit transformation" (Elliot, Kroeber, & Qiao, 2015, p. 4). The system in China differs from shadow banking in another countries in its structure (Table 1).

Table 1 *The comparison between shadow banking in China and in Western countries*

China's shadow banking	Western shadow banking
Domestic financial system	Both domestic and foreign financial system
Mainly driven by commercial banks	Mainly driven by non-bank financial institutions
Underdeveloped secondary market	Well-developed secondary market
Low securitization rate	High securitization rate
Low leverage rate	High leverage rate
Purchases made by individual investors	Purchases made by institutional investors
Immature development phase with inherent risks	More mature development phase
Irregular fund raising and lending operations	More regular fund raising and lending operations

Source: van der Linden, 2015, pp. 111–114.

By contrast to Western economies, where shadow banking refers to an investment management scheme on the financial market, China's shadow banking is playing an active role in broadening investment channels to the private sector. The Chinese shadow banking consists of less complex financial instruments. The system is shallow, does not have any protection from the state, and is quite underdeveloped

in the institutional side. The other important feature of the system is that it is more strictly interconnected to the traditional banking than shadow banking systems in other countries. Comparison to the shadow banking in the United States and China shows that the Chinese system is based on implicit guarantees and is bank oriented, whereas the American system is based on financial engineering and is oriented on capital market (Van der Linden, 2015; Elliot et al., 2015; Dang, Wang, & Yao, 2014).

In the Chinese model it resembles straightforward lending. It allows to develop lending activity and to bypass the regulations imposed on the operations. In the literature are enumerated three major groups of shadow banking entities:

- banks with their Wealth Management Products (WMP),
- non bank financial institutions, e.g. trusts, brokers, insurance companies, security funds and leasing companies,
- financial intermediaries for small businesses and underprivileged consumers (Zhang, 2014, pp. VII–VIII).

Strong regulations for banks and very low official rates of interests have led banks for searching alternative ways of investments. One of the best alternatives to traditional products offered by banks in China are WMP. They are products created by trust companies – intermediaries which are not allowed by law to accept deposits or lend out money, but they are allowed to manage them. Trust companies use traditional banks as their agents and by this way collected money and invest them in market companies and different enterprises. Banks connected with trust companies roll out loans off balance sheet into trust products, which banks then resold to retail customers. WMP provide returns based on the performance of a pool of underlying assets. Some of the investments are typical credit like investments, but other are more speculative products, oriented on different risky issues like spirits, graveyards or even more imaginative investments. The high risk inclined in such products are cushioned by collateral and downgraded by leverage (The credit culacs, 2013). WMPs play significant role in the Chinese financial system – together with trust products they represent over 50% of China's GDP and create the shadow banking system in China (Sekine, 2015).

Apart from the traditional banks, Chinese shadow banking includes also non-bank institutions, like microfinance companies, guarantee companies, leasing entities and some other similar institutions. Their aim is to help encourage credit access for small and rural borrowers (Elliot et al., 2015). Significant role in Chinese shadow banking play trust companies and created by the companies Trust Products.[2] Trust companies are a special institutions that engage in the financial intermediation that the traditional banking sector and capital market cannot fulfill. They are able to invest in the money market businesses, capital market businesses, and al-

[2] Trust Products are financial transactions undertaken and managed by trust companies.

ternative investments. During last few years trust companies invested in China in selected industries, like: manufacturing, energy transportation and construction, mining, electricity, gas and water production, wholesale and retail, software and IT services and real estate sector (Sheng & Soon, 2015).

Table 2 *Comparison between Wealth Management Products and Trust Products – the main components of Chinese shadow banking*

	Wealth Management Products	**Trust Products**
The main creating institutions	WMPs are typically structured and sold by banks as savings products but are recorded off banks' balance sheets, and hence, not subject to the deposit regulation.	Trust products are structured by non-bank financial institutions like trusts, brokers, insurance companies, and security firms. These entities typically need to cooperate with banks in reaching out to individuals or corporate savers.
Investment goals	Invested mainly in interbank lending and interbank bond markets.	Funds raised by trust products are channeled to riskier borrowers (e.g. property developers, mining companies and local government financing vehicles) as trust loans.
Growth	China's WMP have grown rapidly, from less than ¥500 billion in 2004 to ¥9.5 trillion by the end of 2013.	Trust industry became the second largest subsector of China's financial system in 2012, with total assets of ¥7.47 trillion, up from ¥1.24 trillion in 2008. The total assets of the trust sector were ¥12.48 trillion by June 2014.

Source: based on Dang et al., 2014; Liansheng, 2015.

The last group of Chinese shadow banking entities is formed by non-bank financial intermediaries, which activity is oriented on the small businesses and individual consumers. Among such institutions are: micro lenders, pawn shoppers and the underground black market (Dang et al., 2015).

2. The reasons of development shadow banking in China during 2005–2015

Shadow banking in China is developing very quickly, especially after the financial crisis of 2007–2009. It is estimated that the annual growth of non-financial intermediaries in China in the period 2010–2012 was growing at a rate of 34% per year (Labes, 2013). The system started to develop at the end of 1990s, but its rapid development and the increase in coverage occurred in the last few years. It is reflected by the statistical data on the size and composition of shadow banking in China (Table 3).

Table 3 *Size and composition of China's shadow banking (in RMB 1 bilion)*

Year	Entrusted loans	Trusted loans	Bankers' acceptances	Interbank entrusted loan payments	Financial leasing	Small loan companies	Total
2002	267	0	256				523
2003	328	0	457				784
2004	639	0	428				1067
2005	836	0	430				1266
2006	1105	172	580	444			2212
2007	1442	342	1250	558			3503
2008	1868	657	1357	738			4530
2009	2546	1093	1818	628			5995
2010	3421	1480	4152	1680	270	198	11111
2011	4717	1683	5179	1872	426	391	14180
2012	6001	2972	6229	2894	608	592	19207
2013	8551	4812	7004	3000	766	819	24952

Source: Elliot et al., 2015, p. 10.

The Chinese credit system is dominated by banks. They are the main credit supplies in the country. The other sectors of the Chinese financial market are underdeveloped and businesses cannot treat them as an important source of financing. The data concerning 2012 states that banks provide the private sector with credit amounting to 128% of GDP, whereas the bond market provides credit equivalent to 41% of GDP and the stock market capitalization was about 44% of GDP (Elliot & Yan, 2013, p. 7). Despite rapid growth of the Chinese stock market during the last years, much of securities purchases are made by banks what means that it is difficult to diversify the financing source. Among the main features indicating the dominance of banking sector are:

- the legal position of banks in the country (they are mainly state owned and state controlled),
- the state protection for banks against competition and implicit guarantees,
- the prudential regulations concerning lending activities which determine the privileged position of banks (Elliot et al., 2015).

The position of traditional banking sector determines shadow banking development in the country. Shadow banking in China is acting as a substitute for financing within the formal financial system. Its development is caused by a desire to circumvent the existing regulatory impediments. The banking sector did not pro-

vide financing for businesses in the level as it is needed in the fast growing economy. This situation is caused by the number of regulations imposed on bank lending (e.g. the limits of bank loans to deposits, discouragements on lending to certain industries, caps on bank lending volumes imposed by the central bank, etc.). The limited credit availability is particularly severe for small and medium-sized enterprises, which started to searching alternative ways of financing. The opportunities for savings and other forms of investment for the commonage and the small businesses are also limited (Allison, 2015). In order to circumvent the regulatory measures banks have started cooperation with shadow banks.

An important factor, which led to the development of Chinese shadow banking were the interest rates in the country. The interest rates are being strictly controlled by the Chinese government (e.g. by the deposit rate ceiling), what led to the situation when real interest rates were either close to zero or negative. The aim of the policy was to artificially reduce the relative price of capital, especially for selected branches of industry. Commercial banks were trying to evade the regulatory restrictions on deposit rate and interest rate. The maximum interest rate allowed by the regulations was 3.3%. The very low or close-to-zero interest rates resulted with withdrawal deposits from banks and search for new, higher-yielding investments. Banks were trying to limit the deposit outflows by increasing household investments return and to provide higher level of financing to the private sector. To achieve this they started to operate in the shadow banking system. In accordance with the law the big state-owned enterprises had an easy access to cheap bank credit, while more efficient private enterprises were struggling for financing. The development of shadow banking allowed such private-owned enterprises better access for capital (Wang, Wang, Wang, & Zhou, 2015). It had a positive impact on the entire economy. The system helped to fuel the Chinese economic growth by making financial services widely available to a larger group of the country's population at a cheaper price.

In the Chinese system banks were not able to give loans for unsecured companies, like real estate developers or coal miners. Such enterprises were forced to pay high rate of interest, but the banks had to give loans to the state-owned enterprises firstly, and had a short of capital to finance the more risky enterprises. On the other hand they were motivated to give loans to private enterprises, which guaranteed higher return. In order to collect necessary deposits they set up WMPs, and offered them via a trust companies to keep the transactions off the bank's books. By the way they were able to offer loans to the private enterprises. The interbank rates connected with the off-balance transactions were higher than the official rates. Due to the fact banks were able to collect very easily additional deposits when official interest rates were kept at the very low level, and many individual investors were looking for favorable investment opportunities.

The crisis that began in 2007 in the United States also moved to China. It caused a decline in the FDI inflow and export decrease. In response, the Chinese government has prepared a stimulus package for Chinese economy, amounting to 586 bil-

lion USD. The money not only boosted the real economy, but also strengthened the Chinese financial market, opened various channels of financing investments and resulted in the development of shadow banking. The system was considered as necessary for the development of Chinese economy. Non-bank shadow banking channels have a number of key advantages over the traditional banking, which were hampered by the rigid rules. It has grown very rapidly after the financial crisis and enlarged its share (Figure 1).

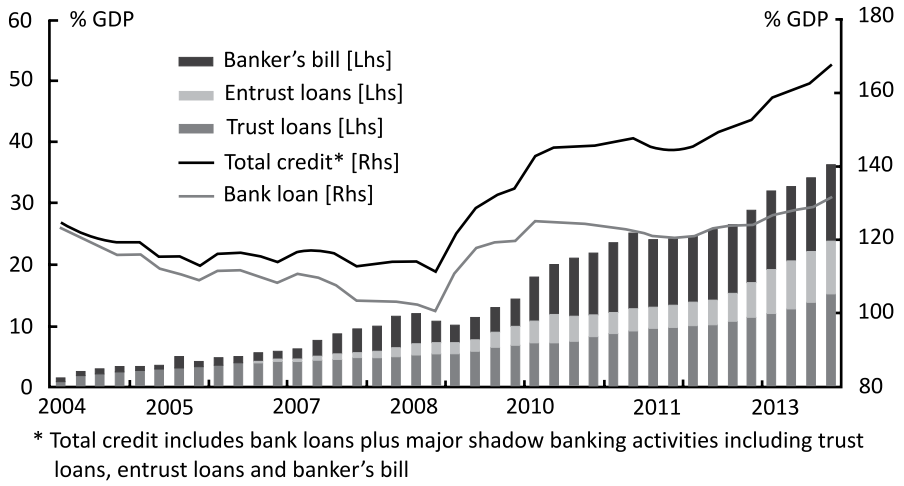


Figure 1. *Chinese shadow banking system, as a percentage of GDP during 2004–2014.*

Source: Bloomberg and CEIC in Dang et al., 2015, p. 28.

The Figure 1 shows that after the financial crisis the total credit level increased its share in relation to the bank loans. It was a consequence of the policy adopted in response to the crisis.

3. Crisis on the horizon

The functioning of shadow banking in China, like in other countries, is associated with high risk. It is due to the fact that the system is unregulated and is not protected by a lender of last resort. Among the main threats are risks of liquidity and solvency, moral hazard, interconnectedness between shadow banking entities and regular banking system, and the most important which comes from the nature of shadow banking – the systemic risk.

Some economists argue, that Chinese shadow banking is associated with lower risk in comparison to other countries, because its constituent institutions do not use aggressive strategies such as hedge funds, investment funds and other such entities and they do not use so high leverages as are being used in foreign shadow banking systems. They are less involved in the securitization process and do not use instruments like derivatives, CDOs, CDS, etc. and such long chain of financial intermediation as in some other countries are nonexistent.

The counterargument is that products like WMPs or Trust Products which are widespread in Chinese shadow banking cause the same risks and can be the same opaque to the complicated derivatives. Moreover, China's shadow banking is linked with the real economy to a greater extent. It means that if the crisis happens, the problems of the institutions forming the shadow banking will have a great impact on the real economy. Among the most endangered entities are: real estate developers, coal miners and steel makers. The dangers stem from some trust companies, involved in lending to the branches and endangered by maturity mismatch.

During the last several years the Chinese shadow banking was very helpful for the real economy, but in time of turbulence it will have the opposite effect. The traditional banks by participation in the shadow banking started lending to local governments and supplying large, credit intensive infrastructure projects. Many of the projects were of poor quality (e.g. returns do not compensate risks). If some of the long-term investments fail, the banks will have big financial problems in the future. In a case of default the investors are prone to lose their capital. The other threat arises from the fact that the WMPs are associated with liquidity risk. The products attracted short term deposits and invested in longer term investments. In case of liquidity problems, there will be negative influence on banks and other institutions, which are not able to roll out their liabilities.

Originally among the WMPs' investors were real estate companies and municipalities. Unfortunately since 2013, these businesses were slowing down and banks decided to change the form of investment and put their money into the stock market. It means that the shadow banking in China has transformed from a relatively safe into a more risky investment system. An essential issue is that they did it in a very leveraged way, converting equity investments into structured products. They used the underlying stocks for creation fixed-return products and variable-return products (Archarya, Qian, & Yang, 2015). The first category of products were offered for ordinary depositors and the second for hedge funds and other investors with riskier investment profiles. This mechanism meant linking banking operations with capital market. It created high leverage and contributed to the creation of a speculative bubble in the Chinese capital market. The whole situation generates a danger for Chinese banks of a loss given default (Altman, 2015). If there will happen a crisis, the future of the whole system will depend on whether the banks and regulators will be able to prevent run on the shadow banking institutions in China.

A very important danger associated with the Chinese shadow banking is its impact on the world economy. Theoretically the threat of the Chinese financial market for the world economy should be unimportant because the size of the market is insignificant. Banking debt problems in emerging markets should be rather domestic without global systemic implications. Despite this some analysts have a fear that if something wrong happens in the China's financial sector, it can spill over to foreign banks and investors, because China is becoming increasingly integrated with the global financial system (Yao & Hu, 2015). If there are any problems in the Chinese capital market, the global economy will bear the consequences. Even if the threats will cause only a slowdown of the Chinese growth, it can send a shockwaves and have strong impact on the whole world economy. It shows how important is the Chinese shadow banking. If it is better regulated, it will avert the next global crisis.

4. Proposals for Chinese shadow banking regulation

The last turbulences in the Chinese economy have shown that regulatory reform in the country's financial system is needed. The necessary regulatory changes for the shadow banking sector were among the key guidelines developed by the Chinese government in recent years. The Chinese authorities very strongly stressed the need to regulate the shadow banking system in the 12th Five-year-Plan for the period 2011–2015 (*The 12th Five-year Plan*..., 2012). Additionally in January 2014, the Chinese government promulgated a document with respect to regulation of shadow banking in China, entitled *Circular of the General Office of the State Council on Relevant Issues of Strengthening the Regulation of Shadow Banking* (*Circular of the General Office...,* 2013). It is the latest regulatory framework in China, related to the shadow banking issues (Huang, 2015).

In general the regulatory approach concentrates on three important aspects:

- determination of the shadow banking supervision powers and clear arrangements of their responsibilities,
- guidelines on transparency – e.g. rules of shadow banking statistics and information policy,
- regulations for institutions and products – e.g. referring to banks' WMP, trust companies, small-loan companies, etc.

A key issue for efficient regulation is proper institutional regulatory structure. The current financial regulatory framework in China is sector-based approach, with separate regulators for banking, securities and insurance (the China Banking Regulatory Commission, the China Securities Regulatory Commission, and the China Insurance Regulatory Commission). They conduct the supervision togeth-

er with the central bank (the People's Bank of China). The new regulation (Circular No. 107) states, that the responsibility for shadow banking regulation is divided between all the enumerated supervisors. It states clearly that whoever approves the establishment of the shadow banking entity shall be responsible for regulating it. The general opinion is that it introduces transparency for the supervision task, however some critics highlight, that sometimes shadow banking products are cross-sector in nature, what will cause some competence problems in the future. Despite this shortcoming, the regulation is treated as a significant achievement. At the international arena sometimes are applied different models of supervision (e.g. "twin-peaks" model or "integrated model") but in the Chinese context the adopted one seems to be adequate to the challenges. Some changes should be considered for the future but with the present level of the financial market development the adopted solutions seem to be sufficient.

Shadow banking by its nature leads to a reduction of transparency of financial institutions and capital flows. In conjunction with regulatory arbitrage it leads to a decline in the effectiveness of macro-prudential regulation and increase of systemic risk. The enhancement of transparency is one of the most important elements of the Chinese government strategy to ensure a sound development of banks and non-bank financial service providers. It is essential for securing the investor protection and the proper functioning of the financial market. The Chinese banks are expected to disclose information accurately and in timely manner about all aspects of the issuance, rolling over and maintain of WMP in order to make them more transparent (Sekine, 2013). Some efforts in this direction have been taken e.g. in the area of WMP products transparency was improved by requiring banks to maintain separate accounts for each WMP with transparent documentation of assets funded by each WMP account. The use of funding pools by bank WMP and trust plans for investment in non-standardized debt instruments was prohibited (Zhu & Conrad, 2014). There is a need for increase transparency in non-bank lending activities. It means that should be implemented some rules enabling better oversight and proper risk management to facilitate more rational assessment of credit risk.

There were some specific requirements among the regulations for the shadow banking institutions and products. An example is the requirement of the China Banking Regulatory Commission (CBRC) that commercial banks must limit their involvement of WMP proceeds in credit-related assets at any time to below the lower of 35% of WMP fund balance or 4% of banks' total assets. Another example relates to trusts. The CBRC requires trust product to discontinue the asset/fund pool business model (Yao, 2015).

In conclusion, the regulations already implemented in China will have two-dimensional impact on the country: impact on financial institutions and impact on the economy. The regulatory impact on financial institutions means tightening the regulations on shadow banking activities and the financing conditions to the private sector. Implemented restrictions not only tighten up the shadow banking ac-

tivities, but require traditional banks to move away from shadow banking business and return to the traditional deposit-taking and lending business.

Shadow banking in China differs from the system in developed countries and the fact determines its regulation proposals. The first priority is strictly connected with the reason of the emergence and rapid growth of shadow banking. Many sectors and entities of the Chinese economy faced difficulty in obtaining bank loan or other sources of funding. This is especially apparent in the case of small and medium enterprises (SMEs). Shadow banking (e.g. credit guarantee companies, leasing companies, pawn shops) has become an important source of financing many such entities and households. The present regulatory reforms in China require very high sensitivity in this area. On the one hand formal banks should be encouraged to increase funding SMEs and households, but on the other hand such changes require a lot of time. Regulatory changes should not cut off these entities of funding but it should be more traditional, regulated way of funding.

Conclusions

The Chinese economy has been growing rapidly during the last two decades and has a great influence on the financial market's development in the country. The market is asymmetrical – it provides funding primarily for the big, state-owned enterprises, but many smaller businesses (especially private), have problems with access to the highly restricted banking financing. This is the main reason of the shadow banking development in China.

China did not restrain the shadow banking after the financial crisis of 2007 –2009. It has become quite the contrary, the crisis led to a greater development of the credit intermediation behind the traditional banking sector. The process was strengthened by the stimulus package, prepared by the Chinese government in response to the crisis and strict government controls over the official interest rates.

The collapses on the Chinese real estate market and the stock exchange helped to realize by analysts and the government, how is the real danger connected with shadow banking. The high risk connected with the growth of Chinese shadow banking has mobilized the country's government to some regulatory reforms. The changes include some key areas: new model of financial market supervision, greater transparency on the operations hidden "in the shadow" and implementation of prudential regulations for the shadow banking institutions and products.

It is difficult to anticipate the impact of the introduced regulations for few reasons:

– The Chinese financial market is in the middle of its development and the directions of the development are unpredictable.

- The effectiveness of the implemented regulations in China will depend on the appropriate investment financing policy, which is necessary for the real economy.
- The existence of two contradictive regulatory effects – the unstable situation of the economy forces the government to strengthen the regulation, but too strict regulations are encouraging the market participants for locating their transactions outside the official, regulated market.
- Similarly as in the other developing countries in the past, further development of the Chinese economy will be dependent on its opening, which in turn will weaken the national regulations in the confrontation with foreign capital.

The awareness of the risks generated by the shadow banking system is increasing, so for sure it will cause greater attention on this sector than in the past. Only such approach, combined with a flexible response to occurring processes and new threats are able to provide greater security of the Chinese financial market.

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