

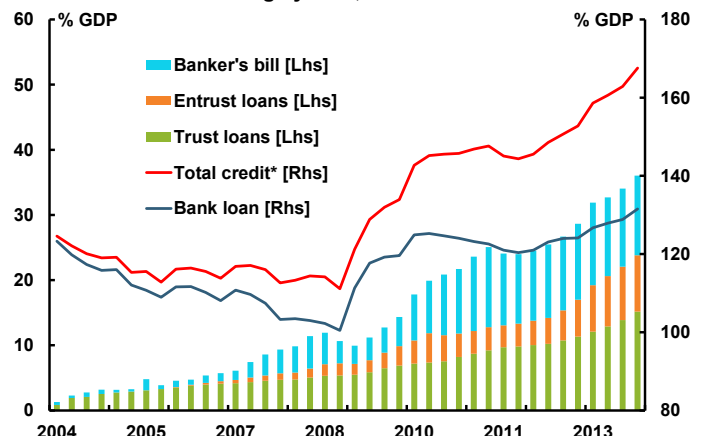
# China: debunking the shadow banking system

## Key points

- The rise of shadow banking has substantially changed China's financial landscape in the last few years. Its rapid expansion has been driven by the collective desire of banks and investors to overcome financial regulation, and endorsed by the government to reform the financial system and fund its CNY4tn stimulus.
- The system is made of three key components: savings instruments (WMPs) akin to money market funds, credit intermediation by non-bank financial institutions, and informal lending in the underground credit markets. Despite its rapid growth, the size of the overall system is still small compared to those in developed countries.
- Shadow banking in China relies heavily on banks to perform basic functions of credit intermediation, making it very "*bank centric*". This has created a huge distortion in the perception of risks associated with many savings and credit products. The unclear relationship with banks and the absence of hard defaults have reinforced expectations of implicit guarantee and moral hazard.
- To correct the risk misperception, the government needs to make an ultimate choice between giving more leeway to banks in the intermediation process ('Europeanization' of shadow banking) or guiding the system towards the capital markets ('Americanisation'). In the near term, it has moved in the right direction by allowing defaults to take place. We believe this process will be managed carefully, so that the risk of systemic disruption caused by shadow banking is low in 2014.

## Shadow banking has grown rapidly since the financial crisis

Chinese shadow banking system, as % of GDP



\* Total credit includes bank loans plus major shadow banking activities including trust loans, entrust loans and banker's bill

Source: Bloomberg, CEIC & AXA IM Research

One of the most talked-about financial phenomena in China is a rapid shift of deposits from traditional banks to wealth management products (WMPs), including those provided by online platforms. Ye E Bao, for example – a form of online deposit account – has become hugely popular among retail investors since its launch last June, with assets under management reaching CNY600bn (US\$96bn) at the end of February this year. In addition, rising financial risks outside the formal banking system, for example in the trust sector, have caught investors' attention and created jitters in financial markets. These developments have drawn attention to the so-called "shadow banking" sector, whose rapid growth in recent years has caused a quantum shift in China's financial landscape.

Despite widespread media coverage, understanding of China's shadow banking system remains shallow and incomplete. This note is designed to provide a holistic view of the sector by discussing the structural factors propelling its rise, and how the system functions and what it contributes to China's overall financial reform. We also compare shadow banking in China and in the US to uncover some unique features of the system, along with structural defects that are giving rise to financial risks. Finally, we discuss future reforms needed to correct these defects in order to bring shadow banking onto a more sustainable path.

## Overview of shadow banking in China

Shadow banking, loosely defined as credit intermediation taking place outside the formal banking system, has been expanding rapidly in China over the past few years.<sup>1</sup> According to "total social financing" figures compiled by the People's Bank of China, the share of non-bank credit intermediation surged from less than 10% of the system in 2008 to almost 40% in 2013. Given the lack of transparency and good-quality data, gauging the precise size of the shadow banking system is difficult. Estimates from market analysts and academics put the aggregate size at CNY15~25tn, which represents 43% of GDP and 17% of the banking system at the upper end of the estimate.<sup>2</sup> In comparison, these ratios are considerably smaller than those in most developed countries (*Exhibit 1*).

Activities in China's shadow banking system have grown significantly in diversity and breadth. In general terms, they can be classified into three broad groups based on organization structure.

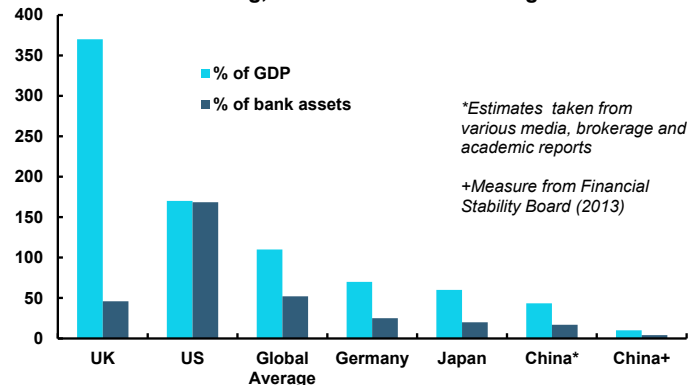
The first group comprises banks as direct credit intermediaries, where WMPs sold by them or their subsidiaries are the main component. These activities are

structured off banks' balance sheets and hence, are not subject to official oversight. A significant share of WMP investment is in money and bond markets, making them similar to money market funds (MMFs) in developed countries.

*Exhibit 1*

### China's shadow banking remains small in a global context

Size of shadow banking, as % of GDP and banking sector assets



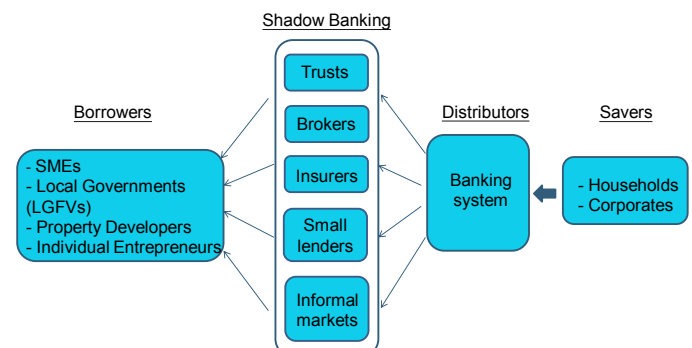
Source: FSB (2013), various sources, CEIC & AXA IM Research

The second group of activities consists of credit intermediation by non-bank financial institutions, such as trusts, brokers, and insurance companies. Some of these entities can raise funds directly from investors, but most have to cooperate with banks, using the latter's reputation and vast network to reach out to potential investors and borrowers. Compared with WMPs, these entities face higher funding costs and, hence, have to undertake riskier investments for higher returns (such as lending to property developers, mining companies and local government funding vehicles).

The last group, which comprises activities by small-business lenders, pawn shops and underground lending markets, is the most opaque and riskiest part of the system, and, typically involves highest interest rates.<sup>3</sup>

*Exhibit 2*

### Stylized chart for shadow banking credit flows



Source: AXA IM Research

<sup>1</sup> FSB (2013) "Global Shadow Banking Monitoring Report 2013" Financial Stability Board, 14 Nov 2013

<sup>2</sup> Estimates are compiled in early 2013; the size of shadow banking would have grown further since then. Some of these market estimates are prone to double-counting, for example, adding the liabilities (e.g. WMPs) and the assets (e.g. trust loans) of shadow banks together.

<sup>3</sup> In Wenzhou, where the private lending market is better established, interest rates on short-term loans have been running above 20% per annum in recent years.

*Exhibit 2* illustrates, in a stylized fashion, the relationship among key players of the shadow banking system, and how credit is intermediated. At the funding end, households and corporates provide liquidity to banks through deposits, WMPs or other investment products. This liquidity is then channelled to non-bank entities before being lent to borrowers in the real economy. These borrowers are typically those who cannot access cheaper funding from traditional banks, and are therefore willing to pay extra for loans from shadow banks.

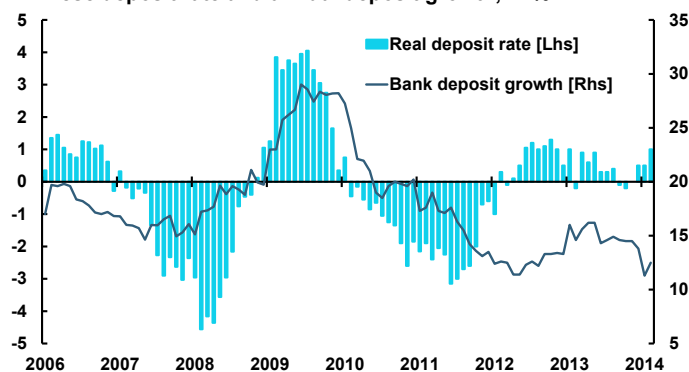
## Shadow banking as a way to circumvent regulation

To understand why shadow banking exists in China, we need to delve deeper into the regulatory structure of the financial system. Despite progress on financial liberalization, banks in China still face significant regulations. In particular, the existence of the deposit ceiling has depressed interest rates in the economy, creating financial repression that transfers wealth from savers to borrowers.

The rapid pickup in inflation since 2010 has turned real deposit rates negative, forcing some depositors to move money out of banks into money markets (*Exhibit 3*). To retain deposits, banks created WMPs and structured them off-balance sheet, so that their yields can move freely with market interest rates. Issuance of bank WMPs grew strongly in subsequent years, with total assets under management reaching CNY10tn (US\$1.6tn) by end-2013. In essence, WMPs offered investors and banks a way to overcome prevailing interest rate regulation, and opened up part of the financial system to market forces.

*Exhibit 3*

### Negative real interest rates caused slower deposit growth



In addition to the deposit ceiling, banks in China face lending restrictions, such as the loan quota, reserve requirements and loan-to-deposit ratios. These restrictions can limit banks' lending capacity and bias their loan distribution towards state-owned enterprises. The unfulfilled credit demand from private-sector businesses creates an opportunity for non-bank financial institutions, which are unconstrained by regulation and willing to lend to private companies at a fair

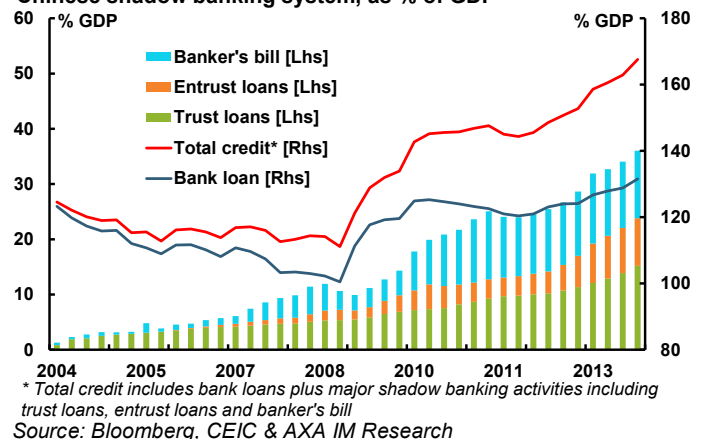
price. However, these institutions lack both sufficient liquidity to support their lending and the capacity to conduct proper due diligence on borrowers. Therefore, they have to rely on the support and expertise of banks to perform credit intermediation.

For banks, cooperation with non-bank entities allows them to overcome credit restrictions and expand lending off-balance sheet. In many cases, shadow banking credit (e.g. trust loans) has been used as a conduit for banks to lend to existing customers when their lending quota is exhausted. *Exhibit 4* shows an acceleration of shadow banking activities immediately after the global financial crisis, as the government pressured banks to implement the CNY4tn (US\$586bn) stimulus, forcing them to become innovative in exploring off-balance sheet lending.

*Exhibit 4*

### Shadow banking has grown rapidly since the financial crisis

#### Chinese shadow banking system, as % of GDP



## Shadow banking as a true “shadow” of banks

One way to further our understanding about China's shadow banking system is to compare it with that in the US. Our analysis suggests that certain activities, such as WMPs and MMFs in the two countries, have emerged for the same reason, i.e. overcoming financial repression. MMFs grew rapidly in the US in the 1970s following a period of interest rate regulation – known as Regulation Q – which limited the movement of bank deposit rates, much like the deposit ceiling in China.<sup>4</sup> In addition, the rise of trust loans and other shadow banking credit, which allow Chinese banks to structure their lending off balance sheets, is also similar to asset securitization that prevailed in the US before the subprime crisis. The difference is that Chinese banks undertake these activities to circumvent regulation – a process that does not require complex structures and

<sup>4</sup> For more details, see Borst (2013) “[Shadow Deposits as a Source of Financial Instability: Lessons from the American Experience for China](#)” Policy Brief 13-14, Peterson Institute for International Economics

leverage; while US banks used them to amplify returns, which required significant gearing.

In addition, there is a fundamental difference in the structure of the two systems. In China, shadow banking relies heavily on traditional banks to perform basic functions of credit intermediation. Without banks' active involvement in liquidity provision, product distribution, credit guarantee and investment recommendation, shadow banking would not have reached the scale today. This makes shadow banking in China very *bank-centric*. By contrast, shadow banking in the US has long since established its footprint in the capital markets. MMFs can operate independently from banks, while repo and securitization markets are open to all participants – banks and non-banks alike. US shadow banking is therefore more market-based, operating in parallel to banks.

### Risk misperception is central to shadow banking problems

The bank-centric nature of Chinese shadow banking reflects of a lack of diversity in the financial system, where traditional banks command the lion's share of resources and have most credibility in the public. Non-bank institutions, such as trust companies, typically do not have enough credibility to raise funds independently. Active cooperation with banks can therefore mitigate the credibility issue, although it creates a new form of distortion: *risk misperception*.

This misperception is perhaps best illustrated using an example of a trust product from China Credit Trust (CCT), which nearly defaulted early this year. In this case, CCT raised funds from some 700 high-net-worth investors through Industrial and Commercial Bank of China (ICBC) as its distributor. CCT used the proceeds to make a loan to Zhenfu Energy Group – a mining company that was also introduced to CCT by ICBC. The role played by ICBC in both funding and lending was critical for bringing the deal together. But it was also a major source of misperception.

At the funding end, investors who bought the trust products from ICBC thought their investment carried the bank's credit guarantee, and hence, contained little risk. At the lending end, since ICBC was involved in arranging the trust loan, CCT believed that the credit risk in the loan was shared between itself and the bank. In reality however, the legal document freed ICBC from any credit risks, given its role as a product distributor.

To be fair to the investors and CCT, their expectations of ICBC as an ultimate risk bearer were not entirely unfounded. Previous failures in the trust sector have all been resolved through shared bail-ins or bail-outs involving trusts, banks and, in some cases, the government. This absence of hard defaults has reinforced expectations of implicit guarantee,

leading to ever-growing moral hazard problems in the shadow banking system.

### Addressing structural defects and make shadow banking more sustainable

Given the importance of shadow banking in contributing to China's financial reform, properly addressing structural defects is critical for the system's long-run development. We believe there are a number of ways in which the prevailing risk misperception can be resolved.

First, hard defaults need to take place in order to remove the dilution of implicit guarantee and moral hazard. This is arguably the most effective way to educate investors about risks in shadow banking investment, and signal to non-bank entities the importance of risk management. Rising defaults will likely lead to a re-pricing of risk, which may slow the growth of shadow banking in the near term in exchange for more sustainable development in the long run. The government is clearly moving in this direction by allowing the first-ever corporate bond default to take place in March.

Second, the mismatch between investors' perception of banks as the ultimate risk bearers and banks' actual function as non-risk-bearing intermediaries is key to creating the prevailing misperception. Expectations can be realigned by asking banks to bring shadow banking assets back onto the balance sheet, and to start applying proper due diligence and risk monitoring.

In the near term, the authorities may allow this to happen if shadow banking defaults start to cause panic. Banks may be asked to roll over the debt created by shadow banks in order to prevent a dramatic slowdown of credit in the economy. This will likely increase banks' provisioning on assets, and non-performing loans, affecting their profitability. Bank stocks will likely take a hit as a result. In the long run, a reversal of shadow banking is conducive neither to financial liberalization nor to building a more diverse financial system.

Finally, the authorities could speed up the development of capital markets in order to detach shadow banking from banks and make it part of the capital markets. This essentially means turning China's shadow banking into a US-style market-based system. Financial activities and innovations can then take place in the markets, where risk sharing and pricing is done through the collective wisdom of institutional investors, rating agencies, analysts, and regulators. Apart from addressing misperception, this transformation will also increase the diversity of the financial system. The downside is that developing an efficient capital market is both challenging and time consuming, and hence, such transformation will take time.



## Concluding remarks

The rise of shadow banking is one of the most important developments in China's financial system over the past few years. It has helped speed up interest rate liberalization, enabled private businesses to access credit, and contributed to a more diverse financial system. Our analysis suggests that the emergence of shadow banking was primarily a result of financial repression created by interest rate regulation – a development similar to the one that spawned shadow banking in the US. However, the two systems have since gone their separate ways, with shadow banking in China evolving around the banking system, while the US system has thrived in the capital markets.

The bank-centric nature of shadow banking in China has given rise to a problem of risk misperception. Allowing hard

defaults to occur is necessary for removing the implicit guarantee and moral hazard. We think the authorities have started to move in this direction by allowing controlled failures to take place. Going forward, it is possible that riskier parts of shadow banking may shrink or vanish as risks are re-priced and regulation strengthens.<sup>5</sup> If these failures start to cause panic, we think banks, with total assets of over CNY150tn (US\$24tn), are capable of absorbing potential losses, thus reducing the chance of a systemic crisis in 2014. Over the long run, the authorities may guide shadow banking towards the capital markets, reducing its interconnection with banks and make it a genuine part of a multi-layer financial system

<sup>5</sup> Changes in the political system, such as local governments moving away from solely pursuing GDP growth, will also help reduce demand from local government funding vehicles for shadow banking credit

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