

Impacts of the Shadow Banking on China's Economy

Jing Xu

Department of Finance, Dongfang College, Shandong University of Finance and Economics, Jinan, Shandong, China

Xujing6617@126.Com

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Abstract: Recently, with the Rapid Development of Shadow Banking in China, It Has Become an Important Source of Financial Risk, Attracting Extensive Attention of Academia and Regulators. This Paper Starts from the Definition of Shadow Banking, and Analyze the Favorable and Adverse Effects through the Three Most-Striking Types: Banking Wmps, Trust Products and Internet Finance.

1. Introduction

The Concept of “Shadow Banking” Originated from the United States in the 1970s and Was the Outcome of the Desire of Traditional Banks for Interest Rate Liberalization. Although Shadow Banking System Promoted the Expansion and Spread of the 2008 Financial Crisis, It Represents the Game between Financial Innovation and Financial Supervision in the America, Combining Both Positive and Negative Effects and is a Neutral Concept. Compared with America, the So-Called “Shadow Banks” in China Are Not Only Different in Regulatory System, Economic Environment and Policy Background, But Also Have Not Appeared the Two Characteristics of “Highly Leveraged Operation” and “Mainly Trading Derivatives”. the Essence of Chinese Shadow Banking is the Channel Problem, Which Traditional Banks Channel is Unable to Meet Finance and Investment Needs [1] . an Increasing Number of Scholars and Regulators Pay Lots of Attention to Shadow Banking and Believed That the Limited Supervision of It is One of the Main Reasons for the Outbreak of the Financial Crisis, Which Urgently Needs a More Comprehensive Macro Prudential Policy. in Response to Financial Crisis, Chinese Government Launched a 4 Trillion Bailout to Stimulate Domestic Demand and Economic Growth, Resulting in Blowout of New Domestic Loans in 2009-2010. Afterwards, Monetary Policy Gradually Returned to Moderate Easing from Quantitative Easing, Credit Conditions Tightened While Shadow Banks Were Booming. At Present, China's Shadow Banking Together with Increasing Corporate Debt Has Become an Important Hidden Danger of Brewing Systemic Financial Risks and Enlarging Financial Vulnerability. Therefore, the People's Bank of China (Pboc) is Gradually Expanding the Scope of Macro Prudential Coverage, Exploring the Framework Containing Shadow Banking, Real Estate Finance, Online Finance and More Types of Innovate Finance.

2. Definition

The concept of shadow banking system was first put forward by Mcallie in 2007, executive director of Pacific Investment Management Company at the annual meeting of Federal Reserve. It was also adopted as “Parallel Banking System”, which provided credit in line with the business of traditional banks. Shadow banking operates almost all banking activities except for taking deposits, as a result, it won't be intervened by financial supervisions. Shadow banking refers to the credit intermediary engaged in the credit provision same as but outside the traditional commercial bank system, through different financial instruments to complete the credit transfer, liquidity transfer, and term conversion. Although China does not have specialized institutions as hedge funds, investment banks and money market funds in real sense, compared with developed countries, China's shadow banks have their own particularity. Firstly, the banks are highly involved in shadow banking business, transferring the assets that are essentially loans to the off balance sheet, meanwhile

transforming the corresponding deposits into financial products. Secondly, shadow banks bypass supervision and invest in high-risk industries, especially real estate and local government financing platforms, and some of them flow to small and medium-sized enterprises or private enterprises. Thirdly, rigid payment, implicit guarantee and multilayer nesting are ubiquitous. Shadow banks are imperfectly developed and are prone to greater risks without adequate and timely regulation and supervision. For more precise statistics of quantity and scale, we put Chinese shadow banking into three categories according to diversified institutions: bank-leading shadow banks, non-bank financial institutions adopting the traditional bank mode, less regulated or unregulated banks [2]. At the same time, it is believed that such classification does great help for risk identification of banking system.

3. Operation Mechanism

In 1938, American government funded Fannie Mae that had ignited shadow banking, and followed by financial securitization, dis-intermediation, interest rate liberalization and highly derivatization. American shadow banking is based on “Issue-Distribute” mode, forming a complete capital flow from various channels to financial markets, which a typical off-balance sheet operation with its core of asset securitization. Unlike America, China’s shadow banking rose up after stepping in 21 century and aggrandized when stimulus policies were promulgated in 2008. Despite the fact that Chinese interest rate marketization reform has almost been progressively completed, shadow banking is still at emerging stage. The mature and multi-layer capital market in US is capable to content all investing and financing needs, leading to shadow banking funds dramatically flow towards derivatives for high-margin returns, while shadow banking in China concentrates on providing credit and investment channels for mismatching credit market under commercial banks’ leadership. Rigorous monetary control and financial regulation in China has been existed for ages, and commercial banks dominate more than 80% credit supply in financial market, most of which mismatches to state-owned enterprises. The financing difficulty of private enterprises together with relative low rate of return of banking products due to interest rate liberalization both boomed shadow banking expansion. This paper will analyze the operating mechanism focusing on the three dominant forms: bank WMPs, trust loans and private lending.

3.1 Banking Wealth Management Products

Banking WMPs have become the main force of domestic asset management market since 2008, exceeding the sum of other types: insurance, trust and securities financial products, and public funds. On micro level, saving rate experienced explosive growth in recent half century, and peaked at 51.8% in 2010. The average rate was 36.1%, 47% and 45% in 2016, 2017 and 2018 separately while world average saving rate is 26.5% according to IMF’s statistics. Although Chinese economy slowed down since 2015 and entered into the “new norm”, the balance of household deposits was 77.67 RMB trillion in the first quarter of 2019, laying the solid material foundation for WMPs. On macro level, tighter monetary policy had been implemented after 4 trillion bailout to neutralize excess liquidity and PBOC raised reserve rate for more than 10 times at 2010. Besides, with CPI had raised continuously for years resulting negative real interest rate, the strong desire for wealth value maintenance and appreciation with tightened policies were catalyst for commercial banks financed off-balance sheet to get funds and make credits.

More than half portion of bank WMPs adopt the operation model of “Pool of funds- Pool of assets”, which is sold and responsible by banks to invest and operate at multiple assets such as bonds, bills and trust etc. as a kind of capital investment and management plan. Generally, banks are engaging in rolling sale of multiple financial products with different maturities to constantly raise money and funds will pool in steadily as a consequence. Then banks process a collective operation of different types of financial instruments under the preceding investment strategies and limitations framework in order to maximize economies-of-scale effect and diversification needs. Funds gathered should totally be invested into portfolio assets, cash inflows of which become the sources of principal and interest payment. As most residual duration of assets is longer than that of liabilities, term spread (buy-long, sell-short) is a major source of bank income. Meantime, assets pool is priced

separately from funds pool to guarantee a stable yield for investors.

Bank-trust cooperation products as a typical WMPs have become a prominent power in shadow banking system. Through this channel, commercial banks are able to provide credit to firms either without enough high value collateral and security or eligibility for loans from banks as affiliate dealers. For example, firm A (low credit rating or industry restriction) is a loan-restricted firm from banks, and at this point a big bank recommend a trust company to firm A who can package firm A's assets and project into a trust product sold by the bank. When time is due, bank earns the channel fees, shared with trust companies and investors after firm A paid money back. This win-win cooperation combines good reputation and widespread mass base of commercial banks with less regulated and unlimited investment advantage of trust companies.

Despite of these attractions, risks are indispensable and concentrated at two aspects. Firstly, opaque operation makes assets pool unable to correspondent with liability pool, resulting that once assets occur credit risk event, without transparency disclosure, banks may cash through previous accumulation or borrow-new to return-old for their own reputation. Eventually, investors have to pay the bill as liquidity risks make banks fail to pay. Secondly, rolling finance, a rigid demand, brings uncertainty of financing costs especially when interest rate fluctuate violently while yield rate of long-term asset is relatively steady.

3.2 Trust Products

Traditional trust loans and products also stand at an important position as a professional financial management method while trust products design tend to be diversified in China and mainly concentrate on the four investment areas: loan trusts, equity trusts, financial leasing trusts, and Real Estate Investment Trusts (REITs). Overall, trust investments involve in extensive fields as securities, funds, leasing, private equity, real-estate, service industry, manufacturing and construction industry. This character empowers trust firms competence to do legal mixed operation under segregate management and supervision in China.

Based on this superiority, commercial banks, whose investment are strictly limited especially in overheating industry (real-estate) and excess-capacity industry (iron and steel) get themselves involved in trust business through "account receivable investment" operation. Banks put proprietary trading money into trust products in which most popular real estate and infrastructure projects are selected as targets.

Intensively invested in those industries brings not only huge profits but corresponding risks. The first issue is about excess-capacity. Under the Supply-Side Reform, the capacity utilization and profit margin of mining and manufacturing industry, as two largest excess-capacity industries, continued going down. Once accumulated to certain extent, it brings out trust companies' default risk. In addition, house-price bubbles and false prosperity attract countless investors and speculators into the strong cycle industry represented by real estate, once house prices are falling and interest rates are increasing because of the lack of vigilance for periodic decline, capital strand breaks, crisis comes and party ends [3].

3.3 Internet Finance

Whether third party payment (Alibaba, Wechat), Peer-to-Peer (P2P) lending, crowd- funding projects or Internet banking, e-financial business is inherently innovative relying on networking platform and big data technology, making investment and financing more convenient, low-cost and efficient. With the irreplaceable competitive advantage compared with traditional banking, deepened innovation of e-technology, intense transmission and pervasive power, various types of Internet finance emerged in the last decade, providing strong impetus to promote the inclusive finance. Alibaba (Zhejiang Internet Commerce Bank) and Tencent (Webank), as two magnates of Internet finance were authorized the Internet banking license and subsumed into the supervision of China Banking Regulatory Commission at 2015. Then three batches of private banks totally of 18 banks got license in recent years, most of which are the most-largest-scaled Internet banks.

Internet finance is thriving on its "Openness, Equality, Cooperation and Sharing" to enable itself spontaneously get cloud data, dealing with which may precisely and effectively settle information

asymmetry and credit risk identification based on population other than samples. “Ali small loan” is the best illustration with less than 0.85% NPL ratio until now. Besides, the wealth management function has been perfected by Internet finance through providing low-cost, low-threshold and quick boundless platform for everyone who has balance in account. Take Yu’e Bao as an example, it pioneered an “initial with 1RMB but anytime withdraw” wealth management era. Although Internet banking weakened the monopolistic condition of state-owned commercial banks, the randomness, sensitiveness and unpredictability of e-finance products may build up the infectiousness and danger of a single tiny event. Not only do Internet banks stretch over real economic activities and virtual economy, but also pass through money market, capital market, credit market and settlement market etc., extending complicated chains among countless institutions and residents, making their financial activities highly uncertain and risky. Together with uncontrollable information dissemination, under catalysis of “Herding Effect”, may touch off the “Butterfly Effect” and expand within-system financial risks towards systematically risks [4].

P2P is a online platform connecting small or medium sized lenders and borrowers to realize person-to-person or person-to-firm borrowing. When accelerating financial dis-intermediation process, an average of 15 problematical platforms were revealed per month from September 2013 to October 2014, and a slew of making-off-with-money platforms made huge losses to investors. Financial fraud occurred frequently as lack of credit investigation system to guarantee full and real disclosure of borrowers, lack of risk hedging mechanism like banks’ loan risk provision mechanism as well as strict supervision system. Furthermore, moral deficiency of borrowers and platforms combined with money laundering of some creditors aggravated the default risks, making online credit to the front of illegal fund-raising.

4. Impacts and Sustainability

On one side, Chinese shadow banking is at elementary stage and not enough perfect, which is prone to trigger systematic risks without sufficient supervisions and regulations for its own particularity. From a macro perspective, shadow banking has the trait of pro-cyclicality that can promote growth but also bring risks. It transfer risky assets to liquidity assets at a normal time while assets turn out to be illiquid under great uncertainty period. Shadow banks raise the accumulated leverage of financial department and magnify external shocks, especially after financial crisis, it is essential to give shadow banks the regulations analogous with commercial banks. History had proved that shadow banking played a vital role before financial crisis with similar functions of traditional banks to provide credit and liquidity conversion. However, without Fed discount window and Fed deposit insurance, and the lack of effective regulations largely contribute to financial vulnerability during the crisis. Collier [5] emphasized that as shadow banks were closely related to traditional banking, securities and insurance departments, it is extremely fragility at heart because being unable to get government liquidity support and credit backstop under liquidity dilemma, and it will disseminate this fragility easily to other departments, contributing to systematic risks at end. Shadow-banking-caused 2008 crisis proved its infectiousness of risks and influence on stock markets fluctuation, more importantly, those serious consequences were not confined only in America, but spread to all developed and emerging economies. Therefore, last resort and macro prudential are conducive to reduce wholesale banks risks while asymmetrical supervision on traditional banks and shadow banks would weaken effectiveness of policies. Wang [6] concluded that the threshold effect and risk spillover effect were existed between shadow banking and economy stabilization using GARCH-CoVaR model. When the scale of shadow banking was below 46.09 RMB trillion, the larger the scale, the more stable in financial system, and vice versa. Private lending had the maximum spillover effect, trusts and securities related to shadow banks were slightly weaker, but all of them did negative effects on financial stability.

On the other side, from the fact of the capital chain rupture of many cities like Shen mu, Wen zhou, E’erduosi etc., and house price bubbles, constant thunderstorms of P2P platforms to the stock markets abnormal fluctuation in 2015, shadow banking were highly participated while Chinese

government never meant to thoroughly clear it up. Thus, it can be obviously seen the dependence of Chinese, American and the whole world's financial markets on shadow banking system due to its positive effects. In spite that the current economic structure adjustment and upgrading lead to a climbing default rate, shadow bank is of great significance to improve multi-level financing market and economic transition. As a supplementary form of banks, shadow banks provide kinds of products differentiating from types, maturities and risks, as well as a better investment portfolios management. Chinese shadow banks is breaking interest rate control through providing funds to SMEs, more than half of which are incapable to obtain loans from banks while the large enterprises get access to bank funds with ease and a lower cost. By relieving financing difficulties and broadening credit channels, shadow banks remedy commercial banks' defects. Simultaneously, WMPs, trust, funds and securities products are breaking saving rate limitation to raise society idle capital put in high-yield or high-security bonds, projects or companies. Empirical analysis proved that shadow banking had positive correlations with both GDP and CPI. Skyrocketing development of shadow banking is a reflection of the urgent demand for market-oriented interest rate system and supervision reformation, meanwhile shadow banking indeed injects strong source to real economy, promoted direct finance, and improved financial efficiency with multi-level capital market [7].

5. Recommendations and Conclusion

Chinese shadow banking owns its specific characteristics and complex compositions, and this survey gives an estimated scale of Chinese shadow banking, then critically analyzes most three important components: WMPs, trust products and Internet finance, and finally presents the opportunities and risks of shadow banking. Deposit competition, deeply rooted in Chinese financial repression exacerbated by chronically extreme strict regulations, has significantly increase shadow banking development, which is the main channel of increasing systematic risks. It was argued that "Concerned by the difficulty in fully accounting for banks' on- and off- balance sheet activities, the PBOC has been pushing strongly for interest-rate liberalization, which is the necessary foundation for it to ultimately adopt a price-based monetary policy framework as an automatic stabilizer" [8]. Consequently, the prevention of bank risks has important policy enlightenment at this special period of economic transformation.

Firstly, banks should adopt differentiating competition strategy and transform in nature. Currently, shadow banking is an approach for banks against deposit competition with essence of loans while seems like financial innovation. Homogenized competition ties bank risks with non-bank risk tightly, once negative shock happened, it will set off a chain effect. On one hand, different banks should search for their characteristic business depending on their own strong points. Stagger competition can improve banks' competitive power in financial markets. On the other hand, banks should take fully advantage of Internet finance and big data technology to assist innovation and risk management.

Secondly, it is necessary for governments to guide banks to complete in an order way, preventing against excessive competition. Basel Committee issued Basel III, introducing "Counter-cyclical Capital Buffer" and embedding shadow banking into regulatory perimeter. In 2011, PBOC put forward "Dynamic Adjustment Mechanism of Differential Reserve" and updated into "Macro Prudential Assessment (MPA)", regarding macro-prudential capital adequacy ratio as a key indicator and using capital to restrain over-extension of financial institutions. However, the stronger the regulatory constraints on loan-to-deposit ratio and capital adequacy ratio, the banks are more inclined to cooperate with shadow banking. Improving supervision requirements too fast possibly contributes to actively regulatory arbitrage of banks, which instead will eventually increase financial systemic risks. Hence during the overlying financial reforming periods, banking regulatory should be carried forward gradually and moderately.

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