Global Institute for Sustainable Prosperity

Policy Note No. 102
November 2014

Risk-taking in China’s Shadow Banking Sector

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The Rise of Shadow Banking

China’s shadow banking sector grew at a rapid pace between 2007 and 2013, and has slowed in recent months as the economy was cooling. The shadow banking sector, which includes different shades of financial activity outside of traditional bank loans, expanded in the wake of the global financial crisis, as riskier ventures were undertaken, to provide alternative sources of growth. The sector was subject to regulation but had sufficient latitude to lend to riskier businesses through trust loans, entrusted loans, and bankers’ acceptance notes. Riskier loans were in turn often securitized and sold off to retail or institutional investors, leading to a rise in systemic risk.

Shadow banking assets included trust products, entrusted loans, wealth management products, and bankers’ acceptance notes, among other instruments. Trust products and wealth management products often included bundles of assets, some of which included trust loans, bonds, equities, and/or other assets. Trust products and wealth management products were sold through banks, securities companies and insurance companies, and provided yields that were higher than returns on traditional bank loans, which made them very attractive to investors. Entrusted loans were loans that were often provided from parent companies to subsidiaries to provide liquidity where necessary, but were increasingly used for loans to riskier firms. The latter was also true for bankers’ acceptance notes, which were normally used for trade credit between two parties, and later used to finance shadow banking loans.

The size of the shadow banking system grew to 46 trillion RMB ($7.5 trillion) in 2013, and was driven by trust products and wealth management products, which maintained 10.9 and 10.24 trillion RMB in assets under management, respectively. Bankers’ acceptance bills hit 8.94 trillion RMB in assets under management in 2013, while entrusted loans stood at 8.2 trillion. Shadow banking is reflected to some degree in total social financing (it is understated but representative), which is a measure that includes bank loans, trust loans, entrusted loans, and other financial instruments. The growth of total social financing, particularly the divergence from bank loans, can be seen in Figure 1 below. The growth of the shadow banking system is particularly noticeable from 2009 onward.

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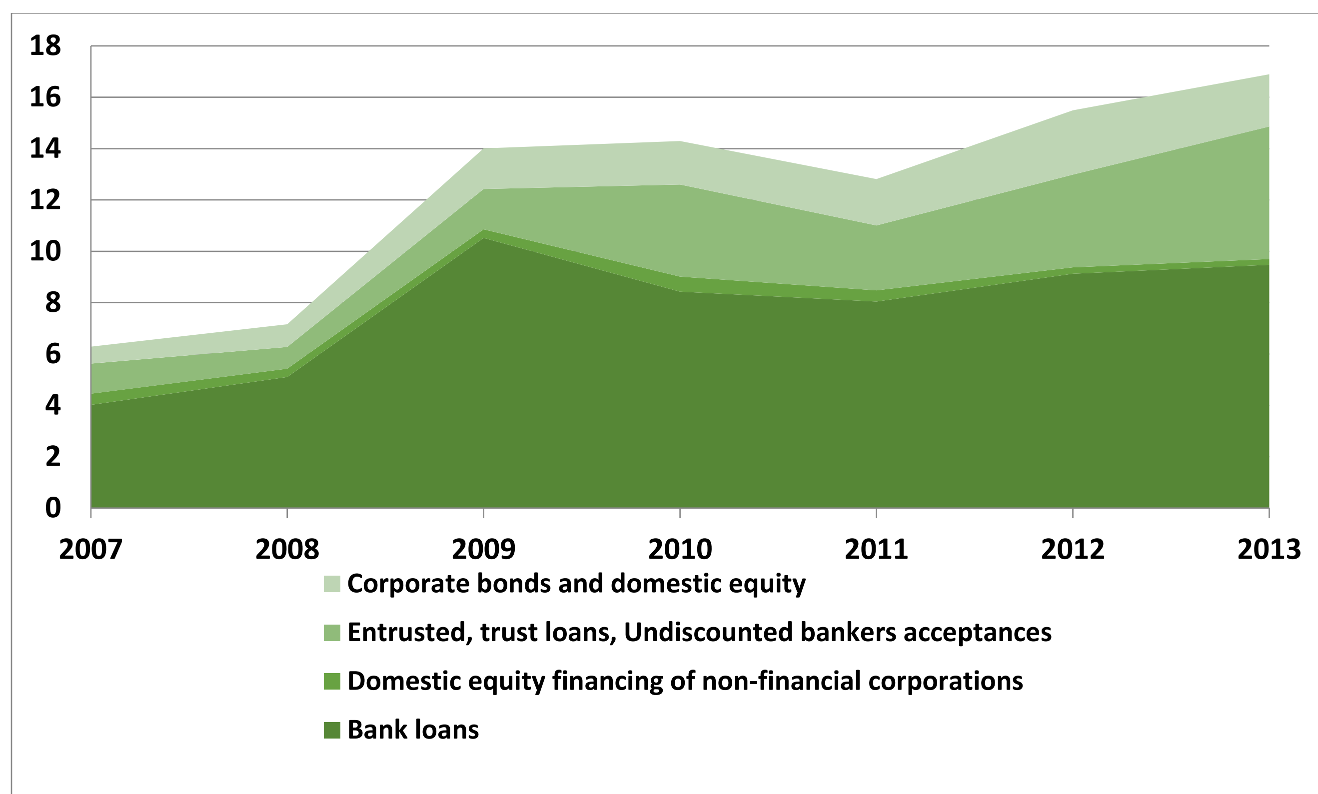
Figure 1: Total Social Financing (RMB trillions)



Source: National Bureau of Statistics 2014, People's Bank of China 2014

Risks

As the global financial crisis hit, and as China's economy shifted from a labor-intensive manufacturing-based economy to a technology-intensive manufacturing and service-based economy, China lost sources of growth without gaining a foothold in new sources of growth. Shadow banking investment in fixed assets such as plant capacity, property, and infrastructure boosted the role of investment in GDP. Shadow banking played an important part in maintaining GDP growth as reforms were slowly being implemented.

However, risks associated with shadow banking grew during 2012 and 2013, as some trust and wealth management products faced potential default. Underlying these products were often trust loans that had lent to risky borrowers, such as real estate developers, mining companies, or local government financing vehicles, which faced declining profits. These products therefore carried through the credit risks of the underlying borrowers. While most of the time, trust or wealth management product payments were bailed out by the trust company or other entity, anxiety mounted as GDP growth threatened to stall. It was unclear whether shadow banking entities would have sufficient liquidity, or funds to pay out interest and principal on assets, given the large number of products that were coming due.

Research conducted at the end of the third quarter of 2013 by Shanghai Jiaotong University found that trust companies face liquidity and credit risks of underlying assets (China Finance Research Institute of Shanghai Jiaotong University 2013). Should the trust loan borrower be unable to pay interest and/or principal on the loan, the trust company bears the responsibility to make the payment, particularly when the trust product payment is guaranteed. The credit risk of borrowers has also proven problematic, as borrowers in the real estate or mining sectors have faced declining returns.

Systemic risk also appeared to be a threat, particularly in terms of interconnectedness between banks and trust companies (Hsu, Li and Xue 2014). Since banks sold wealth management products that frequently contained trust loans, there was a question of the degree to which banks would be liable for these products should the underlying trust loans default. Although regulatory authorities frequently absolved banks of responsibility from repayment on such products, in practice, banks have ended up paying out on failed wealth management products that contained trust loans; in one case, and an intervention was even made by a state-owned asset management company to prevent the product from defaulting on retail bank customers.

Analysts watched nervously as the interbank market froze during the second half of 2013, indicating liquidity stress among banks and unwillingness by the central bank to accommodate the additional need for cash, possibly as a signal to banks to rein in shadow banking. Non-performing loans rose by 19.47% in 2013 in the top ten banks (Li 2014), and continued to increase through 2014. Then, particularly at the beginning of 2014, the stock of unsold housing increased as China's real estate boom came to an end. Indicators such as factory and trade growth declined, and bank and non-bank financing cooled as overall economic growth slowed.

Most riskier borrowers, particularly real estate developers, were forced to turn to other sources of funding as financing became increasingly tighter, while, by contrast, local governments were allowed to roll over debt into municipal bonds. Risk was felt as smaller companies in particular became tightly constrained in funding options, but the risk was not easy to assess. Measuring the risk associated with different borrowers and specific products is difficult because interest rates and risk ratings often do not adequately reflect risks, due to China's underdeveloped financial markets, implicit government backing with little precedent of loan failures, and dampened interest rate regime, in which interest rates inadequately capture risk.

Policy Response and Recommendations

China's regulators have been keenly aware of potential fragility imposed by the shadow banking sector and have implemented regulations as the sector grew. Regulation avoided significantly reining in shadow banking activities because it was viewed as a necessary temporary source of growth.

Wealth management products were closely watched by the China Banking Regulatory Commission, which imposed regulations to control for risk. In May 2009, banks were required to seek approval of wealth management products prior to issuance, and in July 2009, proceeds

from wealth management products were prohibited from being invested in secondary markets. An increase in information disclosure was required as of August 2011, while banks were admonished to scrutinize third-party wealth management products as of December 2012. Non-standard debt assets, consisting of trust loans, entrusted loans, and other riskier products, were capped at 35% of wealth management products in March 2013. Wealth management products and bank loans were accounted for together until July of 2014, when the China Banking Regulatory Commission required that banks' wealth management business be separated from retail lending.

Trust products were relatively lightly regulated, even though there was an implicit requirement that trust companies pay off defaulting loans under any conditions. Initial cooperation between banks and trusts, in which banks rolled loans off their balance sheet into trust products, was quashed in 2010 when the China Banking Regulatory Commission prohibited these products from exceeding 30% of the financing business. Beyond that, regulation stated that trust companies should have a minimum net capital (July 2010 and January 2011), and that trust companies should apply risk weightings to their assets under management (August 2010) (Hsu 2014). Additional rules and regulations put in place through 2011 attempted to control risk, regarding onsite risk evaluations, controlling real estate trust risk, and setting guidelines on the trading of stock futures trading. However, these regulations did little to curb mounting activity and risk within the industry. It was not until April 2014 that trust companies were required to sell off holdings in the case of a liquidity crunch and to refrain from maintaining "cash pools" to fund payouts on existing products with revenue from new product sales.

Regulation on the shadow banking sector may still be insufficient. While activity in this sector is currently stalled due to tightened bank liquidity and slowing GDP growth, shadow banking practices have not been banished, and substantially improved risk control and risk ratings systems have not been put into place. However, the goal of the reform program under the Xi-Li leadership is to enhancing market signals and advance risk control over time. It is essential that the shadow banking system be included in these measures in order to prevent the same large buildup in risky credit that we have witnessed in recent years.

The rise and current fall of China's shadow banking sector points to potential problems created by financially-fuelled GDP growth. When there is an increase in the credit gap or credit intensity, instability arises. China's credit gap, or the difference between changes in private sector credit growth and economic output from trend, reached 10-15% in 2009-10 (Lanzeni and Weistroffer 2013). A spike in the credit gap above 6% is often a predictor of a financial crisis (BIS 2012).

Credit intensity is another measure of China's debt distress. China's credit intensity, or the amount of debt needed to create additional economic activity, has also increased. As a result, the credit-to-GDP ratio has surged in recent years. China's total debt service ratio is 30%, which is above the warning level of 20-25% given by the Bank for International Settlements (Drehmann and Juselius 2012).

Shadow banking has financed unproductive or less productive activities that are currently creating a drag on future growth. Debt levels in sectors such as real estate threaten the health of the financial sector to some degree. The need to implement reforms that lead to a real increase in productivity are essential at this moment, particularly in the service sector, while regulations that control for risk and prevent an over-reliance on credit-fuelled growth must be put into effect. Only in this way can sustainable prosperity be attained.

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