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Shadow banking and firm financing in China☆

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ABSTRACT

Shadow banking, an informal, largely unregulated, financial market, has become increasingly important in China because the fact that it is largely unregulated can threaten the viability of the financial system. This study discusses various issues involved in Chinese shadow banking, including the type, size, risk, and reasons behind the growth of this market. Small and medium-size enterprises (SMEs) in China in particular rely on this informal market as they have limited opportunities for obtaining funds in the formal market. Policymakers have to implement financial reforms to incorporate this informal market into the formal one so as to exercise better control and monitoring.

1. Introduction

Shadow banking has become increasingly important in China in recent years. Financial Stability Board (2012) defines shadow banking as credit intermediation or lending activity that involves entities and transactions outside the regular banking system.[4] Although this definition is general and useful, it is not precise enough. As a result, some people equate shadow banking with securitization and others with non-bank lending. Shadow banking activities are not subject to the regulatory capital requirement framework and supervision of the central bank.

This paper discusses Chinese shadow banking, its size, and causes with the general definition. We also define shadow banking more properly in the financial reform section, attempting to provide more effective and clearer policy on shadow banking for China. In China, The central bank (the People's Bank of China) and all depositary institutions are part of the regular banking system,

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[4] The definition has weakness because it ignores the fact that banks are large part of the shadow banking. See also Shen (2013) for the general definition of shadow banking.

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which include policy banks, commercial banks, credit cooperatives, and licensed finance companies.[5] All of them are subject to certain banking regulations intended to protect the credit system of the country with sudden deposit withdrawal and the real economy from unnecessary shocks that affect the production of goods, services, and consumption. Chinese shadow banking exists alongside the formal financial system and within commercial banks and has begun to present a challenge to the traditional banking system because banks are heavily involved in the shadow banking, which is beyond the current regulatory framework.

One of the oldest credit-granting institutions is pawnshops, which are considered part of the traditional shadow banking by Chinese policymakers and many scholars and they have been operating in China for hundreds of years. Bank financial products, trust products (financial products by trust corporations), and private lending have grown very rapidly, especially since the global financial crisis in 2008, when the Chinese government substantially increased the money supply and credit to the financial market, which prompted even more rapid growth in shadow banking.

A large part of shadow banking in China comprises commercial banks and nonbank institutions that work closely with banks. Because commercial banks offer financial products that are off balance sheet, they effectively providing services and products to the financial market that are not subject to the regulations on bank capital. As of the end of 2011, the registered outstanding off-balance-sheet total in banking institutions (including entrusted loans) was RMB39.16 trillion, which equaled 35.1% of total balance sheet assets (FSAG, 2012).[6] China's regulatory authorities suspended operations between trusts and the banking sector in August 2012 in response to the increasing risks posed by their joint efforts that trigger shadow banking. Thereafter, regulation between securities and the banking sector was relaxed, spurring a new burst of growth in wealth management products beyond those involved in the bank–trust cooperation (see below) (McMahon, 2013). Thus, it is clear that landscape of shadow banking in China changes rapidly in response to changes in regulation. At the same time, shadow banking has become increasingly notable because the accumulation of risks has become so large that it can cause an economic recession (Besancenot & Vranceanu, 2011).

Shadow banking has caused concerns and raises questions about the lack of proper financing channels in China's credit market and the inherent risks that will threaten the entire banking system. As Roy and Kemme (2012) indicate, a banking crisis can be sparked by asset bubbles (e.g., accumulation of public debt and an absence of sustained cash flows) in a deregulated financial system, so regulators need to prevent potential threats that originate in shadow banking, in which the commercial banks play an important role in it.

The purpose of the paper is to explain the scope of shadow banking in China, its size, risk, and the reasons for its growth. We also discuss the relationship between shadow banking in China and financing of Chinese firms, especially SMEs, which are the growth engine for the Chinese economy (Guo, Brook, & Shami, 2010). The reliance of SMEs on financing from shadow banking highlights the importance and need for a proper credit channel for these Chinese firms, as Chinese banks are reluctant to lend to them.

The rest of the paper is organized as follows. Section 2 presents the different types of shadow banking. We discuss the size of shadow banking in Section 3, and reasons for growth in the shadow banking market in Section 4. Section 5 discusses the results of how Chinese firms finance their operations and their relationship with shadow banking. We discuss various risks of shadow banking in Section 6. Section 7 discusses the prospects for shadow banking and financial reforms. The last section is the conclusion.

2. Types of shadow banking

In general, there are four major types of conventionally defined shadow bank products in China. First, they are bank-related products.[7] Second, financial products are generated by nonbank financial institutions. Third, these products are created by nonfinancial institutions, which include private lending and online shadow banking. Finally, credit guarantees are considered part of the shadow banking, which are also sizable in China. We discuss them one by one in greater detail below.

2.1. Bank-related products

2.1.1. Financial products

Most loan products offered by banks are a normal part of bank transactions and they are part of the trading formal banking system. However, some bank products are high risk and can generate a high profit margin. For these noninsured bank financial products, funds are invested primarily in the stock market, funds, foreign exchange, trusts, notes, and other instruments. Investments of this type are risky because most of them are off-balance-sheet items for banks, and they are not regulated as tightly as regular banking activities. Thus, they are included in shadow banking statistics.

One important category of shadow-banking financial products that stands out is called wealth management products (WMPs), which attract investors who want a higher return than is available on deposits at banks, whose interest rates are set by the government. The majority of these products are short-term savings vehicles often created by third parties and issued through banks, giving the public the impression that these products are guaranteed by the banks, although China has just

[5] Policy banks are those Chinese banks that are supposed to carry out policies of the Chinese government, including the China development Bank, Agricultural Development Bank of China and Export-Import Bank of China.

[6] Off-balance sheet items imply that banks earn fees in providing the required financial intermediation services that are beyond the traditional management of banking deposit receipt and loan activities. Entrusted loans will be defined later in the paper. For the source, see *2012 Chinese Shadow Banking Report*, http://bank.jrj.com.cn/2013/01/14151714940440.html.

[7] See Financial Stability Board (2012) and references on Table 2.