

The Future of Shadow Banking in China

It's not illegal, and it plays an important role in the world's largest economy. But shadow banking in China may be drying up — or going farther underground.



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Executive Summary

Shadow banking in China may not be as shadowy as you think. Defined simply as loans made outside the formal banking sector, shadow banking derives a big chunk of its ante from individual investors buying so-called wealth management products, or short-term bundled loans devised by banks and other financial players. The loans typically go to entrepreneurs and businesses too small to enjoy the PRC's seal of approval.

Dangers exist: Shadow banking is non-transparent and has few formal safety backstops. Financing may be overextended in some industries. Investor interest could switch off as suddenly as it turned on, leaving the financiers with no capital to lend.

But the sector could also be the key to China regaining its growth momentum as it finances new business models that the State can't.

Today, though, shadow banking is at a tipping point. As some products leach into the purview of accepted practices and as government oversight begins to take hold, the days of shadow banking as China knows it may be numbered. Financing made possible through shadow banking is poised to become more mainstream — and could very well propel the country to new growth trajectories. But the next phase could also involve even more opaque practices, including derivatives and leverage.

It's time to understand what China's shadow banking behemoth is and where it's heading.

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The Basics of Shadow Banking

What it is

In China and elsewhere, shadow banking usually is not the nefarious, illegal activity that the name implies. Although loan sharks and shady deals do fall into the shadows, more often the designation merely refers to alternatives to bank financing. Shadow solutions tend to occur when financiers have ample access to money but traditional lending sources don't serve pressing needs.

Shadow banking encompasses everything from highly securitized and leveraged credit pools to pawnshops.

How widespread it is

Shadow banking is huge globally, accounting for about one-fourth of total money transfers between savers and borrowers worldwide, estimates the International Monetary Fund.¹ Moody's Investor Service estimates that China's shadow banking transactions equaled 65 percent of the nation's GDP in 2014.²

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Source: Moody's Investment

Why it's different in China

China's version far more resembles straightforward lending, with most shadow banking products developed as a way for banks to bypass government restrictions. Although interest payments may rise to twice the officially condoned rate in these off-balance-sheet vehicles, entrepreneurs can usually tap into loans carrying an annual cost of capital of under 14 percent.

Because many activities in shadow banking are not transparent, and because regulatory oversight is nonexistent or significantly less stringent than applied to banks, the sector naturally arouses suspicions. Global bodies, including the IMF and Financial Stability Board, as well as local regulators, have called for increasing light to be thrown onto the shadows.

But shadow banking has led to some very positive results in emerging markets such as China. By providing retail investors with a place to park their funds and by loaning to borrowers smaller than the official state policy allows, shadow banking is paving the way to market liberalization as the economy transitions from strict state ownership and control to a broader focus.

Why it's important now

The stakes are particularly high as China's growth rate slows from the double-digit pace of the 2000s. "Finance is not that important when growth brings in its own funds," Franklin Allen, a professor of economics at Imperial College London and the University of Pennsylvania, said at *The Fourth Symposium on Emerging Financial Markets: China and Beyond*, held in May 2015 at Columbia Business School.

But as China's growth engine shifts from state-owned enterprises to small, private businesses, new financing rules and mechanisms must come into play. "If the Chinese government can reform the formal financial sector to allow adoption of some shadow banking practices, GDP could again grow at 13 percent," predicted Allen.

What the future holds

Shadow banking as we know it in China may be a fairly short-lived phenomenon as banks reform their lending practices to more closely resemble those of shadow lenders and as the government rejiggers banking regulations. As practices gain credibility, shadow banking products are more likely to join the official economy.

Shadow Banking in a Global Context

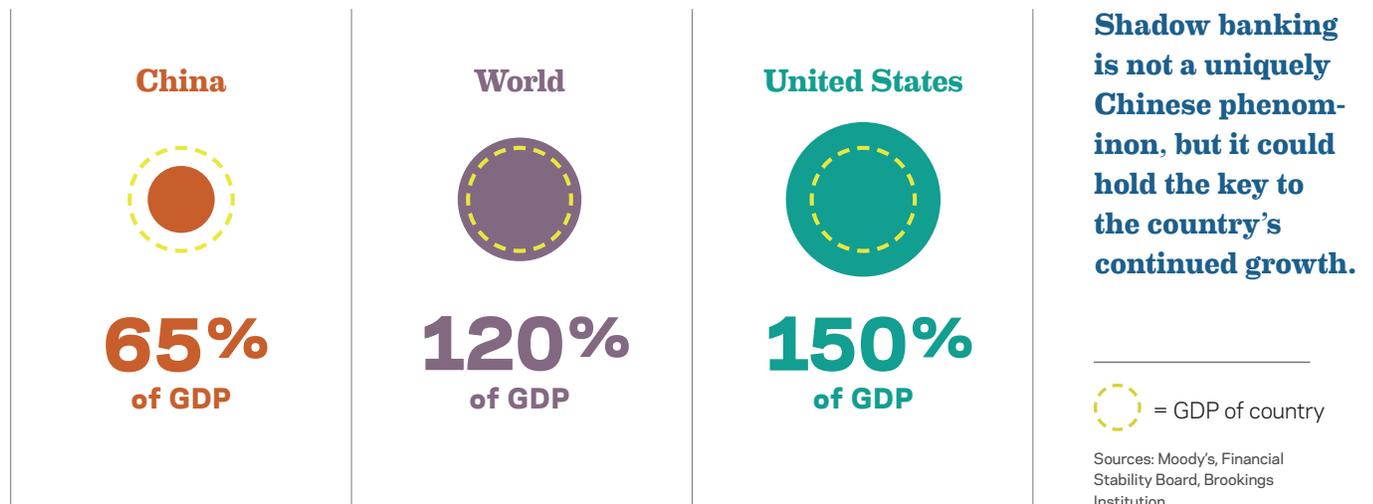
To grasp how shadow banking practices are changing the Chinese economy, it helps to put the sector into an international context.

In the West, the biggest commerce in shadow credit flows through the capital markets — bonds and asset-backed financial products such as mortgages that are bundled together and sold to third parties. Some activities, such as credit default swaps offered by major investment banks, have come under more scrutiny since the 2008 financial crisis. Others, including high-leverage hedge fund purchases and sales, remain less regulated.

In China, shadow banking is typically a form of off-balance-sheet bank lending intended to skirt the country's loan-to-deposit rules. Some types of shadow activity are impossible to track—for example, peer-to-peer loans that have sprung up as a thriving Internet business, or direct loans among family members and business associates. But the Brookings Institution characterizes about two-thirds of shadow banking lending in China as “bank loans in disguise.”³

Whereas “Western shadow banking arises from the gains from financial disintermediation, China's shadow banking system has its genesis in regulatory arbitrage around interest rate controls and other quantitative limits on market-based finance,” explains Moody's.⁴

SHADOW BANKING ASSETS AS A PERCENTAGE OF GDP



Shadow Banking Drivers

China's shadow banking system has vaulted to its current maturity in only six years or so. Three sets of drivers are responsible:

Investors looking for great returns

China's savers have increasingly balked at putting their cash into banks that are prohibited from offering interest rates that even match the rate of inflation. As real estate opportunities sagged and volatility-prone equity markets failed to meet expectations, retail investors had no where to put their money.

SMEs needing capital

Leading Markets for Shadow Banking

- Local real estate developers
- Miners
- Shipbuilders

As China transitions from state ownership to capitalism, entrepreneurs had no way to score working capital. Although most large SOEs could borrow to their heart's content, the banks were discouraged if not forbidden from lending to smaller entities. Similar restrictions blocked borrowers in certain sectors. Currently, local real estate developers, miners, and shipbuilders are among the least-favored-nations of Chinese industry, as determined by the People's Bank of China.

Banks facing regulations

Meanwhile, new non-state-owned banks in particular were unable to attract enough depositors to fill their coffers, especially after liquidity restraints limited banks from lending more than 75 percent of deposits.

And banks saw the prohibition against lending to smaller SOEs as well as most privately owned SMEs as a loss of business.

The solutions to these problems came with off-balance-sheet products that allow banks to entice depositors with whatever returns they deem attractive yet prudent, and lend to whichever borrower they want. The Brookings Institution indicates that the new products are a result of "regulatory arbitrage," meaning bank-structured vehicles designed to detour over, under, and around the rules of China's financing game.⁵

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Two-thirds of shadow banking in China is characterized as bank loans in disguise.

Source: Brookings Institution

Shadow Products

Fully half of all Chinese shadow banking instruments fall into two categories: wealth management products and entrusted loans.

Wealth management products

Banks create WMPs by offering investors the chance to pony up short-term money against a single large loan, or a package of loans and other credit instruments, including bonds and interbank placements. Increasingly, some equity is part of the mix as well. Securities firms and asset managers offer similar products, sometimes labeled Directional Asset Management Products.

One segment of WMPs — structures created by trust companies — is so large and different from the bank-created sector that those who follow Chinese shadow banking often break it into a separate category. Trust companies tend to lend to low-profit sectors or industries subject to cash flow volatility, such as real estate and mining. They then bundle loans into WMPs, which are distributed through banks.

Target customers are individuals shopping for higher returns than they can get by socking their money in a bank, and most observers consider WMPs a near substitute for term bank deposits. The issuers then deploy the funds as loans, or channel them into trust companies that don't have to play by loan-to-deposit rules.

BREAKDOWN BY PRODUCT TYPE

Trust loans and assets funded by wealth management products (short-term securities backed by loans banks make to commercial borrowers) have grown relative to other shadow banking components, although growth is now slowing.

	2014	2011
Assets funded by wealth management products	28%	15%
Entrusted loans	22%	23%
Undiscounted bankers' acceptance	16%	26%
Trust loans	13%	09%
Informal lending	08%	18%
Loans by finance companies	06%	05%
Others (includes financial leasing, microcredit, pawn shop loans, online "peer to peer" lending, and asset-backed securities)	07%	04%

Source: Moody's Investment

WEALTH MANAGEMENT PRODUCTS LEAD THE WAY

15T

RMB 15 trillion is the total worth of wealth management products (WMPs) held by banks

25%

Percentage of Chinese GDP represented by WMPs

13.2%

WMPs as percentage of all outstanding bank deposits

Source: Moody's Investment.

Entrusted loans

Until very recently, entrusted loans represented the biggest proportion of China's shadow banking universe and still account for about 15 percent of the country's total financing needs, according to Franklin Allen.

Entrusted credit simply implies loans extended between companies, which often use banks or similar financial institutions as an intermediary. Considered off-balance-sheet transactions, entrusted loans affect neither the bank's credit risk profile nor its loan-to-deposit ratios.

Within the broad category, entrusted loans come in two common varieties. High-profitability corporations and SOEs make *affiliated loans* to related entities, such as subsidiaries, customers, suppliers, and other corporate vehicles they do business with. The cost of capital for the large company is usually cheaper than that to the affiliate, which means the large company can pass along significant savings or make loans to enterprises that might not otherwise qualify for traditional bank loans in China.

Lenders of *nonaffiliated entrusted loans* often supplement their low-profit, core businesses by lending to companies with which they have no ties. In other words, their intent is just to make money, often borrowing the cash to relend at about double the officially condoned bank interest rates — 13.9 percent is typical, vs. 6.4 percent for affiliated loans, estimates Franklin Allen.⁶

Target customers for wealth management products (WMPs) are individuals shopping for higher returns than they can get by socking their money in a bank.

Other instruments

Additional forms of shadow banking vehicles include:

- **Undiscounted bankers' acceptances**, which are short-term notes issued by a trading company and guaranteed by a bank. The debt may not count against corporate leverage and banks treat it as an off-balance-sheet item. The use of undiscounted bankers' acceptances has fallen after tighter regulations went into effect in 2012.
- **Bankers' acceptances** are promises by banks to pay corporate borrowers a fixed amount a few months in the future. Although the original intent was to cover nonfinancial transactions, such as purchases of goods, usage has spread broadly.
- **Guarantees.** Many companies set up to guarantee loans in China have gone beyond backing bank or trust loans. Many today also make direct loans.
- **Peer-to-peer lending.** Internet-based money-matching services had grown to a 160 billion yuan industry by the end of February 2015, estimates PPMoney, a Chinese online wealth-management platform. Although a number have closed up shop as repayments prove elusive, others have sprung up in their place.⁷
- **Pawn shops and unofficial lenders** such as family members make up a sizeable, albeit undisclosed, source of funds for households and small businesses.

Risks in the Shadows

Potential dangers lurk any time a financial product is not well understood or not subject to oversight

Most observers consider shadow banking to be less dangerous in China than in the West due to its smaller size and relative simplicity. What's more, much of China's transition to a service society supported by small- and medium-sized businesses would not be possible through the country's straitjacketed official lending channels.

Still, there are risks. These include:

Unreliable supply

Rather than too-liberal use of derivatives and exposure to bubble sectors, China's biggest risk is that the shadow banking sector could dry up. If investors simply stop buying WMPs, banks and other financiers will have no choice but to stop lending to the country's new entrepreneurs.

Loss of investor capital

At the top of China's structural risk column is the danger of maturity mismatches between short-term investment products and long-term loans. Returns on WMPs are based on the underlying assets, but the duration is usually much shorter — the average maturity is under three months, even though loans may apply to real estate or other long-term credits.

To a degree, the constant need to cover long-term loans with short-term financing fertilizes the environment for Ponzi-like structures. Issuers and arbitrageurs have developed a growing interbank market to address maturity mismatches. Zheng Michael Song and Kinda Hackem of the University of Chicago estimated that the transaction volume on the repo market more than tripled between 2008 and 2013, with China's Big Four Banks acting as the main liquidity providers.⁸

Default on loans

Although borrower defaults are rare in China, the potential certainly exists for loans to sour, since the risk profile for major borrowers — SMEs and entrepreneurs — is usually higher than the average bank-loan customer. In particular, risks are rising in real estate and infrastructure, which, Moody's estimates, account for one third of all trust loan exposures.⁹

Despite the lack of any guarantees, Chinese retail investors almost universally expect banks or the government to cover any losses. Even so, last year a handful of WMPs in high-risk sectors such as mining reported losses of interest, if not principal. "People underappreciate WMP risks," warned Gaston Gelos, division chief at the Global Financial Stability Analysis Division of the International Monetary Fund.¹⁰

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THE PRC'S LIGHT TOUCH

Chinese authorities appear fully aware of the dangers of shadow banking — and simultaneously cognizant of the risks that a too-heavy-handed crackdown would have on the Chinese economy.

In 2014, the China Banking Regulatory Commission (CBRC) addressed some of the biggest dangers surrounding wealth management products, ruling that banks could not trade the products to improve returns on their portfolios, and forbidding them from using proceeds from new issues to cover payouts on those that are maturing.

An official crackdown on entrusted loans is also a possibility. In January, the CBRC proposed regulations that would prohibit corporate borrowers from relending bank loans or investing in financial assets such as WMPs, bonds, and equity.

Nonetheless, as China's economy increasingly tilts toward smaller, privately owned companies, policy makers are recognizing the need for a broader credit mandate, which could allow more widespread bank loans and capital market credit solutions within the formal lending sector. Liberalization of banking laws could put an end to many shadow banking products.

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Obsolescence

Debate among shadow-watchers centers on whether the government will relax banking regulations that created the need for shadow banking in the first place. Should the PRC raise depositor interest rate caps and loosen the reins on debt-to-loan requirements, banks could conceivably attract more depositors and make more on-the-book loans. Such moves could make most shadow banking uncompetitive and unnecessary.

The Future of Chinese Shadow Banking

As China's shadow banking sector shape-shifts, most observers expect current lending channels to revert back to the banks

What's ahead? The consensus is that today's shadow bankers will either disappear or embrace more sophisticated Western tactics such as securitizations and use of derivative structures that are still off-limit to banks.

"In China, shadow banking has been mostly a channel for banks to bypass regulators," said Hongbin Cai, dean of the Guanghua School of Management at Peking University. If government reforms kick in to provide banks more leeway to conduct business, "I don't think shadow banking will last."¹¹

30%+

After five straight years of annual growth exceeding 30 percent, shadow banking began to level off in 2015.

Source: Moody's Investment

Momentum is slowing

Indeed, the growth of Chinese shadow banking hit an unexpected speed bump in 2015. After five straight years of 30-percent-plus annual growth, the pace began to level off. Moody's Investors Service estimates the current growth rate just about matches China's nominal GDP growth rate.

The slowing momentum is a result of:

- Moves by the formal banking sector to poach many of the products and customers once relegated to shadow banking
- Government efforts to check some of the riskiest aspects of shadow banking
- The prospect of loosening burdensome regulations that have restrained the banks
- Weaker credit demand: The People's Bank of China reported that credit creation from all sources fell 6 percent in 2014 from the previous year.¹² The economic slowdown has been especially noticeable in real estate, a prime source of shadow borrowing.

Moving forward, two nearly opposing scenarios seem plausible. What's clear, though, is that banks hold the key to the future of shadow banking.

SCENARIO I: The banks move out of the shadows

Should regulators lower loan-to-deposit ratios required for banks from the current 75 percent and raise or eliminate the cap on interest rates offered to depositors, banks could find it profitable to lend to current shadow borrowers. Either move could make shadow products less crucial for banks since they may need less surplus to conduct business through more traditional instruments such as regular bank loans. Projected ROI on WMPs could sag as banks and other financial entities find them less attractive.

SCENARIO II: Banks take over the shadows

A nearly opposite scenario calls for China's largest banks to step up their WMP off-balance-sheet efforts, especially if the PRC fails to move quickly on the regulatory front. Although the Big Four banks hold about half the WMP market share, their motivation has been defensive, a response to efforts of smaller banks and trust companies that have used the products as a way to attract depositors. In fact, many of the bigger banks retain at least some WMPs on their balance sheets "since their goal is not to evade regulators," said Zheng Michael Song.¹³

Should the Big Four begin to view WMPs as a source of meaningful income, though, look for the competition to attract investors to heat up. That could result in smaller, capital-restrained banks offering even higher returns.

The rush to attract investors with higher returns could trigger higher rates for borrowers — and/or lower margins for financiers. Franklin Allen predicts interest rates on non-affiliated entrusted loans will rise, "particularly in the real estate market," as credit risks continue to grow. "The market does a good job of pricing risk."¹⁴

Prediction: The shadows shift shape

Regardless of which pivot the banks and regulators take, look for shadow banking to adopt more Western practices as the economy becomes more sophisticated. More primitive lenders will likely fall by the wayside as shadow lenders incorporate practices dealing with leverage, securitizations, and derivatives.

This move would open the doors to wholly new challenges to police the sector. In all likelihood, some of the largest players in traditional banking as well as shadow circles are already exploring many of these new solutions.

Further Reading

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Footnotes

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