HKU Global Finance and Its Regulation 2013

Shadow Banking or Bank's Shadow: A China's Perspective

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1. Overview of Shadow Banking in China

Size of Shadow Banking in China

- **<u>Financial Stability Board (FSB)</u>: Size of shadow banking in China is USD 0.4 trillion or 1% of global shadow banking in 2011 (Global Shadow Banking Monitoring Report 2013).**
- **<u>China Social Science Academy (CSSA)</u>: Size of shadow banking in China is estimated to be USD 2.4 trillion (official data) or USD3.4 trillion (market data) (April 2013).**
- **<u>China Banking Regulatory Commission (CBRC)</u>: News report indicated that CBRC estimated that size of shadow banking in China was USD3.4 trillion as of 2012 end.**

Composition of Shadow Banking in China

- **FSB uses "non-bank financial intermediary" (NBFI) to refer to the shadow banking system, and break NBFI into nine sub-sectors. In China, different views exist regarding the composition of its shadow banking.**
  - **<u>Banking sector</u>: Wealth management products offered by banks increased 14 times from RMB 500 billion (USD 82 billion) in early 2008 to RMB 7 trillion (USD 1 trillion) as of 2012 end.**
  - **<u>Non-bank financial sector</u>: Total assets of trust companies increased 6 times from 2008 to 2012, most of which were invested in housing markets (RMB 216.9 billion or USD 35.6 billion as of 2012 end) and infrastructure projects of local governments (RMB 1.65 trillion or USD 0.3 trillion as of 2012 end).**
  - **<u>Private lending</u>: Estimated to be as high as RMB 10 trillion (USD 1.6 trillion) as of 2012 end, one of the causes for the "run-away" debt crisis in Wenzhou and "Peer to Peer" lending (P2P) has become another increasingly hot topic.**

Characteristics of Shadow Banking in China

- **<u>"Bank's shadow"</u>: Shadow banking is either part of commercial banking (wealth management products), or the result of "financial depression" (private lending due to interest rate regulation and SOE bank dominance).**
- **<u>Less complex</u>: Shadow banking products are traditional loan products (trust companies loans or direct lending) compared to securitization involving investment banks or other funds in U.S. or Europe.**
- **<u>Smaller size</u>: Wealth management products, trust companies and private lending account for about 11% of total banking assets in China.**
- **<u>Largely regulated</u>: Except for Internet P2P lending, wealth management products, trust companies, other non-bank financial institutions and private lending are all subject to certain level of regulation.**

Driving Forces of Shadow Banking in China

- **<u>Financial liberation</u>: Rapid development of wealth management products is partly the response of commercial banks to demand of investors/depositors for higher returns compared to regulated low interest rates for deposits. This is also the case for private lending.**
- **<u>Regulatory arbitrage</u>: Development of wealth management products is also driven by off-balance sheet treatment of these products, and rapid development of trust companies is partly driven by less stringent capital adequacy and other prudent regulation imposed on trust companies.**
- **<u>Technology development</u>: Recent rise of Internet P2P lending is partly driven by technology development that facilitates "disintermediation".**

2. Issues and Regulatory Responses

Consumer Financial Protection

- **Example: Huaxia Bank scandal in 2012**
  - **Annual interest rate of 11% - 13%, triple the 3% deposit rate. Supposed to invest in RMB 200 million in a pawn shop, two car dealerships and a TV production company.**
  - **Suffered a default resulting in losses of RMB 100 million for customers.**
- **This and other scandals or defaults by those banks (and trust companies) offering wealth management products reflect typical "information failure" and "rationality failure" we have seen elsewhere in the world.**
- **In addition to a number of circulars issued by CBRC since 2010, the central bank and the three financial regulators (banking, insurance and securities) all established consumer protection bureau in 2012.**

Housing Bubble & Local Investment Platforms

- **Trust companies sell trust products (similar to wealth management products) to investors, and use money to invest in housing markets and infrastructure sponsored by local government investment platforms.**
  - **In 2012, a number of real estate trust products were unable to meet payment demands of investors due to the default of real estate developers.**
  - **Infrastructure trust products face payment pressure as the result of potential default by local governments providing credit support to these projects.**
- **The CBRC has started to implement more stringent capital and other requirements upon trust companies.**
- **The CBRC has also imposed balance sheet treatment of wealth management products offered trust companies in collaboration with banks.**

“Red Lines” of Private Lending

- **Problems of private lending in Wenzhou led to a “run-away” debt crisis in 2011, which has now resulted in the establishment of “Special Financial Zone” in the city where financial reform measures have been implemented.**
- **The collapse of a number of P2P lending platforms, together with loan guarantee companies or small loan companies involved in the P2P lending process, has drawn close attention from the regulators in China.**
- **For example, a vice governor of the central bank warned in August 2013 that P2P platforms should not step on “two red lines”, namely, illegally raising funds from the public and illegally receiving deposits (i.e. operating banking business).**

3. Concluding Remarks

What Will Happen in the Near Future?

- **System risk? Probably unlikely because of small size and simplicity nature of shadow banking in China as well as the fact that it has been subject to certain level of banking and other regulations.**
- **Risks? Yes, in particular investments in housing markets and local government investment platforms using funds raised through offering wealth management products and trust products.**
- **More regulations? Yes, in particular those governing wealth management products in respect of transparence, consumer protection, etc.**

Long Term Driving Forces

- **Dynamics between central and local governments. Issues arising from local investment platforms are in essence the result of a "new battle" between central and local governments in respect of allocation between them in fiscal, tax and other revenues vs. their respective responsibilities.**
- **"Dual financial regulation model". A "dual financial regulation model" will continue to evolve in China where different financial institutions are subject to the regulation of the central (banks, trust companies) and local governments (small loan companies, loan guarantee companies).**
- **Technology. Internet banking/P2P lending will likely be an area where the need for regulation will be debated, and it is too early to tell the result.**

Thank you !

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