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Insiders' insights

The Development and Characteristics of Shadow Banks in China

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Abstract: *Shadow banking systems are gaining increased attention from economic theorists and practitioners in China and abroad. In recent years, China has seen significant developments in the domestic shadow banking system. However, the common characteristics of shadow banks, excessive leverage and intentional avoidance of financial regulation, have brought new vulnerabilities to the financial system. The development and characteristics of China's shadow banking system are somewhat different from those abroad, as revealed in this paper.*

The term "shadow bank" was coined by Paul McCulley, the managing director at Pacific Investment Management Company (PIMCO), in 2007. Not long after that, Timothy Geithner, the United States Secretary of the Treasury, introduced the concept of the "parallel banking system", which refers to the parallel financial system which emerged outside of the framework of traditional commercial banks. Ben Bernanke, the Chairman of the U.S. Federal Reserve, in his testimony to Congress on September 2, 2010, defined shadow banks as "financial entities other than regulated depository institutions that serve as intermediaries to channel savings into investment".

I. The Development of the Shadow Banking System in China

Shadow banking is an effective complement to the financial industry and the development of the shadow banking system in China is closely related to the development of the financial system. The limited financing channels, strict credit control policies, and innovation in the domestic commercial banking system, have all contributed to the growth of shadow banks. Here are the main reasons:

First, China's economy is under great pressure because of the impacts of the global economic environment, especially the sustaining effects of the U.S. subprime mortgage crisis and the ongoing European debt crisis. In response, the People's Bank of China has implemented prudent and tight monetary policies. It has raised the deposit reserve rate repeatedly, even to its historic highest level. As a result, the commercial banks have increasingly limited amounts of funds to lend. To break this constraint, the banks promote cooperation with trust companies, through which they can lend without the use of deposits. By issuing trust wealth management products, the banks can collect funds to lend to enterprises under less or no supervision from the regulators, as trust wealth management products exist off the balance sheets of the banks. To some extent, this situation has helped to fuel the development of shadow banks.

Second, the traditional commercial banks, which are no longer totally dependent on traditional banking businesses, now rely more on financial markets to obtain liabilities, allocate resources, and get benefits. The role of investment banks is also changing. By playing the part of intermediary institutions and service providers, the investment banks have penetrated into all the fields of the traditional financial businesses. In the context of innovation, a variety of structured financial instruments have been developed, which help to address issues like financial needs, capital sources, matching and risk management through technical arrangements. The third-party payment and settlement system has also developed to facilitate the basic payment and settlement process with no need to rely on the central bank.

Third, financial innovation goes hand in hand with the shadow banking system. Financial innovation has directly resulted in the appearance of the shadow banking sector, and the shadow banking sector has fueled financial innovation. The transfer of credit risk, or securitization, gave rise to the shadow banking system, while the latter, with its huge credit creating capacity, has supported the ability of the commercial banks to transfer credit risk on a larger scale. The interaction between these two activities is based on the needs of financial investors. Since the 1970s, the introduction of new investment instruments, which have the capacity to expand risks to an even larger scale, has experienced considerable progress, thus further promoting the growth of the shadow banking system.

Fourth, regulatory arbitrage has stimulated the development of the shadow banking system. As the main provider of credit, commercial banks (or depository institutions) are subject to more stringent supervision compared with other common financial institutions. From the late 1980s, the framework of regulation for the capital adequacy ratio has been continuously expanded and intensified in China; as a result the commercial banks are under an integrated regulatory burden which includes the deposit reserve rate, the capital adequacy ratio, liquidity requirements and regulations regarding provision coverage. Reducing the regulatory burden and improving liquidity and profitability has become a common motive for the business operations of all commercial banks. Thus, to avoid excessive regulation, the commercial banks are continuously transferring high-risk assets to the shadow banking institutions sponsored by governments, to the special purpose entities established by banks in offshore centers, and to investment banks, which has also contributed to the development and growth of the shadow banking system.

To sum up, the development of shadow banks is rooted in market demands. When the market players have huge financial needs which cannot be satisfied by the original commercial banking system due to excessive costs (higher management costs, risk costs or monitoring costs), the shadow banking system helps meet these financial needs through the design and use of innovative instruments and risk diversification arrangements, thereby making the financial system more efficient and expanding the number of potential customers. In this sense, the shadow banking system is a positive force in promoting financial development. But, because the shadow banking system is outside of the formal regulatory framework (to some degree the efficiency advantages it gains are because of this fact), many key risks cannot be effectively controlled, which can lead to greater exposure to a range of financial hazards.

II. A Comparison between the Chinese and Foreign Shadow Banking Systems

Shadow banks manifest distinctive characteristics in different countries and financial markets which have varying levels of regulatory intensity.

1. The Differences

The first difference is in the financial vehicles. The funding and capital sources for China's shadow banks are very similar to those of the traditional commercial banks, which mostly come directly from the entrusted funds of depositors. In comparison, the funds in the shadow banking systems of many foreign countries are mostly collected directly from capital markets coupled with market financing and leveraging. If asset securitization is one of the key identifying symbols for shadow banking systems, shadow banks in China do not fall into this category.

The second difference lies in attribution. Most of China's shadow banking activities fall into the category of conventional direct financing; it is the replacement of some traditional business usually provided by commercial banks and provided on the basis of a real economic background. In foreign countries the shadow banking systems are often based on capital market derivatives and re-development, with the virtual economy as a service target and background, thereby fulfilling the function of supporting financial transactions. The shadow banking systems in China and abroad have different attributes, being at different stages of financial development.

Third, the impacts on commercial banks are different. The shadow banks in foreign countries have played a considerable role in promoting and leading the way towards building the modern international financial system and the development of modern international commercial banks. They have encouraged financial innovation in modern commercial banks, allowing business to be conducted inside and outside of traditional banking structures, but at the same time they may be leading the commercial banks in an unknown direction. The shadow banking system in China is still developing its role in the real economy, functioning as an alternative to traditional indirect financing, as a supplement to commercial banking business, and as a complement to the inadequate provision of private finance and private financial services. The shadow banks in China have also had some impacts on the commercial banks, mainly reflected in the crowding out effect on deposits, loans and interest rate pricing. As far as risk transfer is concerned, China's commercial banks have relatively low leverage, and their capital mainly comes from depositors, rather than from competing with other commercial banks, so the domestic shadow banking system is at a different stage of development compared with foreign situations.

Finally, from the perspective of regulation, as China's shadow banking system is at a different development stage from those abroad and the risk exposure is different, different regulatory rules have been adopted. China's shadow banks are mainly subject to credit risk and moral risk. To prevent these risks from expanding to other areas, the regulatory agencies must apply appropriate limits on the leverage ratios within the domestic shadow banking system.

2. Similarities

As the development of shadow banking in China (or the financial innovation system which it represents) is still at a preliminary stage, the problems which have been exposed are mostly small scale and are more a result of insufficient innovation and supervision than the excessive accumulation of risks. The development of China's shadow banking system bears some similarities with development in foreign countries, which are outlined as follows:

First, they share the same motivation. The shadow banking system, in the broad sense, also called the parallel banking system, includes entities such as investment banks, finance companies, money market funds, hedge funds, special purpose entities and other vehicles which integrate and hold financial assets. Unlike the commercial banking system, the shadow banking system is a non-bank financial system; in foreign countries, the purpose of creating the shadow banking system is to get more revenue and maximize benefits; in the same way, its existence in China is also motivated by realizing greater profits in areas which are beyond the reach of regulation.

Second, both the foreign and the domestic shadow banks bear the same basic characteristics. These basic characteristics include operating under a wholesale trading pattern in contrast to the retail model of commercial banks, the use of opaque over-the-counter (OTC) transactions, and an imperfect system of information disclosure. The shadow banking systems in China and abroad are rampant with murky OTC transactions and receive less monitoring and regulation, making them almost beyond the reach of authorities.

Third, they have the same operating mechanisms. Shadow banks, to some extent, can promote market prosperity. In theory, with the combined action of commercial banks and shadow banks, a capital-market-dominated financial system can function better as a market capital intermediary, more effectively diversify risks, and make more flexible portfolio strategies, so as to get higher returns. From a macro perspective, it is the shadow banks that carry out and promote the trend towards global financial integration; as a matter of fact, shadow banks have gradually become the institutions which provide international intermediary financial services and which hold international financial assets.

Last, but not the least, both of them may cause financial instability. As shadow banks generally carry out innovative leveraged financial activities on a large scale and adopt a value at risk (VAR) based asset-liability management model, a decline in the value of their assets would force them to start the process of deleveraging, which means to sell risk assets to pay off their debts, to take the initiative to shrink their balance sheets, or to expand the amount of their self-owned capital by attracting new equity investment. Furthermore, a maturity mismatch between assets and liabilities often exists in the shadow banking system, which is difficult to overcome and may lead to a liquidity risk or crisis. The liabilities of shadow banks are generally short term because they are mainly obtained from short-term capital market financing, whereas their assets are longer term. In this process, coupled with the rapid development of the repurchase market, the original high quality liquid assets of shadow banks, like government bonds, would be turned into illiquid assets. Thus, for the entire financial system, the maturity structure of credit has been changed.

To sum up, the financial crisis has exposed the serious consequences of the overdevelopment of shadow banking systems and the lack of appropriate supervision. Therefore, financial institutions in China should not rush to implement financial innovation, particularly in the development of shadow banking systems and products. Thorough research needs to be conducted, and the experiences and lessons of foreign financial markets should be examined. Finally, the actual situation in China must be taken into consideration when an overall strategy is formulated so as to promote the healthy development of the shadow banking market.

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