The Rise and Fall of Shadow Banking in China

Sara Hsu and Jianjun Li

February 2015

WORKING PAPER SERIES

Number 375
The Rise and Fall of Shadow Banking in China

Sara Hsu and Jianjun Li

Economics Department, SUNY New Paltz

Central University of Finance and Economics, Beijing

Abstract

In this paper, we discuss the economic and political conditions that gave rise to shadow banking in China and the relationship of those conditions to the financial crisis in the West. There is very little literature on Chinese shadow banking, examined from a political economic perspective. A finance-fueled stimulus package, coupled with moral hazard, produced a shadow banking system that fomented risk. We examine the types of shadow banking instruments, including trust and wealth management products, bankers’ acceptance notes, and entrusted loans, that arose. We then look at the way in which shadow banking rapidly lost its luster and converted from a lending boom into a debt debacle that was absorbed under the umbrella of restructuring. We examine the political economy of this process, and conclude with policy implications.

Introduction

The global crisis that hit the United States and Europe in 2008 presented a negative shock to countries around the world, impacting global stock markets and reducing exports from other countries to these developed nations. China experienced a sharp contraction in foreign direct investment through 2008 and in exports at the beginning of 2009, and in response ambitiously pushed forward a $586 billion stimulus package to bolster economic growth. The stimulus package channelled funds to upgrading and reconstructing infrastructure and other programs, fomenting a boom in fixed asset investment.

Infrastructure comprised 72% of the stimulus package, or 2.87 trillion RMB of the 4 trillion RMB stimulus package. The majority went to general infrastructure and reconstruction after the Sichuan earthquake. Most of the spending was carried out by local governments. The central government financed 30% of the package, while the rest was financed through local government borrowing. As local governments could not borrow funds themselves, local government financing vehicles took on debt from banks and shadow banking institutions. Implementation of the stimulus package launched the rapid growth in fixed asset investment that accompanied the growth of shadow banking.

Critically, the global crisis hit at a time when China’s real wages were rising, and labor supply for low-skilled labor jobs was on the decline. Multinational enterprises considered moving overseas. The economy was in a transition from a low-skilled, labor-intensive, manufacturing-based economy, to something else, which at the time was not well-defined. The global crisis reduced demand for Chinese-

\[1\] This research is sponsored by the National Natural Science Foundation of China, Project Number 71173246.
produced goods as economic growth in developed countries shrank, forcing local and state officials to turn to a fixed asset investment-based growth model.

Exports of goods and services (% of GDP)

![Graph showing exports of goods and services (% of GDP) from 2004 to 2013](image)

Source: World Bank

Fixed asset investment growth was reinforced by the growth of shadow banking, which provided funding to riskier borrowers. Shadow banking, which included trust and entrusted loans, bankers’ acceptance bills, and wealth management products, acted as an alternative source of funding to real estate developers and local government financing vehicles, which built up properties and infrastructure, effectively generating GDP.

The figure below shows how gross capital formation, as a percentage of GDP, increased in the post-crisis period. Gross capital formation is fixed asset investment plus inventory change.
This shows that the stock of fixed assets, including land improvements, plant and machinery purchases, construction of roads, railways, schools, hospitals, private dwellings and corporate and industrial space, increased in the wake of the global crisis and the ensuing implementation of the stimulus package.

Shadow banking has been acknowledged by China’s leadership as risky, as can be seen in the following comments:

- The size of the shadow banking sector... "is not that great, but the biggest risk here is that growth is very rapid." --Vice Finance Minister Zhu Guangyao, November 15, 2014 (Reuters 2014b).
- "We have a long-term accumulation of problems...[Shadow banking] "is not that big, but the biggest risk here is growing very fast." Deputy Finance Minister Zhu Guangyao, November 17, 2014
- "I am deeply convinced that the Chinese economy will sustain its sound growth. At the same time, we are soberly aware of potential problems and challenges from falling demand, overcapacity, local debts and shadow banking, and we are paying close attention to possible impacts coming from the outside." Chinese President Xi Jinping, October 6, 2013
- “Unsurprisingly, although Chinese banks' non-performing loans are at a low level of 0.9 percent, the potential risks are worse than the official data suggest,” Chairman of Bank of China Xiao Gang, October 12, 2012

In response, government officials increased monitoring and regulation of the sector rather than eradicating it completely. Banking officials became aware that the banking system is procyclical, and can be strongly impacted by systemically important financial institutions (Li 2014). In response, Basel III requirements placed less of an emphasis on internal monitoring and increased countercyclical capital
buffers. Shadow banking was recognized as a potential source of systemic risk, and the way it was addressed was to comply with the Financial Stability Board monitoring framework. The CBRC closely watched both the bank and shadow banking sectors for potential sources of risk.

- “We can't just say 'no' to shadow banks, because to some extent, they satisfy some financing demands of a diversified economy,” Hu Xiaolian, Vice Governor People’s Bank of China, September 26, 2014
- “Shadow banking is inevitable when banks are developing their business... But there are fewer problems here than the shadow banking sector in some developed countries that have been hit by the global financial crisis,” Zhou Xiaochuan, Governor of the People’s Bank of China, November 25, 2012

Several assertions reinforce the assertion that China’s leadership accepted shadow banking. First and foremost, China’s financial system, dominated by the large banks, has been tightly controlled by the leadership since reform began in 1979. As Gruin (2014) points out, the China Banking Regulatory Commission and the People’s Bank of China both have direct control over banking regulation and operations. Although some gradual reforms have been made, full marketization of the system has not yet occurred, since an important part of the economy, the state owned enterprises, continue to depend on loans. Yet, state owned banks were allowed to sell shadow banking products and even participate in incorporating their own loans into wealth management products in the beginning. Banks had the incentive to profit off of wealth management products, since other asset channels, including the extension of lower interest loans to state owned enterprises and returns on central bank bills, yielded little profit. If the practice of selling wealth management products had proven unpalatable to China’s leadership, as the practice of banks rolling loans off balance sheet was later found to be, the entire wealth management business could easily have been banned. In fact, there was precedent for this. The trust industry had first originated in the eighties to channel foreign funds into China. Guangdong International Trust and Investment Corporation (GITIC) defaulted on its payments due to risky investment in the real estate sector, and trust and investment companies were thereafter suspended and ordered to recertify in 2000.

China’s leadership was therefore supportive of the shadow banking sector, as it satisfied liquidity supply and demand needs and fuelled economic growth. What is more, local governments, which could not obtain financing from banks after some time, were able to obtain shadow bank financing, mainly from trust companies. Local governments were compelled to maintain growth through building up fixed investment, even if the projects faced low returns. Local government financing vehicles, the corporate arms of local governments, secured many loans in order to finance projects in the name of generating growth, but this process was rife with moral hazard; local government financing vehicles obtained loans based on the creditworthiness of local governments (rather than the local government financing vehicles themselves), who were technically not themselves the loan borrowers. Funds were used to construct entire cities that were never populated, as well as roads, bridges, and other infrastructure projects, some more viable than others. Ghost cities attracted international attention for their waste; a replica of Manhattan in the Conch Bay District of Tianjin and an empty town for one million prospective
residents in Ordos, Inner Mongolia were prime examples of the waste of resources on unused physical capital.

Finally, China bore witness to the fallout from the financial crisis in the United States and Europe, and China’s shadow banking system grew up in a global climate of financial risk aversion. Wariness of the shadow banking sector might rationally have prompted government officials to stave off the sales of such products. In the wake of the global crisis, risky financial products faced a potential ban in the UK, for example, after the initiation of the Financial Conduct Authority in 2013.

Shadow banking products satisfied not only financing demands but also investment demands, as retail and institutional investors obtained higher yields from shadow banking products than from banking deposits. Wealth management products frequently offered 2% annual interest more than deposits. Individuals and corporations with excess liquidity were becoming increasingly savvy and interested in profiting off financial investment.

Shadow banking was estimated to comprise 20-41% of on-balance sheet bank lending (Thomson Reuters 2014). Without shadow banking, total lending would have declined by 16-29%, impacting GDP creation in turn. Therefore, China might have experienced a growth rate lower than its current rate 7.5%.

**Rise of Shadow Banking**

It was a matter of good timing that the trust industry was restructured in 2007, and that wealth management products had appeared starting in 2004. These new, relatively untapped channels for investment had the potential to incorporate non-traditional types of products with higher risks and higher yields. This created the financial backdrop against which the shadow banking system arose, utilizing trust loans, often bundled into trust or wealth management products, to recycle risky debt. In the following paragraphs, we describe trust products, entrusted loans, bankers’ acceptance bills, and wealth management products, and discuss their relative risks.

China’s trust industry was restructured several times, starting in 1979. There were many problems such as unauthorized fund raising and investing, so that the industry was streamlined many times. When the policy on collective trusts was enacted, the industry developed and expanded in a healthier way. By 2012, trusts had overtaken insurance as the second biggest financial sector in China by assets and played an increasingly important role in funding for local government infrastructure projects, property developers and small companies during a period of tight liquidity within China. By the end of September 2014, the assets of the trust industry in China amounted to 12.9 trillion RMB, according to the China Banking Regulatory Commission.

Trust products could include the trust loan itself or a bundle of products, including securities, equity investments, and trust or entrusted loans. The single trust fund was often purchased by an individual, possibly an institutional investor, while the collective trust fund catered to a group of investors. The trust industry reached its pinnacle in 2010, when it experienced a growth rate of 196% (Hsu and Li 2014). The level of collective trust products measured in at 627 billion RMB.
Trust products were insufficiently regulated. The initial cooperation between banks and trusts was quashed in 2010 when the China Banking Regulatory Commission put a cap of 30% on these products in the financing business (Hsu 2014a). Trust companies were also required to have a minimum net capital, to apply risk weightings to assets under management, and to control risk (KPMG 2012). These regulations registered at the bare minimum and did not prevent trust products from maintaining popularity. Finally, in April 2014, trust companies were required to sell off holdings in the event of a liquidity crunch, and were banned maintaining “cash pools” to fund payouts on existing products with revenue from new product sales.

Entrusted loans were another type of shadow banking loan that could be included in wealth management or trust products as an asset. These were loans agreed upon between two companies, and were at first carried out between two related parties, such as between a parent and a subsidiary company, but during the shadow banking boom were increasingly carried out between non-related parties. About 20% of entrusted loans went to the property sector (Wang 2013), and of these, some were extended to risky or poorly performing parties.

Bankers’ acceptance bills were used as shadow banking instruments. While these bills were normally used to finance trade and were traded on the interbank market, they were used in place of cash to pay bills by riskier borrowers. This occurred especially around mid-2013, as a liquidity crunch set in.

The business of wealth management in China also has seen its boom in recent years. Due to the rapid growth of GDP and high savings, the scale of China’s wealth management market expanded each year. Wealth management products were first created by Everbright Bank in 2004, and other banks took up the concept. Wealth management products came to be sold by banks, trust companies, and securities companies to investors seeking a higher yield than they might receive on bank deposits. These products bundled various types of assets together, stocks, bonds, and non-standard debt assets such as trust loans, entrusted loans, and bankers’ acceptance bills. The most popular types of wealth management products had short-term maturities of around 3 months and average returns of around 5.2% (National Wealth Management Product Registration System 2014).

Wealth management products promised higher returns than bank deposits and were therefore very popular. At year-end 2013, there were 44,525 wealth management products, weighing in at 10.24 trillion RMB (National Wealth Management Product Registration System 2014). The number of wealth management products continued to expand through the first half of 2014. Because higher returns originated from the non-standard debt assets included in the asset pool, and these assets included riskier loans, risk continued to rise during this period.

Regulations were imposed by the China Banking Regulatory Commission imposed regulations to reduce risk. Banks were required to obtain approval of wealth management products prior to issuance starting in May 2009. The CBRC then in July 2009 banned investment of wealth management products in secondary markets (Hsu 2014a). Banks were required to fully disclose information to customers on August 2011, and to better scrutinize third-party wealth management products as of December 2012. In March 2013, non-standard debt assets, comprised of riskier products such as trust and entrusted loans,
were limited to 35% of wealth management products. In July 2014, banks were ordered to separate their wealth management business from retail lending.

Loose monetary policy implemented after the global crisis hit at year-end 2008 spurred shadow banking activity, as liquidity rose in the financial system. Loose monetary policy was maintained through year-end 2010, when interest rates were gradually raised. By this time, shadow banking had taken off and was in a high-growth stage.

At the beginning of growth in the shadow banking industry, risk stemmed from moral hazard in trust loans, the unguaranteed nature of most wealth management products, and an overly intimate bank-trust relationship. Besides that, the problem of low data transparency presented an obstacle to scholars and regulators in assessing risk. Low transparency of information made it harder to detect risk, allowing systemic risks accumulate faster.

Trust loans were rife with moral hazard, for several reasons. First, trust companies were closely linked to local governments. The boom for trusts coincided with a hefty build-up in Chinese debt at local government level. Though trust companies were not set up by local governments themselves, they acted as a key source of funding for local government projects. The close connection between these two parties probably positively biased trust companies toward lending to local government financing vehicles, even where projects were unviable.

Second, trust companies have extended loans to local government financing vehicles without sufficiently checking for risk, on the assumption that local governments would not allow trust loans to default. The finance-fueled stimulus package in 2009 caused a frenzy of investment in the energy and real estate sectors. According to data from the China Trustee Association, more than 100 billion RMB of mining-related trust products were repaid in 2014, with a large chunk of trust money going into the real estate industry as well. The assumption that local governments would pay for poor financial decisions fomented moral hazard among both trust companies and local government financing vehicles.

Third, trust companies were later required by the CBRC to bail out defaulting firms’ payments. An additional bailout fund was set up by the CBRC in December of 2014. Investors in trust products therefore ultimately do not have to shoulder the risk of such products. In mid-2012, trusts in China faced a wave of default risks. However, China’s four asset management corporations—China Cinda asset management company, China Huarong asset management company, China Great Wall asset management company and China Orient asset management company,—and local private equity investors stepped in as lenders of last resort eventually, bailing out the trusts. The extension of trust loans to nonviable borrowers, and purchase of trust products incorporating these loans on the assumption that trust loans would be bailed out by other parties reeked of moral hazard.

Wealth management products were increasingly dominated by unguaranteed products, but bank workers often sold the products as if they were guaranteed, reassuring customers that that products were entirely safe. Retail investors themselves believed the products were safe, despite the fact that banking regulatory officials stated outright that many of the products were not guaranteed. Shang
Fulin, Chairman of the CBRC, remarked on June 29, 2013, “The wealth-management products are actually a type of investment products. It is different from deposits, and investors must shoulder some risks. The question is did banks clearly tell them of that?” (Bloomberg 2013). The line between expected returns and real returns was blurred in product manuals. Most wealth management products were sold with some form of bank guarantee. Due to the lack of financial skills, investors took it for granted that they would receive a guaranteed return when the investment ended. As investors believed that wealth management products were in effect risk-free; wishing for the high promised yield, investors faced frustration as long as the financial market fluctuated in a negative direction.

Banks and trust companies were overly connected, especially in the first years, when banks rolled loans off balance sheet into trust products, which banks then resold to retail customers. In this way, riskier loans could be taken off balance sheet and passed on to unwitting customers. While this practice was curbed in 2010, when the CBRC strengthened the supervision on cooperation between banks and trust companies, banks continued to sell products from trust companies. Products themselves could be kept off balance sheet, with banks picking up a commission.

As to regulation circumvention, one of the major ways of containing bank risks in China is through the requirement to hold a loan-to-deposit ratio of 75%. In order to maximize their profits, banks get around that limit by shifting lending off the books. Lending through channels such as entrusted loans increased by a net of 2.55 trillion RMB ($407.38 billion) in 2013, accounting for 29% of all new bank loans issued during the year. The number was up from 1.28 trillion RMB in 2012, equivalent to only 16% of bank loans. Another way for banks in China to get around supervision is to do direct asset management transactions with securities companies. In fact, direct asset management plans are not part of trust loans or the loan portfolio of banks and are indeed non-standard debt securities of banks. According to a report by the China Financial Stability in 2014, the outstanding amount of direct asset management plans issued by securities companies at the end of 2013 was 4.83 trillion RMB ($790 billion), increasing by 186% from 2012. As financing business was carried out off-balance sheet, it has been difficult for scholars and regulators to assess the scale and the risk of shadow banking.

This leads us to another risk associated with China’s shadow banking, low transparency of data. Currently, existing market trading database and other related information disclosure systems in China are far from sufficient to assess and monitor the risk in shadow banking. The central bank of China has come up an index –total social financing -as the indicator of the scale of shadow banking. The indicator assesses the amount of such shadow banking products as bankers’ acceptance notes and entrusted loans, but other shadow banking instruments like wealth management products are outside the scope of statistics. As the mechanism of shadow banking products is somewhat complicated, it is hard to collect data about cooperation transactions between different shadow banking sectors in extant databases.

While these aspects incurred some level of regulation or risk control as time went on, in the beginning risk rose rapidly. Contributing to these risks were lenders and borrowers ravenous for yield in an environment of tightening profitability. Both suppliers and demanders of funds wished to ignore the
building hazards present in this less transparent sector of the financial system. Wealth management products became ubiquitous and highly popular, and were advertised on billboards, on the internet, and even by text. The public believed the wealth management products would be bailed out if there were any issues, as the products bore the good name of government backed banks. The trust industry often attracted skilled financial specialists interested in making money.

Total social financing, also known as aggregate financing to the real economy contained a large share of trust loans in 2012 and 2013, at 8.1% and 10.7% respectively. Even though this proportion declined to 2.1% in 2014, the amount of trust loans remained high, almost equalling the amount of equity financing on the domestic stock market by non-financial enterprises. In the wealth management industry, the Asia-Pacific region had become the biggest wealth management market by population in 2013, according to RBC Wealth Management.

As shown in the following figure, both the types and amounts of wealth management products issued by banks continued to ascend in recent years. By the end of 2014, there were as many as 6,539 kinds of wealth management products issued by banks, which were available for retail investors to choose from. Due to the decline in bank deposit yields, wealth management products which pay higher returns were welcomed by retail investors. By the end of June 2014, the scale of wealth management products issued by banks was 12.65 trillion RMB.

<table>
<thead>
<tr>
<th>Years</th>
<th>AFRE</th>
<th>RMB loans</th>
<th>Foreign currency-denominated loans (RMB equivalent)</th>
<th>Entrusted loans</th>
<th>Trust loans</th>
<th>Undiscounted bankers' acceptances</th>
<th>Net financing of corporate bonds</th>
<th>Equity financing on the domestic stock market by non-financial enterprises</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>147192</td>
<td>90840</td>
<td>3016</td>
<td>20518</td>
<td>3072</td>
<td>-1891</td>
<td>23075</td>
<td>3692</td>
</tr>
<tr>
<td>2013</td>
<td>172904</td>
<td>88917</td>
<td>5848</td>
<td>25465</td>
<td>18448</td>
<td>7750</td>
<td>18022</td>
<td>2219</td>
</tr>
<tr>
<td>2012</td>
<td>157631</td>
<td>82038</td>
<td>9163</td>
<td>12838</td>
<td>12846</td>
<td>10498</td>
<td>22551</td>
<td>2508</td>
</tr>
</tbody>
</table>

Source: The People’s Bank of China

Notes: a. AFRE refers to the total volume of financing provided by the financial system to the real economy during a certain period of time. It is a flow value.
    b. Data for 2014 was collected by the end of November 31, 2014.
Lack of alternative savings and investment outlets for individuals, coupled with a high savings rate to cushion against income shocks (such as medical issues) also contributed to the amount of available funds that poured into the shadow banking sector. Banks found the sales of trust and wealth management products attractive as a source of profit, in a financial industry that lacked channels for making higher returns.

Shadow banking loans, including trust loans, were frequently tied into the property sector, since China’s leadership attempted to cool down the real estate sector in 2010, restricting bank lending to property developers (CBRE 2014). Small and medium-sized developers, which comprise the majority of the real estate sector, turned to the shadow banking sector for loans.

Around 2012, risks became apparent, as trust and wealth management products threatened default. Huaxia Bank allowed a wealth management product to default in December 2012. A number of trust loans threatened to default, particularly in the property sector. Coal trust loans deteriorated starting in December 2013 and 2014, as the coal mining industry lost profitability. In the most visible case of threatened trust loan default, “Credit Equals Gold #1,” a 3 million RMB wealth management product based on a trust loan to a collapsed coal miner, Huarong Asset Management, a state-owned enterprise, secretly bailed out the product by lending the funds to the Industrial and Commercial Bank of China, the trust product seller. When “Credit Equals Gold #1” was packaged as a trust product and sold by the branches of ICBC in 2010, it promised investors a yield of 10 percent. However, in 2012 the coal industry was hit hard by the country’s efforts to reduce pollution levels. The borrower, Zhenfu Energy, which struggled in a declining industry, was caught in management and cash troubles. When the day of repayment came, it failed to keep its promise. Ultimately, trust loans were frequently bailed out by the trust companies or other parties.

Systemic risk built up in the financial system through 2013. The shadow banking system can be seen as a network of interlinked sectors, which can generate systemic risk through balance sheet contagion,
with the total amount of unexpected losses extending to other areas. In a prior paper, we estimate systemic risk in China’s shadow banking over 2007-2012. Results suggest that trust companies were the main source of financial instability, and commercial banks suffered the most from the adverse impacts (Li & Xue 2014). This proves the systemic risk was forming by mining investment projects supported by trust funds and entrusted loans, which were supported by banks WMPs.

The Political Economy of Financial Fallout

In 2014, the downturn of China’s real estate industry grew serious. The oversupply of housing, combined with increased difficulty for developers in finding finance, led to deterioration in the property sector. China Real Estate Index System showed that property sales in China by volume in the 44 cities it tracked fell by 9% in April from the prior month and 19% compared with a year earlier. Average home prices, meanwhile, rose 0.1% in April from March and 9.1% from a year earlier. The sequential gains were the lowest since mid-2012, when the housing market ticked upward after the last downturn. The amount of property investment also sent a negative message. Investment of the real estate industry turned negative in four of China's 26 provinces in the first quarter of 2014, and in two of them, Heilongjiang and Jilin, the fall was greater than 25%.

What is more, the development in China’s energy industry was not promising in recent years. According to the National Bureau of Statistics, sales of China's coal industry in 2013 amounted to 3 trillion RMB, declining by 3.23% from a year earlier. Total profits of the coal industry amounted to 237 billion RMB, decreasing by 33.34% from a year earlier. It was clear that operating efficiency of the coal industry declined. As a large proportion or trusts’ capital was invested in areas like real estate and energy, credit risk remained high though some of these projects were carried out by local governments.

While the real estate sector deteriorated through 2013 and 2014, analysts feared the worst. However, though the environment reeked of financial fragility, the economy was sustained through government intervention, as trusts were ordered to absorb any losses, monetary policy was loosened to encourage spending, often in targeted sectors, and real estate purchase policies were eased.

Trust companies were told by the CBRC in 2014 that they must be prepared to provide funding for defaulting companies. Trust companies were required to restrict business and reduce assets, or get shareholders to provide additional capital. This curtailed rapid expansion of the trust industry and put trust companies on notice that they were to proceed with caution.

Dwindling confidence in the real estate industry was shored up by central bank policies on September 29, 2014 that allowed home buyers who had paid off a mortgage to be reclassified as first-time home buyers, provided discounted mortgages to second-time home buyers, and made mortgages accessible for third-time home buyers (PBC 2014). Local governments also implemented easing measures, preceding or complementing the central government policy. For example, Tongling in Anhui province initiated a policy in May 2014 to provide tax subsidies for first time home buyers and cut the down payment rates from 30% to 20% for some home buyers (Qi and Ru 2014). Nanning attempted to increase the potential pool of home buyers by relaxing hukou requirements on April 25, 2014.
A draft document suggesting that local governments be allowed to roll over their debt into municipal bonds, in order to maintain government operations, was circulated in an announcement put forward by the National Development and Reform Commission in May 2014 (Reuters 2014a). Ten wealthy cities were allowed to issue municipal bonds as part of a pilot program ending the ban on issuing municipal bonds. This allowed the larger local governments to continue to obtain funding as shadow banking loans dried up.

While China had previously experienced bursting real estate bubbles, this time the falling property market was intricately tied up with the shadow banking sector, resulting in more extensive fallout. As shadow banking loans were reduced in 2014, financing to smaller developers was either cut off entirely or increasing in cost. A reduction in pre-sales as a source of financing also curtailed smaller developers’ funding pool.

The decline in shadow banking also signalled a permanent shift. The political atmosphere changed as officials emphasized that a permanent slowdown in growth was setting in. At this point, the leadership recognized that the heady growth enjoyed for decades, under the growth of manufacturing, and later under expansion of fixed asset investment and shadow banking, could not be sustained.

- “China's development is still at a key strategic phase. We need to strengthen our faith, reboot from this periodic phase of economic development, and adapt to the new normal,” Xi Jinping, China’s President, May 10, 2014
- “We set the GDP growth target at about 7.5 percent; this 'about' shows that there is a level of flexibility,” Li Keqiang, China’s Premier, March 6, 2014

Analysts projected a GDP growth of 7% for 2015 (Morningstar 2014), and it was widely recognized that China’s economy must restructure in order to maintain growth. While fixed asset investment had, for a short time, buoyed growth, China’s leadership was aware this could not last. Emphasis on reforming the services and high-tech manufacturing sectors was made.

The decline in shadow banking was therefore wrapped into a larger political economic stance warning that an economic slowdown was a natural part of restructuring. It was not as if sentiment was high and dropped off due to the problems associated with shadow banking.

Consumers generally accepted this view; consumer confidence showed great volatility and was lower on average after the global crisis hit at the end of 2008, especially compared to the pre-crisis period from the late nineties until year-end 2008. Consumers had therefore never fully believed that the economy was on track following the global crisis.
The slowdown was viewed as rational, even inevitable, and not caused solely by the drop off in shadow banking activity, which allowed the leadership plenty of room to manoeuvre. The international community accepted this explanation; although there was some negative response toward China for allowing the build-up of bad debt, international responses generally viewed the decline in shadow banking and the overall economy as an acceptable component of structural change.

- “Simple logic shows that it is nearly impossible for China’s GDP to grow at current rates while rebalancing away from its dangerous over-reliance on exports and debt-fuelled investment.” – Michael Pettis, Peking University Professor in the Financial Times, July 28, 2013
- “[China’s slower economic growth] is a good thing, and it will ensure steadier growth of the Chinese economy in the future,” Zhu Min, Deputy Managing Director of the International Monetary Fund at the IMF/World Bank Annual Meeting, October 14, 2014 (China Daily 2014).
- “… analysts suggest markets shouldn’t worry too much about the slowdown, which may be largely due to an economic restructuring on China’s path toward more sustainable growth.” Laura He, Market-watch, April 1, 2014.

The slowdown was viewed as justifiable, which prevented markets from reacting irrationally. China’s stock markets remained generally stable through mid-2014 and even rallied at year-end 2014. The size of trading inflated quickly in December and there were several days trading volume over one trillion RMB yuan; before those dates, the daily average trading volume was less 300 billion RMB yuan.

What is more, the shadow banking system acted as a key source of funds for the stock market. Some WMPs were redeemed; since housing prices are going down slowly, investors put money into the stock market. As the Hugangtong (Trading channel between Shanghai and Hong Kong stock exchanges) was carried out, investors anticipate a bull market.

**Death of Shadow Banking?**
Since shadow banking was generally not viewed as a cause of China’s economic decline per se, there was ironically inefficient additional regulation imposed on shadow banking. While a couple of regulations were brought about, including a notice issued in the end of 2013, which clarified the scope of shadow banking, as well as the provisions of the shadow banking regulators for the first time, a draft rule that encouraged banks to directly invest funds from wealth management products in December 2014, Circular 127, which restricted loans to enterprises disguised as interbank lending in May 2014 (Wang 2014), and 10 principles which were came up by CSRC in September 2014 to regulate P2P, there were no regulations imposed that truly quashed the spirit of the shadow banking business. In fact, shadow banking entities expanded in some directions despite the slowing economy; insurance and securities companies increased their holdings of trust products, while crowdfunding, a new type of financing that allowed smaller investors to purchase shares in risky property developments, has become increasingly popular (Hsu 2014b).

As a result, the sector was neither eradicated nor scapegoated. This is quite the opposite of what occurred in the United States during the global crisis, when the financial sector was blamed for the economic slowdown. The story was different, since the slowdown in the US was the result of financial failure and was not engineered. In China, the story was that the economic slowdown was necessary, and from a radical standpoint even intentional. While focus shifted to overall economic growth, shadow banking changed in nature but did not disappear. As a result of tight monetary conditions and distress in the real estate sector, new financing from trust loans and bankers’ acceptance bills declined in the second half of 2014, but additional flows to entrusted loans (as well as flows to corporate bonds and equity) were positive.

**Discussion**

Should we have witnessed the death of shadow banking in China?

Not necessarily, although it was due more blame for the economic slowdown than it ultimately received. How can a trust company lend to a local government that is building a copy of Manhattan or even worse, repaying old loans from the new loans? Shadow bankers received a mere slap on the wrist for such transgressions.

What needs to happen is what analysts have been suggesting for years now: reform of the financial system. Shadow banking, while an alternative to bank financing, does not represent true financial deepening in an environment of semi-controlled interest rates, close state intervention in the banking sector, and a poor financial institutional environment. Both repressed deposit rates and ingrained bank lending preferences (to larger and state owned firms) has pushed borrowers and lenders to the shadow banking sector, which inadequate controls for risk. Poor risk rating mechanisms outside of the banking sector have rendered the shadow banking sector not a viable alternative to the banking system, but rather an uglier, riskier stepchild.

By contrast, healthy financial deepening would require liberalization of interest rates and freer flows of capital, coupled with a more sophisticated rating regime. While we do not recommend that China
To liberalize its financial markets over a short period of time, we do recommend that the nation stay on track for its planned course of opening up. Attention must also be paid to the institutions that accompany risk liberalization, such as enhanced legal channels for enforcing regulation, improved ability to unwind failing companies, and, as mentioned above, a more sophisticated risk rating regime.

Without all of these components, shadow banking in China has become the catch-all for non-mainstream, more market-based, and riskier finance. While China’s shadow banking system was only lightly chastened in the most recent downturn, it should not be taken for granted that shadow banking has effectively considered risk. This is an area that needs constant attention if the nation’s financial system is to compliment, rather than curse, China’s growing economy.

References:


14. Pettis, Michael. 2013. China is Going to Slow Down But It Can Handle It, July 28,  
http://www.ft.com/intl/cms/s/0/2f018d1c-f475-11e2-a62e-00144feabdc0.html#axzz3OzSX5TBe


http://www.reuters.com/article/2014/05/20/us-china-economy-reforms-idUSBREA4J03020140520

17. Reuters. 2014b. China's economy experiencing 'period of pain': vice minister, November 15,  

http://accelus.thomsonreuters.com/sites/default/files/GRC00715_0.pdf

