Reforming China's Financial Markets: the Problems of Shadow Banking and Non-performing Loans

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Abstract

In May–June 2013, interest rates rose on China’s money market (interbank market). While this was a liquidity problem in the short term, structurally it was the result of the expansion of banks’ balance sheets and the development of off-balance-sheet financial products. The latter is also sometimes seen as China’s shadow banking problem. Shadow banking in China consists largely of bank wealth management products and trust products, which together have been estimated to make up more than 50% of China’s GDP. In recent years, Internet finance has also been growing. The response of the Chinese government at the end of 2013 was to issue an internal directive to the country’s monetary authorities and local governments to tighten the regulation of shadow banking, to assign regulators for shadow banking operations and individual financial institutions, and to create a comprehensive regulatory framework. In addition, the Chinese government has set a timetable with a deadline of 2018 for adopting the Basel III framework and is seeking to put bank balance sheets on a sounder footing.

While shadow banking in China has some negative aspects, such as circumventing regulation and introducing risk factors into financial markets, it also has some positive aspects, such as making it easier for SMEs to raise capital and offering Chinese households what amount to financial products with deregulated interest rates. Ultimately, the problems need to be solved as part of the process of reforming China’s financial markets and fostering the development of the country’s securities and asset management industries.

Keywords: Shadow banking, wealth management products, trust products, Internet finance
JEL Classification: E58, G21, G28

I. Introduction

China’s new leaders, who were chosen at the CPC’s 18th National People’s Congress in November 2012, have committed themselves to achieving the goal set out in the 12th Five-year Plan (2011–2015) of adopting a new economic development model, where economic growth is driven by domestic demand (consumption) and the service sector, to replace the previous model, which relied on external demand (exports) and investment. In addition, they want to step up the pace of transition to the new model. China has no alternative but to use
the market mechanism if it is to change its economic development model, and the new leaders have demonstrated that they also want the country’s financial markets to be deregulated, be it in terms of the interest rates and exchange rates that correspond to prices on these markets, be it in the form of a gradual deregulation of the movement of capital, or by means of allocating economic resources efficiently.

At about the same time as China’s new leaders were chosen, its State Council adopted the 12th Five-year Plan for the Development and Reform of the Financial Industry (September 2012), while, at a press conference following the conclusion of the National People’s Congress in March 2013, Premier Li Keqiang said that the government would harness the leverage effect of reforming public finance, the financial system, and prices to bringing about a change in the country’s economic development model. With regard to financial reform, he mentioned (1) that the government would continue to deregulate interest rates and exchange rates; (2) that it would develop a wide range of stock markets; (3) that it would increase the proportion of direct finance; and (4) that it would improve investor protection, especially legal protection for individual investors. Market participants, both in China and overseas, were pinning considerable hopes on the new leaders’ attitude to and policies on financial market reform.

However, events were coming that would threaten to derail these reforms. Just after the Labor Day holiday in May 2013, interest rates on China’s money market (“interbank market”) began to rise sharply (Figure 1). The first sign of this was a sharp rise in SHIBOR (Shanghai Interbank Offered Rate), the market’s benchmark rate.

Officially introduced in 2007, SHIBOR is calculated by averaging the interbank rates of

![Figure 1: Overnight, 1-week, and 3-month SHIBOR rates](image)

Note: Data are for the period from 4 January 2013 to 13 May 2014.
Source: Nomura Institute of Capital Markets Research, from CEIC data
16 panel banks regulated by the People’s Bank of China (PBOC) and published each business day at 11:30AM (Beijing time). On Saturday, 8 June 2013, just before the Dragon Boat Festival (Monday, 10 June to Wednesday, 12 June) the SHIBOR overnight rate rose to 9.581% and the 1-week rate to 7.603%, while after the festival on Wednesday, 20 June, these rates rose to 13.444% and 11.004%, respectively. These rates also rose in December 2013 towards the end of China’s financial year. On Monday, 23 December they stood at 4.515% and 8.843%, respectively.

In its Monetary Policy Report Quarter Four 2013, published on 8 February 2014, the PBOC assesses these rises in interbank interest rates as follows.

“The situation facing those trying to control liquidity in the banking system in 2013 became more complicated. This was connected, on the one hand, with a change in the direction of capital flows, which became more diverse, reflecting changes in the policy expectations of the main economic agents. On the other hand, the role of the degree of liquidity in the banking system in increasing the amount of money, lending, and social financing to a reasonable extent has increased as financial markets have developed and financial innovation accelerated.”

The PBOC defines “social financing” as “the total amount of money (flows) the real economy draws from the financial system” and publishes statistics on the amount. It consists of lending in renminbi, lending in foreign currencies, entrusted loans, trust loans, bank acceptance bills, corporate bonds, and shares issued in China by non-financial companies. The amount rose from RMB2,011.2 billion in 2002 to RMB17,290.0 billion in 2013 (Figure 2), and it is noteworthy that the amount of social financing in foreign currencies has risen since the global financial crisis of 2008. In its Monetary Policy Report Quarter Four 2013 the PBOC concludes that all these changes were accelerated by changes in market participants’ expectations, causing changes in capital flows, and increased liquidity as a result of the development of financial markets.

The report sees the quantitative easing carried out by leading central banks at the beginning of 2013, the resulting substantial increase in inflows of foreign currencies (to mainland China), increased liquidity in the banking system, and increased expansionary pressure on money and lending as the precursor of the rise in interest rates on the interbank market in May–June 2013. The report also mentions a temporary decline in liquidity on the interbank market in May–June 2013 as a result of the following short-term factors. First, a growing number of market participants apparently expected the US Federal Reserve to end its current round of quantitative easing (“QE3”); second, the Chinese economy apparently found itself facing some unexpected downward pressure; third, inflows of foreign currency apparently eased; fourth, many people apparently withdrew cash from their bank accounts during a national holiday (the Dragon Boat Festival); and, fifth, many people apparently paid their taxes during this period.

In addition, in its Annual Review of China’s Bond Market 2013, published on 6 January
2014, the China Central Depository & Clearing Co. says that factors such as market rumors and commercial banks’ need for liquidity reserves to meet regulatory capital requirements as well as to meet payments and settlements ahead of the national holiday also contributed to the rise in interbank interest rates.

All these factors relate to temporary liquidity shortages on the interbank market. In its Monetary Policy Report Quarter Four 2013, however, the PBOC also deals with more structural issues on the banks’ part. In other words, it takes the view that an expansion of bank balance sheets and the creation of off-balance-sheet financial products as a result of pressure to pursue profits and a desire to circumvent regulation increased the demand for liquidity. Similarly, it takes the view that this demand reflected asset/liability maturity

\textbf{Figure 2: Amount of social financing (2002–April 2014)}

<table>
<thead>
<tr>
<th>Year</th>
<th>Shares issued in China by non-financial companies</th>
<th>Corporate bonds</th>
<th>Bank acceptance bills</th>
<th>Trust loans</th>
<th>Entrusted loans</th>
<th>Foreign currency loans</th>
<th>Renminbi loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>20,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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<td>0</td>
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<tr>
<td>2003</td>
<td>40,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2004</td>
<td>60,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2005</td>
<td>80,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2006</td>
<td>100,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2007</td>
<td>120,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2008</td>
<td>140,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2009</td>
<td>160,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2010</td>
<td>180,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2011</td>
<td>200,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2012</td>
<td>220,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2013</td>
<td>240,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2014</td>
<td>260,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
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</table>

Note: 2014 data are for January–April 2014.
Source: Nomura Institute of Capital Markets Research, based on PBOC data
mismatches resulting from short-term borrowing (on the interbank market and via wealth management products) and long-term investment that made market participants sensitive to interest rate risk. It also takes the view that an excessive reliance on the interbank market for short-term borrowing and long-term investment exacerbated the rise in interest rates.

When banks expand their balance sheets, the PBOC and other financial authorities can monitor their activity. However, when, in the name of innovation, they increase their short-term borrowing and long-term investment on the interbank market using financial products they have originated and sold off their balance sheets, they inevitably create risks on financial markets in the form of maturity mismatches. Also, as we saw when we looked at social financing, the financial products originated and sold by the banks off their balance sheets include investments in trust loans and securities, such as corporate bonds and shares issued by non-financial Chinese companies. As a credit risk can arise if there is a change (deterioration) in an investee’s creditworthiness, this is bound to pose a risk to both the interbank market and securities markets.

As well as being a source of financial market innovation, the “off-balance-sheet financial products” mentioned in the PBOC’s Monetary Policy Report Quarter Four 2013 are often mentioned in connection with the risk shadow banking poses to these markets. We now consider the problems posed by China’s shadow banking system in the following order: definitions of “shadow banking,” the functions and problems of shadow banking, and the responses of and challenges facing the Chinese government.

II. Defining “shadow banking”

II-1. International definitions

Before we discuss the problems posed by China’s shadow banking system, we need to define what “shadow banking” means.

According to Kodachi (2013b), “shadow banking” is “the use of quasi-money such as short-term debt to fund long-term investments, a role traditionally performed by commercial banks as part of their core deposit-taking and lending operations.” At the same time, Kodachi contends, “unlike the credit intermediation model of banking, which involves taking credit risk, using deposits to fund loans, and earning an interest rate spread on a single balance sheet, the credit intermediation model of shadow banking involves taking market risk, using the wholesale market to fund loans, and earning fees (rather than an interest-rate income) using a complicated on- and off-balance-sheet network, while trying to spread credit risk.” Kodachi also gives the Financial Stability Board (FSB)’s definition of “shadow banking.” FSB (2011) defines “the shadow banking system” as “credit intermediation involving entities and activities outside the regular banking system.”

Kodachi (2013b) discusses three financial intermediation functions (maturity transformation, liquidity transformation, and credit transformation) as the key aspects of the shadow banking system. According to Kodachi, “maturity transformation” is the use of
short-term money to fund long-term investments; “liquidity transformation” is the use of liquid financial products to fund illiquid investments; while “credit transformation” sometimes involves the use of credit intermediation that is different from traditional banking, a typical example being securitization. Kodachi points out a number of risks associated with the financial intermediation functions of shadow banking. First, the use in maturity transformation of short-term money to finance long-term investments involves rollover and duration risks because of the difficulty of coordinating information between borrower and lender. Second, the use in liquidity transformation of liquid financial products to fund illiquid investments poses a risk to the stability of the financial system because of the disparity between the liquidity of the assets and that of the liabilities. Third, while credit transformation may involve the use of credit intermediation that is different from traditional banking, this does not alter the fact that, if all the credit risk is not transferred to investors, some of it will remain in the shadow banking system.

II-2. Chinese definitions

II-2-1. Chinese government definitions

We now consider the Chinese government’s views on shadow banking. Although the Chinese government has produced very little by way of an explanation of China’s shadow banking system for outsiders, its China Financial Stability Report 2013 does touch on the subject as part of an analysis of yingzi yinhang, Chinese for “shadow banking.”

After referring to the discussion in FSB (2011) (see above), the report presents the following view of China’s shadow banking system. First, although China does not have a shadow banking system as generally defined internationally (because of differences in its financial markets, financial system, and financial regulation), some Chinese banks do have institutions and operations that do not bear their name but have attracted wide public interest. Second, if we apply the international definition to the situation in China, we can say that shadow banking in China is largely “credit intermediation involving entities and activities outside the regular banking system, with the functions of liquidity and credit transformation, which could potentially cause systemic risks or regulatory arbitrage.”

In addition, non-bank lenders and some of the operations of banks in China can be categorized as shadow banking. First, non-bank lenders. These include (1) small-loan companies, of which there were 6,080 with total outstanding loans of RMB592.1 billion as of end-2012; (2) pawnshops, of which there were 6,084 with total outstanding loans of RMB70.61 billion; (3) financing guarantee companies, of which there were 8,590; (4) private equity funds; (5) rural mutual credit cooperatives, with 16,000 pilot projects as of end-2012; and (6) a variety of private-sector lenders (Table 1). Second, regarding some of the operations of banks: (1) Some off-balance-sheet wealth management products apparently pool their cash to achieve maturity transformation; (2) some trust schemes roll their short-term funds over time and again into medium- and long-term projects; and (3) money market funds buy
bank debentures, invest in bank deposits, engage in money market repo trading, etc., thereby boosting bank credit and social financing, or buy corporate bonds and short-term financing bills (equivalent to commercial paper), thereby providing companies with debt capital (Table 1).

II-2-2. Definitions of Chinese scholars

Chinese scholars have also tried to define the country’s “shadow banking system.” The

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</thead>
<tbody>
<tr>
<td>Bank wealth management products (on-balance-sheet)</td>
<td>◯</td>
<td>O(1) Narrowest definition</td>
<td>O</td>
<td>O</td>
<td>1.50</td>
<td>2.89%</td>
</tr>
<tr>
<td>Bank wealth management products (off-balance-sheet)</td>
<td>◯</td>
<td>(Some off-balance-sheet liquidity pools)</td>
<td>O</td>
<td>O</td>
<td>5.60</td>
<td>10.78%</td>
</tr>
<tr>
<td>Collective trust plans</td>
<td>◯</td>
<td>O(1) Narrowest definition</td>
<td>O</td>
<td>O</td>
<td>1.90</td>
<td>3.66%</td>
</tr>
<tr>
<td>Single trust plans (&quot;channel&quot; business)</td>
<td>◯</td>
<td>(Long-term investment products funded by short-term borrowing)</td>
<td>O</td>
<td>O</td>
<td>2.50</td>
<td>4.81%</td>
</tr>
<tr>
<td>Single trust plans</td>
<td>◯</td>
<td></td>
<td>O</td>
<td>O</td>
<td>2.60</td>
<td>5.01%</td>
</tr>
<tr>
<td>Securities company investment plans (&quot;channel&quot; business)</td>
<td>◯</td>
<td></td>
<td>O</td>
<td>O</td>
<td>1.50</td>
<td>2.88%</td>
</tr>
<tr>
<td>Securities company investment plans (other)</td>
<td>◯</td>
<td></td>
<td>O</td>
<td>O</td>
<td>0.40</td>
<td>0.77%</td>
</tr>
<tr>
<td>Entrusted loans</td>
<td>◯</td>
<td>O(3) Relatively broad definition</td>
<td>O</td>
<td>O</td>
<td>5.90</td>
<td>11.36%</td>
</tr>
<tr>
<td>Financial leases (excluding those entered as bank loans)</td>
<td>◯(Non-banks)</td>
<td>O(2) Relatively narrow definition, non-banks</td>
<td>O</td>
<td>O</td>
<td>0.94</td>
<td>1.81%</td>
</tr>
<tr>
<td>Pawnshops</td>
<td>O(6,084 companies)</td>
<td>O(3) Relatively broad definition</td>
<td>O</td>
<td>O</td>
<td>0.28</td>
<td>0.54%</td>
</tr>
<tr>
<td>Small-loan companies</td>
<td>O(6,080 companies)</td>
<td>O(3) Relatively broad definition</td>
<td>O</td>
<td>O</td>
<td>0.59</td>
<td>1.14%</td>
</tr>
<tr>
<td>Financing guarantee companies</td>
<td>O(8,590 companies)</td>
<td>O(3) Relatively broad definition</td>
<td>O</td>
<td>O</td>
<td>0.57</td>
<td>1.10%</td>
</tr>
<tr>
<td>Money market funds</td>
<td>◯</td>
<td>O(4) Most broad definition</td>
<td>O</td>
<td>O</td>
<td>4.50</td>
<td>8.66%</td>
</tr>
<tr>
<td>Private equity funds</td>
<td>◯</td>
<td>(Including some 16,000 rural mutual credit cooperatives)</td>
<td>O</td>
<td>O</td>
<td>28.78</td>
<td>55.41%</td>
</tr>
<tr>
<td>Private-sector lenders</td>
<td>◯</td>
<td>(Including some 16,000 rural mutual credit cooperatives)</td>
<td>O</td>
<td>O</td>
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</tr>
</tbody>
</table>

Note: Outstanding amounts as of the end of 2012 are based on Asset Management Association of China data in the case of money market funds but otherwise on Chen Daofu (2014).


Ba Shusong, “Kin’yu Kouzou no Shinka kara Miru Genzai no ‘Shadoo Bankingu’” (‘Shadow Banking’ from the Perspective of China’s Financial System), Kikan Chuugoku Shihon Shijou Kenkyuu, Nomura Foundation, Summer 2013

Special research team, Department of International Finance, Institute of World Economics and Politics, Chinese Academy of Social Sciences, China’s Shadow Banking System, December 2013

Chen Daofu, “Kin’yuugyou to Jittai Keizai ga Kairi Suru Chuugoku no Genjou to Sono Gen’in oyobi Taisaku” (Divergence between China’s Financial Services Industry and Real Economy: Causes and Policy Responses), Kikan Chuugoku Shihon Shijou Kenkyuu, Nomura Foundation, Spring 2014
following is a survey of papers by researchers at some of the country’s leading think tanks.

(1) Ba Shusong, vice director of the Financial Research Institute, Development Research Center of the State Council

Ba Shusong (2013) gives four definitions of “shadow banking” (Table 1 above).

According to the narrowest definition, China’s “shadow banking system” has only two players: the banks (with their wealth management products) and the trust companies. Another, slightly less narrow, definition adds non-banks such as finance companies, auto finance companies, financial leasing companies, and consumer loan companies. Another, slightly broader, definition adds interbank operations, off-balance-sheet products such as entrusted loans, and non-banks such as financing guarantee companies, small-loan companies, and pawnshops. The broadest definition adds private-sector lenders.

In its discussion, and to be as generally relevant as possible, Ba Shusong (2013) adopts the second and currently most popular of these definitions (namely, the relatively narrow one that includes the banks (with their wealth management products) and non-banks such as trust companies).

(2) Special research team, Department of International Finance, Institute of World Economics and Politics, Chinese Academy of Social Sciences

The Department of International Finance at the Chinese Academy of Social Sciences’ Institute of World Economics and Politics formed a special research team that published a report on China’s shadow banking system in December 2013 (“CASS (2013)”).

Following a review of Chinese papers on the subject, including Ba Shusong (2013), this report defines China’s shadow banking system as the banks (with their wealth management products), trust companies, and yinzheng hezuo (Table 1 above). Yinzheng hezuo refers to collaboration between the banks and securities companies in originating and marketing products aimed at individual investors, using securities companies’ “investment plans” (asset management products). In such cases, the securities companies act as conduits as both the investors and the companies trying to raise capital are bank customers. As we will see later, similar collaboration between the banks and trust companies, using trust products as conduits, is referred to as yinxin hezuo.

CASS (2013) gives four reasons for its choice of definition. First, bank wealth management products and trust companies are currently the two most controversial areas of China’s shadow banking system. Second, bank wealth management products and trust companies have seen the most rapid growth of any areas of China’s financial markets in recent years and are now two of the largest areas of investment/lending. Third, bank wealth management products and trust companies are the two most typical areas of China’s shadow banking system, with the former representing the transfer of bank loan assets between the asset and liability sections of their accounts as well as between on their balance sheets and off them, with the latter representing the transfer of bank loan assets from their balance sheets to trust company balance sheets. Fourth, while yinzheng hezuo is simply a new
phenomenon, having only existed since about 2011, it has developed at breakneck speed in recent years.

CASS (2013) estimates that, as of the end of 2012, there was RMB7,100 billion in bank wealth management products outstanding, RMB7,471 billion in trust products outstanding, and RMB1,890 billion in joint bank/security company products outstanding.

(3) Chen Daofu, head of State Council Development Research Center Financial Research Institute Comprehensive Research Office

Chen Daofu (2014) points out that in recent years the correlation between the expansion of China’s financial markets and the growth of the country’s non-financial economy has been declining and that not only companies but also financial institutions have been seeking to earn an interest rate spread by raising capital.

First, it says that financial institutions try to earn a spread between the regulated low interest rates of the regular banking system and the high rates of the private financial system, enhancing their return by arbitraging the regulatory differences between each sector. This is because managing assets across regulatory boundaries makes it easier to circumvent strict regulation and standards.

Second, it says that collaboration between companies in different financial sectors (e.g., banks, trust companies, securities companies, insurance companies, and funds) has increased, as has the range of financial institutions with channels (tongdao in Chinese) resembling the conduits that proved such a problem in the US securities industry. It also mentions the closer links between financial institutions (especially banks), interbank trading (call market), the bond market, and non-standard direct finance.

Chen Daofu (2014) presents the following areas/players as involved in shadow banking as a source of interest spread income for financial institutions together with figures for the scale of the activity as of the end of 2012 (Table 1 above): (on-balance-sheet) bank wealth management products (RMB1,500 billion); (off-balance-sheet) bank wealth management products (RMB5,600 billion); collective trust plans (RMB1,900 billion); single trust plans (“channel” business) (RMB2,500 billion); (other) single trust plans (RMB2,600 billion); securities company investment plans (“channel” business) (RMB1,500 billion); (other) securities company investment plans (RMB400 billion); entrusted loans (RMB5,900 billion); financial leases (RMB940 billion); pawnshop loans (RMB280 billion); small-loan companies (RMB590 billion); and private-sector lenders (RMB4,500 billion). This gives a combined total of RMB28,210 billion. If, like China Financial Stability Report 2013, we include money market funds in our definition of shadow banking, the total, adding the Asset Management Association of China’s figure of RMB571.7 billion for net asset value as of the end of 2012, would be RMB28,780 billion. This is an indication of the scale of shadow banking in its broadest sense and is equivalent to 55.41% of GDP as of the end of 2012.
II-3. Government’s views on shadow banking

We now consider the Chinese government’s views on shadow banking. In its China Financial Stability Report 2013, albeit published before the rises in interbank interest rates in May–June 2013, the PBOC’s position on shadow banking is as follows. While acknowledging the role played by shadow banking in channeling funds to the real economy, the PBOC considers both the scale and the risk posed by China’s shadow banking system small by international standards. However, it emphasizes the need for the system to be properly regulated.

(1) International comparison of shadow banking

The scale and risk posed by China’s shadow banking system are minuscule by international standards.

First, the money to fund loans is borrowed mainly from companies and individuals. While this is essentially similar to how banks traditionally raise funds from depositors, shadow banking institutions have limited direct access to financial and credit support from the traditional banking system.

Second, the way in which shadow banking institutions use their funds is similar to bank lending but makes relatively little use of financial derivatives to create credit. Essentially it complements the role of commercial banks as lenders.

Third, the customers they serve are mainly companies, especially SMEs, which tend to have difficulty borrowing from the traditional banking system.

Fourth, shadow banking institutions tend not to use a high degree of leverage, with the main risk being illegal operations.

(2) Positive aspects of shadow banking

The origins and development of shadow banking lie in the continuous activity in financial markets. To some extent, shadow banking has succeeded in reducing borrowers’ overdependence on banks, met some of the real economy’s demand for capital, and created more investment opportunities for households and businesses. Shadow banking can also be said to have increased liquidity and activity in all China’s financial markets as well as helping to improve their price discovery mechanism and make investment/lending more efficient.

(3) Risks involved in shadow banking

However, if shadow banking is not properly regulated, it can pose a serious risk.

First, it reduces the effectiveness of macroprudential controls and financial supervision. Some shadow banking institutions invest in local government financing vehicles, property companies, and companies in energy-inefficient, high-pollution sectors with excess production capacity, thereby interfering with macroprudential controls and affecting the rate of economic adjustment. The “rigid redemption” (in Chinese gangxing duifu) policy of providing an implicit guarantee to shadow banking institutions brushes the debt problem
under the carpet and risks causing moral hazard and adverse selection.

Second, it can transmit risks to the regular financial system. Because shadow banking’s operations and sources of funding have close and complicated links with the regular financial system, risks can be transmitted from one to the other if effective firewalls are removed. Some companies receive funds from both commercial banks and shadow banking institutions, with the risk that they may be using loans from the former to repay loans from the latter.

Third, shadow banking has serious implications for regular financial institutions. Some of the returns from shadow banking are unreasonably high, providing a false incentive for customers, unleashing unjustifiable competition, and threatening to steal business from regular financial institutions.

Fourth, some shadow banking institutions are not properly regulated. Some non-bank lenders such as small-loan companies, pawnshops, and financing guarantee companies have expanded recklessly with little regard to risk management. Moreover, government departments do not supervise the day-to-day business of such institutions properly, with the result that such institutions can easily cause problems in areas of business other than their own.

III. Situation in and regulation of different areas of shadow banking

Having considered the PBOC’s views on shadow banking, we now take a closer look at the situation in and regulation of the different areas of shadow banking we have touched on: in particular, where the money is invested and how collaboration (hezuo) between different markets and different types of financial institutions is regulated.

III-1. Bank wealth management products

III-1-1. How bank wealth management products work

Bank wealth management products (WMPs) can be defined as collective investment schemes originated and marketed by banks. In China, bank wealth management products are regulated as retail financial products. Also, they are treated differently from bank deposits.

The blueprint for the wealth management products later offered by China’s commercial

1 In the Notice on Problems Related to the Strengthening of the Management of Local Government Financing Vehicles issued by the State Council on 10 June 2010, local government financing vehicles are defined as “economic agents with the status of independent corporations established by local governments or local government departments/agencies by means of fiscal spending, the provision of land, or equity assets for the purpose of raising funds for local government projects.” Furthermore, in Guiding Opinions on Strengthening Risk-based Regulation for Loans to Local Government Financing Vehicles in 2013 issued by the CBRC on 9 April 2013, local government financing vehicles are defined as “agencies, businesses, or companies financed and established by local governments, which share responsibility for redeeming their debt.
banks was apparently developed by foreign banks, starting in 2002. On 24 September 2005 the China Banking Regulatory Commission (CBRC) promulgated *Provisional Rules on the Wealth Management Business of Commercial Banks* (effective from 1 November 2005), officially permitting commercial banks to offer their retail customers specialist services ranging from financial analysis and planning to investment advice and asset management. These rules define wealth management services for retail customers as follows.

(1) Differences in services offered

Retail customers can be offered two types of wealth management service: either (1) a wealth management advisory service or (2) a comprehensive wealth management service (Figure 3).

Of these, the wealth management advisory service consists of financial analysis and planning, investment suggestions, and an introduction to recommended investment products.

The comprehensive wealth management service, on the other hand, is a discretionary investment and asset management service presupposing the wealth management advisory service and based on an investment plan and method agreed with the customer in advance at his request and with his permission. Commercial banks offering a comprehensive wealth management service are also permitted to market wealth management plans developed and designed for particular groups of customers.

(2) Differences in products offered

Customers are offered two types of wealth management plan according to how the return on their plan is earned: guaranteed-return plans and non-guaranteed-return plans.

Two types of guaranteed-return plan are envisaged: (1) one where the bank bears the investment risk and pays a fixed return to the customer in accordance with the plan agreement and (2) one where the bank bears the risk and pays a minimum return to the customer in accordance with the plan agreement but where any additional return is divided between the bank and the customer in accordance with the agreement. According to the rules and the *Guidelines on Risk Management in the Wealth Management Business of Commercial Banks*, promulgated on the same day, renminbi guaranteed-return plans require a minimum investment of RMB50,000, whereas foreign-currency guaranteed-return plans require a minimum investment of $5,000.

Two types of non-guaranteed-return plan are envisaged: (1) one where the capital is guaranteed but the return is variable and (2) one where the capital is not guaranteed and the return is variable. In the former case, the bank guarantees the capital but the customer bears the risk for the rest of the investment and receives a return in accordance with investment performance. In the latter case, the bank does not guarantee the capital and the customer receives a return in accordance with the plan agreement.

Figure 3: Legal classification of bank wealth management products

Source: Nomura Institute of Capital Markets Research, based on CBRC data
accordance with the plan agreement but where any additional return is divided between the bank and the customer in accordance with the agreement. According to the rules and the *Guidelines on Risk Management in the Wealth Management Business of Commercial Banks*, promulgated on the same day, renminbi guaranteed-return plans require a minimum investment of RMB50,000, whereas foreign-currency guaranteed-return plans require a minimum investment of $5,000.

Two types of non-guaranteed-return plan are envisaged: (1) one where the capital is guaranteed but the return is variable and (2) one where the capital is not guaranteed and the return is variable. In the former case, the bank guarantees the capital but the customer bears the risk for the rest of the investment and receives a return in accordance with investment performance. In the latter case, the bank does not guarantee the capital and the customer receives a return in accordance with investment performance. According to the guidelines, non-guaranteed-return plans require a minimum investment commensurate with the risk awareness and loss-bearing capacity of the target customer group.

III-1-2. Issuance of bank wealth management products

(1) Bank wealth management products outstanding

According to CASS (2013) and figures from CBRC and the China Banking Association, the value of Chinese banks’ wealth management products outstanding increased from RMB467 billion as of the end of 2006 to RMB7.1 trillion as of the end of 2012 (Figure 4). The annual rate of increase since the global financial crisis of 2008 peaked at 146% in 2010 and declined to 100% in 2011 and 42% in 2012.

Since then, in a speech on 29 June 2013, CBRC chairman Dr. Shang Fulin has revealed that the value of bank wealth management products outstanding as of end-March 2013 was RMB8.2 trillion, while figures of RMB9.08 trillion for end-June 2013 and RMB9.92 trillion for end-September 2013 have been published by the CBRC and China Banking Association, respectively.

(2) Maturity structure

One of the distinctive features of wealth management products is their short maturity. According to CASS (2013), ultra-short-term wealth management products (i.e., those with a maturity of less than a month) accounted for 13.7% of the renminbi wealth management products issued in 2008 in terms of issue amount. This proportion increased to 24% in 2009, 31% in 2010, and 36.6% in 2011 (Table 2). The reason for the shortening of the maturity of these products is that the banks found themselves short of cash and were able to raise cash by issuing high-yielding wealth management products with short maturities despite loan-to-deposit ratio limits.

Since then, however, this trend has reversed. Until 2011 the banks would issue ultra-short-term wealth management products with maturities of less than a month and record
Figure 4: Chinese bank wealth management products outstanding

Original data from Shanghai Wind Information Co., Ltd. and the CBRC
Note: Data for 2013 are as of end-September. Data announced by Han Qiang, chairman of the China Banking Association Specialist Committee on Wealth Management Products on 6 December 2013.
Source: Nomura Institute of Capital Markets Research, based on Chinese Academy of Social Sciences, CBRC, and China Banking Association data

Table 2: Maturity structure of renminbi wealth management products (issue amount)

<table>
<thead>
<tr>
<th>Maturity structure</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than a month</td>
<td>2.60</td>
<td>1.70</td>
<td>13.70</td>
<td>24.00</td>
<td>31.00</td>
<td>36.60</td>
<td>4.91</td>
<td>4.01</td>
</tr>
<tr>
<td>1–3 months</td>
<td>15.70</td>
<td>19.80</td>
<td>27.40</td>
<td>26.80</td>
<td>30.00</td>
<td>30.20</td>
<td>60.18</td>
<td>61.15</td>
</tr>
<tr>
<td>3–6 months</td>
<td>35.40</td>
<td>23.20</td>
<td>26.10</td>
<td>22.50</td>
<td>18.10</td>
<td>18.90</td>
<td>21.87</td>
<td>20.75</td>
</tr>
<tr>
<td>6–12 months</td>
<td>29.80</td>
<td>27.50</td>
<td>22.00</td>
<td>21.00</td>
<td>17.80</td>
<td>11.90</td>
<td>10.01</td>
<td>11.13</td>
</tr>
<tr>
<td>1–2 years</td>
<td>14.30</td>
<td>18.80</td>
<td>5.50</td>
<td>3.30</td>
<td>2.00</td>
<td>1.50</td>
<td>0.98</td>
<td>1.08</td>
</tr>
<tr>
<td>More than two years</td>
<td>1.90</td>
<td>5.60</td>
<td>2.40</td>
<td>1.90</td>
<td>0.60</td>
<td>0.40</td>
<td>0.31</td>
<td>0.18</td>
</tr>
<tr>
<td>N/A</td>
<td>0.30</td>
<td>3.30</td>
<td>2.80</td>
<td>0.60</td>
<td>0.50</td>
<td>0.60</td>
<td>1.74</td>
<td>1.69</td>
</tr>
<tr>
<td>Total</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Original data from Shanghai Wind Information Co., Ltd.
Note: (1) 2013 data for January–June 2013.
(2) Based on special research team, Department of International Finance, Institute of World Economics and Politics, Chinese Academy of Social Sciences, *China's Shadow Banking System*, December 2013.
Source: Nomura Institute of Capital Markets Research, based on Department of International Finance, Institute of World Economics and Politics, Chinese Academy of Social Sciences data
them as deposits on their books but then re-enter them as wealth management products at the end of each month and each quarter in order to stay within their loan-to-deposit ratio limits. However, when the monetary authorities restricted or banned the issue of ultra-short-term wealth management products in 2012, the banks began to issue wealth management products with maturities of 1–3 months instead. As a result, 80% of the wealth management products issued in 2012 had a maturity of less than six months. Noteworthy was the increase in the issue of products with a maturity of 1–3 months (60.18% of the amount issued) and the sharp decrease in the issue of products with a maturity of less than a month (4.91% of the amount issued). This trend continued in 2013, with products with a maturity of 1–3 months accounting for 61.15% of the amount issued in the first half of the year and products with a maturity of less than a month accounting for 4.01%.

(3) Investments

CASS (2013) gives a breakdown of the assets in which renminbi wealth management products have been invested by issue amount (interest rate products [bonds and money market instruments], portfolio products, loan products, forex products, equity products, and commodity products) and records changes in the breakdown (Table 3).

In 2012, forex products, equity products, and commodity products accounted for roughly 3.5% of the total. The proportion of interest rate products declined from 95.9% in 2004 to 37% in 2009 but has since increased again. Interest rate investment products are invested in the call market, government bonds, bank debentures, corporate bonds, subordinated bank debt, T-bills, commercial paper, medium-term notes, repurchase agreements, bank deposits, and other instruments. The product that has shown the greatest variation is loan products, which accounted for nearly 50% in 2008 but for less than 1% in 2012. This reflects a temporary increase to circumvent aggregate limits imposed on bank lending and a subsequent

Table 3: Asset structure of renminbi wealth management products (issue amount)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate products</td>
<td>95.93</td>
<td>87.80</td>
<td>60.78</td>
<td>42.74</td>
<td>40.40</td>
<td>37.02</td>
<td>55.27</td>
<td>54.32</td>
<td>62.81</td>
<td>56.12</td>
</tr>
<tr>
<td>Portfolio products</td>
<td>0.00</td>
<td>0.32</td>
<td>0.78</td>
<td>3.06</td>
<td>1.09</td>
<td>15.63</td>
<td>31.47</td>
<td>37.64</td>
<td>33.21</td>
<td>36.31</td>
</tr>
<tr>
<td>Loan products</td>
<td>0.00</td>
<td>0.32</td>
<td>22.82</td>
<td>20.21</td>
<td>49.94</td>
<td>42.83</td>
<td>10.81</td>
<td>5.69</td>
<td>0.52</td>
<td>2.38</td>
</tr>
<tr>
<td>Forex products</td>
<td>3.25</td>
<td>8.19</td>
<td>6.12</td>
<td>1.11</td>
<td>0.75</td>
<td>0.92</td>
<td>0.72</td>
<td>1.12</td>
<td>1.89</td>
<td>0.07</td>
</tr>
<tr>
<td>Equity products</td>
<td>0.81</td>
<td>1.28</td>
<td>7.92</td>
<td>30.63</td>
<td>5.46</td>
<td>2.80</td>
<td>1.37</td>
<td>0.97</td>
<td>1.05</td>
<td>2.18</td>
</tr>
<tr>
<td>Commodity products</td>
<td>0.00</td>
<td>2.09</td>
<td>1.57</td>
<td>2.25</td>
<td>2.36</td>
<td>0.80</td>
<td>0.35</td>
<td>0.27</td>
<td>0.52</td>
<td>0.31</td>
</tr>
<tr>
<td>Total</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Original data from Chinese Academy of Social Sciences, Annual Report on China’s Financial Development (2013) and Shanghai Wind Information Co., Ltd.

Note: (1) 2013 data for January–June 2013.

(2) Based on special research team, Department of International Finance, Institute of World Economics and Politics, Chinese Academy of Social Sciences, China’s Shadow Banking System, December 2013.

Source: Nomura Institute of Capital Markets Research, based on Department of International Finance, Institute of World Economics and Politics, Chinese Academy of Social Sciences data
rapid decline in issuance as a result of tighter regulation (e.g., the requirement to put such products back on banks’ balance sheets) in response to the banks’ collaboration with trust companies (see below).

What has increased its share instead is portfolio products, which can invest in bonds, money market instruments, loans, bills, trusts, beneficiary rights, equities, equity investments, or funds. The demand for portfolio products has increased in inverse proportion to the tighter controls that have been imposed on wealth management products, which consist simply of loan assets.

Banks have originated portfolio products to raise cash by combining assets subject to a variety of different risks. As the cash raised by issuing wealth management products is paid into a liquidity pool, it has been argued that these products are similar to collateralized debt obligations (CDOs). However, the two types of products differ in two respects. First, in the case of portfolio products, the source of the liquidity is not isolated from the underlying assets. As a result, any interruption to the cashflow from the investment assets inevitably poses a liquidity risk. Second, multiple wealth management products are not used to create overlapping layers of collateral, and the degree of leverage is relatively low.

III-1-3. Risks posed by bank wealth management products

(1) Market participants’ views on risk

Participants in China’s domestic markets have also expressed views on the risks posed by bank wealth management products. For example, on 12 October 2012, Mr. Xiao Gang, chairman of the China Securities Regulatory Commission (CSRC) since March 2013 and, at the time, chairman of Bank of China, had the following to say about the subject in China Daily.

“... in China, shadow banking has mainly taken the form of a large amount of wealth management products, ... underground finance and off-balance-sheet lending.

“Chinese banks work closely with trust companies or other entities by packaging trust loans into WMPs, offering investors a higher yield than conventional bank deposits can. These products are mainly sold by commercial banks either at their branches or online. Many of the funds that were obtained through these channels went into real estate development, infrastructure projects, the manufacturing sector and local government financing vehicles. ...

“There are more than 20,000 WMPs in circulation, a dramatic increase from only a few hundred just five years ago. Given that the number is so big and hard to manage, China’s shadow banking sector has become a potential source of systemic financial risk over the next few years. Particularly worrisome is the quality and transparency of WMPs. Many assets

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2 A type of asset-backed security backed by corporate bonds and loan assets.
3 http://www.chinadaily.com.cn/opinion/2012-10/12/content_15812305.htm
underlying the products are dependent on some empty real estate property or long-term infrastructure, and are sometimes even linked to high-risk projects, which may find it impossible to generate sufficient cash flow to meet repayment obligations.

“Moreover, many WMPs are not even linked to any specific asset, rather, just to a pool of assets, whose cash inflows may often not match the timing of scheduled WMP repayments.

“China’s shadow banking is contributing to a growing liquidity risk in the financial markets. Most WMPs carry tenures of less than a year, with many being as short as weeks or even days. Thus in some cases short-term financing has been invested in long-term projects, and in such situations there is a possibility of a liquidity crisis being triggered if the markets were to be abruptly squeezed.

“... The rollover of a large share of WMPs could weigh heavily on formal banks’ reputations ...

(2) Chinese government’s views on risk

In its Monetary Policy Report Quarter One 2013, published on 9 May 2013, the PBOC defines the “liquidity pool” of bank wealth management products as “a type of financial investment plan sold and managed by banks” and characterizes it as “generally maintaining the balance between the source and the use of the liquidity by continuously selling a large number of wealth management products with different maturities and investing in a wide range of assets such as bonds, bills, and trust plans.” In addition, it points out that “‘liquidity pool’ wealth management products currently account for more than 50% of all off-balance-sheet wealth management products” and have recently been the subject of considerable interest because of the following risks that they pose.

In addition, it has the following to say about the risks posed by liquidity pool wealth management products.

A  Impossibility of identifying the return on individual products

By the very nature of the liquidity pool model, where the money raised by selling a large number of wealth management products is pooled before it is invested, there is no one-to-one match between the source and the use of the money. This makes it impossible to calculate the return earned on each individual wealth management product.

This distinctive feature means there may be a mismatch between the risk and the return of bank liquidity pool wealth management products. In other words, there is a risk that banks may attribute profits from one wealth management product to another.

B  Maturity mismatch

Bank liquidity pool wealth management products maintain their liquidity pool by issuing new short-term wealth management products (many with maturities of less than six months), often to roll over maturing products. In addition, the portfolio assets, such as loans and bonds, in which this liquidity is invested often have quite long maturities. This therefore creates a maturity mismatch.
There is a liquidity risk if the timing of the issuance of a wealth management product and the timing of the maturity of an existing product do not dovetail properly or if there is a hitch in the rolling issuance of a product.

C Off-balance-sheet treatment of both assets and liabilities

The use of liquidity pools by banks has led to bank deposits being converted into off-balance-sheet wealth management products. In other words, liabilities are being shifted off the balance sheet. At the same time, however, the assets in which the liquidity pool is being invested (mainly wealth management products with no capital guarantee and a variable return) are also being recorded off the balance sheet. In other words, assets are also being shifted off the balance sheet. This poses a twofold risk.

First, there is a risk that the bank concerned may not have enough capital. If a bank that had failed to build up a sufficient capital base overinvested in high-risk assets (and effectively assumed investment risk on behalf of customers), the capital needed to redeem those investments could overstretch the bank’s risk management capability.

Second, there is a risk that the line between off-balance-sheet activities and on-balance-sheet activities could be blurred. As the two types of activity are currently linked, the risks posed by the wealth management product pool could spread to other activities.

D Lack of transparency

When banks issue liquidity pool wealth management products, they often provide only a general explanation of where the proceeds will be invested. As a result, the disclosure of information about such details as investment products, investment ratios, risks, and profit/loss during plan periods as well as investors’ understanding of their investments are likely to be inadequate.

E Unclear rights and responsibilities

The division of the rights and responsibilities of banks and investors with regard to bank wealth management products is unclear. On the face of it, with regard to wealth management products with no capital guarantee and a variable return in particular, banks are only responsible for managing customer assets, for which they charge a fee. They have no joint and several responsibility for the return on those assets. In practice, however, banks have a reputation to consider and find it increasingly difficult to argue that their customers should accept all of the risk. This introduces an element of legal risk for both banks and their customers.

F General considerations

In short, bank liquidity pool wealth management services should, strictly speaking, be an asset management service for customers, who should receive all the investment gains (less

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4 The parentheses are the author’s.
any fees) in exchange for assuming all the investment risk. In practice, however, any investment gains in excess of the return expected at the time of issue revert to the bank in accordance with the terms of the customer agreement. As this detracts from the supposed objective of wealth management services (namely, to act on behalf of customers), it automatically tends to take on the character of proprietary trading. In particular, if not even investors are going to assume risk, wealth management products could become more like bank deposits.

III-1- 4. Tighter regulation of bank wealth management products

Against this backdrop of views on bank wealth management products, the following action has been taken to tighten regulation of how bank wealth management products are originated and marketed.

(1) Tighter regulation of collaboration between banks and trust companies

On 12 August 2010, the CBRC promulgated a circular clarifying and tightening the rules governing collaboration between banks and trust companies on wealth management products, services, investments, and risk management (Circular on Matters Relevant to the Regulation of Cooperation between Banks and Trust Companies on Wealth Management Business). In particular, the CBRC called on the banks (1) to put back on their balance sheets in two years (2010 and 2011) the assets they had previously removed, (2) to raise their loan-loss reserve ratios to 150%, and (3) to raise their capital adequacy ratios to the required levels.

(2) Tighter regulation of marketing

On 28 August 2011 (with effect from 1 January 2012), the CBRC promulgated a circular entitled Measures for the Administration of the Sale of Wealth Management Products of Commercial Banks. The circular consists of 11 chapters (Ch. 1: General provisions; Ch. 2: Basic principles; Ch. 3: Management of promotional and marketing documents; Ch. 4: Risk assessment of wealth management products; Ch. 5: Assessment of customer risk-bearing capacity; Ch. 6: Sales management of wealth management products; Ch. 7: Management of sales staff; Ch. 8: Internal sales controls; Ch. 9: Regulation; Ch. 10: Legal responsibilities; and Ch. 11: Supplementary provisions) with a total of 80 articles.

While the circular does not mark any change in the CBRC’s desire to foster the sound and sustainable development of bank wealth management services in accordance with the basic principle of “calculable costs, controllable risks, and adequate disclosure,” it does seek to correct some of the mismanagement and misselling that has occurred as a result of the rapid growth of some banks’ wealth management services.

(3) Tighter regulation of risk management

On 30 September 2011 (with immediate effect), the CBRC promulgated a circular entitled Notice on Further Strengthening Risk Management of Wealth Management Business.
of Commercial Banks. The circular calls on banks to develop wealth management products “objectively,” be more transparent in their product disclosure, provide separate plan calculations, and manage their affairs properly.

(4) Tighter regulation of assets not issued or traded on public markets

On 25 March 2013, the CBRC promulgated its Circular on the Regulation of the Investment and Operation under Wealth Management Business by Commercial Banks in an effort to tighten the regulation of wealth management products, especially non-standard debt-based assets, which are not issued or traded on public markets. “Non-standard debt-based assets” are debt-based assets that are not traded on the interbank market or on securities exchanges. They include, but are not limited to, credit assets, trust loans, entrusted creditors’ rights, bank acceptance bills, letters of credit, accounts receivable, and various types of beneficiary rights.

The essence of the circular’s regulations is (1) to improve the accounting and managing of individual wealth management products, (2) to improve disclosure, and (3) to set aggregate limits on lending. In particular, the amount of wealth management funds invested by a bank in non-standard debt assets must not exceed 35% of the bank’s average wealth management products outstanding. Similarly, it must not exceed 4% of the bank’s total assets as disclosed in its latest audit report. The aim of setting aggregate limits on lending is to limit uncontrolled investment by means of wealth management products in illiquid debt-based assets of doubtful creditworthiness not traded on public markets (e.g., local government financing vehicles (LGFVs)).

(5) Tighter regulation of interbank bond market accounts

On 13 February 2013, the PBOC promulgated a circular on the investment by commercial banks of wealth management products in the interbank bond market, setting out its policy on opening accounts for this purpose.

There are three types of participant in this market: A, B and C. Category A and B participants settle trades directly, while Category C participants can only settle trades indirectly. Category A participants can trade not only on their own account but also on behalf of clients. In contrast, Category B participants can trade only on their own account. Category C participants, however, can trade only indirectly, namely by settling trades through a Category A participant.

Whereas Category C participants had until then been able to invest multiple wealth management products using an account in the name of a single investment partnership, they were now required to open separate accounts for each product as Category B participants. If they were unable to do this, they could still participate with a Category C account but were required to use a bank other than their own bank as custodian. The regulation aimed at using trading accounts to exercise control over liquidity pools.
III-2. Trust products

III-2-1. How trust products work

(1) Regulations governing the trust business and trust companies

The trust business and trust companies are also subject to the law in China. First of all, as part of the process of restructuring trust companies and learning lessons from the collapse of Guangdong International Trust and Investment Corporation (GITIC) in October 1998, the Standing Committee of the National People’s Congress passed and promulgated the Trust Law on 28 April 2001 with effect from 1 October 2001.\(^5\)

Second, as part of the process of regulating trust companies, the industry’s regulator, the CBRC, promulgated the Rules Governing Trust Companies on 23 January 2007 with effect from 1 March 2007.\(^6\)

(2) Defining “trust” and “trust property”

Next we consider the definitions of “trust” and “trust property.” First, “trust.” Article 2 of the Trust Law defines “trust” as follows: “For the purposes of this Law, trust refers to the fact that the settler, based on his faith in the trustee, entrusts his property rights to the trustee and allows the trustee to, according to the will of the settler and in the name of the trustee, administer or dispose of such property in the interest of a beneficiary or for any intended purposes.”

Second, regarding the scope of a trust company’s business, Article 16 of the Rules Governing Trust Companies lists various types of trust business, including the following: (1) the entrusted management of cash, (2) the entrusted management of movable property, (3) the entrusted management of real estate, and (4) the entrusted management of securities. In addition, regarding the aforementioned administration or disposal of trust property, Article 19 of the Rules Governing Trust Companies stipulates (1) that a trust company may manage, use or dispose of the entrusted property by means of investment, sale, interbank placement, purchase-and-sellback, leasing and lending, etc. according to entrustment contracts, but (2) that, if the CBRC otherwise makes a policy on it, such policy shall prevail.

III-2-2. Issuance of trust products

(1) Trust products outstanding

China Trustee Association (CTA) publishes quarterly statistics on Chinese trust products. According to these statistics, the value of Chinese trust products outstanding increased from RMB2,374.5 billion as of the end of March 2010 to RMB11,727.2 billion as of the end of

\(^6\) http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/2007020146C75FE4EC42DAA9FFADADCB71D8A300.html
March 2014 (Figure 5). Judging by the latest statistics, however, the quarterly rate of increase peaked at the end of December 2012.

Trust companies have three different sources of business: (1) collective trusts, (2) single trusts, and (3) property management trusts. (1) Collective trusts manage the assets of a number of investors whereas (2) single trusts manage those of a single investor. In both cases, the trustee manages the entrusted assets (e.g., in the form of a loan trust or as a bond investment). Wealth management trusts manage entrusted assets according to the original function of a trust.

As of end-March 2014, the amount of trust assets under management in China was RMB11,727.2 billion. Of this amount, RMB2,927.9 billion (or 24.97%) was managed in the form of collective trusts, RMB8,149.4 billion (or 69.48%) in the form of single trusts, and RMB650.7 billion (5.55%) in the form of property management trusts.

The lion’s share (namely, RMB5,133.5 billion or 46.34%) of the RMB11,077.2 billion in assets managed as either collective or single trusts as of end-March 2014 was managed in the form of loan trusts, while the next-largest share (RMB2,116.2 billion or 19.10%) was managed in the form of investments held until maturity.

(2) Investments
China Trustee Association’s statistics divide these investments into the following categories: basic industries, real estate, securities (equities), securities (funds), securities (bonds), financial institutions, industrial and commercial companies, and other.

The lion’s share (namely, RMB3,084.7 billion or 27.85%) of the RMB11,077.2 billion in assets managed as either collective or single trusts as of end-March 2014 was invested in “industrial and commercial companies,” while the next-largest share (RMB2,745.3 billion or 24.78%) was invested in “basic industries” (Figure 6). Coal mine development and LGFVs (see below) are classified as “industrial and commercial companies” and “basic industries,” respectively.

III-2-3. Dealing with risks of collective trust plans

(1) Rules on Trust Schemes of Collective Funds by Trust Companies

As was mentioned above, trust products that, like bank wealth management products, invite subscriptions from a number of investors are called “collective trusts.” Investment schemes (products) based on collective trusts are governed by special rules. These are the Rules on Trust Schemes of Collective Funds by Trust Companies promulgated by the CBRC on 23 January 2007 with effect from 1 March 2007. A revised version was subsequently promulgated on 4 February 2009 with immediate effect. These rules consist of a total of 55
articles: Chapter I, General Provisions (Articles 1–4); Chapter II, Establishment of Trust Schemes (Articles 5–18); Chapter III, Custody of Trust Scheme Property (Articles 19–22); Chapter IV, Operation and Risk Management of Trust Schemes (Articles 23–28); Chapter V, Alteration, Termination and Liquidation of Trust Schemes (Articles 29–33); Chapter VI, Information Disclosure and Supervision (Articles 34–40), Chapter VII, Beneficiaries’ Meeting (Articles 41–46); Chapter VIII, Penalties (Articles 47–51); and Chapter IX, Supplementary Provisions (Articles 52–55). The main points of the rules are as follows (Table 4).

First of all, the rules define “trust schemes” as “entrusted fund management activities where a trust company acts as a trustee, in line with the clients’ will, to manage, use or dispose of the funds entrusted by two or more clients in a collective manner with a view to benefiting the beneficiaries.”

Second, only “qualified investors” may invest in collective trust schemes. As a rule, only investors with a minimum of RMB1 million to invest per scheme are considered.

Third, trust companies are forbidden from guaranteeing entrusted funds against losses or guaranteeing minimum returns.

(2) Attitude of collective trusts to risks and losses to trust property

The rules also define risks and losses to the trust property of collective trust schemes. First of all, where a trust company manages the entrusted property in line with the trust scheme documents, the risks arising from the management shall be covered by the entrusted property.

Although the rules do not explicitly define “risk,” we assume that this would in practice mean extending the trust period. In such cases, a beneficiaries’ meeting has to be convened. Alternatives would be for the scheme concerned to be taken over by another scheme or, where the priority was to recover funds or distribute income at the end of the trust period, to proceed against the investment collateral.

Second, a trust company that infringes an entrustment contract or causes a loss to the trust property as a result of not taking due care must make good the loss using its own assets. If the trust company is unable to make good the entire loss, the investors must bear the residual loss.

This applies if the trust company infringes any regulations or fails to exercise due diligence. However, even in such cases, investors bear joint responsibility for making good any losses.

7 http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/2007020140E41E8F4749E6F8F15F12F68C86600.html
8 http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/200909155AD71D59AFD82FB5FFA27E225216B800.html
III-2-4. Case study of failure to repay a trust product

(1) Failure to repay a trust product

In February 2011, China Credit Trust, one of China’s largest trust companies, originated a collective trust product (“Credit Equals Gold #1”) that was privately placed with qualified institutional investors (Figure 7). The proceeds of the issue were lent to Zhenfu Energy Group, a private coal-mining company in Shanxi Province. The amount raised was RMB3.03 billion and the maturity was three years.

The RMB30 million subordinated portion was kept by the group’s owner, while the remaining RMB3.0 billion senior portion (with an expected rate of return of 9.5–11%) was sold to investors via Industrial and Commercial Bank of China. This kind of collaboration

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Table 4: China: main rules governing collective trusts

<table>
<thead>
<tr>
<th>Name of law</th>
<th>Rules on Trust Schemes of Collective Funds by Trust Companies (revised version promulgated with immediate effect on 4 February 2009)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition of collective trust plan</td>
<td>Article 2</td>
</tr>
<tr>
<td></td>
<td>・Entrusted fund management activities where a trust company acts as a trustee, in line with the clients’ will, to manage, use or dispose of the funds entrusted by two or more clients in a collective manner with a view to benefiting the beneficiaries.</td>
</tr>
<tr>
<td>Definition of settler</td>
<td>Article 5(1)</td>
</tr>
<tr>
<td></td>
<td>・The settler must be a qualified investor.</td>
</tr>
<tr>
<td>Definition of qualified investor</td>
<td>Article 6</td>
</tr>
<tr>
<td></td>
<td>・One of the following types of investor:</td>
</tr>
<tr>
<td></td>
<td>① A natural person, corporation, or other organization investing at least RMB1 million in a single trust plan.</td>
</tr>
<tr>
<td></td>
<td>② A natural person (individual or household) with financial assets of more than RMB1 million at the time of purchase. He/She must be able to provide proof of their financial assets.</td>
</tr>
<tr>
<td></td>
<td>③ An individual with an annual income of more than RMB200,000 for the past three years or a couple with a joint annual income of more than RMB700,000 for the past three years. He/She/They must be able to provide proof of their income.</td>
</tr>
<tr>
<td>Requirements for establishment of trust plan</td>
<td>Article 5(3)</td>
</tr>
<tr>
<td></td>
<td>・No more than 50 natural persons per trust plan.</td>
</tr>
<tr>
<td></td>
<td>・However, this numerical restriction does not apply if the amount entrusted per natural person investor or qualified institutional investor is at least RMB3 million.</td>
</tr>
<tr>
<td>Product design</td>
<td>Article 5(4)</td>
</tr>
<tr>
<td></td>
<td>・A trust period of at least one year.</td>
</tr>
<tr>
<td></td>
<td>Article 5(5)</td>
</tr>
<tr>
<td></td>
<td>・The entrusted money must have a clear investment strategy and comply with government industrial policy and any related rules.</td>
</tr>
<tr>
<td>Rules governing product design</td>
<td>Article 8(1)</td>
</tr>
<tr>
<td></td>
<td>・The trust company may not guarantee the plan against losses or guarantee any minimum return.</td>
</tr>
<tr>
<td></td>
<td>Article 27(1)</td>
</tr>
<tr>
<td></td>
<td>・The trust plan may not be used as a third-party guarantee.</td>
</tr>
<tr>
<td></td>
<td>Article 27(2)</td>
</tr>
<tr>
<td></td>
<td>・Any loans to third parties may not exceed 30% of the value of the trust plan’s assets on an actual return basis. However, any rules issued by the CBRC take precedence.</td>
</tr>
<tr>
<td></td>
<td>Article 27(3)</td>
</tr>
<tr>
<td></td>
<td>・The trust money may not be invested, either directly or indirectly, by either shareholders or affiliates of the trust company. However, this does not apply if all a trust plan's money originates from the trust company's shareholders or affiliates.</td>
</tr>
<tr>
<td>Risks and losses to trust property</td>
<td>Article 14</td>
</tr>
<tr>
<td></td>
<td>・Where a trust company manages the entrusted property in line with the trust scheme documents, the risks arising from the management shall be covered by the entrusted property.</td>
</tr>
<tr>
<td></td>
<td>・A trust company that infringes an entrustment contract or causes a loss to the trust property as a result of not taking due care must make good the loss using its own assets. If the trust company is unable to make good the entire loss, the investors must bear the residual loss.</td>
</tr>
</tbody>
</table>

Source: Nomura Institute of Capital Markets Research, from CBRC data
between trust companies and banks where banks market trust products is called *yinxin hezuo* in Chinese.

(2) Repayment problem and outcome

The group used the money to develop its mining business. However, as a result of falling coal prices, problems with local residents, and its failure to obtain a mining license, the group found itself unable to repay its debts by the redemption deadline of 31 January 2014. This became public knowledge on 20 December 2013. As a result, according to a report in the *Shanghai Securities News* on 24 January 2014, the selling agent, Industrial and Commercial Bank of China (Shanghai Branch), announced on 23 January 2014 (1) that it would honor its responsibilities towards investors and (2) that it would publish a bailout plan by 28 January.

Subsequently, on 27 January, according to a 28 January 2014 report by *China Securities Journal*, China Credit Trust offered just over 700 investors the option of either (1) accepting repayment of only the principal by a third party and foregoing any payment of interest or (2) extending the tenure of the trust product (with no guarantee of (re)payment of either principal or interest) in what amounted to an agreement to repay the RMB3.0 billion of principal. We see this as an attempt to resolve the issue before the Chinese New Year holiday, which, as it happens, was due to begin on the mainland on 31 January. However, no one knows who

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9 The interest rate set by the People’s Bank of China on ordinary savings accounts is 0.35%, while that on one-year savings deposits is 3.00%. (Both rates have applied since 6 July 2012.)
assumed responsibility for repaying the principal or where the money came from.

It is not clear which of the provisions of Article 14 of the Rules on Trust Schemes of Collective Funds by Trust Companies applied in the case of “Credit Equals Gold #1.” However, the fact that investors were given the choice of either having the scheme taken over by a third party or having the trust period extended suggests to us that it was probably the provisions that apply when trust property is at risk. As far as the identity of the third party is concerned, some take the view that it was (1) China Credit Trust, Industrial and Commercial Bank of China, or the Shanxi provincial government, while others take the view that it was (2) China Huarong Asset Management, a bad-debt manager affiliated to ICBC. However, ICBC, the Shanxi provincial government, and Huarong all deny any involvement. Whatever the truth of the matter, the assets underlying the loan to Zhenfu Energy Group still exist, and investors will want to know how they are going to be managed and recovered.

III-3. Other functions and institutions

We now deal with the existing regulations and regulators connected with the shadow banking institutions and functions covered in Chen Daofu (2014). Each is likely to be subject to change as a result of the comprehensive and stricter regulation envisaged by the State Council in its “Document No. 107.”

(1) Securities companies

Securities companies’ investment plans are an investment management service provided by securities companies (fund managers) to clients (investors) on the basis of an agreement between the two that the securities company will invest in and manage securities and other financial products on the client’s behalf. Licenses are granted by the CSRC. On 26 June 2013 the CSRC promulgated the Measures for the Administration of the Customer Asset Management Business of Securities Companies with immediate effect.

The measures divide securities companies’ investment plans into two main categories. The first is what are called “directional asset management plans” (i.e., one-to-one asset management agreements between securities companies and their clients). This corresponds to what is referred to as “SMAs” (separately managed accounts) in Japan. Such plans are originated and marketed by Chinese securities companies for specific clients, and the range of investments is specified in each agreement. Only investors with a minimum of RMB1 million to invest per plan are considered. The second is what are called “collective asset management plans” (i.e., one-to-many asset management agreements between securities companies and their clients). This corresponds to privately placed investment trusts in Japan. Such plans are originated and marketed to groups of no more than 200 qualified investors in China.

They may be marketed by banks as joint bank/security company products (yinzheng hezuo). According to CASS (2013), the outstanding amount of such asset management products increased sharply from RMB200 billion as of the end of 2011 to RMB1,890 billion...
as of the end of 2012. It attributes the increase to efforts to evade tighter regulation of joint bank/trust company products (yinxin hezuo).

(2) Entrusted loans

The legal basis for entrusted loans is the General Rules on Loans promulgated by the PBOC on 28 June 1996. According to Article 7, “‘Entrusted loans’ shall refer to loans for which the funds are provided by an entrusting party such as a government department, a unit of an enterprise or institution, or an individual, and of which the use is supervised and the recovery assisted by the lender (being the entrusted party) in accordance with the loan beneficiary, purpose, amount, term, interest rate, etc. determined by the entrusting party.” In addition, “The lender (being the entrusted party) receives only a handling fee but does not bear the loan risk.”

The PBOC publishes figures for the amount of entrusted loans each year as part of its figures for social financing. The figure for 2013 (RMB2,546.5 billion or 14.7% of social financing) marks a significant increase, both in the amount and the proportion, on the figures for 2010 (RMB874.8 billion or 6.2%), 2011 (RMB1,296.2 billion or 10.1%), and 2012 (RMB1,283.8 billion or 8.1%).

Also, according to China Financial Stability Report 2014, published by the PBOC in April 2014, there was RMB8,200 billion in entrusted loans outstanding as of the end of 2013.

(3) Financial leases

In China, financial leasing companies are licensed by the CBRC if they are funded and established by banks but by the Ministry of Commerce if they are funded and established by leasing companies, including leasing companies affiliated to banks.

In the former case, financial leasing companies are governed by the Measures for the Administration of Financial Leasing Companies promulgated by the CBRC on 23 January 2007 with effect from 1 March 2007 and amended on 17 March 2014 with immediate effect. In the latter case, they are governed by the Management Measures on Foreign Investments in the Leasing Industry, promulgated by the Ministry of Commerce on 3 February 2005 with effect from 5 March 2005, if they are established by a foreign-invested company.

There are no official statistics on financial leasing companies regulated by the CBRC. As far as risk management is concerned, financial leasing companies are required to meet the same capital adequacy standards as commercial banks. As amended on and with effect from 17 March 2014, the measures ease a number of restrictions on financial leasing companies, abolishing the requirement for their principal shareholder to own at least 50% of their shares, and allowing them to establish subsidiaries and to engage in a wider range of activities, including investing in fixed-income securities. We see the easing of restrictions on financial leasing companies as a possible indication that they are expected to engage in shadow

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10 [www.cbrc.gov.cn/chinese/home/docView/9E195304AEAB4E918C3AC1EF7F2CB566.html](http://www.cbrc.gov.cn/chinese/home/docView/9E195304AEAB4E918C3AC1EF7F2CB566.html)
banking as well as part of a move to open up China’s services industry following the creation of the Shanghai Pilot Free Trade Zone as a testing ground for the deregulation of inward direct investment in September 2013.

(4) Pawnshops

Pawnshops are regulated by the Ministry of Commerce and the Ministry of Public Security in accordance with *Measures for the Administration of Pawn*, which came into effect on 1 April 2005.

Article 2 of the measures defines “pawnning” as “the act that a pawner gives his or her chattel or property rights to a pawnshop as a pledge for pawned item or gives his or her real estate to the pawnshop as a mortgage for the pawned item, pays expenses at a certain rate, obtains pawn money and then, within the agreed period of time, redeems the pawned item by repaying the pawn money and the interest thereof.” Similarly, it defines “pawnshop” as an enterprise juridical person that is established according to the present Measures and specially engages in the pawning activities.”

The commercial aspects of the pawn industry are regulated by the Ministry of Commerce, while the law-and-order aspects are regulated by the Ministry of Public Security. Although pawnshops are not directly licensed by China’s financial authorities, they are, to all intents and purposes, financial service companies and are therefore classified as shadow banking institutions (e.g., by both *China Financial Stability Report 2013* and Chen Daofu (2014). According to *China Financial Stability Report 2013* and *China Financial Stability Report 2014*, there were 6,084 registered pawnshops in China as of the end of 2012 and 6,833 as of the end of 2013, respectively.

(5) Small-loan companies

Beginning in 2005, pilots were carried out of privately funded, non-deposit-taking small-loan companies in five areas (Shanxi Province, Guizhou Province, Sichuan Province, Shaanxi Province, and the Inner Mongolia Autonomous Region). The aim was to provide financial services for SMEs and microenterprises.

On 5 May 2008, the PBOC and CBRC promulgated *Guiding Opinions on the Pilot Operation of Micro-credit Companies*. The opinions allow the establishment of small-loan companies as either limited liability companies or joint stock limited companies licensed and regulated by provincial governments. In addition, they may be funded by loans from up to two financial institutions as well as by shareholders’ equity or donations.

Although small-loan companies are not directly licensed by China’s financial authorities, they are, to all intents and purposes, financial service companies and are therefore classified as shadow banking institutions (e.g., by both *China Financial Stability Report 2013* and Chen Daofu (2014). However, the PBOC does publish regular statistics on these companies. As of end-2013, there were 7,839 small-loan companies with a total of RMB819.1 billion in loans outstanding. New lending by these companies amounted to RMB226.8 billion in 2013.
(6) Financing guarantee companies

Financing guarantee companies in China, which could be said to be the Chinese equivalent of monoline insurers, are governed by Interim Measures for the Administration of Financing Guarantee Companies, jointly promulgated by the various government departments involved on 8 March 2010. The seven departments involved were the CBRC, the National Development and Reform Commission (NDRC), the Ministry of Industry and Information Technology, the Ministry of Finance, the Ministry of Commerce, the PBOC, and the State Administration for Industry & Commerce (SAIC).

Article 2 of the interim measures defines a “financing guarantee” as “the actions by which the guarantor enters into a contract with creditors, including banking financial institutions, stating that it/he will assume the liabilities as agreed in the contract when the guaranteed party fails to fulfill its/his obligations to the creditors.” Similarly, it defines a “financing guarantee company” as “a limited liability company or joint stock limited company that is duly established and engages in the financing guarantee business.” Financing guarantee companies are licensed and regulated by the government of the province in which they are located.

Although financing guarantee companies are not directly licensed by China’s financial authorities, they are, to all intents and purposes, financial service companies and are therefore classified as shadow banking institutions (e.g., by both China Financial Stability Report 2013 and Ba Shusong (2013). According to China Financial Stability Report 2013 and China Financial Stability Report 2014, there were 8,590 registered financing guarantee companies in China as of the end of 2012 and 8,185 as of the end of 2013, respectively.

(7) Money market funds

The money market funds classified by China Financial Stability Report 2013 and Ba Shusong (2013) as part of the shadow banking system are subject to the Securities Investment Fund Law, promulgated on 28 October 2003 with effect from 1 June 2004 and amended with effect from 1 June 2013.

In particular, money market funds are governed by the Interim Provisions for the Administration of Money Market Funds jointly promulgated by the CSRC and the PBOC on 16 August 2004.

(8) Private equity funds

The private equity funds classified by China Financial Stability Report 2013 as part of the shadow banking system are officially regulated by the CSRC under the Securities Investment Fund Law as amended with effect from 1 June 2013 (“new fund law”).

As well as incorporating a new chapter (“Non-publicly Offered Funds,” Chapter 10) and restricting investment in private funds to a maximum of 200 qualified investors as a rule (Article 88), the new fund law requires fund managers of private equity funds to be registered with the Asset Management Association of China (Article 90).

Subsequently, on 17 March 2014, the Association granted licenses and registration
certificates to 50 private equity fund managers, thereby harmonizing the treatment of investment in privately placed securities, equities, and venture companies by private equity funds and putting them officially under government regulation. As of 11 May 2014, 1,559 companies were already registered as private equity fund managers.

(9) Private-sector lenders

As far as private-sector lending is concerned, the Certain Opinions on the Court’s Trial for Lending Cases, issued by the Supreme People’s Court on 13 August 1991, permits private-sector lenders to charge higher interest rates than banks but not more than four times higher rates for loans of the same period, thereby acknowledging that private-sector loans are not illegal while placing a cap on them.

In particular, rural mutual credit cooperatives are governed by the Interim Provisions on the Administration of Rural Mutual Cooperatives promulgated by the CBRC with effect from 22 January 2007.

Article 2 of the interim provisions defines “rural mutual cooperatives” as “community-based mutual banking financial institutions which are jointly funded by the farmers of a township (town), administrative village, and rural small enterprises with the approval of the CBRC and provide their members with financial services such as deposits, loans and settlements.” According to China Financial Stability Report 2013, there were some 16,000 rural mutual cooperatives as of the end of 2012.

IV. Position of Chinese government

IV-1. New approaches to shadow banking

IV-1-1. Rise of Internet finance

(1) Types of Internet finance

As we have seen, the wide range of institutions and functions classified as shadow banking in Chen Daofu (2014) generally have their own regulations and regulators, while the regulation of bank wealth management products and trust products has been tightened. At the same time, a new type of shadow banking has emerged that has slipped through the regulatory net: Internet finance.

Yang Xiaochen and Zhang Ming (2013) distinguish three different types of Internet finance in China. The first is Internet lending. Otherwise known as P2P social finance, the leading providers of this service in China include companies such as Yixin, Renrendai, and PaiPaiDAI. The second is Internet wealth management. This business, whether conducted by a traditional financial institution or an Internet company, involves issuing wealth management products on the Internet, investing the money raised, and using the return on the investment to pay principal and interest to the investors in the wealth management products. One of the leading providers of this service is the Yu’ebao platform of Internet giant Alibaba. The third
is Internet payment and settlement. This service involves using the Internet as a third-party payment platform to provide payment and settlement services to Internet shopping customers. One of the leading providers of this service is Alibaba’s Zhifubao platform. Of these providers, however, it is Yu’ebao that has caused a stir among market participants and is at the center of the debate on the future of Internet finance in China.

(2) The case of Alibaba

To begin with, we need to say a word or two about Zhifubao. Zhifubao is the largest third-party online payment platform in China and is operated by Alipay (www.alipay.com), a member of the Alibaba e-commerce group founded in 2004. The platform was launched by Taobao, a member of the Alibaba Group founded in 2003 and the largest C2C shopping site in Asia.

Some 800 million accounts are reported to be registered with Zhifubao (as of end-June 2013); daily turnover is reported to be some RMB6 billion (as of end-January 2013); and a record 188 million transactions per day are reported to have been conducted via the platform (as of end-December 2013).

Yu’ebao, which was launched by Zhifubao in June 2013, enables individual account holders to invest the balances of their accounts (Figure 8). (yu’e means “balance of account” in Chinese.) The first product that users of Yu’ebao have been able to invest in is Tianhong Asset Management’s money market fund Tianhong Zenglibao. Yu’ebao users can also use their accounts to make payments (e.g., for Internet purchases or electricity bills).

The minimum amount for payments or investments is RMB1. Considering that the minimum investment amounts for bank wealth management products, trust products, and normal money market funds are RMB50,000, RMB100,000, and RMB1,000, respectively, the ability to invest small amounts is an attractive feature. Settlement for Yu’ebao payments is T + 0, and liquidity has not been an issue. The rate of return (the annualized one-week interest rate) is 5.864% (as of 5 March 2014). This is also an attractive feature, considering that the interest rate set by the PBOC on ordinary savings accounts is 0.35% and that on one-
year savings deposits 3.00%. (Both rates have applied since 6 July 2012.) Reflecting Yu’ebao’s features, the bulk of its users are reported to be young people in their twenties or thirties.

Since Yu’ebao was launched in June 2013, the amount outstanding in user accounts has continued to increase. As a result, Tianhong Asset Management’s assets under management have risen sharply to RMB197.9 billion (as of the end of 2013), putting it in second place behind China Asset Management with RMB288.6 billion. As of end-February 2014, the amount outstanding in Yu’ebao accounts was reported to have passed the RMB400 billion mark.

(3) Rapid growth of money market funds

We now take a look at the Chinese market for money market funds as a whole. The value of Chinese money market funds increased from RMB571.7 billion as of the end of December 2012 to RMB1,457.8 billion as of the end of March 2014 (Figure 9). We can see that the increase has been particularly marked since the launch of Yu’ebao in June 2013.

The rapid growth of Yu’ebao has been matched by outflows from bank deposits, and the platform has been seen as posing a threat to smaller banks, in particular. Another point to bear in mind is that Yu’ebao invests in the money (interbank) market, where most of the
activity is in bonds (bank debentures) and ultra-short-term negotiated deposits, and that it has
taken advantage of the interest rate rises in that market (see Figure 1 above). What this means
for banks is that money is flowing out of their ordinary savings accounts only to reappear
(via Yu‘ebao) on their balance sheets as a liability, namely in the form of high-interest-rate
negotiated deposits. There have therefore been increasing calls from the banks for tighter
controls on Internet finance. On the other hand, there have been calls from securities
companies, mindful of the liquidity money market funds add to the money market and the
role they have played in anticipating the deregulation of interest rates, to allow them to
continue to develop, subject to proper risk management.

IV-1-2. Regulatory policy on Internet finance

(1) CSRC’s views

The CSRC has also voiced its views on how Internet finance should be regulated. The
following is a summary of comments by a CSRC spokesman at press conferences on 14 and
28 February 2014. There were also comments on money market funds, namely that some had
used inappropriate marketing methods.

(Assessment of Internet finance)

The development of Internet finance has not only taken advantage of modern information
technology but also improved the quality, quantity, and efficiency of financial services,
reduced the cost of financial transactions, and made it easier for SMEs and microenterprises
to borrow.

Internet finance is essentially still finance. Therefore it needs to comply with the financial
rules and regulations currently in force. At the same time, there are some non-traditional
aspects to Internet finance, and these must also be regulated.

(On Yu‘ebao)

Yu‘ebao is a very convenient, high-value-added service for users of Zhifubao and is
essentially an innovative combination of a third-party payment service and a money market
fund. Under the Yu‘ebao model, Zhifubao is not involved in marketing the fund; nor does it
interfere in the fund’s investment operations. All it does is act as a portal for customers.

Yu‘ebao is a by-product of interest rate deregulation and the growth of the Internet in
China. In order to ensure that Yu‘ebao and other Internet funds continue to develop steadily
and in a healthy manner, the CSRC will require money market funds to improve their risk
management and is currently devising rules for regulating funds sold on the Internet.

(2) PBOC’s views

The PBOC has also posted its views on Internet finance on its website (as of 24 March
2014).11 This follows the incorporation of a policy to foster the healthy development of
Internet finance in the Government Work Report delivered to the National People’s Congress
earlier this year. The PBOC’s views are as follows.

First, third-party payment and settlement via the Internet is governed by the *Measures for the Administration of Payment Services of Non-financial Institutions*, which came into effect on 1 September 2010. Article 2 of the measures defines “online payment” as “the act of transferring monetary funds between the payer and the beneficiary through a public network or special network” and gives “online payment” as one example. However, the measures do not say whether interest may be paid on money paid in advance as part of the payment process. Nor do they forbid this.

Second, in August 2013, the State Council published *Several Opinions on the Promotion of Consumer Spending on Information Technology to Expand Domestic Demand*, in which it set out policies to (1) foster innovations in Internet finance and (2) regulate Internet financial services. This is why the PBOC has invited public comment on draft measures for the administration of network-based payments by payment organizations.

It is on the basis of such views and the following principles that the PBOC sets out its plans to introduce a system of regulating Internet finance in order to support its sound development.

First, innovations in Internet finance must be based on the fundamental principle of providing a financial service to the real economy, and their limitations and level must be properly understood.

Second, innovations in Internet finance must be subject to the overall requirements of macroprudential controls and financial stability.

Third, consumers’ legal rights must be safeguarded.

Fourth, the market must remain a level playing field.

Fifth, a proper balance must be struck between government regulation and industry self-regulation.

For the time being we will have to wait and see what final form the draft measures for the administration of network-based payments by payment organizations take. However, in order to prevent an explosion in demand and ensure a soft landing, there may initially be daily, monthly, or annual limits on payment amounts or the amount of spare cash that may be invested.

**IV-2. Likely course of regulation**

IV-2-1. Regulation of shadow banking

The aforementioned *China Financial Stability Report 2013* also contains some policies...
for regulating shadow banking. However, following the liquidity problems on the interbank market in May–June 2013 and by the end of that year, the State Council issued comprehensive policies to all central government departments on how shadow banking should be regulated. These policies are based on a document entitled *Notice of the General Office of the State Council on Relevant Issues Concerning the Strengthening of the Supervision of the Shadow Banking System*, but generally called *Document No. 107* after its number.

Although the document is an internal government circular and has never been published, copies have been circulating on the Internet. The following are its main points.

(Categories of shadow banking)

It argues that, although China’s shadow banking system is largely controllable and has given rise to some useful innovations, it is also complex, opaque, vulnerable, volatile, and contagious, and the risks it poses to the financial system need to be controlled. In addition, the document divides China’s shadow banking system into the following three categories.

The first is unlicensed and completely unregulated operators. The document gives as examples independent financial advisors and new types of Internet finance.

The second is unlicensed and inadequately regulated operators. The document gives as examples financing guarantee companies and small-loan companies.

The third is operators that are licensed but either inadequately regulated or evading regulation. The document gives as examples money market funds, securitized products, and some wealth management services.

(Need for clearer division of responsibility)

Document No. 107 clarifies the division of responsibility among regulators. It proposes the following.

First, for those operations where the law is clear about the division of responsibility among regulators, the relevant agencies should divide their responsibilities in accordance with the law and adopt a common approach to regulation. In the case of the wealth management operations of financial institutions, each regulatory agency should act as regulator in accordance with the principle that the State Council’s regulatory agency should combine its legal responsibility and both on- and off-balance-sheet operations. For example, the CBRC should regulate the wealth management operations of banking institutions. Similarly, the CSRC should regulate the wealth management operations of securities and futures institutions and private investment funds, while the China Insurance Regulatory Commission (CIRC) should regulate the wealth management operations of insurance companies. In the case of operations involving more than one market or third-party payment operations, the PBOC should act as regulator and arbitrator.

Second, for those operations where the law is clear that the relevant agencies of the State Council are responsible for devising the rules, and local governments for ensuring that they

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are complied with, local governments should exercise their responsibilities on the assumption that they are enforcing consistent rules. In the case of financing guarantee companies, local governments should be responsible for detailed regulation in accordance with a consistent system of regulation and corporate governance rules devised by an interagency panel on financing guarantee operations chaired by the CBRC. In the case of small-loan companies, a self-regulatory organization should exercise self-regulation while local governments should be responsible for detailed regulation at the provincial level in accordance with a consistent system of regulation and corporate governance rules devised by the CBRC and the PBOC.

Third, for those operations where local governments are clearly responsible for regulation and the State Council is clearly the government agency responsible, local governments should be responsible for detailed regulation in accordance with a consistent set of requirements from the government agency responsible, while the government agency responsible should take the lead in devising the necessary laws and policies.

Fourth, for those operations where the law is not clear who the regulator should be, urgent action is required to clarify the situation. In the case of independent financial advisors, securitized products from nonfinancial institutions, and Internet finance, the PBOC will devise rules together with the relevant agencies.

(Creation of regulatory system and rules)

According to the principle of separate regulation for each financial subsector, Document No. 107 envisages the creation of a regulatory system and rules for (1) wealth management services, (2) trust services, (3) collaboration between banks and trust companies or securities companies, (4) private-sector loans (small-loan companies, pawnshops, financial leases), (5) financing guarantees, (6) Internet finance, and (7) private investment funds.

The document contains the following policies for improving the regulation of wealth management services. First, each financial regulator would closely monitor the wealth management operations of financial institutions in accordance with the requirement to manage assets on behalf of customers and the principles of “buyer beware” and “seller perform.” To be more specific, each financial institution should manage its wealth management operations separately from its other operations, set up a separate organizational structure, and make it subordinate to one specialist department. At the same time it should set up a separate regulatory structure for its wealth management operations as well as separate books and bank account management. Each regulator should set up a separate operational regulatory structure and improve its oversight of all operational processes. Second, commercial banks should account for their capital and loan-loss reserves according to the principle that reality is more important than appearance. Third, commercial banks should separate the money they manage on behalf of their wealth management clients from their own money and not use it to purchase bank loans or for liquidity pools, ensuring that the sources and applications of funds match. Securities companies need to improve how they manage their capital, while insurance companies need to improve their ability to pay insurance benefits.
Also, trust companies need, first, to clarify their role as trustees and revert to their traditional business model. Second, they should use their net capital management to impose discipline on their lending operations and not engage in shadow banking activities such as liquidity pools that use unconventional assets. Third, a system is needed for recording information about trust products, and consideration should be given to creating a secondary market for trust beneficiary rights.

In addition to the above, Document No. 107 calls on the regulators (1) to prevent and control risks by means of monitoring, inspections, and administrative penalties; and (2) to implement related measures (such as greater cooperation among regulators, better statistics, a better system of social financing, and greater regard for public opinion) sooner rather than later. We think China’s financial regulators are now likely to draw up a division of responsibility amongst themselves and implement it step by step.

IV-2-2. Regulating the banking system

(Regulating the liquidity of the interbank market)

We think the problem of the liquidity of the interbank market is likely to recur as improvements are made to regulating shadow banking. Although, as in May–June 2013, the PBOC would probably be able to avoid a dislocation by supplying liquidity to the market, in the longer term the financial institutions that participate in the market need to manage liquidity themselves.

With regard to commercial banks, the CBRC issued *Measures for the Liquidity Risk Management of Commercial Banks (for Trial Implementation)* on 17 January 2014 (published on 19 February 2014) with effect from 1 March 2014.\(^{13}\)

Based on the text of the finalized *Liquidity Coverage Ratio* published by the Basel Committee on 7 January 2013, the CBRC document represents similar measures. The ratio is the minimum requirement for banks to have enough liquidity for 30 days in the event of a liquidity shortage and, like the Basel Committee’s ratio, must be fully implemented by each bank, after a transition period, by 2018. The situation envisaged by Article 23 of the Measures includes (1) increased demand for liquidity for off-balance-sheet operations and (2) a serious reputational risk. In the former case, it is envisaged that problems arise when banks try to roll over wealth management products they hold off their balance sheets. In the latter case, it is envisaged that a commercial bank that has sold off-balance-sheet wealth management products is obliged to assume some degree of responsibility for their repayment even though this risk should, strictly speaking, be borne by the investors. The Measures require the CBRC to monitor the impact on banking liquidity of changes in the economic and financial situation, and allow it to take appropriate action, if necessary.

As was mentioned above, banks are now required to recognize trust products created in collaboration with trust companies on their balance sheets. We therefore consider how they deal with any loan assets that become non-performing.

After China joined the World Trade Organization (WTO) in 2001, it adopted the international five-category system of classifying loans as “pass,” “special-mention,” “substandard,” “doubtful,” or “loss,” the last three being considered “non-performing.” Disclosure is required every quarter.

As of end-December 2013, non-performing loans amounted to RMB592.1 billion (Figure 10), a ratio of 1.00%. As of end-March 2014, both the amount (RMB646.1 billion) and the ratio (1.04%) were higher. After the end of 2008, when Agricultural Bank of China cleaned up most of its non-performing loans, non-performing loans have declined, reaching RMB407.8 billion as of end-September 2011. Since then, they have edged higher. Meanwhile, loan-loss reserves stood at RMB1,674.0 billion, a loan-loss reserve coverage ratio of 282.7%, as of end-December 2013. As of end-March 2014, they had increased to RMB1,768.0 billion, while the loan-loss reserve coverage ratio had declined by 9.04 percentage points to 273.66%. The loan-loss coverage ratio has been increased, in accordance with Article 7 of the CBRC’s Administrative Measures for the Loan Loss Reserves of Commercial Banks (issued on 27
July 2011 with effect from 1 January 2012), to the greater of either (1) 150% of non-performing loans or (2) 2.5% of loans outstanding. Although the current level of loan-loss reserves is said to be adequate for any increase in non-performing loans, one solution to the need to trim loan assets as part of any adjustment to commercial bank balance sheets would be to securitize them.

China’s securitization market made a trial start in 2005. Although approval is required from the financial authorities (PBOC, CBRC, and CSRC), the securitization of loan assets, housing loans, non-performing loans, and auto loans has taken place on the interbank bond market, while the securitization of specific cash flows has taken place on the country’s stock exchanges. However, following the global financial crisis of 2008, the issue of new securitized products was suspended from 2009 to 2011 but resumed in 2012. Following the resumption, China’s National Association of Financial Market Institutional Investors (NAFMII) issued Guidelines on the Asset-backed Notes of Non-financial Enterprises in the Interbank Bond Market on 4 August 2012. This was followed, on 15 March 2013 (with immediate effect), by the issue by the CSRC of Provisions on the Asset Securitization Business of Securities Companies. On 28 August 2013, an executive meeting of the State Council decided to expand the securitization of loan assets on a trial basis. The focus was to be on the rural economy, microenterprises, old housing stock, and infrastructure projects, with the option of listing the securitized products on stock exchanges. In 2013, RMB19.8 billion of securitized products was issued on the interbank bond market, while in the first fourth months of 2014 alone RMB55.3 billion was issued.

Another option besides securitization would be to use the asset management companies (AMCs) set up by the four major state-owned commercial banks in 1999. In particular, Cinda Asset Management Corporation, which was listed on the Hong Kong Stock Exchange in December 2013, still has the disposal of non-performing loans as its main business. There have also been moves by a number of local governments to set up asset management companies. We therefore need to keep our eyes on these companies to see how the banks adjust their balance sheets.

IV-2-3. Use of Basel III regulatory framework

(Fixing the time horizon)

At a press conference he gave in March 2014, after the close of the second National People’s Congress held under China’s new leadership, Premier Li Keqiang said with regard to the risks to the financial system (e.g., from shadow banking) (1) that regulation was being tightened and (2) that a timetable had been fixed for the implementation of Basel III. In terms of Premier Li Keqiang’s press conference, we could summarize this report by saying (1) that Document No. 107 is an attempt by the State Council at comprehensive regulation of China’s shadow banking system, (2) that the application of Basel III to domestic banks is an attempt to control market liquidity risks, (3) that the capital adequacy ratio of the banks whose balance sheets have been bolstered as a result of tighter regulation of shadow banking will
meet the Basel III standards, and (4) that the deadline for implementation of Basel III is 2018, leaving four years to normalize China’s shadow banking system.

(Increasing capital adequacy ratios)

With regard to (3) above, the Capital Rules for Commercial Banks (Provisional) issued by the CBRC on 7 June 2012 with effect from 1 January 2013 (China’s equivalent of Basel III) require systemically important banks to raise their capital adequacy ratio to 11.5% by the end of 2018 and other banks to raise theirs to 10.5% by the same deadline.

This breaks down into a core Tier 1 ratio of 5%, a Tier 1 ratio of 6%, and a total capital (Tier 1 + Tier 2) ratio of 8%. Whereas Basel III requires a minimum core Tier 1 ratio of 4.5%, the Chinese rules have raised this by 0.5 percentage points to 5%. Adding a capital buffer of 2.5% gives a core Tier 1 ratio of 7.5%, a Tier 1 ratio of 8.5%, and a total capital ratio of 10.5%. As systemically important banks are subject to a (in China’s case, provisional 1%) capital surcharge, they will ultimately have to have a total capital adequacy ratio of 11.5%. Other banks will have to have a total capital adequacy ratio of 10.5%.

Although bank wealth management products are, effectively, the result of deregulation, their issuance is likely to decline as deposit rates are deregulated. In this connection, we note that PBOC Governor Zhou Xiaochuan commented during the most recent National People’s Congress that, in his own view, deposit rates would be deregulated over the next 1–2 years. We welcome the new leadership’s efforts, such as these, to deal fully and effectively with the risks to China’s financial system (e.g., from shadow banking) by adopting international rules and implementing them within a clear timeframe.

IV-3. Possible risk scenarios

IV-3-1. Repayment problems and defaults

As Premier Li Keqiang indicated at the aforementioned press conference, China’s new leaders appear to regard defaults on at least some financial products as inevitable. This marks the end of the age of the “implicit guarantee” (literally, “rigid redemption”) referred to in China Financial Stability Report 2013. China Financial Stability Report 2014 also refers to the need for the “orderly breaking [of] the practice of ‘rigid redemption’ of wealth management products.” As was mentioned above, a number of trust products and listed (publicly offered) corporate bonds encountered repayment difficulties early in 2014. We can envisage two possible scenarios for these products.

First of all, trust products. The commercial banks that market these products are not responsible for their redemption. However, if they did accept some of the responsibility in order to preserve their reputation, overseas credit rating agencies would regard the amounts as contingent liabilities on the banks’ balance sheets and possibly lower their ratings. In particular, if banks listed on overseas exchanges were subject to a possible re-rating, this could have a knock-on effect on overseas financial markets (Scenario 1).
Second, if a large number of trust products encountered repayment difficulties, even if confined to particular parts of the country or sectors of the economy, this could have a knock-on effect, especially on domestic financial markets, if other companies in the same sector with corporate bonds were re-rated. This would inevitably affect the confidence of overseas investors, as well (Scenario 2).

In either case, if there was a knock-on effect on financial markets, the initial response of the government, including the financial authorities, and especially the dissemination of news to market participants and proposals for a convincing resolution, would clearly be crucial. Premier Li’s approach is to improve monitoring, deal promptly with any defaults, and to avert any regional or systemic risks.

IV-3-2. Scale of banks’ off-balance-sheet operations

According to China Financial Stability Report 2014, trading among banks on the interbank market is called tongyeyewu (literally, “same-business business”) in Chinese. It appears that the volume of this trading has increased sharply in recent years.

First of all, the value of interbank traded assets (deposits with other banks, call loans, and purchases/sellbacks) increased from RMB6,210.0 billion as of the beginning of 2009 to RMB21,470.0 billion as of the end of 2013. This is an increase of RMB15,260.0 billion or 246% and is 1.79-fold the increase in banks’ total assets and 1.73-fold the increase in their outstanding loans during the same period. The value of interbank traded liabilities (deposits, call borrowings, and sales/buybacks) also increased during this period: from RMB5,320.0 billion to RMB17,870.0 billion. This is an increase of RMB12,550.0 billion or 236% and is 1.74-fold the increase in banks’ total liabilities and 1.87-fold the increase in their outstanding deposits during the same period. China Financial Stability Report 2014 points out that interbank traded assets and liabilities have both grown much more rapidly than either bank loans or deposits and that this entails a certain degree of risk. Hence the great importance of banks’ achieving the liquidity coverage ratio required by Basel III.

In addition, bank off-balance-sheet assets outstanding (including entrusted loans and entrustment investment) stood at RMB57,700.0 at the end of 2013, RMB9,500.0 billion or 18.6% more than at the end of 2012. Off-balance-sheet assets, on the other hand, were 38.12% the amount of on-balance-sheet assets, having grown by 1.71% since the end of 2012.

China Financial Stability Report 2014 points out that some commercial banks have transferred non-performing assets from their balance sheets (e.g., in order to evade regulators or invest in restricted industries or sectors), thereby obscuring the risks to their loan assets. Hence the great importance of shadow banking institutions’ putting their assets back on their balance sheets and achieving the capital adequacy ratios required by Basel III as well as of managing bank liquidity.
IV-3-3. PBOC’s stress tests

This raises the question of how bank capital adequacy ratios will be affected once banks put their off-balance-sheet operations back onto their balance sheets and if problems arise with their on-balance-sheet loan assets and these become non-performing. China Financial Stability Report 2014 reports the results of stress tests carried out on banks regarded as systemically important (D-SIBs) by the Chinese government according to their financial statements for the end of 2013.

The following are the assumptions behind the stress tests. First, the tests were carried out on the 17 banks that are either major commercial banks or joint-stock commercial banks and that accounted for 61% of total bank assets as of the end of 2013. Second, the tests consist of external tests conducted by the PBOC and internal tests conducted by the banks themselves. Third, the tests are divided into three risk categories: credit risk, market risk, and liquidity risk.

The following are the results of the tests for credit risk.

(Rise in non-performing loan ratio)

The stress tests for sensitivity to credit risk included the following scenarios: (1) a low-stress scenario where the non-performing loan ratio rises to double its current level; (2) a moderate-stress scenario where it rises to 3.5 times its current level; and (3) a severe-stress scenario where it rises to 5 times its current level. The capital adequacy ratio at the initial stress level was 11.98%. This declined to (1) 11.61% in the low-stress scenario, (2) 11.06% in the moderate-stress scenario, and (3) 10.5% in the severe-stress scenario.

In the case of the major commercial banks, the capital adequacy ratio at the initial stress level was 12.57%. This declined to (1) 12.17% in the low-stress scenario, (2) 11.56% in the moderate-stress scenario, and (3) 10.94% in the severe-stress scenario. In the case of the joint-stock commercial banks, the capital adequacy ratio at the initial stress level was 10.55%. This declined to (1) 10.27% in the low-stress scenario, (2) 9.85% in the moderate-stress scenario, and (3) 9.43% in the severe-stress scenario.

As the capital adequacy ratio at the initial stress level at the end of 2012 was 12.92% and this declined to (1) 12.54% in the low-stress scenario, (2) 11.92% in the moderate-stress scenario, and (3) 11.37% in the severe-stress scenario, we can say that stress tolerance declined slightly in the course of 2013.

(Economic slowdown)

The macro-economic stress tests for credit risk included the following scenarios: (1) a low-stress scenario where the GDP growth rate declines to 7%; (2) a moderate-stress scenario where it declines to 5.5%; and (3) a severe-stress scenario where it declines to 4%. The capital adequacy ratio declined to (1) 11.79% in the low-stress scenario, (2) 11.23% in the moderate-stress scenario, and (3) 10.17% in the severe-stress scenario. As the capital adequacy ratio at the end of 2012 declined to (1) 12.40% in the low-stress scenario, (2)
11.33% in the moderate-stress scenario, and (3) 9.77% in the severe-stress scenario, we can say that stress tolerance declined slightly in the course of 2013 in the low- and medium-stress scenarios but improved slightly in the severe-stress scenario.

Of the 17 banks, 14 had an initial capital adequacy ratio of more than 10.5%, but the number declined to (1) 11 in the moderate-stress scenario, (2) 7 in the medium-stress scenario, and (3) 3 in the severe-stress scenario.

As of the end of 2012, 11 of the 17 banks had an initial capital adequacy ratio of more than 11.5%. The number remained at (1) 11 in the moderate-stress scenario but declined to (2) 9 in the medium-stress scenario, and (3) 3 in the severe-stress scenario. Although we cannot directly compare the data at the end of 2012 with those at the end of 2013 because the benchmarking level of capital adequacy requirements was different, the fact that as many as 14 of the 17 banks failed to achieve a capital adequacy ratio of 10.5% in the severe-stress scenario at the end of 2013 suggests to us that the negative impact of the economic slowdown on the banks’ balance sheets had increased.

(Loans to local government financing vehicles)

The stress tests for sensitivity to credit risk included the following scenarios: (1) a low-stress scenario where the ratio of non-performing loans to particular industries is 5ppt higher than the current level; (2) a moderate-stress scenario where it is 10ppt higher; and (3) a severe-stress scenario where it is 15ppt higher.

In the severe-stress scenario where banks lend to local government financing vehicles, nine of the banks had a capital adequacy ratio of 10.5% or more, seven a ratio of between 8.9% and 10.5%, and one a ratio of 8.9% or less. As of the end of 2012, eight of the banks had a capital adequacy ratio of 11.5% or more, seven a ratio of between 10.5% and 11.5%, and two a ratio of less than 10.5%. Although we cannot directly compare the data at the end of 2012 with those at the end of 2013 because the benchmarking level of capital adequacy requirements was different, the fact that as many as eight of the 17 banks failed to achieve a capital adequacy ratio of 10.5% in the severe-stress scenario at the end of 2013 indicates that we need to keep a close eye on the negative impact of increasing non-performing loans on the banks’ balance sheets.

(Banks’ on-balance-sheet/off-balance-sheet exposure to wealth management products)

The stress tests for sensitivity to credit risk included the following scenarios: (1) a low-stress scenario where exposure to on- and off-balance-sheet wealth management products results in a 10% loss to the outstanding amount; (2) a moderate-stress scenario where it results in a 20% loss; and (3) a severe-stress scenario where it results in a 30% loss. The exposure is to (bank) loan wealth management products and excludes fixed-income-type, deposit-type, capital market trust-type, and qualified domestic institutional investor (QDII)-type wealth management products.

In the severe-stress scenario where banks suffer losses as a result of their on- and off-balance-sheet exposure to wealth management products, six of the banks had a capital
adequacy ratio of 10.5% or more, 10 a ratio of between 8.9% and 10.5%, and one a ratio of 8.9% or less. As of the end of 2012, eight of the banks had a capital adequacy ratio of 11.5% or more, four a ratio of between 10.5% and 11.5%, and five a ratio of less than 10.5%. Although we cannot directly compare the data at the end of 2012 with those at the end of 2013 because the benchmarking level of capital adequacy requirements was different, the fact that as many as 11 of the 17 banks failed to achieve a capital adequacy ratio of 10.5% in the severe-stress scenario at the end of 2013 indicates that we need to keep a close eye on the negative impact of increasing non-performing bank wealth management products on the banks’ balance sheets.

IV-3-4. Market participants’ views on the risks and required action

We now consider what market participants themselves think about the above risks to banks from their on- and off-balance-sheet operations. As an example we cite the views of Agricultural Bank of China’s chief economist, Xiang Songzuo, on the risks facing financial markets.\(^\text{14}\) His views are from a *China Securities Journal* article of 8 May 2014.

“2014 is likely to be the first year in which risk, especially the risk of default, emerges on a large scale. About 40% of shadow banking business and 30% of local government debts fall due this year. There is likely to be a sharp increase in non-performing loans in sectors with overcapacity, and property prices are likely to begin to decline. The problem of overcapacity is particularly serious in the manufacturing sector, where the rate of capital flow has already slowed sharply and accounts receivable and payable increased significantly, fueling the demand for short-term bank loans or working capital. Some companies have found themselves unable to repay loans and have requested their banks to lend them more money for this purpose, with refinancing fueling the demand for money. Some banks have been facing constant maturity mismatches. Inflows into products such as Yu’ebao have therefore been the result of outflows from bank savings accounts, with some of this money being lent to banks in urgent need of liquidity and interest rates at a relatively high level. Local government debt, shadow banking, and declining property prices will ultimately all be reflected in mounting non-performing bank loans. [Omitted] Banks need to recapitalize on a massive scale. In the longer term these risks will hamper monetary and lending policies, constraining the growth of lending and debt, and slowing investment and economic growth.”

As Dr. Xiang pointed out, China’s banks will have to recapitalize in order to avert a credit crunch. On 21 March 2014, the CSRC issued, with immediate effect, *Measures for the Pilot Administration of Preferred Stock*, while, on 8 May 2014, Agricultural Bank of China announced that it would issue RMB80.0 billion in preferred stock, the largest such issue in China thitherto. The proceeds will be used to replenish the bank’s Tier 1 capital. As of the

end of 2013, the bank’s Tier 1 capital adequacy ratio was 9.25%, the lowest of China’s four major state-owned commercial banks and an indication that the bank needed to improve its finances. Recapitalizations such as this will probably be necessary for some time. Also, assistance in the form of injections of public capital should be envisaged as a possible risk scenario if capital adequacy ratios deteriorate rapidly as suggested by the stress test outcomes.

V. Conclusion

While shadow banking in China has, as Ba Shusong (2013) points out, some negative aspects, such as circumventing regulation and introducing risk factors into financial markets, it also has some positive aspects, such as satisfying some of the needs of the non-financial economy (e.g., by making it easier for SMEs to raise capital) and enabling Chinese households to diversify their investments (e.g., by offering them what amount to financial products with deregulated interest rates). Normally, securities companies and fund management companies would be expected to channel this risk capital, and, as we have seen, there have been moves (e.g., in the form of Yu’ebao) to satisfy consumers’ needs for products other than those offered by conventional financial institutions. Even if commercial banks continue to play a role as vendors in the origination and marketing of wealth management products, thereby supplying risk capital to financial markets, securities companies and fund management companies also have an important role to play. This role needs to be fostered urgently if banks are not to face disproportionate risks. Deregulation encouraging the entry of securities companies and fund management companies, including non-Chinese companies, is therefore increasingly important.

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