Short Term Policy Brief 52

The Role of Shadow Banking in Chinese Business

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Main Points

- The informal lending market in China has expanded in recent years with tightened credit conditions. However, off-balance-sheet activities are not a new phenomenon in China.

- The size of informal lending is hard to measure but estimates generally provide a range between Rmb 2tn (EUR 0.25tn) and Rmb 18tn (EUR 2.2tn) for 2011 (i.e. from 2% to 38% of GDP).

- The expansion of the Chinese shadow banking system is related to financial repression: (1) negative deposit rates have prompted savers to find higher-yield investments outside the formal lending sector; (2) few alternatives are available, residential property being the best option. To fund this, many households and small and medium enterprises (SMEs) had to turn to underground finance; (3) an increase in the reserve requirement ratio has led to large and unsatisfied demand for credit, particularly from households and SMEs.

- Much shadow finance is actually driven by or through the major state banks (bankers’ acceptances, letters of credit, designated loans) and some estimates state that 90% of shadow lenders are state-owned. Many of the state-owned enterprises that benefitted from official loans at low rate have also started to engage in the lending business (ChinaMobile, Cofco, PetroChina, BaoSteel, etc.).

- The informal lending market is mostly localised in the eastern provinces of China, particularly in Wenzhou (Zhejiang), Hongzhou (Zhejiang), Nanjing (Jiangsu) and Shenzhen (Guangdong).

- The biggest risk in shadow banking lies with the property market. Estimates show that this sector attracted around 60% of the informal lending market and the government has yet to try and contain speculation in this sector.

- Chinese authorities have already undertaken various regulations to restrain the development of the informal lending market, for instance, by increasing access to the formal lending market for households and SMEs.
**Background Briefing:** The Role of Shadow Banking in Chinese Business

**Introduction: the Chinese financial system**

With China’s rising economic and financial role at the international level and the singular success of its economic development (including its capacity to fight against the 2008-09 global financial crisis), the interests of researchers and observers have increasingly focused on understanding the complexity of China’s financial system and the way the People’s Bank of China (PBoC) conducts its monetary policy.

According to the statutes of the PBoC, the goals of its monetary policy include maintaining stability of the value of its currency, thereby promoting economic growth. To achieve this objective, a group of intermediate targets has been set. These include the level of aggregate money supply, domestic loan growth, exchange rate stability, and a non-legally formulated target of maintaining profitability of state-owned banks.

Since 2000, the PBoC’s record in terms of inflation performance has been rather remarkable. Despite being a country that is officially non-inflation targeting, China is thought to have achieved a substantial fall in inflation persistence since the end of the 1990s. China has also made an effort to maintain relative monetary policy independence, while often quasi-pegging its currency to the dollar, and trying to regulate capital flows in order to get around the well-known Mundell’s incompatibility triangle. Basically, this trilemma states that the following three phenomena cannot coexist in a country: fixed currency, autonomous monetary policy and free capital movements.

To achieve its goals, the PBoC has used a large range of monetary instruments, such as regulated interest rates on bank deposits, open market operations, required-reserve ratio (RRR), interest on required and excess reserves, credit quota and ‘window guidance’ (this terms is used to describe central bank pressures on financial institutions to stick to official guidelines). However, the PBoC controls interest rates in a way that has led to significant financial repression. The PBoC does not set interest rates based on the marginal return on capital but fixes them at an artificially low level to encourage growth and to prevent ‘hot money’.
As defined by Nicholas Lardy, financial repression in China is represented by the low and sometimes negative real return on deposits. Since 2002, various periods of steep negative real deposit rates have been observed. Indeed, the PBoC has been reluctant to increase the deposit rates in line with the pace of inflation for fear of attracting even larger speculative inflows. In addition, the Chinese strategy to keep interest rates low has driven investments thanks to the low cost of capital.

To control the pace of Renminbi appreciation, the government has massively intervened in the foreign currency market and has very frequently used open market operations (through central bank bill issuance) and reserve requirement ratio to drain liquidity. Both types of sterilisation clearly constrain banks and impose a kind of tax as the interest rate on required
reserves and on 3-year central bank bills (1.62% and 3% respectively at the end of 2011) is far below the nominal 1-3 years lending rate (6.65% at the end of 2011). Based on recent academic research, this implicit tax on banks has increased since 2007, particularly in 2008 and 2010. In 2009, the easing monetary policy period, characterised by a loosening in credit quota and a cut in regulated interest rates, explained the slowdown in the implicit tax burden.

(*) Tax burden is the required reserve amount outstanding at year-end multiplied by the annual opportunity cost associated with holding RRR. The opportunity cost is the difference between a full-year average 5-year government bond yield and a full-year average remuneration rate on required reserves.

So, one consequence of the Chinese strategy to control the pace of the appreciation has been an increase in financial repression, constraining and taxing banks, households and corporates, which has contributed to the expansion in unofficial channels of credit - the so-called shadow banking system (dixia jinrang).

The rapid expansion of the Chinese shadow banking system

There is a lack of consensus defining the exact meaning of the term ‘shadow banking’. Referring to the Financial Stability Board’s (FSB) definition, the shadow banking system can basically be described as ‘credit intermediation involving entities and activities outside the regular banking system’. This term started being used widely in the run-up to the recent financial crisis, reflecting an increased recognition of the importance of entities and activities structured outside of the regular banking system. This includes non-depository banks and other financial entities such as investment banks, mutual funds, hedge funds, money market funds and insurers, who typically do not fall under banking regulations. In other words,
shadow banking is a term which includes both the off-balance-sheet activities of banks as well as credit created by other companies.

Economists’ concern with the expansion of the shadow banking system is not just focused on China. Prior to the 2008-2009 financial crisis, the size of the shadow banking system in the United States was estimated to be significantly larger than that of the formal banking sector. Moreover, off-balance-sheet activities are not a new phenomenon in China; companies and individuals have always lent money to each other. However, for the most part, the massive increase seen in this type of activity in recent years has been driven by tightened credit conditions in China (notably due to increasing inflation and the formulating housing bubble).

Basically, three main reasons explain the recent expansion of the shadow banking system in China, all of them related to the rise in financial repression:

- First, China’s high level of saving (around 51% of GDP in 2011). Multiple periods of negative real deposit rates have led to a substantial incentive for savers to find higher-yield investments outside the formal banking system.

- Second, regulated lending interest rates at low levels, credit quota and quantitative controls on bank reserves have resulted in a large unsatisfied demand for credit (except in 2009). Basically, banks have prioritised loans to state-owned enterprises (SOEs) leaving households and small and medium enterprises (SMEs) with little access to the formal market, forcing them to turn to the informal lending market.

- Third, there are few investment alternatives for Chinese households and SMEs. Of these alternatives, real assets, such as residential property, are a good option and this has resulted in the rapid acceleration of property prices in urban areas in recent years.
To fund these investments, householders and SMEs have had to fall back on underground finance, which is willing to lend well above the benchmark rate.

As a result, Chinese households and SMEs are willing to borrow in the informal market at interest rates at least twice or triple the official one-year lending rate (which was around 6.5% in 2011) rising to as much as 60-70%, according to Credit Suisse. The lack of transparency and the complexity of monitoring the informal lending market make it difficult to manage.

**How large is China's informal lending?**

Estimates regarding the size of informal lending in China provide very different results, mostly dependent upon the definition used. The estimates of different sources range from RMB 2tn (EUR 0.25 tn) to RMB 18 tn (EUR 2.2 tn) in 2011, equivalent to around 8% and 38% of GDP. GaveKal Dragonomics’ estimation of RMB 17 tn (EUR 2.1 tn), reveals that informal lending in China may have accounted for over 40% of new credit creation in 2010 and 2011 Q1-Q2, making it a potential challenge for Chinese banking regulation. However, Credit Suisse’s reported estimation of around Rmb 4tn (EUR 0.5 tn) does not cause alarm for China.

Total Social Financing (TSF), a broad central bank measure of liquidity in the economy, reached a peak of RMB 14.3 tn (EUR 1.8 tn) in 2010. However, the concept of social finance is not perfectly analogous to shadow banking. Basically, the indicator includes all the funds raised by entities in China’s real economy during a certain period, such as loans of local and foreign currencies, entrusted loans, bank acceptance bills, corporate bonds, equity financing, foreign direct investment and foreign debt.
## Estimates of the size of shadow banking in China in 2011

<table>
<thead>
<tr>
<th>Sources</th>
<th>Estimates (in RMB, in 2011)</th>
<th>Euro equivalent</th>
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<tbody>
<tr>
<td>State Information</td>
<td>2 tn annual flow</td>
<td>0.25 tn</td>
</tr>
<tr>
<td>Barclays Capital</td>
<td>3.1 tn, 22% of new financing</td>
<td>0.39 tn</td>
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<tr>
<td>Bernstein Research</td>
<td>2.7 tn, 5% of loans</td>
<td>0.34 tn</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>4 tn</td>
<td>0.5 tn</td>
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<tr>
<td>Nomura Securities</td>
<td>8.5 tn</td>
<td>1.1 tn</td>
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<tr>
<td>FT China Confidential</td>
<td>10 tn</td>
<td>1.25 tn</td>
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<tr>
<td>ANZ Bank</td>
<td>10 tn</td>
<td>1.25 tn</td>
</tr>
<tr>
<td>Barclays Capital</td>
<td>11.6 tn, 22% of loans</td>
<td>1.45 tn</td>
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<tr>
<td>UBS</td>
<td>12 tn</td>
<td>1.5 tn</td>
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<tr>
<td>Roubini Global</td>
<td>12.7 tn</td>
<td>1.59 tn</td>
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<tr>
<td>Société Générale</td>
<td>14.5 tn</td>
<td>1.82 tn</td>
</tr>
<tr>
<td>GaveKal</td>
<td>17 tn</td>
<td>2.13 tn</td>
</tr>
<tr>
<td>China UnionPays</td>
<td>17.7 tn</td>
<td>2.22 tn</td>
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*Adapted from: PIIE*

To go into detail, we take reference from the estimate of GaveKal Dragomics. In their definition, three main types of credit are considered: (1) loans from financial institutions that are not banks, (2) credit arranged by banks that does not appear on their balance sheets, such as designated or entrusted (i.e. company to company) loans, letters of credit and bankers’ acceptances and (3) loans made entirely outside the formal financial system, by private money lenders or individuals. Their estimates show that shadow banking increased by 69% in 2010 and 20% and 2011 H1.

### Major actors of the shadow banking system

The list of actors who play a role in informal lending business is quite long: banks, guarantee...
companies, pawnshops, investment guarantor companies, SOEs, entrepreneurs and individuals.

- Most of China’s commercial banks participate in informal lending by offering services that do not fall on their balance sheets. The most important financing instrument is a bankers’ acceptance, a short-term credit instrument created by a non-financial firm and guaranteed by a bank. They usually arise in the course of international trade. Designated loans have also been frequently used in recent years, through which banks arrange loans from one company to another.

- In general, shadow banking lending operations proceed through an intermediary, a guarantor. In most cases, they are companies (often subsidiary companies of SOEs) but they are also sometimes connected with banks. Some estimates state that 90% of the shadow lenders are state-owned. Credit Suisse’s estimate suggests that about 60% of lending in the informal market is ultimately funded by banks through various channels (for instance, lending to SOE parent companies), 20% by private entrepreneurs and about 20% by individuals.

- SOEs, which benefit from official loans at low rates, started to engage in lending due to a lack of compelling investment opportunities. Many SOEs have separate financing arms. For instance, in 2011 China Mobile announced the establishment of a finance company to lend out money at higher rates; China Railway Group and China’s food giant Cofco also have similar lending operations. PetroChina has an asset management arm, a trust bank, a commercial bank as well as an internal finance unit.

- Trust companies are an important source of finance outside of the traditional banking system. They serve as a third arm that links financial institutions and wealthy individuals. Basically, trusts purchase loans from banks, take them off the balance sheet and then sell these loans to other financial institutions or private borrowers. Baosteel Group has a 98% stake in Fortune Trust, one of the largest trust firms, while Hunan Valin Iron and Steel Group has a 49% stake in Huachen Trust.

Most of China’s commercial banks (including the big four state banks) play a key role in the expansion of shadow finance, accounting for 65-70% of total outstanding credit in 2010 and 2011 through bankers’ acceptances, letters of credit and designated loans. Trust loans have also boomed in recent years, even though they still represent just a small share of total credit. Basically, banks move part of their loan portfolios off their books by repackaging them as Wealth Management Products (WMPs), the maturity of which can range from several days to
several years. These totalled around Rmb 3.8tn (EUR 0.5 tn) at the end of 2010 according to the China Trustee Association. Private lending represented around 20% of the shadow banking system in 2010-2011.

Challenges for authorities and risks for business

In 2011, growing concern regarding the expansion of shadow banking was in part fed by the debt crisis that hit Wenzhou city in southeastern Zhejiang province (which ranks among the top 5 cities in China in terms of highest amount of disposable income). Indeed, large debt issues have led to 29 bankrupt businesses in the city and even suicides by entrepreneurs. The blame has fallen on the shadow financing system. Even though the system has existed for a long time, it has grown rapidly, particularly thanks to borrowing by Chinese SMEs. The Wenzhou People’s Bank estimates that 90% of families and 60% of businesses are involved in the private lending market, amounting to 110 bn yuan (EUR 14 bn, 38% of its 2010 GDP). The annual interest rates for a private loan could be as high as 100%, almost 15 times China’s benchmark lending rates.

Credit Suisse estimates that the size of the informal lending market in 20 major Chinese cities equals around Rmb 2.8 tn (EUR 0.35 tn). Among these cities, the informal market is most developed in the east China region (Jiangsu, Zhejiang and Fujian). More precisely, Nanjing, Hangzhou and Wenzhou are the cities with the biggest informal lending market, representing 39%, 43% and 38% of GDP respectively. Shenzhen (Guangdong province) is also a city with a
very developed shadow banking system, representing 35% of GDP in 2010 and 20% of loans.

What are the major potential risks?

- A property market correction presents the first risk. The real estate market has been the best destination for money loaned from the informal system (accounting for around 60% of informal lending). However, worries about price expectation grew as the government tried to contain speculation. If property prices fall sharply, private property companies will be most exposed although SOEs will also be affected.

- A potential liquidity shortage would represent a risk for deposit-taking institutions, particularly if shadow banking continues to develop and attract savers.

- A potential economic slowdown coupled with inflationary pressures could reduce expected investment yields and could deteriorate credit quality.

The development of shadow banking in China could represent a serious challenge for banking regulation. To discourage the development of the shadow banking system, the PBoC and the China Banking Regulatory Commission (CBRC) undertook various regulations in 2011, such as requiring banks to move certain off-balance-sheet assets back to their books by year end-2011.
In May 2011, the CBRC issued a guideline to instruct Chinese banks to boost their credit to small business operators and to tolerate a higher ratio of bad loans (a term generally used to describe unsecured loans) relating to SMEs. To address the credit crisis in Wenzhou city, the government imposed an upper limit on the interest rates that private non-bank lenders can charge borrowers. Under this special administrative measure, private non-bank institutions can only offer loans if the rate of interest does not exceed four times the benchmark lending rate. Premier Wen Jiabao has urged Chinese banks to provide preferential financial credits to support SMEs by reducing lending costs and eliminating unnecessary fees.

Conclusion

Many economists argue that the development of underground finance could force the Chinese government towards monetary policy normalisation and further interest rate liberalisation, especially on the deposit side, where rates are currently subject to a cap. If this takes place, it could be a signal of significant risks to come. In many countries, interest rate liberalisation has been followed by a banking crisis a few years later - a point the International Monetary Fund made in its recent assessment of China’s financial sector.

It is worth noting that the shadow banking phenomenon is not a new phenomenon in China - companies have always lent money to each other and this has contributed to the dynamic economic growth seen in several provinces in the few past years. However, the debt crisis in Wenzhou city (one of the richest cities in China) and the large increase in the size of the informal lending market has increased concern. All agents, i.e. banks, SOEs and SMEs, play an important role in the informal lending market but any instability and potential risks would mostly affect SMEs, which are highly dependent on this kind of financing. Bearing this in mind, a European business investment strategy would be more secure focusing on SOEs, which already have access to the formal market.

However, following the debt crisis that hit Wenzhou city, the PBoC and the CBRC have undertaken various regulations to promote increasing support for SMEs. This switch should allow for a more healthy and fair financing system. In addition, a decrease in systemic banking risks in China would reduce the potential global impact on European business in terms of their trade and investments in China.