



PhD seminar on Contemporary Issues in Finance

Shadow Banking in China and its potential risk

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Outline

- What does shadow banking refer to in the Chinese context?
- Why does shadow banking exist?
- How large is it? Will it cause a crisis?
- How did/will the authority regulate shadow banking?

Shadow banking in China includes: (Different from western countries)

- Composition
 - Loans made by trust companies *
 - Entrusted Loans *
 - Bankers' Acceptances *
 - Interbank entrusted payments
 - Small loan companies and pawn shops
- Conducted by: banks (in most cases)
- Financed by:
 - Wealth management products
(substitute for bank deposit)

Funds chain of shadow banking



The rationale of shadow banking:

- Regulation on banks
 - Caps on lending volumes
 - Loan to deposit cap of 75% is constraining
 - Discourage lending to certain industries
(coal-mining, real estate)
 - Non-performing loan rate (less than 1%)
(SMEs cannot get enough financing)
 - Less flexibility in pricing loan (--deregulated now)
- 2/3 shadow banking consists of disguised bank loans

Regulations on shadow banking:

- Problems:
 - Implicit guarantee from government
 - Implicit guarantee by banks if trust loans default
- Regulation and reactions:
 - Forbid banks direct dealing with trust companies
(Banks restructure products through securities companies)
 - Forbid funds pool
(Banks issue roll on products—One product without finite maturity, different yield for different length of investment)

Size and Risk

Shadow banking size comparison

Shadow Banking Assets as % of 2013 GDP	
Netherlands	760%
United Kingdom	648%
Switzerland	261%
United States	150%
China	31%

Data source: Financial Stability Board



Zhou Xiaochuan
Governor of the People's
Bank of China

Relatively small compared with GDP and total financial sector

Less leveraged compared to developed countries

Powerful government with low central government debt to GDP ratio

Scenario Analysis

- Bank Off-balance sheet loans 10.7 trillion RMB
- Suppose 60%-100% damage transferred to formal banking
- 4-24% estimated default rate *

(* Marsh&Mclennan Companies)

		Transferable to formal banking (Trillion, RMB)	
	NPL%	60%	100%
Optimistic Scenario	4%	0.2568	0.428
Base Scenario	10%	0.642	1.07
Disastrous Scenario	24%	1.5408	2.568

Is it a big threat?

By the end of 2014:

- Formal banking loan is 81.68 trillion RMB, Non-performing loan rate is 1.16% (766.9 billion RMB), Banks hold 1.96 trillion RMB loan loss reserves.
- Net Capital is 9.71 trillion, Capital ratio is 12.93%. If the 2.5 trillion is absorbed by formal banking system, banks can still meet the basic capital ratio requirement (8%).

$$\frac{9.71}{12.93\%} = \frac{9.71 - 2.5}{9.6\%}$$

Threat to New Zealand

- Main commercial banks in China have rather limited shares held by foreign investors (less than 10%)
- ANZ Group: owns a 20% stake in two unlisted commercial
 - Bank of Tianjin (20% of 28.6 billion RMB)
 - Shanghai Rural Commercial Bank (20% of 38.5 billion RMB)

Reforms

- Improve risk management on bank related shadow banking products and prevent risk mismatch and mislabelling
- Establish a credit “firewall” between commercial banks and non-bank shadow banking activities
- Clarify credit liability to avoid non-contracting-binding risk spill-over to banks via “guaranteed return”

Summary

- Shadow banking in China have different composition compared to western countries
- The size of shadow banking in China is under control and the foreseen negative effect on global financial market is limited
- The Chinese government has taken actions to regulate the shadow banking sector, which is expected to improve with further reform in the banking system in China.