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ARTICLE

The Research on Shadow Banking System in China

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ABSTRACT

The shadow banking system has grown stronger in the process of evading supervision. Together with traditional commercial banks, it has become an important participant in the financial system, which has caused a fundamental change in the structure of the global financial system. As an exogenous reform force in China's special period, Shadow Bank has become an important channel for financial resources to "disconnect from reality". Despite the lack of substantial securitization, China's shadow banking system has developed rapidly. This paper analyzes the development motivation.This paper believes that the scope of China's shadow banking system can be defined according to the nature of the fund supply side.

1. Introduction

At present, the global economic recovery is slow while Sino-US economic and trade frictions are constantly escalating, and the domestic and international situation is undergoing profound and complex changes. The Chinese economic slowdown has become the new normal. China's dependence on export-driven growth model is unsustainable. It is in the critical period of economic transformation while the overall face of the economic cycle downside risks. China's financial industry has also undergone tremendous changes. The banking industry has encountered a series of challenges such as financial disintermediation, interest rate marketization and the rise of internet finance. The credit supply of the traditional commercial banking system has been tightened year by year, and the off-balance sheet business (especially wealth management products) has been fast.

In the environment of increasing financial innovation and competition, shadow banking system has become an important part of China's financial system. Compared with enterprises or individuals through traditional commercial bank financing, shadow banking financing has become a more valuable alternative choice. Shadow bank provides financing channels to help support real economic activities and compete effectively with traditional commercial banks.

However, shadow banking financing involves traditional commercial banking activities and is closely interlinked with traditional commercial banks. Moreover, shadow banking, like traditional commercial banks, can also be used for term conversion, liquidity conversion, and leverage operations, which have become direct or indirect sources of systemic risk. Although there is a big difference between China's shadow banking system and the shadow bank system of Western countries, it also accumulates huge risks while developing rapidly. Since 2012, the scale of financing through shadow banking system has accounted for nearly 40% of the total social

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financing scale in the same period. Since 2014, the central government has strengthened supervision on shadow banking system and the scale of shadow banking has declined. However, since 2017, the proportion of financing from shadow banking has once again jumped, and there is a resurgence. From the statement in the relevant documents issued by the central government, shadow banking has become one of the "grey rhinoceros" of the current financial system in China. From the money shortage in 2013, to the stock market disaster in 2015 and E-rental case in 2016, the source of traceability is closely related to shadow banking system. The Chinese-style shadow banking system covers a wide range of areas, including credit, guarantees, small companies, pawn shops, underground money houses, and so on. Since the outbreak of the Wenzhou private lending crisis, the risks of private finance in various places have begun to surface and have implicated the local banking system. As we all know, the problems of the financial industry have always been the most important and most troublesome issue for any country's economy. Some experts even pointed out that China's "Lehman moment" is coming soon. Its shadow bank system is the largest time bomb in China's current financial system and may become the source of the next round of systematic global financial crisis.

2. The Development Motivation of Shadow Banking System in China

Compared with western developed countries, China's shadow banking system has developed rapidly although its complexity is relatively low. Due to the lack of substantial securitization process, the development of shadow banking system is still at a relatively early stage. However, with the continuous development of financial markets, shadow banking system which is generated by traditional commercial banks to avoid credit supervision system has deserved high attention. Most of shadow banking funds come from traditional commercial banks and are inextricably linked with real estate, local financing platforms, and the stock market. Once the shadow banking funds which are mainly invested in the real estate market, local debt and stock market is in danger, it will likely result in systemic risk in the financial system. It may trigger financial crises and even economic crises through the money market and the credit market, and ultimately jeopardize the real economy and social stability [1].

The main reasons for the rise and rapid growth of China's shadow banking system can be attributed to the following four aspects:

2.1 Active Participation of Traditional Commercial Banks

An important feature of China's shadow banking: it is closely related to the formal traditional commercial banking system. In fact, without the active participation of traditional commercial banks, China's shadow banking cannot experience such rapid growth and reach today's scale and significance. In China, despite the substantial progress in financial liberalization, the traditional commercial banking system is still subject to a strict regulatory system. Due to the upper limit of the deposit interest rate, especially the decline in economic interest rates, financial restraint has been caused. In order to maintain their own profit growth, traditional commercial banks often have strong incentives to increase the size of loans which means that traditional commercial banks need to break through the existing loan-to-deposit ratio, capital adequacy ratio and loan quota. After experiencing a surge in loans in 2009, traditional commercial banks are increasingly facing a 75% loan-to-deposit ratio. In order to continue to expand the scale of loans, traditional commercial banks need to absorb deposits and transfer deposits by issuing higher-yield wealth management products which is alleviating the liquidity constraints caused by the loan-to-deposit ratio and enhancing their ability to continue to issue loans. Through the issuance of non-principal-guaranteed wealth management products, loans are provided to the external pool of wealth management products. The yields of these products are allowed to be consistent with market interest rates. Traditional commercial banks have actually completed the transformation of some loans from the balance sheet to the off-balance sheet, which is breaking through the restrictions imposed by the deposit ceiling.

Moreover, traditional commercial banks also provide clear credit guarantees for some wealth management products. Most of these wealth management products are short-term investments. In fact, they are almost a substitute for deposits in terms of credit risk and liquidity risk. For example, through the cooperation between commercial banks and trust companies, traditional commercial banks have actually completed the transformation of some loans from their balance sheets to the balance sheets of trust companies. The process of "out of the loan" can significantly increase the capital adequacy ratio of traditional commercial banks. Compared with traditional commercial banks, shadow banks are exempt from many credit and macro-prudential requirements, and loans are subject to less official intervention. The cooperation between shadow banking and traditional commercial banks is very

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meaningful because they can achieve complementary competitive advantages [2].

2.2 Strong Investment Demand of Chinese Resident Sector for Shadow Banking Products

Investors' desire for alternative investments has also created demand for shadow banking products. China is one of the countries with the highest savings rate in the world. However, due to the underdeveloped capital market and the not open capital account, investment channels are few. It relies mainly on traditional commercial bank deposits to obtain meager returns. The upward rigidity of the nominal deposit interest rate causes the real interest rate to be negative or close to zero. Many savers have begun to transfer deposits from traditional commercial banks to higher-yielding investments to maintain the purchasing power. In order to limit the outflow of deposits, traditional commercial banks need a tool that can provide higher interest rates to maintain their capital base. The desire for alternative investment provides a fertile ground for the rise of bank wealth management products and other shadow banking products [3].

From the perspective of investors (mainly Chinese residents, including enterprises and financial institutions, etc.), the emergence and development of the shadow banking system provides new investment tools in addition to bank deposits, stocks, real estate, and foreign exchange. The yield of shadow banking products is significantly higher than that of traditional commercial banks. This is actually a kind of market-based interest rate marketization behavior, which breaks through the financial restraint against the traditional commercial bank benchmark deposit interest rate cap. This will help Chinese residents to further diversify their assets with strong investment demand for bank wealth management products and other shadow banking products. Since 2009, the monthly circulation of wealth management products initiated by traditional commercial banks has increased significantly, reaching nearly 4,000 times per month in 2013.

2.3 Regulatory Endorsement for Shadow Banking Products

The above two types of development motivations indicate that there are structural supply and demand reasons for the rise of the shadow banking industry. However, the circumvention of regulation does not fully explain why shadow banking has developed rapidly in recent years, as regulations have existed for decades.

This paper believes that there must be some cyclical impulses behind the surge in the shadow banking industry. First of all, the rapid growth of shadow banking is inseparable from the clear recognition and endorsement of the regulatory authorities. The rise of shadow banking has been seen as a clear and positive financial innovation that expands the diversity of China's financial system and accelerates interest rate liberalization. On the one hand, shadow bank system provides services to borrowers who cannot finance traditional commercial banks and capital markets. On the other hand, shadow banking system provides a testing ground for interest rate liberalization. Deregulation that allows for more diversified traditional commercial banking operations can also help increase shadow banking. China needs to further enhance the competitiveness of traditional commercial banks' integrated operations in the context of financial and economic globalization. At present, most traditional commercial banks in China have departments engaged in shadow banking (such as trusts and mutual funds), which help to directly fund the real economy and bypass banking supervision [4,5].

2.4 Stimulating Changes in Policy

Another driver of the surge in shadow banking comes from the dramatic changes in China's policies after the global financial crisis. As we all know, China has emerged from the crisis and has a lot to do with the substantial policy stimulus of the People's Bank of China and the massive liquidity injection.

After the US subprime mortgage crisis broke out in September 2008, the global financial tsunami triggered and the overall world economy was in a downturn. China's exports experienced negative growth and the economy faced a risk of a hard landing. In order to boost the Chinese economy, the Chinese government launched 10 measures to further expand domestic demand and promote stable and rapid economic growth in November 2008. With the introduction of the four trillion yuan plan, a large amount of cheap credit has flooded into the market, which significantly stimulated investment demand. Credit easing led to real estate price bubbles and local debt expansion. A large amount of loans were loaned to large credit-intensive infrastructure projects. These projects usually take several years to complete and require ongoing credit input, which could lead to a wide range of project failures and a significant increase in bank non-performing loans. In order to protect the balance sheet, traditional commercial banks have further expanded their off-balance sheet business and are increasingly relied on shadow banking as an intermediary for substantial loans. As a result, China's shadow banking has experienced explosive growth [6].

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3. The System of Shadow Banking in China

3.1 The Research Foundation

The shadow banking system can be broadly described as an economic entity and business activity that assumes the function of credit intermediation outside the traditional commercial banking system. Although this kind of non-traditional commercial bank credit has an important contribution to the financing of the real economy and has a comparative advantage, it can easily lead to systemic risks, especially when engaging in banking (for example, term conversion, liquidity conversion, high leverage Operation) as the correlation with traditional commercial banks is significantly enhanced. From the perspective of the development of the shadow banking system in the world, it has developed inflated since the 21st century, and has been growing steadily in the process of evading supervision and obtaining regulatory arbitrage.

Schwarcz (2012) believes that the relaxed regulatory policy environment and the regulatory arbitrage of traditional commercial banking are important reasons for the rise of shadow banking. By shifting credit assets from the table to avoid capital regulatory restrictions, the shareholder return rate is improved [7].Calmes & Theoret (2011) pointed out that traditional commercial banks use off-balance-sheet activities to build a shadow banking system, which is a profit model for obtaining non-interest income, a natural product and an inevitable result of dealing with competition and chasing profits [8].

The Financial Stability Board (2011) pointed out that the existence of the shadow banking system is closely related to changes in financial innovation and regulatory systems while is closely linked to the national economic and financial conditions of each country and changes dynamically over time[9]. In the United States, for example, the main components of the shadow banking system include five categories. The first category is securitization arrangements involving multiple financial institutions and most of them are investment banks. The second category is such as money market mutual funds, private equity funds, hedge funds, independent financial companies, various types of private credit lending institutions and other market-based financial companies. The third category is structured investment entities, real estate investment trusts, asset-backed commercial paper pipelines which are mostly initiated by traditional commercial banks or financial holding companies and constitute an indispensable part. In the fourth category, brokers and market makers engaged in financing, securities lending activities, and overnight payments of third-party payments. Purchase, etc. The fifth category includes all kinds of payment, settlement and clearing facilities outside the bank.

In Europe and the United States, the distinction between shadow banking and traditional commercial banks is mainly based on whether or not they are included in the regulatory system. In contrast, China's shadow banking mainly relies on traditional commercial banks to perform many of the basic functions of credit intermediaries. This makes it often "centered on traditional commercial banks" and is the true "shadow" of the traditional commercial banking system.

In 2014, the "Notice on Strengthening the Supervision of Shadow Bank Supervision by the General Office of the State Council" (No. 107) made a relatively comprehensive and clear official definition of shadow banking for the first time. The notice clarified that shadow banking generally includes three categories. The first category is credit intermediaries that do not hold financial licenses and are completely unregulated, including new Internet finance companies, third-party financial institutions, etc. The second category is credit intermediaries that do not hold financial licenses and have insufficient supervision, such as financing guarantees and microfinance companies. The third category is that the relevant institutions which hold financial licenses, but there are financial services that are under-regulated or evaded, mainly including money market funds, asset securitization, and some wealth management businesses.

Based on the above notice, China's shadow banking can only cover the first type of credit intermediaries if shadow banking is defined only by whether or not it is regulated. It is obviously not in line with the actual situation which will lead to the inability of many existing financial products in China to be included in the statistics and cannot fully reflect the structural changes and risk distribution of the Chinese financial system.

3.2 Accounting Interpretation of Shadow Banking System

This paper argues that it is not appropriate to distinguish traditional commercial banks from shadow banks in China only by internationally accepted supervision standards. In fact, wealth management products that rely on the traditional commercial banking system are typical shadow banks although regulators have issued a number of regulatory documents for wealth management products. Excluding wealth management products from the shadow bank is problematic if it is only from a regulatory perspective and ignores its essential attributes. Different from whether to accept supervision as the main basis for distinguishing between shadow banking and traditional commercial banks, this paper attempts to explore the essence of shadow

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banking by using the basic principles of accounting. This paper argues that the difference between shadow banking and traditional commercial banks is that the supply properties of the two funds are different. The supply of funds of traditional commercial banks has savings attributes while the supply of funds of shadow banks has investment attributes.

We know that whether it is a traditional commercial bank or a shadow bank, the most important function is to achieve the financing of funds and to promote the effective supply of funds to meet the financing needs of enterprises or individuals. Look at the shadow bank's balance sheet. Regardless of the financial institution's specific form of financial institutions, its balance sheet should still meet the accounting identity: assets = liabilities + owner's equity. Different from traditional commercial banks, their liabilities are not public deposits, but investment funds with investment nature. The scope of China's shadow banking is very wide including bank wealth management, trust loans, entrusted loans, undiscounted bank acceptance bills, securities companies and fund companies, credit financing companies, off-balance sheet business, private lending, internet finance, etc.

This paper believes that the debt based on shadow banking is not from public deposits and has investment attributes. Compared with traditional commercial banks, the money providers of shadow banks pursue high risks and high returns. Therefore, the general regulatory tone of shadow banking in different countries is often different from the prudential supervision of traditional commercial banks.

4. Conclusion

In the financial system, financing is basically achieved in two ways. First, it relies on the direct financial method of equity financing through the stock market. The indirect financial method is the other one which mainly relies on financial intermediaries. Furthermore, the indirect financial approach through debt financing can be furtherly subdivided into two channels. One is to achieve the financing through the traditional commercial banking system. In this channel, the funds are of a savings nature because the fund providers' goal is the pursuit of security. To this end, governments generally implement prudent and strict financial regulatory policies. The other channel is through the shadow banking system to achieve financial integration. Based on the above considerations, this article thinks that the traditional commercial bank's wealth management products should be classified into the shadow banking category. The model of financing through shadow banking is very different from traditional commercial bank financing. Because the funds from shadow banking are not of a saving nature, but an investment nature.

Therefore, it is not the only way to distinguish between traditional commercial banks and shadow banks by strict supervision. This article believes that it should be based on the nature of the supply of funds. Whether the nature of savings is of investment, it is an important criterion for distinguishing between shadow banking and traditional commercial banks.

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