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China starting to regulate shadow banking

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Executive Summary

Chinese shadow banking is largely market-driven financial innovation. While Chinese regulators have started to take action to mitigate shadow banking's potential risks, they also face the urgent task of also laying the groundwork for full-fledged financial deregulation.

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Chinese shadow banking's characteristics and negatives

Interest rates in China's short-term money market rose at the end of last quarter (September), but only mildly in comparison to their late-June spike and the ensuing market volatility. The People's Bank of China (PBoC) has apparently succeeded to some extent in asserting its will over the markets as it endeavors to curb growth in banks' off-balance-sheet lending. Nonetheless, banks continue to engage in off-balance-sheet lending and its latent risks still persist.

Chinese shadow banking, which has attracted widespread media attention this year even in Japan, is aimed at circumventing restrictions on bank lending[1]. This is true of any financial intermediation other than banks' on-balance-sheet lending. Specifically, shadow banking is intended to circumvent China's 75% cap on banks' loan-to-deposit ratio and restrictions on loans to real estate companies and local government financing platforms, which are major borrowers.

A second aspect of Chinese shadow banking is financial innovation. The process of moving liabilities off balance sheet involves utilization of various techniques, not only refinancing of existing debt through bond issuance but also de facto securitization of assets and loans, which are packaged in wealth management products sold by trust companies, securities firms and banks (Exhibit 1). These wealth management products offer unregulated interest rates to their purchasers[2]. In other words, the market is driving liberalization of securitization and deposit rates.

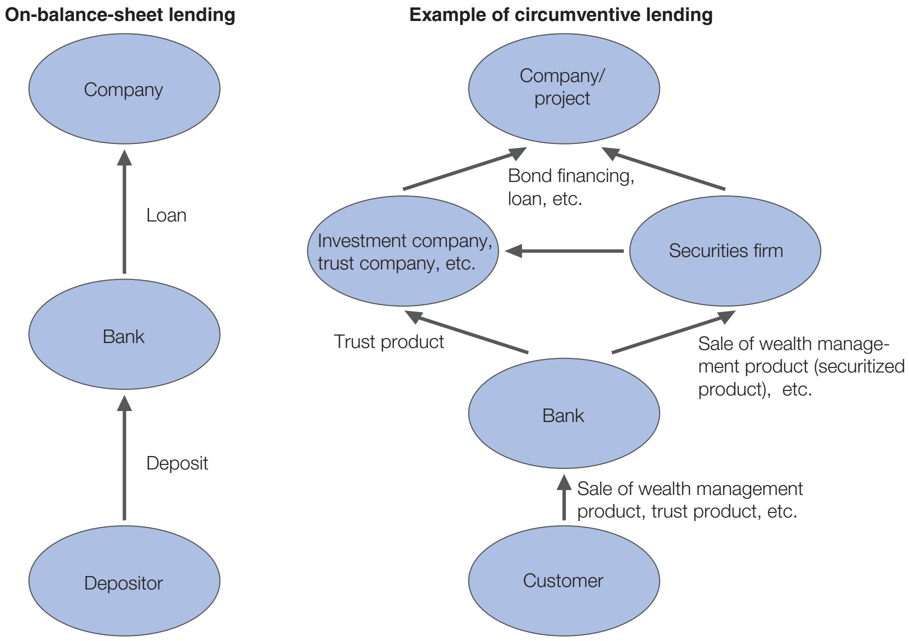
Bank wealth management products' negatives include mismatched maturities (short-term funding, long-term assets), concerns about comingling and misappropriation of client assets, and lengthening of the financial intermediation chain without adequate information disclosure (e.g., lack of transparency about accountability in the event

NOTE

1) See http://www.nri.com/global/opinion/lakyara/2013/pdf/lkr2013161.pdf.

2) Banks use off-balance-sheet accounts to account for products without principal guarantees.

Exhibit 1. Example of off-balance-sheet bank financing scheme



Source: NRI

of bankruptcy of a party to the wealth management scheme). Because China currently does not have deposit insurance, products sold by banks are paradoxically tacitly guaranteed in their entirety by the state. Against such a backdrop, products without principal guarantees are being sold to individual investors without adequate disclosure. In short, moral hazard exists.

Some warn that the risks posed by Chinese shadow banking are on a par with the 2008 global financial crisis, but one key difference between the two is that the products sold by Chinese banks are not globally dispersed. Additionally, nearly all of the players involved in off-balance-sheet financing (banks, trust companies, securities firms, etc.) are regulated by government authorities, which are at least somewhat aware of their activities. However, China has a separate regulatory agency for every financial industry, including the China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC) and China Securities Regulatory Commission (CSRC). Shadow banking is seen as an adverse consequence of China's regulatory silos.

Regulatory authorities have started to take action

As such problems have come to light, the regulatory authorities have not been standing idly by.

First, the authorities began to regulate wealth management products from March 2013. The CBRC issued accounting rules for banks' wealth management products (as a precaution against comingling and misappropriation of assets), imposed limits on wealth management products' non-standardized asset content, banned bank guarantees of non-standardized assets, and mandated information disclosure about such products[3]. The CSRC clarified the universe of assets eligible for inclusion in securities firms' wealth management products[4]. For instance, the CSRC basically banned securities firms from purchasing notes from banks.

3) The CBRC did so by issuing a Notice of Issues Concerning Regulation of Commercial Banks' Wealth Management Businesses' Investment Activities. Non-standardized assets are debt assets not traded in the interbank market or on a securities exchange, including loan receivables, trust loan receivables, trust receivables, notes receivable, accounts receivable, and beneficiary interests. Banks utilize such assets in structuring circumventive finance schemes. Banks' holdings of such assets cannot exceed the lesser of 35% of their total wealth management products outstanding or 4% of their total assets as of the previous fiscal year-end.

4) The CSRC did so by issuing a Notice Concerning Strengthening of Regulatory Oversight of Securities Firms' Asset Management Businesses. Since 2012, securities firms have increasingly been purchasing banks' on-balance-sheet notes receivable to be packaged into wealth management products. Such deals have been used for circumventive financing.

Second, when short-term interest rates spiked in June, the PBoC refrained from injecting enough liquidity into the banking system to drive rates back down. With credit, including off-balance-sheet loans, growing rapidly, the PBoC refused to supply the banking system with base money beyond what was required to support the amount of credit that it deemed appropriate. Its refusal sent a strong message that the PBoC is serious about keeping credit creation, including off-balance-sheet lending, under control.

Third, China's National Audit Office launched a nationwide audit of local government debt in August. According to the previous (2010) nationwide audit, local government debt totaled RMB10.7 trillion at December 31, 2010. However, the previous audit ignored the debt of small municipalities[5] and used an inadequate definition and classification of debt. This time, the audit's scope and definition of debt has been broadened. The size of local government debt is consequently expected to be larger than the total revealed by the previous audit. The key point is that the audit will reveal the scale of local government debt inclusive of local government financing platforms, which are the ultimate borrowers of much of banks' off-balance-sheet loans, and the nature of debt guarantees. Like during Japan's nonperforming loan cleanup of the 1990s, ascertaining the debt's size and risk is the first step in formulating a regulatory response.

5) These municipalities occupy the bottom rung of China's four-tier hierarchy of administrative subdivisions. The three other tiers are (in descending order) provinces, major cities, and minor cities.

Fourth, the State Council authorized the establishment of a financial regulation coordination entity headed by the PBoC on 15 August 2013[6]. In addition to the PBoC, the other participating regulators are the CBRC, CSRC, CIRC, and State Administration of Foreign Exchange. Other government agencies, including the National Development and Reform Commission and Ministry of Finance, will also participate on an as-needed basis. The new entity's responsibilities include interagency coordination for regulation of products and financial innovations that transcend the bounds of a single financial industry. The intent behind the new entity is

6) The coordinating entity is responsible for coordination in five areas: (1) monetary policy and financial regulatory policy, (2) financial regulatory policies, laws and regulations, (3) preservation of financial stability and prevention of localized and systemic financial risks, (4) cross-industry financial products and cross-market financial innovation, and (5) financial information sharing and maintenance of comprehensive financial industry statistics.

to regulate the aforementioned off-balance-sheet financing schemes involving banks, trust companies and securities firms. Although interagency coordination faces certain difficulties, including limitations on regulators' authority, it is seen as a precursor to deregulation of the banking, securities and insurance industries.

While the above measures mainly address potential risks, the extent to which they address the root causes that have given rise to shadow banking remains to be seen. In other words, with the markets spearheading liberalization driven by financial flows between regulated and deregulated sectors, how well regulators can carry out orderly deregulation is an open question.

In terms of securitization and interest rate liberalization, regulators' initial steps have included upgrading securitization to a routine business from its previous status as a pilot program[7]. Next, the PBoC essentially liberalized interest rates on bank loans in July. Deposit rates have yet to be liberalized, but their complete liberalization appears to be unfeasible at present. China has not yet established a mechanism for resolution of failed banks after interest rates are liberalized. Additionally, with deposits fully, albeit tacitly, guaranteed by the state due to an absence of deposit insurance, liberalization of deposit rates poses a risk of moral hazard in the form of banks offering high interest rates to attract deposits. Establishing a bank resolution process and deposit insurance program are urgent tasks for China.

7) Asset securitization became a routine business for securities firms in March 2013. Credit securitization is slated to soon become a routine business for banks. For more details, see http://www.nri.com/global/opinion/lakyara/2013/pdf/lkr2013176.pdf.

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