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Reforming Shadow Banking in China

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Introduction

"Shadow banking" has become an important, and rapidly growing, part of Chinese finance. Much of the reporting and analysis for this sector focuses on the risks of shadow banking, which clearly do exist and are significant. However, the societal benefits, on the whole, appear to be even greater. Therefore, shadow banking should be reformed, to reduce the risks and increase the benefits, not abolished or shrunk simply for the sake of reducing its importance. The right approach is to find the optimum balance of societal benefits and risks, not to aim for an arbitrary size or role.

Further, much of shadow banking results from a web of regulatory, bureaucratic, and policy constraints and pressures on the formal banking sector, as well as some internal weaknesses at the banks. Therefore, reform recommendations arising from a consideration of shadow banking need to extend into the formal banking sector.

This paper will focus on recommendations for regulatory reform and will presume some knowledge of Chinese shadow banking and finance more generally. For those less familiar with the topic, we will start with a summary of the key background points. A much longer analysis from the authors is available at Elliott, Kroeber, and Yu (2015).

Reforming Shadow Banking in China

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Summary of shadow banking and its role in China

Shadow banks are financial firms that perform similar functions and assume similar risks to banks. Being outside the formal banking sector generally means they lack a strong safety net, such as publicly guaranteed deposit insurance or lender of last resort facilities from central banks, and operate with a different, and usually lesser, level of regulatory oversight. These characteristics increase the risks for financial stability, which is the main reason there is a focus on shadow banks today.

Shadow banks can help spur economic growth by making financial services cheaper and more widely available, but there is usually a trade-off in terms of reduced financial stability. One reason for the trade-off is that shadow banks' flexibility and price competitiveness often come at the expense of safety margins. Banks, for example, are generally required to have significantly more capital and liquidity than shadow banks may choose to carry. Shadow banks are also less regulated. This combination forces policymakers into difficult balancing acts to try to maximize the benefits while minimizing the risks.

Shadow banking in China must be viewed in the context of a system which remains dominated by banks, especially large state-controlled banks, and in which the state provides a great deal of direction to banks, through a variety of regulations and formal and informal guidance. In the last few years, those constraints have become sufficiently binding that business has flowed to shadow banks.

There are a number of pressures pushing business away from banks towards shadow banks, including the fact that:

- There are caps on bank lending volumes imposed by the People's Bank of China (PBOC).
- The limit of bank loans to deposits of 75% has been constraining.
- Regulators discourage lending to certain industries.
- Most non-bank channels have lower capital and liquidity requirements.
- Shadow banks are not subject to bank limits on loan or deposit rates.

- Shadow banking avoids costly PBOC reserve requirements.

Perhaps two-thirds of the flow of business into shadow banking is effectively "bank loans in disguise," where a bank is at the core of the transaction and takes the great bulk of the risks and rewards, but pays non-banks to participate in order to avoid regulatory constraints and costs. The other third or so of the business that has moved results from a combination of competitive advantages for the non-banks, many due to looser regulation, and a willingness and ability to reach out to smaller, private sector businesses that are not well-served by the banks.

Shadow banking transactions generally make use of one or more of the following institutions, techniques and instruments:

Loans and leases by trust companies. Trust companies are financial firms in China that have a quite flexible charter and combine elements of banks and asset managers.

Entrusted loans. These are loans made on behalf of large corporations, using banks or finance companies as intermediaries. They are most commonly to other companies in the same group or to suppliers or customers. There is also an interbank version, where one bank will act on behalf of another.

Bankers' Acceptances. These are notes issued by banks that promise to pay a fixed amount a few months in the future. Generally these are supposed to be issued in connection with a non-financial transaction, such as a purchase of goods, but reports suggest they are often used more loosely.

Microfinance companies. These are separately regulated financial firms that are licensed to lend in small amounts to help encourage credit access for small and rural borrowers.

Financial leasing. This represents leasing of all kinds that is not already on a bank or trust company balance sheet and is not a short-term operating lease. Some of this is provided by specialty leasing companies.

Guarantees. Guarantee companies in China provide financial guarantees, including to facilitate shadow banking transactions. Many guarantee companies have branched out to make direct loans, even though they do not have legal licenses to do so.

Internet finance activities. There are many types of companies employing the internet to directly match savers and users of funds. These include peer-to-peer (P2P) lending networks and crowd funding platforms. As of June 2014, there were 1263 P2P networks with nearly RMB 100 billion of loans outstanding. In addition, there were 21 crowd funding platforms that had raised a total of RMB 187 million.

Pawn shops and various unofficial lenders. Pawn shops are important lenders to some households and small businesses. In addition, there are other types of lenders that operate informally or even clearly illegally.

Trust Beneficiary Rights (TBRs). TBRs are effectively a simple form of derivative transaction whereby the purchaser of the TBR receives all or a stated proportion of the returns accruing to a trust. Banks have sometimes used TBRs as part of complex shadow banking transactions to keep the economic benefits of a loan without showing it as a loan on their balance sheets, but moving it to a more favorably treated investment category.

Wealth management products. These are investment products that provide a return based on the performance of a pool of underlying assets. Typically the underlying investment is a single large loan or a pool of loans. WMPs are generally offered by banks or trust companies, although securities firms offer similar products. WMPs are included in discussions of shadow banking in large part because they are a close substitute for bank deposits. WMP investors generally assume that the target return of these products is effectively guaranteed by any bank or trust associated with the product. WMPs are usually purchased by relatively wealthy investors as substitutes for bank deposits, with the benefit of higher yields than banks are allowed to offer on formal deposits.

Inter-bank market activities. Another substitute for formal deposits is created using the inter-bank market. Despite its name, many participants in this market are not banks but are large corporations using finance company subsidiaries to participate. They can lend money to banks in deposit-like arrangements without being subject to caps on deposit rates and without forcing banks to incur many of the regulatory costs of deposits, such as triggering the minimum reserve requirements.

There is a range of estimates of the size of shadow banking in China, depending on the definition of shadow banking and estimates of some important statistics. Six reasonable estimates in the recent past produced figures ranging from about RMB 5 trillion to RMB 46 trillion, or roughly 8 to 80 percent of the size of China's Gross Domestic Product (GDP). Dr. Yu, a co-author of this paper, estimated the size at RMB 25 trillion, or 43% of GDP, in 2013.[1] This compares to an estimate from the Financial Stability Board (FSB) that global shadow banking assets were equivalent to 120% of GDP. On the same basis, the US was at 150%. Thus, China's shadow banking sector is relatively small compared with advanced economies. Further, it is not especially large in comparison with other emerging market countries as a percent of national GDP.

Using figures from the PBOC's measure of Total Social Finance (TSF), shadow banking accounted for about 18%[2] of net flows of TSF in 2014. These figures should be used with some caution, as there are questions of definition and data quality that lead different analysts to different estimates, as explained in Elliott, Kroeber, and Yu (2015). However measured, it is clear that, despite its rapid growth, shadow banking remains substantially less important than formal banking as a source of credit in China.

One of the key questions is whether China could be subject to a severe crisis in shadow banking and how bad the damage might be in such an event. There is certainly significant risk that a crisis could develop in shadow banking, for multiple reasons; among others: the business is inherently riskier than regular banking and operates with smaller safety margins; China is going through some difficult adjustments economically that could trigger loan losses; and there is too little transparency in shadow banking and too much reliance on implicit guarantees. In particular, the recent economic slowdown, together with the big drop in property values and energy prices, has significantly affected the ability of borrowers to service debts obtained through shadow banking channels. To prevent insolvencies, it is a common practice for commercial banks to extend revolving loans from various channels to end users, in order to allow them to service interest payments and avoid default. Thus, the level of bad debts is likely considerably higher than reported.

However, the financial system and the central government appear to be well positioned to deal with such a crisis. First, shadow banking is

[1] See Elliott, Kroeber, Yu (2015).

[2] Calculated as the share of total net flows of TSF accounted for by trust loans, entrusted loans, and undiscounted bankers' acceptances. People's Bank of China, "All-system Financing Aggregate Statistics in 2014," People's Bank of China News, January, 29, 2015, available at http://www.pbc.gov.cn/publish/english/955/2015/20150129085803713420369/20150129085803713420369_.html.

small enough compared to the size of the total financial sector to be handled without disaster. Second, most of the shadow banking is closely enough tied to banks that they are likely to end up honoring their implicit guarantees and dealing with most of the mess on their own. Third, the authorities have more than enough fiscal capacity to deal with even a large shadow banking crisis, given quite low central government debt to GDP ratios, even when adjusted for off-balance sheet obligations, such as the need to rescue some local and regional governments.

In fact, the Chinese central government has taken already taken important measures to tackle this issue in recent years. In January 2013, the General Office of the State Council issued the "Notice on Some Issues of Strengthening the Regulation of Shadow Banks" to classify China's shadow banking activities into three categories: credit intermediaries without a financial license which are totally unregulated; credit intermediaries without a financial license which are under inadequate regulation; and credit intermediaries with a financial license which have inadequately regulated or unregulated businesses. In 2013, the State Audit Commission conducted a comprehensive audit of local government debts, especially local government-owned financing vehicles, which mainly obtained funds from shadow banking. In October of 2014, a document entitled "The Directions of the State Council on Management of Local Government Obligations" was issued to outline a framework and principles for regulating how local governments raise, use and repay their debts. In the beginning of 2015, the Ministry of Finance (MOF) approved a local debt swap scheme with a quota of RMB 3 Trillion. Under this scheme, each provincial government is able to sell low-interest local bonds directly to commercial banks to replace high-interest debts obtained from shadow banking channels. A quota of RMB 1 trillion has been allocated to the provincial level as of the first quarter of 2015.

If this optimistic view is wrong, it is likely to be because the lack of clarity about shadow banking has hidden larger problems than appear to exist and also slows down and muddies a government response. A possible contributing factor would be if the anti-corruption campaign makes it too hard for authorities to make the necessary decisions quickly enough with the information available to them. The financial system is much more complicated now than the last time the government rescued it, when the major banks were completely owned by the government and financial relationships were simpler all around. Now there would be questions about how the government chose to allocate costs and benefits across a much wider range of players, many in the private sector.

In sum, China's shadow banking sector is not especially large by international standards, is relatively simple (with low levels of instruments such as securitized assets and derivatives), and is overseen by regulators who have so far shown themselves alive to the most important risks (namely funding risk and lack of transparency) and have taken prudent steps to minimize these risks. The authorities take seriously their mandate to maintain financial stability, and have acted pre-emptively (for instance in the inter-bank squeeze of June 2013) to nip in the bud practices that might threaten that stability.

The problem for China's financial authorities is that the very large traditional banking sector is not fully serving the increasingly complex financial needs of an economy transitioning from a focus on industry and infrastructure to one based mainly on consumer services and also moving from state ownership and control to a greater level of private enterprise.

The balancing act between encouraging shadow banks to supply needed credit to sectors that are not well served by traditional banks and at the same time protecting financial stability and investors is a very difficult one. The remainder of this paper focuses on recommendations for policy actions by the Chinese authorities. These include a number of recommendations to improve the formal banking sector, and other parts of the financial system, in order to eliminate or reduce the need for shadow banking.

Key objectives of shadow banking reform

We believe there are eight key objectives that should be pursued in designing a better regulatory approach to shadow banking:

- Expand financial services to SMEs, rural businesses, and households
- Diversify financial services provision beyond the current bank-centric model
- Increase the efficiency of the financial sector
- Strive for a level playing field across the financial sector
- Promote the wider financial reforms being introduced in China
- Increase systemic safety
- Increase consumer opportunity and safety
- Help ensure the PBOC can exercise appropriate monetary policy tools

Strategies for Reform

Based on these objectives, we support seven broad strategies for reform of shadow banking and of related changes to the broader financial sector. (There are other desirable financial reforms that are not captured here because they do not relate primarily to the issue of shadow banking.) The seven strategies are:

- Free the banks of most policy obligations and constraints that are not about safety
- When using the financial sector for social policy, work through all relevant financial institutions, not just banks
- Clearly define the nature of the safety net for the different financial institutions
- Heighten the regulation of shadow banks and increase their transparency
- Move monetary policy away from an over-reliance on banks
- Focus on building the corporate bond markets and the institutional investor base
- Focus on cleaning up equity markets and corporate governance

Key Principles of Reform

Expand financial services to SMEs, rural businesses, and households

One of the drivers of growth in shadow banking is the difficulty that many sectors of the economy have in obtaining financing through banks. Small and Medium-Sized Enterprises (SMEs) have a particularly hard time obtaining bank loans, as do rural businesses and households in both urban and rural areas. This produces a high demand for funds from shadow banking channels.

The largest banks, which still dominate the financial system, retain a strong bias to lend to State-Owned Enterprises (SOEs). They are favored borrowers for a variety of reasons, including: implicit State guarantees; favored market positions for some SOEs that make them better credit risks; asymmetric internal reward and punishment systems that mean a failed loan to an SOE is unlikely to be punished severely while bad loans to the private sector can lead to job loss; social/career considerations that make lending to entities run by powerful Party members attractive; and even direct pressure from Party or State officials. The last factor is of decreasing importance, but has not vanished.

Many of the other banks in the system have very close ties to local and regional governments and face even stronger pressure to lend to local SOEs. In fact, few of China's banks, if any, fail to face significant incentives and pressures leading them to favor SOEs.

When banks do look outside of the SOE sector, there is a natural tendency to extend loans to large private firms rather than smaller ones. Partly this reflects factors which are true in virtually every country: larger firms tend to be more stable; they are more likely to need other financial services on which banks can earn profits; they may be large because they have natural monopolies or good business strategies; their senior officers are well-placed socially; etc. In addition, the central role of the state and the party in China mean that the largest firms are also likely to be politically well connected and therefore have some of the same extra advantages as SOEs do.

The problem is that favoring SOEs has a societal cost, since it means disadvantaging private firms, especially SMEs. These are the very companies that are the most efficient overall and have been contributing the most to China's growth and employment. They are reported to have provided 70% of employment and 60% of China's GDP in 2012, while receiving only 20% of bank loans.[3]

The government and party authorities in Beijing recognize that this systemic bias is harmful to the economy as a whole and have explicitly pressured banks to lend more to SMEs. However, this has been only modestly effective, especially since there are many regulatory and political pressures in the opposite direction.

As a result of these remaining biases, SMEs have many profitable opportunities for which they have difficulty obtaining funds. Some of this gap is filled by shadow banks, such as credit guarantee companies, leasing companies, pawn shops, SOEs acting through entrusted loans, and even loan sharks and other less savory funders. Increasingly, internet-based shadow banks, such as peer-to-peer funders and crowd funding platforms, are also filling in this gap.

[3] Sheng, Ng, and Edelmann (2015). Please note that it is unclear from the report in what year the 20% of bank loans figure is for. Some other sources suggest figures closer to 30% for SME loans in 2012.

Some other sectors of Chinese society face similar financing gaps, especially firms in rural areas and households of all kinds. For example, it is comforting in terms of financial stability that Chinese households make down payments of forty and fifty percent when they buy homes, but it is also a sign of serious deficiencies in the mortgage market that even good borrowers cannot make smaller down payments than these very high levels.

Over time, the formal banking system needs to become more willing and better able to fund private firms and SMEs in particular. This should be a priority. But, realistically, it will be a long time before the funding gap narrows to a level similar to more advanced economies, where SMEs still have more difficulty with bank financing than larger firms, but not to nearly the same extent.

Reforms in shadow banking regulation need to avoid unnecessarily reducing access to financing for SMEs, households, rural borrowers, and other disadvantaged sectors. Shadow banks that have particular skills in these types of lending, and a willingness to take those risks, should be encouraged. However, this priority should not override the other principles given below, such as improving consumer safety and financial stability. In most cases, it is possible to achieve all of the key objectives without conflict. At other times, there may need to be a balancing of priorities.

Diversify financial services provision beyond the current bank-centric model

Chinese finance remains dominated by banks, which still provide a large majority of total social credit. More than half of this comes from the "Big Five" banks, (the four behemoths originally split off from the PBOC some thirty years ago, plus the Bank of Communications.)

There are four main reasons to want a more diverse credit system than China has today, one that will be less reliant on banks.

Financial stability. Banks are subject to common shocks that can cause substantial swings in lending activity, usually in a pro-cyclical way that increases the risk of recessions or dangerous booms. Increasing lending through other channels that are subject to somewhat different influences would reduce the cyclical impacts.

Competition. When one sector of finance is clearly dominant, rent-seeking and inefficiencies may flourish, taking advantage of that sector's incumbent position. The high returns on equity achieved by banks in recent years suggest the lack of fully effective competition in finance.

Efficiency. Related to competition, banks have, at least until recently, been strongly favored by government policies that artificially bolstered their profits. For example, bank profit margins were supported by strong limits on how much they could pay for deposits and how little they could charge for loans, although the latter limit has been formally repealed. This created a set of implicit subsidies for banks that encourage uneconomic behavior and reduce pressures for efficiency, innovation, and customer service.

Market-based choices. Banks in China retain substantial vestiges of central planning and allocation of resources, such as government-determined targets for lending volumes, strong encouragement to lend to some industries and avoid others, etc. Shadow banks, and financial markets, tend to be considerably less directed by the government and powerful bureaucrats. To the extent that one believes, as the authors do, that China will ultimately be better off with more market allocation of resources, this is another pragmatic reason to preserve and even expand shadow banking.

Interestingly, Europe is undergoing a similar re-examination of its bank-centric model and has clearly concluded that banks have an excessive share of financial activity on that continent, for many of these same reasons. In Europe's case, most of the focus is on increasing the role of the capital markets through a move towards a "capital markets union", to complement its new "banking union." A recent consultative "green paper" by the European Commission[4] listed three main reasons for encouraging their capital markets. These are, to: unlock more investment for all companies, especially SMEs, and for infrastructure projects; attract more investment into Europe from the rest of the world; and make the financial system more stable by opening up a wider range of funding sources. Increased capital markets activity is likely to increase the role of shadow banking as well, since such firms often rely on market financing as a substitute for the deposits available to help fund banks.

Increase the efficiency of the financial sector

Reform of the shadow banking sector should encourage these firms to be better providers of financial services to their target market than banks are, which then should spur banks to improve their own businesses. At the end of the day, financial services providers need to offer their customers services that are well designed for their needs, are provided effectively, and are offered at a good price.

Probably no one would argue with the objective of increasing the efficiency of the sector, but it is too important to leave out of a listing of the key objectives. The devil will, of course, be in the details of policy recommendations.

[4] European Commission (2015).

Strive for a level playing field across the financial sector.

One of the best ways to achieve a more efficient and safer financial system that includes shadow banks is to strive to ensure that different financial sub-sectors compete on a level playing field. That is, China should seek to avoid influencing which sub-sectors win or lose market share through provision of implicit subsidies or the creation of regulatory arbitrage advantages. There may be activities that merit special aid, such as lending to SMEs, but that aid should be made available, to the extent possible, to all the sub-sectors of finance that are interested in providing the desired service.

Currently, banks and shadow banks operate under very different rules that give them unique combinations of benefits and costs. Banks have major advantages from their position as the dominant incumbent financial services providers, implicit state guarantees that mean that it is unlikely that any funders really believe they will lose money by making a bank deposit or buying a piece of bank debt, access to cheap bank deposits where they are somewhat shielded from competitive pressures by caps on bank rates, and certain other advantages. Implicit state guarantees will be lessened by the new deposit guarantee system, and remaining implicit subsidies will be reduced by the cost of deposit insurance premiums. However, it is unlikely that these benefits to the banks will completely disappear anytime soon, since this would either require that the public comes to accept the theory that even the largest banks will be allowed by the central government to fail or it would require the government to charge premiums high enough to offset the economic benefits of the public's belief in the likelihood of a state rescue. Neither of these conditions is likely to be true for some years.

Shadow banks are allowed to operate with considerably lesser amounts of costly capital and liquidity than banks. This gives them a substantial cost advantage, at the expense of reduced safety margins to protect them from crises.

As a general matter, credit will be allocated most optimally in China if the various sub-sectors can compete on an equal basis. There is no underlying economic reason why one set of financial firms should be favored over another, barring a competition problem that needs to be solved. This may seem contradictory to our principle of recommending diversification from the bank-centric system of today, but it is not. Allowed to compete on an equal basis, and with sensible regulation to provide adequate protections, non-bank financial firms and markets should end up taking substantial market share from the banks.

Promote the wider financial reforms being introduced in China.

As described in Elliott, Kroeber, and Yu (2015), perhaps two-thirds of Chinese shadow banking today is effectively bank activity that is being conducted using non-bank parties in order to avoid onerous restrictions faced by the banks on at least some of their activity. The use of shadow banking is often effectively an inefficient way of achieving economic benefits that could more directly be gained by full implementation of financial reforms that the Chinese authorities have endorsed in principle years ago. Therefore, promoting these wider reforms should reduce the need for shadow banking.

Further, it is important that the specific reforms undertaken to improve shadow banking do not conflict with the larger reform priorities for the financial sector in China.

Increase systemic safety

Shadow banking clearly creates a number of risks for financial stability in China. These stem from:

Lower prudential standards than for banks. Banking regulation is substantially stricter than that applied to shadow banks. Banks hold more capital and more liquidity, are required to avoid certain riskier activities, and are monitored more closely to avoid them going off the rails. Shadow banks in China are almost always run in a riskier manner than is true for a bank engaging in broadly similar activities.

Implicit guarantees. Much of Chinese shadow banking only works because funders believe that a bank or the government will effectively guarantee them against losing their investment. This is most obvious when wealth management products are being used. It is clear from surveys and a myriad of anecdotes that investors in all but the riskiest wealth management products are operating under the assumption that the bank at the beginning of the chains of transactions will rescue them if needed or, failing that, the government will step in to ensure that social unrest does not arise from a failure of the implicit guarantee to be honored. The strength of this implicit guarantee is bolstered still more by what appears to be a substantial degree of mis-selling, whereby bank or trust company employees effectively assure some customers that, in practice, their investments would be guaranteed.

The danger of implicit guarantees comes from the risk that they may not be honored, either because of incapacity in the midst of a crisis or because the two sides to the transaction had different expectations of the unstated guarantee. Once there is a failure of one implicit guarantee, there is a real risk of contagion, where holders of other wealth management products or other customers of the bank become uncertain as to the safety of their investments and withdraw their funds as soon as possible, in a version of the classic "bank run."

It should be noted that an implicit guarantee that is correctly understood by both sides and which the guarantor has the ability and intent to honor may not be very dangerous. For example, a system of guarantees of bank deposits is only now being put into place, but everyone had operated under the assumption that the government and the Party would never allow straightforward bank deposits not to be fully honored, because of the high risk of social unrest, as well as fear of more ordinary forms of financial contagion. However, most implicit guarantees come with more doubt or are at risk of changing circumstances that make them harder to honor.

Lack of transparency. Because so much of shadow banking is a form of regulatory arbitrage, there is usually an element of opacity or even misdirection in the transactions. For instance, banks have used Trust Beneficiary Rights as way to retain the economic risks and rewards of a bank loan while classifying the transaction on their balance sheets as an investment in a financial entity. Opacity makes both government regulation and similar discipline from the financial markets more difficult and likely to fail. Perhaps even worse, in a crisis it can lead to panic as perceptions of the real strength of a bank or other financial institution can plunge sharply as investors and depositors realize that they do not really know what the balance sheet categories represent.

Regulatory inconsistency. There are numerous, consistent reports of regulators allowing, or turning a blind eye, to activities that are not authorized, explicitly not allowed, or even illegal. Some of this is arguably benign in that it is a form of the classic Chinese approach of the reform era of "crossing the river by feeling the stones"; that is, taking small steps and learning as you go. It is reported that when Alibaba started an online money market fund, it informed the authorities of what it planned to do and was allowed to start, as long as it kept the authorities informed. The idea was apparently that, at a certain point, regulators would decide how best to regulate this new, but growing activity, with the advantage of learning by the initial experience. There are clearly some advantages to this approach, but it also creates an environment in which providers do not know what will be acceptable and what will not, and how this might change over time. There is also the danger that authorities may allow a risk to build in the system unrecognized.

Lack of a fully integrated regulatory framework. Financial institutions engage in a wide range of businesses either directly, through their subsidiaries, or in cooperation with independent entities, including shadow banks. However, China's regulatory system consists of the central bank (PBOC), China Banking Regulatory Commission, China Securities Regulatory Commission, China Insurance Regulatory Commission, and various other agencies, including at sub-national levels. This creates regulatory gaps and loopholes which financial institutions can arbitrage to find the most lenient treatment. This problem is far from unique to China but may be particularly dangerous in a rapidly evolving financial and economic environment such as the nation continues to experience.

We have repeatedly heard reports of credit guarantee companies making direct loans, which they are not allowed to do. In some provinces, it is more commonly leasing companies making loans rather than leases. It is difficult to tell whether this is a result of local authorities secretly allowing the institutions under their more direct control to operate with a wider charter than legally allowed in order to maintain higher credit levels in their locality. It may instead be a form of experimentation that is viewed as low risk and therefore tolerated, along the lines of "crossing the river". Or it may be due to corruption or negligent supervision.

Increase consumer opportunity and safety

Banks have offered a fairly limited range of services to households and they have been forced to deliver unattractive deposit rates in recent years as a result of the regulatory caps. One of the first shadow banking products to take off in China has been wealth management products that have, by and large, served as higher-yielding substitutes for bank deposits while being perceived as being virtually as safe as deposits. Thus, this part of shadow banking provided an immediate consumer benefit.

Some of the lending through shadow banking channels has gone to households and small businesses, giving them access to funds they could not otherwise obtain. The rates have been higher than for corporate borrowing, but have still often been quite attractive to borrowers without other good options.

It is important that reform of shadow banking not reverse this increasing consumer access to higher "deposit" rates and the availability of loans on reasonable terms. In fact, reforms should aim at expanding these benefits still further.

Reforms should also improve consumer safety, principally by ensuring that purchasers of wealth management or other investment products understand what they are buying and the risks attached. As noted above, there are disturbing reports of mis-selling of WMPs. It is also possible that borrowers do not always understand the terms of their loans, although this has not come to the attention of the authors as a serious issue at this point.

Help ensure the PBOC can exercise appropriate monetary policy tools

One of the challenges to finding the right balance in reform of shadow banking is that monetary policy has to this point been conducted in China almost entirely by affecting the lending behavior of banks. The more that markets and non-bank financial institutions provide credit, the more complicated monetary policy will become. This has already been seen in the events of the summer of 2013, when the PBOC allowed short-term inter-bank credit markets to tighten considerably, apparently in an indirect attempt to rein in shadow banking activity that was funded through banks reliant on these inter-bank markets. Financial activity was affected considerably more than the PBOC appeared to expect and rates went up higher and faster than anticipated, until the PBOC relaxed the original tightening move.

Monetary policy attempts to influence the level of economic activity and prices in the non-financial portion of the economy (traditionally called the “real economy”), by changing interest rates and credit conditions in the financial economy. Unfortunately, even in the advanced economies, there is a limited understanding of the exact mechanisms by which these monetary policies are translated into real world impacts. Under stable conditions, central banks have learned that using a given tool will usually produce a broadly consistent result, but they generally only understand why this works in very broad terms. When macroeconomic and financial conditions are changing rapidly, this makes it quite difficult to guess how the real world responses to monetary tools will be transformed.

For some time, the PBOC has conducted monetary policy mainly by managing monetary aggregates along with issuing directive administrative orders and restrictions on credit provided by commercial banks. However, the effective translation of these policies to the non-financial sectors of the economy is increasingly in doubt due to the rapidly changing financial environment. A very bank-dominated financial system is evolving to one in which banks are the most significant players, but no longer dominant in a diverse financial sector.

Strategies for Reform

Free the banks of most policy obligations and constraints that are not about safety

As the authorities have acknowledged on numerous occasions, banks in China are subject to an excessive level of direction from the government, both through formal limits and requirements and through less formal direction. There has been a move over the last decade or so to free up the banks from some of these constraints, but there remains much to be done. For instance, the so-called “policy banks”, including the China Development Bank, Export and Import Bank of China, and Agricultural Development Bank of China, are the primary channels through which the government provides credit to priority sectors these days. However, the authorities still encourage some commercial banks to lend for policy reasons to certain favored types of borrowers, such as alternative energy providers, and to shun others, such as in the coal mining and shipbuilding sectors where there is significant over-supply and too much leverage.

It will continue to be appropriate for the authorities to provide guidance and constraints intended to protect the banks from taking excessive risks; this is part of what regulators are supposed to do around the world. We suggest two changes in attitude, moving in the direction that the authorities have already indicated. First, regulators should be more cautious about substituting their own credit judgments for those of the banks. There remains too much of a tendency to direct banks, rather than relying on market forces. Second, there are a number of constraints that are intended to further social policies rather than acting as prudential safeguards for the banks. To the extent possible, it would be better to find other ways of achieving these objectives. As discussed in the next sub-section, if it is desirable to use the financial sector to further such social policies, it would be best to find a way in which the entire financial sector could be directed to do these things, rather than relying purely on the banks

One of the most important steps would be to follow through quickly on the broad agreement that China eventually needs to allow banks to pay rates to depositors that reflect market conditions, meaning that the current caps on bank deposit rates would be abolished. The existence of these rate caps has created a robust market for wealth management products designed to provide virtually the same safety as bank deposits, but with higher rates. (There also exist wealth management products intended for other purposes, but most WMP are deposit-substitutes.) The volume of these products would shrink sharply if banks were allowed to offer similar rates for straightforward bank deposits.

On the lending side, much of the credit provided through shadow banks could come from the formal banking sector were it not for micro-management by the authorities. The PBOC still applies formal lending quotas to the banks, so as to control the volume of bank lending. The authorities also send strong signals at times to reduce or eliminate lending to certain industries, often as an indirect way of managing the ability of declining industries to fund themselves. For instance, there is a glut of certain commodities such as coal and the authorities would like to shrink the coal mining sector. One way of helping ensure that happens is to push banks not to lend into the sector. However, there are sometimes good reasons for a bank to make such a loan anyway, whether it is to help keep a firm afloat so that it will eventually repay an earlier loan from the bank or because the loan makes economic sense in its own right. A shadow banking transaction can avoid violating directives from the authorities while still proceeding with the desired loan, with the bonus that some costly regulatory burdens may fall away if the transaction is not directly on the books of the bank.

Moving to a more market-based credit system, by removing layers of regulatory prohibitions, incentives, and disincentives would allow banks to operate more straightforwardly. They could make commercially sensible decisions, within the normal constraints of prudential supervision intended to ensure adequate safety margins and sensible risk management procedures.

When using the financial sector for social policy, work through all relevant financial institutions, not just banks

There may continue to be times when the authorities in China choose to implement social policy in part through rules or supervisory guidance affecting the behavior of financial institutions. For example, fear of a housing bubble may lead to a requirement that mortgages have higher down payments. Or the authorities may require that at least a minimum portion of loans be made to SMEs. Or lending to industries that the authorities wish to see downsized may be capped or strongly discouraged.

Currently, there is a strong tendency for these rules to be applied to banks, in view of their continued dominance of finance, but not to other types of financial institutions. This distorts the competitive balance within the financial sector and creates incentives for business to move to shadow banking, or, less frequently, towards banks if there is a subsidy or other benefit involved.

Whenever possible, tools should be designed to achieve the social purpose that can be applied in a similar manner across the financial sector, rather than tailored to and applied solely to banks.

One implication of this strategy is that there will be a greater tendency to use “price based” tools rather than “quantity based” ones. Taxes and subsidies are classic price based tools and could be used to discourage or encourage certain activities in a manner that would apply uniformly across the financial sector. Further, capital requirements function similarly to prices across all parts of the sector that have formal minimum capital requirements, since there is a cost, analogous to a tax, to the institution when it funds itself more through expensive capital and less through cheaper debt or deposits.[5] Quantity based tools, such as limits on loan volumes, may be harder to apply across a wide range of financial institutions and markets. For instance, how are caps divided across institutions, especially when additional types of shadow banks may enter the game if there is excess demand beyond the caps?

Price based tools have the additional advantage of giving financial institutions more flexibility to determine when to undertake an activity and how to structure it. For instance, shutting down new loans to an industrial sector by imposing strict limits on loan volumes at banks has in the past led the banks to find ways around the limits, such as by working with the shadow banking sector. If instead, there were the equivalent of a tax or an insurance premium for making such loans, and it were applied across the whole financial sector, the institutions could determine which of these loans were still worth making. This could lead to an aggregate volume that was either higher or lower than intended, but that volume might better reflect the economics of the situation than the figure determined by the authorities initially. Further, the likely cost of meeting the objective would generally be lower, because the volume would be divided across the sector in a market driven manner that concentrated the business with the institutions for whom it was cheapest or where there was the strongest business case to proceed.

Clearly define the nature of the safety net for the different financial institutions

One of the biggest underlying risks in Chinese finance today comes from the high volume of “implicit” guarantees throughout the financial system. It is impossible to completely eliminate implicit guarantees, since they arise whenever someone believes that another party will step in to bail out a transaction or institution, even though the purported guarantor has made no such promise. However, implicit guarantees tend to wither away when there are explicit and plausible guarantees or other mechanisms that define what will happen if trouble arises.

Explicit guarantees are preferable for multiple reasons. First, their clarity makes it much less likely that a crisis will arise, or be worsened, by a misunderstanding as to what guarantee exists. Second, it reduces the potential for a guarantee to change over time, because explicit responsibility will have to be taken for the change. Third, it is easier to charge an insurance premium for an explicit guarantee and thereby remove any distortion of the economics of a transaction that would arise when a free guarantee is given, albeit implicitly.

In addition to implicit guarantees of payment, there is also the question of the “lender of last resort” function of the central bank. Clearly, the PBOC would provide emergency funding to a solvent bank facing a liquidity crisis, as is true for central banks in almost all nations. However, would the PBOC step in if a large trust company or other type of shadow bank had the same problem? The answer to this important

[5] There is a long-standing debate as to whether the total cost of funding a bank rises when equity is substituted for debt, since there is an off-setting reduction in the unit cost of debt and equity when more of the (expensive) equity is used. Under idealized conditions, this reduction provides a full offset. However, conditions in the real world are different and the reduction does not provide a full offset. See Elliott (2013) for a fuller discussion.

question is not clear, which can lead to several problems. The worst case is if a trust company or its funders assumed that the PBOC would intervene and then the funders face losses when this turns out not to be true. The prospect of this could aggravate a crisis, even if the PBOC did in the end intervene. On the other side, the trust company might hold more liquidity than it needs, reducing its ability to provide efficient funding to customers, if it believes it would not have PBOC assistance in a crisis, when it fact the PBOC would have stepped up. Then there are the technical uncertainties that a lack of clarity creates. Central banks usually lend against collateral, as long as the assets being offered as collateral meet its rules, which vary from central bank to central bank. The trust company might own the wrong kind of assets to be used as collateral with the PBOC if it were uncertain in the first place if it had access to PBOC funding in a crisis.

Ideally, the authorities would make clear that there are explicit guarantees for bank deposits and perhaps for specific deposit-like instruments at trust companies or some other financial institutions. There would be limits on the amount covered and certain customers or types of deposits might be excluded. Other funders would explicitly not be guaranteed. In particular, wealth management products and similar items would not be guaranteed.

Similarly, the authorities would make clear which institutions would be eligible for lender of last resort assistance and the rules for that assistance would be spelled out, particularly the collateral requirements.

In fact, the Chinese authorities are in the process of instituting a formal deposit guarantee system for banks. Although many of the details are still to be announced, such as the pricing of the deposit insurance premiums, it is clear that the effect will be to reduce the total level of deposit guarantees from the implicit guarantee currently perceived to exist on all bank deposits. Reports indicate that perhaps half of all deposits, by aggregate size, would fall outside the coverage limits.

An important question will be whether the authorities can convincingly show the public that deposits outside the limits will genuinely be at risk. There may be a strong tendency to assume that the authorities will not permit a large bank, and perhaps even a small bank, from failing to pay out on deposits, for fear of social unrest. If so, then there would continue to be a substantial level of implicit subsidies for the banking system, despite the formal rules.

The authorities should also insist that there be clarity in the financial relationships, especially guarantees, between financial institutions. Investors need to know clearly whether a wealth management product that they bought from a trust company or securities company is backed by the bank associated with the product or not. There is strong evidence that buyers of these products believe that they will ultimately be protected by the bank at the beginning of the chain of transactions. This should either be confirmed, and backed by law and regulation, or investors must be convinced that it is not the case.

Unwinding implicit guarantees is very difficult, especially in China. It will not be sufficient to simply proclaim that the guarantees no longer exist; the investors will have to see a plausible mechanism by which the assumed guarantee will fail to operate. For instance, Fannie Mae and Freddie Mac in the US were very explicitly not backed by the US government and yet everyone “knew”, correctly, that the government could not allow either institution to fail to pay off its debts. Of course, most holders of the preferred shares of these firms, which are debt-like from an economic point of view but are legally equity, assumed they too would be covered, which they were not.

China is in a particularly tough spot in regard to implicit guarantees, because of the well known very strong reluctance of the Party-State to allow social instability to develop. If many people took major losses on wealth management products today, there would likely be such a strong public reaction that the authorities would organize a rescue.

There is always a balancing act in government guarantees of financial institutions in a time of crisis. Many nations, including the US, have dramatically expanded their guarantees in the midst of a major crisis. Countries need the flexibility to do this, but they also need a set of laws and regulations that allow them to avoid this in all but the worst crises.

Despite the difficulties, China should move forward with the elimination of implicit guarantees. It will never be able to move away from the dangers of implicit guarantees unless it clearly defines its intentions in law and regulation and underlines its firmness with words at the beginning and appropriate actions in time of crisis. However, there may need to be provisions of some kind for those transactions previously undertaken with a different set of assumptions by all parties to the transactions.

If China does not provide the needed clarity on guarantees and lender of last resort facilities, there will remain distortions such as we see with wealth management products today, where banks are finding alternative sources of funding to traditional deposits by offering products that are riskier, but which are perceived by investors as being virtually as safe as deposits, due to the likelihood of a bailout.

Heighten the regulation of shadow banks and increase their transparency

There is a huge gap today between the regulation and supervision of banks and other credit intermediaries. Banks have large volumes of rules applicable to them and close supervision, not to mention a substantial amount of less formal guidance from regulators and other authorities. On the other hand, many shadow banks operate with fairly light regulation and supervision and a significant number appear to conduct operations that are outside their charter, and hence at least technically illegal, such as for those guarantee companies that are providing direct loans.

This disparity is too great. As previously noted, banks face too much intervention and micro-management by authorities, which ends up pushing business to shadow banks, which generally face too little supervision. As discussed in our key principles, finance in China will work better when the different parts of the sector operate on a more level playing field. Admittedly, there is a counter-argument for allowing many intermediaries to operate informally or outside their charters in order to encourage innovation. However, this advantage is outweighed by the harm done when substantial amounts of business flow to lightly regulated firms operating with little experience and low safety margins of capital and liquidity.

It may be necessary for some lending rates offered by shadow banks to rise further as they are pushed to operate with higher capital ratios, more liquidity, and more safely in other ways. All of these changes are likely to increase operating costs and there do not appear to be excess profit margins sufficient to absorb the difference without price increases. However, the benefits of a safer shadow banking system should more than outweigh any rate increases.

Authorities have taken a number of steps recently to bring the regulation of shadow banks closer to that of regular banks. In particular, trust companies are facing substantially higher capital requirements and closer supervision than they had in the past. However, many other parts of shadow banking still operate in a quite different regulatory universe where they operate less safely and with far greater freedom. For instance, the required capital levels for guarantee companies are far below those that would be required for a bank, despite the fact that they are both primarily in the business of taking credit risk on loans. In fact, guarantee companies usually get involved when loans are at the risky end of the spectrum, so it is unfortunate that they carry less capital, not more, for the same risk as a bank would.

At the same time, regulation and supervision of shadow banks needs to appropriately reflect the differences between the different types of credit intermediaries. For instance, there is apparently strong pressure on banks not to allow their non-performing loan volumes to exceed 1% of their assets. However, shadow banks that lend primarily to SMEs and households need to accept substantially higher NPLs, since the loans are intrinsically riskier. This does not make this lending bad business, since the higher expected losses can be covered by higher interest rates on the loans. If China develops financial institutions that specialize in credit cards, they may experience even higher average credit losses, while still operating profitably and meeting a social purpose.

As another example, traditional banks in China rely heavily on collateral to protect their loans. This makes sense for some shadow banks, particularly pawn shops, but there is a useful role for lenders that accept the higher risk of uncollateralized loans. Many households and businesses are acceptable credits, but do not have the volume of assets suitable for pledging that would be needed to meet their needs solely through collateralized loans.

Move monetary policy away from an over-reliance on banks

Although a discussion of monetary policy is largely outside the scope of this paper, it must be noted that the shrinking relative role of banks threatens to seriously disrupt traditional Chinese monetary policy based on controlling bank behavior. It is neither desirable nor likely that banks will regain their former share of finance, so the PBOC will have to find, and be allowed to use, other methods for operating its monetary policy. This almost certainly means an eventual move to the use of target interest rates, such as is the case in essentially all advanced economies.

There are likely to be implications for monetary policy from the reform of shadow banking regulation, and vice versa. We do not have recommendations at this point, but urge the authorities to take account of these inter-relationships as they consider both monetary policy and regulatory reform.

Focus on building the corporate bond markets and the institutional investor base

China ought to promote diversity of funding sources by encouraging the growth of its corporate bond and other capital markets, along with the growth of institutional investors to play a major role in these markets. A solid and active corporate bond market that was not dominated by banks as end-investors would provide a major improvement in the efficiency, stability, and overall safety of China's financial sector.

The authorities share this goal of expanding the role of corporate bond markets, and of institutional investors. It would be useful to accelerate this process as quickly as possible, since bond markets dominated by professional investors are among the most efficient methods known for allocating credit in an economy to those corporations that are large enough to issue bonds in efficient volumes. Moving this corporate business away from banks and to markets would also help achieve the goal of pushing banks to lend to SMEs, by taking away the easy business of lending to SOEs and requiring banks to work for new business in the SME and household sectors if they want to continue to grow.

Two ideas could help to achieve these goals. The creation of a system of nationwide credit records, using modern information technology, could be established and opened to all market participants. This would considerably increase the transparency of credit information and improve decision-making while putting diverse market participants on a more level playing field, reducing the current dominance of the banks.

Further, independent local and international credit rating agencies should be encouraged to provide neutral and responsible analyses. Considerable work remains to be done raise the standards and credibility of such ratings in China, including establishing a clear and sufficient distance from potential official pressure for excessively high ratings.

Focus on cleaning up equity markets and corporate governance

Similarly, improvements in the regulation and operation of equity markets and of corporate governance more generally would have side benefits for shadow banking. Many Chinese businesses operate with excessive leverage in part because it is difficult to raise equity from the markets. That leverage in turn makes it more difficult for them to borrow on good terms and raises the level of risk for the credit intermediaries that do lend to them.

Further, there is a problem with corporate governance in China. Ownership is often opaque and there is the risk that management or the majority owners will act for their own benefit to the disadvantage of minority holders. This not only makes it hard to raise equity on good terms, but it also makes borrowing more difficult and riskier for the lenders.

These problems primarily lie outside the scope of this paper, however, so we will not cover them further here.

Conclusions

Shadow banking provides important services in China, helping to spur growth and innovation and assisting in the ongoing move away from state control and towards a more market-based economy. However, shadow banking also brings important financial stability risks, because of less stringent regulation, lower safety margins, riskier business models, and opaque business methods.

Non-bank financial institutions should be encouraged, but they should also be regulated more carefully and comprehensively. Perhaps counter-intuitively, however, many of the most important measures to deal with shadow banking involve actions to make the more formal parts of the financial sector, such as the still-dominant banking system, more efficient and with better incentives to serve the private sector, especially SMEs. Banks in particular are still too controlled by the state, despite broad agreement on the ultimate need for a range of reforms to allow and require them to make decisions on a more commercial basis. A formal banking sector that served society better would eliminate much of the pressure for regulatory arbitrage that produces shadow banking and would push non-bank financial institutions to focus on areas where they have true economic advantages and not just regulatory benefits.

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