'Shadow' Products and Activities with Chinese Characteristics

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Abstract: The rise of shadow banking in China is a multifaceted phenomenon. This research paper investigates the role of non-bank financial institutions (NBFIs) in China's shadow banking system and its implications for financial stability. Shadow banking has raised concerns in China's economic framework, while the NBFIs are playing a significant role in the growth of shadow banking. The study digs deeply into the various types of NBFIs involved in shadow banking activities. We examine the risks these institutions may cause, their interconnections with traditional banks, and the regulatory responses to keep potential dangers under control. The paper aims to give a well-rounded understanding of the overall shadow system in China. It challenges the Chinese financial market by analyzing the status of NBFIs in China's shadow banking system. The Chinese authorities' responsibility to regulate and manage shadow banking activities has achieved some success. However, the challenges persist due to the complex interconnections between formal and shadow banking.

Keywords: Shadow Banking, Non-Bank Financial Institutions, Financial Intermediation, Financial Innovations

1. Introduction

The emergence of diverse financial sectors has contributed to China's rapid economic growth over the past years. In addition to traditional banking institutions, another financial ecosystem has been formed, namely shadow banking (SB). After the 2008 financial crisis, conventional banking channels faced industry credit and regulatory restrictions, and non-bank financial institutions became the leading players in meeting the growing credit needs of enterprises and individuals.

As China's financial services diversify and meet growing demand, non-bank financial institutions have become critical in providing alternative sources of credit and investment opportunities. These entities provide financial products and services outside the scope of traditional banks. However, the rapid expansion of non-bank financial activities has raised worries about financial stability, regulation, and economic health.

This paper focuses on the structure of non-bank financial institutions and their role in China's shadow banking sector. We dig into the factors of the development of these entities, the products and

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services they provide, and their impact on China's financial system and the economy. In addition, we explore the challenges regulators face in supervising and dealing with these activities and their efforts to balance promoting financial innovation and guarding against potential risks.

The first part of this study provides an overview of the historical background and regulatory framework of NBFIs in China. We study the evolution of these entities from their early beginnings to their status. Next, we analyze the diversified financial products and services offered by non-bank financial institutions in the Chinese market, such as wealth management products (WMPs), entrusted loans, online peer-to-peer lending platforms, etc.

As we delve deeper, this paper explores the potential risks of the activities of NBFIs and their potential implications for financial stability. We illustrate the interconnections between these entities and traditional banks to explore how risks in the shadow banking sector are transmitted to the whole financial system. Finally, we investigate the regulations taken by Chinese authorities to address the challenges posed by NBFIs and shadow banking.

Overall, this paper aims to provide an understanding of the role of NBFIs in China's shadow banking system, the challenges and opportunities it presents to policymakers, investors, and the economy and society, and to contribute to discussions on innovation and stability.

2. Literature Review

According to the International Monetary Fund, shadow banking accounts for approximately one-fourth of total money transactions between savers and borrowers worldwide. According to Moody's Investor Service, China's shadow banking transactions accounted for 65 percent of the country's GDP in 2014.

China's version of shadow banking is distinct from other countries and primarily functions as a means for banks to bypass government restrictions. These off-balance-sheet vehicles operate like straightforward lending, with interest payments sometimes exceedingly officially allowed rates but still offering entrepreneurs access to loans at the cost of capital below 14 percent annually. However, the lack of transparency and weaker regulatory oversight compared to traditional banks has raised concerns among global bodies like the IMF and local regulators, prompting calls for increased transparency and scrutiny. Despite these concerns, shadow banking has yielded positive outcomes in emerging markets like China. It serves as a platform for retail investors to invest their funds and enables lending to borrowers outside the official state policy limits. This has significantly advanced market liberalization and economic transition, moving away from strict state ownership and control to a more diversified focus in the Chinese economy. [1]

[2] categorized China's shadow banking into three categories. The first group comprises "unregulated financial institutions without financial services licenses". The second category consists of "intermediaries managed with fewer regulations and do not have financial service licenses". The third and last type refers to "Financial institutions that are fully licensed and regulated but engage in an unregulated or poorly regulated business, such as asset securitization, money market funds, and most importantly, wealth management products".

3. Discussion

3.1. Historical Background of Shadow Banking in China

In the initial years of economic reforms, China's financial system was relatively simple and dominated by state-owned banks. The primary function of these banks was to allocate credit to state-owned enterprises (SOEs) and fund government projects. However, the financial needs of non-SOEs, private businesses, and individuals were often unsatisfied. As a result, informal lending and financing channels are growing outside the formal banking system.

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During the 1990s and 2000s, China introduced NBFIs and addressed the needs of different finance sections. Trust companies were established as one of the earliest forms of non-bank financial institutions to facilitate corporate financing and provide wealth management products. These institutions operated with less regulatory supervision than traditional banks and started to engage in off-balance-sheet lending, laying the groundwork for the shadow banking system.

As time passed, China's economy experienced rapid economic growth and increased credit demand in the early 2000s. Traditional banks faced constraints in meeting this demand due to regulatory requirements and credit allocation biases. As a result, various non-bank financial entities, including trust companies, wealth management firms, and online P2P lending platforms, provide alternative sources of financing.

Wealth management products (WMPs) gained the most popularity among all kinds of' shadow' products because Chinese investors seek higher returns than traditional bank deposits. WMPs were typically marketed by banks and non-bank financial institutions, promising higher yields but often involving investment in those assets with higher risks. These products were considered shadow banking activities because they operated outside the scope of traditional banking regulations.

As the shadow banking sector expanded, concerns about financial stability and potential risks intensified. Regulators in China began to recognize the need to regulate the growth of shadow banking to prevent a buildup of risks. Starting in the late 2010s, Chinese authorities implemented a series of measures to control shadow banking activities.

3.2. ‘Shadow’ Products and Activities

3.2.1. Off-balance-Sheet Lending Products

In China, off-balance sheet products are financial instruments and activities that financial institutions do not record on their official balance sheets. They are commonly linked to the shadow banking sector. Financial institutions employ off-balance sheet activities to conduct different transactions without directly including the assets or liabilities on their balance sheets.

Wealth management products (WMPs) are one kind of Off-balance-sheet Lending products in China that offer fixed rates of return significantly higher than the regulated interest rates on deposits and are frequently used to support investments in industries with limited bank credit. By creating special-purpose vehicles (SPVs) or other entities to hold the underlying assets, financial institutions can keep the products off their official balance sheets, making it difficult to assess their actual exposure.

Here's how it works: When a financial institution, such as a wealth management firm or trust company, creates a WMP, it aims to attract investors seeking higher returns than conventional bank deposits. These investors subscribe to the WMP by pooling their funds, collectively making a substantial investment pool. Instead of directly lending this money to borrowers, the financial institution employs it to provide loans or invest in various assets, like corporate debt or bonds.

Financial institutions set up an intermediary entity to keep these lending activities off their official balance sheets, often referred to as a "special-purpose vehicle" (SPV). This SPV is a separate legal entity from the institution's central financial records. The pooled funds from the WMP are channeled through this SPV, enabling the institution to transfer the risks associated with the lending activities away from its balance sheet.

Through the SPV, the financial institution effectively offloads the exposure to the underlying assets, shifting the risk burden onto the investors who subscribed to the WMP. Consequently, the institution's responsibility is limited to managing and servicing the SPV rather than directly holding the assets or liabilities. Acting as an intermediary, the SPV becomes the holder of the loans or investment assets, making the lending activities seemingly independent of the institution's core financial structure.

As a result, the investors who participated in the WMP become the ultimate bearers of the risks and returns generated by the underlying assets. If the loans perform well, the investors receive attractive returns on their investment. Conversely, the investors may face losses if the underlying assets underperform or default.

Trust Beneficiary Rights (TBRs) are a typical example of a wealth management product (WMP) that facilitates moving lending activities outside the balance sheet of financial institutions, such as trust companies. When a trusted company in China creates Trust Beneficiary Rights, it offers these investment products to investors seeking attractive returns. Investors participate by contributing funds to the Trust Beneficiary Rights, creating a pool of money. Instead of directly lending this money to borrowers, the trust company utilizes the pooled funds to make loans or invest in various assets, such as real estate projects, infrastructure, or corporate debt.

The trust company establishes a trust structure as an intermediary vehicle to keep these lending activities from its official balance sheet. The trust structure acts as a separate legal entity, distinct from the trust company's core financial records. The pooled funds from the Trust Beneficiary Rights are channeled through this trust structure, enabling the trust company to transfer the associated risks away from its balance sheet.

Through this trust structure, the trust company effectively transfers the exposure to the underlying assets to the Trust Beneficiary Rights investors. The trust company's role becomes limited to managing and administering the trust structure rather than directly holding the loans or investment assets.

As a result, the investors who purchased the Trust Beneficiary Rights become the ultimate bearers of the risks and rewards tied to the underlying assets. If the loans perform well and generate returns, the investors receive their share of the profits. However, the investors may incur financial losses if the underlying assets underperform or experience losses.

By employing the trust structure and offering Trust Beneficiary Rights, the trust company accomplishes a form of off-balance sheet lending. The lending activities, although funded by investors, are not directly recorded on the trust company's official balance sheet. This practice allows the trust company to manage risks, optimize capital utilization, and pursue alternative investment opportunities.

However, this off-balance sheet approach raises concerns about transparency and potential risks. As the lending activities are not directly visible on the trust company's balance sheet, assessing the true extent of the institution's financial exposure becomes challenging. This lack of transparency can create uncertainties about the trust company's financial stability and may pose risks to the broader financial system. As a result, regulatory authorities in China closely monitor and regulate Trust Beneficiary Rights and other off-balance sheet activities to ensure financial stability and mitigate potential systemic risks.

3.2.2. Off-balance-Sheet Lending Activity

There is an often-seen off-balance-sheet activity in China which are called Interbank Payment. Interbank payment systems enable banks and other financial institutions to settle payments and transfer funds between each other efficiently. When a bank needs additional funds to meet its reserve requirements or address liquidity needs, it can borrow from other banks through the interbank market. This borrowing typically takes the form of short-term loans known as "interbank loans." The lending bank transfers funds electronically to the borrowing bank using the interbank payment system.

The borrowing bank may use the funds to meet its immediate funding requirements, invest in various financial instruments, or extend customer loans. Since interbank loans are typically short-term, they are frequently used to manage daily liquidity fluctuations and short-term funding gaps.

From an accounting perspective, interbank loans do not directly impact a bank's balance sheet. The borrowing bank records the loan as a liability, which is an obligation to repay the funds, but does not reflect the transferred funds as an asset. Similarly, the lending bank records the loan as an asset, which is the right to receive repayment without reducing its deposit liabilities.

By engaging in interbank lending, financial institutions can effectively move lending activities outside their balance sheets, at least temporarily. This practice allows banks to access funds from other institutions without directly raising new capital or affecting their deposit base. It also gives them greater flexibility to manage their liquidity positions and optimize their balance sheet composition.

However, while interbank lending offers benefits in terms of short-term liquidity management and efficient fund transfers, it also poses risks. Overreliance on interbank funding can leave institutions vulnerable to sudden changes in market conditions and may contribute to financial instability during periods of market stress. As such, regulators closely monitor interbank lending activities to ensure the financial system's stability and mitigate potential risks.

3.3. Bridge-Loan - as Private Lending

3.3.1. Background

China's non-financial enterprises mainly participate in shadow banking through proxy, commercial credit, and equity innovation [3]. Bridge loans are one of the common forms of business.[4] A bridge loan is a short-term loan usually used to address a shortage of funds. Bridge loans are typically provided by private financial institutions, investors, or lending companies. They can be used for different funding needs of individuals or businesses, such as down payment for a home purchase, purchase of investment assets, execution of business expansion plans, etc.

3.3.2. Literature Review on Bridge Loans

Under the high threshold of bank loans and the current less sound capital market in China, some small and medium-sized enterprises (SMEs) will use bridge loan financing to alleviate the temporary shortage of funds.

The bridge loan term is generally less than six months, with the highest proportion of financing in less than one month and a lot of funding between two and three months. The purpose of bridge loan financing is to alleviate the temporary liquidity shortage. Bridge loan financing has three main features: high-interest rate, high risk, and short-term.

3.3.3. Categorization of Bridge Loans

Three main transaction models for SME financing bridge loans are corporate renewal, bank margin, and securities value class. The specific differences between the three types of enterprise bridge loan transactions are summarized in the table below.

Comparison of different bridge loan business models

Table 1: Comparison of varying bridge loan business models

Bridge loan business model	niche model	funding requirement side	Use of bridge funds	source of repayment	purpose of crossing the bridge
Business loan renewals	None	borrowing company	Refund of the last loan from the bank	New bank loans	Realization of borrowing from banks

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Table 1: (continued).

Bank margins	None	borrowing company	Issuance of bills of exchange	Bills of exchange/deposits	close an account
Portfolio value class	Stock Pledge Bridge	Shareholders of listed companies	Redemption of pledged shares	New Stock Pledge Loan	Spread seeking, financing needs
	Fixed-income bridging - repayment purpose bridging	The target beneficiary of the fixed-income plan	Redemption of pledged shares	New Stock Pledge Loan	Avoiding the risk of the share price falling below the issue price
	Fixed Bridge - Gap Financing Bridge	The target beneficiary of the fixed-income plan	Reaching the size of the fixed increase	Stock Pledge Loan	Successful issuance of fixed assets

We cover the first and second forms of bridging loans in detail.

The first form of bridge loan is the business renewal loan. The operation process of an enterprise renewal loan is generally divided into three steps. In the first step, the borrowing enterprise submits a loan renewal application to the original lending bank, and the bank investigates and evaluates the enterprise and gives credit approval. In the second step, the borrowing enterprise applies for a loan from a third-party intermediary, and the third-party intermediary (non-bank financial institutions such as P2P lending platforms, microfinance companies, guarantee companies, crowdfunding platforms, etc.) examines the borrowing application and then issues the loan. In the third step, after the bank's new money is in place, the borrowing enterprise returns the principal and interest of the loan to the third-party intermediary.

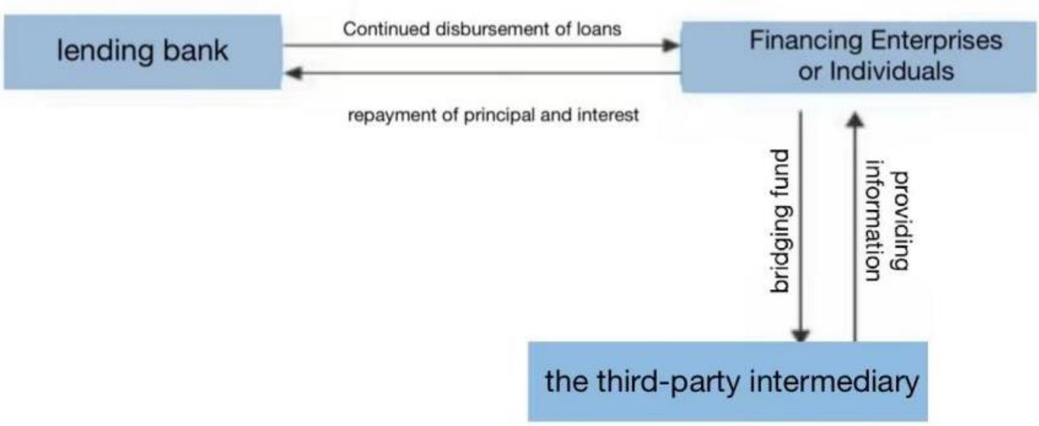

Figure 1: Bridge loan business model

The second form of bridge loan is the bank deposit bridge loan business. In general, the borrower applies to bank A for a bill of exchange, and bank A examines the invoicing person's ability to pay the amount of the bill of exchange before stating sale. If the borrower has insufficient funds, he can apply for a loan to a third-party/intermediary agency. After reviewing the borrower's qualifications, the third-party/intermediary agency approves the loan request. The borrower uses the income loan to pay the deposit and obtain a bank acceptance bill. After the loan is due, the borrower borrows the principal and interest after repaying the third party/intermediary institution. There are two ways for the borrower to repay the principal and interest. One is to repay the principal and interest directly in the form of a bank acceptance bill; the other is to repay the principal and interest in the form of funds.

The source of the funds can be the borrower's bill of exchange discounted to the bank B or the deposit returned.

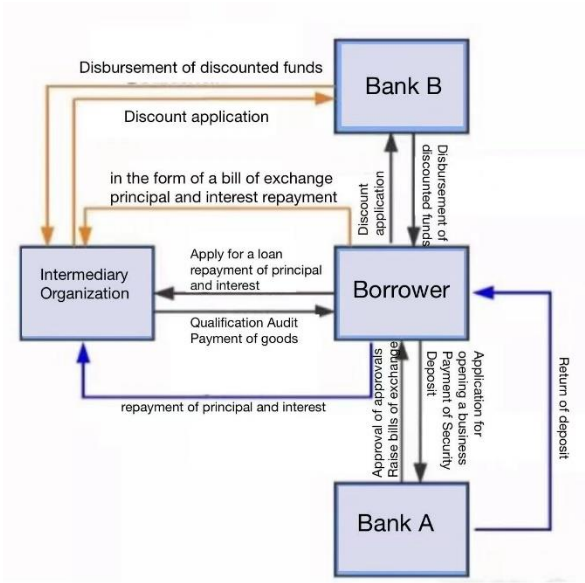

Figure 2: Bank Margin Business Process
Note: No colors are used to represent different processes

3.3.4. Literature Review on the Impact of Bridge Loan Financing on SME Performance

The benefits of bridge loans are simple procedures, fast payment, and other advantages, which are conducive to the timely resolution of the urgent needs of small and medium-sized enterprises, and at the same time, increase the bank's understanding of the specific situation of small and medium-sized enterprises to reduce the degree of information asymmetry, so that banks can eliminate the concerns of small and medium-sized enterprises, improve the efficiency of SMEs in utilizing the lending funds. It should be noted that as they are not subject to the regulation of traditional banks, the operation and lending process of shadow banks for bridging loans usually lack transparency and regulatory mechanisms, which increases risks and uncertainties. Therefore, investors and borrowers should exercise caution when dealing with shadow banks for bridging loans and ensure they are fully aware of the associated risks.

4. Risks to financial stability

The risks of entrusted loan business mainly fall into two categories: Policy risk and operational risk. Policy risk refers to the threat of punishment by regulators because commercial banks do not strictly follow the provisions of policies and regulations on entrusted loan business. For example, whether the source of funds is compliant (such as social security funds, insurance company premiums, listed companies cannot be used to issue entrusted loans between affiliated enterprises), whether the use of funds is compliant, and whether the relevant contract elements such as interest rates are compliant. At the same time, the risk is that the investor cannot judge the risk of the loan project through proper examination means. Due to the diversity of lenders and the inability of investors to accurately grasp the guaranteed ability of guarantors, the function of guaranteed behavior cannot be correctly reflected. Entrusted loans are loans provided by the principal such as government departments, enterprises, institutions, and individuals, which are issued, supervised, and recovered by commercial banks according to the loan object, loan purpose, loan amount, loan term, loan interest rate, and other factors

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determined by the principal. The main problem of supervision is strengthening reasonable compliance policies' management.

The linkages between non-bank financial institutions and traditional banks can allow risks in the shadow banking sector to be transmitted to the board's financial system.

The sources of funds and profit distribution of non-bank financial institutions usually need to be routed through traditional banks, and the operations of the two are often interlinked. For example, the shadow banking sector may apply for credit or financing from conventional banks and use those funds for investing or lending. In the event of problems with the operational risks of the shadow banking sector, these risks may be transmitted to traditional banks and other financial institutions, leading to the spread and contagion of financial troubles.

However, non-banking financial institutions and traditional banks have certain loopholes in their regulatory and compliance regimes, which allow the shadow banking sector's informal operations and risky activities to rely on gray-zone space to avoid regulation, thus making it easier for them to have impacts and shocks on the system.

NBFIs are exposed to financial market risks, including equity, bond, foreign exchange, and commodity volatility. The investment portfolios of these institutions can be affected by fluctuations in market prices, which can lead to asset depreciation and investment losses.

One of the core businesses of NBFCs is the provision of loans and credit facilities. As such, they are exposed to the risk that borrowers or debtors may be unable to repay their loans or debts on time. NBFIs may be exposed to the risk of illiquidity of funds, i.e., the inability to meet the withdrawal needs of borrowers or fulfill payment obligations for other liabilities promptly.

The trust industry in China also faces several specific risks, including the opacity of trust products, the source of funds of trust companies, and the risk assessment of trust projects. These risks may affect the profitability and solvency of trust companies. To increase revenue and expand business scale, some platform companies intentionally conceal lousy information on the network and engage in "Ponzi scheme", leading to continuous moral hazard occurrence. For example, when P2P investment is booming, non-performing loans are the secret each platform is unwilling to mention, which is prone to moral hazard.

5. Regulatory response and challenges

In "Risk Analysis and Modelling of Shadow Banking [5], it is pointed out that government regulators should take measures to prevent risks[6].

1. Strictly issue Internet financial licenses and require guarantee companies to deposit bank deposits

The Banking Supervision Bureau should only issue Internet finance licenses to enterprises that have reached a certain number of years, have been operating well for a long time, and have a high reputation. It should also stipulate that the guaranteed company should deposit a certain percentage of "compensation reserve" in the designated bank account. The CBRC should formulate the entry threshold of P2P, especially the requirement of registered capital and the qualification of practitioners, to avoid the occurrence of P2P and Ponzi schemes and improve the industry's credibility [7].

2. Local financial regulators should establish a regional inspection system to prevent fake banks from showing up

Local financial regulators rely on the public security system regularly or irregularly, employing full-time and part-time informants to report about private lending shadow banks at any time and to take urban business buildings with rallies and rented rooms in urban and rural areas as a focus of monitoring.

3. Deepen interest rate marketization reform

Promote the reform of interest rate marketization to increase transparency, change the way of regulating the financial behaviors of private lending and shadow banking, and formalize private financial institutions so that they are brought into the realm of proper regulation.

Non-bank financial institutions are an essential part of China's financial system, and the trade-off between their innovation and stability is also of great significance [8].

Innovation can promote the development and upgrading of non-bank financial institutions. Innovation can enhance an institution's competitiveness and service capacity while meeting people's changing financial needs. For example, innovations in emerging areas such as internet finance, supply chain finance, and consumer finance can promote the further development of NBFIs.

Stability is the foundation of non-bank financial institutions. NBFIs are responsible for the transit of capital and risk management, and if the institution itself is unstable, it will lead to risk exposure of the entire financial system. Therefore, maintaining the institution's stability is essential in ensuring financial stability [9].

The trade-off between innovation and stability of non-bank financial institutions needs to be guided by policy orientation. The government should adopt various means, such as improving supervision and establishing a risk prevention system, to safeguard the stability of financial institutions. At the same time, it should also actively guide financial institutions to carry out innovative activities, such as strengthening investment in science and technology and optimizing financial products [10].

Strengthening the risk management capacity of non-bank financial institutions is also essential for balancing innovation and stability. NBFIs should strengthen their risk identification and prevention capabilities, improve their ability to cope with risks and ensure institutional stability.

Overall, the trade-off between innovation and stability for NBFIs needs to be mindful of the importance of financial stability while at the same time giving full play to the driving role of innovation. Policy orientation and improved risk management capabilities are vital in balancing innovation and strength [11].

6. Conclusion

The rise of shadow banking in China is a multifaceted phenomenon with unique 'Chinese characteristics.' It has emerged as a parallel financial system, offering benefits such as increased credit availability and investment opportunities and posing significant financial stability risks. The Chinese authorities' efforts to regulate and manage shadow banking activities have yielded some success, but challenges persist due to the complex interconnections between formal and shadow banking.

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