

The Research on Shadow Banking System in China and Its Impact on Small and Medium Enterprises (SMEs) Financing

--- Taking Wealth Management Products as an Example

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Abstract: The project aims to explore the shadow banking system in China and its impact on small and Medium Enterprises (SMEs) Financing. It mainly studies the development of shadow banking in the last ten years, the effects of regulation in the financial industry, and its shape process of the financial injection into small and Medium Enterprises, the source of funds, and the balance of the shadow banking system in four main channels, and the structure of wealth management products. This paper concluded that the development of the shadow banking system, especially the industry of wealth management products, has encouraged the SMEs financial to some extent. However, more regulation policies focused on the hidden risks are still needed to develop.

Keywords: Shadow Banking System, Small and Medium Enterprises, wealth management product

1. Introduction

The paper explores the relationship between the development of the shadow banking system and the financing issues that existed in small-and-median enterprises. It summarizes the official definition of shadow banking and its unique features in China, including the market size, the relationship with traditional commercial banking, and strict regulation policies. The related data and data analysis indicated that the significant markets are wealth management products and trust products, mainly originated and managed by commercial banks and well-known as off-balance assets.

Since the small-and-median business contributed a lot to the Chinese economic system. However, the financing problems are the major issue these enterprises face as they present higher risk in cash flow management and higher solvent risk. The development of wealth management products (WMPs) helps these companies enlarge the choice of financing channels and related the financing stress in the Chinese financial market to some extent. However, the structure of WMPs shows the importance of management abilities within the management institutions. The literature analysis proves that shadow banking governance has made remarkable achievements. However, the person in charge of the CBRC said to maintain high pressure, severe rectification of key areas of critical risks in violation of the law, and persistent dismantling of high-risk shadow banking business.

2. Research review

In the past 20 years, China's Shadow banking has shown an explosive development trend. From 2008 to 2009, when the world economic crisis broke out, China introduced a 4 trillion-yuan economic stimulus plan, and the scale of China's "shadow banking" expanded rapidly. Shadow banking plays a key role in driving China's economy, but it also raises concerns about the size of its liabilities and the dangers they pose. The size of the debt and the threat it poses to the fiscal system. In essence, it is a wealth management product (WMP) or other forms of financial derivatives funded by financial intermediaries such as banks, banks, accounting firms, etc. Assets or financial plans issued by banks, trusts, securities firms, and other financial intermediaries. These products are aimed primarily at individual and institutional investors rather than bank deposits, which generate more revenue from funds.

Allen and Qian believe that both basic and information factors should be taken into account in entrusted lending, especially unrelated lending. The stock market reflects that both affiliated and nonaffiliated loans are compensated investments. They conduct transactional-level analysis of entrusted loans, which are one of the largest components of shadow banking in China [1]. Allen proposed a comprehensive assessment of China's financial system and explored the way forward. They held in-depth discussions on the future development of China's stock market and other financial markets. [2].

Diamond and Dybvig point out that under certain conditions, state deposit guarantees can create more favorable contracts. The results show that bank deposit contracts can be more competitive in financial institutions than in exchanges, which is why banks can absorb more capital. [3].

Nicholas Bost points out that in the process of economic development, there is usually a compromise between ideally and politically feasible policies. According to the report, policymakers have finally lifted the cap on deposit rates, which makes it impossible for banks to compete efficiently with mutual funds in the financial markets. China's shadow deposits have only recently emerged and faster than in the United States. If financial progress is not made and prudent management of banks is strengthened, China's shadow deposits will continue to grow and may bring instability to the economy. [4].

Viral V. Acharya pointed out that in the overall financial crisis if there is a stronger government guarantee that even poorly run and struggling national financial institutions can obtain and issue loans at lower prices, this makes the private sector particularly vulnerable in this crisis. They studied the vulnerability of the Indian banking industry in the financial crisis in 2007-09 and used the data before the financial crisis to examine the role of state guarantee on the banking industry in the financial crisis. [5].

The research method similar to Kinda Cherly uses these rules to constrain cross-sectional differences as well as time changes in product characteristics. They also discussed other ideas about the rise of shadow banking. The opinions expressed in this article only represent the author's own views and do not represent the position of the National Bureau of Statistics. It will also explain why the above assumptions do not explain the origin of the system [6].

Wang said that after the implementation of the two-track reform, the complete liberalization of formal control over banks will not bring higher returns if they continue to maintain poor credit conditions for state-owned enterprises (SOE). They have carried out a two-track interest rate reform of China's "shadow banking," which is a new market approach under the control of conventional banks [7].

Melanie L. Fein did talk about the concept of "shadow banking," but she saw it as a part of the development of the banking industry and spoke highly of its benefits, but managers didn't really realize it until after the economic crisis. The shadow bank is seen as a sin outside the regulated

banking system. The article calls on managers to think more deeply about shadow banking as something created in a regulated banking system, while trying not to let its positive impact on their own financial reforms [8].

Chen discussed the relationship between the "shadow banking system" and "monetary policy implementation." They argue that shadow banks are asymmetric because they promote the growth of the supply of capital while weakening the effect of tighter monetary policy decisions based on interest rates [9].

Ehlers also suggests that shadow banking is an essential dimension of understanding modern finance. In recent years, the development of shadow banking in China has been unprecedented [10].

3. Discussion / Development

3.1. Shadow Banking System in China

3.1.1. Definition and Features

What is the Shadow Banking in Chinese Financial Industry

The concept of shadow banking was first proposed by Paul McCauley, executive director of Pacific Investment Management, at the Fed's annual meeting in 2007 as financial institutions that are outside the regulatory system and correspond to the traditional commercial banking system subject to the regulation of the central bank [11]. With the financial deregulation in the United States, a series of innovative financial products emerged, and the shadow banking system was gradually formed.

At present, there are three forms of "shadow banking" in China's financial market: bank wealth management products, credit products of non-bank financial institutions, and private loans. Whether it is a Person-to-Person lending (P2P) platform, microfinance companies, or private equity funds, the essence of their business is the collection and placement of funds, approximately equal to the bank's deposit-taking and loan issuance. The China Financial Regulatory Report 2014 divides China's shadow banking business into three levels [12].

The first level is the narrow caliber shadow banking system, which is defined based on whether to accept supervision and mainly produces Product tools, including small loans, financing guarantees, P2P network loans, and no record under the non-financial license business private equity funds, third-party finance, and private lending.

The second level is medians-caliber shadow banking. Its business scope includes the shadow banking system in a narrow sense, and the other is trust, financial management, money market funds, asset management, asset securitization, equity financing, and other wealth management products.

The third level is the broad shadow banking system, which includes the medians shadow banking system, the bank off-balance-sheet unconventional credit business (i.e., bank acceptance bill, account payable, loan commitment, etc.), and the non-traditional credit business on the bank balance sheet (i.e., standardized and non-standardized investment, non-interest-bearing assets, deposit of central bank funds, etc.).

China's shadow banking is obvious compared with foreign countries difference [10,13]. The shadow banking system in the United States exists in a non-bank financial form. But in China, China's "shadow banking" is played by commercial banks.

The Main Features of the Chinese Shadow Banking System

The role of the field tools in the shadow banking business is very limited. Shadow banking in China started relatively late, so its structure, scale, and pattern could be more stable. In recent years, China's economic development level and industrial knot Structural adjustment, the structure of the financial

market, and policy changes have all contributed significantly to the development of China's shadow banking influence. At this stage, the funds of China's shadow banks are mainly made from the non-capital protected financial products of banks Industry debt to raise funds composition.

First, funds mainly come from the banks, and the main body of the funds is still the savings funds of the depositors. Thus, it prompts investors to seek opportunities to achieve high investment returns, equivalent Part of the bank funds through the bank financial products, trust funds, private lending, and other ways flow into the shadow bank system.

Secondly, funds are mainly invested in the bank's customers. On the one hand, commercial banks should maintain customer relations and deal with finance from the perspective of disintermediation challenge, the financial products issued by bank-trust are used to raise funds, and through non-bank finance Institutions set up the investment asset management plans and other forms, will raise the funds to purchase the asset management plan and finally realize the credit out outside. On the other hand, financing enterprises achieve the purpose of financing through non-credit and other forms. In this kind of bank table, the development of external business can not only expand the loan scale but also meet the regulatory requirements, realizing the reduction of bank wind. The target of insurance assets and improving capital adequacy ratio has certain defects and cannot fully meet the needs of commercial banks. Companies that pay for loans have also raised money.

Thirdly, banks play a leading role, and securities brokerages trust companies are only reflected in the channel. Our shadow Another characteristic of banks is that commercial banks dominate them. To a large extent, China's shadow banking is in order to avoid supervision, and commercial banks take the initiative to transfer their resources out of the traditional deposit and loan business. Therefore, this situation will occur mainly because commercial banks in China's financial system have absolute advantages in capital scale, branches, and customer resources. Therefore, in China's shadow banking, The Bank of China is still the core, and the primary source of funds and credit support of the whole system depends on banks. In the shadow Under the "channel" mode of banks, the status between banks and non-bank financial institutions that undertake the function of the channel is not In ally, banks occupy a dominant position in providing funds and choosing investment projects to bypass supervision To manage the purpose of issuing loans or their own assets, and ultimately bear the risks and returns of the investment Financial institutions such as trust and securities firms become the bridge between commercial banks and the underlying assets, charging channel fees, Use the scale effect to achieve income, but cannot play an active asset management function.

In summary, shadow banks in China have several unique characteristics: (1) the source of funds is influenced by market liquidity; (2) it is subject to less strict regulation of deposit money institutions; (3) the leverage ratio is higher than the traditional banking system. Overall, it has a similar financing and lending intermediary function with commercial banks but outside the traditional monetary policy supervision of the monetary authorities.

3.1.2. Development Trend

This research paper collected the following data from Wind Financial Terminal as the market size of the shadow banking system in China, including the balance of commercial banks wealth management products, the trust assets, the scale of brokerage asset management business, and microfinance company loans.

China's broad shadow banking assets decreased by 1.34 trillion yuan to 57.8 trillion yuan in the first half of 2021, and their share of nominal GDP fell to 52.9% from 58.3% at the end of 2020, an eight-and-a-half-year low, according to the latest China Shadow Banking Quarterly Monitoring Report by international rating agency Moody. The main part of the decline was a \$1.1 trillion decrease in assets docked to wealth management products and asset management plans. Over the same period,

shadow banking assets declined to 17.6% of total banking sector assets, down from 18.9% at the end of 2020.

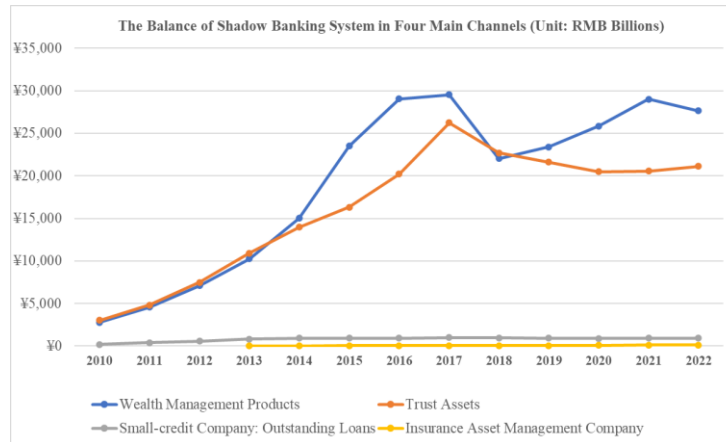


Figure 1: The Balance of Shadow Banking System in Four Main Channels (Unit: RMB Billions) [14]

The market sizes of the four channels of the shadow banking system are shown in Figure 1. The wealth management products and the trust assets are two major products that increased sharply from 2010 to 2017, which presents the overall development of the Chinese shadow banking system. The development of small credit companies and insurance asset management companies is at the early stage with relatively smaller market sizes. In summary, the data in the figure shows that the four categories of shadow banking are developing in an upward trend. Shadow banking is growing at an increasing rate in China, and its market share is getting higher. The highest share is for wealth management products, which this paper will investigate in more detail in the product structure and its impact on SME financing.

The Source of Funding

As the Wind Financial Dataset indicated, the main funding of China's shadow banking comes from three sources. More than 70% of funding comes from individual investors, 20% of funding comes from commercial bank financial derivatives (mortgage loans, commercial paper), and the rest of the funding comes from shadow banking financial institutions (insurance, hedge funds).

Lending (credit assets) of China's shadow banking flows mainly into three types of borrowers, the local government financing vehicle (LGFVs), the enterprises with excess capacity and need more funding, and real estate developers. As Figure 2 shows, funds of shadow banks in China mainly flow into Local Government Financing vehicles at 76.6%, followed by Real Estate Developers in China at 11.9%, and Enterprises with excess capacity and needs funds have minor funds at 11.5%.

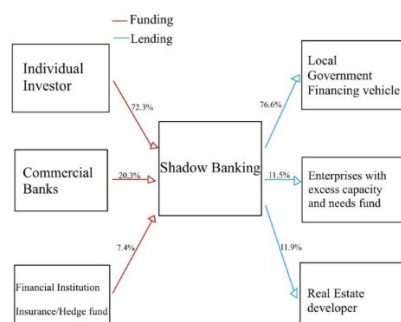


Figure 2: Source of funds and main borrower

Figure 3 summarizes the funding and lending resources of the shadow banking system. Shadow banking, taking wealth management products as an example, promises investors a rate of return that is relatively higher than the money market rate on the funding collected and individual investors. Individual investors take up nearly 73% of the source of funding, which means that most of the money in shadow banking comes from people's savings. The right side shows the lending of shadow banking for these funds. The local government financing vehicle used up nearly 77% of the investment. These projects are the major financing resource of SMEs.

The Major Cash Flow Injected into Small and Medium Enterprises

Moreover, the development of shadow banking has helped small and Medium Enterprises (SMEs) to solve financing difficulties, but it has also increased systemic risks and regulatory arbitrage. Most shadow banks in China are independent financial institutions not subject to financial supervision by the Chinese government. To be more specific, most shadow banks in China are independent financial institutions that are not subject to bank supervision by the China Banking and Insurance Regulatory, supervised directly by the Chinese government, foreshadowing potential risk.

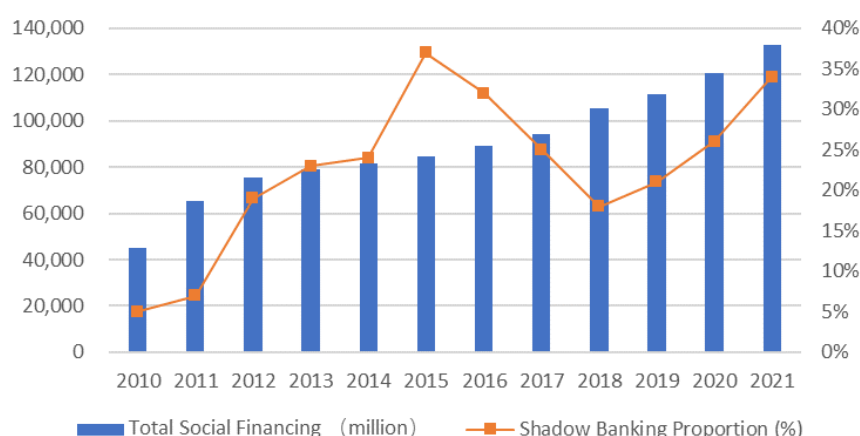


Figure 3: The Financing Injected into Small and Medium Enterprises (Unit: RMB million) [15]

Figure 3 summarizes the total social financing of SMEs and the proportion issued from shadow banks from 2010 to 2021. There was an upward trend from 2010 to 2015. In 2015, the percentage of SME financing from shadow banks peaked, followed by a downward trend from 2015 to 2018 and an upward trend from 2018 to 2021. Reasons for the decline in shadow banking financing from 2015 was the P2P thunderstorm in 2016, which led to the closure of many institutions with a shadow banking nature, this percentage decline highlights the continued focus of regulators on reducing shadow banking risk. Overall, the shadow banking channel provided nearly 30% of social financing to SMEs with an upward trend.

3.1.3. Major Issues of Shadow Banking to Corporate Financing

Compared with developed countries, China's debt leverage, although low overall, is growing too fast and has some problems. Some issues include more invisible debt; the overgrown debt related to over-reliance on indirect financing, overcapacity taking up a large amount of funds, inefficient use of funds, and over-instrumentalization of monetary and credit policies [16].

Shadow banking promotes bank competition and discourages firms from obtaining bank financing. In a competitive credit market, banks compensate for the risk premium by raising interest rates, making it more burdensome for firms with lower cash flows in the short term to forego loans. In

contrast, in a monopoly credit market, banks can compensate for the loss of initial project cash flows through monopoly rents with a view to higher future cash flows [17].

3.2. The Analysis of Product Structure

3.2.1. The Structure of Wealth Management Products

Wealth Management Products (WMPs) plan refers to a kind of securities investment business carried out by commercial banks and some non-bank financial organizations. Sometimes, it's also a way to save money. Among the various forms of "shadow banking" in China, the WMPs business is undoubtedly the most widely known and popular one. Anecdotal news and opinion polls show that investors firmly believe that the products are well-expected earnings which are provided by banks and their affiliates. One of the reasons is that the role of China's commercial banks is the authoritative role of financial institutions.

WMPs can be categorized into two major types based on the financial institutions involved in issuance: banks and "channel" firms. "Channel" firms are usually banks' subsidiaries created as banks' investment or wealth management arms. Non-bank financial institutions issue the third type of WMPs without banks' active involvement [10].

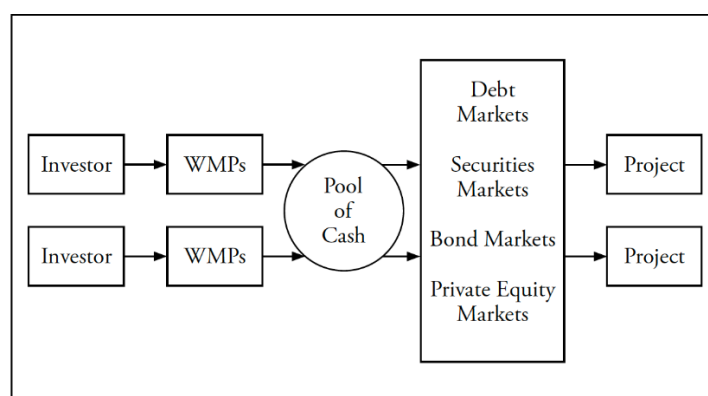


Figure 4: WMP's Cash Flow [18]

Figure 4 shows that the money collected from individual investors into WMPs will be invested in debt markets, securities markets, bond markets, and private equity markets, and finally, private equity invests the money in various small and medians-sized enterprise projects.

It is conducive to the redistribution of social resources, as well as this process can help SMEs to develop better. WMPs financially redistribute the social funding, from which they collect the individual funding to support SME financing.

3.2.2. The Risk Analysis

Small and medium-sized enterprises play an important role in China's economic development. Overall, they contribute more than 60 percent of GDP, 79 percent of jobs, and 68 percent of exports. Small and medium-sized enterprises are an important force in China's economic development. Today, most large enterprises and innovative enterprises, which were once small and medium-sized enterprises, are small and lack capital. However, among these small and medium-sized enterprises, some people can become creative entrepreneurs who can bring new vitality to China's economy.

In recent years, Chinese authorities have tried to streamline cumbersome approval processes to free up more money for small and medium-sized enterprises. This is why the proportion of loan requests rejected has declined in recent years. Bad debts will also rise sharply as it becomes easier for

small and medium-sized businesses to borrow from banks. In 2020, the credit rejection ratio for small, medium, and micro enterprises was 3.79%, 0.26 percentage points lower than that in 2019. The survey showed that 57.94 percent of SMEs tried to obtain credit from banks. According to statistics, 55.74% of small and medium-sized enterprises have achieved good financing results. Most SMEs are privately owned and do not have as high a reputation as state-owned enterprises, so most SMEs are classified as non-performing loans (NPLs). Those loans are then written off their balance sheets through the issuance of financial products.

Therefore, the demand for WMPs will also rise. Although the state stipulates the number of financial institutions that a commercial bank can invest in WMPs, this does not mean that its issuance will become less. Another 42 percent of unapplied small and medium-sized enterprises, including those making loans to banks, are obtained through hidden financial institutions such as trust companies. Compared with companies in the United States, they raise money by selling high-return financial assets. In any case, financial services provide a large source of funding for small and medium-sized enterprises [14].

In the process of China's development, WMPs have also achieved some results recently. However, behind the rapid growth, there are different problems and risks. At present, every buyer of financial products has to face and think about these risks.

The Lack of Transparency

The lack of transparency in many parts of the WMP sector also means investors need more time to get to know them. The lack of transparency in the sector also means that investors need to have information to price these risks appropriately. WMP prospectuses issued by banks generally provide only general statements informing potential investors that the product is not a deposit, that there are investment risks, and that a standardized risk rating is given. However, there needs to be more helpful information about which investments will be funded; the indicative portfolio allocations are incredibly general, and asset class descriptions are limited.

Maturity Mismatch

Another problem is the mismatch in debt maturities. All financial commodities need to go through special calculations to establish overall economic development. Although its core value has strong stability, its price will inevitably fluctuate when the external environment changes. For example, with the rapid development and transformation of all walks of life, the economic benefits of various financial products used by commercial banks for various fields of society have also changed. This causes commercial banks to fail to make correct judgments on the development of financial markets in the process of financial asset management, which leads to the risk of financial asset investment. Financial institution is a kind of short-term financial institution, the capital raised by it is mostly concentrated on the longer and illiquid assets, so it is easy to run, which brings great liquidity risk to commercial banks.

3.3. The impact of Shadow Banking on SME financing

Chinese shadow banks mainly act as financial intermediaries. Shadow banks act as credit intermediaries between traditional commercial banks, large enterprises, individual residents, or small and medians-sized enterprises and play a role in transferring funds. In this process, active shadow banking promoted the flow of monetary funds and increased the scale of social financing.

As a financial intermediary, shadow banking mainly obtains funds to provide to SMEs in three ways. The first is through cooperation with commercial banks. This approach is mainly a means for commercial banks to transfer on-balance sheet assets to off-balance sheet assets through shadow

banking. For example, trust financial products in bank financial products, that is, the product of bank-trust cooperation. Through cooperation with trust companies, commercial banks invest the absorbed funds into the projects of trust companies in the form of investment. Trust companies use this business to raise money and lend to small and medians-sized enterprises to generate revenue.

Second is access to capital through large enterprises. Large enterprises have an advantage in scale capital strength, and are easier to obtain low-interest loans from commercial banks. When meeting their own business needs, large enterprises usually invest in trust projects of trust companies or small loan companies and other shadow banking businesses or institutions with spare low-interest loans, and small and medians-sized enterprises obtain loans from the funds absorbed by shadow banks. In this process, shadow banking plays the role of credit intermediary, which increases the scale of social financing and promotes the financing of small and medians-sized enterprises by absorbing funds.

Finally, funds are obtained through individual residents. Nowadays, with the development of the economic level, the living standard of residents has been improved, and the awareness of creating wealth has been enhanced. The traditional way of saving and investing can no longer meet people's demand for wealth. In order to obtain higher investment returns, people turn to the simple procedures and flexible time of private lending investment. Social idle funds, therefore, flow to the shadow banking system through the private lending system. After absorbing funds, shadow banking provides them to small and medians-sized enterprises to meet their financing needs and bring benefits to fund investors.

4. Conclusion

WMPs are neither the best financial instrument for SMEs to finance nor the best financial tool for individual investors to invest their hard-earned money. However, it is evident that over the past few years, the Chinese government has put much effort into addressing these risks by improving the regulatory framework or issuing relevant guidance on the shadow banking system. Therefore, rather than looking for alternatives to replace WMPs, the government could quickly abandon WMPs because the market for WMPs represents a large percentage of China's GDP. The importance of WMPs goes beyond how large the market is. Without WMPs, Chinese SMEs would likely have a much shorter life span. In the absence of financial instruments, investors who do not have access to high-quality asset management services can easily find their money unreliable. In response to this need, financial derivatives came into being. This mechanism may not be perfect, but it still plays a key role in China's economy.

In summary, WMPs redistribute the social funding financially, from which they collect the individual funding to support the SMEs financing. WMPs are conducive to the redistribution of social resources, as well as this process can help SMEs to develop better. However, more intelligent regulations focusing on this industry are urgently needed to help shadow the banking system more healthily.

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