BBVA | RESEARCH

Banking Watch

China

Hong Kong, November 23, 2011
Economic Analysis

Chief Economist of Emerging Markets
Alicia Garcia Herrero
alicia.garcia-herrero@bbva.com.hk

Chief Economist for Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Senior Economist
Le Xia
xia.le@bbva.com.hk

George Xu
george.xu@bbva.com.hk

China's shadow bank lending: a threat to financial stability?

Summary

China's informal and unregulated shadow banking system has grown rapidly in the past two years, and now accounts for over one-fifth of total credit in the economy. Among the reasons for this rapid growth are: (i) efforts by depositors to shift from standard bank accounts to higher yielding wealth management products; and (ii) incentives for lenders to circumvent tighter prudential regulations imposed on the formal banking system. The shadow banking system has played a useful function in the past, by channeling credit to profitable businesses, especially SMEs that might otherwise have been credit constrained.

The pace of recent credit growth has given rise to a number of financial stability concerns:

A first risk relates to lending concentration. Most of the recent lending associated with the boom in shadow banking has been extended to real estate developers, who face increasing challenges in selling housing units at the prices they had originally projected.

A second risk stems from maturity mismatches, as the funding of shadow-bank vehicles are often very short term and increasingly expensive given the tightening monetary policy cycle.

A final risk lies in potential liquidity shortages within deposit-taking institutions, particularly if shadow banking continues to attract savings deposits looking for higher yields (this is already happening). On the other hand, a sudden change in policy which favors deposit-taking institutions in the formal sector in attracting deposits could create sudden liquidity shortages in shadow banking vehicles, and thereby increase their dependence on short term funding even further.

We believe the overall risks outlined above are manageable as long as the authorities take timely steps to slow the growth of credit extension in the informal part of the financial sector and also step up its oversight. While capital requirements have been introduced in some parts of the formal financial sector (namely trust companies) others parts remain untouched. Furthermore, capital requirements are still lower for trust companies than banks so more efforts are needed to avoid regulatory arbitrage.

One crucial measure to discourage shadow banking is interest rate liberalization, especially on the deposit side, where rates are currently subject to a cap. Such liberalization would allow deposit-taking institutions to compete for wholesale deposits as well as those of affluent households. Finally, it would also be helpful to encourage banks to service SMEs better, not through directed lending, but rather through indirect policies such as subsidized lending rates.

What is China's shadow banking?

Recent reports of turmoil in the "private lending market," for example in Wenzhou City of Zhejiang Province, have generated concern about the vulnerability of China's shadow banking system. There are good reasons to worry as the shadow banking system has witnessed very rapid growth in the past two years. We estimate that credit extended by the shadow banking system amounts to 22% of total credit in the economy (or 29% of total bank loans). Given its size, therefore, instability in the shadow banking system could pose systemic risks to the broader financial system (Chart 1). [1]

The shadow banking system consists of trust loans, entrusted loans (or designated loans), bank acceptances, and private lending:

- Trust loans refer to the loans of trust companies, which are prohibited from taking deposits, but which are authorized to manage assets for enterprises and individuals. As such, trust companies can extend interest-bearing loans, financed through various financial products sold to enterprises and individuals. A recent type of financial product commonly used by trust companies are "bank-trust cooperation wealth management products" (WMPs), which are essentially notes issued by trust companies. Under this operating model, trust companies sell various WMPs to individuals through banks' retail channels and then use the proceeds to issue loans (Chart 2). Though not guaranteed by banks, WMPs are attractive to individual investors as they offer attractive yields, usually well above bank deposit rates which are capped by the central bank.

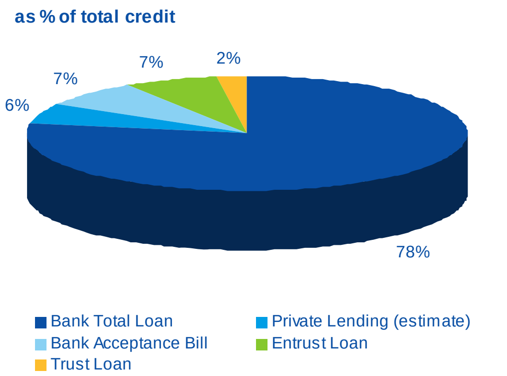
- Entrusted loans are company-to-company credits with the involvement of banks or other financial institutions acting as a broker (such as finance companies, trust companies and lease companies). Banks typically monitor the process, including contract signing, loan withdrawals, and repayment. However, such banks only receive fees, but do not assume credit risk on these entrusted loans. In this way, entrusted loans are treated as an off-balance-sheet business of banks.

- Bank acceptances are drafts or bills issued by a company and endorsed by a bank. With a bank's endorsement, companies can use bank acceptances as a means of payment. In essence they are credits of a company guaranteed by banks.

- Private lending is the least transparent part of the shadow banking system. Private lending participants consist of enterprises and individuals, who are either in need of liquidity or have excess funds to invest. Small financial intermediaries act as guarantors in these markets. Unlike entrusted loans, private lending activities are not channeled through the formal banking system, making them difficult to monitor or regulate. Indeed, many such intermediaries operate in a legal grey area. Interest rates in this market tend to be much higher than bank lending rates (for example, the typical one-year interest rate in Zhejiang Province's private lending market is reported at around 18-23%, compared to bank lending rates of 7-8% at present).

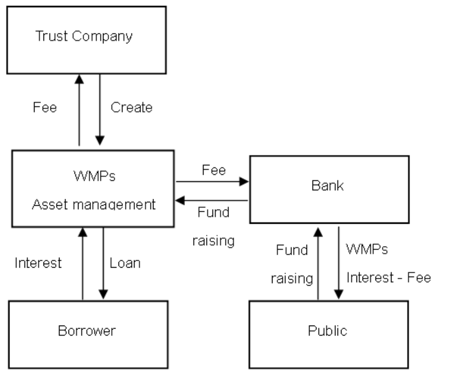
[1] Data for this report, covering off-balance-sheet activities of banks, are mainly from the PBoC's quarterly report of *social financing aggregate*, which covers the flow of new credit including banks loans and various off-balance-sheet activities of banks. Private lending data are from various media reports.

Chart 1
Total Financial Sector Credit Outstanding



Source: PBoC and BBVA Research estimates

Chart 2
Operating model of bank-trust business



Source: BBVA Research

Genesis of the shadow banking system

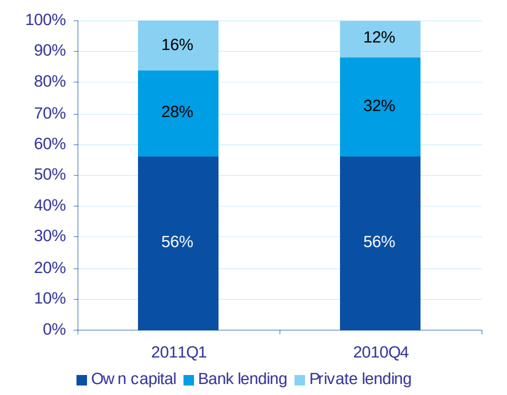
The shadow banking system has historically played a beneficial role in economic growth:

First, the formal banking sector has not been good at servicing SMEs. The origins of China's banks relate to their role as government agencies in extending credit to the state sector during an era of central planning. Only in the last decade have the authorities set out to commercialize these banks to make them more market oriented. In this respect, the shadow banking system helped to close the gap in providing credit to SMEs. This phenomenon is especially prominent in Wenzhou, where export-oriented SMEs have prospered. A large share of SMEs in Wenzhou obtain finance from the private lending market (Chart 3).

Second, the shadow banking system can help mitigate information asymmetries in the credit market. For example, entrusted loans typically occur between related enterprises, who are business partners or who are engaged in a long-term supplier-customer relationship. In this regard, knowledge of the lender toward the borrower may be better than for banks. As such, lending through entrusted loans may be safer and more efficient in terms of lower information asymmetries between lenders and borrowers.

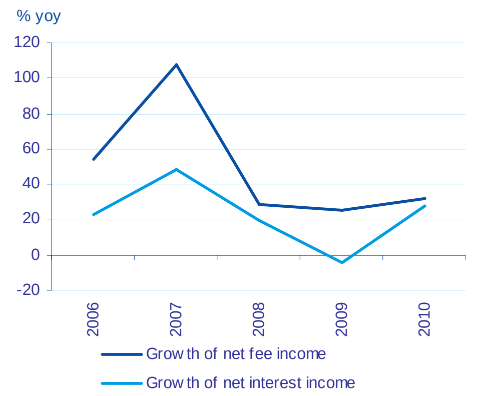
Third, the off-balance sheet activities of banks are an important source of revenue, apart from their reliance on conventional interest income (Chart 4).

Chart 3
Source of SME financing



Source: 21st Century Business Herald and local government report,

Chart 4
Commercial banks' net fee income growth



Source: Bank financial statements and BBVA Research

Regulation of the shadow banking system

Until recently, regulating of the shadow banking system has been lax, perhaps due to the authorities' recognition of the positive effects in fuelling economic growth as described above.

There is little regulation of entrusted loans and bank acceptances. Under current capital rules, which are based on Basel II, banks do not need to set aside capital for entrusted loans, nor are they included in credit quotas imposed on banks. Capital requirements do apply to bank acceptances, but they are exempt from measurements used in calculating credit quotas. Therefore, entrusted loans and bank acceptances have become methods for circumventing capital requirements and/or loan quotas.

Compared with the above two shadow banking vehicles, trust loans have received relatively more attention from the authorities. This is partly because of a high profile trust company bankruptcy scandal in 1998 in which the government had to intervene to liquidate the insolvent Guangdong International Trust and Investment Corporation (GITIC).

Despite concerns with trust company lending, however, until recently regulators refrained from imposing capital requirements on such activities. This created incentives for banks to channel their lending through off-balance sheet activities facilitated by trust companies. In particular, banks were able to approach trust companies to issue so called joint "bank-trust cooperation wealth management products", or WMPs. The trust companies were then able to use the proceeds to issue trust loans. The borrowers of these trust loans were usually designated by the banks, which accrued the majority of associated fees. Through these transactions banks were able to evade capital requirements on their loans and reserve requirements on their deposits.

The private lending market is the least transparent segment of the shadow banking system, falling almost entirely outside the regulatory reach of the authorities:

- Although interest rates are capped at four times the PBoC's benchmark lending rate, in practice there is no enforcement mechanism.
- While non-financial institutions and individual are prohibited from receiving deposits for the purpose of extending loans, the practice is quite common, especially between family members and friends, making it difficult for the authorities to enforce.

In response to the recent rapid growth of shadow bank lending and the risks posed to broader financial system, beginning in August 2010 the regulatory authorities (PBoC and CBRC) have imposed a series of regulations to restrain the further growth of the shadow banking system (Table 1). These regulations include: (i) imposing capital requirements on trust companies; (ii) requiring banks to bring certain high-risk off-balance-sheet activities back onto their books; (iii) applying deposit reserve requirements to the collateral deposits associated with bank acceptances.

Table 1
Regulations to restrain the development of shadow banking system

Time	Regulator	Detail
12/08/2010	CBRC	Notice on Regulating Relevant Matters concerning the Wealth Management Cooperation between Banks and Trust Companies as follows: 1) banks required to move certain off-balance-sheet assets back to their books by end-2011 and hold a provision coverage ratio of 150%; 2) large banks to maintain a capital adequacy ratio (CAR) above 11.5% and small & medium banks to maintain CAR above 10%; 3) balance of the financing business not to exceed 30% of the total bank-trust cooperation business.
13/01/2011	CBRC	Notice on Further Regulating the Wealth Management Cooperation between Banks and Trust Companies: 1) bank should move back off balance-sheet assets related to bank-trust cooperation by end of year; 2) trust companies should set aside risk-weighted capital of 10.5% for trust loans extended in the bank-trust cooperation not included in banks' balance-sheets; 3) trust companies should not distribute dividends if the trust compensation reserves fall below 150% of the non-performing bank-trust loans or 2.5% of the total balance of bank-trust cooperation loans.
26/08/2011	PBoC	Notice to broaden the base for calculating banks' required reserve ratios by including banks' margin deposits. Six large banks required to set aside 21.5% of deposits as of September 5. Medium and small banks to set aside 19.5% of deposits.

Source: CBRC, PBoC and BBVA Research

Recent developments

The shadow banking system has experienced an unprecedented boom over the past few years. In terms of new credit extended, the size of the shadow banking business amounted to RMB 4.25 trillion in 2010, which accounts for around one-third of the total credit extended by the financial system (Chart 5).

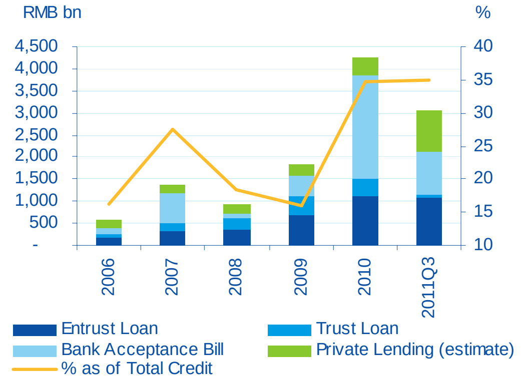
The recent lending boom through the shadow banking system is the result of several factors. First, monetary policy tightening since 2010 created demand for credit outside the formal banking system. In particular, monetary policy tightening made it difficult for a number of enterprises, particularly SMEs, to obtain funds to complete projects already underway. Real estate developers also felt the squeeze due to policies to clamp down on an emerging property bubble. As a result, both SMEs and real estate developers have turned to the shadow banking system to meet their funding demands.

Second, the existence of negative real deposit interest rates has provided the shadow banking system with an abundance of fund supply. Negative real rates, in turn, are due to rising inflation and caps on deposit rates (Chart 6). Negative rates of return have prompted depositors to search for higher yielding financial products.

Third, as noted above, loopholes in the regulatory framework have created incentives for using the shadow banking system to circumvent regulations imposed on formal bank activities.

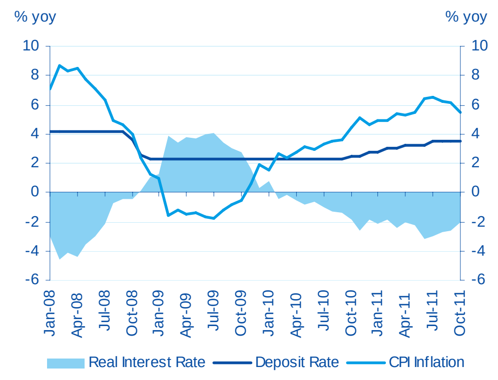
As policy measures have been taken to restrain the growth of the shadow banking system, SMEs who rely on the system as an important source of financing have been squeezed. To address this, various steps have been taken to support SMEs (Table 2). These include a mix of regulatory forbearance, fiscal incentives, and moral suasion.

Chart 5
Shadow bank lending has accelerated



Source: PBoC and BBVA Research estimates

Chart 6
Negative real interest rate



Source: CEIC and BBVA Research

ble 2
Recent measures to support SME financing

Time	Regulator	Detail
07/06/2011	CBRC	Series of regulatory measures to support commercial banks lending to SMEs as follows: 1) differentiated supervision and requirememst on NPLs with higher tolerance on SME NPLs; 2) credit growth for small businesses required to match overall loan growth; 3) loans below RMB 5 million to SMEs to be considered as retail lending with lower risk weightings; 4) loans below RMB 5 million RMB to SMEs to be excluded in calculating loan-to-deposit ratios; and 5) higher priority to banks-issued financial bonds designated to SMEs lending.
12/10/2011	State Council	Financial measures to provide tax relief and financial easing towards SMEs: 1) set up higher VAT and operation tax thresholds to SMEs; 2) provide improved credit support to SMEs with underlying credit growth to match overall loan growth; 3) deepen varied use of bond and other financial instruments for SMEs financing channel; 4) regulate private lending behavior in pursuit of healthy development under government supervision.
24/10/2011	Ministry of Finance	Exempt stamp duties on loans for SMEs from November 2011 to October in 2014.
25/10/2011	CBRC	Supplementary notice to launch detailed plans for encouraging financial support to SMEs: 1) stipulating credit growth for SMEs to match overall loan growth and to be faster than last year; 2) encourage commercial banks to give more support to SMEs loans below RMB 5 million RMB; 3) permit banks to issue special financial bonds as an SMEs financing channel.

Source: CBRC, MoF, State Council and BBVA Research

Risks from the shadow banking system

One of the main risks is associated with the interconnectedness of the shadow banking system with the formal banking sector. As discussed above, both bank acceptances and entrusted loans have become important sources of bank revenue. Anecdotal evidence suggests that some firms or individuals may have improperly obtained bank loans to re-lend into the private lending market at higher interest rates. Banks' exposure to shadow banking activities increase the overall vulnerability of the financial system, which has already been affected by the weight of local government debt (see our report: Who will pay the bill for local governments' fiscal stimulus?)

We see three risks associated with the shadow banking system:

First is **a high concentration of loans to the real estate sector** combined with relatively weak risk management practices. We estimate that total shadow bank lending to the property market amounts to around RMB 2.9 trillion.[2] Although collateral has been reported to be as high as 189% of total loans outstanding to real estate developers (according to remarks attributed to then CBRC Chairman Liu Mingkang made last August), if shadow bank lenders' exposure to developers is included, such collateral coverage would fall to 146% by our estimates, which would leave the system more exposed in the event of a sharp decline in real estate values (relative to the prices at which the collateral is valued).

Second, in the shadow banking market, there are likely to be more serious **maturity mismatches**. Lenders in the shadow banking market lack access to the interbank market and liquidity support facilities typically available in the formal banking system. They also tend to use shorter term and more complex funding instruments to finance the long term projects of the borrowers. For example, among the 4,796 outstanding WMPs by end-October, nearly two-fifths of them have maturities of less than one month. Indeed, it is common for banks and trust companies to roll over these WMPs to obtain funds to issue trust loans. The same can be said of bank acceptances, most of which have maturities of 3-6 months.

Maturity mismatches also impose risks on borrowers. For example, if the authorities strengthen the regulation of off-balance-sheet activities, borrowers may find it difficult to roll over their credits, which may impair their operations and liquidity, causing bankruptcies, especially for SMEs. The recent turmoil of the private lending market in Wenzhou City is a prominent example. As one of the richest costal regions in south east China, Wenzhou prospered on its export oriented SMEs, which typically rolled over short term loans borrowed from the private lending market. Allured by high profits, a large amount of funds flowed from the banks to the private lending market. However, in the past two years more real estate developers joined this market and pushed up the lending rate in the market. When the banks realized the increasing risks associated with private lending and attempted to reduce their exposure, many SMEs were no longer able to renew their credit and as a result, have been squeezed into bankruptcy.

Third, the shadow banking system may also increase **liquidity risks of the formal banking sector**. As noted above, the shadow banking system results in a siphoning of deposits from the formal banking system as depositors are lured by higher returns on WMPs. Although the current situation is not so serious as to cause a liquidity problem for the banking system as a whole, it may cause regional problems in areas where private lending has grown. In addition, any sudden change in policy which favors deposit-taking institutions in the formal sector in attracting deposits could create sudden liquidity shortages in shadow banking vehicles and, thereby, increase their dependence on short term funding even further.

---

[2] Only trust companies have revealed their exposure to the real estate sector, of 17% at end-2010. We apply the same ratio to entrusted loans and bank acceptances to infer their respective exposures.

Overall, we believe that risks associated with the shadow banking system are still manageable. Unlike their counterparts in some developed economies, the structure of China's shadow banking system is relatively simple. Moreover, a large share of such activities are channeled through banks, which may make them easier to monitor and restrain. But the interconnectedness with the formal banking system and weak risk management practices add to the vulnerability of the entire financial system.

Policy suggestions

In our view, the roots of the growth of the shadow banking system lie in distortions of the formal financial system as well as elements of the monetary policy framework. Mitigating risks in the shadow banking system, therefore, would necessitate a deepening of the financial system reforms as well as improvements in policymaking. Indeed, the benefits of the shadow banking system in facilitating financing to credit-starved segments of the market are themselves due to the existing distortions in the existing financial system and policy framework.

Our suggestions are as follows:

First, liberalization of interest rates is a priority. As argued above, deposit rate caps have led to distortions, resulting in negative real interest rates. Liberalization of interest rates would attract funds back into the formal banking system and rein in the expansion of the shadow banking system.

Second, completion of reforms to the regulatory framework is needed. Regulations should be expanded to cover non-bank financial institutions. Having imposed capital requirement on trust companies, the authorities could consider additional requirements, such as leverage ratios to reduce the room for "regulation arbitrage" between banks and non-banking financial institutions.

Third, the authorities should amend the form of monetary policy execution, which places too much emphasis on direct quantity controls such as loan quotas and too little emphasis on price-based mechanisms. As undesirable effect of quantity controls is to widen spreads between interest rates in the formal capital markets and those in the shadow banking system.

Last but not least, the authorities can help to encourage credit extension to SMEs. In addition to existing measures, the authorities could develop the domestic bond market to meet the financing needs of the large-size enterprises, so that banks would have more incentive to service SMEs. Policies that aim at directed lending should be avoided, in favor of indirect policies such as guarantee schemes and subsidized lending rates.

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document are based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") Of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the financial services and markets act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons. The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA is not a member of the FINRA and is not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".

BBVA is a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), registered with the Bank of Spain with number 0182.