Chinese Shadow Banking—Credit Creation Mechanism and Credit Expansion of Bank Financial Products

Cai-xia ZHANG

China University of Political Science and Law, NO. 25, Xitucheng -Road, Haidian District, Beijing, China, 100088

Keywords: Shadow banking, Bank financial products, Credit creation mechanism, Credit expansion.

Abstract. In China, shadow banking can be described as credit intermediations involving entities and activities outside the regular banking system broadly, also some non-bank credit entities and activities. Then we should pay more attention on shadow banking, which can particularly increase maturity and liquidity transformation, imperfect credit risk transfer and/or leverage by different financial tools. In our country, the financial system is dominated by commercial banks, so more and more internal financial innovations, especially bank financial products could be viewed as the representative of shadow banking. In essence, the process of bank financial products is not an independent credit creation, but it can enlarge the credit creation of commercial banks and enhance the scale of credit expansion by means of trust loans, entrusted loans, trust beneficiary, specific assets usufruct, and the asset pool, which will result in a higher liquidity risk. Therefore, expanding the scope of the legal deposit reserve rate, establishing more laws and regulations about bank financial products, and constantly improving the internal management mechanism of bank financial products are particularly important.

The Definition of Chinese Shadow Banking

The modern "shadow banking" was proposed by McCauley in 2007. These “shadow banking” can be known as some financial institutions outside the regulatory system, corresponding to the traditional commercial bank system, which also can be named as Shadow Financial System, Parallel Banking System or Quasi Banking System. Since then, Gross (2007), Gorton (2010) [1], Krugman (2008), Paul Tucker (2010) made various interpretations about shadow banking system from different perspectives [2, 3]. In its October 2011 report, FSB broadly defined shadow banking as the system of credit intermediation that involves entities and activities fully or partially outside the regular banking system, and it has the potential to pose systemic risks or regulatory arbitrage risk, particularly on activities involving four factors: maturity transformation; liquidity transformation; (iii) imperfect credit risk transfer; and/or (iv) leverage. That is a broadly definition of shadow banking [4, 5].

After sub-prime crisis in United States, more scholars and related sectors in China have paid more attention on the shadow banking system [6]. For example, Yi Xianrong pointed out that "Some activities as long as involved borrowing relationship and outside the regulatory system all belong to the shadow banking”. Xiao gang, as the former chairman of China Securities Regulatory Commission, said that the forms of Chinese shadow banking usually referred to financial products, underground financial and some off-balance sheet lending. Zhou Xiaochuan indicated that shadow banking referred to some non-bank financial institutions unregulated or less-regulated by traditional regulatory agencies, such as hedge funds, private-equity fund and some
special purpose entity (SPV) [7, 8, 9]. In 2011, CBRC sets up special column about shadow banking and defined shadow banking as credit intermediation.

At present shadow banking system has not been clearly defined [10]. According to FSB, we can put forward the definition of Chinese shadow banking system as credit intermediation outside the traditional banking system. Also, Chinese shadow banking system can realize the functions of traditional banks, such as maturity transformation, liquidity transformation, and credit risk transfer and highly leveraged through different financial instruments. Firstly, shadow banking is different from the traditional commercial banking regulatory system, rather than completely free from supervision or less-regulation. Secondly, shadow banking system can be considered as various credit intermediations, including series of financial entities, activities, behavior or instruments. Thirdly, shadow banking should provide the functions, such as maturity or liquidity transformation and credit risk transfer and so on. Fourthly, shadow banking system may result in systemic risk or regulatory arbitrage risk for the whole economy. At last, shadow banking should be dynamic. Any a credit intermediation in its initial stage, due to its small scale, it is impossible to trigger systemic risk which cannot be seen as shadow banking. With its expansion, it may become one kinds of shadow banking system.

The Modes of Credit Expansion for Bank Financial Products

Bank financial products magnify the scale of credit creation and credit expansion of commercial banks. The credit expansion of traditional commercial banks mainly rely on some deposit and loan business, while financial products are different, the intermediate links may be more diverse and complex. In the early stage, commercial banks raise money by issuing RMB financial products, and these funds are mainly invested into some fixed-returns products, such as bonds, bank bonds, bills, money market funds and so on. With the development of financial innovation and financial reform and the increasing social demand for wealth management products, commercial banks began to rely on credit cooperation expanded rapidly into the stock market and industrial investment. With QDII, more financial products began to appear in economy which refers to interest rate, currency or commodity price. Overall, they can be summarized into the following seven categories:

The Credit Loans of Financial Products

The credit loans of financial products, in nature can supply funds for some demanded corporate by use of trust company, which can be seen as an intermediation. The process is shown in Fig.1. Firstly, some commercial banks issue some financial products and collect funds on the basis of the delegation and empowerment of investors. Then as single clients, these commercial banks invest all of funds into the plan established by trust company as trustees and supply funds for enterprises in various forms of loans. In such financial products, banks and trust companies charge fees and the customers can get benefits on the premise of taking risks. In these products, trust companies are just as related bridges; commercial banks play a dominant role in trust loans and while the trust companies can be seen as medial tools in borrowing business. The process of trust loans is similar to the general loans, but they are not in bank-balance sheet for the traditional banks and unnecessary to accept bank statutory deposits reserves. Therefore the trust financial products essentially can be seen as the loan of commercial banks in order to avoid regulatory and weaken the effects of currency policy regulation. Moreover, it can be invest into energy or real estate at last.
Trust Beneficiary Right Transfer Financial Products

Due to the limit to such credit loans of financial products, commercial banks start to invest into the trust beneficiary right transfer financial products.

The first one is the "bridge mode", that is to say, commercial banks plan to invest the trust beneficiary right, just to find the bridge company, not to transfer the beneficial right. The specific process is shown in Fig.2. Firstly if the financing companies need funds, these "bridge company" as a single trustee can be set up trust financial products, and invest these funds into financing company by issuing loans (or providing financing by another mode), then financial bank get trust beneficiary right from "bridge company". This mode elongate the process of transferring credit assets which belonged to trust company, in nature it is also credit financing.

The second one is "double trust mode". Its nature is to establish some self-benefit-trust scheme by the related finance companies and transfer trust beneficiary right to bank financial products. These financial products seems to transfer trust benefit right, but there exists more dislocations in real process. For example, the investment party essentially get high returns from the investment of financial products, and trust company acts as channels of commercial banks, while for financing enterprise, in essence it is a behavior to avoid the supervision of loans and deposit. In June 2011, the Department of ADB in BRC issued clearly that some trust businesses established by commercial banks can be regarded as credit cooperation, which including banking funds directly given by trust company or indirectly given by the beneficial right, and all of them should be appropriately supervised and seen as bank-trust credit cooperative businesses especially in the process of calculating risk capital.
Entrusted Loans Financial Products

Entrusted loans financial products put credit funds into market by entrusted loans. In some regulations such as General Loans Rules and Commercial Bank Law, lending behaviors between different enterprises directly are forbidden, but the government allows to sign the tripartite contract to realize the financing between different enterprises if commercial banks as intermediary. According to the various financial needs, entrusted loans also has two ways: one is to introduce other banks as the intermediary of entrusted loans, all of bank financial funds are issued through these trustee, such as CCB Inner Mongolia Branch issued "Qianyuan" series of entrusted loans financial products. The other one is to transfer creditor's rights established by the original creditor entrusted loans to the bank's financial products, which commonly known as the entrusted loans financial products, such as Bank of Beijing" beyond "series PB11077, commissioned loan debt financial products. Regardless of what form, commercial banks as the lender (the principal) only charge a little fee, do not assume risk loans.

Specific Asset Returns Financial Products

The definition of invests financial assets by China Banking Regulatory Commission is equity rather than debt, that is to say, financial investment cannot form a loan property rights. Therefore, the specific asset returns financial products have the space for development. These financial products are based on some specific assets or returns rights belonged to some enterprises, and also commercial acceptance bills, accounts receivable, other receivables, inventory and fixed assets etc. can be seen as these specific assets or assets rights. At present, receivable assets holds the dominant position, which accounting for about 50%. Although these specific asset returns financial products are defined as investment business, in essence, these financial products are still credit derivatives for financial product.

Financial Product Between Banks and Securities

When stopping the entrusted loans financial products, there are some alternative channels produced in financial products market. The most important one is financial product between Banks and Securities. Banks can invest to credit assets or trust assets by use of jointing trust plan into assets management by different securities company. Due to the reporting system in the process of assets management, the approval is faster and the costs are significantly lower than the trust. Nowadays, with more rigid supervision for banks financial products, the brokers targeted asset management, as an alternative channel, will play an important role in the future.

Figure 3. Financing products between banks and securities.
**Entrusted Credit Financial Products**

Another channel for financial products is to make a relationship with Gold Exchange. The main process is to invest into some credit products issued by Gold Exchange. The specific process can be described in Fig.4. First of all, commercial banks as a financial planning manager, delegated by different customers, will make some financial investment or assets management in accordance with the investment plan and some ways agreed with customers; and then invest various funds into some credit products issued by Gold Exchange.

[Diagram of Entrusted Credit Financial Products]

Entrusted credit financial products can be seen as out-balance business, which accounted for in subject “Resale of financial assets”, so they can be evading the supervision of finance products, without any provision for capital and reserves. So these financial products are different from financing products, not only their different channels, but also the special investment into loans rights owned by some companies who want to get more funds. But in reality, with the short history of the gold exchange, this immature asset management function and the imperfect regulatory system, there are still more risks in entrusted credit financial products.

**Assets Pools Financial Products**

Because of tightening regulatory and continual consolidation, commercial banks generally began to turn to assets pools financial products. The key is to raise some different financial products into an assets package, such as bonds, notes, money market instruments, trust financing, deposits and other collections, and then make an unified operation and management. The mode can be summed up in Fig.5. Firstly, commercial banks collect various assets in-balance sheets (such as money market instruments, bonds and credit assets) and form regular "asset pool"; at the same time, banks establish a "funds pool" by raising funds from customers, and then establish credit asset products according to the demands of some enterprise or individual customer; finally, commercial banks make trust products into regular "asset pool" which can be realized some assets out of table.

On March 25 2013, China Banking Regulatory Commission carried out effective prevention to manage non-standardized credit assets, and required that these assets must insist the principle of using one-by-one correspondence. When not up to these requirements, commercial banks should provide risk weighted assets reserves according to self-loans in the end of 2013. Meanwhile, this notice proposed the principles of limit management, that is to say, commercial banks should reasonably control the total amounts of money funds invested into non-standardized assets, which should be the lower one between 35% of the accounts of financial products at any point and 4% of total assets disclosed in the last audit report.
The Risks and Suggestion for the Development of Financial Products

From above analysis, we find that the development of financial products can be seen as a process of avoiding regulatory by use of varieties of non-bank financial intermediaries or credit regulatory capital. Financial products are ostensibly different from traditional commercial banks money creation, mainly through financial contracts the way money creation, but in essence it remains a debtor and creditor relationship between different parties with chains in the supply and demand of funds. This form of credit creation and credit expansion give birth to a higher risk due to its highly-concealment and its association with Commercial Bank [11].

Such as the regulatory arbitrage risk for deposits. In our country, deposit ratio and capital adequacy ratio are statutory supervision indexes for commercial banks, at present the deposit ratio is less than 75%. Deposit ratio is more likely to be adopted by use of financial products at the end of every quarter. In General, commercial banks set the raising date and the maturity date at the end of every month, particularly in the quarter, and then banks can realize to increasing the balance of the deposit at the end of the month, quarter, half-year and the end of one year (see Figure 9). Even some banks pay for high interest rates by use of some incomes in-balance, and trigger vicious competition. In November 2011, the regulators will halt for some short-term products which are less than one month.

Also the credit risk of regulatory arbitrage. The main purpose of financial products is to exceed the limit of credit and to pursue of high returns. Looking for the development of financial products, trust loans, trust beneficiary right, double trust and entrusted loans and so on, all of them don't consume bank capital, and transfer the financial program outside their strong balance sheet, in order to adjust the structure of credit and to avoid the scale of credit supervision [12].

Again as the risks in assets pool: Firstly, the mode of assets pool exists obviously defects, with continual funds input by use of "scroll issued", and then put various funds into unified assets pool, which must include some high-returns and low-liquidity assets (such as credit assets). And the mismatch of short-term liabilities and long-term assets must become one of important resources which induce the risk of systemic liquidity. Secondly, asset pools are lack of transparency and its regulatory effectiveness are easy to be interfered. So it is difficult to disclose effective information and contact various funds with the subject of investment during the asset pool products, which will make banks and their customers hard to put forward some irrational estimate in the costs of investment and risk parameters. Thirdly, the asset-pools closely linked to proprietary business, in essence, it is likely to cause cross-infection risk because of some hidden guarantees for off-balance sheet business.
Finally, the level of management in different banks are uneven, with the increase of financial products and the expansion of assets, more factors such as different industry or geographic or various types of financial contracts may affect the flow of every cash, and then will transfer risks to entire assets pool [13].

Based on these above risks, this paper puts forwards some suggestions in order to improve the process of financial products as follows:

Firstly, it is important to expand the scope of statutory reserves, that is to say, banks financial products especially non-guaranteed products should impose statutory reserve. The statutory deposit reserve ratio is an indispensable instrument as one of monetary policy in our country, and plays an important role in enhancing the effectiveness of monetary policy. Therefore, imposing banks financial products, not only can weaken the expansion effect of credit creation for financial products, but also facilitate Central Bank to control money supply on the market effectively.

Secondly, we should put forwards some sound laws and regulations for financial products. The interim measure for the management of personal financial services in commercial banks so far has been for 9 years. During this period, financial products have grown and developed gradually, more factors such as the regulations, the forms, modes of operation, information disclosure and risk mitigation mechanisms for financial products has taken place more and more great changes. Therefore, it is necessary to amend the interim measures for the management of personal financial services in commercial banks, especially taking accounting methods; general processes; information disclosure and risk management systems into account. At the same time, the government should put forwards some single rules or guidelines for improving the internal management, the design and the provision for risk reserve.

Thirdly, it is necessary to perfect the internal management mechanism for financial products constantly. On one hand, banks should establish special financial business sector, which can be as professional system to build financial products risk "firewall" and isolate the in-balance assets from off-balance assets. Then financial products can play an important role in improving the operating mode and dispersing non-systematic risks. On the other hand, banks should establish risk mitigation mechanism for financial products in order to perfect risk monitoring mechanism. At last, the full process of financial products should be reorganized completely, including pre-sales information, after-sales service, funds management, accounting management, investment management, information disclosure and complaints and so on, particularly the risk-assessment process for financial products.

References


