BROOKINGS | QUALITY. INDEPENDENCE. IMPACT.

Challenges for China's Financial System

Douglas Elliott, The Brookings Institution
December 11, 2014
delliott@brookings.edu

Banks Dominated Credit Until Recently

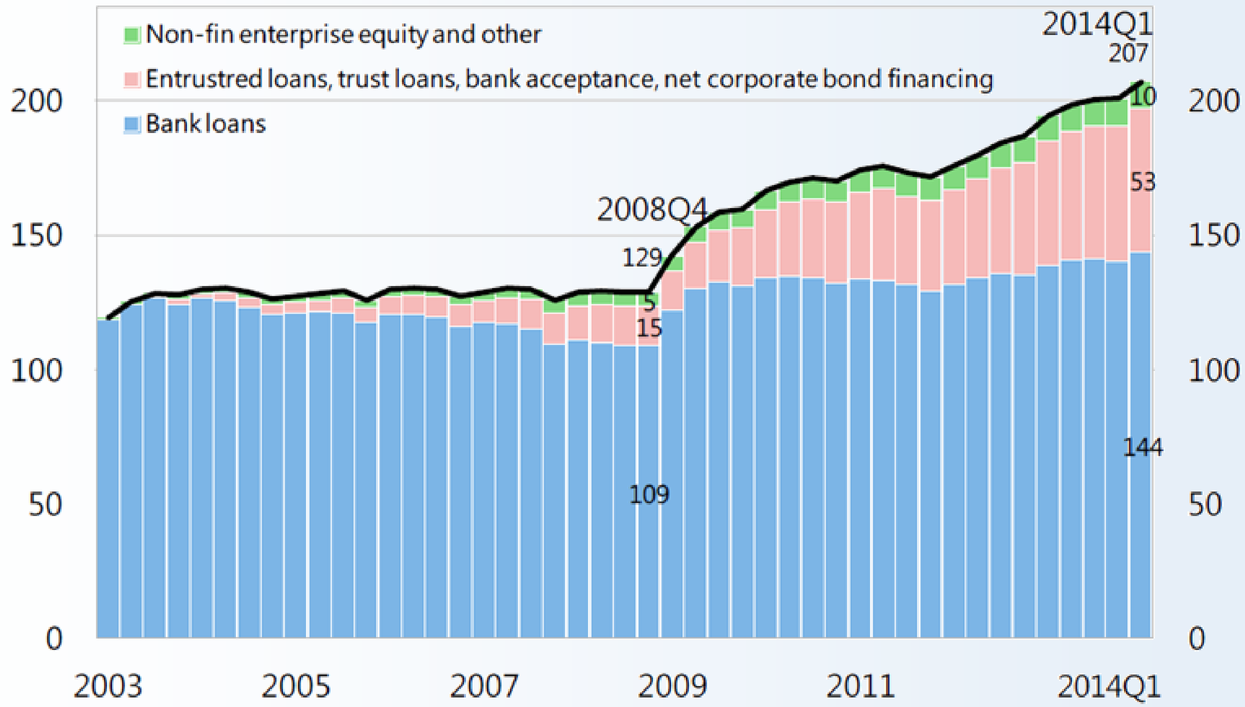
- Banks inherited a privileged position
  - Large base of existing borrowers
  - Few legal alternatives to bank deposits and loans
  - Strong implicit state guarantees of their deposits
  - Regulatory limits on deposit and loan rates
- The State imposed burdens which partly offset this
  - Controls on loan volumes, sometimes by category
  - Micromanagement of lending to particular borrowers
  - Strict loan to deposit ratio limits
  - High required reserves held at the PBC

But, Banks Face Critical Challenges

- Key advantages are declining as competitive sectors and products develop, while cost of bank privileges are high
- Multiple regulatory constraints make expansion of lending more difficult or expensive, draining market share
  - » 75% loan to deposit ratio
  - » High required reserves held at PBC earning low rates
  - » Aggregate lending limits
  - » Discouragement of particular loan types
- Depositors are moving to higher yielding products
- Banks have weak credit skills and relationships with dynamic private sector, especially SME's

Bank Dominance is Eroding

China: Social Financing Stock
(in percent of GDP[1])

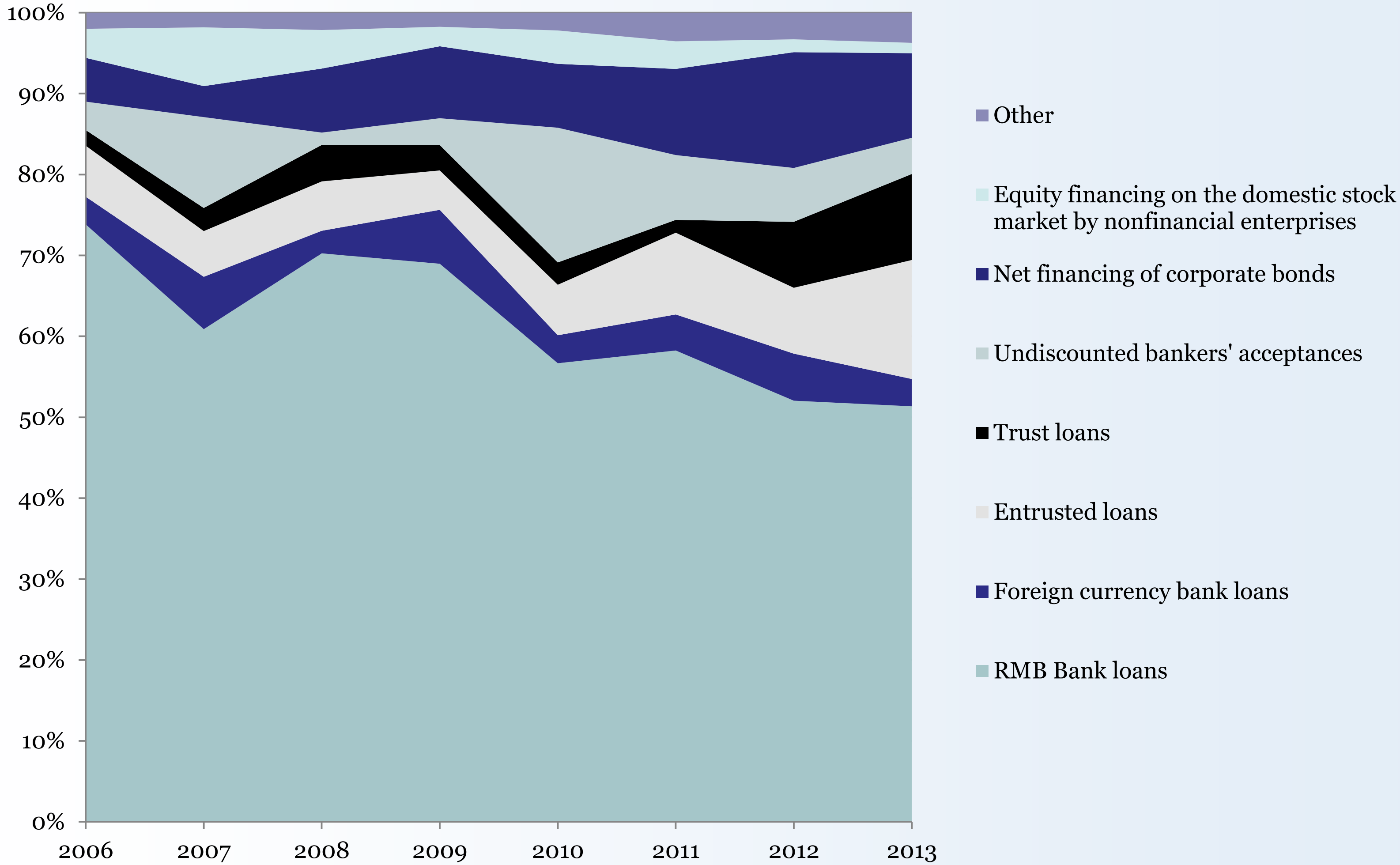


Note 1: in percent of 4Q rolling sum of quarterly GDP
Source: International Monetary Fund. *People's Republic of China: 2014 Article IV Consultation – Staff Report*. IMF Country Report No. 14/235, Washington, D.C.: IMF Publication Services, July 2014, p. 5.
Data Sources: CEIC; and IMF staff calculations

Alternatives to Banks Are Growing

- Trust company loans
- Entrusted loans, especially by SOE's
- Wealth management products, as deposit substitutes
- Guarantee companies
- Pawn shops and unofficial lenders
- Bond markets
- Other channels

Product Shares of Total Social Financing



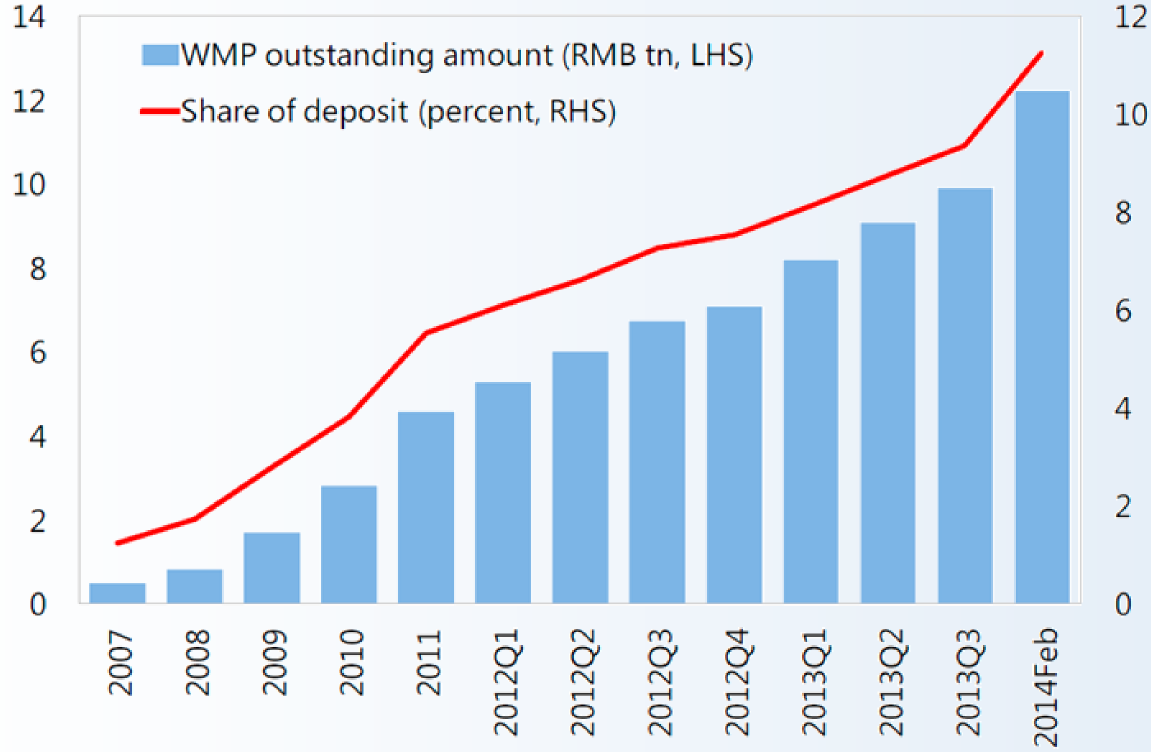
Source: People's Bank of China / Haver Analytics

Alternative Channels Have Advantages

- Banks both cooperate and compete with alternative credit channels. Cooperation allows banks to bypass high regulatory burdens and micro-management by authorities
- Non-banks have many advantages as credit providers
  - Lower capital requirements
  - Avoidance of PBC reserve requirements
  - Greater freedom of pricing and product form
  - Less intrusive regulation
- Wealth management products effectively allow higher deposit rates to be paid to rate-sensitive depositors
- It is difficult to assess how much shadow banking is "bank lending in disguise" and how much competes with banks

WMPs Are Replacing Deposits

WMP Outstanding Amount and Share of Deposits
(in RMB trillion)



Source: International Monetary Fund. *People's Republic of China: 2014 Article IV Consultation – Staff Report*. IMF Country Report No. 14/235, Washington, D.C.: IMF Publication Services, July 2014, p. 29.
Data Sources: CRBC, CEIC, local media, and IMF staff calculations

Shadow Banking Has Societal Benefits

- Shadow banking sidesteps excessive intervention by authorities in a system that has not implemented the full range of necessary reforms
- Some shadow banks channel funds to SME's and other entities that have difficulty obtaining traditional bank loans
- Authorities are also currently reluctant to reduce leverage growth in the economic system by strongly curtailing shadow banking activity

But, Shadow Banking Has Major Risks

- The regulations being side-stepped often controlled risks
  - Loan to deposit ratios
  - Capital requirements
  - Discouragement of lending to troubled industries
- Borrowers using shadow banks are riskier and not as well understood by the lenders
- Implicit guarantees are rife in shadow banking
- Divisions of responsibilities between parties are unclear
- There is no clear methodology for dealing with troubled shadow banking loans in practice, in most cases

Shadow Banking Risks Appear Manageable

- Much of shadow banking is less risky than portrayed
- The total volume is lower than often described, partly because there is double-counting
- The central government has more than enough fiscal capacity to cover a shadow banking crisis

Estimates of the Size of the Shadow Banking System

	Estimate Period	RMB (trillion)	USD (trillion)	% of GDP
IMF	March-2014	19.9	3.2	35% of 2014 GPD
UBS	YE-2013	28.4 – 39.8	4.6 – 6.5	50 – 70% of 2013 GDP
Standard Chartered	YE-2013	4.5 – 12.5	0.7 – 2.0	8 – 22% of 2013 GDP
Bangkok Bank	YE-2013	36.4	6.0	70% of 2012 GDP
JP Morgan	YE-2013	46	7.5	81.2% of 2013 GDP
Financial Stability Board	YE-2013	18.2	3.0	32% of 2013 GDP

Note: Some of the figures have been derived by the authors; for example, if a source only provided an estimate in dollars for a given period, then the authors used exchange rate and GDP figures to estimate the other rows

FSB Estimates of Size of Sector

	Shadow Banking Assets at YE-2013 ($ billions)	as % of 2013 GDP
Euro Area	25,568	194%
US	24,816	148%
Great Britain	9,024	337%
Japan	3,760	76%
China	**3,008**	**33%**
Canada	2,256	123%
Korea	1,504	115%
Brazil	752	33%

Source: Financial Stability Board, “Global Shadow Bank Monitoring Report 2014,” October 30, 2014.

But, Shadow Bank Rescue Would Be Messy

- This would not be like State rescues of banks in the 1990's and 2000's
  - No longer 100% state ownership of institutions
  - Many parties involved, not just banks
  - Opacity and reliance on implicit guarantees
  - Anti-corruption efforts could slow intervention
- The big risk is that the State might not be able to restore credibility to the financial system quickly enough and with enough certainty of outcomes
- Crises can spin out of control when the perceived rules change quickly, implicit guarantees lose credibility, and there is no clear lender of last resort or the rules by which it operates are uncertain

Proposed Reforms Should Help Reduce Risk

- Reduction in quantitative controls should reduce micro-management by authorities, improving economic efficiency and reducing incentives for shadow banking
  - Freeing loan rates
  - Freeing deposit rates
  - Eliminating loan volume limits
  - Loosening loan to deposit ratios
- Introduction of explicit deposit insurance should help clarify what is guaranteed and what is *not*
- Allowing some owners of WMP's to lose money would underline this, but has transition risks and difficulties, and may not fairly reflect banks' role as marketers

Proposed Reforms Should Help (continued)

- Continuing efforts to increase safety margins and improve operational management at shadow banks are important
- Clarifying what is allowed would be helpful. *Ad hoc* regulation and supervision has disadvantages
- Continuing reforms to grow bond markets would improve efficiency and reduce need for shadow banking

Transition Will Raise Its Own Risks

- The reforms are necessary and should be beneficial over time
- However, banks will need to adapt and some may make major mistakes in the process
  - “Search for yield”, as net interest margins decline
  - Problems in credit underwriting will be revealed
  - New banking products may be developed which have hidden risks
- Shadow banks may be under even greater pressure and they have more regulatory room to make mistakes

Banks Face Other Problems and Dangers

- Direct exposures to:
  - Housing, construction, and related industries
  - Troubled industries such as coal and ship building
  - Local Government Financing Vehicles
- Indirect exposures to the same industries
- Exposures of banks to wider economic trends, such as:
  - Slowing overall growth in the economy
  - Need to reallocate resources from investment to consumption
  - Transitional effects of wider reforms

Conclusions

- Financial sector reforms remain critical and should not be delayed
- Banks will face troubled times over at least the next few years, although they have the capacity to adapt
- Shadow banking needs to be more carefully controlled, but it would be unwise to curtail it altogether
- The central government has the resources to resolve a shadow banking crisis, but it will be trickier than it might seem
- Wider economic reforms are crucial and careful macroeconomic management is called for, but I am not qualified to comment at length on these