

## Recent trends in financial risks in China

Yusuke Miura, Senior Economist, Research Department – Asia, China Unit

While the Chinese government has been dealing with overcapacity and the elimination of zombie companies as part of economic structural reform, it has also positioned the prevention of financial-sector risks as an important policy since the second half of 2016. Of these, the Chinese government is particularly enhancing a sense of vigilance against risks over shadow banking. Shadow banking is the generic term given to the financing channels other than banking lending. Since it is rather hard for the financial authorities to effectively extend their supervision and control to the sector, shadow banking has come to draw attention within and outside China as the flash point of financial risks since the early 2010s.

One of the specific problems involved in shadow banking is the complicated investment structure ([see the chart](#)). When commercial banks engage in the management of their own funds and funds collected through wealth management products, they invest them in wealth management products of other banks and/or entrust securities firms and other kinds of financial institutions with their investment. This structure makes the flows of funds multi-layered, and as margins are being pursued at each layer, the investment leverage ratio is rising. Furthermore, although financial institutions from a variety of business categories are involved in investment management, the financial administration is being undertaken in a compartmentalized manner, with the involvement of the central bank and different supervisory agencies corresponding to respective business categories, such as banking, securities and insurance, making it all the more difficult to flexibly and effectively deal with shadow banking.

Another problem that has also been pointed out is that shadow banking is being used as the fund-raising channel by sectors subject to restrictions on banking lending, such as real estate-related industries and local government financing vehicles (LGFVs) used for infrastructure development. For example, looking at the balance of outstanding bonds, the main investment assets of wealth management products by industry at the end of 2016, the mining and manufacturing industries, where some companies are burdened with overcapacity, accounted for 18.9% of the total balance, the real estate and construction industries 33.7%, and infrastructure-related industries (electricity/heat/gas/water supply, transport/storage/post, and water conservancy/environment/public facilities management) 23.2%. Aside from bonds, wealth management products are believed to be also investing in low-liquidity assets called “non-standardized credit assets,” such as entrusted loan assets and beneficiary rights of real estate development projects.

Furthermore, also problematic is the fact that liquidity risks traced to the maturity mismatch can materialize easily. This is because funds raised by wealth management products, most of which have maturities of less than one year, are invested in long-term assets referred to above. While wealth management products rarely default, it is perhaps simply because de facto defaults have not been brought to the surface. Under the investment management mode called the fund pool, wealth management products do not correspond to investment assets on a one-to-one basis but are often managed with sloppy accounting. In addition, it is believed that banks are compensating for losses to avoid defaults.

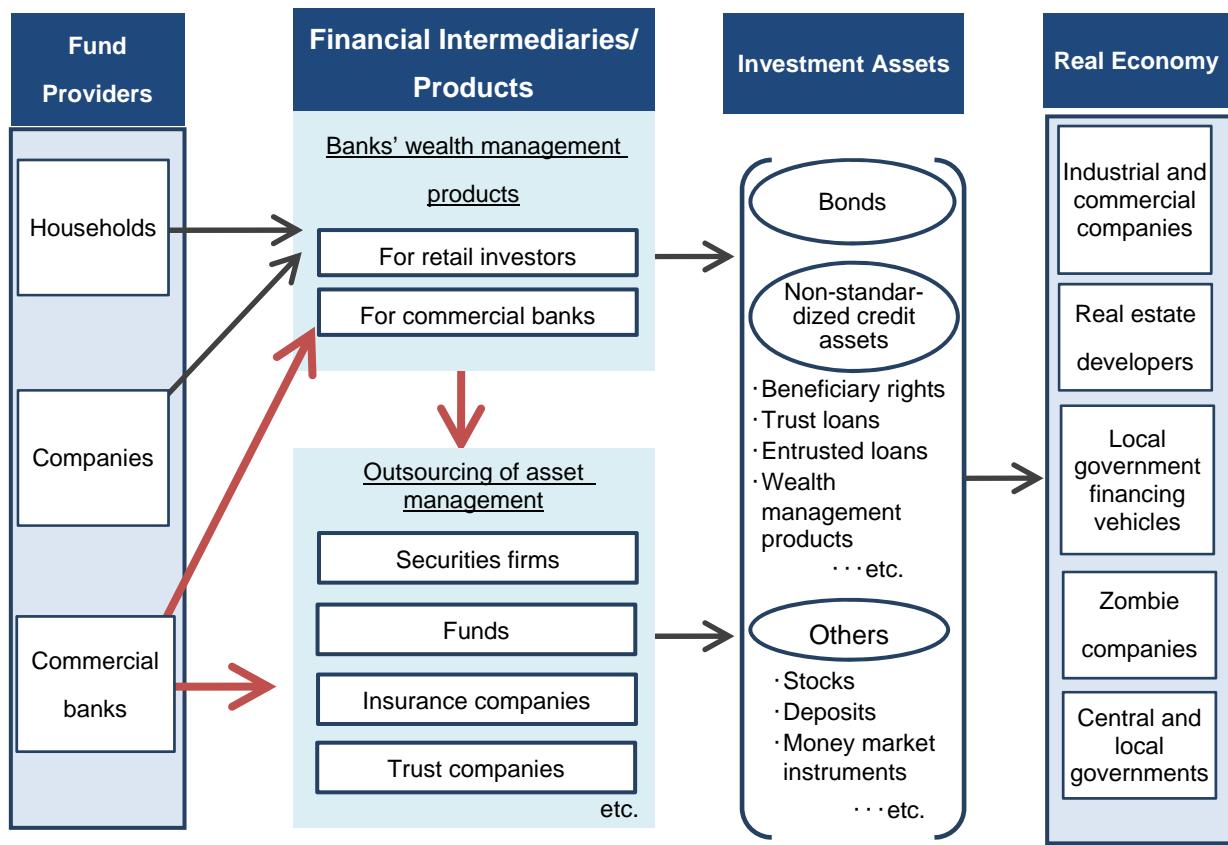
Shadow banking that involves these problems has been consistently growing in size in recent years. Looking at the balances of outstanding bonds, entrusted loans, trust loans, and bank acceptance bills, which are the main investment assets of wealth management products based on the classification of China's total social financing (TSF) statistics, many of them have been expanding at a pace faster than the balance of bank lending. In addition, the balance of investment in the aforementioned non-standardized credit assets, which is allegedly omitted in the TSF statistics, is believed to be also increasing. Though there is the possibility of double counting, the simple total of these categories came to 64.3 trillion yuan as of the end of 2016, expanding to close to 60% of the balance of banking lending at 107.8 trillion yuan.

Under these circumstances, the China Banking Regulatory Commission (CBRC) has released a string of circular notices in succession from the beginning of spring 2017, strengthening its stance of supplementing deficiencies in the existing regulatory system and clamping down on law violations by financial institutions. For instance, the CBRC requires commercial banks to monitor assets of final destinations of investment through wealth management products, set aside necessary reserves, prepare the means of securing liquidity in an emergency, ban the management of wealth management products by the fund pool, restrict investment in non-standardized credit assets, and enhance the disclosure of information for investors in financial instruments.

The People's Bank of China (PBC), under its "prudent and neutral" monetary policy stance, is guiding interbank market rates to higher levels than before and conducting its monetary adjustment in a manner conducive to curbing the growth of shadow banking. In administering the Macro Prudential Assessment (MPA) framework for assessment of the quality of assets of financial institutions, the PBC has improved the management system to make wealth management products offered by banks subject to its assessment by regarding them as broadly-defined lending from 2017.

Going forward, if defaults of wealth management products rise in the process of deleveraging of companies, depositors and investors could grow anxious, and the possible tapering off of financing channels through wealth management products could lead to a deterioration of corporate financing, touching off an increase in corporate bankruptcies. In addition, the likelihood cannot be entirely ruled out of a sudden occurrence of liquidity risk spreading among financial institutions via the interbank market, etc. and, in the worst-case scenario, giving rise to systemic risk. As the Chinese government plans to seek the regulation of shadow banking by paying close attention not to destabilize the financial system, the elimination of financial-sector risks is expected to take some more time.

**[ Chart: Characteristics of the utilization of shadow banking  
by commercial banks in recent years ]**



Note: → indicates the flows of funds

Source: Made by MHRI based on various documents and materials

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