China's 2009 Stimulus Package, (De)regulation and Shadow Banking

China's recent shadow banking growth emerged via the interaction between China's 2009 4 trillion RMB stimulus package, an attempt to minimise the impact of the 2008 global financial crisis, and existing financial policies. While this package was central government directed, Chinese local governments faced a 3 trillion financing gap out of the 4 trillion package, and thus face significant difficulties to finance the stimulus package. Under the 1994 budgetary tax reforms designed to strengthen central government's redistribution ability, local governments are only allotted 50 per cent of local tax revenues and generally not allowed to take bank loans. Instead, local governments rely on Local Government Financing Vehicles (LGFVs) i.e. SOEs exclusively or predominantly owned by local government for urban development and road/bridge constructions purposes. However, from 2009, both the Chinese Ministry of Finance (MOFCOM) and China Banking Regulatory Commission simultaneously encouraged LGFVs deregulation to 'finance [local government] investment projects by essentially all sources of funds'. Correspondingly, Chinese banks provided about 90 per cent of 2009 local government investments. Inevitably, this rapid increase in credit necessitated compromises regarding credit worthiness standards, ultimately raising financial stability concerns. In response, the People's Bank of China (PBoC) raised regulatory capital requirements 12 times, eventually reaching a high of 21.5 per cent for the largest Chinese banks in mid 2011. Additionally, PBoC also deployed 'window guidances', i.e. informal quotas that influence price and quantity of loans, to predominantly direct bank loans to SOEs. Cumulatively, shadow banking activities appeal to yield-hungry investors and credit-hungry sectors due to promises of higher interest rates and borrowing ease respectively, while allowing banks to circumvent interest rates and deposit ratios regulations. Investors are also emboldened by the inaccurate assumption that shadow banking practices are implicitly guaranteed by the banks and/or institutions that issue them.

Chinese Shadow Banking Products and Regulatory Oversight

Two Chinese shadow banking activities, namely money market funds (MMFs) and online peer-to-peer (p2p) lending have recently been subjected to rigorous regulatory scrutiny. Both products mainly target ordinary everyday investors alongside small and medium enterprises, and hence help facilitate financial inclusion if properly managed.

MMFs are professionally managed funds that are mainly marketed online through e-commerce companies such as Alibaba/Yue'E Bao, Baidu and WeChat. Despite some advantages, MMFs are vulnerable to large groups of investors withdrawing their deposits/investments simultaneously, thus rendering MMFs unable to fulfill...
their financial obligations. To strengthen the stability of MMFs, Chinese regulators since February 2016 require MMFs to hold high quality debt securities such as government bonds and central bank bills. MMFs leveraged investment activity, i.e. using borrowed capital for investments, have been restricted to 20 per cent down from 40 per cent. MMFs are now also empowered to deal with sudden large withdrawal volumes, such as fees on redemptions totaling more than 1 per cent of the MMF and the ability to delay payouts should any investor redemption exceed more than 10 per cent of the MMF. P2P platforms match borrowers to investors via online platforms, and are administratively cheaper due to lower operating costs. P2P platforms also provide loans to financially riskier entities. Chinese P2P platforms experienced some scandals in recent months, most prominently with the December 2016 collapse of the Ponzi-scheme Ezubao, where Ezubao fraudulently introduced fake new investment products to fulfill older investments payouts. New 2016 regulations include individual (RMB 1 million) and corporate (RMB 5 million) borrowing limits. Other measures include strengthening data protection policies, and requirements for P2P platforms to engage qualified third-party banking custodians, so as to separate fund management activities (P2P platforms) from physical assets and investor records (custodians). Currently, only about 500 out of an approximately 4,900 existing P2P platforms are allowed to continue operations. Nevertheless, over-zealous regulation can detrimentally affect ease of business. Chinese P2P growth rates have declined by half in 2016 as compared to 2014/2015 with expected further declines, a trend similarly observed in other Chinese shadow banking activities.

China’s Regulatory Experiences for South African Shadow Banking

Generally, African regulators, South Africa excluded, do not have specific regulations for shadow banking, but rely on existing financial legislation. Examples include the use of Kenya’s Capital Markets Act to create a ‘regulatory sandbox’ i.e. a safespace where P2P lenders can experimentally engage in shadow banking activities within prescribed timelines and guidelines. Nevertheless, South African shadow banking activities remain relatively unregulated. For example, South African money market funds were notably threatened by the 2014 collapse of African Banking Investment Limited. With South Africa’s recent credit rating downgrade to ‘Junk’ by Standard and Poor, SA MMF activities are expected to grow since everyday investors look for ways to secure higher deposit interest rates amidst financial uncertainty. One regulatory challenge facing South African MMFs is asset pool composition, a problem tackled by Chinese regulators in 2016. Currently, South African MMFs experience ‘credit concentration’, where they need to hold instruments or bonds issued by large and highly rated institutions. However, given the monopoly of South Africa’s top 5 banks on 90 per cent of SA banking assets, credit concentration is risky since a collapse of any of these banks will also greatly affect the MMFs, thus precipitating systemic instabilities.

Moving forward, South Africa’s ongoing transition to the ‘twin peaks’ regulatory model that separates market conduct and consumer protection regulations should address the structural dominance of the top 5 banks, thus managing the growth of shadow banking activities. South Africa regulators such as National Credit Regulator also require shadow banks to register under the 2005 National Credit Act (NCA). Further 2014 NCA amendments are similar to Chinese regulatory regimes such as requirements to conduct more stringent risk assessments. While plans for a NCA 2 have been temporarily shelved, a list of potential shadow banking regulations includes loan credit limits as well as further adjustment to risk management. Ultimately, shadow banking in developing countries is poised for greater growth, and regulatory approaches should provide corresponding oversight to the extent that shadow banking becomes allies, not alternatives, to traditional banking activities.

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