

Shadow banking and recent regulatory developments in China

Following the 2008 financial crisis, regulators around the world have been looking closely at the regulation of shadow banking activities in order to ensure that systemic stability is maintained. As a significant emerging economy, Chinese regulators are also tackling risks arising from shadow banking activities that have developed unique characteristics within China's controlled lending environment. This briefing examines the driver of shadow banking and regulatory trends in China, and introduces the most notable developments in the relevant non-banking sectors such as trust companies, money market funds (MMFs), "internet finance" and securitisation.

What is shadow banking?

"Shadow banking" is an imprecise term. It generally refers to the system of financial intermediation which creates credit across institutions or a financial market outside, or in ways only loosely linked to, the traditional banking system. The Financial Stability Board (FSB) has defined it as "the system of credit intermediation that involves entities and activities (fully or partially) outside the regular banking system", or non-bank credit intermediation for short. The FSB then identified five areas where oversight and regulation needs to be strengthened, namely mitigating risks in banks' interactions with shadow banking entities, reducing the susceptibility of MMFs to "runs", improving transparency and aligning incentives in securitization, dampening pro-cyclicality and other financial stability risks in securities financing transactions such as repos and securities lending, and assessing and mitigating financial stability risks posed by other shadow banking entities and activities (other than MMFs). The term is not, therefore, intended to designate a group of identifiable entities, but rather to identify a group of activities or techniques as a precursor to potentially regulate the entities which engage in those activities or techniques.

Features of Intermediaries

A financial intermediary that engages in shadow banking activities usually possesses one or two of the three key features of a traditional banking institution. The three key features are: (i) the ability to process payments; (ii) the capacity to handle liquidity mismatch such as

borrowing short term and lending long term; and (iii) the capability to make credit investments so as to gain profits from the interest rate spread between borrowing and lending. Aside from these features, shadow bank activities or techniques (*i.e.* maturity/liquidity transformation and credit mismatch) and shadow banks in China also have some unique characteristics of their own.

Driver for China's shadow banking

The growth of shadow banking in China is very much attributed to the controlled lending environment which exists in China.

Although Chinese policy makers have announced their intention to further remove restrictions on interest rate levels, the RMB interest rate market in China is still not fully liberalized. Benchmark interest rates are one of the monetary policy tools deployed by the People's Bank of China (PBoC) in order to monitor the interest rate levels for both lending and deposits. The PBoC has full discretion to adjust the benchmark interest rates so as to implement its changing monetary policies. Although the PBoC is considering ways to liberalise the interest rate market (including launching a deposit insurance scheme) and it has already lifted restrictions on interest rates for bank loans (except for loans to individuals for residential real property), the interest rates for deposits are still subject to a cap of 120% of the corresponding PBoC benchmark rates as last adjusted on 21 November 2014.

In addition, as Chinese regulators use deposit-to-loan ratios and sometimes give guidance (which is usually understood as mandatory) to banks as to how much they may lend, and other policy instruments such as open market operations (*e.g.* repos, central bank note issuance and short or mid-term liquidity operations) to control the amount of credit injected by banks into the Chinese economy, Chinese banks tend to lend more money to State-owned enterprises and projects endorsed by the government than to the private sector. Lending between corporate entities is required under PRC law to be intermediated through a bank, which is referred to as 'entrustment loans', and Chinese regulators now intend to further enhance the regulation in this aspect, clarify the restrictions on entrustment loans and impose corresponding duties on the banks to monitor the use of the entrustment loans. This has led to a strong demand from the private sector for credit provided by non-banks. Alternative credit channels have therefore been created to support borrowers that are not favoured by traditional commercial banks. At the same time, and in light of the restrictions on interest rate levels on deposits mentioned above, entities as well as individuals with cash surpluses are also looking for more profitable investment channels. Against this background, shadow banking has evolved in China as a parallel credit intermediation system outside the traditional banking system.

Concerns raised by shadow banking in China

Generally speaking, concerns raised by shadow banking in China are less complex than those in developed countries. The primary reason is that complex structures created by sophisticated financial engineering techniques are still uncommon in China. Furthermore, as Chinese banks have long dominated the credit intermediation market in China, there is a strong connection between shadow banks and the traditional commercial banks. For instance, shadow banks often leverage the client base of commercial banks, sourcing funds and support from commercial banks; in some cases, shadow bank platforms may even be established or invested in by commercial banks. To prevent any spillover as a result of this close connection, the PBoC, the China Banking Regulatory Commission (CBRC), the China Insurance Regulatory Commission, the China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange jointly issued the *Circular on Regulating Inter-bank Business of Financial Institutions* on 24 April 2014 to lay down prudential measures regarding investment and financing activities between financial institutions. The CBRC further issued the *Circular on Regulating the Governance of Inter-bank Business of Commercial Banks* on 8 May 2014, which imposes even greater requirements on commercial banks in relation to the conduct of their inter-bank businesses, such as requiring separate departments to engage in inter-bank businesses, maintain a list of eligible counterparties and set up credit limits for each counterparty.

The Regulation of shadow banking in China

Circular 107

In spite of the market discussion on shadow banking, the State Council of the PRC has only recently begun to devise a regulatory framework specifically for shadow banking in China.

At the end of 2013, the General Office of the State Council issued an internal document known as the *Circular Relating to the Issues on Shadow Banking Regulation* (Circular 107). Subsequently, Circular 107 became public albeit only informally in early 2014.

Although Circular 107 does not clearly define "shadow banking" or what a "shadow bank" is, it identifies the following three types of shadow banking entities in China:

- credit institutions that do not hold any financial licence and are not subject to any regulation (e.g. new Internet-based financial companies and third-party wealth management institutions);
- credit institutions that do not hold any financial licence and are not sufficiently regulated (e.g. financial guarantee companies and micro-credit companies); and

- licensed financial institutions which carry out certain businesses that are not subject to any proper regulation or which circumvent the relevant regulations (e.g. money market funds (MMFs), securitization and certain wealth management services).

While Circular 107 recognises the function of shadow banking as a helpful supplement to the traditional banking sector, it also warns of the systemic risks associated with shadow banking.

Bank-trust cooperation arrangement

There are several aspects of shadow banking that involve risks, among which the "bank-trust cooperation" arrangement has probably attracted the greatest amount of attention and therefore is now most closely regulated.

Under the "bank-trust cooperation" model, a bank launches a wealth management product to raise money from end investors, and uses the proceeds of such product to invest in a trust scheme launched by a trust company. Although banks are subject to restrictions on credit extension as discussed above, they have, by investing in trust schemes of trust companies, been effectively able to get around various investment rules in terms of utilising wealth management funds or other assets as well as capital restraints. Trust companies offer the advantage of having a generally wider investment scope whilst being subject to lower capital requirements than banks. Furthermore, credit financing under a bank-trust cooperation arrangement will not be counted towards bank credit lines. This advantage has provided good potential for the bank-trust cooperation arrangement to develop in China, which has facilitated credit creation and expansion outside the normal banking system.

Accordingly, the CBRC has been gradually strengthening the monitoring and regulation of bank-trust cooperation arrangements. Concrete measures that have been implemented by the CBRC include:

- prohibiting banks from providing guarantees or repurchase undertakings for the assets underlying the trust schemes;
- imposing capital requirements on trust companies to ensure that their capital is compatible with the assets held under their trust schemes;
- imposing a 30% cap on trust companies allocating assets under a bank-trust cooperation arrangement to credit assets (for example loans and bonds); and
- requiring that all assets held by a bank through a bank-trust cooperation arrangement be reflected in the bank's balance sheet and therefore subject to capital adequacy and other applicable requirements.

The rise of money market funds

During the winter of 2013, MMFs became a hot topic for retail investors in China. One of the MMFs in the spotlight was Yu'E Bao. Legally speaking, Yu'E Bao is a MMF launched and distributed by Tian Hong Asset Management Co., Ltd. (Tian Hong), which itself is a fund management company licensed by the CSRC. Tian Hong engages Alipay (the payment services arm of China's e-commerce company, Alibaba) as its payment service provider in connection with fund sales and redemptions. Alipay includes the Yu'E Bao MMF within its payment service portal and enables its users to subscribe for Yu'E Bao by using their spare cash in Alipay accounts, by virtue of which Yu'E Bao is able to leverage Alipay's vast client base. As of 30 September 2014, the assets under management of Yu'E Bao reached RMB535 billion (approximately USD87 billion) after only 16 months following its establishment.

As discussed, given the close connection between China's banking and non-banking credit sector, it is not surprising that nearly 90% of Yu'E Bao's portfolio consists of bank deposits and cash deposited with depositary and clearing agencies for settling and clearing money market instruments. While limiting their participation in securitization deals and other money market instruments, many other MMFs also invest the majority of their portfolios with banks as deposits so as to earn more interest. This is because MMFs' deposits are not subject to the interest rate cap as discussed above and banks may therefore offer MMFs a relatively higher interest rate, in particular at times when the inter-bank market is short of liquidity. In fact, some investors are withdrawing their deposits from banks to subscribe for MMFs in order to obtain a higher return.

In China, MMFs typically have a constant net asset value (NAV) (*i.e.* the NAV per unit remain a constant at RMB1 and the profits generated each day being distributed as new fund units). As discussed above, currently MMFs mainly allocate their portfolios with banks as deposit, while funds in the form of other money market investment (rather than deposits) are maintained in the same pool. As Yu'E Bao and many MMFs offer T+0 redemption for any amount not exceeding a specific threshold, there is a liquidity risk that an MMF's constant NAV may not reflect the real value of the MMF (in particular where there is significant redemption request which requires the MMF to realise its investments on an expedited basis to meet the cash payout requirement, which may therefore instigate runs considering MMF investors' low tolerance in absorbing losses). Therefore, systemic risk is increased due to MMFs' higher susceptibility to "runs" given that investors treat them as deposits (resulting from constant NAV and T+0 redemption features) and there is a significant retail investor base.

While foreign regulators are considering the need for floating NAV in order to ensure that the asset value of a MMF is accurately reflected, or the imposition of mandatory buffers for potential runs, Chinese regulators are still assessing the risks involved with the rapid growth of MMFs and have yet to take any concrete measures to address the susceptibility of MMFs to "runs". So far it is only reported that the *Interim Measures on the Regulation of Money Market Funds* might be amended to address the systemic risks associated with MMFs.

The PRC State Council has long proclaimed an intention to develop a "multi-layered capital market" which is yet to unfold through any detailed proposals. We believe that the shadow banking function of MMFs will further develop in China and become more complex as they participate in securitizations and other structured products. It is very likely that Chinese regulators will implement more prudential measures to regulate the activities of MMFs, so as to ensure that the rapid growth of MMFs is properly monitored.

"Internet finance"

"Internet finance" has emerged as another recent phenomenon in China's financial market. While "internet finance" is not defined under Chinese regulations, it commonly refers to any financial or quasi-financial activities involving the use of the internet. Among various innovations of "internet finance", peer-to-peer online lending platforms (P2P Platforms) seem to underlie the greatest shadow banking concern.

P2P Platforms in China currently operate in an unregulated manner. There are several P2P Platform operating models, including:-

- a platform for simply matching lending and borrowing information (Model 1);
- a platform with guarantee or other credit support facilities from the P2P Platform operator or its affiliates (Model 2);
- a repackaging and sale of credit assets through securitization and other financial engineering techniques (whereby a P2P Platform issues "wealth management products" to raise money for purchasing the credit assets of the P2P Platform's affiliates such as micro-credit loans, with the relevant "wealth management products" being issued as standalone products or on a rolling basis for an asset pool) (Model 3); and
- a transfer of credit assets created by a P2P Platform operator or its affiliates to end investors (whereby the P2P Platform or its affiliates extend certain loans to borrowers first and then sell these loans through the P2P Platform to end investors) (Model 4).

With the exception of Model 1, other models raise concerns over shadow banking risks – Model 2 and Model 4 may facilitate credit creation by leveraging the creditworthiness of the

P2P Platform and its affiliates, while Model 3 additionally involves liquidity mismatch if it uses "asset pool" techniques to fund long-term assets by taking in short-term investments from clients on a rolling basis.

CBRC officials have, on various occasions, mentioned that regulatory rules on these P2P Platforms are being drafted. They have also emphasized that P2P Platforms should only play a pure intermediary function and are not permitted to employ cash pooling or other financial engineering techniques involving credit mismatch, so as to ensure that P2P Platforms fall outside the scope of shadow banking. For the time being, the market is still awaiting the promulgation of the relevant CBRC rules.

Securitization

Before the global financial crisis, there were only a limited number of securitization transactions in China, all mainly driven by policy considerations. Deals driven by commercial considerations have only started in recent years. Generally speaking, securitization is less of a shadow banking issue in China. One reason is that although there is an overall trend towards deregulation, securitization in China is still subject to stricter regulation than in most developed markets. The other reason is that the current structures used in securitization deals in China are relatively straightforward.

The most significant component of China's securitization market is the credit asset securitization regime, under which banking and financial institutions approved by the PBoC and the CBRC can legally securitize their credit assets (e.g. loans). Securities institutions regulated by the CSRC may also launch securitization programmes under another regime called "corporate asset special management regime," which involves broader underlying assets (which, apart from credit assets under the credit asset securitization regime, may include commercial receivables, lease agreements, trust interests as well as infrastructure and other real properties) and invites more opportunities to be listed on the stock exchange. China's insurance regulator also launched a programme in 2013 which allows insurance asset managers to participate in securitizations. As for non-financial institutions, they may issue asset-backed notes in the inter-bank market through a registration system administrated by the National Association of Financial Market Institutional Investors, which apparently may accept innovative structures similar to traditional securitization deals. However, the current main methods of securitization in China remain to be the credit asset securitization regime and the corporate asset special management regime. The scale of securitizations in China is growing rapidly. For example, the total issuance size of the credit asset securitization regime was about RMB10 billion (approximately USD1.78 billion) in 2013, while the issuance size as of November 2014 rocketed to nearly RMB202 billion (approximately USD32.96 billion).

We expect that China's securitization market will continue to grow in terms of both issuance levels and transaction structures. With the introduction of more complex structures involving maturity/liquidity transformation and leverage, and thus resulting in higher risks, regulators will need to pay closer attention to the shadow banking issues in the context of securitization, such as whether there is sufficient transparency and whether risk retention rules should be imposed.

Conclusion

It is clear that Chinese regulators are now considering how shadow banking in China should be regulated. Nonetheless, it remains to be seen how the relevant regulatory policies will be adopted into concrete regulatory measures. We can certainly expect, as instructed by Circular 107, that the different PRC regulators will collaborate to introduce new rules to regulate businesses which currently appear to operate in a regulatory vacuum, such as the P2P Platforms as a start. Understanding the current regulatory thinking around these matters is crucial when considering the launch of any innovative financial product that could be captured within the deliberately imprecise definition of "shadow banking".

Contacts

Hong Kong

Mark Shipman

Partner

E: mark.shipman@cliffordchance.com

Peter Kilner

Partner

E: Peter.Kilner@CliffordChance.com

Beijing

Tiecheng Yang

Partner

E: tiecheng.yang@cliffordchance.com

Ying White

Partner

E: ying.white@cliffordchance.com

Shanghai

Stephen Harder

Managing Partner

E: stephen.harder@cliffordchance.com

Ge Yin

Senior Associate

E: yin.ge@cliffordchance.com

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Clifford Chance, 33/F, China World Office 1, No. 1 Jianguomenwai Dajie, Chaoyang District, Beijing 100004, People's Republic Of China

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