Commentary
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China: Shadow Banking and the Global Economy

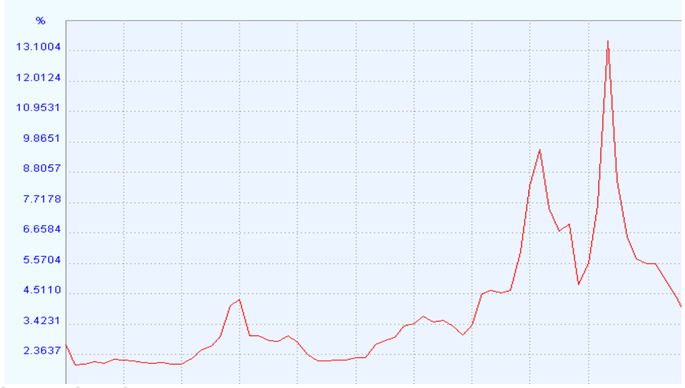
By: Maria Ma, CFA, Senior Investment Analyst, Fixed Income Team

- China's fast-growing shadow banking system poses significant risks to the country's economy and financial sector.
- There is some risk that trillions of dollars in shadow liabilities could end up on the balance sheets of traditional banks.
- While a meltdown in China would threaten the global economy, we don't expect a worst-case outcome, as China's government seems willing and able to backstop the system.

In June, China saw the interest rate on overnight loans between banks (the Shanghai interbank offer rate, or SHIBOR) soar above 13% before falling back to a range of 3% to 4%, as shown in Exhibit 1. The run-up in SHIBOR caused bank lending to freeze up and Asian stock markets to tumble. Although things have stabilized since then, the episode has raised serious concerns about China's so-called "shadow banking system."

Like most observers, we believe non-bank financial institutions are the weakest link in China's financial system, and as such, they pose significant risks to the country's economy and financial market stability. Given the nation's role in global finances, the potential implications of a negative economic event are also worrisome beyond China for big emerging- and developed-market economies. If China exports less, it also imports less. This places further downward pressure on global economic activity and weakens commodity prices. However, we believe the Chinese government will take whatever steps are necessary to backstop the country's banking system.

Exhibit 1: Overnight SHIBOR



Source: SHIBOR.org
Data from 3/29/2013 through 7/2/2013.

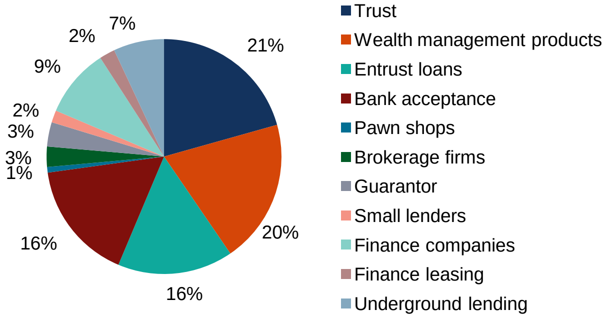
"Shadow Banking," Defined

Unfortunately, there is still no official universal definition of shadow banking, but the following attempts are a good start. According to the Financial Stability Board (FSB), the shadow banking system can be defined as "the system of credit intermediation that involves entities and activities outside the regular banking system." The New York Federal Reserve has defined shadow banks as "financial intermediaries that conduct maturity, credit and liquidity transformation without explicit access to central bank liquidity or public sector credit guarantees." Describing the U.S. financial system in 2007, Paul McCulley (a managing director of asset management firm PIMCO at the time) wrote that the shadow banking system was "the whole alphabet soup of levered up non-bank investment conduits, vehicles, and structures."[1]

In China, the term generally refers to a somewhat diverse range of non-bank financial institutions, including trust companies, wealth management products, entrust loans (a loan made to a borrower through an intermediary third party), brokerage firms, small lenders, financial guarantors and underground lending. The components and their estimated contributions to the system are provided in Exhibit 2.

[1] "Strengthening the Oversight and Regulation of Shadow Banking: Progress Report to G20 Ministers and Governors," 16 April 2012, <http://www.financialstabilityboard.org/publications/r_120420c.pdf> accessed on 8/20/2013; Zoltan Pozsar et al, "Shadow Banking," Staff Reports Number 458, July 2010 (rev. February 2012), <http://www.newyorkfed.org/research/staff_reports/sr458.html> accessed on 8/20/2013; "Global Central Bank Focus: Teton Reflections," September 2007, <http://www.pimco.com/EN/Insights/Pages/GCBF%20August-%20September%202007.aspx> accessed on 8/20/2013.

Exhibit 2: Components of Shadow Banking System



Sources: PBOC, CBRC, China Trust Association, JP Morgan
As of December 2012, based on estimated total size of RMB 36 trillion.

Recent estimates of the assets held by China's shadow banking system vary widely, as shown in Exhibit 3.

Exhibit 3: Estimated Size of Shadow Banking System

Source	Date	RMB (trillion)	USD (trillion)	Percent of 2012 GDP	Percent of bank assets*
JP Morgan	May 2013	36.0	5.8	69	27
CICC	Apr 2013	27.0	4.4	52	20
Deutsche Bank	Jan 2013	20.0	3.2	38	15
UBS	Dec 2012	24.4	3.9	47	18
Median		**25.7**	**4.2**	**50**	**19**

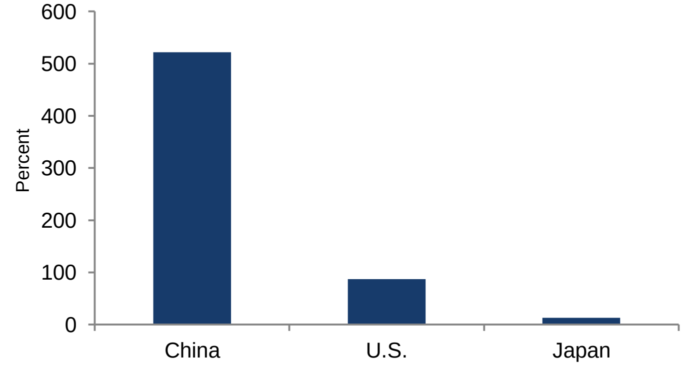
Source: xinhua08.com (http://rmb.xinhua08.com/zt/2013/rmbgc5/, accessed on 8/20/2013)
* Bank assets as of year-end 2012.

To put the estimates in Exhibit 3 in context, the FSB estimated that shadow banking assets around the world totaled $67 trillion as of 2011, which equated to roughly 111% of global GDP, or 50% of global bank assets. Thus, by comparison, the size of China's shadow banking system is still relatively small. However, there are grounds for concern, including the system's opacity and insufficient regulation as well as the rapid growth it has experienced. According to recent estimates by Credit Suisse, when non-bank credit creation (a proxy for shadow banking) is included, total credit in China has gone from roughly 120% of gross domestic product (GDP) in 2008 to over 170% at the end of 2012. Over the same period, the contribution of non-bank credit has gone from roughly 10% to approximately 40% of GDP.

Emergence of the Shadow Banking System

While China has achieved exceptional economic growth over the last decade, its financial system has expanded even more dramatically. Under the country's central bank, the People's Bank of China (PBOC), broad measures of money supply have increased at a much stronger pace than in more developed economies, as highlighted in Exhibit 4.

Exhibit 4: China's Rapid Pace of Money Creation

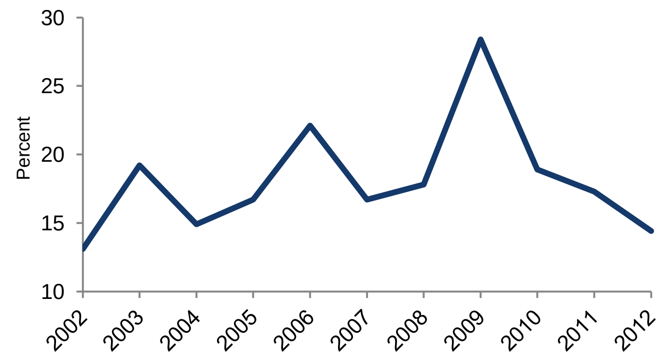


Sources: World Bank, SEI
Compound growth rate of money and quasi-money (M2), defined as the sum of currency outside banks plus demand, time, savings and foreign-currency deposits of resident sectors other than those of the central government, from 2002 through 2012, inclusive.

In fact, relative to its GDP, China has seen a larger credit expansion during the last two decades than, for example, Europe, Japan and the U.S. How did this happen?

In 2008, in response to the global financial crisis and recession, China's central government launched a massive stimulus package of four trillion renminbi (RMB), or $585 billion (at November 2008 exchange rates). As a result, bank lending surged to an annual growth rate of almost 30%, as seen in Exhibit 5.

Exhibit 5: Annual Growth Rate of M2 in China



Source: World Bank

This rapid pace of growth caused widespread concern over the credit quality of the loans being made. In response, regulators adopted several policies designed to tighten control over traditional banks' lending activities and thereby to prevent a credit bubble. One of their first measures was to put an upper limit on the rate of interest that could be paid on deposits. As a result, real (inflation-adjusted) deposit rates have been much lower than inflation and economic growth for several years, causing many savers and investors to seek higher-yielding alternatives. Another regulatory measure was the establishment of yearly loan quotas for traditional banks. Given these banks' preference to lend to large state-owned enterprises, this measure limited the bank credit available to other borrowers. Finally, in 2010, following a surge in housing prices, regulators restricted the ability of property developers to access traditional bank credit. All of these measures motivated savers and borrowers to look outside the traditional banking system for credit, and non-bank financial institutional quickly filled the gap. Even traditional banks have issued products designed to capitalize on the demands for shadow banking.

Intermediaries—Wealth Management Products, Trusts

Two major sources of financial intermediation in China's shadow banking system are wealth management products (WMP) and trust companies. The first WMP came to the market in 2004. The majority of WMPs (which are exempt from restrictions on bank deposit rates) are issued by banks, but trust companies, insurance companies, brokerage firms and private equity funds are also active players in the market. According to the China Banking Regulatory Commission (CBRC), the total outstanding WMPs issued by banking institutions were over seven trillion RMB at the end of 2012 and are expected to exceed 13 trillion RMB by the end of 2013. WMPs are typically short-term instruments; the vast majority of them mature in six months or less. Issuers often pool the proceeds of different WMPs and invest in a wide range of assets, which vary from short-term liquid money-market assets to small enterprise and real estate loans to local government financing vehicles. There is little transparency into the underlying assets, and investors don't usually request the information. The products do not carry credit ratings, nor do they have a secondary market where holders can buy and sell them prior to maturity.

In contrast to WMPs, which are a relatively recent innovation, the largest non-banking financial institutions in China—trust companies—have a long history in the country's financial system. They specialize in lending to private enterprises, and local governments also rely on them to finance risky long-term real estate and infrastructure projects. The first trust company was established in 1979, and the sector has been restructured six times since then (more than any of China's other financial sectors by far) as a result of recurring boom-and-bust cycles. Each time, trust companies have been subjected to aggressive regulatory steps in order to clean up problem assets and improve risk management. According to Baidu.com, at their peak in 1988, there were over 1,000 trust companies in China with total assets over 600 billion RMB, accounting for 10% of total financial assets in China. When the Chinese economy experienced a downturn in the early 1990s, their asset quality quickly deteriorated. Nonperforming loans forced one of the largest trust companies to declare bankruptcy in 1999. By 2007, there were only 54 trust companies left. However, the sector quickly regained momentum in the recovery that followed the financial crisis of 2007–2008; from 2007 to 2012, assets under management increased by a factor of six, reaching 7.5 trillion RMB by last December. If and when the music stops, poorly managed trust companies could face significant liquidity and default risk.

Borrowers—Local Governments, Property Developers

Both local governments and property developers rely heavily on the shadow banking system for credit. In China, local governments deliver most social services but they have few revenue sources, as the central government is responsible for major tax collections. Land sales are the primary source of local-government income, accounting for 40% to 60% of all local revenue. Local governments are not permitted to borrow from major banks, nor are they able to issue municipal bonds. (It should be noted that the central government has lifted the restrictions on bond issuance for a few provinces and cities, and we believe it will eventually—though gradually—permit all local governments to issue bonds.) As a result, when local governments need to invest in large-scale projects, they have no choice but to turn to shadow lenders. Today, nearly half of local governments carry debt that is over 100% of their budget revenues. Some local governments are already insolvent, having to take on new debt in order to repay old debt. (See our February 2013 commentary, "Financial Crises—A 'Hardy Perennial,'" for a discussion of different financing methods and how they can lead to systemic fragility.) We believe this is a structural issue that will persist until there is comprehensive and effective tax reform. Until then, there are several risks facing local governments. Returns on infrastructure projects are likely to fall if China's economic growth continues to slow. If the prices or volumes of real estate transactions fall, local tax revenues could decline. Local governments could also be called on to provide subsidies to troubled companies. All of these risks would serve to worsen local governments' fiscal situations, which could ultimately have a devastating impact on the financial system. In fact, some observers have characterized local government debt as having the potential to spark a bigger crisis than subprime mortgages did in the U.S.

Property developers are also big borrowers in the non-traditional sector. In the past decade, about 60% to 70% of the funding used in real estate development was sourced from the shadow banking system. It's also worth noting that the share of official bank lending in development transactions has declined in the past few years. If there is a shock to the real-estate market, property developers and their lenders could take a hit.

Is "Off Balance Sheet" Really Off Balance Sheet?

Shadow banking institutions have strong ties to traditional banks. Banks can lend funds to trust companies, who then lend to small and private enterprises that don't normally have access to traditional bank lending. By doing this, banks essentially outsource some of their lending business to trust companies, which permits them to keep those loans off their own balance sheets. In addition, banks can own controlling shares of the trust companies. Unlike traditional loans, shadow banking activities are not subject to the constraints imposed by either the loan-deposit ratio or loan quotas.

Given their close ties to many entities in the shadow banking system, banks could wind up assuming non-bank liabilities if things turn south. Although more than 60% of all bank-issued WMPs have no explicit guarantee on either rate of return or principal repayment, investors tend to view them as having implicit bank or government guarantees; and historically, we have yet to see a major WMP default. As recently as December 2012, a small number of WMPs sold by representatives of a traditional bank threatened to go into default. Although the bank had not issued or guaranteed these WMPs, it repaid all of investors' principal after a series of negotiations in order to protect its reputation. A larger-scale version of this occurrence could significantly weaken banks' balance sheets, which could cause lending to contract in the official banking sector as well.

Improving Regulation

Financial regulators in China have been tightening their control over the shadow banking system. In 2010, trust companies became subject to restrictions on their leverage ratios and net capital requirements. In March 2013, the CBRC issued guidelines tightening regulation on nonstandard credit products (those credit products not traded on exchanges) of WMPs. More recently, the CBRC stepped up its monitoring of interbank exposures.

Our View

China's shadow banking activities have grown at a rapid pace in recent years. However, their total size still looks manageable relative to the country's economy and bank assets. The capitalization and liquidity profiles of major traditional banks in China look solid, which should provide a buffer capable of absorbing potential losses elsewhere in the system. The country's newly installed leadership also appears to be determined to prevent systemic financial risk, even if this results in slower economic growth. Moreover, China is in the process of transitioning from an investment-driven to a consumption-driven economy. Since almost all major banks in China are state-owned, we believe the central government will step up to backstop the financial system if regulators see systemic pressures intensifying. Given China's sizeable foreign reserves, as well as restrictions on capital flows into and out of the country, we also believe the central government has the financial capacity to backstop the system. Thus, while we view the shadow banking system as a meaningful risk to China's economy, we do not expect a financial crisis in the near term, nor do we believe the country will be pushed into a "hard landing" scenario.

China's challenges also pose risks to emerging markets in general. As we observed in a recent commentary ("Unhappy Emerging Markets," August 2013): "China faces a number of challenges, both economic and financial, that will help determine the speed of global economic expansion and the relative strength of emerging financial markets over the next few years … [the] government's ability to gain control over the country's shadow banking system … will be [a key milestone] for investors in emerging-market asset classes."

Our Funds

With respect to China, absolute exposures are most meaningful across our emerging market equity funds. While our managers are generally neutral in their absolute positioning to the country relative to their benchmark, they have identified specific themes to drive their allocations. As is the case for our aggregate positioning across emerging markets, managers are positioned to benefit from the domestic emerging growth, as opposed to commodity-based and export-driven growth. As we have commented in the past, we remain optimistic that China's new leadership is determination to move toward a more balanced economic model.

Within our global equity ex-U.S. and developed international portfolios, managers believe that, in the longer term, emerging markets will remain the source of global growth, despite recent weaker growth reports and debt concerns in China. For both portfolios, positioning within the country represents a minor overweight, driven by security selection analysis.

Within fixed income, a small allocation to Chinese debt exists in our emerging market debt funds. However, manager positioning is neutral to the benchmark, with the emphasis on security selection (specifically, corporate debt) as opposed to a broad regional theme.

Fund	China: Fund Weight (%)*	China: Benchmark Weight (%)*	Fund Weight in Financials Sector (%)
SIT Emerging Market Equity Fund	19.3%	18.8%	5.2%
SIIT World Equity Ex-U.S. Fund	7.1%	6.1%	2.8%
SIT International Equity Fund	3.6%	2.9%	1.7%
SIT Emerging Market Debt	1.5%	1.6%	
SIIT Emerging Market Debt	1.7%	1.6%	

Source: SEI; data as of 7/2013
* China weight includes allocations to China and Hong Kong.

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- ***Not FDIC Insured***
- ***No Bank Guarantee***
- ***May Lose Value***