Box B

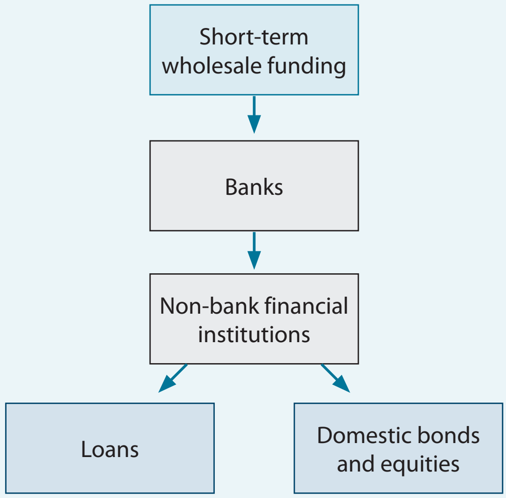
Recent Developments in Chinese Financial Regulations

Chinese regulators have recently announced a range of measures to reduce leverage, improve transparency and strengthen risk management practices in the financial system. This follows a Chinese Government directive issued late last year to curb financial risks, and builds on earlier efforts to address high-risk activities. The regulatory measures are wide-ranging and entail a degree of coordination across agencies. Consistent with this, President Xi recently announced the establishment of a Financial Stability and Development Committee to improve coordination among financial regulators. Many of the regulatory measures expand on existing rules and enforce them more tightly, although some are yet to be implemented (including because the details are yet to be finalised for some measures).

A key aim of the regulatory agenda is to reduce the extent to which small and medium-sized banks borrow funds in short-term wholesale markets to invest in, or channel funds to, non-bank financial institutions (NBFIs), such as asset management companies.[1] NBFIs use the funds to provide loans, which are typically directed towards more risky borrowers than traditional bank loans or to purchase domestic financial assets (Figure B1). Regulators are targeting three aspects of this behaviour, which are interrelated, by: limiting new 'channel investments'; improving transparency and risk management of some riskier financial products; and discouraging the reliance on short-term wholesale funding.

1 NBFIs operate across the financial sector and tend to face less onerous regulatory requirements than banks.

Figure B1: Stylised Example of Practice Targeted by Regulators



Source: RBA

Limiting New Channel Investments

Chinese regulators are targeting channel investing because of concerns that it contributes to an increasingly opaque and interconnected financial system. Channel investing refers to the practice whereby banks distribute funds through another financial institution or asset management product (AMP). AMPs capture a broad range of financial products, marketed by, or in coordination with, a bank or NBFI. They offer the holder the right to the income stream from underlying assets. Channel investing enables banks to: (i) circumvent restrictions on providing funding to specific sectors of the economy; (ii) exceed credit growth restrictions; (iii) take speculative positions in financial markets; and/or (iv) reduce capital and loan-loss provisioning.[2] Channel investing is often complex and lacks transparency. It can involve multiple investments across layers of intermediaries and AMPs are often sold in tranches that have varying levels of subordination (with different credit ratings). Small and medium-sized banks have used this approach to expand their balance sheets significantly in recent years; for example, banking system claims on NBFIs have risen more than six-fold since 2012, to be around 20 per cent of total assets at the end of 2016.

In response, the China Banking Regulatory Commission (CBRC) instructed banks to conduct internal reviews and monitor their existing channel investments in early 2017. Banks were already required to treat loan-like assets as loans for capital and provisioning purposes, but the recent guidance sought to enforce this requirement more rigorously. This stricter enforcement of existing regulations, together with new proposed measures that restrict banks' off-balance sheet and affiliated entities from investing in other off-balance sheet entities, are expected to reduce the extent of new channel investments. The People's Bank of China (PBC) has also made its new macroprudential assessment (MPA) framework more stringent by including banks' off-balance sheet assets in their credit assessment.[3]

Improving Transparency and Risk Management of AMPs

Regulators are also trying to improve the transparency of AMPs and strengthen the risk management practices of NBFIs (which typically manage AMPs). AMPs have several features that contribute to their underlying risk. In particular, managers of AMPs and their investors have little incentive to ensure that investments are prudent because there is a widespread perception that banks will guarantee returns. The limited visibility of the underlying exposure – exacerbated by the practice of AMPs investing in other AMPs – also means that retail investors would find it difficult to monitor the ultimate investments.

Regulators have proposed that AMPs that are not on a bank's balance sheet will no longer be able to offer a guarantee that principal and interest will be returned and will have stricter reporting requirements. Other proposals include: imposing a cap on the leverage of the most popular types of AMPs to mitigate regulatory arbitrage (previously different limits had existed depending on the type of sponsor of the AMP); requiring higher provisioning; and banning investment in non-standard assets.

Discouraging Reliance on Wholesale Finance

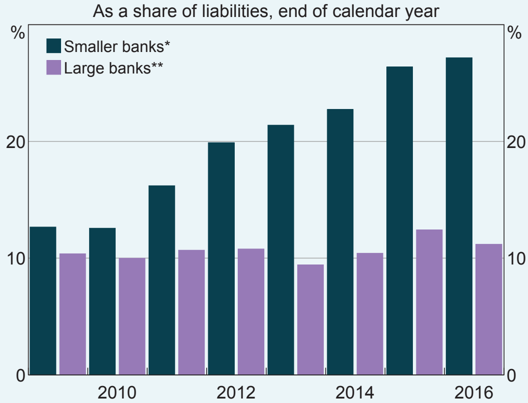
Finally, regulators have targeted the growing reliance on short-term wholesale financing by small and medium-sized banks (Graph B1). Some of these banks obtain short-term funding from the large state-controlled banks, partly by issuing tradeable debt instruments, such as negotiable certificate of deposits (NCDs). These funds are often used to finance channel investments, resulting in increased rollover risk and interconnectedness among financial institutions.

In response to growing risks in wholesale funding markets, the PBC has facilitated an increase in money market rates since August 2016 in order to dampen activity in these markets. Also, the CBRC is assessing banks' wholesale (interbank) funding practices more stringently with the interbank liabilities cap of a third of total liabilities

2 For further details, see RBA (2016), 'Box A: Recent Growth of Small and Medium-sized Chinese Banks', *Financial Stability Review*, October, pp 14–16.

3 The MPA groups banks into various risk categories based on capital adequacy ratios, leverage ratios and liquidity coverage; a bank's risk category affects some prudential requirements and can influence the availability and price of PBC liquidity.

Graph B1
Wholesale Deposits at Chinese Banks
As a share of liabilities, end of calendar year



* Smaller bank data based on an unbalanced sample; includes only city and joint-stock banks

** Includes five largest state-owned banks but excludes policy banks

Sources: RBA; S&P Global Market Intelligence

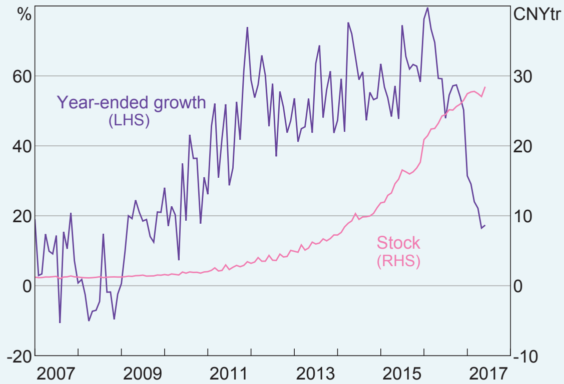
reportedly expanded to include NCDs from late 2018. On the asset side, the CBRC has restricted interbank lending to less than 50 per cent of Tier 1 capital to limit large banks' direct exposure to smaller banks. Some of the large state-owned banks appear to have net interbank lending close to, or above, the proposed capital ceiling.

Response to Regulations

Banks have started reducing their use of channel investments ahead of their internal reviews, as shown by the sharp slowdown in the growth of banks' claims on NBFIs (Graph B2). Reports suggest that with reduced access to funding, NBFIs have responded by reducing their holdings of financial assets, with corporate bond yields increasing and issuance declining as a result.

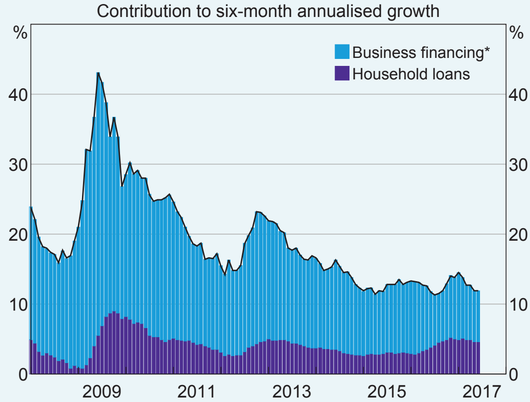
To date, the regulatory announcements appear to have had only a modest impact on the measured growth of broad credit, as captured by total social financing (TSF) (Graph B3). However, the TSF data do not capture some credit extended through channel investments, so they are likely to understate the slowing in the growth of financial activity. This is especially the case given that the latest reforms are targeted at loopholes that have allowed these less regulated forms of credit to grow rapidly in recent years. ✈

Graph B2
Banks' Claims on NBFIs



Sources: CEIC Data; RBA

Graph B3
China – Total Social Financing
Contribution to six-month annualised growth



* Business financing is the sum of business loans, securities financing and off-balance sheet financing

Sources: CEIC Data; RBA