Huge growth in China’s shadow banking system

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China’s shadow banking sector has rapidly burgeoned and now ranks as the third largest in the world, according to a report issued last month by the Financial Stability Board (FSB), which was created by the G20 economies in the aftermath of the 2008 global financial crisis.

By definition, shadow banking refers to capital-lending intermediaries, or “other financial intermediaries” (OFI) that operate outside the traditional banking institutions (banks where money is deposited) and therefore are exempt from the limited regulations and oversight placed on the traditional banking sector. However, some analysts accuse traditional banks of being a principal force in the shadow banking sector.

The most advanced capitalist countries such as the United States and the United Kingdom have the largest shadow banking systems, representing a third and 12 percent respectively of the totality of shadow banking around the world.

Analysts did note, however, that emerging markets, particularly China, warrant special attention due to the magnitude and rapid rise of shadow banking in that country. As the second largest economy in the world, a major financial meltdown would precipitate massive consequences throughout the globally integrated capitalist system.

The report states that Chinese OFIs have set a pace for rapid expansion year-over-year. OFI assets grew by by 42 percent in 2012 compared to the prior year, whilst these assets increased more than 37 percent in 2013, almost touching $3 trillion.

Some independent economic analysts have said the FSB’s report underestimates the scope of the shadow banking industry in China. The Chinese Academy of Social Sciences has estimated that it may be $1.5 trillion more than the FSB’s report of $3 trillion. This equates to one-fifth of China’s supposed regulated banking sector. To date, OFI’s assets have ballooned to $6.54 trillion, according to analysts.

The report is timely as it comes amidst a series of shadow banking defaults in China. Chinese state media had reported in September that a major bank faced $652 million of defaults from surreptitious lending practices such as off-balance-sheet products.

This type of parasitic lending has exploded in popularity recently. Banks and trust firms have been marketing off-balance-sheet products as high-yielding alternatives to bank deposits. They are risky and as the Chinese economy slows the risk of default disproportionately increases, according to analysts.

The government has sought to step up its authority over the shadow banking to prevent a potential bubble collapse. Chinese banking regulators in August published draft rules to augment oversight of financing activities and in May the government had dictated limits on interbank borrowing.

Louis Kuijs, the Chief China economist at Royal Bank of Scotland, told Reuters, “The trend as we have seen it in the last four or five years is not sustainable, as in China cannot see another three or four years of credit growth at that pace.” If so, Chinese lenders will be looking for other avenues, including even more parasitic means, to keep profits up and credit flowing.

The South China Morning Post reported this month in a headline entitled, “China’s shadow banking too profitable to stop,” that asset management companies, which the Chinese government created to tackle bad bank debt, “have become key players in financing the [shadow banking] sector.” Some Chinese politicians have, likewise, voiced their support for shadow banking in bringing capital to various businesses.

Globally, the FSB said that the shadow banking industry grew by $5 trillion in 2013 to reach $75 trillion, explaining, "this provides a conservative proxy of the global shadow banking system." It continued, "By absolute size, advanced economies remain the ones with the largest non-bank financial systems." These assets represent on average about 25 percent of total financial assets, about half of banking system assets, and 120 percent of GDP.

"Taking a step back and looking at this whole system," added Kuijs, "I would still feel comfortable saying I don't feel China is at the risk of systemic financial crisis because of (shadow banking)." Were not, however, the world's economists dumbfounded and perplexed when the US financial system collapsed, with a significant role played by shadow banking?