EXECUTIVE BOARD MEETING

SM/16/213
Correction 3

August 3, 2016

To: Members of the Executive Board

From: The Acting Secretary

Subject: **People's Republic of China—Selected Issues**

Board Action:	The attached correction to SM/16/213 (7/8/16) has been provided by the staff:
Factual Errors Affecting the Presentation of Staff's Analysis or Views	**Page 18**
Questions:	Mr. Guo, APD (ext. 34705)

nearly half of total shadow products, have either NSCA or equities as underlying and appear high-risk relative to corporate loans.

4. Banks' on-balance sheet exposures to shadow products are large and growing fast. At end-2015, banks held RMB 15.2tn[2] of shadow products—equivalent to 8 percent of banks' assets and 92 percent of capital buffers, and up 58 percent year-on-year for listed banks. Because these positions appear to be motivated in part by some banks' practice of repacking deteriorating loans into investment securities to avoid recognizing and providing for nonperforming loans (NPLs), banks' exposures are likely skewed toward the riskier products (those with NSCA as underlying asset). The "big four" banks have small exposures, but several other listed banks and the unlisted in aggregate have exposures that are several times their capital.

5. Shadow products also can generate transmission risks that are potentially less manageable than loan losses. Where shadow products differ qualitatively from high-risk loans is in their greater power to transmit risk across the financial system. Of greatest concern are holdings by investors who have little ability or incentive to continue supporting market liquidity in the face of shocks or deterioration in credit conditions. Vulnerable segments include 'collective' instruments (RMB 10.9 trillion at end-2015); and holdings by nonbank financial institutions (particularly investment funds), corporates and individuals. Sizing the 'high-transmission' segment of the shadow system is difficult; but it appears sufficient to potentially catalyze significant liquidity challenges.

6. Rapid asset growth has increased banks' and other financial institutions' reliance on wholesale funding. From 2010 to 2015, total financial system assets grew by 5½ times more than GDP, twice as much as total social financing and three times as much as loans. Thus while the banking system loan-deposit ratio remained stable, total assets have grown much faster than deposits. Financial system assets relative to the stable bank deposit funding in the system rose from 163 percent in 2010 to 193 percent in 2015; and for banks, from 130 to 143 percent. The gap has been funded from wholesale sources; staff estimate that wholesale sources as a percent of total bank funding essentially doubled, from 15 to 34 percent, over the period 2013 to 2015. (Counting banks' principal-protected wealth management products as quasi-deposits would lower wholesale funding dependence to 30 percent at end-2015.) This wholesale funding is potentially less stable than deposits.

7. The interbank market, which accounts for about half of bank wholesale funding, may become a stress transmitter in the event of a shock. Banks source about 16 percent of their total funding from the interbank market, up from 8 percent at the end of 2010. Financial institutions, including banks, are in aggregate net borrowers in the interbank market. The funding providers are investment vehicles, mostly structured as 'wealth management products', by which trust and fund management companies source funds (mostly less than three months in tenor) from yield-seeking investors. The interbank market is also shifting toward riskier practices—for example, increasing use of 'pledged' repurchase agreement contracts to increase leverage and investment returns.~~; and high-risk trust products as collateral for repurchase transactions.~~

[2] Excluding Agricultural Bank of China due to data availability.