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Post-crisis Shadow Banking system circumvention: Banks and peer to peer industry upside Down in China

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Abstract
There are 10 developing and emerging members in 16 members of Regional Consultative Group for Asia. China provides one model from developing and emerging countries to harness shadow banks and fulfill the transformation of market-based finance. The financial policy uncertainty and delay stimulates shadow bank circumvention in the Chinese capital markets during 2010 and 2016. Inadequate regulatory regimes and underdeveloped infrastructure can not walk shoulder to shoulder with the economically booming shadow banking system in China. Two ways in the banking industry and peer to peer industry respectively rake in enormous profit by regulation arbitrage. Complex chains with off-balance sheet financial instruments, inter-bank products, credit alternatives, and small lenders are carried out for shadow money under regulatory oversight. This kind of shadow bank circumvent has undergone short rising and falling period from 2011 to 2019. Under the case study of China which has undergone a life cycle, three key recommendations are rapped to confront circumvent efficiently such as credit reference system, technology energization, and policy perfection.

Keywords: *arbitrage; circumvention; shadow bank; peer to peer*

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Shadow banks pose one source for systemic risk of financial crisis.The clear definition of shadow banks varies in the jurisdiction which has respective regulation systems and structured banking sectors. The core was first coined in 2011 by Financial Stability Board (FSB) that Shadow banks is the credit intermediation performing bank-like functions (FSB, 2011). The definition extent shrinks from non-bank financial intermediaries to other financial intermediaries from developed economies to emerging or developing economies in Asia report (FSB, 2012). The conservative proxy for other financial intermediaries is adopted better by 10 emerging and developing economies members from 16 members of Regional Consultative Group for Asia members (FSB RCG, 2014).

As one of emerging and developing economies members, China's shadow banking system explicitly differs from shadow banking in high-income economies in terms of its background, operation mechanism, and risk profile. Shadow banks of developed countries are the secondary market of credit assets of commercial banks.

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Bank holding companies promote the process which is the cycle in bank loan, asset securitization, selling, and repo. They earn profits mainly depending on liquidity conversion and term mismatch from subprime loans and illiquid assets securitization. Taking 2008 crisis as an example for advanced economies, researches on shadow banking mainly focus on securitization and credit intermediation. Without official bakstops, Loss of collateral value including trust instruments and rehypotecation denoted over-leveraged shadow banking system (Helgadóttir, 2016). Contrarily, one of key nodes of China's shadow banking system is the bank system themselves. Banks bridge the arbitrage process by providing legal value and promise such as entrusted loans and banker's acceptances. The other is that enterprise without financial license shelters under the innovative technology working on similar financial business even banking business (Sheng, 2015). A series of reforms including Basel III, Dodd-Frank Act from the USA published in 2010, and rules implementation from 2013, reduced participation of financing transactions of repo activity and derivatives activity. Until 2016, authorities the published serial measurements to regulate capital circumvention which are People's bank of China (PBC) and China bank regulatory commission (CBRC). The scale and development of both the banking system and online lending are normalized and optimized gradually.

The financial policy uncertainty and delay stimulates shadow bank circumvention in the Chinese capital markets during 2010 and 2016. This uncertainty is divided into four sorts. First, the shadow banking system risk was issued in 2011 and Asia phenomenon was started to concern from 2013 under guidance of the work by FSB. Second, the scale of shadow banking is 43% of GDP which has a big gap with high leveled index of advanced economies in 2013 (Sheng, 2015). Third, the transition which is a period from planned to a market-based economy in China (Gabor, 2018). Forth, non-bank financial intermediaries can positively facilitate financial inclusion and sustain development by further tapping financial markets (FSB, 2014). Shen, H. et al.(2021)points that the uncertainty period promotes innovation especially state-owned firms, firms with high-quality internal control and firms with lower managerial ownership. Both techno-nationalist strategy and techno-globalist strategy from the Chinese government are used to encourage innovation and competition of FinTech firms (Arner et al., 2015). Process innovation along with internet payment innovation builds a shield for shadow banks.

This article takes China as the case study to provide the model for developing and emerging countries to harness shadow banks and fulfill the transformation of market-based finance. Respectively aiming at the direct and indirect part of shadow banking, the article contains two main categories including bank-centric arbitrage and online lending arbitrage. Three recommendations of credit reference system, technology energization, and policy perfection are tapped to confront circumvent.

Financial repression from authorities stimulate banks develop credit creation and have a stake in relative institutions. Together with their affiliates and financial institutions, banks take advantage of imperfect supervision policy and inconsistent supervision standards in China. To avoid classification of loan risk and satisfy the request of bank provision, operation happen on the origin of fundamental credit assets. Banks adopt the method of transmitting balance sheet business to off-balance or transmitting credit assets to non-credit, so they can satisfy enterprise financing

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demand and fulfill self-profit objects. They choose to trust, asset management plans to evade loan scale limit.

The lag period between jurisdictional regulation and internet finance creates arbitrage opportunities and inter space. The technology industry is leading the transaction costs revolution, where a platform is used to avoid central control and intermediary. Traditionally digital infrastructures abound and transactions happen which are originally take place in physical stores. Internet finance broke the physical limit and centralization management and the effect of the restriction of traditional policy plunged. Peer to Peer (P2P) soars under the background and branch out from intermediary agent. They work on capital credit activity and locate in a vacuum zone of supervision. Circumvent motion is handsome profit under imperfect financial policy and infrastructure.

Banks bridge the process by providing legal value and promise during jurisdiction arbitrage. Different banking regulations of cross-country promote bank capital flow from heavily regulated markets to less regulated markets (Houston et al., 2012). Domestic banks issue cross-border RMB letters of credit as the pledge of funds and offshore banks give loans basing on the credit. In addition, domestic banks are responsible for enterprises to connect with offshore banks and assist with making up trade background. The whole process which includes issue, presentation, acceptance, and loans usually accomplish in one day according to the circumvent plan. Domestic banks provide balance sheet business of loans through off-balance sheet business of credit depending on the cooperation with foreign banks which are unconstrained. By utilizing the different regulations between domestic banks and foreign banks, products to avoid supervision are part of shadow banks' service.

Financial intervention from authorities stimulate regulatory arbitrage where banks develop collusion and have a stake in relative institutions. On account of different policy permission, banks build multi-level channels to achieve arbitrage. Multi-level channels contain two main aspects which are corporate collusion and proxy derivative service. Corporate collusion includes trans-trade shareholder alliance and trans-trade contract alliance. Comparatively, the latter one is more flexible during the capital junction and plastic in evolutionary cross financial derivative instruments. Regarding the variance between regulatory requirements in diverse institutions, banks link various channels to reduce the whole net regulatory burden. Liquidity stimulates that main market players transfer from high level supervision to low level. Banks assemble diverse organizations which can be other banks, security companies, fund companies, and trust companies, to fulfill the disguise. For example, ICBC international holdings limited buys shares of 'Alibaba', which is regarded as the bank precedent of private equity investment. Indirectly, industrial and commercial bank of China provides loans to support the subsidiary realizing the combination of stock rights and creditor's rights. For another example, bank A transfers loans to the collusive institution which can be a trusted company, insurance company, or bank B, and the institution or multiple institutions issue beneficial products. Then by one step of multiple steps, bank A re-buy the product and record it in the balance business sheet as an investment asset.

Banks provide integrated proxy derivative service which involves insurance, financial products, foreign exchange, fund, security. During financial products, inter-bank trade is the easiest way to remove the business out of the balance business sheet.

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Bank A issue financial products carrying on credit and loan assets, and bank B buy them as an inter-bank financial product by signing repurchase agreement. Participants are respectively responsible for assets removal, financial issue, inter-bank investment, and guarantee repurchase. The Multiple processes and nest loop lead to complication flow in entities and time consuming. We can see in figure 1 soured from People's bank of China, the inter-bank product balance increase during 2014-2016, and decrease from 2017. Because the administrations start to reinforce the management and guide the transition of products. Two big guidance and measures about asset management and supervision issued respectively in April and September 2018 by CBRC together with other regulatory agencies. Two files are useful to decrease inter-bank financial product scale and drive the transmission of financial products from capital preservation to capital non-preservation. In the same year statistic data and analysis are based on capital non-preservation products except inter-bank products, published by banking financial management registration and custody center. We can see the change in figure 2 soured from People's bank of China, compared to 2017 with 2018, the non-preservation part is a bit lower. But the preservation part is without official data. In 2019 non-preservation part increase higher than the whole financial part in 2017, this implies that the removal of the preservation part happens efficiently. This can be efficient to release the financial risk by avoiding rigid payment. The regulation on inter-bank arbitrage, structural risk step forward progressively along with upgrading jurisdictional policy.

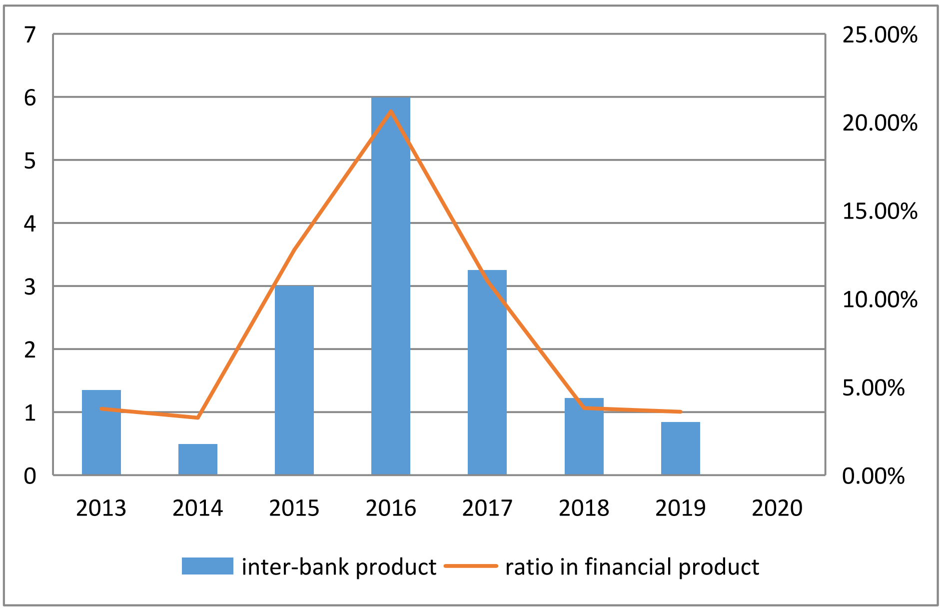

Figure1. 2013-2019 inter-bank financial product balance and ratio in financial product

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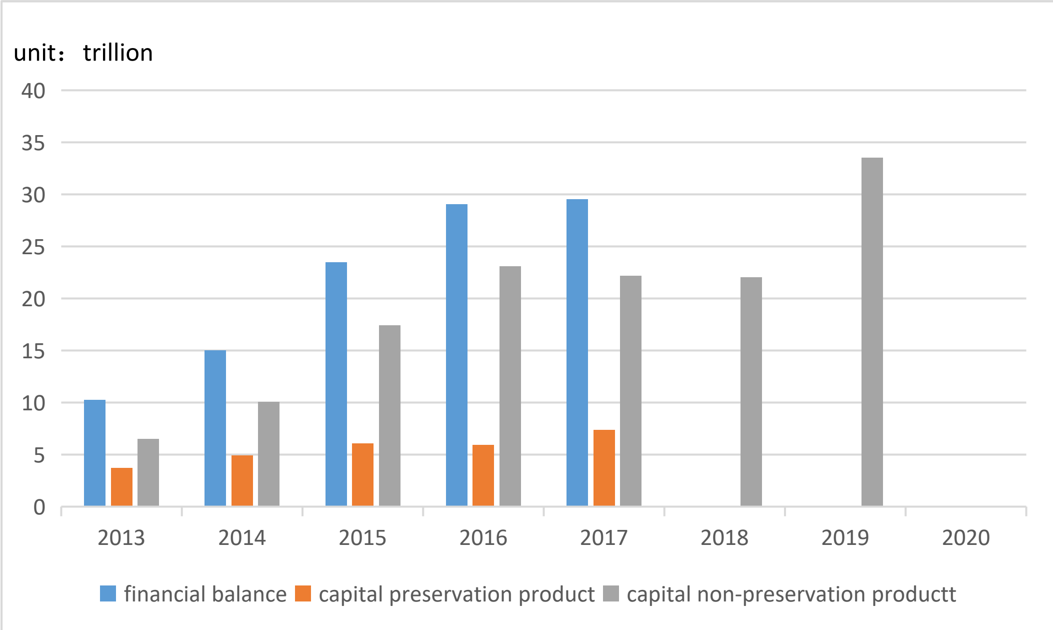

Figure 2. 2013-2019 financial balance.

Peer To Peer Lending(P2p) Arbitrage

P2P is the internet information intermediary platform where point to point capital loan service happens between individual lenders and individual borrowers. Lenders and borrowers post debit and credit information and match depending on each willingness. Platforms offer trading floor, confirm the deal and collect service charges. Chinese P2P is a new pattern financial service attributing to the iteration of internet product originating from private lending. Compared with the regular banking system, network platforms are accepted by more and more users due to simple and flexible procedures. The online lending help micro-business, individual management, and moderate and low income citizens obtain financial service equally. This makes contributions to social stability, increasing job opportunities, and creating economic value.

Online lending contain four kinds of original product structures depending on current research (Huang, 2018). First is disseminating and matching information platform mode. The platform makes profit on quantity of successful matches and are separated from transactional capital, such as ppdai company. Second is principal guarantee mode including Renrendai company, which guarantees both principal and interest for lenders even though borrowers default happens. Third is debenture transfer mode including CreditEase, where platforms loan money to debtors. The lending company reassembles pledger loans to investors so that they gain capital channels to operate the whole process without matching parts between lenders and borrowers. Fourth is securities of credit assets mode including Lufax which sell transferable bonds originated from debit and credit business. The company earns 0.2% of the transactional capital depending oneither in fixed price or aucton.

Risk management Credit ranking reveals the condition and credit risk of borrowers so that rational decisions and avoidance of adverse selections are ensured for lenders. Americans usually use fair lsaac company (FICO) credit scores to analyze personal credit quality and risk. They follow the 5C policy which is moral character, repayment capacity, capital strength, collateral, and business condition. Chinese platforms build their credit authentication mechanism because they cannot share the data from People's China bank databases. Financial technology formulates credit ranking and facilitates economic exchange from both hard information and soft information. Hard information contains human capital with professional skills, experience level, and health condition, and physical capital with buildings, machines,

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and transportation facilities. Soft information points up social capital including reputation, friendship, word of mouth. P2P use valid soft information from blogs, Facebook, WeChat moments to alleviate the risk of asymmetric information. Lin et al. (2013) put forward that online friendship of soft information can be a signal to grade the borrower credit depending on the US prosper platform. The positively social network was highlighted and regarded as new additive to evaluation index. Baihang credit was set in china in 2018. It is a unique technological credit institution that contains both personal credit and corporate credit. A mature credit reference system will assist market stabilization under a free competition environment.

Policy perfection P2P has gradually transmitted into the new platform of investment and financing from aim subsidizing low-income groups including college students, peasants, and wage-earning classes. Financial constraint policy guarantees a higher profit of financial departments than common firms which can't engage in a financial transaction. Circumvent motion is handsome profit for an enterprise without a financial license while working on a similar business. Most P2P platforms provide a guarantee by themselves while they have not applied the guarantee license for arbitrage of regulation and costs. There are potential juristic risks and problems of illegal fundraising, illegal fraud, and contract fraud. If intermediaries store lender's funds in self-account, they match conditions of illegal fundraising. Furthermore, if platforms embezzle lender's funds or abscond with the money, they are involved in illegal fraud. During the contract process, borrowers sign up by frictional personage or name infringement with the purpose of illegal encroachment. This confirms contract fraud. According to the Chinese webpage of the home of net lending, scandals of platform absconding and difficulty in deposit withdrawal happens increasingly from 2011 to 2015 in figure 3. Until 2016 interim Measures about P2P were published, the proportion of problematic platforms go down in fluctuation and the number of normal platforms decreases year by year. After a series of notifications about P2P and online lending in 2019 released, in the same year, P2P business has already vanished in three regions which are Hunan province, Shandong province, and Chongqing city. Advertisement of Ant credit pay in the subway station was torn down in January 2020. The slogan is that learn to carefully plan at your expense! This misleads consumption view and sense of value directing users to consume by platform loan. Shanghai Stock exchange has already published announcements and impose moratoriums on Ant Group initial public offerings on The Science and Technology Innovation Board at third January 2020.

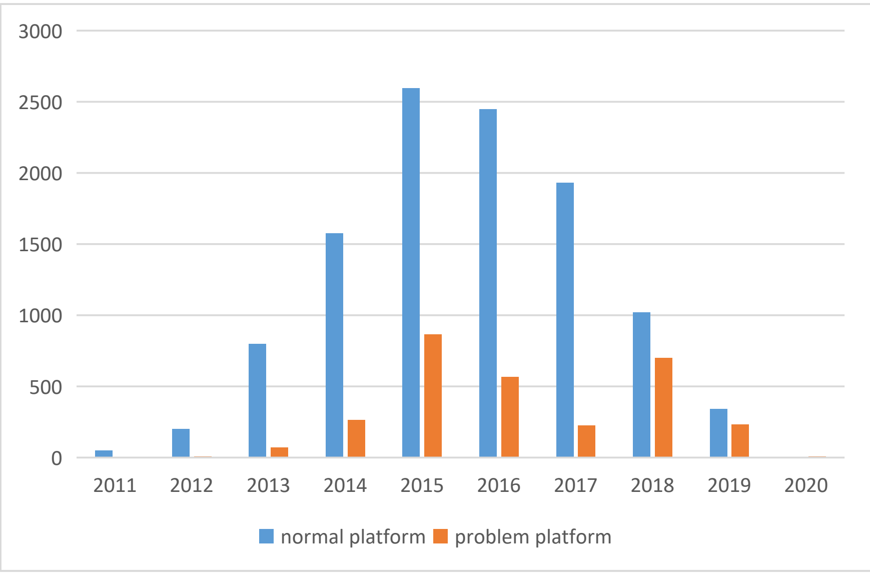

Figure 3. numbers of normal lending platforms and problematic platforms.

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Provisions are published to control existing risks including systemic risk, default risk, moral risk, and adverse risk. State council approved online lending information intermediary interim Measures published in 2016 and guidelines on online debit and credit custodian business in 2017. All main directions of online lending institutions are concerned in the above two official provisions. Combined emphasizes are made that disseminating and matching information are basic funtions and participation of transactional capital are peeled from P2P platform. Funds of lenders and borrowers should deposit in only one commercial bank as the custodian. Custodian banks have no responsibility to provide the promise of platform conduct and guarantee of principal and returns. Internet financial risk workgroup and P2P risk workgroup issued a series of notifications about P2P and online lending in 2019. These files are aimed at promoting information and data disclosure and adding online lending institutions to the credit reference system. Internet finance remediation office and online lending remediation office jointly announced guidelines of transition from online lending information intermediary to micro-loan company. The difference between online lending information intermediary and micro-loan companies is that the former can not join in the debit and credit activity, and the latter is a lender during the whole process.

Technology energization Online lending information intermediary and micro-loan company aim at assisting three Agricultural Questions (agriculture, rural areas, and rural people) under the guidance of jurisdictional issuance after 2019. Above objectors including small and medium-sized enterprises still exist problems of risk management, for example, loan fraud and process data deficiency. The traditional business model is low efficient and highly risky, because of multiple manual participation, centralized management, and whole process authenticity. The problems can be remissive by innovative technology which are blockchain, logistics networks, and cloud computing, etc. The integration of multiple sciences offers the system of traceability, tamper-resistant, intelligent management, and remote control. Financial inclusion upgrades the computational efficiency and submits transparent transaction flow by improving the infrastructure under supported by governments. Industry chain finance equipped sufficiently becomes the tight bond between loan industry and object groups. Yiren Enabling Platform (YEP) claimed that they would exploit financial technology deeply on both loan and wealth management in 2019. Technology energization embodies platform technology, risk management, and customer acquisition.

CONCLUSION

China obtains a big bonus share from financial inclusion because its leading unicorn company and the relative institutions flourish, and acquisition of great support from the government. Credit risk, high leverage operation, inter-bank product circumvent, foreign exchange circumvent, structural risk, and online lending industry all under the prosperity exist huge financial hidden danger. The existing credit reference system mainly concentrates on hard information including credit card information and banking loan information. Soft information mining are in still initial stage and can be penetrated under assist of innovative technology. The access permission of reading should classify sub-levels. Try best to protect personal privacy. A mature credit reference system can reduce the cost of consumer identification and risk recognition. Also, a mature credit reference

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system will assist market stabilization and supervise arbitrage under a free competition environment.

The mismatch between jurisdictional regulation and financial innovation together with policy uncertainty provides boom period for shadow bank. Competition and evolution in financial innovation form the helix structure with changeable provocation. During P2P lending part, it has examined how informal financial companies which have legally subversive business models or innovations. Interest rate liberalization and technology of Privacy and data mining generates efficient credit market share re-allocation . New regulations should be published at the pace of unusual economic prosperity. Laws about privacy and data safety should be renewed to protect countless netizens. Through ravines existent between regulation of harvest in mature period and financial innovation. Timely update the juristic rules and Overall protect netizen privacy and data would relieve the arbitrage scale and bad influence. Technology energization can be scientific and efficient for high social welfare and low systematic risk. Under mature economic and digital infrastructure, financial institutions can foster decentralized transactions and transparent circumstances. Logistics network fulfills remote control which saves the communication cost. Cross financial innovation circumvents traditional regulation while also can be tracked in data by blockchain. Supply chain realize the whole process regulation from suppliers to retailers. Technology innovation is a double-edged sword. Sometimes it develops too fast to control. Sometimes it increases the whole size of the social profit. Nevertheless, technology development and innovation will continue forward in courage.

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