

# **In the Shadow of Banks: Wealth Management Products and Issuing Banks' Risk in China\***

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## **Abstract**

To support China's massive stimulus plan in response to the global financial crisis in 2008, large state-owned banks pumped huge volume of new loans into the economy and also grew more aggressive in the deposit markets. The extent of supporting the plan was different across the 'Big Four' banks, creating a plausibly exogenous shock in the local deposit market to small and medium-sized banks (SMBs) facing differential competition from the Big Four banks. We find that SMBs significantly increased shadow banking activities after 2008, most notably by issuing wealth management products (WMPs). The scale of issuance is greater for banks that are more constrained by on-balance sheet lending and face greater competition in the deposit market from local branches of the most rapidly expanding big bank. The WMPs impose a substantial rollover risk for issuers when they mature, as reflected by the yields on new products, the issuers' behavior in the inter-bank market, and the adverse effect on stock prices following a credit crunch. Overall, the swift rise of shadow banking in China seems to be triggered by the stimulus plan and has contributed to the greater fragility of the banking system.

**JEL Classifications:** G2, E4, L2.

**Keywords:** Shadow banking, Wealth Management Product, loan-to-deposit ratio, rollover risk, SHIBOR.

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## I. Introduction

Since the 2007-2009 financial crisis, an extensive strand of literature focuses on how a shadow-banking sector arises in the financial system as a result of ‘regulatory arbitrage’—by banks in the form of off-balance sheet activities or by non-banking entities that are entirely unregulated or lightly regulated compared to banks. Due to the opaqueness and complexity of this sector, shadow banking is more difficult to monitor and often deemed to increase the overall fragility and risk of the financial system.<sup>1</sup> Much of this literature focuses on developed economies. There is little research studying shadow banking in emerging markets, including what many believe to be a large sector in China, the second largest economy in the world.<sup>2</sup> Recent turbulence in China’s stock market has been attributed to be a source of greater risk of the global financial system, with the shadow-banking sector reportedly providing much leveraged capital fueling the market bubble during the first half of 2015.<sup>3</sup>

In this paper, we examine a major component of China’s shadow-banking sector—wealth management products (WMPs) issued by banks, and link the growth of this sector to the RMB 4 trillion stimulus initiated by the Chinese government in response to the global financial crisis in 2008. To support and implement this massive stimulus plan, the largest four state-owned banks (‘Big Four’ banks) issued huge volume of new loans into the economy, and also raised deposits so as to fulfill requirements for on-balance-sheet lending.<sup>4</sup> However, the extent of expanding their balance sheets was different across the Big Four banks, creating a plausibly exogenous shock in the local deposit market to small and medium-sized banks facing differential competition from the Big Four banks.

We find that SMBs significantly increased the issuance of WMPs after 2008, and the scale is greater for banks that are more constrained by on-balance-sheet lending and have greater likelihood of losing deposits to local branches of the fastest expanding big bank. These issuer banks take on substantial rollover risk, especially when large amount of WPMs mature, as shown by the yields set on new products, their behavior in the inter-bank market, and the adverse effect on stock prices following an interbank market credit crunch. Overall, our results extend the literature by showing that the rapid growth of China’s shadow banking

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<sup>1</sup> See, e.g., Acharya and Oncu (2013) for a review of this literature.

<sup>2</sup> At the end of 2014, according to World Bank, China has overtaken the U.S. and become the largest economy in the world as measured in Purchasing Power Parity (PPP) terms.

<sup>3</sup> *Financial Times* estimates that the scale of China’s shadow banking, in terms of lending, is half of that of total bank lending, and that China’s shadow banking provides much of the leveraged capital that eventually went into the stock market (*FT* 06/25/2015, article by Gabriel Wildau).

<sup>4</sup> They are the Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BOC), and Agricultural Bank of China (ABC).

appears to be triggered by the massive stimulus plan, and it has contributed to the greater fragility of the banking system.

Our dataset covers all the WMPs issued by the largest 25 banks in China over the period 2008-2014, with matched data on the issuing banks. We separate the banks into two categories: the Big Four banks and the remaining group of 21 banks. The Big Four banks are among the largest institutions in the world, and are directly controlled by the central government. They are predominant players in the financial system including the deposit and the loan market and the interbank market. The rest of the banks are much smaller in size as compared to the Big Four, and hence we label them ‘small and medium-sized banks’ (SMBs), with many of them concentrating their business in certain regions.

During our sample period, China’s central bank—People’s Bank of China (PBC) set ceilings on bank deposit rates, which changed over time but were almost always *below* the market rates (Shanghai Inter-bank Offered Rate, or SHIBOR). Banks face on-balance-sheet lending restrictions including capital ratio requirements and a limit on loan-to-deposit ratios (LDR)—loans *cannot* exceed 75% of total deposits. With these tight regulations, profit-seeking banks pursue unregulated or less regulated activities, most notably in the form of WMPs, to benefit from the difference between regulated deposit rates and market lending rates. By offering higher interest rates than deposits, WMPs help banks attract more savings, and principal-floating products can move loan assets off the balance sheet. Hence, banks’ incentive to issue WMPs ought to be affected by regulations of on-balance-sheet lending and the spread between regulated deposit rates and market lending rates, among other factors.

We find that the issuance of WMPs is negatively affected by banks’ Capital Ratio and positively affected by banks’ LDR, especially during times when the regulated deposit rate is considerably below the market lending rate. In terms of both the magnitude and statistical significance, the effect of LDR is much more important than that of Capital Ratio on the issuance of WMPs, especially for SMBs.

Next, we study factors explaining the variation in LDR among SMBs and link them to the RMB 4 trillion stimulus plan implemented during 2009-2010. The stimulus plan was mostly implemented by the Big Four banks through the injection of large volume of new loans into the economy. As a result, these banks also raised deposit levels in order to stay below the LDR limit. Among the four banks, Bank of China (BOC) became by far the most aggressive in the expansion of both new loans and new deposits during 2009-2010. While all four banks have branches throughout the country, the intensity of their branching across

regions is different (Figure 5). The differential pace of expansion in support of the stimulus plan and geographic branching strategies among the four banks thus created a plausibly exogenous shock to local SMBs facing different degrees of competition from the big banks.

Our identification strategy is therefore to track the issuance of WMPs by SMBs confronting various degrees of competition from the Big Four banks. With information on branch openings and closings at city level of all the sample banks, we find that both the LDR and the amount of WMP issuance are greater for SMBs more exposed to local competition from the branches of BOC. This finding is consistent with our hypothesis of banks' activities both on- and off-balance sheet in light of regulations. After dramatic increase in new loans to support the stimulus plan, the Big Four banks—especially the BOC—became more aggressive in the deposit market in order to maintain their LDRs. The heightened competition in the local deposit market pushed SMBs' LDR to rise and approach the upper limit, and to satisfy their regulatory mandate (to stay below the LDR upper bound of 75%) and compete with Big Four banks, SMBs issued WMPs to attract savings and move on-balance sheet loans off the balance sheet.

Big Four banks' issuance of WMPs also rose during the second half of the sample period. This can be regarded as their response to the WMP issuance behavior of SMBs. We conjecture that another reason for this increase is related to an unintended 'outcome' of the stimulus plan. A large fraction of the new bank credit, created during the implementation of the stimulus plan, went to real estate and infrastructure projects, leading to rising leverage and risks in these sectors. PBC then began tightening credit supply to these sectors in 2010. Facing restrictions on making new loans and to help avoid defaults on these long-term projects—many owned by local governments, Big Four banks issued WMPs to refinance these project (and rollover old loans). In this regard, we find a positive relationship between the estimated loan increase due to the stimulus plan and WMP balance in later years (when loans matured) for the Big Four banks, consistent with our hypothesis.

In analyzing the rollover risk of WMPs for the issuing banks, we first look at the maturity structure of these products. When WMPs mature, the funds redeemed by depositors can be put back in their deposit accounts with the bank, which helps the bank lower its LDR. WMPs typically mature in three months or less, and, interestingly, many products mature immediately before quarter end, when banks' LDRs are calculated and monitored by the CBRC. At the same time, investment projects financed by WMPs, such as those in real estate and infrastructure, pay off in much longer horizons. Banks thus need to issue new WMPs to

meet redemption of matured products and refinance assets. We find that when there are more WMPs due on a certain date, SMBs offer significantly higher yields on the *new* WMPs, in order to raise sufficient funds and manage liquidity needs.

The amount of WMPs due also affects banks' behavior in the interbank market. As the major players in the interbank market, Big Four banks are willing to borrow at higher interest rates, as shown by the ask quotes submitted, when they have a greater amount of WMPs due. At the aggregate level, the one-week SHIBOR closely tracks the aggregate amount of maturing WMPs issued by the Big Four banks during the sample period. Finally, we look at the stock market response during episodes of credit crunches. When the cost of interbank funds unexpectedly rises, we find that stock prices drop more for banks with more WMP maturing in the short-run. This indicates that investors and the market seem to be aware of the rollover risk associated with WMPs of the issuing banks.

Our paper contributes to and extends the literature on the formation and risk of shadow banking. There are at least two important differences between the U.S. shadow banking sector and its counterpart in China. First, the process of moving debt obligations from institutions' balance sheets and packing and re-packaging them into structured products make these products complicated and opaque in the U.S. By contrast, most of the WMPs offered by Chinese banks are simple, short-term fixed income products.<sup>5</sup> Second, after institutions sell the loans and other (unpacked) debt to the underwriters, there remains some connection between the structured products and the originating institutions in the US (Acharya, Schnabl and Suarez, 2013). But the WMPs and their issuing banks—in terms of on- and off-balance sheet activities and the overall risks—are closely tied together, as shown by our results. Overall, the growth of the WMPs in China resembles more closely the growth of money market in the US as a result of Regulation Q, and, more recently, the growth and collapse in the issuance of asset-backed commercial paper (Acharya, Schnabl and Suarez, 2013).

There are a few recent studies on China's shadow banking. Dang, Wang and Yao (2014) provides a theoretical model to explain the differences between the US and Chinese shadow banking as described above. Allen, Qian, Tu and Yu (2015) and Chen, Ren and Zha (2016) study another large component of the shadow banking—trusted loans, which are extended by non-bank companies or institutions. Hachem and Song (2015) provides theoretical analysis on the interactions between large and small banks both in on- and off-balance sheet markets and focuses merely on the role of LDR. Unlike these papers, we use a large, product-level

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<sup>5</sup> Some of the funds raised from selling WMPs *do* go into risky and speculative areas, mostly through trust companies, such as leveraged trading in the stock market, but banks often retain the senior tranches.

data to empirically examine the relationship between WMP issuance and issuing bank characteristics. Our empirical strategy—tracking how SMBs respond to competition from the big four banks expanding their lending and deposits at different paces—allows us to establish a direct link between the implementation of the massive stimulus plan and the growth of shadow banking. Our results also indicate that the swift rise of WMPs has contributed to the greater fragility of the banking system.

The rest of the paper proceeds as follows. In Section II we describe China's banking sector and the regulatory framework. In Section III, we describe our sample of WMPs and their issuing banks. In Section IV, we assess the effect of Capital Ratio and LDR on WMP issuance. In Section V, we link the rising of WMPs to the 4-trillion stimulus plan and show how it is triggered by the stimulus plan for both SMBs and big 4 banks. In Section VI, we study the rollover risk of WMPs. We conclude in Section VII. The Appendix contains the explanations of all the variables used in the paper.

## **II. Institutional Environment and Shadow Banking**

There are mainly four types of banks in China. The first is state-owned *policy* banks, whose only goal is to carry out a particular type (or types) of policy lending. This category includes China EXIM Bank, China Development Bank and Agriculture Development Bank of China.

The second category is the Big Four banks, including Agriculture Bank of China (ABC), Bank of China (BOC), China Construction Bank (CCB) and Industrial and Commercial Bank of China (ICBC). They are all listed in both the domestic A-share market and in the Hong Kong Stock Exchange. They are the predominant players in China's commercial loan and deposit market. They are mostly market-oriented but also carry out some policy lending especially during extreme periods. Presidents of these banks are directly appointed by the State Council.

The third is national joint-equity commercial banks. There are 12 of them now. Their average bank size is about 10% of the average size of the big 4 banks. Bank of Communications was in this category, and is regarded by PBOC as the fifth big bank now. But its size is way below the other big 4 banks, so in the paper we still consider it to be a SMB so that there are 13 joint-equity commercial banks.

The fourth is urban and rural commercial banks, which are founded by the city or the province governments. They are usually very small.

All commercial banks are under the supervision of PBOC and China Banking Regulatory Commission (CBRC). Standard regulations such as capital ratio requirements, in conjunction with the Basel III Accords, are in place for all the banks. Banks' reserve ratios have been quite high—21.5% in June 2011 and 17.5% for big banks at the end of 2015—in part to help sterilize large amount of foreign currency reserves accumulated over the past decade.<sup>6</sup>

Interest rates have been tightly regulated in China. As part of the macroeconomic policies, PBOC sets base interest rates along with upper and lower bounds, and these rates and bounds fluctuate over business cycles and with loan maturities. The key is the upper bound of deposit rates which was effective until 2015. The upper bound, up to 1.5 times of base rates, was binding during our sample period (2008-2014). These interest rate policies were also part of China's investment-driven growth model--'forced' transfers from savers to borrowers such as large industrial enterprises (e.g., Song, Storesletten, and Zilibotti, 2011). Lending rates have been gradually liberalized as well as the lower bound of deposit rate.

The difference between regulated deposit rate and market lending rate gives banks strong incentives to engage in excessive lending. In response, CBRC sets limits on total bank lending. Tools include Capital Ratio (described earlier) and loan-to-deposit ratio (LDR) limits. Bank cannot lend more than 75% of their total deposits, and this upper bound on lending was also binding during our sample period<sup>7</sup> especially for SMBs.

These regulations have given rise to the growth of shadow banking in China. First, to maintain a high level of capital ratio, banks can increase their capital by issuing new equity and junior bonds, but they can also conduct more off-balance sheet activities which won't increase banks' on-balance sheet assets. The most important off-balance sheet activity is the issuance of WMPs, especially principal-floating WMPs. Principal-guaranteed WMPs (the yield could be either guaranteed or floating) are often recorded on the balance sheet as required by the CBRC. Second, to depress the level of LDR, banks can attract more deposits or conduct less on-balance sheet lending. Again, WMPs can help. Loans financed by principal-floating WMPs don't increase on-balance sheet loan balance, and banks can offer higher return on WMPs to attract more savings since they cannot offer a higher deposit rate

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<sup>6</sup> For a comprehensive description of the banking sector, its relationship with other parts of the financial system and overall economy, see Allen, Qian, Zhang, and Zhao (2012), and Qian, Strahan and Yang (2015).

<sup>7</sup> The restrictions on deposit rates as well as the loan-to-deposit ratio are currently in the process of being lifted. However, Chinese banks still face high reserve ratios and their lending remains capped by the PBOC; hence, there is still incentive for them to continue shadow banking activities including the issuance of WMPs.

than the deposit rate ceiling.

The broadest definition of ‘shadow banking’ refers to all the investment products in the market that are off the balance sheet of banks. In this paper, we only study the largest component—WMPs offered by banks. Similar products are also offered by non-bank institutions. Although there is no regulatory ceiling on the interest rate that these non-bank financial institutions can offer, they also benefit from the low deposit rate since the presence of a deposit rate ceiling lowers the required return by investors. The most famous product is probably *Yu’e Bao*, offered by *Alibaba* along with a money market fund.<sup>8</sup> Another important component of China’s shadow banking sector is trusted loans offered by trust companies. As we will describe later, trust companies usually package their loan assets to form a trust plan, which banks can invest in with money raised from WMPs.<sup>9</sup>

In effect, with the rise of shadow banking, there is a ‘dual-track’ system of intermediation in China’s financial system. On one hand, bank deposits are constrained by interest rate control and on-balance sheet lending by capital ratio and LDR. Excessive lending is, however, always appealing especially when the regulated deposit rate is very much below the market lending rate, creating an impetus for the growth of shadow banking. On the other hand, the shadow banking sector is relatively lightly regulated. Both commercial banks and non-bank financial institutions want to benefit from the ability to raise off-balance sheet funding in the shadow banking markets.

Shadow banking as they may be in, WMPs are also subject to some regulations. In fact, the game between CBRC and commercial banks has been largely dynamic.

The first WMPs were produced through bank-trust cooperation. Banks sell their loan assets to the lightly-regulated financial institutions called trust companies. Trust companies then package these loan assets to form a trust plan. In the meantime, banks issue WMPs and invest the WMP money into the trust plan. In this way, borrowers get financed, banks and trust companies get paid by the interests from the trust plan, and banks’ on-balance sheet loan balance doesn’t increase.

This strategy was soon realized by CBRC. Concerned about its influence on the effectiveness of monetary policy, on July 6<sup>th</sup> 2009, CBRC forbade banks from investing money raised from WMPs into the banks’ own loan assets. This policy didn’t work. Bank A

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<sup>8</sup> Offered by *Alipay* (the payment arm of *Alibaba*) and *Tianhong Fund Management Co.*, *Yu’e Bao* grew very fast, with its net assets growing from RMB 200 million in May, 2013 to over RMB 700 billion in April, 2015. For more information, including its promised returns, see <https://bao.alipay.com/yeb/index.htm>.

<sup>9</sup> There are also many private credit agencies throughout the country, and they primarily lend to small firms that do not have access to formal bank lending. See, e.g., Allen, Qian and Qian (2005) for more information.



can sell its loan assets to trust companies to form a trust plan and ask Bank B to issue WMPs and invest the WMP money to the trust plan. The borrower gets financed, both Bank A and B get paid and neither bank's loan balance increases.

On August 10<sup>th</sup> 2010, CBRC required that WMPs targeting loan assets shall not exceed 30% of all bank-trust cooperation WMPs. Again, banks circumvented this policy by adding another channel—investment banks. First, the trust companies make loans to borrowers and package the loan assets into a trust plan. Second, banks issue WMPs and delegate the investment bank to manage the money. In fact, the banks would require the investment bank to invest the money into the trust plan. In this way, banks claim to delegate the job to investment banks. The WMPs are not targeted to loan assets by banks themselves.

The game between CBRC and banks continued. In late March 2013, CBRC passed a new policy: WMPs invested in non-standard financial assets (including all trust assets) couldn't exceed 35% of all WMPs or 4% of bank assets. To circumvent this policy, banks needed to invest the money into some standard financial assets which can facilitate firm borrowing and somehow get riskless return higher than deposit rate for WMP investors. Banks and trust companies developed a new counterpart business model. In short, Bank A places WMP money in Bank B as some kind of contracted deposits. Bank B invests its own money or delegates investment banks to invest the money in certain trust plans packaged by trust companies. The contracted deposits are pledged as guarantee for the trust plans and in return swap the interest rate with return on the trust plans. In this way, Bank A invests the WMP money in some standard deposits, Bank B uses its own money not WMP money to invest in non-standard financial assets, WMP investors get a safe (implicitly guaranteed by Bank A) return higher than deposit rate from the trust plans, and the borrowers get financed.

Figure 2 shows the WMP balances by the 4 main investment targets starting from Dec 2011. As we can see, balance of WMPs targeting loan assets peaked in March, 2013 when CBRC passed the new policy and has been stable since then. WMPs targeting deposits increased in Jan, 2014 when banks developed the new counterpart business model.

WMPs targeting the money market also increased a lot over time. Banks can invest WMP money in treasury bonds and make arbitrage profits. Banks can also lend the WMP money to other banks who can then purchase non-standard financial assets like trust plans. The complicated interactions among banks make it almost impossible to stop WMP money from being channeled to trust plans.

Overall, the dynamic game between CBRC and commercial banks reflects the

inefficiency of the banking industry when the market economy and planned economy coexist. The deposit rate ceiling and on-balance sheet lending restriction leave a large credit market unsatisfied and banks want to profit from it. No matter how CBRC sets the cannot-do list, banks can always find a way to channel WMP money to borrowers. The fact that banks can circumvent these restrictions doesn't imply the equilibrium is as efficient as if there were no such restrictions. Inefficiency arises as additional channels add more transaction costs for the borrowers, reduce transparency and increase agency problems. In fact, the longer the cannot-do list is, the more channels there are, and the more potential inefficiency occurs.

In addition, there are two important risks involved. The first is rollover risk. Loans financed by WMPs are usually long-term, but WMP investors want liquid assets. The counterpart banks want liquidity too because they don't want to take on long-term risks. The issuing banks also prefer the WMPs to mature soon because when WMPs mature, WMP money is transferred to the deposit accounts and can help with LDR. This maturity mismatch causes rollover risk. That is, banks face great liquidity management pressure to rollover these WMPs. Banks can usually go to the inter-bank market for liquidity and in the meanwhile, issue new WMPs to refinance these loans. But if there is not enough liquidity in the market, as the situation in June 2013 which we describe and analyze in the paper, banks with lots of WMPs due to mature go into trouble.

Second, the rollover risk of an individual bank can get spread to the whole market. The multiple channels of WMPs make financial institutions more closely connected to each other than ever. If one individual bank goes into liquidity shortage, banks closely connected to it may go into trouble too.

### **III. Data and Summary Statistics**

We focus on the 25 most important banks in China, including the big 4 banks, the 13 national joint-equity commercial banks and 8 biggest urban commercial banks. Table 1 Panel D is a list of the 25 banks. All banks except the big 4 are considered as SMBs in this paper. Our data come from multiple sources.

First, bank financial and WMP information comes from public datasets and surveys. Listed banks and banks that have issued bonds publish their financial information. Most listed banks do it on a semi-annual basis while some do it on a quarterly basis. We collect the information from various sources like listed firm datasets and central bank reports. For information missing of these banks and information of other banks, we conducted a survey of

each bank asking about their financial and WMP information. The final data we obtain from public sources and surveys run from 2008 to 2014 and include bank equity, total loan and deposit balance, Capital Ratio, LDR as well as aggregate WMP quantity information for each bank in each quarter.

Second, bank branch information is from the website of CBRC. Each individual branch of all financial institutions needs to acquire a unique financial license from CBRC. From Nov. 2007, CBRC publishes the information of all these licenses, information including the opening date, the closing date if closed, operation location, and affiliation of the branch.

Third, individual WMP information is from WIND, a leading data provider in China. We collect yield and maturity information for all the WMPs issued by the 25 banks during the sample period. We also collect stock price data for listed banks from WIND.

Fourth, Shanghai Interbank Offered Rate (Shibor) and each bank's quoted rates are downloaded from the official website of Shibor.

Table 1 reports summary statistics of bank and WMP characteristics. See the appendix for detailed definition of all the variables. In Panel A, big 4 banks are typically 10 times the size of SMBs in terms of equity, total deposit balance and total loan balance. Big 4 banks and SMBs are similar in terms of Capital Ratio. According to Basel Accord, banks' Capital Ratio cannot be lower than 8%. Most bank are qualified long before our sample period except Agricultural Bank of China. Before 2009, ABC had negative Capital Ratio and only after a new capital injection from the government did its Capital Ratio become qualified in 2009 Q4. Starting from 2013 a new approach to calculate Capital Ratio is adopted but the previous approach is still in use. For consistence we use Capital Ratio calculated with the previous approach. Empirical results using the updated Capital Ratio barely change.

The average LDR of SMBs is higher than the average LDR of big 4 banks. SMBs generally suffer more from the quantity regulation. In our sample, 75 out of the 700 bank-quarter observations have LDR exceeding the regulatory limit 75%. Among the 75 observations, only one observation belongs to a big 4 bank. When LDR exceeds 75%, banks will get a severe warning from the CBRC. Although not absolutely infrangible, the limit of 75% is very strict and stressful for banks.

All the big 4 banks take part in the Shibor bid and ask process but only 9 to 10 SMBs do so. We calculate the bank's Shibor quoted rates minus Shibor for different maturities but only report overnight rate to save space. SMBs seem to ask for higher rates than big 4 banks. This is in accordance with the fact that SMBs are in more shortage of liquidity.

Panel B reports statistics of WMPs. Big 4 banks issue much more WMPs than SMBs. But if we scale total WMP issuance by bank equity, SMBs are more aggressive in issuing WMPs. If we divide WMPs according to the yield type, both big 4 and SMBs issue more principal-floating WMPs than principal-guaranteed WMPs. The reason is that most of the principal-guaranteed WMPs are recorded on the balance sheet while principal-floating WMPs are off the balance sheet. So principal-guaranteed WMPs will still increase banks' total asset and don't help maintain Capital Ratio but principal-floating WMPs do. The same pattern is found for the amount of WMP that mature.

Panel B also shows that, WMPs issued by SMBs generally have higher annualized expected yield than those issued by big 4 banks, especially principal-floating WMPs. For both SMBs and big 4 banks, principal-floating WMPs have higher expected yield than principal-guaranteed WMPs. WMP expected yield is stated in the prospectus. Figure 3 shows the change of WMP annualized yield as well as the Shibor and deposit rate ceiling over time. The yield of WMPs tracks 3-month Shibor very closely. Except for the first half year in 2009 when Shibor dropped dramatically because of major liquidity injection by PBOC in response to the financial crisis, Shibor remains way above the deposit rate ceiling.

Panel C shows a decreasing trend of the maturity of WMPs issued by both groups of banks and with both types of yield. As described above, this pattern reflects banks' strategic response to the LDR regulation. When WMPs mature, the principal and the return is collected and transferred to investors' deposit account with the same bank, so the bank's total deposit will increase. Therefore, banks deliberately choose WMPs' maturity date so that they can report a higher deposit balance when LDR is calculated and monitored. At first, CBRC policed end-of-year *LDR*. In 2008 before the 4-trillion stimulus plan, the PBOC was worried about the inflation and tightened liquidity in the inter-bank market. In response, banks especially SMBs cut the WMP maturity a lot so most of the WMPs could mature before year end so that banks could report a higher deposit balance. In late 2009, CBRC switched to end-of-quarter ratios which caused banks to further cut the WMP maturity. In 2014 the average maturity is around 3-4 months which coincided with the quarterly monitoring basis. The decreasing trend of WMP maturities reflects banks' more dependence on WMP financing, greater maturity mismatch and rollover risk.

## **IV WMP Issuance and Quantity Regulation**

### ***A. Hypothesis***

It's widely recognized by the market that the rising of WMPs is regulatory arbitrage. Deposit rate ceiling and on-balance sheet lending restrictions are the core driving forces for banks to issue WMPs. Before 2015, bank deposit rate is strictly controlled by the CBRC, e.g. no banks were allowed to offer a rate higher than a specified ceiling. As shown in Figure 3.2, the ceiling is quite effective. Most of the time market rate is at least 1% above the deposit rate ceiling. Banks want to lend more than the otherwise market equilibrium level. In response, the CBRC imposes quantity regulation such as Capital Ratio and *LDR* to prevent excessive liquidity and inflation. The high *Spread* between deposit rate ceiling (cost of money for banks) and loan rate (return of money for banks) drives banks to disguise their loans as items not included in the quantity regulation, the most important of which is WMPs. CBRC set a long cannot-do list for WMPs attempting to shut down the channeling of WMP money to borrowers, but as mentioned in Section II.B, it didn't work.

However, there hasn't been any empirical evidence so far. Also, whether it is Capital Ratio that matters more or it is *LDR*? Capital Ratio and *LDR* are related but different. There are two hypotheses.

First, Capital Ratio plays the big role. Capital Ratio targets the asset side and is aimed to control the total size of the bank relatively to its capital. To maintain Capital Ratio, a bank can conduct more off-balance sheet activities or move on-balance sheet assets off the balance sheet. WMPs do the trick, especially principal-floating WMPs. To test this hypothesis, we estimate the following model:

$$issue\_e_{it} = \alpha + \beta_1 Cap_{i,t-1} + \beta_2 spread_t + \beta_3 spread_t \times Cap_{i,t-1} + bank_i + quarter_t + e_{it} \quad (4.1)$$

The dependent variable is total amount of WMPs issued in quarter  $t$  divided by bank equity at the end of quarter  $t-1$ . We also use lagged value for Capital Ratio. The variable *spread* is defined as the difference between 3-month market rate (SHIBOR) and deposit rate ceiling. We use 3-month rates because they match the maturity of WMPs and are driven by market rate for loans while shorter-term rates are driven by inter-bank market liquidity. The first prediction is that  $\beta_3$  is negative. That is, when the market rate is high above the deposit rate ceiling, banks with lower Capital Ratio will issue more WMPs. The second prediction is that the effect should be more important for principal-floating WMPs since principal-guaranteed WMPs are often regarded as on-balance sheet activities and cannot help decrease Capital Ratio.

Second, *LDR* plays the big role. *LDR* targets both sides of the balance sheet and is aimed to control the bank's loan balance relative to deposit balance. To control *LDR*, banks

can either increase deposit or decrease on-balance sheet loans. WMPs do tricks on both sides. On one hand, the higher yield of WMPs relative to deposit rates can attract more money from WMP investors. Principal-guaranteed WMPs are directly regarded as deposits. Principal-floating WMPs are off-balance sheet, but banks can set the maturity date right before the end of the quarter when LDR is calculated and censored. In this way principal-floating WMPs can increase deposit too. Banks are not truly intermediaries when issuing WMPs because they offer implicit guarantee to WMP investors. Not a single bank WMP has ever defaulted on principal up to now, even principal-floating WMPs. On the other hand, loans financed by principal-floating WMPs are off-balance sheet and won't increase banks' on-balance sheet loan balances. We estimate the following model:

$$issue_{-e_{it}} = \alpha + \beta_1 LDR_{i,t-1} + \beta_2 spread_t + \beta_3 spread_t \times LDR_{i,t-1} + bank_i + quarter_t + e_{it} \quad (4.2)$$

The definition of variables is the same as Model (1). Similarly, we use lagged value for LDR. The first prediction is that  $\beta_3$  is positive. That is, when the market rate is high above the deposit rate ceiling, banks with higher LDR will issue more WMPs. Second, the effect should hold for both principal-guaranteed and principal-floating WMPs since both can help attract savings.

Big 4 banks and SMBs may act differently. The assets of SMBs are not of the same magnitude as big 4 banks. Table 1 shows the two groups are similar in Capital Ratio but different in LDR. So we also estimate the models by banks separately.

## ***B. Empirical Results***

Results are shown in Table 2. The empirical results seem to indicate that LDR matters more. In Panel A, as predicted, the coefficient of the interaction between *spread* and Capital Ratio is significant for principal-floating WMPs and insignificant for principal-guaranteed WMPs, and this pattern holds for both groups of banks. However, the interaction term is only significant at 10% confidence interval.

In Panel B we repeat the same estimation but replace Capital Ratio with LDR. LDR doesn't matter for big 4 banks on average, but has a quite significant effect on WMP issuance for SMBs. In Column (4), the estimated coefficient of the interaction term is 3.449, significant at 1% confidence interval, and remains significant for both principal-floating WMPs and principal-guaranteed WMPs.

Not just more significant, the effect of LDR is also bigger in terms of magnitude than the effect of Capital Ratio. For SMBs, the standard deviation of Capital Ratio is 0.03 and of

LDR is 0.08. If we use the estimated coefficients, then one standard deviation decrease in Capital Ratio will increase WMP issuance over bank equity by  $0.25 \times spread - 0.25$ , and one standard deviation increase in LDR will increase WMP issuance over bank equity by  $0.28 \times spread$ .

The different importance of Capital Ratio and LDR may reflect the relative difficulty in increasing capital and deposit. Capital Ratio is capital over asset, and LDR is loan over deposit. Asset and loan are closely related, but capital and deposit are different. It's really easy for banks to increase equity and issue junior bonds, especially for listed banks. A small increase in capital can increase Capital Ratio considerably. In our sample, the average Capital Ratio for both big 4 banks and SMBs is 12%, well above the regulatory floor.

In contrast, it is hard to attract more deposits for SMBs. SMBs have far less branches than big 4 banks and are usually regional. Households and firms prefer to deposit money in banks with wide-spread branches that they can have easy access to. SMBs usually offer higher deposit rates than big 4, but the presence of a deposit rate ceiling limits their ability to do so. Generally, SMBs suffer from LDR regulation, but not Capital Ratio.

With all being said, two things remain unexplained. First, what explains the variation of LDR<sup>10</sup> across SMBs in the first place? The variation could come from the deposit side, namely, different SMBs have different ability to attract deposits or face different competition in the local deposit market. The variation could also come from the loan side, namely, different SMBs face different loan demands and thus suffer differently from the LDR regulation. Second, why did WMPs increase dramatically from 2008, right after the massive stimulus plan China's government conducted in response to the global financial crisis? Is there a possible connection between the two events? The following section answers these questions.

## **V. Shadow Banking and the Four-Trillion Stimulus Plan**

### ***A. The Stimulus Plan during 2008Q4-2010Q4***

As an economy that heavily relied on exports, China was severely hit by the financial crisis. Total export decreased from 136.7 billion U.S. dollars in Sept. 2008 to 64.86 billion U.S. dollars in Feb. 2009. Net export also declined from 2.4 trillion RMB in 2008 to 1.5 trillion RMB in 2009, a drop of 37.9%. GDP growth rate sharply decreased from 13.9% in

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<sup>10</sup> For the rest of the paper, we focus on LDR. All results are robust whether we include Capital Ratio in the regressions or not.

2007 Q4 to 6.2% in 2009 Q1, an unprecedented slowdown since China's entry into WTO. At the end of 2008, PMI dropped to 38.8 and CPI to 1.2%.

China's government responded by introducing a massive stimulus plan, commonly known as the 4-trillion Stimulus Plan. According to the National Development and Reform Commission, from 2008 Q4 to 2010Q4 the government planned to initiate 400 billion RMB investment to indemnificatory housing, 370 billion to rural infrastructure, 1,500 billion to transportation infrastructure and electricity network, 150 billion to public health and education, 210 billion to energy conservation and emission reduction, 370 billion to innovation and structural adjustment and 1,000 billion to reconstruction following the Wenchuan Earthquake. The plan was meant to increase domestic demand and improve public services.

This massive investment plan involved three parties. The central government led the plan by investing 1,180 billion RMB with its fiscal revenue and other incomes. The other 2,820 billion RMB investment was mostly conducted by local governments through state-owned City Infrastructure Investment Corporations (CIICs). These CIICs can borrow bank loans and issue bonds against land properties contributed by the local governments. Officials of local governments were so eager to gain favor from the central government that total investment by these CIICs turned out to be far larger than 2,820 billion RMB.

The last party involved was banks. Most of the investment projects were financed by banks either through bank loans or bank purchase of CIIC bonds. In response to the call of the government, most major banks announced credit support for the plan. For example, BOC initiated 10 plans to support the construction of railways, airports, urban and rural infrastructures, CCB claimed to supply another 50 billion RMB credit to the construction of major infrastructure projects and post-earthquake reconstruction in 2009, and ABC promised to expand its credit support to agriculture-related industries, small and medium-sized firms and post-earthquake reconstruction.

Figure 4.1 shows total loan balances during the period of all 4 big banks and all national SMBs, respectively. For these SMBs, data only became available from 2010. Most of infrastructure projects were medium and long-term and thus financed by medium and long-term bank loans. Figure 4.1 shows a fast increase of big 4 banks' medium and long-term loan balance while their short-term loan balance remained relatively stable. From Jan. 2009 to Dec. 2010, big 4 banks' medium and long-term loan balance increased by 5.80 trillion RMB (66%) and short-term loan balance by 1.26 trillion RMB (31%). In the contrast, both



short-term and medium and long-term loan balances of the national SMBs remained relatively stable. From Jan, 2010 to Dec, 2010, these banks' medium and long-term loan balance increased by 1.27 trillion RMB (25%) and short-term loan balance by 0.82 trillion RMB (18%). Big 4 banks were definitely the major lenders during the stimulus plan.

### ***B. Difference Among the Big 4 Banks***

The big 4 banks were not equally supportive for the stimulus plan. Figure 4.2 shows total loan balances of the 4 big banks, respectively. For purpose of comparison, we scale each by the bank's loan balance at the end of 2008, the beginning of the stimulus plan. From 2006 Q4 to 2008 Q4, each bank exhibited similar growth rate. There were two jumps in the loan balance of ABC because ABC was preparing for IPO. New capital was injected to it and non-performing loans were separated from it. ABC went public in 2009. Except for the two jumps, ABC also exhibited similar growth rate in loan balance. Things started to change in 2009. BOC took a much steeper growth path than the other three. From 2009 Q1 to 2010 Q4, BOC's total loan balance increased by 77%, while ABC by 60% and CCB and ICBC by only 48%.

The same conclusion can be drawn from Figure 4.3. At the end of 2008 Q4, none of these banks' LDR exceeded 65%, way below the regulation limit 75%. But starting from 2009, BOC's LDR jumped high approaching the limit, while LDR of the other banks went even lower than before.

The difference between BOC and the other 3 banks is widely believed to result from the presidents' personal preference. The extent to which the bank supported the government's call during the stimulus plan played a big role in the bank president's later political career. The president of BOC at that time was Mr. Gang Xiao. Xiao joined the People's Bank of China upon graduation in 1981 and worked there until 2003, when he began to serve as president of BOC. His deep connection with the central bank might explain his support for the government. In 2013, he was promoted as the president of CSRC. In Feb. 2016, due to his poor performance as president of CSRC, the State Council relieved him from his position. In the contrast, the president of ICBC at that time was Jianqing Jiang. Jiang has a doctor's degree in management and spent some time studying in Columbia University. He had a lot of working experience both in academics and industry. After serving as president of ICBC in 2000, He led ICBC to the biggest and the most profitable company in China. His deep understanding of and respect for the market might explain why he was the least supportive

for the stimulus plan. “The government recent decision to boost domestic demand provides great opportunities for banks. But ICBC is a commercial bank, and we should consider these opportunities from a commercial standpoint.” Said Jiang during an interview with McKinsey Quarterly in March 2009. Despite his great performance as the president, he didn’t receive any political promotion. In May 2016, he retired from ICBC and became a professor in China Europe International Business School.

The rising of loan balance and LDR would, of course, put much pressure on the deposit side. All banks became more aggressive in the deposit market competition. Figure 4.4 shows the change of total deposit balances for these banks, respectively. Similarly, we scale each by the bank’s deposit balance at the end of 2008. From 2006 Q4 to 2008 Q4, all banks were on an almost same growth path. There was a kink in 2009 Q1, when the growing rate suddenly took off. But since BOC suffered more from the LDR regulation, it was the most aggressive in the deposit market. From 2009 Q1 to 2010 Q4, BOC’s total deposit balance increased by 58%, while ABC by 47%, CCB by 43% and ICBC by only 35%. Considering the massive size of these banks’ size, the increases were huge.

### ***C. Shadow Banking Triggered by Deposit Competition***

It’s no coincidence that the rise of bank WMPs followed the 4-trillion stimulus plan. Big 4 banks enjoyed a big advantage in the deposit market because of their extensive branches across the country. So traditionally quantity regulation like LDR didn’t matter for big 4 banks. SMBs, however, suffered from deposit shortage with their LDR just below the regulatory limit 75%. SMBs would usually offer a deposit rate higher than that of big 4 banks to attract some deposit.

Things changed in 2009 because of the stimulus plan. With increasingly pressure from LDR regulation, big 4 banks became more aggressive in the deposit market. This put SMBs into an even more difficult situation in the deposit market, and the deposit war among banks got worse and worse. First, to circumvent the regulatory ceiling of deposit rate, banks offered extra gifts to depositors as long as they deposit certain amount of money to the bank on certain days<sup>11</sup>. These gifts included cooking oil, gold bar and even cash. The closer it was to the day when LDR was censored, the more generous the gifts were. Second, the war among banks went down to individual level. Every individual employee of banks was assigned a certain amount of deposits that the employee must attract before some deadline. Failure to

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<sup>11</sup> See a collection of news reports here: <http://finance.qq.com/zt2010/banklc/>

reach that amount would cause deduction in salaries and even loss of the job. Everyone at the bank was doing everything they could and making use of every relationship they had to attract as many deposits as possible.

The chaotic phenomenon soon caught the attention of CBRC. Concerned about the effectiveness of the interest rate policy, CBRC forbade banks from giving extra gifts in all forms to depositors. The WMPs, however, seemed to have gained favor from the CBRC. Since there was no restriction on the interest rate of WMPs, and WMPs were implicitly guaranteed by the banks, WMPs were in fact deposits with no interest rate control. WMPs were therefore thought by the government to be a tool to slowly liberate the deposit rate. With acquiescence from the CBRC and the need to attract savings, issuance of WMPs soon took off.

## ***D. Empirical Strategy and Results***

### *D.1 Empirical Strategy*

LDR is known to have caused the rise of WMPs, but what affects LDR in the first place? In this section we argue it is a deposit-competition story. In response to the call of the government, the big 4 banks greatly increased their credit supply and grew more aggressive in the deposit market so as to control their LDR. This worsened SMB's LDR and pushed SMBs to issue WMPs as an alternative to compete with the big 4 banks.

We exploit cross-sectional evidence to support the story. The empirical test assumes that the deposit market is local, namely, households and firms make deposits in the local bank branches. So, only if the SMB has branches in the same city as the big banks will the aggressiveness of the big banks in the deposit market affect the SMB. And since most SMBs concentrate their branches in certain regions, they are differentially exposed to the big bank's deposit competition. We construct a measure  $banknm_{it}$ , which is the competition that SMB  $i$  faces from the big bank  $banknm$  during time  $t$ .

Our second identification comes from the difference among the big 4 banks. As documented above, BOC was the most supportive for the 4-trillion stimulus plan and also the most aggressive in the deposit market. So exposure to competition from BOC would have a bigger effect on the SMB's WMP issuance behavior.

The third identification comes from the difference in the effect of big 4's competition on SMBs before and after the stimulus plan. Before the plan was in effect, competition from big 4 banks should not affect SMBs.

To test our story, we first look at whether  $banknm_{it}$  has a positive effect on SMBs'

LDR. We run the following regression:

$$LDR_{it} = \alpha_0 + \alpha_1 BOC_{it} + \alpha_2 ABC_{it} + \alpha_3 ICBC_{it} + \alpha_4 CCB_{it} + banktype_i + quarter_t + \varepsilon_{it} \quad (5.1)$$

We should expect  $\alpha_1$  to be significantly positive and bigger than  $\alpha_2$ ,  $\alpha_3$  and  $\alpha_4$ . We cluster the regression by banks instead of introducing a bank fixed effect because the competition measure seems quite stable over time. But we do control for the type of banks (urban or joint-equity commercial banks). And we are more interested in the cross-bank variation in exposure to big 4 competitions rather than cross-time change.

Secondly, we introduce the competition measure into the WMP issuance regression. Given the bank's LDR at the beginning of this period and the deposit competition the bank faces during this period, the SMB determines how many WMPs to issue.

$$issue\_e_{it} = \gamma_0 + \beta_1 LDR_{i,t-1} + \beta_2 spread_t + \beta_3 spread_t \times LDR_{i,t-1} + \gamma_1 BOC_{it} + \gamma_2 ABC_{it} + \gamma_3 ICBC_{it} + \gamma_4 CCB_{it} + banktype_i + quarter_t + \varepsilon_{it} \quad (5.2)$$

Similarly, We should expect  $\gamma_1$  to be significantly positive and bigger than  $\gamma_2$ ,  $\gamma_3$  and  $\gamma_4$ . Again, we don't include the bank fixed effect but only the type of banks in the model because of the persistence of competition measure.

## D.2 Measure Exposure to Big 4 Competition

The basic idea is to calculate the number of the big bank's branches located in the same city as the SMB's. To take into account the market size of the city, we scale the branch number by total number of bank branches in that city. Denote  $n_{i,j,t}$  as the number of bank  $i$ 's branches in city  $j$  at the beginning of quarter  $t$ .

First, calculate the market share of big bank  $b$  in city  $j$  at the beginning of quarter  $t$ .

$$MarSha_{b,j,t} = \frac{n_{b,j,t}}{\sum_i n_{i,j,t}} \quad (5.3)$$

Second, calculate a weighted average of  $MarSha_{b,j,t}$  for SMB  $i$ .

$$banknm_{i,t} = \frac{\sum_j n_{i,j,t} MarSha_{b,j,t}}{\sum_j n_{i,j,t}} \quad (5.4)$$

The variable  $banknm_{i,t}$  measures on average, how much bank  $i$ 's deposit market interacts with that of the big bank  $b$ . We calculate  $BOC_{i,t}$ ,  $ICBC_{i,t}$ ,  $ABC_{i,t}$  and  $CCB_{i,t}$ , respectively. Name the sum of these 4 variables as  $BIG4_{i,t}$  and  $1 - BIG4_{i,t}$  as  $SMB_{i,t}$ .

The variation in  $banknm_{i,t}$  across SMBs comes from two sources. First, if SMBs

proportionally allocate their branches across cities, e.g.,  $\frac{n_{i,j,t}}{\sum_j n_{i,j,t}}$  doesn't depend on  $i$ , then there is no variation in  $banknm_{i,t}$ . Second, if big banks equally allocate their branches across cities, e.g.,  $MarSha_{b,j,t}$  doesn't vary with  $j$ , then there is no variation in  $banknm_{i,t}$ .

The first issue is not a problem because most of the SMBs concentrate their branches in certain regions. Among the 21 SMBs in our sample, the 8 urban commercial banks are regional, which means they can only operate in a restricted area. For example, Bank of Chongqing only operates in 4 provinces (Chongqing, Ningxia, Sichuan and Guizhou), and Huishang Bank only operates in 2 provinces (Jiangsu and Anhui). For the other 13 national banks, most concentrate their business in regions where they originated. For example, a national bank as it is, as the end of 2012, Guangdong Development Bank locates about 60% of its branches in Guangdong Province, where it was founded. China Minsheng Bank locates about 45% of its branches in only 6 provinces. The online appendix offers the choropleth map of branch allocation across the country for each of the 21 SMBs.

The second issue is not likely to be a concern, either. We calculate (5.3) for each big bank in each province on 2012/12/31, a representative time point of our sample period. Figure 5 shows the choropleth map of each big bank. We show the provincial-level instead of city-level market share to make the pattern more obvious. National as they are, the big 4 banks seem to avoid competition in the same area. ABC has most branches in the western area, ICBC in the upper and lower middle area, CCB in the middle area, and BOC in the coastal and upper middle area. If we aggregate the 4 banks together, the big 4 banks have more existence in less developed areas, a market where SMBs are not likely to enter.

The two sources of variation give us confidence that our competition measure is exogenous for our analysis. Because SMBs are regional, we can think of the variation of the competition measure coming from big banks' local market share. Reverse causality is not likely to happen, so the only concern is omitted variables. What factors could affect the local SMBs' LDR, WMP issuance and big banks' market share? Local economic environment might do, that is, poor areas might have more big 4 existences and the local banks have higher LDR and WMP issuance. This only seems true for ABC, but not for the other 3 big banks, as shown in Figure 5. Furthermore, we have the second identification approach: effect of BOC should be bigger than other three. As discussed above, the uniqueness of BOC is due to Gang Xiao's personal preference, not that BOC strategically allocate branches in areas with higher LDR or more WMP issuance.

Figure 6.1 plots the change of average market share over time for the 4 banks, respectively. ABC has the biggest market share in terms of number of branches. For historical reasons, many branches of ABC were located in under-developed areas to support local economy instead of making profit. After China's entry into WTO, ABC went through massive branch adjustment, as shown by the picture. The declining trend of big 4 bank's market share coincides with the rising of SMBs which are set up by local governments and enterprises.

Figure 6.2 plots the average exposure to big 4 competitions of the 21 SMBs and Table 3 shows some statistics.

### *D.3 Empirical Results*

Table 4 reports estimation results for model (5.1). In the first column, we run estimation for the 21 SMBs from 2007 to 2014. The variable *BOC* has a significantly positive effect on SMBs' LDR, which is in accord with the story. When exposed to the competition of *BOC*, SMBs find it harder to attract deposits and their LDRs go higher. Coefficients of *ICBC*, *CCB* and *ABC* are not very significant, which is also predicted since *BOC* is the most aggressive supporter for the 4 trillion stimulus plan and thus the most aggressive competitor in the deposit market.

The stimulus plan mainly happened between 2009 and 2010, and *BOC* became more aggressive afterwards, so should the effect be. Column (2) – (5) repeat the estimation for every two years. First, the relation only holds after 2010. In 2007-2008 when the stimulus plan did not begin yet, competition from the big 4 banks did not affect SMBs' LDR. In 2009-2010 when the stimulus plan was in effect, competition from the big 4 banks did not have any significant effect either probably because there was much liquidity provided by the central bank to support the plan at that time. Second, the effect of *BOC* was not only significant but also very big after the plan. According to the estimation, one standard deviation increase in *BOC* increases LDR by 0.48 (0.52) standard deviation in 2011-2012 (2013-2014).

Table 5 reports estimation results for model (5.2). Similarly, we find that even control for LDR, *BOC* still has a significant and positive effect on banks' WMP issuance, and this relation only holds from 2009. According to the estimation, one standard deviation increase in *BOC* will increase banks' WMP issuance over equity by 0.27 standard deviation in 2009-2010, 0.22 standard deviation in 2011-2012 and 0.52 standard deviation in 2013-2014. In the contrast, none of *ICBC*, *CCB* or *ABC* has a consistently significant effect on banks'

WMP issuance.

Banks' LDR itself is affected by *BOC*. Therefore, *BOC* not only affects banks' WMP issuance directly, as shown above, but also affects banks' WMP issuance indirectly through LDR. To see the total effect of *BOC*, we repeat the estimation without LDR. Column (5) - (8) show that all the conclusions hold except that the coefficient of *BOC* becomes much bigger. According to the estimation, one standard deviation increase in *BOC* will increase banks' WMP issuance over equity by 0.33 standard deviation in 2009-2010, 0.33 standard deviation in 2011-2012 and 0.56 standard deviation in 2013-2014.

Table 5 strongly supports the deposit-competition story. *BOC* has a significant positive effect on WMP issuance even if LDR is in the model. Faced with the local level of big 4 competitions, SMBs strategically choose the amount of WMPs to issue to compete for deposits.

#### ***E. Big Four Banks' WMP Issuance and the Stimulus Plan***

With so much said about why SMBs issue WMPs, why the issuance of WMPs by big 4 banks also took off following the stimulus plan? We address this question in this section.

During the stimulus plan, most of the bank loans eventually went to CIICs. The government didn't publish bank loan balances to CIICs regularly but did it occasionally. At the end of 2008, bank loan balances to CIICs was 4.33 trillion, almost doubled to 7.66 trillion RMB in June 2009, and then slowly increased to 9.20 trillion RMB at the end of 2012.

The sharp increase in the debt of CIICs worried the central government a lot. As the main source of money to repay the debt, the total income of local governments in 2010 was only 11.51 trillion RMB (including fiscal income, extra-budget financial revenue, land selling profit, transfer from the central government and the government bond income) while total CIIC debt balance at the end of 2010 was over 7.66 trillion RMB. It is estimated that 1.84 billion RMB of bank loans for CIICs was due in 2012. On 10th June, 2010, the State Council passed a new regulation regarding CIICs and required certain CIICs be shut down, commercial banks tighten credit supply to CIICs, and local governments support the CIICs within their contributed capital. Existing debt shall be reduced and new debt shall be strictly controlled.

A lot of the extra credit supply also went to the real estate sector and pushed up housing price, which also worried the central government. After an average increase of 7.93% in house price in 2011, the increase in bank loans to real estate shrank from 2.02 trillion RMB in

2009 and 2010 to only 1.38 trillion RMB in 2011 and 2012.

These regulation changes brought about a sharp increase in shadow banking activities. On one hand, investment by CIICs like infrastructure and indemnificatory housing generates very little cash inflow, and CIICs could only pay back the loans slowly during a long period of time, even with the limited financial support from the local governments. So when the principal was due, CIICs need to turn to banks to refinance their debt. Real estate companies also depend heavily on banks for liquidity support. On the other hand, commercial banks would want to refinance these loans too because otherwise, these loan assets would go default. But banks simply couldn't do so by granting new bank loans. Shadow banking showed up as a solution. Banks could refinance these loans with principal-floating WMPs, with which they move these on-balance sheet loans off the balance sheet.

We don't have information about how banks dealt with those loans granted due to the stimulus plan when they matured, but since most of these loans are medium and long-term, we can look at the change of medium and long-term loan balance over time. Figure 7.1 shows that the percentage of medium and long-term loan balance increased from 56% (68%) in 2008 to 63% (73%) in 2010 for all banks (big 4 banks), but then slowly decreased back to the original level. This reverse trend reflects banks' efforts to move loans to CIICs and real estate companies off the balance sheet.

To directly test the story, we estimate the loan increase due to the stimulus plan for each bank and analyze its relation with banks' WMP balance in later years. First, for each bank we estimate a linear trend of total loan balance using quarterly observations from 2006 Q4 to 2008 Q4 and calculate the predicted loan balance in 2010 Q4, which would be the value if there hadn't been the stimulus plan. We then calculate the difference between the actual loan balance and the predicted loan balance in 2010 Q4, and use it as a proxy of loan increase due to the stimulus plan. Finally, we scale this proxy and WMP balance by banks' loan balance at the end of 2008.

Figure 7.2 shows that there is a clear and positive relationship between bank's WMP balance at the end of 2013 and the estimated loan increase. In Table 6, we regress banks' WMP balance in each year on our proxy of loan increase. For principal-floating WMP balance, the effect grows stronger and stronger over time when more and more medium and long-term loans matured. But for principal-guaranteed WMPs, there is no such pattern since principal-guaranteed WMPs cannot move loans off the balance sheet.

Overall, there are two mechanisms in which the 4-trillion stimulus plan triggered the



rising of China's shadowing banking in the form of bank WMPs. For SMBs, the local deposit market became more competitive as a result of big 4 especially BOC's massive credit support for the stimulus plan and desire to decrease their LDR. The increasing competition in the deposit market pushed SMBs to issue WMPs and offer higher return to investors so as to attract more savings. For big 4 banks, they granted too many loans to CIICs and the real estate during the stimulus plan and later when CBRC tightened credit supply to these sectors, banks use principal-floating WMPs to refinance these loans and move them off the balance sheet.

## **VI. Rollover Risk of WMPs**

### **A. Maturity Mismatch of WMPs**

We have already shown some evidence about the maturity mismatch of WMPs and the target assets in Table 1, Panel C. Banks deliberately set the maturity date of WMPs right before the end of the quarter when LDR is calculated and censored. The average maturity of 3-4 months coincides with the quarterly basis.

The more direct evidence is, whether an abnormal proportion of WMPs mature on the last day of each quarter. We collect information of individual WMPs from WIND and count the number of WMPs that mature on each day within a quarter. WIND doesn't cover all WMPs in China, but does cover the majority of them. Figure 8 shows the results.

Firstly, both big 4 banks and SMBs deliberately choose the last day of a quarter as the maturity day of WMPs. Figure 8.1 shows that quite a large number of WMPs issued by big 4 banks mature on the last 4 days of a quarter, and Figure 8.2 shows that an abnormally high proportion of WMPs issued by SMBs mature exactly on the last day of the quarter.

However, it is possible that the cluster of maturity date is purely for accounting convenience. So secondly, we divide the sample by yield type. As we claimed, principal-floating WMPs are all off the balance sheet. Banks need to make them mature before the end of the quarter to help increase the deposit balance, as shown in Figure 8.3. Principal-guaranteed WMPs, however, are already on the balance sheet so the cluster of maturity date is less extreme for them, as shown in Figure 8.4.

The key of rollover risk is that when WMPs mature but the target assets haven't, banks need to refinance these loans by issuing new WMPs. We construct a variable *WMPdue*, the amount of WMPs due in each quarter over bank equity at the end of last quarter, and study its effect on the bank's behaviors.

### **B. Rollover Risk and WMP Yield**

The first effect is on the yield of new WMPs. To issue new WMPs and raise money to refinance the asset as quickly as possible, the most obvious approach is to offer a higher yield on new WMPs. We estimate the following model for individual WMP expected yield:

$$WMPreturn\_d_{it} = \alpha + \beta_1 WMPdue_{it} + \beta_2 Shibor\_d_t + bank_i + e_{it} \quad (6.1)$$

The dependent variable is the difference between WMP's annualized yield and bank deposit rate ceiling, and  $Shibor\_d_t$  is the difference between Shibor and bank deposit rate ceiling. We choose deposit rate and Shibor with the same maturity as the WMP and take value on the day when the WMP is issued. We deduct the deposit rate ceiling from the WMP yield and Shibor because for the investors, it is the difference above the deposit rate ceiling that matters. Quarter fixed effect is not included because of the presence of  $Shibor\_d_t$ .

The key independent variable is  $WMPdue$ . For principal-floating (guaranteed) WMPs, we use only the total amount of principal-floating (guaranteed) WMPs that mature in that quarter over bank equity. We should expect  $\beta_1$  to be significantly positive.

Table 7 shows the results. No matter what the yield type of the product is and which banks issue it, the estimated value for  $\beta_2$  is stable. Our key independent variable,  $WMPdue$ , shows two interesting results.

First,  $WMPdue$  only matters for SMBs, not for big 4 banks at all. This is not surprising. On one hand, big 4 banks are not as aggressive as SMBs in issuing WMPs, so the amount of WMPs that mature in each quarter is not big enough to cause liquidity problems for them. On the other hand, due to their great advantage in the deposit market, big 4 banks don't necessary need to increase WMP yield to attract enough money. SMBs, however, face greater liquidity needs and need to offer a considerably high yield on WMPs to attract enough money.

Second, the effect of  $WMPdue$  on new WMP yield is bigger for principal-floating WMPs than for principal-guaranteed WMPs, but both effect is significant at 1% confidence interval. WMP investors require higher yield on principal-floating WMPs that are riskier.

### **C. Rollover Risk and the Interbank Market**

Besides raising new funds as soon as possible, banks can go to the inter-bank market for liquidity. The great amount of WMP rollover poses great liquidity pressure on the issuer bank and the market as well. This is probably the most important risk associated with the rapid

development of WMPs. We first analyze how *WMPdue* affects individual banks' liquidity management behaviors and then see how *WMPdue* affects the interbank market as a whole.

First, *WMPdue* should affect the bank's ask rate in the inter-bank market. In China, bank ALWAYS report the same ask rate and bid rate for Shibor. Therefore, the ask rate reflects both the bank's willingness to lend (marginal cost of money) and the counterparts' eagerness to borrow (market demand) in the interbank market. Banks should ask for a higher rate when they have more WMPs approaching maturity and when other banks are in greater need for liquidity. SMBs are typically the borrowers in the inter-bank market, thus we use the average *WMPdue* of SMBs (*WMPdue\_SMB*) to measure market demand for money. We run the following regression:

$$Ask_{it} = \alpha + \beta_1 WMPdue_{it} + \beta_2 WMPdue\_SMB_t + \beta_3 Cap_{i,t-1} + \beta_4 LDR_{i,t-1} + e_{it} \quad (6.2)$$

The dependent variable is the bank's average ask quoted rate within quarter *t*. We do not include the bank fixed effect because we are interested in cross-sectional evidence, namely, how the variation in *WMPdue* across banks affects the variation of ask rate. We do not include quarter fixed effect because otherwise, *WMPdue* only explains the cross section variation in ask rate between banks in a given quarter while *WMPdue\_SMB* only explains the time series variation in ask rate so that we cannot compare their relative importance.

We use quarterly observations of banks that participate in the Shibor ask and bid process from 2008 Q1 to 2014 Q4 and estimate the model for big 4 banks and SMBs, separately. We standardize ask rate, *WMPdue* and *WMPdue\_SMB* by dividing them over their standard deviation. There are only 14 banks in the regression sample, so clustering by bank will dramatically reduce the significance. Instead we cluster the regressions by quarter.

The results are reported in Table 8. Panel A shows that both *WMPdue* and *WMPdue\_SMB* have a significantly positive effect on the Shibor ask rate. First, compared to SMBs, *WMPdue* plays a much bigger role in determining big 4's ask rate. For example, one standard deviation increase in *WMPdue* increases big 4's overnight ask rate by 0.448 standard deviation but SMBs' overnight ask rate by only 0.075 standard deviation. Second, for big 4 banks, the effect of *WMPdue* and *WMPdue\_SMB* on ask rate is of the similar size. Third, the effect of *WMPdue* and *WMPdue\_SMB* on the bank's ask rate holds for terms as long as 6 month.

To see more clearly whether big 4 or SMBs' *WMPdue* plays a bigger role in determining the interbank market rate, we calculate the average *WMPdue* of big 4 banks (*WMPdue\_BIG4*) and include it in the regression. In Panel B, we find that with *WMPdue\_BIG4* in the model,

coefficient of *WMPdue\_SMB* is no longer significant. In the contrast, the coefficient of *WMPdue\_BIG4* is not only significant but also very big. For overnight Shibor, one standard deviation increase in *WMPdue\_BIG4* increases the bank's ask rate by 0.805 standard deviation. Moreover, the effect of *WMPdue\_BIG4* tends to be slightly bigger for shorter term rates, as banks turn to the interbank market for short-term money for liquidity needs.

The difference between Big 4 and SMBs are probably due to their different roles in the inter-bank market. Big 4 are usually the main liquidity providers and SMBs are the net borrowers. Due to their great impact on the inter-bank market, Big 4 are to some extent the price makers and SMBs are passive price takers. Therefore, only quoted rate by Big 4 matters to the market participants. As a result, big 4 banks carefully choose their quoted rates by first considering their own liquidity needs while SMBs are more likely to just passively follow the market rate.

Furthermore, to analyze how *WMPdue* affects the inter-bank market as a whole, we look the relationship between aggregate *WMPdue* and 1-week Shibor during our sample period. In Figure 9, we calculate the aggregate amount of WMPs that mature over M2 for all big 4 banks and all SMBs separately and plot them again 1-week Shibor. The first graph shows that 1-week Shibor closely tracks big 4 *WMPdue*. In the second graph, SMB *WMPdue* steadily increases over time and there is no clear relationship between the two. The two graphs support the idea that Shibor is mostly decided by big 4 banks and thus strongly affected by big 4 *WMPdue*.

To conclude, the rollover of WMPs puts pressure on banks' liquidity management and increases their marginal cost of money, which is reflected in their higher ask rate in the interbank market. What's more, since the big 4 are the price makers in the interbank market, their total *WMPdue* almost determines the short-term market rate. This is something of great significance considering the great importance of Shibor in China.

#### ***D. Rollover Risk and Stock Market's Response***

Not only does the bank itself reveal the effect of WMP rollover on its liquidity in the interbank market, the stock market may also respond to the WMP rollover risk.

When WMPs mature, banks go to the interbank money market for short-term money to pay the investors and meanwhile issue new WMPs to refinance the investment project. As the cost of rollover, the higher Shibor is, the greater cost banks with lots of WMPs to mature will bear.

Efficient market hypothesis claims stock price only responds to unexpected news. When Shibor suddenly jumps high, hopefully in an unexpectedly way, the cost of rollover suddenly increases, so the stock price should decrease if the stock market is efficient. We calculate the daily change in overnight and 1-week Shibor and regard the changes as unexpected if both changes in overnight and 1-week Shibor are high. Today's 1-week Shibor has 6 days overlap with next day's, so if banks expect the next day's Shibor to increase sharply, they would increase their borrowing in the interbank market today and thus force today's Shibor to grow and approach the next day's level. The change in overnight Shibor also carries information about how tight the interbank market is, so we conditional on it too.

On each business day, Shibor is announced at 11:30 (9:30 from 08/01/2014). If it is unexpectedly high compared to yesterday, the stock close price on that day should adjust accordingly. To empirically test the stock market response, we estimate the following models:

$$return_{it} = \alpha + \beta WMPdue_{it} + \varepsilon_{it} \quad (6.3)$$

The independent variable  $WMPdue_{it}$  is total amount of WMPs that mature in that month divided by bank equity at the end of last quarter and  $return_{it}$  is stock return from yesterday to today. We choose days when both the changes in overnight and 1-week Shibor are above a certain threshold. The coefficient  $\beta$  is expected to be negative only when the threshold is high enough.

Although the exact value of  $WMPdue$  is not available in any public dataset, it is not difficult for analysts to form an estimate of it. On June 22, 2013, Fitch Ratings reported an estimate amount of 1.5 trillion RMB of WMPs to mature during the last 10 days of June, 2013.<sup>12</sup>

Table 9 reports the results. We choose four different thresholds. The highest is 1%. There are 9 trading days when both the changes in overnight and 1-week Shibor is bigger than 1%. The second is 0.8% with 16 trading days, the third is 0.6% with 25 trading days and the last is 0.4% with 48 trading days. Big changes in Shibor usually occur in the middle of the year or at year end right before the on-balance sheet lending requirement is conducted, such as Capital Ratio and *LDR*.

The first row uses raw return as the dependent variable. We find that  $\hat{\beta}$  is significantly negative when  $c$  is bigger than 0.6% and decreases in magnitude when  $c$  decreases. In Figure 10, we plot raw return against  $WMPdue$  with  $c=1\%$ . This graph shows a clear

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<sup>12</sup> [http://finance.ifeng.com/a/20130622/10011843\\_0.shtml](http://finance.ifeng.com/a/20130622/10011843_0.shtml)

negative relation between stock price reaction and *WMPdue*.

We use three risk-adjusted returns. The second row uses raw daily return minus market return as the dependent variable. In the third row, we apply a linear projection of raw daily return on market return for the past 60 days and use the estimated residual today as the dependent variable. In the fourth row, we estimate CAPM using observations for the past 60 trading days and use the estimated residual today as the dependent variable. We use 3-month Shibor as the risk-free rate.

We find a similar trend for  $\hat{\beta}$  using all the three risk-adjusted return measures, although the trend seems not monotonic at  $c=0.8\%$ . This may be because of error-in-variable problem, e.g., estimation using 60 observations doesn't give consistent estimates so that the estimated residual today is not consistent.

The effect is very big too. Take  $c=1\%$  for example, one standard deviation (0.68) increase in *WMPdue* decreases the raw return by 0.64%. This is not annualized, one single day return.

## VII. Conclusion

Much attention has been paid to the rise of shadow-banking as a result of 'regulatory arbitrage' by financial institutions and its impact on the stability of the overall financial system. There is little academic research, however, studying shadow banking in emerging markets. In this paper, we examine the largest component of China's shadow banking sector—wealth management products (WMPs) issued by banks. We link the development of WMPs to the regulations on the banking sector and the 4-trillion stimulus plan and study various effects of WMPs. Our tests and results shed light on how the fragility of shadow banking relates to the overall stability of China's financial system, an issue that is now of first-order importance even to the global financial system.

With regulations on deposit rates and on-balance-sheet lending, China's banks have significantly increased shadow banking activities in recent years, most notably by issuing wealth management products. We first provide some empirical evidence showing that the issuance behavior of WMPs is indeed regulatory arbitrage. The scale of product issuance is greater for banks more constrained by on-balance sheet lending restrictions particularly loan-to-deposit ratio (LDR), especially for small and medium-sized banks (SMBs) and when the difference between market lending rates and the regulated deposit rate ceiling is high.

Second, the rising of WMPs was triggered by the 4-trillion stimulus plan. The big 4

banks were the main source of funding for the stimulus plan. And after a rapid increase in loan balance, big 4 banks especially BOC grew much more aggressive in the deposit market in order to maintain their LDR. This increasing competition in the local deposit market pushed SMBs' LDR up and in response, SMBs issued WMPs to compete with the big 4 banks. Furthermore, when CBRC tightened credit supply to CIICs and the real estate after the plan, big 4 banks issued principal-floating WMPs to move loans to these sectors off their balance sheet, which is another channel how the 4-trillion plan triggered the growth of WMPs.

Third, the rollover of WMPs poses great risk on individual banks and the interbank market. When a large amount of WMPs mature, SMBs offer a higher yield on new WMPs, big 4 banks ask for a higher rate in the interbank market, the short-term Shibor goes up, and bank stock price drops more in times of a sudden credit crunch.

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### Table I Summary Statistics

The sample includes quarterly observations of 25 banks from 2008 Q1 to 2014 Q4. Names of the 25 banks are listed in Panel D. The urban and joint-equity commercial banks are regarded as small and medium-size banks in this paper. Panel A reports bank characteristics at the end of each quarter. Panel B reports total WMP issuance and amount due for each bank in each quarter as well as annualized expected yield of individual WMPs issued by the 25 banks during the sample period. Panel C reports the average maturity of WMPs issued by Big 4 banks and SMBs in each year. All statistics are shown by whether the principal of the WMP is guaranteed or floating. See the appendix for definitions of all variables.

Variables	Banks	Max	Min	Mean	Stdev
Equity (Billion RMB)	Big 4 Banks	1507.3	148.0	737.5	281.58
	SMBs	463.7	2.4	69.9	81.67
Deposit Balance (Billion RMB)	Big 4 Banks	15591.3	3965.6	9660.8	2793.38
	SMBs	4719.5	27.4	860.0	926.25
Loan Balance (Billion RMB)	Big 4 Banks	10441.7	2638.5	6053.4	1839.74
	SMBs	3473.4	21.3	610.3	673.45
Capital Ratio	Big 4 Banks	0.15	0.00	0.12	0.047
	SMBs	0.26	0.06	0.12	0.022
LDR	Big 4 Banks	0.76	0.51	0.63	0.061
	SMBs	0.93	0.44	0.68	0.076
Overnight Shibor Quoted Rate - Shibor (%)	Big 4 Banks	0.0982	-0.1718	-0.0018	0.021
	SMBs	0.0497	-0.0302	0.0039	0.01

Panel B: Summary Statistics of WMPs

Variables	Banks	Max	Min	Mean	Stdev
Issuance (billion RMB)	Big 4 Banks	3022.3	1.0	1002.2	771.16
	SMBs	4249.5	0.0	206.8	506.10
Issuance/Equity	Big 4 Banks	4.41	0.00	1.22	0.83
	SMBs	10.53	0.00	1.55	2.03
Principal-guaranteed WMP Issuance/Equity	Big 4 Banks	3.74	0.00	0.41	0.54
	SMBs	6.57	0.00	0.54	0.94
Principal-floating WMP Issuance/Equity	Big 4 Banks	1.83	0.00	0.82	0.54
	SMBs	10.05	0.00	1.01	1.45
WMP Due/Equity	Big 4 Banks	4.21	0.00	1.19	0.84
	SMBs	11.72	0.00	1.41	1.98
Principal-guaranteed WMP Due/Equity	Big 4 Banks	3.34	0.00	0.40	0.55
	SMBs	6.70	0.00	0.50	0.90
Principal-floating WMP Due/Equity	Big 4 Banks	1.73	0.00	0.78	0.52
	SMBs	11.72	0.00	0.91	1.44
WMP annualized return (%)	Big 4 Banks	30.00	0.36	4.50	1.00
	SMBs	30.00	0.36	4.70	1.15
Principal-guaranteed WMP return (%)	Big 4 Banks	15.95	0.36	4.11	0.97
	SMBs	30.00	0.36	4.19	1.24
Principal-floating WMP return (%)	Big 4 Banks	30.00	1.45	4.68	0.96
	SMBs	30.00	0.80	4.89	1.06

Panel C: Maturity (in days) of WMPs

Banks	Big 4		SMBs		
	Yield Type	Floating	Guarantee	Floating	Guarantee
Year	2007	326	282	377	278
	2008	203	207	165	90
	2009	219	38	162	91
	2010	117	38	129	87
	2011	107	72	90	70
	2012	123	78	116	94
	2013	127	83	125	97
	2014	139	76	118	100

Panel D: List of banks

Big 4 Banks	Joint-equity Commercial Bank
Agricultural Bank of China	Bank of Communications
Industrial and Commercial Bank of China	Bohai Bank
China Construction Bank	China Zheshang Bank
Bank of China	Hua Xia Bank
Urban Commercial Bank	China Citic Bank
Shengjing Bank	Shanghai Pudong Development Bank
Bank of Beijing	China Everbright Bank
Bank of Nanjing	Guangdong Development Bank
Harbin Bank	Evergrowing Bank
Bank of Chongqing	China Merchants Bank
Bank of Shanghai	China Minsheng Bank
Bank of Ningbo	Ping An Bank
Huishang Bank	Industrial Bank

**Table II Determinants of WMP Issuance**

The sample includes quarterly observations of the 25 banks from 2008Q1 to 2014Q4. Both Capital Ratio and *LDR* take values at the end of last quarter. “Floating” refers to principal-floating WMPs and “Guarantee” refers to principal-guaranteed WMPs. Panel A and B report whether Capital Ratio and *LDR* affect the issuance of WMP, respectively. Regressions are all clustered by bank. Robust *t*-statistics are reported in parentheses. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Panel A: Effect of Capital Ratio on WMP Issuance by banks

Bank	Big 4			SMBs		
Yield Type	All	Floating	Guarantee	All	Floating	Guarantee
Dep Var: Issuance/Equity	(1)	(2)	(3)	(4)	(5)	(6)
Capital Ratio	5.040 (0.663)	5.696 (2.123)	-0.861 (-0.167)	8.247* (1.811)	6.619* (1.760)	1.625 (0.446)
Spread	3.835*** (11.18)	2.772*** (6.581)	1.086** (4.784)	8.316*** (6.551)	5.575*** (5.496)	2.757*** (3.992)
Capital Ratio*Spread	-5.571 (-1.329)	-5.108* (-2.632)	-0.440 (-0.174)	-8.469* (-2.039)	-6.141* (-1.928)	-2.378 (-0.839)
Bank fixed effect	✓	✓	✓	✓	✓	✓
Quarter fixed effect	✓	✓	✓	✓	✓	✓
Constant	-4.195*** (-11.05)	-2.929*** (-8.378)	-1.280** (-3.337)	-9.471*** (-4.990)	-6.772*** (-5.070)	-2.713** (-2.715)
Observations	112	112	112	588	588	588
R-squared	0.830	0.787	0.481	0.697	0.605	0.606
Cluster	bank	bank	bank	bank	Bank	bank

Panel B: Effect of *LDR* on WMP Issuance by banks

Bank	Big 4			SMBs		
Yield Type	All	Floating	Guarantee	All	Floating	Guarantee
Dep Var: Issuance/Equity	(1)	(2)	(3)	(4)	(5)	(6)
<i>LDR</i>	-3.822 (-1.419)	-3.489 (-1.469)	-0.537 (-0.360)	-1.215 (-0.326)	-2.541 (-0.971)	1.336 (0.576)
Spread	2.488* (2.731)	2.598*** (7.013)	-0.113 (-0.0953)	5.222*** (3.921)	3.355*** (3.195)	1.867*** (2.873)
<i>LDR</i> *Spread	1.073 (0.847)	-0.259 (-1.018)	1.376 (1.351)	3.449*** (2.902)	2.204** (2.443)	1.263* (1.948)
Bank fixed effect	✓	✓	✓	✓	✓	✓
Quarter fixed effect	✓	✓	✓	✓	✓	✓
Constant	-1.194 (-0.548)	-0.419 (-0.330)	-0.685 (-0.713)	-7.904** (-2.470)	-4.239* (-1.901)	-3.690 (-1.693)
Observations	112	112	112	588	588	588
R-squared	0.836	0.807	0.498	0.707	0.608	0.629
Cluster	bank	bank	bank	bank	bank	bank

### Table III Summary Statistics of the Competition Measure

BOC measures the SMB's exposure to competition from BOC. We take quarterly observation from 2007Q1 to 2014Q for the 21 SMBs in our sample. Similar for ICBC, CCB, and ABC. BIG4 is sum of the 4 measures. The first table reports summary statistics and the second reports correlation of these four.

Variable	Obs	Mean	Std. Dev.	Min	Max
BOC	672	0.077	0.013	0.039	0.128
ICBC	672	0.129	0.024	0.069	0.207
CCB	672	0.107	0.018	0.056	0.167
ABC	672	0.134	0.025	0.035	0.233
BIG4	672	0.447	0.069	0.268	0.719

	BOC	ICBC	CCB	ABC
BOC	1.000			
ICBC	0.632	1.000		
CCB	0.676	0.866	1.000	
ABC	0.707	0.544	0.609	1.000

**Table IV Effect of Big 4 Competition on SMB's LDR**

The sample includes quarterly observations of 21 SMBs from 2007 Q1 to 2014 Q4. Regression (1) includes all observations and Regression (2) - (5) repeat the estimation for every two years. All regressions are clustered by bank. Robust t-statistics in parentheses. \*\*\* p<0.01, \*\* p<0.05, \* p<0.1.

Year	07-14	07-08	09-10	11-12	13-14
Dep Var: LDR	(1)	(2)	(3)	(4)	(5)
BOC	2.379*** (3.700)	0.790 (0.774)	1.177 (1.226)	3.274** (2.720)	5.300** (2.209)
ICBC	0.276 (0.404)	0.336 (0.707)	-0.566 (-0.440)	0.970 (0.580)	3.505 (1.614)
CCB	-1.698* (-1.782)	-1.179** (-2.466)	-0.411 (-0.300)	-3.475 (-1.629)	-5.783** (-2.395)
ABC	-0.395 (-0.637)	0.394 (1.074)	-0.697 (-0.802)	-0.823 (-0.504)	-2.120 (-1.222)
quarter fixed effect	√	√	√	√	√
bank type fixed effect	√	√	√	√	√
Constant	0.804*** (11.58)	0.643*** (6.372)	0.844*** (9.711)	0.838*** (4.311)	0.790*** (3.609)
Observations	672	168	168	168	168
R-squared	0.467	0.633	0.554	0.499	0.451
cluster	bank	bank	bank	bank	bank

**Table V Effect of Big 4 Competition on WMP Issuance**

The sample includes quarterly observations of 21 SMBs from 2008 Q1 to 2014 Q4. Because BOC also affects WMP issuance through LDR, we conduct the estimation with and without LDR, separately. All regressions are clustered by bank. Robust t-statistics in parentheses. \*\*\* p<0.01, \*\* p<0.05, \* p<0.1.

Year	08	09-10	11-12	13-14	08	09-10	11-12	13-14
Dep Var: Issuance/Equity	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
BOC	6.061 (1.319)	7.246*** (3.167)	40.45* (2.056)	146.4*** (2.847)	4.916 (0.985)	8.669*** (3.760)	60.79*** (3.814)	159.4*** (4.011)
ICBC	3.077 (0.948)	2.174 (1.167)	44.10** (2.242)	54.60 (0.855)	3.087 (0.948)	2.155 (0.866)	50.48* (1.876)	62.40 (1.012)
CCB	-6.079 (-1.370)	-1.414 (-0.480)	-52.97* (-1.792)	-93.99 (-1.248)	-4.072 (-0.946)	-3.020 (-0.965)	-77.16** (-2.214)	-107.4 (-1.530)
ABC	0.756 (0.522)	-3.797** (-2.314)	18.87 (1.295)	15.21 (0.347)	0.312 (0.195)	-3.665** (-2.154)	15.02 (0.785)	9.900 (0.237)
LDR	-4.985* (-1.809)	0.502 (0.729)	8.228 (0.845)	2.649 (0.535)				
Spread	-1.807 (-1.254)	-0.880* (-1.896)	-1.277 (-0.467)	3.089** (2.275)	0.0374 (0.105)	0.136** (2.447)	-1.554*** (-4.934)	3.031*** (3.071)
LDR*Spread	2.638 (1.346)	1.488** (2.136)	-0.602 (-0.142)	-0.150 (-0.130)				
Bank type fixed effect	√	√	√	√	√	√	√	√
quarter fixed effect	√	√	√	√	√	√	√	√
Constant	3.594* (1.884)	0.275 (0.536)	-6.079 (-0.945)	-7.651 (-0.999)	0.187 (0.606)	0.674*** (3.788)	0.244 (0.0999)	-5.579 (-0.874)
Observations	84	168	168	168	84	168	168	168
R-squared	0.214	0.431	0.348	0.515	0.179	0.394	0.318	0.511
Cluster	bank	bank	bank	bank	bank	bank	bank	bank



**Table VI The 4-trillion stimulus plan and banks' WMP issuance**

This table reports whether the estimated loan increase due to the stimulus plan during 2009-2010 can predict later WMP balance. We first estimate the linear trend of loan balances for each bank using quarterly observations from 2006 Q4 to 2008 Q4 and use the difference between the actual loan balances and the predicted loan balances in 2010 Q4 as the estimated loan increase during the stimulus plan. Robust t-statistics in parentheses. \*\*\* p<0.01, \*\* p<0.05, \* p<0.1.

Year t	2010	2011	2012	2013	2014
yield type	floating	floating	floating	floating	floating
Dep Var: (WMP Balance in year t)/(Loan Balance in 2008)	(1)	(2)	(3)	(4)	(5)
Estimated loan increase/Loan balance in 2008	0.0237 (0.354)	-0.000119 (-0.00240)	1.227*** (5.547)	1.364*** (5.174)	2.093*** (3.068)
Constant	0.0463 (1.637)	0.0865*** (3.287)	-0.116 (-1.022)	-0.0959 (-0.744)	-0.0997 (-0.383)
Observations	25	25	25	25	25
R-squared	0.006	0.000	0.448	0.485	0.391

Year t	2010	2011	2012	2013	2014
yield type	guarantee	guarantee	guarantee	guarantee	guarantee
Dep Var: (WMP Balance in year t)/(Loan Balance in 2008)	(1)	(2)	(3)	(4)	(5)
Estimated loan increase/Loan balance in 2008	-0.00646 (-0.708)	0.00559 (0.149)	0.252 (1.233)	0.398 (1.166)	0.202 (0.558)
Constant	0.0149** (2.322)	0.0316* (1.950)	0.0230 (0.280)	0.0227 (0.173)	0.234 (1.570)
Observations	25	25	25	25	25
R-squared	0.004	0.001	0.161	0.150	0.029

**Table VII Rollover risk and WMP expected yield**

The sample includes all WMPs issued by the 25 banks from 2008 to 2014. “Floating” refers to principal-floating WMPs and “Guarantee” refers to principal-guaranteed WMPs. For regressions on principal-floating (guaranteed) WMPs, *WMPdue* is total amount of principal-floating (guaranteed) WMPs due in this quarter over bank equity at the end of last quarter. All regressions are clustered by quarter. Robust *t*-statistics are shown in parentheses. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Bank type Yield type Dep Var: WMPReturn_d	Big 4		SMBs	
	Floating (1)	Guarantee (2)	Floating (3)	Guarantee (4)
Shibor_d	0.629*** (13.64)	0.676*** (12.42)	0.621*** (13.8)	0.630*** (14.66)
WMPdue	0.18 (1.275)	0.07 (0.806)	0.132*** (4.37)	0.225*** (4.784)
Bank fixed effect	✓	✓	✓	✓
Quarter fixed effect	×	×	×	×
Constant	0.960*** (5.964)	0.618*** (3.879)	1.319*** (15.7)	0.04 (0.358)
Observations	29,589	14,073	64,322	23,839
R-squared	0.660	0.717	0.671	0.659
Cluster	Quarter	Quarter	Quarter	Quarter

**Table VIII Rollover Risk and Shibor Quoted Rate**

The sample includes quarterly observations for banks participating in the Shibor ask and bid process from 2008Q1 to 2014Q4. See the appendix for definitions of variables. Both Capital Ratio and *LDR* take values at the end of last quarter while *WMPdue* take value in the current period. We standardize *WMPdue* by dividing it over its standard deviation. Because there are only 14 banks in the sample, we clustered the regression by quarter. Panel A reports regression results on all the 14 banks while Panel B separates Big 4 and SMBs. Robust *t*-statistics are shown in parentheses. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Panel A: Effect of *WMPdue* on Shibor quoted rate by banks

Bank	Big 4						SMBs					
Term	o/n	1-w	2-w	1-m	3-m	6-m	o/n	1-w	2-w	1-m	3-m	6-m
Dep Var: Ask Rate	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
<i>WMPdue</i>	0.448*** (2.939)	0.452*** (2.904)	0.459*** (2.963)	0.483*** (2.958)	0.402** (2.543)	0.372** (2.635)	0.0755** (2.759)	0.0724*** (2.821)	0.0736*** (3.044)	0.0760*** (2.839)	0.0864*** (2.995)	0.102*** (3.550)
<i>WMPdue_SMB</i>	0.371** (2.300)	0.391** (2.567)	0.388** (2.669)	0.359** (2.490)	0.367** (2.704)	0.401*** (3.293)	0.587*** (4.151)	0.610*** (4.464)	0.620*** (4.765)	0.612*** (4.883)	0.538*** (4.319)	0.520*** (4.175)
Capital Ratio	-3.221** (-2.060)	-3.694** (-2.278)	-3.432** (-2.138)	-2.913* (-1.923)	-4.747*** (-3.039)	-5.361*** (-3.487)	-1.786 (-0.938)	-1.888 (-0.998)	-1.861 (-1.035)	-1.725 (-0.962)	-1.366 (-0.798)	-0.638 (-0.379)
<i>LDR</i>	-0.501 (-0.556)	-0.308 (-0.329)	-0.147 (-0.159)	-0.285 (-0.313)	0.117 (0.115)	0.0474 (0.0459)	-1.597** (-2.247)	-1.539* (-2.049)	-1.486* (-2.006)	-1.172 (-1.491)	-1.521* (-1.901)	-1.626** (-2.151)
Bank fixed effect	×	×	×	×	×	×	×	×	×	×	×	×
Quarter fixed effect	×	×	×	×	×	×	×	×	×	×	×	×
Constant	2.488*** (4.937)	2.457*** (4.650)	2.209*** (4.270)	2.114*** (4.056)	2.307*** (4.292)	2.687*** (5.051)	3.472*** (5.362)	3.477*** (5.158)	3.300*** (4.914)	2.964*** (4.242)	3.408*** (4.962)	3.656*** (5.561)
Observations	112	112	112	112	112	112	271	271	271	271	271	271
R-squared	0.513	0.543	0.556	0.555	0.448	0.445	0.428	0.454	0.468	0.455	0.377	0.373
Cluster	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter

Panel B: Effect of WMPdue of Big4 and SMBs on bank's Shibor quoted rate

Bank	Big 4						SMBs					
Term	o/n	1-w	2-w	1-m	3-m	6-m	o/n	1-w	2-w	1-m	3-m	6-m
Dep Var: Ask Rate	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
WMPdue	-0.0270 (-1.155)	-0.0127 (-0.475)	-0.0138 (-0.496)	-0.0195 (-0.693)	-0.0527 (-1.488)	-0.0263 (-0.625)	0.0330* (1.968)	0.0301* (1.923)	0.0304** (2.096)	0.0297* (1.838)	0.0492** (2.313)	0.0689*** (3.090)
WMPdue_BIG4	0.805*** (3.971)	0.787*** (3.866)	0.800*** (3.970)	0.851*** (4.115)	0.771*** (3.434)	0.675*** (3.050)	0.728*** (3.696)	0.725*** (3.610)	0.740*** (3.706)	0.794*** (3.857)	0.638*** (2.794)	0.569** (2.489)
WMPdue_SMB	0.0271 (0.143)	0.0544 (0.318)	0.0460 (0.278)	-0.00455 (-0.0271)	0.0379 (0.234)	0.113 (0.764)	0.0121 (0.0638)	0.0379 (0.220)	0.0357 (0.214)	-0.0154 (-0.0903)	0.0346 (0.213)	0.0704 (0.452)
Capital Ratio	-4.073*** (-2.834)	-4.526*** (-2.959)	-4.278*** (-2.903)	-3.814*** (-2.866)	-5.562*** (-3.486)	-6.075*** (-3.737)	-0.869 (-0.646)	-0.974 (-0.752)	-0.930 (-0.741)	-0.725 (-0.589)	-0.563 (-0.410)	0.0788 (0.0540)
LDR	1.134* (1.805)	1.290* (1.915)	1.479** (2.256)	1.445** (2.390)	1.683** (2.304)	1.419* (1.808)	-1.345*** (-3.057)	-1.288** (-2.633)	-1.230** (-2.382)	-0.898 (-1.657)	-1.301* (-1.799)	-1.430* (-1.920)
Bank fixed effect	×	×	×	×	×	×	×	×	×	×	×	×
Quarter fixed effect	×	×	×	×	×	×	×	×	×	×	×	×
Constant	1.335*** (3.543)	1.331*** (3.310)	1.063*** (2.788)	0.895** (2.578)	1.203*** (2.966)	1.720*** (3.833)	2.721*** (5.450)	2.730*** (4.937)	2.537*** (4.417)	2.145*** (3.758)	2.751*** (3.566)	3.070*** (3.707)
Observations	112	112	112	112	112	112	271	271	271	271	271	271
R-squared	0.610	0.636	0.653	0.664	0.537	0.513	0.591	0.616	0.636	0.649	0.502	0.473
Cluster	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter

**Table IX Rollover Risk and Stock Market Response**

The sample includes daily stock return observations from 2009 to 2014. We choose those days when the change of one-week and overnight Shibor are both higher than a specified threshold  $c$ . For these days we regress individual stock return on  $WMP_{due}$  in that month. The first row uses raw report, and the second row uses stock return minus market return. In the third row we apply a linear projection of raw daily return on market return for the past 60 days and use the estimated residual today as dependent variable. In the fourth row we estimate CAPM using observations for the past 60 trading days and use the estimated residual today as dependent variable. Robust  $t$ -statistics in parentheses. \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Threshold	c=1%	c=0.8%	c=0.6%	c=0.4%
Raw	-0.950*** (-3.806)	-0.754*** (-4.204)	-0.683*** (-5.285)	-0.0690 (-0.755)
deduct market	-0.296** (-1.986)	-0.201* (-1.790)	-0.264*** (-2.746)	-0.0345 (-0.478)
Projection	-0.246** (-2.043)	-0.157* (-1.653)	-0.281*** (-3.309)	-0.0801 (-1.122)
CAPM	-0.246** (-2.039)	-0.157 (-1.650)	-0.281*** (-3.306)	-0.0800 (-1.120)
Obs	159	253	397	765

### Figure 1 WMP Issuance across Time

Figure 1.1 reports average (WMP balance/bank asset) and (deposit/bank asset) over time for big 4 banks and SMBs, respectively. Figure 1.2 divides WMP according to their yield type and reports (WMP balance/bank asset) over time for big 4 banks and SMBs, respectively.

Figure 1.1: (WMP Balance/Bank asset) across time

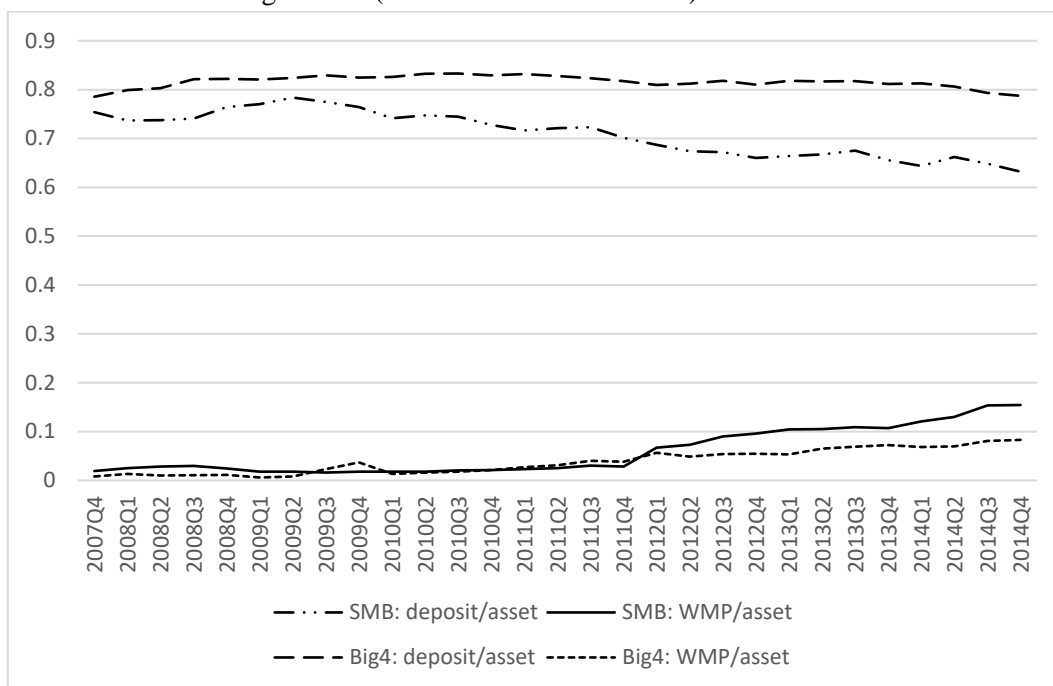
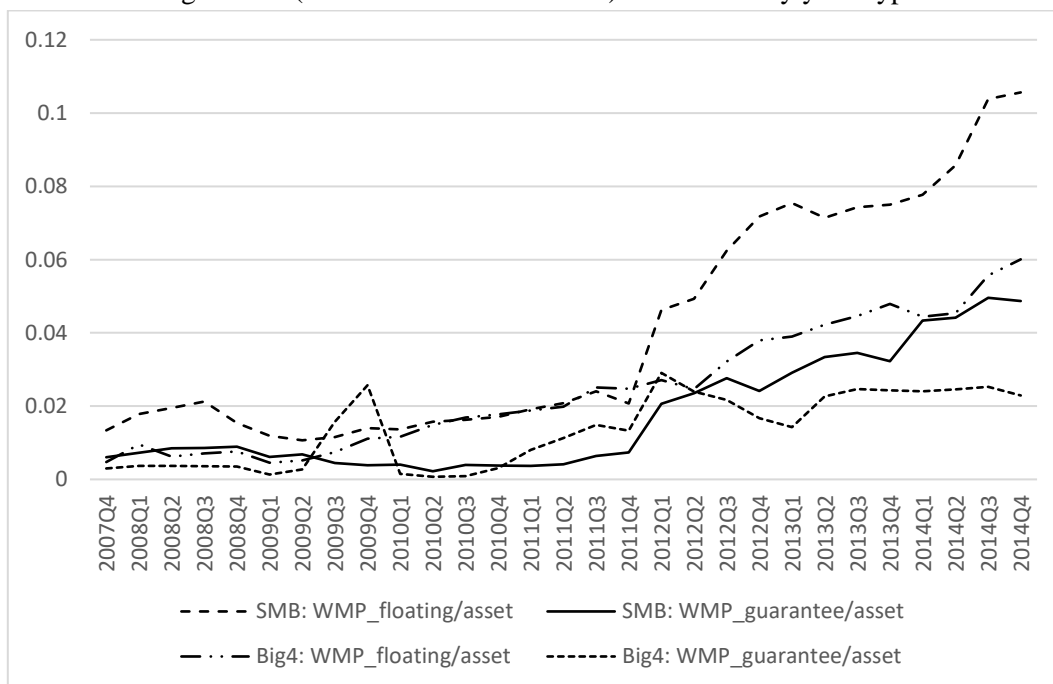
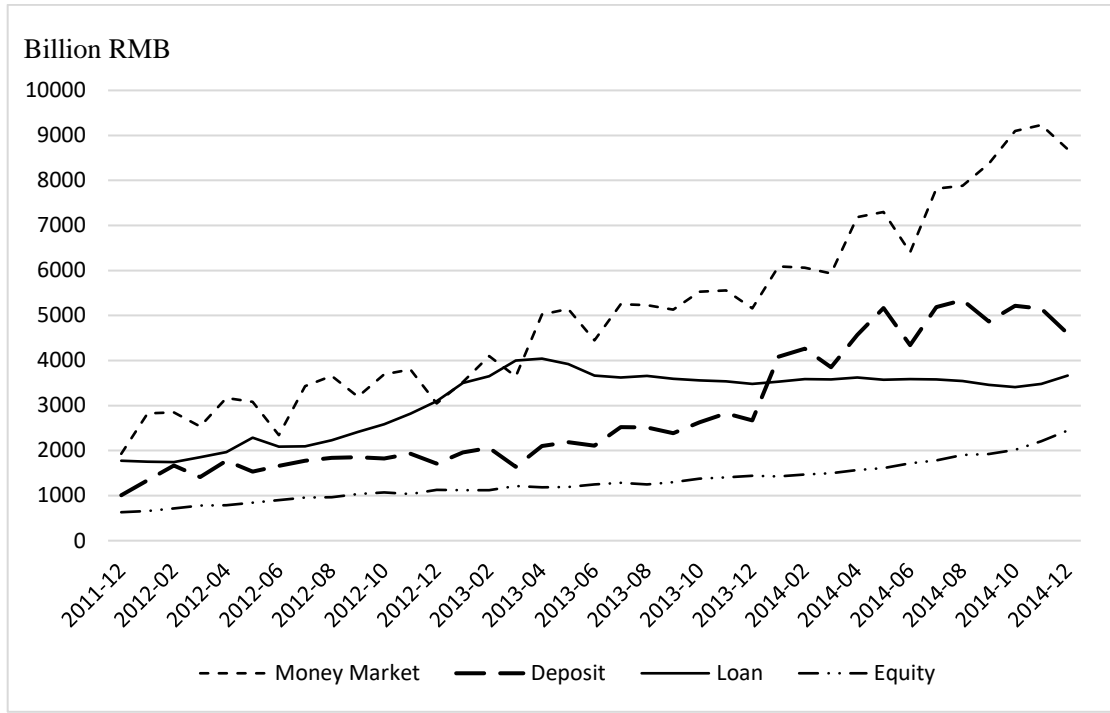


Figure 1.2: (WMP Balance/Bank asset) across time by yield type



**Figure 2 WMP Balances by Investment Targets**

Money raised by WMPs can be channeled to 4 main investment targets: market money, bank deposits, loan assets and equity assets. This graph shows the average WMP balances for each targets at the end of each month from Dec, 2011 to Dec, 2014.



### Figure 3 Interest Rate Change across Time

Figure 3.1 divides WMPs into four categories: whether it's issued by big4 banks and whether it's principal-guaranteed or principal-floating and reports change of WMP expected annualized yield across sample period. Figure 3.2 reports the 3-month Shibor rate and 3-month deposit rate ceiling across sample period.

Figure 3.1: WMP expected annualized yield across time

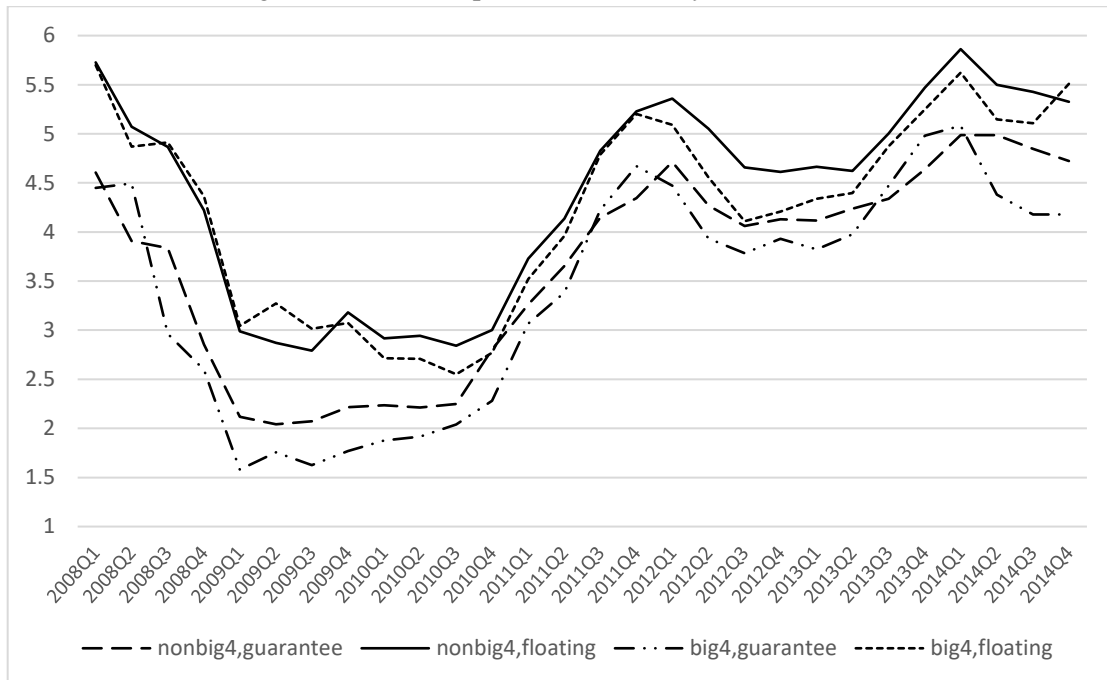
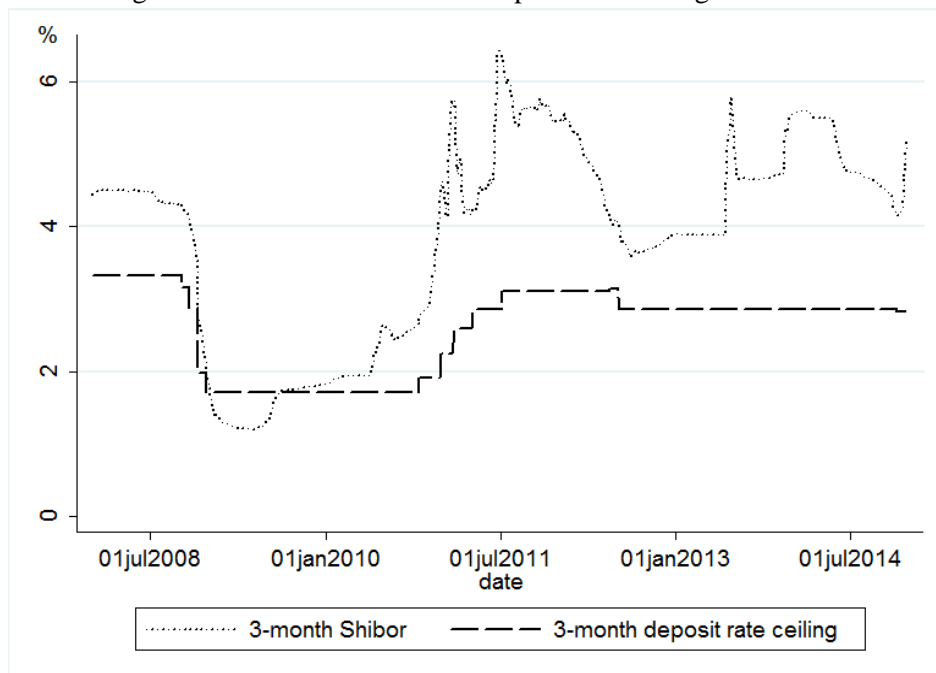


Figure 3.2: 3-month Shibor and deposit rate ceiling across time





## Figure 4 Banks during the 4-trillion stimulus plan

Figure 4.1: Total loan balance of all national banks

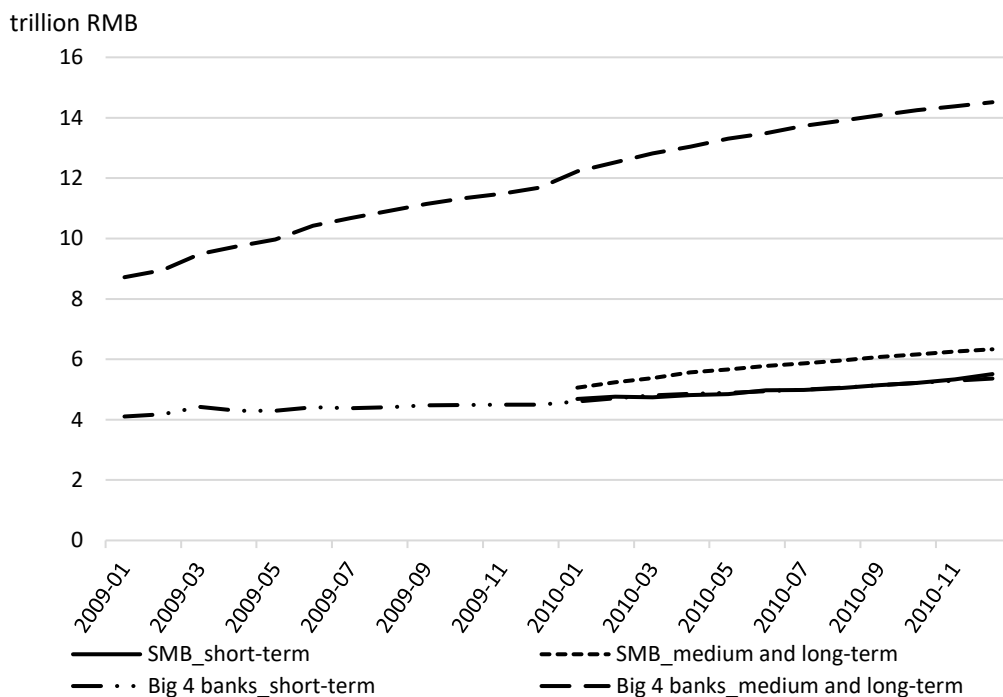


Figure 4.2: Total loan balance of big 4 banks

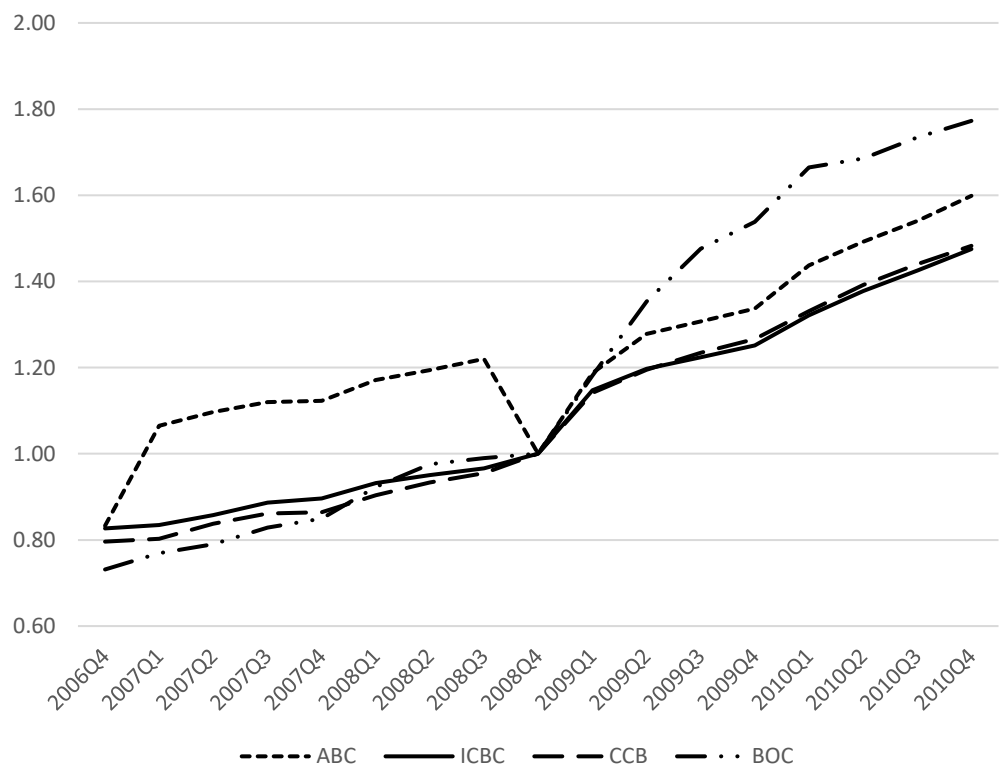


Figure 4.3: LDR of big 4 banks

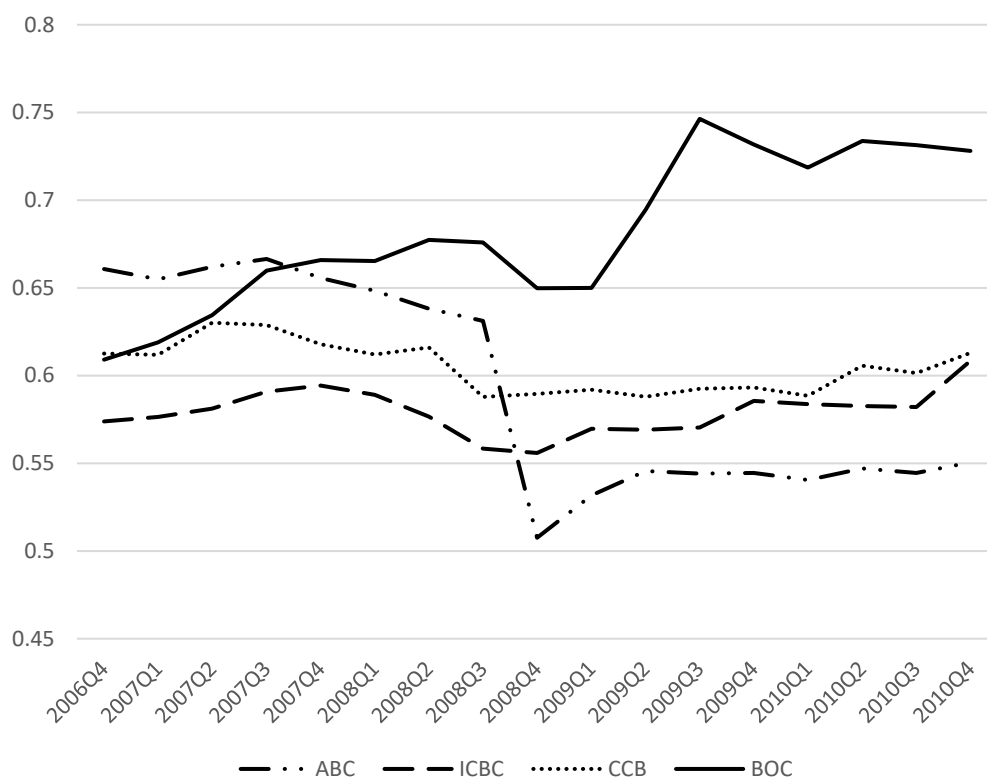
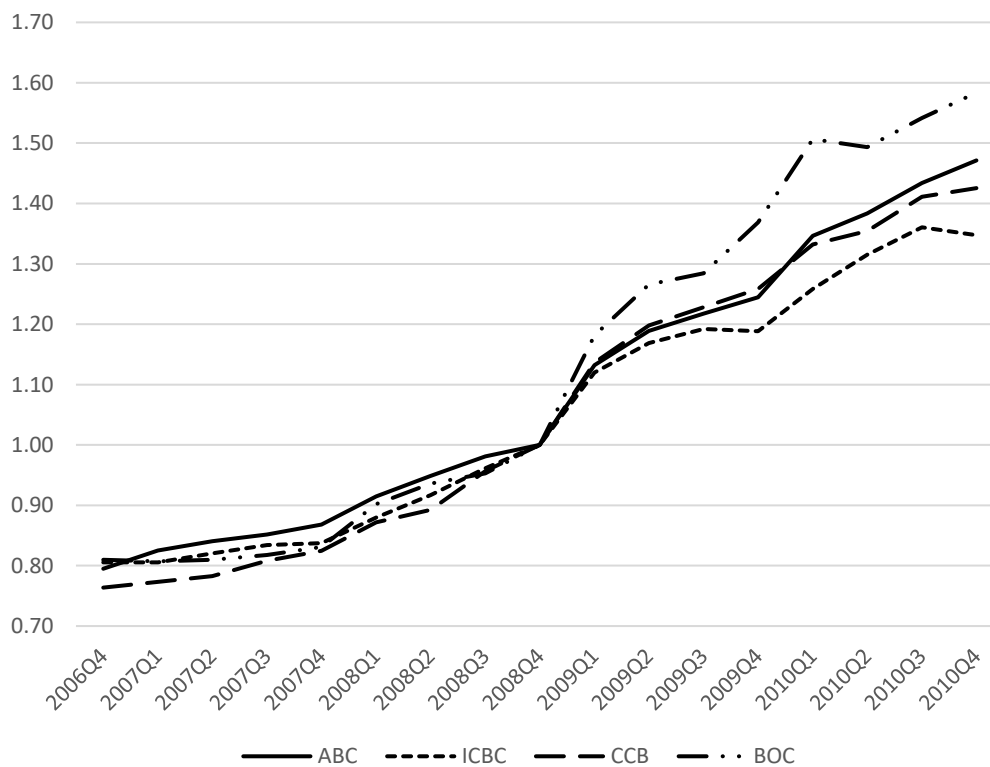


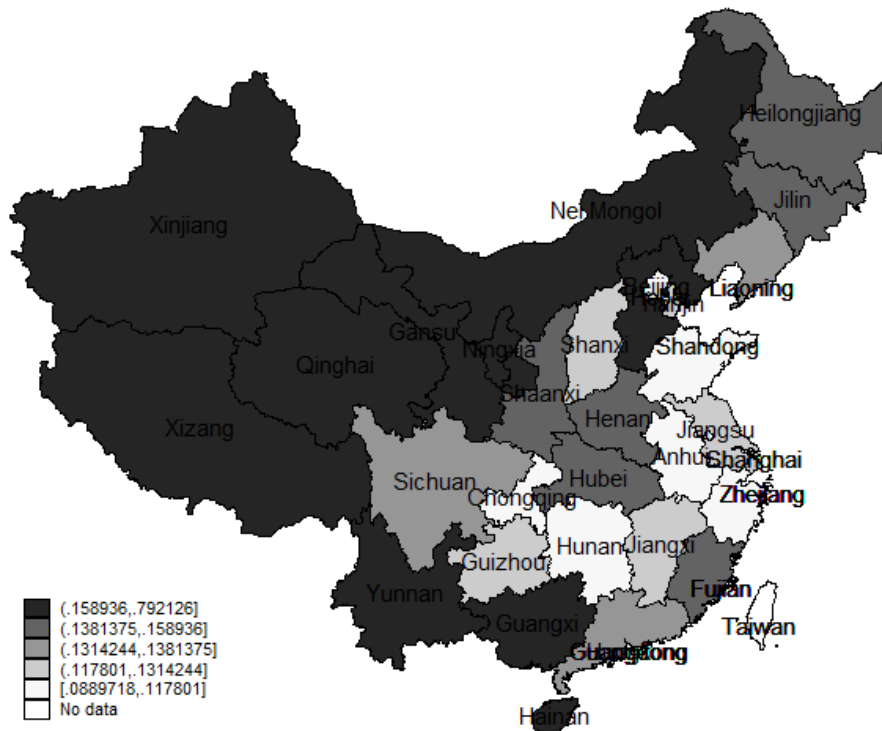
Figure 4.4: Total deposit balance of big 4 banks



**Figure 5 Province-level market share of the big 4 banks**

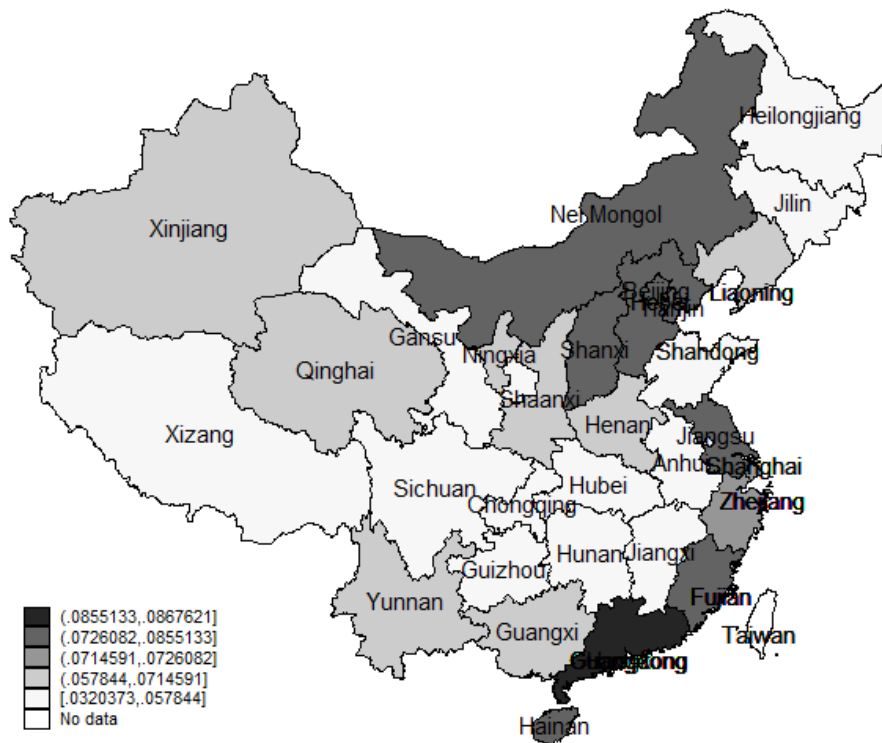
**Province-level Market Share of ABC**

As on 2012/12/31

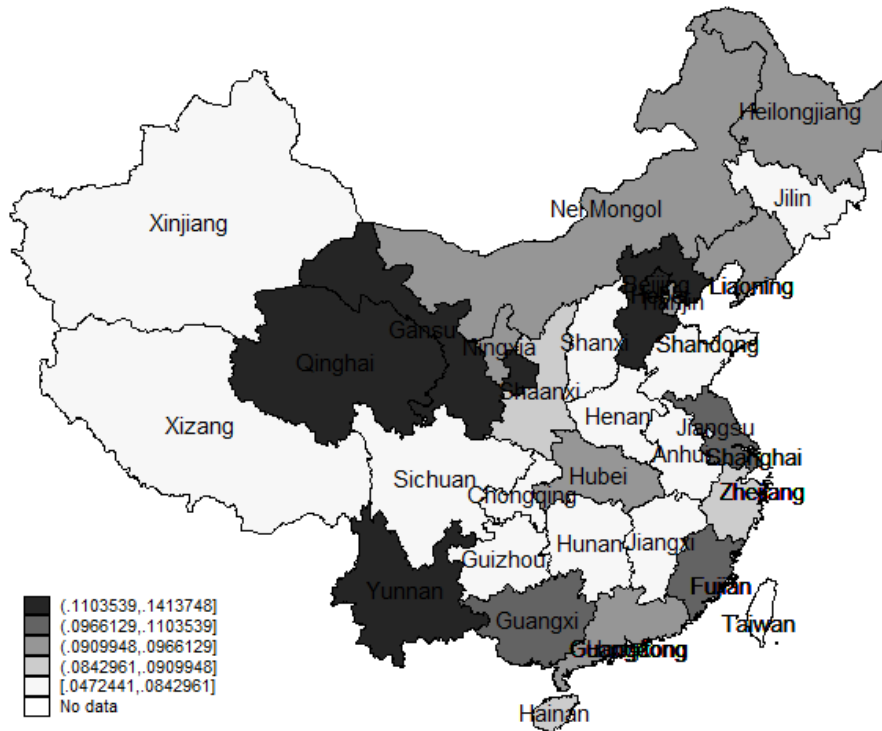


**Province-level Market Share of BOC**

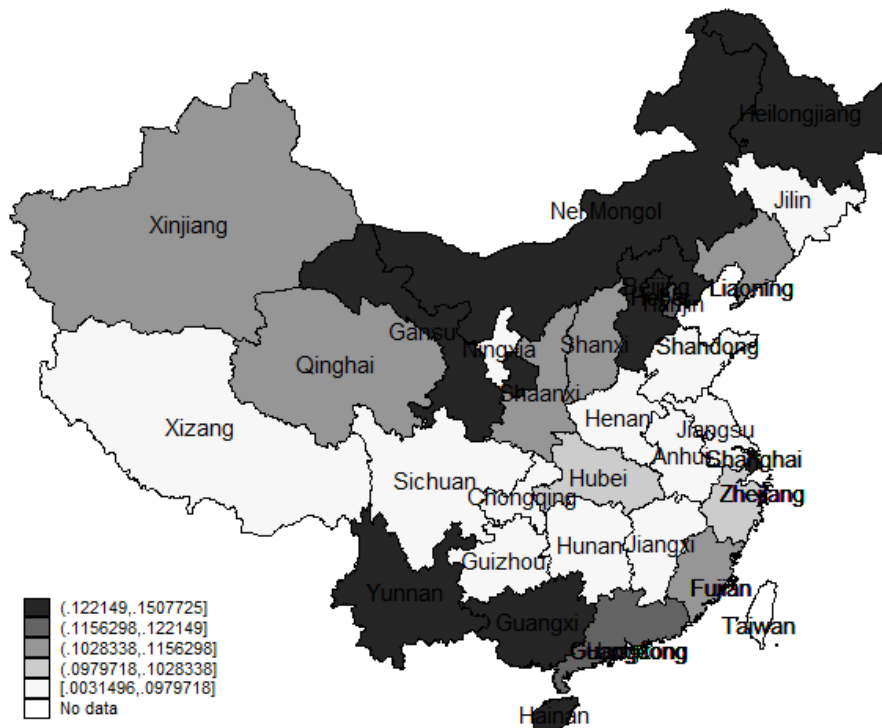
As on 2012/12/31



## Province-level Market Share of CCB As on 2012/12/31



## Province-level Market Share of ICBC As on 2012/12/31



## Figure 6 Change of big 4's market shares and competition over time

Figure 6.1: Market share of the big 4 banks over time

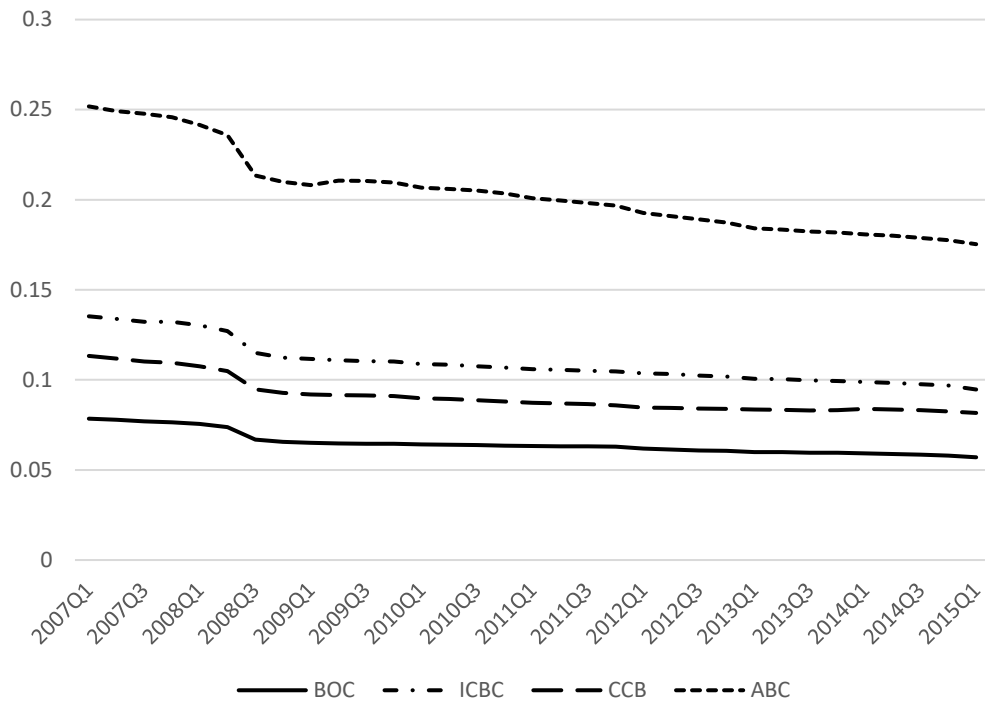
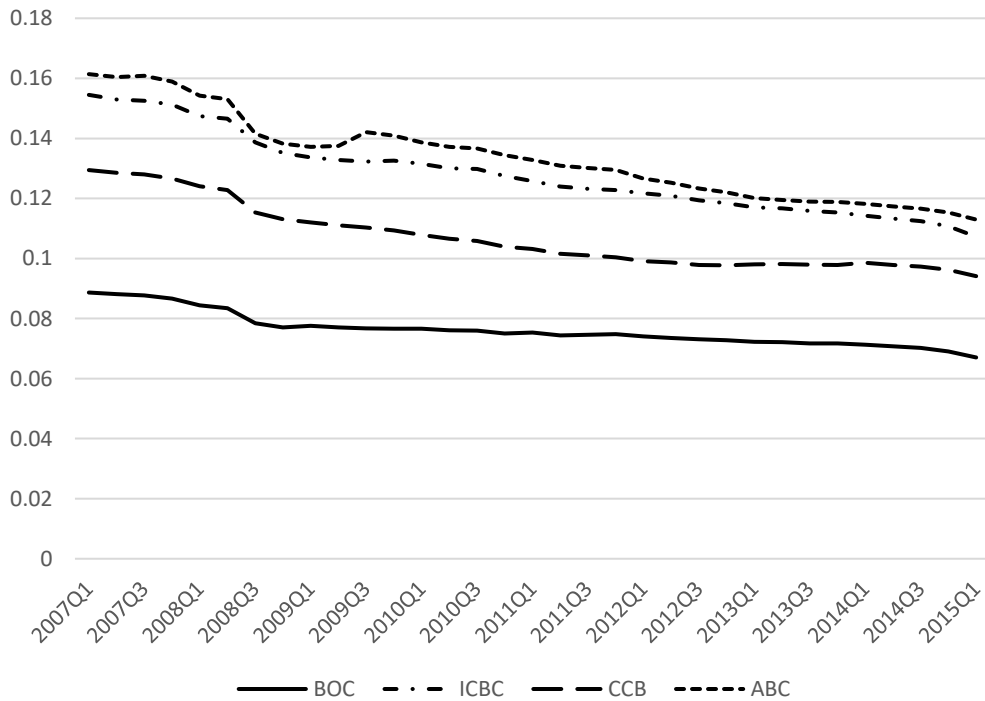


Figure 6.2: Average exposure to big 4 competition over time



### Figure 7 Banks during the 4-trillion stimulus plan

Figure 7.1: Change of percentage of medium- and long-term bank loans

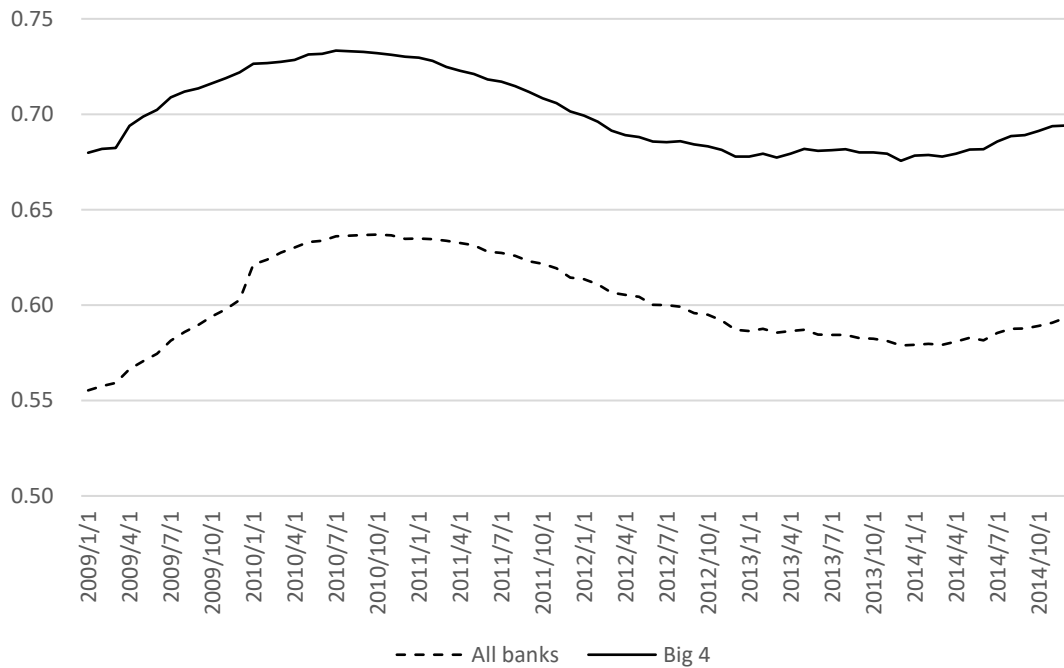
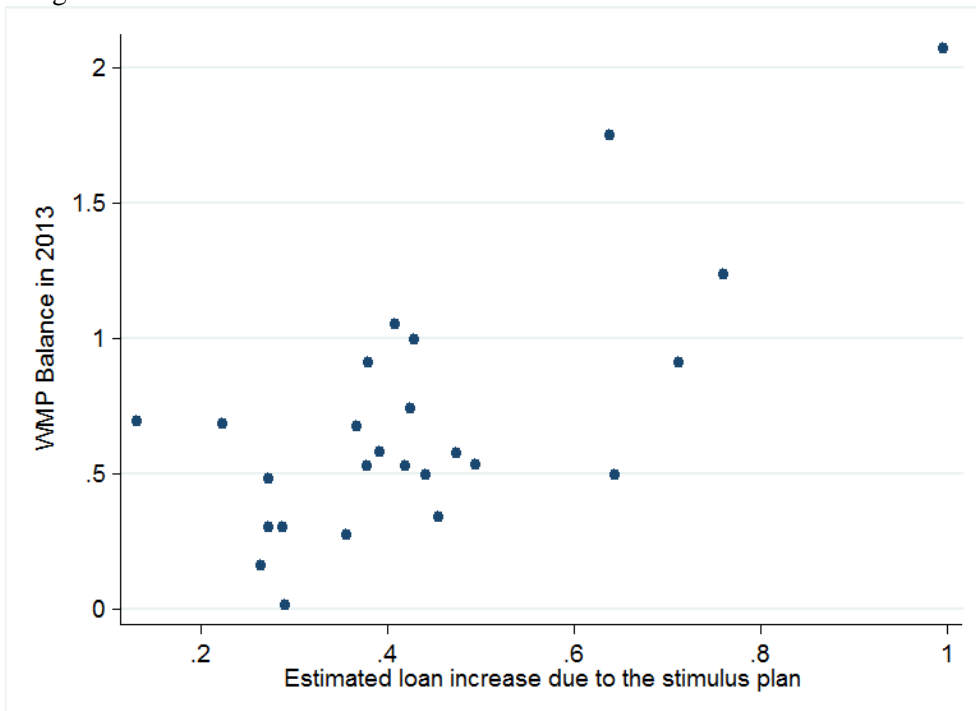


Figure 7.2: Relation between WMP balance in 2013 and estimated loan increase



## Figure 8 WMP Maturity Date Timing

All the individual WMP information is collected from WIND. We label the last day of each quarter as the 90<sup>th</sup> day and then label other days backwards. Figure 8.1 and 8.2 shows the total number of WMPs issued by big 4 band non-big 4 banks, respectively. Figure 8.3 and 8.4 shows the total number of principal-floating and principal-guaranteed WMPs matured on each day of a quarter, respectively.

Figure 8.1: Number of WMPs issued by big 4 banks due on each day within a quarter

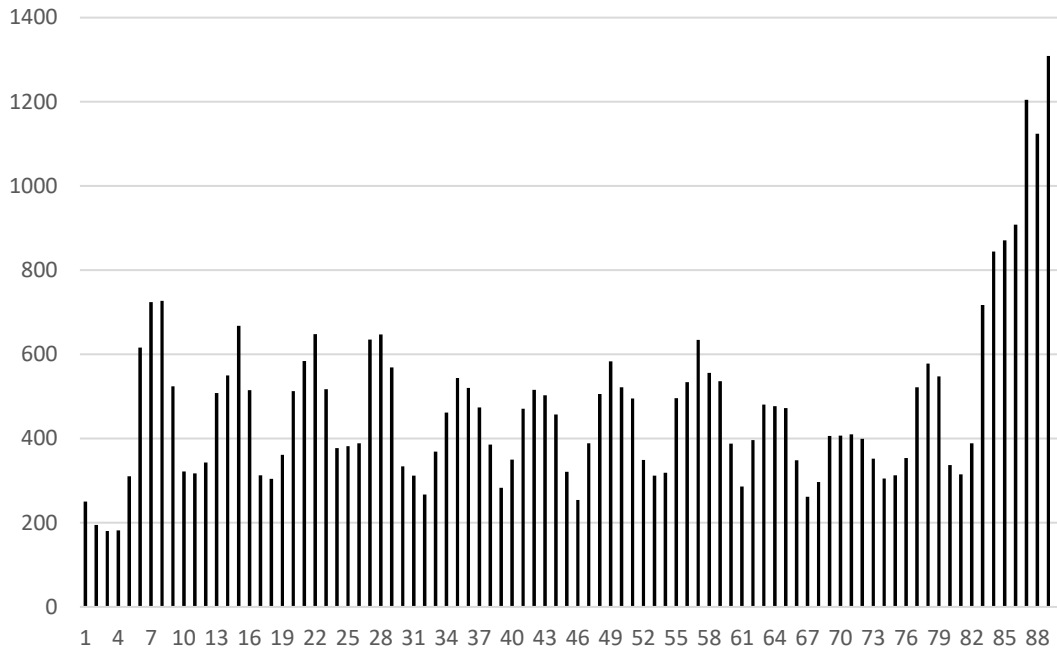


Figure 8.2: Number of WMPs issued by SMBs due on each day within a quarter

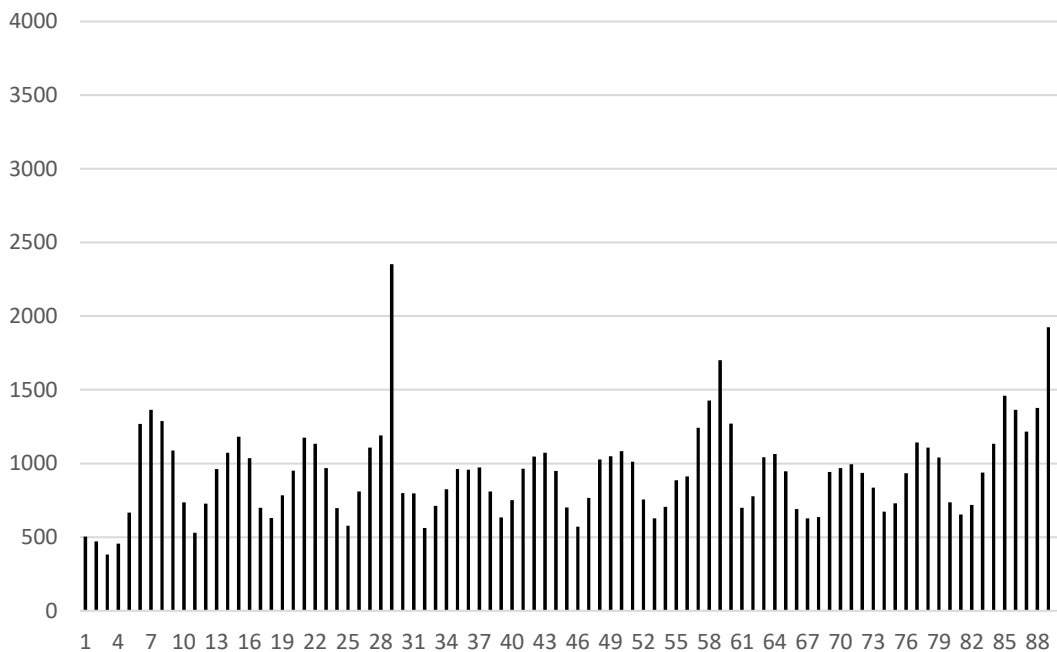


Figure 8.3: Number of principal-floating WMPs due on each day within a quarter

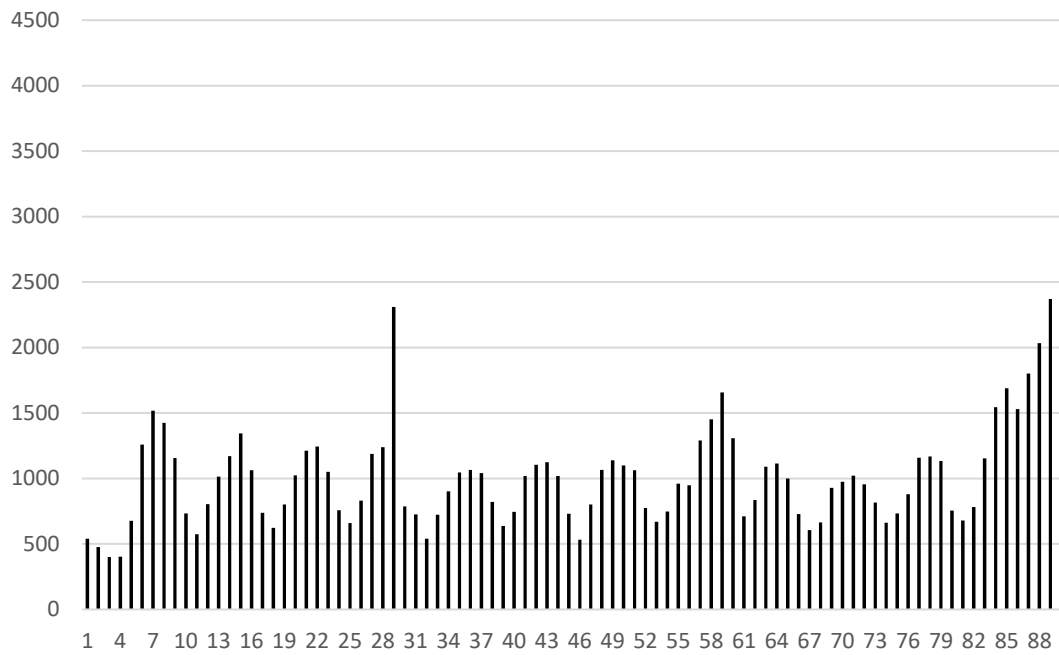
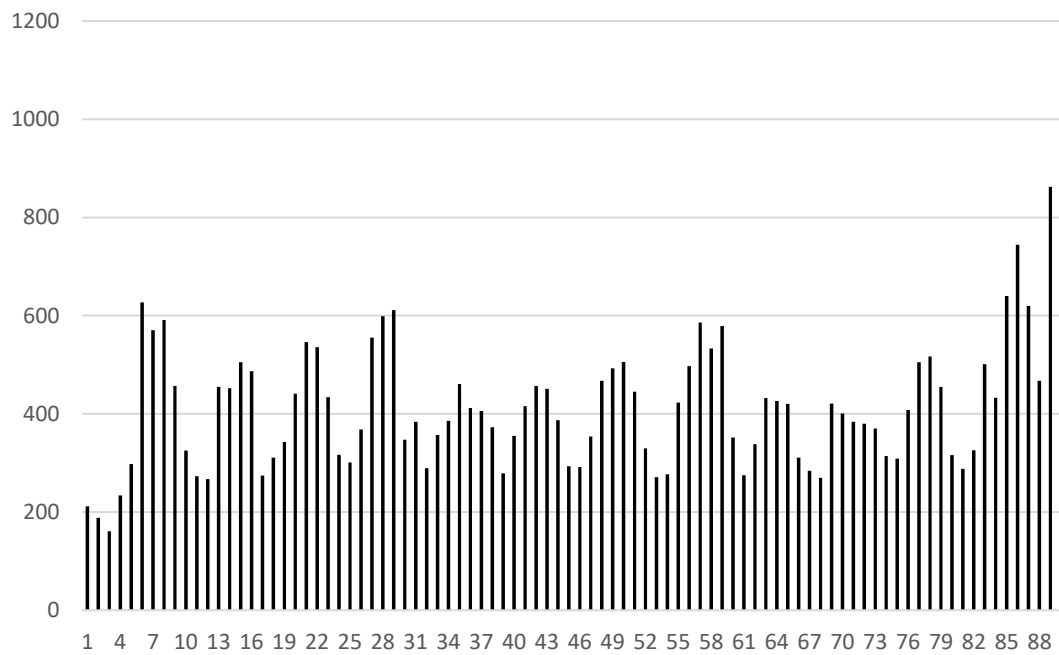


Figure 8.4: Number of principal-guaranteed WMPs due on each day within a quarter





### Figure 9 Aggregate *WMPdue* and 1-week Shibor

The figure shows the relation between aggregate *WMPdue* and Shibor. For each month, we calculate the aggregate *WMPdue* of Big4 and SMBs and divide it by M2 at the end of the month. We also calculate the average daily 1-week Shibor within each month.

Figure 9.1 Aggregate *WMPdue* of Big 4 and 1-week Shibor

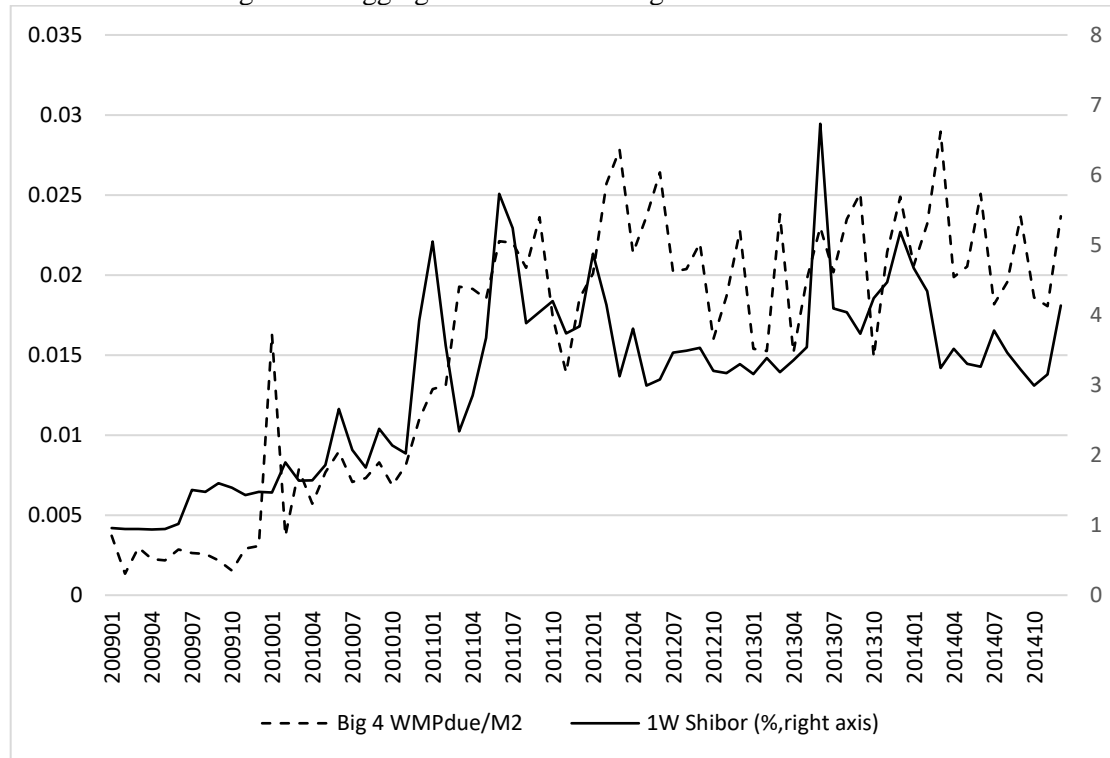
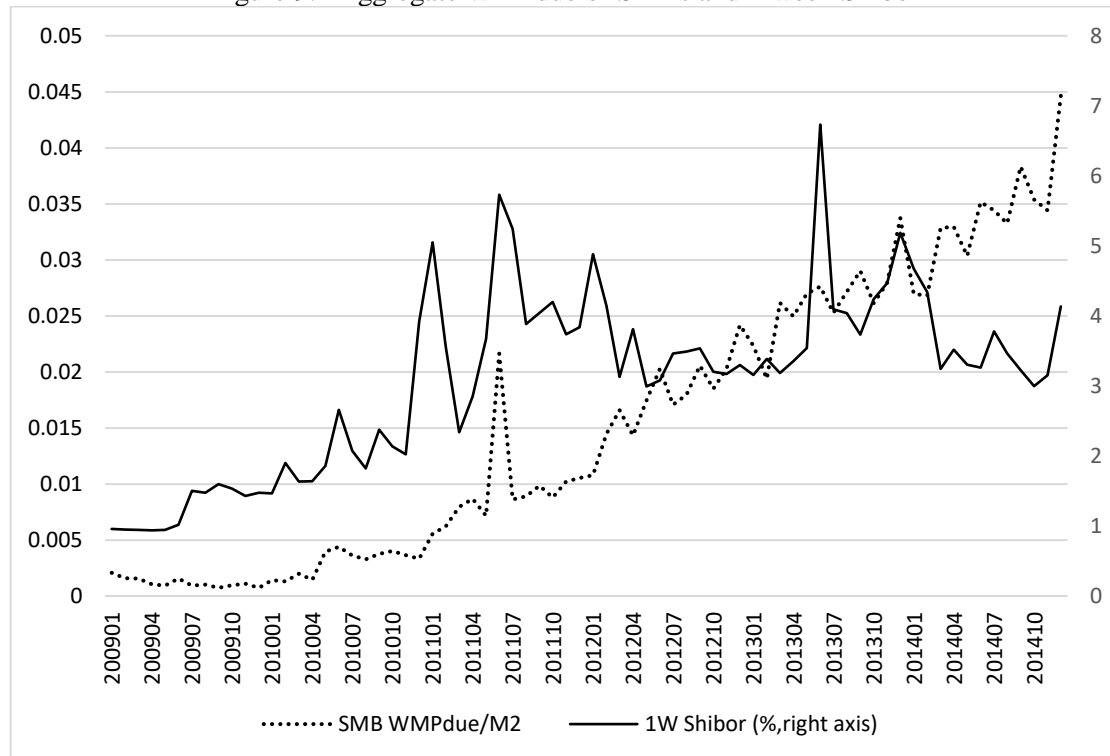
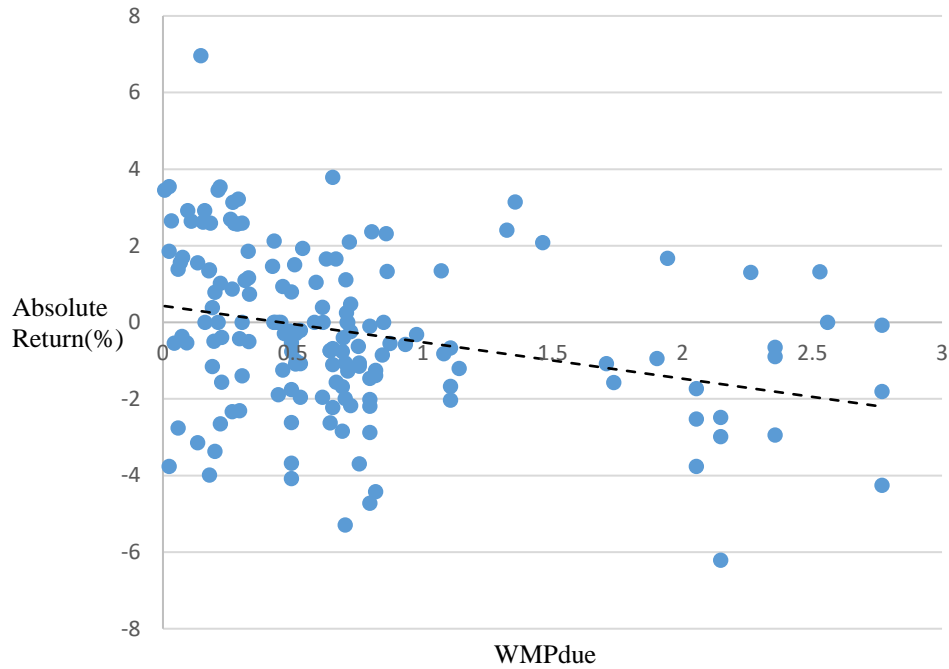


Figure 9.2 Aggregate *WMPdue* of SMBs and 1-week Shibor



**Figure 10 Rollover Risk and Stock Market Response**

This figure shows the stock return vs. *WMPdue* on those days when both overnight and 1-week Shibor increase by more than 1% compared to yesterday. Stock returns are calculated as (today's closing price / yesterday's closing price) - 1. The explanatory variable *WMPdue* is total WMP due in that month over bank equity at the end of last month.



Appendix A: Variable Definition

Variable	Definition
Issuance/Equity	The total amount of WMP issued in this quarter divided by bank equity at the end of last quarter.
Capital Ratio	Commercial bank's Capital Adequacy Ratio, calculated according to "Commercial Bank Capital Adequacy Ratio Management Method" modified by China Banking Regulatory Commission on Dec 28th, 2006. Starting from Jan 1st, 2013, new requirement for Capital Ratio was carried out, but for consistency we stick to the old method. Some banks had extreme Capital Ratios in the early stage of the sample period so we winsorize it at 1%.
LDR	Loan-to-deposit Ratio, calculated as bank's loan balance over deposit balance. Values of loan balance and deposit balance are adjusted according to the risk to different deposits and loan assets.
Spread	Difference between market rate and regulatory rate, calculated using 3-month Shibor minus 3-month bank deposit rate ceiling and take average across days within the same quarter.
Size	logarithm of total bank asset at the end of last quarter.
WMPReturn_d	WMP initial expected annualized yield minus bank deposit rate ceiling with the same maturity on the issuing date.
Shibor_d	Shibor of the same maturity as the WMP minus bank deposit rate ceiling with the same maturity on the issuing date.
WMPdue	Total amount of WMP due in this quarter (month in Table 8) over bank's equity at the end of last quarter.
Ask Rate	The average of bank's Shibor Ask rate within the same quarter. Big 4 banks all participate in the Shibor bid and ask process but only 9 or 10 small and medium-size banks do. Winsorized at both sides by 1%.
BOC	Exposure of an individual bank to the competition from BOC, measured by the weighted average of city-level market share of BOC using the bank's number of branches in that city as weight. Similar for ABC, CCB, ICBC and SMB.