

Research on the Influence of Shadow Banking Development on Financial Risk

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Abstract: The shadow banking sector is an important part of financial markets and has grown in size in recent years as financial markets have developed. This paper examines the impact of the shift of bank lending to this sector and how it affects the financial system. Taking China as an example, the paper focuses on the main problems it faces, the financial risks it poses, the consequences, and the direction and scope of regulation. In order to ensure the stable development of financial markets and to reduce and control risks, theoretical support and useful guidance are essential. This study attempts to explore the impact of the shift of bank lending to the shadow banking sector, which suggests that it may make the financial system more fragile, raise systemic risk, and make financial markets more volatile. This will pose new challenges for regulatory policy, and regulators will have to take action to mitigate the risks. This paper examines the shift of bank lending to this sector and its impact on financial risk. The paper further examines the main issues arising from the growth of shadow banking in China, aiming to determine the direction and concentration of regulation to ensure financial market stability. To this end, the results of the study demonstrate that the transfer of bank loans to shadow banking could heighten market volatility, increase systemic risk, and thus necessitate regulators to take measures to reduce risks, thus introducing fresh challenges to regulatory policies.

Keywords: Bank loans, Shadow banking, Financial risks, Risk prevention, Financial stability.

1. Introduction

Non-traditional financial organizations, through credit creation activities, attain credit, maturity, and risk transformation functions akin to those of commercial banks - essentially. The "shadow banking sector" is sometimes referred to as the financing of a certain type of loans. The transition of banking loans to the shadow banking sector could have a considerable effect on the steadiness and hazard profile of financial markets, due to the remarkable disparities between the shadow banking sectors. Studying this topic is crucial for developing better financial risk prevention and control strategies as well as for gaining a thorough grasp of how financial markets function.

2. Literature review

The shadow banking sector usually refers to the process by which non-traditional financial institutions realize credit, maturity and risk transformation functions similar to those of commercial banks

through credit creation functions, which, in essence, is the financing of a class of loans. The shadow banking sector and traditional commercial banks differ significantly in terms of funding sources, business models, and risk characteristics. The transition of bank loans to the shadow banking sector could have a significant effect on the steadiness and hazard profile of financial markets. This issue's examination is of utmost importance for gaining a thorough comprehension of the functioning of financial markets and for augmenting the prevention and regulation of financial risks. Literature review

The ongoing growth of shadow banking has resulted in significant modifications to the structure and operation of the global financial system, as well as closer ties between the financial systems of other nations. Shadow banking is now widely acknowledged as a significant element influencing financial stability[1-4].Beginning at the end of 2007, the subprime mortgage crisis—which was sparked by the US shadow banking system—and the global financial market's linkage effect helped it to gradually spread and become a global financial crisis, from which many nations have still not fully recovered. The European debt crisis of 2009–2010, which affected Greece, Ireland, Spain, and other nations, saw shadow banks once again abuse credit derivatives to upset the financial system's equilibrium. The three major rating agencies, in succession, downgraded the sovereign credit ratings of those nations, thus leading to the "butterfly effect" of the European debt crisis being disseminated globally. Panic has also been brought on by the "butterfly effect" of the European debt crisis on a worldwide scale. China's shadow banking is likewise concealing a massive problem behind its rapid development because there are no standard institutional limits in place. The Wenzhou private loan scandal has caused a worldwide surge in private financial risks, and this is further evidenced by the continual growth of shadow banking, resulting in drastic modifications to the global financial system and structure. From 2007's close, the financial systems of nations have become increasingly intertwined and shadow banking has been widely acknowledged as a significant factor in maintaining financial stability[1-4].Shadow banking's contribution to the subprime mortgage crisis was immense. The European debt crisis of 2009-2010, with Greece, Ireland, Spain, and other nations included, was a reminder of the use of credit derivatives by shadow banks to destabilize the financial system. Three major rating agencies were also involved. The European debt crisis propagated a "butterfly effect" of downgrading the sovereign credit ratings of countries globally, which was brought about by one after another. This "butterfly effect" caused by the European debt crisis has also triggered panic on a global scale. Due to the lack of standardized institutional constraints, China's shadow banking is also hiding a huge crisis behind its rapid development, which is highlighted by the increase in private financial risks around the world following the outbreak of the Wenzhou private lending crisis in 2011.Xiao Gang, the Bank of China's representative, has cautioned that the interconnection of China's financial system, resulting in shadow banking, poses a grave threat to the nation's economic stability. It is anticipated that within five years, this crisis will be dire. The most hazardous danger to China's financial sector will be a Chinese-style shadow banking system.

Scholars at home and abroad have conducted a great deal of research on shadow banking risks and crises. According to Reinhart and Rogoff, the high leverage of the shadow banking system amplifies credit risk, and its high dependence on liquidity is prone to systemic risk, which leads to the vulnerability of the financial system [5]. David Longworth studied the potential risks in the shadow banking system and concluded that the lack of financial regulation and information opacity are important causes of financial instability in the shadow banking system [6]. Investigating the bond between shadow banking and financial steadiness, Elias Bengtsson utilized European money market funds as an illustration. The regulation of shadow banking should be bolstered, as money market funds have a more pronounced effect on financial stability [7]. Brunnermeier et al. argue that shadow banking as a financial credit intermediary leads to market failure in two ways: one is that the failure of any financial intermediary will cause heavy damage to future credit; the other is that any crisis in

a shadow banking institution will lead to a credit contraction, which in turn will have a negative impact on output and employment [8].

The development of shadow banking in China is still in the early stage, and the research on shadow banking risk and financial stability is still in the exploratory stage, and the related studies mainly include: He Dexu and Zheng Liansheng believe that due to the characteristics of shadow banking, such as leveraged operation, excessive financial innovation, and evasion of financial regulation, The systemic risk of the financial system is augmented by shadow banking, thus posing a grave danger to it [9]. Tan Hongtao and Cai Chun are of the opinion that shadow banking poses a grave danger to the economic stability of China, and that it is not the only one; this is their conviction. The emergence of financial crisis has been greatly impacted by the emergence of shadow banking, a major source of systemic risk. [10] Gong Yuexin and Liu Lanbiao delved into the issues of China's shadow[11].

Though it is widely accepted that the shadow banking system is a source of contagion in the global financial crisis [12], China stands out. Research into the financial market's risk and stability remains limited to the traditional banking risk level, with scant exploration of the correlation between shadow banking and financial stability, as well as risk prevention. A comparison between the growth of shadow banking in China and the United States is the basis of this paper, which investigates the connection between financial intermediaries and the dangers and incentives of shadow banking in China. Examining the extent of information dissemination, liquidity, leverage, supervision, and its endogeneity, regulatory and control countermeasures for the beneficial growth of China's shadow banking system are proposed.

3. Major Problems Facing the Development of Shadow Banking in China

3.1. Shadow banking remains large

By March 2023, China's extensive shadow banking had grown to 77.83 trillion yuan, representing 80.4% of GDP and 30.5%, according to the People's Bank of China's First Quarter of 2023 Monetary Policy Implementation Report. A significant figure, 8% of the whole social financing system. Shadow banking in China remains of great magnitude, and its role in the financial system is still significant, as evidenced by the data. Should it not be managed and controlled properly, a grave peril to financial steadiness could arise.

3.2. Shadow banking structure remains complex

As of the end of March 2023, the three largest components of China's broad shadow banking were wealth management products (RMB 20.67 trillion), entrusted loans (RMB 14.54 trillion) and trust loans (RMB 9.14 trillion), which together accounted for 57.4% of the broad shadow banking balance. Since shadow banking is characterized by maturity mismatch, liquidity conversion, credit conversion and highly leveraged operations, it may accelerate asset bubbles and trigger financial systemic risks.

3.3. Shadow banking still lacks adequate regulation

Shadow banks, as financial credit intermediaries, are outside the banking regulatory system and have significantly lower standards for credit extension than bank credit. At present, there is a lack of adequate regulation because of the incomplete disclosure and low transparency of their business, and the so-called "re-securitization" of some products on the basis of securitization, where the underlying assets and the transfer of packages are very unclear.[13]

4. The shadow banking system's possible financial hazards

Shadow banking's decentralized and concealed character can cause a risk to the financial system's stability, due to its characteristics. The rapid growth of financial operations in recent times has caused a considerable surge in the amount of money in circulation. Shadow banking, with its expansive scope and lack of regulation, has had a considerable effect on financial risk, and the repercussions have been detrimental and enduring. Moreover, the roaring wave of financial innovation leading to the development of a shadow banking system

4.1. The use of financial instruments in the shadow banking system poses financial risks

A number of financial instruments, such as options, futures, swaps, etc., have been developed in an environment of financial innovation. The core feature of financial derivatives is their high leverage, and a range of products that have matured from the interest rate derivatives market in the United States are gradually being "borrowed" and "learned" by financial markets in other regions. The use of these instruments in the shadow banking system often exposes the system to potential risks, including in China, where the financial regulatory system is relatively immature.

The shadow banking system has been revolutionized by financial innovation, introducing novel trading patterns. Shadow banking has arisen due to financial institutions diverting some of their operations from the regulated sector, in reaction to new financial instruments and stricter regulatory regulations. By utilizing novel financial instruments such as asset securitization and "off-balance sheet operations" of classic instruments, like promissory notes, shadow banking can augment its aid to the real economy. Offering investors a broad selection of asset classes and risk/return amalgamations, they can more effectively allocate resources through specialization and economies of scale.

4.2. Financial innovation has continued to expand the living space for the shadow banking system

For example, in the past two years, there have been many joint loans in the market, which are structured financing tools designed by shadow banking financial institutions in cooperation with banks and using bank funds for leveraging. Joint lending allows the participating entities to realize a significant expansion of the scale of "off-balance sheet" lending under their own advantageous financial scenarios. It is essentially the integration of shadow banking institutions using their own advantages and the advantages of bank funds, forming a new financing method and financing channel, and at the same time, the "on-balance sheet" bank funds are continuously "channeled" to the shadow banking internal. The excessive development of financial innovation has facilitated the growth of the shadow banking system while also increasing a series of related risks.[14]

5. The impact caused by shadow banking: the size of shadow banking has two sides to the financial system

5.1. Positive impacts

First, shadow banking overcomes the shortcomings and limitations of traditional bank loans and bond financing, injects a large amount of liquidity into the market, and becomes a powerful supplement and alternative to traditional bank credit.

Secondly, shadow banks that carry out asset management business in the direct financing market have played a role in promoting interest rate market reform and expanding the breadth and depth of financial services. Securing loans from traditional banks is a challenge for small and medium-sized

private enterprises, yet a rigorous demand for capital remains. Shadow banking services are the solution. If from the shadow bank here also can not get funds, many of them will face the fate of the business shrinkage to bankruptcy. Currently, there are still fewer ways for individuals to invest, and the interest rate of money in the bank inevitably fails to meet the expectations of some people. Shadow banking provides a way for a large number of surplus funds in society to invest and helps investors realize the preservation and appreciation of wealth. Shadow banking has arisen from financial innovation, for the present financial system is not sufficient to meet the needs of economic expansion. Shadow banking, a variety of forms, exists to support the gold's existence. Financial regulation has raised new issues, leading to further deepening of financial reforms and financial innovations. To sum up, on the one hand, shadow banks have overcome the shortcomings and limitations of traditional bank loans and bond financing, injected a large amount of liquidity into the market, and become a powerful supplement and substitute for traditional bank credit; on the other hand, shadow banks have carried out asset management business in the direct financing market, which has given impetus to the reform of the interest rate marketization, and expanded the breadth and depth of financial services.

5.2. Negative impact

Liquidity risk refers to the risk that a shadow banking institution will not be able to obtain sufficient cash in a timely manner or sell its assets at a reasonable price when it faces a funding gap or asset sell-off. As shadow banking usually involves maturity mismatches and highly leveraged operations, it can increase the financial vulnerability of commercial banks and cause liquidity distress. Shadow banks typically utilize leverage as an investment strategy to magnify investment returns, but they also magnify risks. Should losses be incurred in investments, these risks could have a ripple effect on the financial system, potentially resulting in systemic risk. Shadow banking activities during the subprime mortgage crisis of 2008 caused a global financial crisis, in fact.

The risk of regulatory arbitrage. Regulatory arbitrage refers to the behavior of financial institutions or market entities that take advantage of differences or loopholes between regulatory rules to circumvent regulatory requirements or obtain additional revenue through various means. Regulations and constraints not applicable to traditional banks are not applicable to shadow banks, a significant element of the financial system. Shadow banking's presence may result in a misallocation of financial resources. The emergence of shadow banking, due to regulatory arbitrage, is a major factor, and one of the greatest risks associated with it. Non-licensed entities, by offering loans with exorbitant interest rates or engaging in P2P online lending, can evade regulatory demands like capital adequacy and loan concentration. Classifying loans and circumventing the restrictions of anti-money-laundering and anti-terrorist financing laws may be possible simultaneously.

Contagion and correlation risk. Shadow banking bundles financial institutions across different industries, transforming individual risks into industry risks and spreading industry risks into cross-industry systemic risks. As the operation and supervision of shadow banks are relatively opaque and the loans and investments they issue may carry a high level of risk, a default or investment failure may cause a chain reaction to the entire financial system, which can lead to the concentration and transmission of financial risks. The emergence of the shadow banking sector may cause investors to switch their focus from traditional banks to these, thus diminishing the market share of traditional banks. This will weaken of the influence of traditional banks in the market leading to a decline in business scale, profits and other indicators. Causing irrational allocation of financial resources.

6. Conclusion

It is evident that, due to the swift expansion of financial markets and the invention of financial services, bank loans have been gradually transferred to the shadow banking sector in recent years. This trend

reflects the restructuring of the financial market and changes in capital allocation. Financial risks present new features: the transfer of bank loans to the shadow banking sector has had a significant impact on financial risks. The shadow banking sector's high-leverage and high-risk attributes have heightened the fragility of financial markets. The potential for an overabundance of funds to be placed in the shadow banking system, thus heightening financial risks, may be a consequence of such a shift. Moreover, this shift could bring about heightened regulatory difficulties. The traditional financial regulatory model is confronted with fresh difficulties. Regulators must bolster the oversight of the shadow banking industry and create a more thorough regulatory framework to confront the ever-evolving financial risks.

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