The Impact of Shadow Banking on Small and Medium Enterprise in China - Based on Trust Company Statistics

Sifan Tao[1], Ziyang Lu[2], Hanyu Li[3*+], Xingcong Liu[4*+]

[1]*Questrom School of Business, Boston University, Boston, Massachusetts, 02115, United States of America*
[2] *Beijing-Dublin International College, Beijing University of Technology, Chaoyang District, Beijing, 100020, China*
[3] *School of Economics and Management, Beijing Institute of Technology, Beijing, 100081, China*
[4] *College of Engineering and Mathematical Science, University of Vermont, Burlington, Vermont, 05405, United States of America*

[*]*Corresponding author. Email: Hanyu Li - 1120191006@bit.edu.cn*
Xingcong Liu - 13041933311xc@gmail.com
+ They are both Co-Third Author.

ABSTRACT

With the development of the Chinese economy, small and medium enterprises have made up an essential part of the national GDP. However, the difficulty of financing of SMEs remains unsolved. This paper evaluates the current situation of shadow banking influencing the funding of SMEs in China. This paper starts with introducing SMEs funding and trust companies' performance, SMEs financing situation during COVID-19 and then examines the chance of survivorship and risky nature of SMEs.

Lastly, a conclusion was made that even though shadow banking could help SMEs resolve their financial difficulty in the short term, however, due to their risky nature and low chance of survivorship, the positive effects of those loans are limited. As a result, the uncertainty poses many risks on nonbank institutions, exacerbating their reluctance to grant loans to SMEs. Therefore, to achieve stable and healthy growth of SMEs, more concrete and suitable funding policies must be endorsed.

This paper has the goal of uncovering the core obstacles SMEs face and finding the possible solutions from variety of perspectives, including government policies, reconstructing companies' structure, etc. This is done through researching in the field of SMEs' capital structure and trust companies' funding mechanism, as well as SMEs' performances with relation to their funding methods. The importance of this paper ties closely into solving the financing difficulty SMEs in China currently facing, and providing a deeper understanding of current SMEs financing situation in China, lastly providing possible solutions to those difficulties.

Keywords: *Shadow Banking, Small and Medium Enterprise, Trust Companies, Risky Nature*

1. INTRODUCTION

Strict and strong supervision of the financial market has become the norm in the Chinese banking system. In the first half of 2021, the regulatory authorities further refined the banking financial management supervision system under the framework of the guiding opinions on standardizing the asset management business of financial institutions. In particular, for some of "net value" disguised as "false net value" financial products, the regulatory authorities emphasized these to strengthen supervision of their valuation methods, to promote the net value transformation. The so-called "net value transformation", popularly speaking, means that financial products no longer promise to guarantee principal and interest, but to obtain profits according to the actual performance of the product. The recent reform of the valuation method of bank financial products, which alters from the cost method to the fair value method, also promoted the process of transformation. Therefore, it can be conducted that more capital will flow into secondary markets and shadow banks. In China, the history of shadow banking is relatively shorter than that in western countries, and its concept has not been clearly defined.

"Shadow banking is all about lending and off-balance sheet business." Yi Xianrong, director of the development department of the institute of finance at the Chinese Academy of Social Sciences, stated this as definition. Shadow banks can serve as credit supplement in traditional banking systems. However, the risks posed by shadow banking are also varied. For example, its potentially high leverage ratio may reduce the efficiency of capital use, and the ease of granting loans may lead to abuse use and fraud cases etc. Moreover, the risky nature of small and medium enterprise also poses a great risk to shadow banking institutions. The effects are mutual.

In the work, the first part talked about the financing difficulties of SMEs, explaining why shadow banking is needed in the current Chinese banking system. Next, trust loan, as a possible alternative financing approach, were introduced from the perspective of its development. Then the focus shifted to the performance of SMEs during COVID-19. Lastly, the risky nature of SMEs and its effects on shadow banks were explained. This essay will now explore these ideas into more details.

1.1. The development of SMEs in China

Small and medium enterprises (SMEs) usually refer to enterprises with a relatively small scale of personnel and operation. In China, the definition of "micro, small and medium-sized enterprises" is constantly evolving, with the tendency to focus on essentially small and micro. For example, for the real estate industry, the business income of 10 million yuan or more, and the total assets of 50 million yuan or more are medium-sized enterprises; The business income of 1 million yuan and above, and the total assets of 20 million yuan and above are small enterprises; those with operating income of fewer than 1 million yuan or total assets of less than 20 million yuan are micro-enterprises.

Using Small and Medium Enterprises Development Index (SMEDI) [1], in 2010 to 2018, from the first quarter of 2010 to the second quarter of 2011, the trend of the index is consistent with the development trend of small and medium-sized enterprises. After the economic crisis in 2008, SMEs made great efforts to change their export-oriented and labor-intensive development mode and embarked on the road of transformational development. In 2010, The State Council issued *Several Opinions on Encouraging and Guiding the Healthy Development of Private Investment*, relaxing market access conditions, opening 18 industries, including infrastructure to private enterprises, and promoting the rapid development of small and medium-sized enterprises.

By the end of 2017, small, medium and micro businesses (including individual businesses) accounted for more than 90 percent of all market entities, contributing more than 80 percent of China's employment, 70 percent of China's invention patents, 60 percent of China's GDP and 50 percent of China's tax revenue [1]. However, in the first half of 2018, policies to prevent financial risks, deleverage, cut overcapacity and regulate environmental protection were implemented in parallel, making it difficult for SMEs to obtain financing.

1.2. The current situation of financing difficulties for SMEs

The financing difficulties of SMEs have been discussed for a long time.

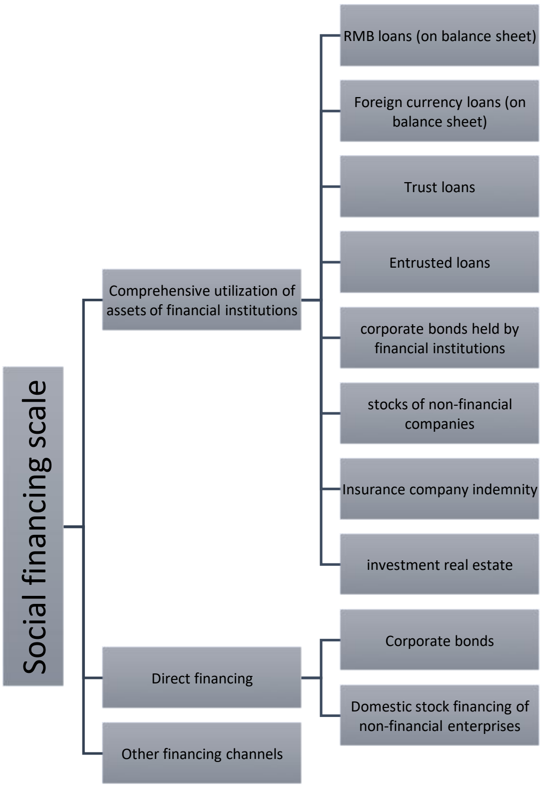

Figure 1 Components of Social financing scale

To explore financing channels for SMEs, a particular index called the 'Social financing scale' should be introduced, officially calculated by the People's Bank of China in 2011. It refers to the total amount of funds the actual economy obtains from the financial system in a certain period. As shown in figure 1, this index contains ten sub-items, which can be categorized into three main modules.

The primary forms of direct financing are equity financing and bond financing. For Chinese SMEs, the issuance and listing of corporate bonds are limited to a few large companies and national key construction projects, and it is almost impossible for small and medium-sized enterprises to finance funds through such channels.

From the perspective of equity financing channels, the opening of the New OTC Market and Growth Enterprise Market (GEM) helps SMEs with the potential to obtain financing opportunities. However, most small and medium-sized enterprises have a weak foundation and cannot make good use of this market. On the other hand, the New OTC Market and GEM are still in the initial stage in China and still have shortcomings. They can only relatively alleviate the financing problem, so it is challenging to fundamentally change SMEs' financing difficulties.

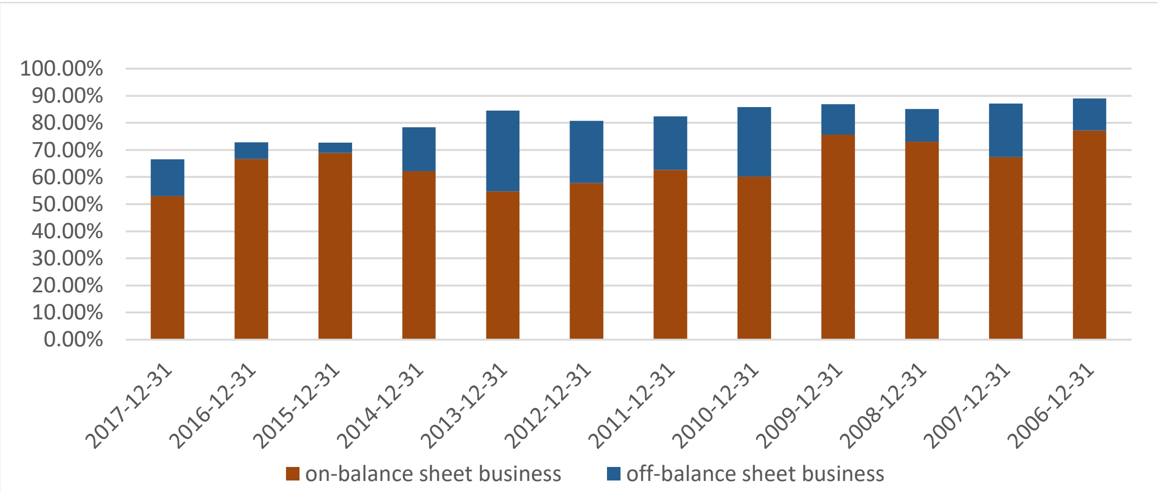

Figure 2 The proportion of social financing loans

Bank loans are the primary external channel of financing for small and medium-sized enterprises in China. According to data, the proportion of social financing loans is about 60% [2].

The dominant position of banks' capital also can be shown from figure 2, where the histogram includes banks' funds through entrusted and trust loans, accounting for 70% or even 80% of total social financing funds.

However, it is worth noting that small and medium-sized enterprises have inherent disadvantages in access to bank loans. Due to such factors as difficult mortgage guarantee, low solvency and opaque information, enterprises are not as competitive as projects supported by large enterprises and local governments in terms of credit capital.

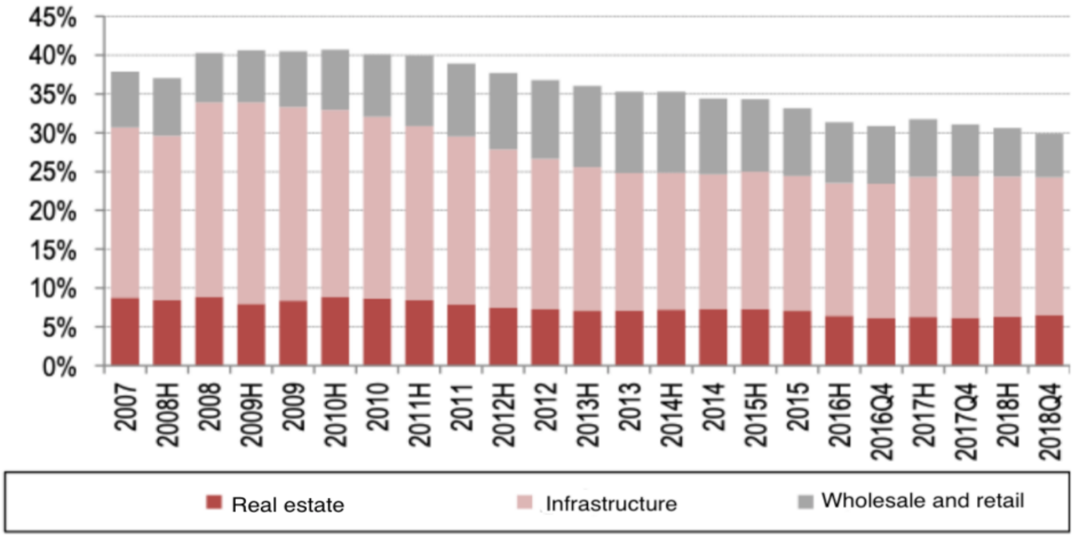

Figure 3 Listed bank loans to real estate and infrastructure projects accounted for a high proportion. [3]

According to the number of legal person enterprises in various industries disclosed by the National Bureau of Statistics in recent years, most enterprises' business is concentrated in production, processing, distribution, and wholesale.

In contrast, as demonstrated in figure 3, real estate and infrastructure projects account for a much higher proportion of bank loans than the wholesale and retail industry, mainly because the former has more reliable collateral. The enterprises undertaking such business are usually large state-owned enterprises, indicating that the capital market dominated by state-owned commercial banks prefers large state-owned enterprises.

Moreover, many literature studies have shown that large banks tend to provide financial support to large-scale enterprises, which means they are not natural players for offering alternative financing channels and capital for SMEs. Berger et al. 's study in 2005 also found that large banks were far away from small and medium-sized enterprises and had little communication with them.

On the contrary, small and medium-sized banks or shadow banking are suitable for serving small and medium-sized enterprises, which determines that the real economy of developing countries has a high demand for small and medium-sized banks and institutions.

In summary, the critical problem of financing difficulty for small and medium-sized enterprises is that the banking structure dominated by large banks in China does not match the industrial structure. The development of Chinese enterprises is different from that of developed countries: small and medium-sized private enterprises began after the emergence of large state-owned enterprises. Accordingly, large banks developed their lending business earlier than shadow banking and naturally preferred large enterprises. Therefore, in the work the key to breaking the situation is to find new alternative financing channels and institutions.

2. THE DEVELOPMENT OF TRUST LOAN

Trust financing is a possible alternative financing channel. Despite the solid regulatory background, the scale of trust assets continues to drop, but it still maintains a relatively large scale. As shown in figure 4, in 2020, more than ***$2 trillion*** will still be invested in the market, with more than 65% invested in the bond market [4]. At the same time, different from direct financing channels, trust business is more extensive, including primary industries, real estate, etc., which can bring financing opportunities for different enterprises.

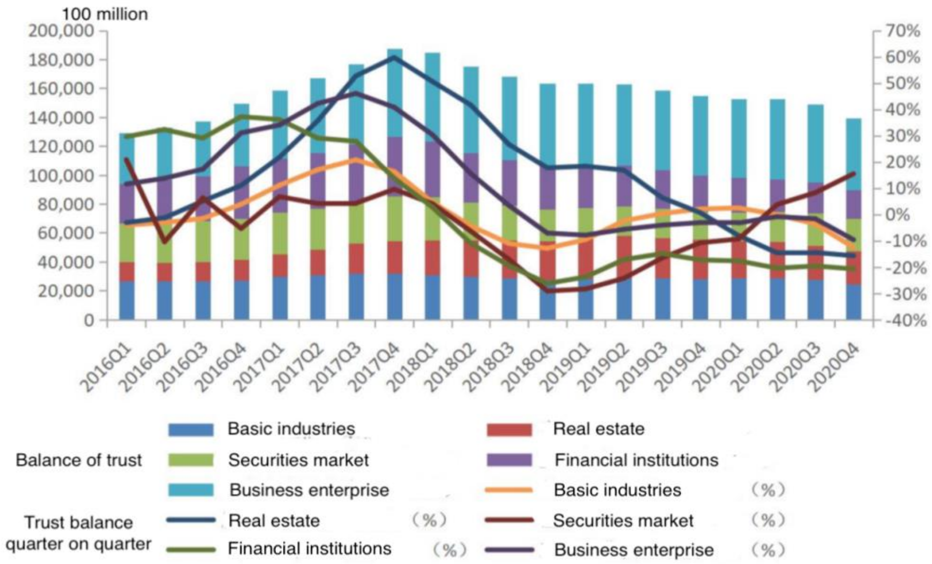

Figure 4 Classified scale and growth of trust assets by investment [4]

According to "Article 2 of the trust law", trust refers to the economic behavior that the asset owner entrusts the trust and investment company to operate and manage the assets in an attempt to achieve the purpose of profit. The asset owner is called the trustee. The trust company that manages the assets becomes the trustor, and the party that obtains the income from the assets is called the beneficiary [5].

The earliest trust industry in China took place in the early 20th century, but its development was slow due to various reasons. From 1985 to 1988, the State Council conducted three rectifications and checks on the trust industry. In 1995, the State Council issued a notice to decouple commercial banks' trust and investment companies completely. Until the end of 2001, the issue of the trust law and a series of subsequent relevant laws and regulations lead the development of the trust industry gradually to the right track [6]. In 2007, the promulgation of the new regulations on asset management has once again brought the trust market into a transition period; it formulates unified regulatory standards according to the types of asset management products, makes consistent provisions on similar asset management businesses, implements fair market access and supervision, eliminates regulatory arbitrage space to the greatest extent, and create a good institutional environment for the healthy development of asset management business [7].

According to the data released by China Trust Industry Association, which is shown in figure 5, from 2016 to 2017, before the release of the new asset management regulations, the scale of trust assets managed by trust companies continued to grow, after that, the trust industry has entered a problematic transformation stage, and the scale of trust assets has continued to decline from the high point at the end of the fourth quarter of 2017 [4]. With the end of the transition period of the new regulations on asset management, the scale of trust assets gradually stabilized and rebounded for the first time in the second quarter of 2021.

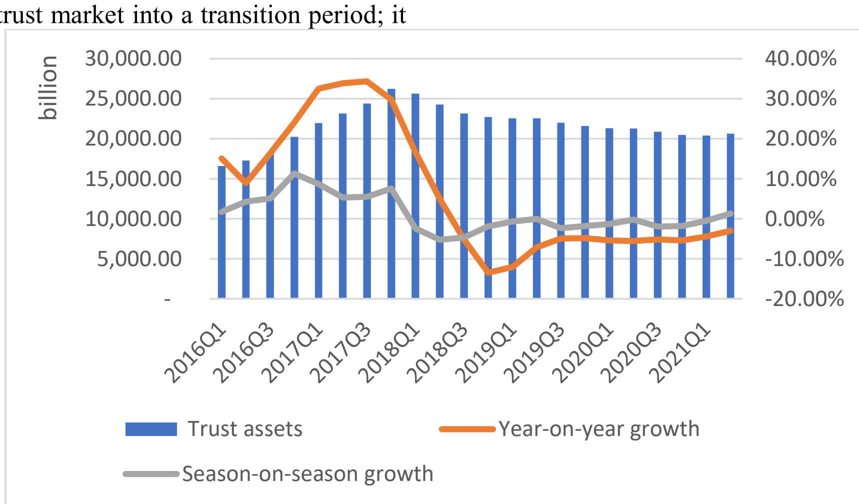

Figure 5 Changes in the scale of trust assets [8]

One of the critical points of trust business transformation is to optimize the structure of the capital source. Based on the data of the proportions of the capital source, figure 6 shows it can be seen that unitary funds trust is gradually being replaced by assembled funds trust [8]. The main difference between the two kinds of funds trust is that the amount of the trustor, which means assembled funds trust has more flexible and multi-sources. As for management property trust, which means the trustors entrust trust companies to help manage their property, had a stabilized proportion in recent years.

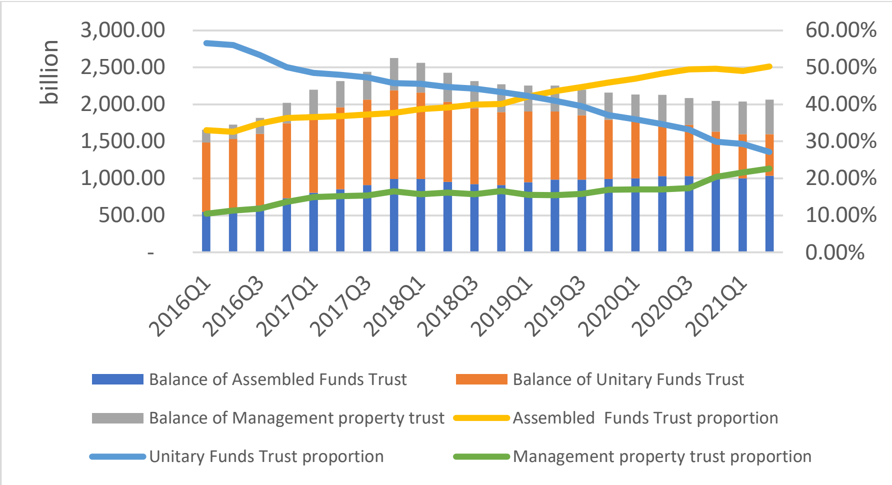

Figure 6 The scale and proportion of trust assets classified by source of funds [8]

As the development of the trust industry, a function of trust gradually appears, which is financing. The management and operation of trust property cause the flow of funds, making the funds flow from high-net-worth clients to fund demanders to fulfil the function of financing. For a long time, people only realized that trust has the function of financial management but did not realize that it has the function of financing [9].

It is a good choice for SMEs to seize opportunities from the trust industry to solve their financing difficulties, for it is faster to finance by trust, direct negotiations between trustor and trustee about the financing source (unitary or assembled) can save the time and costs waiting for bank loan approval. Trust business has the characteristics of singleness. Different trust products must be designed for different projects to meet the needs of different projects. So that trust financing for SMEs has to be established [10]. Trust financing of SMEs refers to that trust companies, as trustees, raise funds from the society by designing and Issuing Trust products and put trust funds into SMEs after the trust is established. With its advantages, trust companies provide comprehensive financial services for the development of SMEs in their financing process.

However, trust financing is still risky. In the real estate industry, for example, in the fourth quarter of 2020, real estate trust accounted for 13.97% of the scale of 2.28 trillion yuan at the end of the year, in which the main form of real estate trust financing is "fake" investment trust packaging, ostensibly equity, but debt, the expansion of the overall scale of trust is not reflected in the financing scale data. This is contrary to current policy guidance. Therefore, under the influence of regulatory pressure, downward pressure of real estate market and weak comprehensive management ability, operation ability and financing ability of SMEs, although trust financing provides another channel for SMEs, how to better provide financing services for SMEs is still worth exploring.

3. SMES FINANCING IN CHINA (DURING COVID-19)

In recent years, the trust industry has been able to bring vitality and capital to more companies and import capital in more areas than government-backed lending platforms and banks. However, the trust industry is still precarious. In southern China, many light industrial SMEs are clustered there. The survival of these companies depends on cash flow, and when the epidemic started, survival became difficult. In Guangdong, the scrutiny of financing by traditional banks is so complex that companies cannot obtain loans and financing promptly. This may have made these SMEs unable to withstand the sudden outbreak, but these companies had a new option: fast financing through the Guangdong government's SME financing platform. The SME financing platform differs from the banking system in that its fast-financing feature means less scrutiny and more risk. The government estimates it will serve more than 300,000 businesses this year, with more than 100 banks offering financial services through digital platforms and fintech.

During a flu pandemic, SME loans will limit their profits and increase their output. At the same time, SMEs will struggle to make enough profits to service their debts due to the uncertainty of the global economy. This may increase the risk that the SME financing platform will not be able to recover its funds. Since SME financing platforms are not part of the banking system, they create more risk of default, which ultimately results in investors not being able to recover their principal, thus increasing financial risk to some extent. The increase in commodity and raw material prices in recent months has caused these companies to struggle with some financing, but still face the risk of bankruptcy, and if these SMEs go bankrupt, the SME financing platforms will face a crisis of confidence [11].

SMEs still need to rely on national policies to survive. As of the end of July, total loans to micro and small enterprises were 17.8 trillion yuan ($2.75 trillion), up 29.3%. The number of small businesses was 38.93 million, up 29.5% year-on-year. The People's Bank of China is expanding its refinancing line by another 300 billion yuan, to be allocated at a 2.25% interest rate for the remaining four months of 2021 [12]. While the SME financing platform has eased the pressure on SMEs caused by the epidemic, it has inevitably raised the level of financial risk in Guangdong Province. To reduce risk, the Guangzhou Municipal Bureau of Financial Supervision has introduced a risk compensation mechanism for SME bank loans, which will help increase new lending to local SMEs by approximately RMB 30 billion (US$4.28 billion) [13].

The government will compensate banks for non-performing loans, up to half of which are credit loans worth less than 10 million yuan ($1.4 million) each. In the first half of this year, loans to small and micro enterprises in Guangdong province totaled 1.81 trillion yuan, up 33.7 percent year-on-year. The government has effectively reduced the risk of default while supporting the growth of SMEs. Since the release of the new asset management regulations, the trust industry has entered a difficult transition phase, with asset size declining since peaking in mid-Q4 2017 and rebounding in Q2 2021. As of the end of Q2 2021, the trust asset size was RMB 20.64 trillion, down RMB 0.64 trillion or 3.02% from the end of Q2 2020 [14]. Compared with fund trust, the proportion of non-fund asset sources, namely managed property trust, showed an upward trend, up 6.08 percentage points from 16.53% at the end of 2017. Both paid-in capital and trust indemnity reserves show more significant growth. As of the end of 2Q 2021, paid-in capital was $315.399 billion, up 10.78% and 0.39% year-over-year; the paid-in capital ratio was 45.54%, up 1.69 percentage points and down 0.48 percentage points year-over-year.

This indicates that the overall risk of the trust industry is decreasing. Thanks to the Chinese government's epidemic control, the negative impact of the epidemic on trust companies was mitigated, and the industry as a whole saw simultaneous growth in operating income and profits. Since the enactment of the new asset management business regulations in 2018, the trust industry has continued to transform.

Financing-type and channel business has continued to decrease, and the scale of the REIT presidency has been optimized. The real estate industry has been an area where trust funds are invested on a large scale, and despite the suppression of trust scale, it still maintains a large scale. Relying on solid government regulation, more industries can be involved in the low-risk positive state. However, given regulatory guidance and market demand, it is expected that the trust industry will continue to return to its roots and undergo transformation.

The first transformation to investment trusts, developing securities investment trusts, focusing on the layout of underlying trusts through TOF, securities investment, fixed income, new investment, and "fixed income +" businesses. As of the end of 2020, the balance of securities investment trusts (including investment in stocks, bonds and funds) was 2.26 trillion, accounting for 13.87% of the total balance of capital trusts, currently accounting for a relatively small percentage, but the scale increased by 15.44% year-on-year.

Secondly, businesses are developing asset securitization to increase the value of business. From the scale effect, more extensive scale and longer-term can provide more objective trust compensation; from the fee level, asset securitization can also improve business value through product design, underwriting, investment and other ways.

Thirdly, businesses are also expanding high-end wealth management business and accelerating the transformation from "product-centric" to "client-centric". In general, the trust is trying to reduce risks and expand into new areas.

3.1. Chance of survival of SMEs

The primary reason that interest rates of financing SMEs are so high is majorly due to the small chances of surviving. As one report in 2019 showed, only 7% of the SMEs in China could last over five years [15]. That means nearly one out of 10 start-up companies could still exist after five years since establishment, not to mention their profitability. By calculation, SME's bankruptcy CAGR [2] (The compound annual growth or decline rate) is about 20% each year. So, when a nonbank institution gives out loans to SMEs, they generally have to require an interest rate at 25% or above to break even. This shows the risky nature of investment in SMEs. It also directly shows the limited ability for SMEs to pay back their loans, leading to a great chance of loss in principle for trust companies. With such great uncertainty, trust companies could offer a high-interest rate, hoping they could pay it back, and if not, at least get some part of principal back in the forms of interests. Even though the financing provided by the nonbank institutions could help SMEs in the short term, with SMEs' risky and high instability nature, the positive effects of those loans to SMEs are limited. Therefore, loaning to SMEs could increase nonbank institutions' financial burden to a large extent.

3.2. Emerging Policies

In order to mitigate the current situation of SMEs financing in China, and also help shadow banking to control the risk, following measures are highly suggested:

•Consummating the more detailed policies on nonbank institutions, making sure shadow banking is positively directing the economy and efficiently supporting the SMEs' capital structure.

•Perfecting the Enterprise credit system, including SMEs, makes background research easier for the institutions. Increase the standard of applying for a loan.

•Develop more customized loan products for SMEs to choose from based on their unique operational circumstances.

4. CONCLUSION

In this paper, by evaluating the performance of SMEs, development of trust loans, SMEs' performance during COVID-19 and the risky nature of SMEs, meaningful findings were made. In the process of analysis, substantial quantitative and qualitative evidence along with strong logical reasoning were used. By doing so, this paper highlights the limitations of shadow banking as means for SMEs funding, and provides possible solutions. To summary the thesis of this paper, it is arguable that even though shadow banking could help SMEs resolve their financial difficulty in the short term, due to their risky nature and low chance of survivorship, the positive effects of those loans are limited. As a result, the uncertainty poses many risks on nonbank institutions, exacerbating their reluctance to grant loans to SMEs. Therefore, to achieve stable and healthy growth of SMEs, more concrete and suitable funding policies must be endorsed. After reviling this reality, one could see the difficult and urgent situations for SMEs financing in China. Therefore, the further discussion and research should aim to find alternative funding sources and further stabilize the growth and development of the SMEs in China, which could contribute to tremendous growth of the Chinese economy. Lastly, this paper's significance is demonstrated by reveling the core difficulties that SMEs are facing and influence of different funding regard to SMEs' capital structure, lastly the possible government policies which could help enhance the situation, which are coming up with more detailed guidelines for non-bank institutions' activities, perfecting the enterprise credit system. And from the institutions' perspective, they should develop more customized loan products specially for SMEs, which have smaller minimum loaning amount and lower interest rate. This enhancement would help SMEs to acquire funding in a more regulated and safer way, while paying less interests payment which could ease off SMEs' financial burden. These findings and solutions combined show the significance of this paper, in the topic of SME's financing methods.

ACKNOWLEDGMENT

[1] The value range of SMEDI is 0-200 :(1) 100 is the critical boom value of the index, indicating that the economic conditions have not changed much; (2) 100-200 is the economic cycle range, indicating that economic conditions tend to rise or improve, the closer to 200, the higher the economic cycle; (3) 0-100 is the depression range, indicating that the economic situation tends to decline or deteriorate, the closer it is to 0, the lower the prosperity degree is.

[2] The compound annual growth rate (CAGR) is the rate of return that would be required for an investment to grow from its beginning balance to its ending one. Here it is the rate that the portion of SMEs goes bankrupt each year.

Hanyu Li & Xingcong Liu (Co-Third Author): With equal contribution to this paper, Hanyu Li & Xingcong Liu are both Third Author to this paper.

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