

Shadow Banking and Commercial Bank Profitability: Evidence from China

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Abstract. In recent years, China has witnessed a growing investment demand from the household sector. However, financing gaps persist in industries subject to macroeconomic regulation and among small and medium-sized private enterprises. These gaps, alongside regulatory arbitrage by commercial banks, have fostered the emergence and gradual expansion of shadow banking, which has become an integral part of the financial system. While shadow banking enhances resource allocation efficiency, eases financing constraints, and boosts the profitability of commercial banks, its high leverage and maturity mismatch may also undermine the stability of bank revenues. This paper reviews the theoretical foundations of shadow banking both domestically and internationally, clarifies its definition, explores its drivers and development, and investigates its relationship with commercial bank profitability. Employing empirical analysis, the study examines the correlation between the size of shadow banking and key profitability indicators in China's banking sector. Based on these findings and the current national context, the paper offers policy recommendations to help shadow banking institutions and commercial banks better recognize and address potential risks and challenges in their development.

Keywords: commercial bank; profitability; shadow banking.

1. Introduction

1.1. Research Background

In contemporary economic activities, commercial banks, as vital financial intermediaries, have gradually expanded their business scopes in recent years, driven by the development of internet finance and the diversification of financial services, in order to capture greater profits in a complex economic environment. While the interest margin between deposits and loans remains the primary source of profit, the significance of non-interest income has become increasingly pronounced. In 2007, Paul McCulley, chairman of Pacific Investment Management Company (PIMCO) in the United States, introduced the concept of shadow banking, referring to non-bank entities that perform bank-like functions but operate outside the formal financial regulatory framework. Following the 2008 global financial crisis, the rapid proliferation of the shadow banking system and its substantial impact have become a focal point of attention.

In China, the shadow banking sector has grown rapidly in recent years, driven by a surge in household investment demand, restricted financing for certain industries under macroeconomic regulation, funding gaps faced by small and medium-sized enterprises (SMEs), and regulatory arbitrage by commercial banks. Since 2010, the Chinese government has adjusted its macroeconomic regulatory orientation, partly due to financing difficulties in the real economy. Insufficient financing capabilities in key regulated sectors such as real estate and local government financing platforms have been crucial factors in the formation and development of shadow banking. The real estate industry, characterized by high debt levels and increased operational risks, has seen a decline in its share of credit allocation. However, rising housing prices have intensified its demand for funds, thereby fueling the growth of shadow banking. SMEs, long plagued by financing difficulties, have increasingly turned to private lending, with shadow banking offering reasonable interest rates and thus experiencing a surge in demand. The 2008 global financial crisis also had a profound impact on

China's financial regulation, prompting commercial banks to expand their business scopes and leading to the emergence of shadow banking as a new tool to circumvent regulatory constraints.

The essence of shadow banking is regulatory arbitrage, characterized by minimal or nonexistent regulation, high opacity, and elevated leverage ratios. Its existence has led to a substantial volume of credit assets operating outside regulatory oversight, thereby weakening the macroeconomic control of the central bank and presenting new challenges. While shadow banking can address challenges posed by traditional financial services, optimize resource allocation, expand service coverage, and enhance profitability, it also introduces operational risks to commercial banks.

1.2. Research Background

In the context of China's rapid economic development, shadow banking, as a financial intermediary that can adapt to societal needs, is poised for expansion. However, if left unchecked, its unbridled growth will pose a significant threat to China's economic stability. Examining the impact of shadow banking on the profitability of commercial banks provides an alternative perspective for relevant research, thereby enriching the existing body of literature. Moreover, this approach enables commercial banks to more accurately assess the development trajectory and potential risks associated with shadow banking, thereby facilitating the mitigation of the risks it may introduce.

1.3. Literature Review

Adrian et al. (2012) noted that since the mid-1980s, the financial system based on the market economy has rapidly evolved and undergone fundamental changes. Shadow banking has emerged as a significant component within the financial system, acting as an intermediary for maturity, credit, and liquidity transformation without the liquidity support of central banks or government credit guarantees. Examples include finance companies and asset-backed commercial paper. The Financial Stability Board (FSB) (2011) defined the “shadow banking system” as credit intermediaries outside the traditional financial system that engage in financial intermediation through non-bank funding channels, highlighting their own advantages. During the 2008 financial crisis, the “shadow banking system” was widely utilized. The crisis revealed its close connection with the traditional banking system, its potential to impact global financial stability, and its ability to introduce systemic risk. It also demonstrated the potential to undermine bank regulation, increase systemic leverage, and amplify risk, thereby necessitating enhanced supervision of the financial system.

Fagan et al. (2011) argued that shadow banking is often perceived as the primary culprit of the 2008 financial crisis. It refers to intermediaries outside traditional deposit-taking institutions that provide credit, typically supported by short-term liabilities to finance long-term assets, with limited regulation prior to the financial crisis. Macey et al. (2011) indicated that the shadow banking system generates the same economic benefits as the traditional banking system, with both profiting from interest spreads. Shadow banking achieves this through the issuance of commercial paper equivalents. With technological advancements, the information advantage of commercial banks has diminished. To ensure profitability, both banks and shadow banks may adopt riskier strategies. The authors suggested that equity holders who benefit from speculative activities of financial institutions should bear the associated losses, by compelling shareholders to provide additional capital to satisfy creditors' claims.

Huang and Chang (2012) argued that shadow banking activities in China mainly consist of entrusted loans by financial institutions and trust funds publicly issued to society. Although these activities carry risks, systemic financial risks have not emerged. Regulatory authorities should strengthen oversight, establish a clear regulatory framework, and deepen financial system reforms. Hu (2016) suggested that the shadow banking system in China includes non-bank financial organizations and their activities, as well as internal shadow banking operations. Five major types exist in China, including asset securitization and wealth management products. Lessons from the financial crisis indicate the need for enhanced regulation, while also gradually promoting financial innovation to reduce constraints and build a credit information disclosure system. Ba (2013) argued

that shadow banking in China represents a market choice when real economy financing needs are constrained. It is a form of financial innovation that brings about interest rate liberalization, helps correct the adverse effects of financial repression policies, improves the efficiency of the financial system, and enhances the vitality of financial markets.

Yu and Chen (2014) argued that interbank transactions and wealth management products are forms of systemic arbitrage caused by regulatory loopholes. Risks are not effectively diversified, and banks are required to backstop and invest in these products. Once risks are exposed, banks and financial markets will be implicated.

1.4. Research Framework

The research framework of this paper is shown in Figure 1. It includes five parts: introduction, conceptual definition and theoretical foundation, theoretical analysis and research hypotheses, empirical analysis, and research conclusions and policy recommendations.

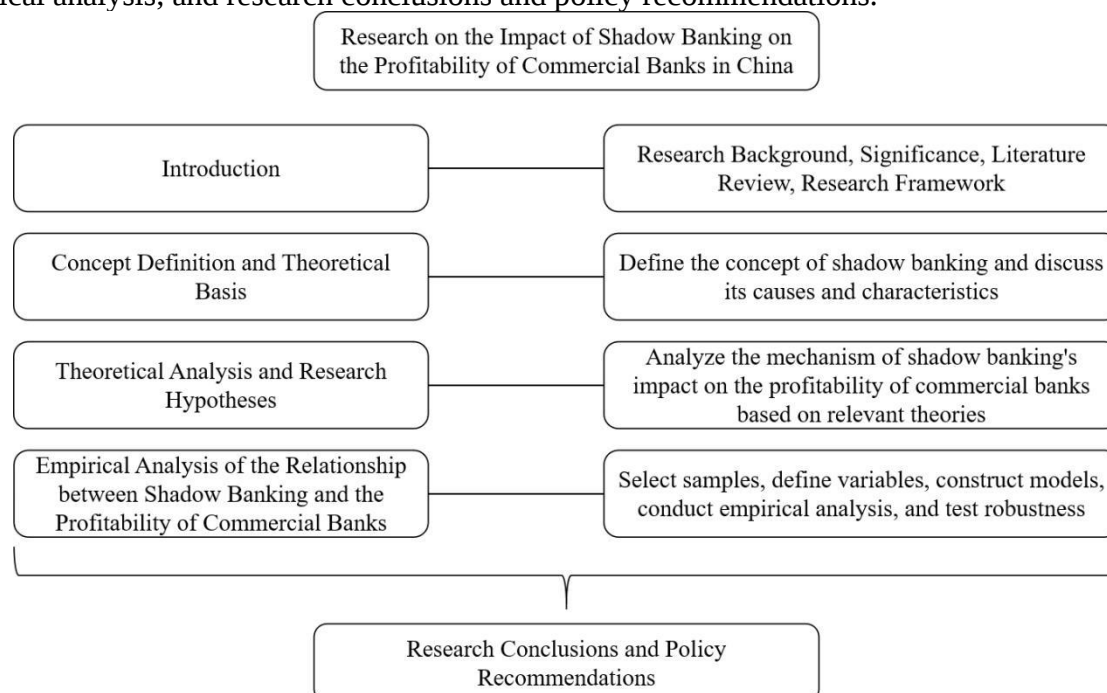


Figure 1. research framework

2. Conceptual Definition and Theoretical Basis

2.1. Definition of Shadow Banking

The concept of the shadow banking system was first introduced by Paul McCulley, Chairman of PIMCO (Pacific Investment Management Company), at a Federal Reserve symposium. Following the 2008 financial crisis, financial reform and regulatory issues garnered widespread attention from all sectors of society, with the rapidly expanding shadow banking system and its significant impact becoming a focal point.

In 2012, Huang and Chang (2012) identified China's shadow banking activities as encompassing interbank transactions, guarantee companies, trust companies, finance companies, and microloan firms. Ba (2009) suggested that China's shadow banking activities cover interbank business, guarantee companies, microloan companies, consumer finance companies, trust companies, and private lending activities. The narrowest definition includes only wealth management services and trust companies. The Notice on Strengthening the Regulation of Shadow Banking categorizes shadow banking into three major types: (1) certain financial activities and asset securitization businesses conducted by commercial banks with financial licenses; (2) "quasi-banking" entities: small credit companies that lack financial licenses and are subject to weak regulation; and (3) third-party financial

institutions and online finance companies that operate without financial licenses and are entirely unregulated.

On the basis of clarifying the scope of “shadow banking,” the concept is proposed to include shadow banking activities within banks, “quasi-banking” financial institutions, and other financial innovation activities.

2.2. Causes of Shadow Banking

From the demand side, in recent years, the shift in China’s macroeconomic regulatory policies and the implementation of a prudent monetary policy have increased the financing difficulties for real enterprises, tightened market liquidity, and widened the social financing gap. After the 2008 policy support led to a massive influx of funds into the real estate sector and a surge in housing prices, the government introduced purchase restrictions to stabilize the market, thereby limiting bank credit. Real estate companies thus turned to alternative financing channels, fueling the growth of shadow banking. Following the 2008 financial crisis, the government injected 4 trillion yuan to stimulate the economy, which led to inflation and prompted the central bank to tighten its monetary policy. Many long-term projects required financing to maintain operations. Small and medium-sized private enterprises, lacking high-quality collateral and facing higher default rates, found it difficult to obtain low-cost bank loans and were forced to seek other high-cost financing channels.

From the supply side, with the rapid development of China’s economy, the household sector has accumulated substantial personal wealth. Many individuals, after meeting their daily living needs, choose to invest in wealth management products to increase the value of their capital. Given the relatively low interest rates on bank deposits, which are insufficient to hedge against the risk of currency devaluation, many people have begun to seek investment products with higher returns. Banks have responded to this trend by launching a series of wealth management products to attract these funds, thereby providing ammunition for the further expansion of shadow banking.

From the perspective of commercial banks, as China’s economy has gradually developed, competition in the banking sector has intensified, and the pace of interest rate liberalization has accelerated. To increase their own profits, commercial banks have continuously introduced a variety of financial products to meet customer needs and have transferred a large amount of on-balance-sheet business to off-balance-sheet activities. As a result, commercial banks have begun to engage in shadow banking activities, thereby driving their rapid development.

2.3. Characteristics of Shadow Banking

In China, commercial banks are the central drivers of shadow banking activities. The primary source of funding for China’s shadow banking system is derived from bank assets, with its clientele largely overlapping with that of the banks. The underlying purpose is to circumvent regulatory oversight from institutions such as the People’s Bank of China and the China Banking and Insurance Regulatory Commission, thereby enabling certain bank assets to be removed from their balance sheets. In this process, banks collect fees to enhance their profitability.

China’s shadow banking sector is highly susceptible to policy changes. At the end of the last century, private lending in China experienced a surge. Lacking state regulation, private lending often involved high leverage ratios, which made it vulnerable to funding chain disruptions. To maintain social stability, the government implemented various measures to ban such activities. After the initial signs of shadow banking issues emerged in China in 2016, regulatory authorities promptly introduced policies to reduce the scale of shadow banking and to standardize the market.

3. Theoretical Analysis and Research Hypotheses

3.1. Factors Affecting the Profitability of Commercial Banks

The primary factors influencing the profitability of commercial banks encompass several key aspects.

First, the capital adequacy ratio is one of the critical determinants. A high capital adequacy ratio not only enhances a bank's ability to withstand risks but also improves its capital operation efficiency and profitability.

Second, the loan-to-deposit ratio significantly impacts bank profits. The higher the deposit ratio, the more effectively a bank can utilize its capital and enhance its profitability. Conversely, a lower level of deposits and loans implies that more bank funds are idle, resulting in higher funding costs. In China, regulatory authorities impose certain restrictions on the loan-to-deposit ratio to prevent systemic financial risks associated with excessive credit expansion.

Third, leverage has a pronounced effect on bank profit efficiency. Banks can operate a larger asset base with lower funding costs by maintaining a high leverage ratio. However, higher leverage also amplifies the operational risks faced by banks.

Finally, the proportion of non-interest income is another important factor affecting bank profits. Bank revenues primarily stem from the interest margin between deposits and loans, as well as fees and service charges generated from financial services. Non-interest income, which does not tie up bank funds and carries relatively lower risks, has become increasingly significant in the overall profit structure.

3.2. Indicators for Evaluating the Profitability of Commercial Banks

The net profit margin, return on total assets (ROA), and return on equity (ROE) are crucial metrics for evaluating the profitability of commercial banks. The net profit margin, calculated as the ratio of net profit to operating revenue (net profit margin = net profit/operating revenue $\times$ 100%), provides a direct indication of the profit level of commercial banks. The return on total assets (ROA = net profit/total assets) measures the efficiency with which a bank generates income from its assets. The return on equity (ROE = net profit/shareholders' equity) reflects the efficiency with which a bank uses its own funds to create returns for its shareholders. Collectively, these indicators form the key dimensions for assessing the profitability of commercial banks.

3.3. Impact of Shadow Banking

Based on the research background and characteristics of shadow banking, this paper posits that shadow banking can effectively evade regulation to provide financing services for small and medium-sized enterprises (SMEs) and real estate companies. SMEs, often characterized by high operational risks, limited high-quality assets, and a higher likelihood of bankruptcy, have traditionally received limited credit services from commercial banks, which prioritize the security of their funds. The emergence of shadow banking has enabled these enterprises to obtain funding at reasonable interest rates, thereby meeting their operational capital needs. Moreover, the high returns offered by shadow banking have attracted numerous investors, enhancing the efficiency of social capital allocation, expanding the channels for capital intermediation, and injecting new vitality into the financial market.

The "loan-like" activities of shadow banking have impacted the traditional financial services of commercial banks. Historically, commercial banks have relied on their reputation to attract household deposits and profit from the interest margin between deposits and loans. With the rise of shadow banking, non-bank financial institutions have also begun to accept deposits and extend loans, leading to a分流 of bank customers and a reduced dependence of enterprises on commercial bank credit. This has eroded the monopoly position of commercial banks. To maintain their profitability, commercial banks must seek business innovation, transform their business models, and explore new markets.

In China, shadow banking products are often closely linked to funds, futures, stocks, and other financial instruments. Many of these financial innovations involve high leverage, allowing for large-scale financing with relatively small amounts of capital. While these products can yield high returns during economic booms, they pose significant risks during downturns. The crisis of investment targets may lead to the non-recovery of funds, the spread of market panic, and the amplification of high-

leverage risks, potentially triggering systemic financial risks. Therefore, it is imperative to strictly limit the scale of shadow banking and pursue its development with caution.

In summary, shadow banking initially has a positive effect on the profitability and expansion of commercial banks. However, rapid and uncontrolled growth can expose its high-risk nature, ultimately having a negative impact on bank profitability.

4. Empirical Analysis

4.1. Sample Selection and Data

By the end of 2020, the number of banks listed on the Shanghai Stock Exchange had reached 33. This paper selects eight large commercial banks as samples, comprising five state-owned banks, two joint-stock banks, and one city commercial bank, and conducts an empirical analysis on them. The selected banks are Bank of China, Agricultural Bank of China, Industrial and Commercial Bank of China, China Construction Bank, Bank of Communications, China Merchants Bank, CITIC Bank, and Ningbo Bank.

Dependent Variable: This paper chooses the return on assets (ROA, calculated as net profit divided by total assets) as the dependent variable. This metric reflects the operational capability of commercial banks, specifically the profit generated per unit of assets. Although the return on equity (ROE, calculated as net income divided by shareholders' equity) is also an important indicator of bank profitability, it only reflects the efficiency with which the company uses shareholders' funds. Therefore, this paper selects ROA as the primary dependent variable.

Independent Variable: The scale of shadow banking is selected as the independent variable to explore its positive and negative effects on the profitability of commercial banks. The extent to which shadow banking affects the profitability of commercial banks needs to be verified through empirical analysis to clarify its specific mechanism of action.

Control Variables: The profitability of commercial banks is influenced by a variety of factors, which can be broadly categorized into bank-specific factors and external environmental factors. Bank-specific factors include total asset size, year-on-year growth rate of operating revenue, net profit margin, and the proportion of non-interest income. Total asset size reflects the economies of scale; larger asset sizes are generally associated with higher profits, but beyond a certain threshold, the marginal effect diminishes, and further expansion may have an adverse impact on profitability. The year-on-year growth rate of operating revenue reflects the future development potential of commercial banks. The net profit margin (the ratio of net profit to operating revenue) indicates the efficiency with which commercial banks utilize capital; a higher ratio suggests that banks can more effectively use their capital to enhance profits. The proportion of non-interest income reflects the importance of non-interest income in the profit structure of commercial banks. Non-interest income activities are relatively safer and more stable, with higher profit margins, and represent a major direction for future banking innovation. Regarding external environmental factors, commercial banks are highly susceptible to macroeconomic conditions. This paper selects gross domestic product (GDP) as an indicator of external environmental influence. An increase in GDP signifies steady economic growth and favorable conditions, which can have a certain impact on the profitability of commercial banks.

4.2. Empirical Model and Methods

4.2.2 Empirical Model Selection

Based on the aforementioned research analysis and references to prior literature, the model is specified as follows:

$$ROA_{it} = \beta_1 ShBank_{it} + \beta_2 ShBank_{it}^2 + \beta_3 Size_{it} + \beta_4 OR_{it} + \beta_5 TAT_{it} + \beta_6 NOI_{it} + \beta_7 NIIR_{it} + \beta_8 CAR_{it} + \beta_9 GDP_{it} + \varepsilon_{it}$$

Here, i represents the selected commercial bank, t represents the year of selection, β represents the coefficient, and the dependent variable ROA refers to the return on assets, which is used to evaluate the profitability level of commercial banks. The explanatory variables are $ShBank$ and $ShBank^2$, which represent the size level and its square of shadow banking, respectively. The control variables include $Size$, which refers to bank assets; OR , which represents the growth rate of operating income; TAT , which stands for the total asset turnover rate; NOI , which denotes the net interest rate; NIR , which indicates the ratio of non-interest income; CAR , which represents the capital adequacy ratio; GDP , which stands for the gross domestic product; and ε , which represents the error term.

4.2.3 Empirical Methods

For the empirical study, financial data from 2012 to 2021 for eight selected banks, along with GDP data and shadow banking scale data, are utilized. Initially, descriptive statistical methods are employed to summarize the data, followed by correlation analysis.

4.3. Descriptive Statistical Analysis

The results of the descriptive statistics are shown in Table 1. As depicted in the figures, the banks in question encompass state-owned banks, joint-stock banks, and city commercial banks. Consequently, their operational performance varies significantly, particularly in terms of return on equity (ROE), size, operating revenue (OR), and net interest income ratio (NIIR). The overall return on assets (ROA), a measure of investment return, ranges from a maximum of 1.47 to a minimum of 0.69, with a difference of 0.78. The variation in the growth rate of operating revenue (OR) is substantial, averaging 0.101. In China, commercial banks primarily derive their income from the interest margin between deposits and loans, although they also have other sources of income, such as investment earnings. There are differences in the operational capabilities of these banks. Meanwhile, the average net interest income (NOI) stands at 35.5%, indicating the profitability of China's commercial banks and the sound operation of the economy. Regarding NIIR, the average proportion of non-interest income is 13.6%, which suggests that the main source of income for China's commercial banks still relies on deposit interest rates. However, some banks have recognized the significant potential of this business area and have shifted their focus towards non-interest income activities. Additionally, the capital adequacy ratio stipulated by the Basel Accord is 8%, while the average value in the selected sample is 14.3%, highlighting the advantage of China's commercial banks in terms of risk resistance.

Table 1. Descriptive statistics.

Variables	Sample size	Mean	Std Dev	Min	Max
ROA	80	1.079	0.199	0.69	1.47
ROE	80	15.6	3.595	10.11	24.78
lnShBank	80	3.889	0.332	3.087	4.213
lnShBank ²	80	15.23	2.43	9.529	17.75
lnSize	80	2.2	1.095	-0.985	3.56
OR	80	0.101	0.0715	-0.0562	0.298
TAT	80	0.0302	0.00527	0.02	0.04
NOI	80	0.355	0.0404	0.252	0.445
NIR	80	0.136	0.0362	0.0602	0.238
CAR	80	0.143	0.0171	0.111	0.18
lnGDP	80	4.288	0.182	3.986	4.557

4.4. Correlation Analysis

The results of the correlation analysis are shown in Table 2. As shown in the figure, the correlation coefficients of return on assets (ROA) with return on equity (ROE), operating revenue growth rate (OR), total asset turnover rate (TAT), net interest income ratio (NOI), and non-interest income ratio

(NIIR) are 0.8475, 0.3381, 0.5976, 0.7324, and 0.2373, respectively. These values indicate that ROA is positively correlated with these variables at the 0.01 significance level. The correlation coefficients of the natural logarithm of shadow banking scale (lnShbank) with the natural logarithm of bank size (lnSize), NIIR, and capital adequacy ratio (CAR) are 0.2167, 0.3241, and 0.3664, respectively. This suggests that shadow banking scale (ShBank) is positively correlated with these variables at the 0.01 significance level. The correlation coefficients of the natural logarithm of gross domestic product (lnGDP) with lnShBank, lnSize, NIIR, and CAR are 0.7924, 0.2661, 0.1504, and 0.6572, respectively. This indicates that lnGDP is positively correlated with these variables at the 0.01 significance level.

Table 2. Correlation analysis

	ROA	ROE	lnShBank	lnShBank2	lnSize	OR	TAT	NOI	NIR	CAR	lnGDP
ROA	1										
ROE	0.8475	1									
lnShBank	-	-	1								
	0.5715	0.6993									
lnShBank2	-	-	0.9992	1							
	0.5782	0.7045									
lnSize	-	-	0.2167	0.2174	1						
	0.0230	0.3768									
OR	0.3381	0.5388	-0.4891	-0.4998	-	1					
					0.6883						
TAT	0.5976	0.5424	-0.2038	-0.2052	-	0.2813	1				
					0.1657						
NOI	0.7324	0.5734	-0.4401	-0.4415	0.1113	0.1230	0.0453	1			
NIR	0.2373	0.0841	0.3241	0.3270	0.0731	-	0.5432	-	1		
						0.1543		0.1913			
CAR	0.0424	-	0.3664	0.3730	0.0465	-	-	0.1941	0.0113	1	
		0.4155				0.2448	0.1183				
lnGDP	-	-	0.7924	0.7948	0.2661	-	-	-	0.1504	0.6572	1
	0.5972	0.7662				0.3346	0.2598	0.4041			

4.5. Analysis of Regression Results

Based on the regression results obtained in Table 3, the following regression equation can be derived:

Table 3. Analysis of regression results

Variables	Dependent variable: ROA	
Independent variables	lnShBank	1.993*** (-4.56)
	lnShBank ²	-0.284*** (-4.78)
	lnSize	0.011* (-1.67)
	OR	0.299** (-2.6)
	TAT	11.146*** (-8.17)
Control variables	NOI	2.546*** (-14.85)
	NIR	1.608*** (-7.88)
	CAR	2.088*** (-3.26)
	lnGDP	-0.358*** (-4.29)
Constant	Constant	-2.619***

	(-3.42)
Observations	80
R-squared	0.956
F test	0
r2_a	0.951
F	174.3

Note: *** indicates $p < 0.01$, ** indicates $p < 0.05$, and * indicates $p < 0.1$. The numbers in parentheses represent the robust t-statistics for the estimated parameters.

As indicated in Table 3, the R-squared value is close to 1, which suggests that the regression model derived in this study exhibits a good fit.

First, the analysis of the individual factors reveals that the coefficient of the first-order term of shadow banking scale is positive, while the coefficient of the second-order term is negative. This indicates an inverted “U”-shaped relationship between the profit level of shadow banking and its scale. Before the scale of shadow banking reaches a certain level, its expansion drives profit increases. However, once the scale reaches a certain threshold, further expansion leads to a decline in profit.

Second, the model shows that when the operational indicators of commercial banks—such as size, operating revenue growth rate (OR), total asset turnover (TAT), net operating income (NOI), non-interest income ratio (NIIR), and capital adequacy ratio (CAR)—increase, their profit levels also correspondingly rise. Specifically, an increase in the asset size of commercial banks can enhance their profits. A higher total asset turnover rate implies improved capital operation efficiency for commercial banks, meaning that they can generate higher sales revenue per unit of capital employed. A greater proportion of non-interest income indicates stronger profitability, and non-interest income is poised to become an important sector for bank profits in the future. Additionally, the negative correlation coefficient between return on assets (ROA) and gross domestic product (GDP) may be attributed to the fact that during economic booms, enterprises have better financing channels, which to some extent hampers the lending progress of commercial banks.

5. Research Conclusions and Policy Recommendations

5.1. Research Conclusions

This paper first reviews the origin and development of “shadow banking” internationally, and on this basis, defines the concept of “shadow banking.” It comprehensively analyzes the causes and characteristics of shadow banking and examines the relationship between the scale of shadow banking and the factors influencing bank profitability, as well as the evaluation indicators. The study reveals an inverted “U”-shaped relationship between the scale of shadow banking and profit levels: initially, expanding the scale of shadow banking can increase the profits of commercial banks, but once the scale reaches a certain threshold, it leads to a decline in profits. Although China’s shadow banking sector is still in its infancy, its scale and potential risks cannot be overlooked.

5.2. Policy Recommendations

Shadow banking originates from financial repression and holds positive significance for addressing the financing difficulties of small and medium-sized enterprises, adjusting the industry financing structure, and promoting the diversification of household investments. However, it also introduces risks. Therefore, it is essential to promote the co-development of shadow banking and traditional banks while controlling risks, thereby reducing bank risks and enhancing profitability. The following are some policy recommendations.

First, establish a disclosure system for shadow banking. Shadow banking is characterized by low transparency and high concealment, which can lead to the accumulation of risks. Regulatory authorities should require commercial banks to disclose their off-balance-sheet activities to enhance

transparency. They should also closely monitor the flow of funds in non-bank financial institutions to prevent them from entering high-risk industries. Additionally, efforts should be intensified to crack down on private lending and underground banking activities.

Second, commercial banks need to expand into new business areas. Currently, commercial banks rely on the interest margin between deposits and loans for profit. However, with the advancement of interest rate liberalization and increased competition, they need to seek new sources of income. Given the high demand for asset preservation and appreciation among households and the limited variety of market wealth management products, commercial banks should learn from the experience of foreign banks to develop financial products suitable for the Chinese market and enhance innovation.

Finally, strengthen the regulation of shadow banking activities. Regulatory authorities need to clarify the business models and risk transmission pathways of different banks, formulate regulatory regulations, standardize the business activities of financial institutions, implement classified management, and establish firewalls to prevent the spread of risks. At the same time, it is necessary to break through the current situation of rigid redemptions, allowing investors to recognize investment risks and to reasonably rate products based on the probability of default of the institutions.

6. Conclusions

The emergence and development of shadow banking in China are closely related to the current situation of “financial repression” and “financial innovation.” Owing to its high leverage and maturity mismatch, shadow banking is able to provide a greater variety of financial products. However, while meeting market demands, it also poses significant potential risks. Moreover, the lack of regulatory constraints, transparency, and the high degree of concealment have presented new challenges to the macroeconomic control of the central bank. In the coming period, the regulation of shadow banking will be a key focus of China’s financial supervision.

Furthermore, there is still much room for further research in this area. China can draw on advanced international experience to effectively support the development of the real economy, promote the healthy development of non-bank financial activities, and effectively curb their potential risks, thereby stabilizing their development trajectory. For the private lending within shadow banking entities, which is difficult to monitor, a method of distributing survey questionnaires could be adopted. By collecting, transmitting, and receiving data, a monitoring platform and an information disclosure mechanism could be established to achieve real-time monitoring and control, thereby providing effective support and assistance to the real economy.

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