The unintended consequences of regulation: Evidence from China's interbank market

Xian Gu

Central University of Finance and Economics;
University of Pennsylvania

Lu Yun

Central University of Finance and Economics

March 2019

Summary

This paper examines how regulations can generate arbitrage across different subsectors of the banking system and how such risks can be transmitted to capital markets, using China's recent fast-growing interbank negotiable certificate of deposits (NCDs) and interbank wealth management product (WMP) market. Our evidence shows that the launch of the interbank NCD market accompanies by other financial regulation policies has been utilized by banks for regulatory arbitrage in the financial system and such effects are more significant for banks with tighter liquidity conditions. Specifically, banks with higher loan-to-deposit (LDR) ratios are more likely to search for funds by issuing newly introduced and lightly regulated financial instruments such as interbank NCDs. We use interest rate deregulation as a shock and our investigation confirms that smaller banks that face greater competition have engaged more heavily in the issuance of interbank NCDs and interbank WMPs, especially when market rates are high.

Further analysis suggests that the initial pricing of interbank NCDs incorporates only the issuing bank size and its growth, but not the bank risks in terms of liquidity mismatch and bankruptcy risk. In addition, banks that participate more in interbank NCD and WMP market have also invested more in the bond market through proprietary trading. Such association across different subsectors of the financial system indicates the potential risk of financial contagion.