Journal of Economics, Finance and Accounting Studies
ISSN: 2709-0809
DOI: 10.32996/jefas
Journal Homepage: www.al-kindipublisher.com/index.php/jefas

JEFAS
AL-KINDI CENTER FOR RESEARCH AND DEVELOPMENT

| RESEARCH ARTICLE

Analysing the Relationship between Financial Innovation and Financial Stability

Enhao Zhu
Seoul School of Integrated Sciences and Technologies; Seodaemun-gu, Seoul 03767, Republic of Korea
Corresponding Author: Enhao Zhu, **E-mail**: zhuenhao@stud.assist.ac.kr

| ABSTRACT
Over the past few years, China's financial market has experienced multiple changes, in particular, the rapid development of financial innovations, including adjustments to shadow banking regulatory policies and new types of wealth management products, which have gradually attracted the attention of academics and regulators, and the rise of Internet finance, which has provided new platforms for capital flows, but has also brought regulatory and risk management challenges. The implementation of the Guiding Opinions on Regulating the Asset Management Business of Financial Institutions (hereinafter referred to as the "Provisions" or the "New Asset Management Rules") aims to regulate the order of the financial market, and it is of great significance to safeguard China's financial stability. By analysing these topics, this paper explores the relationship between financial innovation and financial stability in China in the process of financial development and provides insights into the study of the changing market environment and financial risks.

| KEYWORDS

Financial Innovation; Shadow Banking; Internet Finance; New Regulations on Asset Management; Financial Stability.

| ARTICLE INFORMATION

ACCEPTED: 08 August 2024 **PUBLISHED:** 31 August 2024 **DOI:** 10.32996/jefas.2024.6.5.1

1. Introduction
The relationship between financial innovation and financial stability is an important and complex topic in the modern financial system. Financial innovation, in a broad sense, refers to all forms of innovative activities occurring in the financial field, including financial system innovation, mechanism innovation, institutional innovation, management innovation, technological innovation, and business innovation. Financial innovation, in a narrow sense, mainly refers to business innovation, such as the development of financial instruments and financial services (Peng, 2020). Innovation is usually mainly financial innovation in a narrow sense, aiming to improve the operational efficiency, liquidity, and competitiveness of the financial market. Through financial innovation, it promotes the effective allocation of capital and promotes economic growth and social development.

However, financial innovation also comes with certain risks and challenges. First, rapidly evolving financial innovations may lead to increased complexity in the financial system, making it difficult for regulators to fully grasp and effectively monitor emerging financial product models due to regulatory lags. Second, excessive financial innovation may lead to increased volatility and uncertainty in the financial markets, exacerbating systemic risks. Certain innovative products may be misused or abused in the absence of transparency and market knowledge, leading to a decline in market trust and thus triggering financial risks, so financial stability plays a crucial role in the development of financial innovation. Based on this, this paper discusses the relationship between financial innovation and financial stability from the aspects of financial business innovation, financial product innovation, and financial institution innovation.

2. The Relationship between the Shadow Banking System and Financial Stability
The concept of shadow banking was first introduced by Paul McCauley of Pacific Investment Management Company in 2007. At its core is the innovation of financial business and the emergence of a number of institutions and products that are outside of

Copyright: © 2024 the Author(s). This article is an open access article distributed under the terms and conditions of the Creative Commons Attribution (CC-BY) 4.0 license (https://creativecommons.org/licenses/by/4.0/). Published by Al-Kindi Centre for Research and Development, London, United Kingdom.

regulation and insufficiently transparent in the course of banks' credit intermediation business. China's General Office of the State Council in 2013 issued a relevant notice (No. 107) (Ma, 2014) on strengthening the supervision of shadow banking, which classifies shadow banking institutions into three categories: first, credit intermediaries that do not hold financial licences and are completely unregulated, such as the new type of network financial companies (P2P), second, credit intermediaries that do not hold financial licences and are regulated, but there is a lack of supervision (financial guarantee companies, microfinance companies), third, credit intermediaries that hold financial licences and are regulated, but there is a lack of regulation (financial guarantee companies, microfinance (financial guarantee companies, microfinance companies), the third is holding a financial licence with insufficient regulation, or there are businesses that avoid regulation (commercial banks off-balance sheet wealth management business, asset management business, trust business, etc.) (Li & Li, 2014). China's shadow banking system has always been dominated by commercial banks, which are essentially the “shadow” of banks and belong to the third category of the 107th Circular.

2.1 Shadow Banking Developments

In 2014-2016, under the market environment of easy money and weak regulation, which led to the lower cost of funds for banks, the separate regulation is not suitable for the mixed operation of banks, and the use of funds by banks is broadening, and the two overlapping aspects make the rapid development of China's shadow banking system, which pushes up the leverage ratio of the financial system (the empty transfer of funds) and the real economy. Shadow banking is, in fact, the financial innovation carried out by the banking system originating from the circumvention of administrative control. Then, China's shadow banking is carrying out regulatory arbitrage activities.

In 2016-2017, China adopted a tightening of the currency, raising the cost of funds, strengthening regulation, and reducing investment returns. This led to a sharp decline in M2 and the scale of social financing, the exposure of credit market risks, and a negative impact on the real economy; the policy reversed to adjust the use of structural monetary policy to ease money, regulatory tightening, the market's risk appetite is declining, and the monetary policy transmission mechanism is blocked. SMEs are mostly financed through off-balance sheet shadow banking, with liquidity injected on-balance sheet, and the banks' on-balance sheet business (docking with large SOEs) could not be passed on to the off-balance sheet, leading to the emergence of SME financing difficulties.

The banking sector is a high risk and important, and strict regulatory measures are imposed on banks worldwide, centred on the Basel Accord. China is no exception; there are many restrictions on commercial banks, some regulatory standards are even more stringent than the Basel Accord, and there are also some unique regulatory policies, such as the restriction of commercial banks before 2015, the deposit and loan ratio (credit size) is less than or equal to 75 percent (Zhu, 2017); credit rationing in the negative list is used more in 2009, banks were required to tightly control loans to the “two high and one leftover” industries; in 2010, banks were required to tighten their lending to In 2009, banks were asked to strictly control lending to the “two high and one leftover” industries; in 2010, they were asked to tighten lending to the real estate industry; and in 2012, they were asked to tighten lending to local government financing platforms. Local platforms, real estate, and heavy industry enterprises rely heavily on credit and have sufficient collateral and government guarantees, which are relatively low-risk for banks. This is coupled with soft budget constraints and the ability to withstand higher interest rates, resulting in high returns for banks. However, the successive introduction of regulatory policies to limit the bank's credit investment in these areas, undermining the bank's profits, resulting in the bank having the incentive to use external channels to circumvent the regulation of the transfer of the business on the table to the off-balance sheet, thus breaking through a series of regulatory indicators of the restrictions, such as the size of the credit, the field of lending, capital adequacy ratio, provision coverage ratio and other restrictions on the continuation of the overcapacity industries, real estate, local platforms to provide loan support and increase the bank's own profit.

2.2 An Example of a Bank-trust Co-operation Model, 2008-2010

After the financial crisis in 2008, the 4 trillion financial plan brought a large number of new loan demand (Wang, 2018), but by the regulatory restrictions, the bank's on-balance sheet credit business is difficult to meet the excess demand for loans, at this time, the commercial banks first thought of the weakest ability to be subject to regulation, the least investment restrictions on the trust institutions. From the point of view of commercial banks, trust institutions can lend money for themselves, and the income spread of commercial banks is higher than the channel fee; from the point of view of trust institutions, the income is the channel fee, and they do not bear any risk in the middle of the process, which is almost zero cost, so the trust institutions are very happy to do the channel business. The trust loan business based on “bank-trust cooperation” has seen explosive growth during 2008-2010.

Specifically, the enterprise to the bank to put forward financing needs, the bank due to a variety of restrictions, can not give the enterprise lending at this time by the trust company to set up a trust plan; the trust plan to invest in the enterprise, the commercial bank to buy the beneficiary rights of the trust plan, the bank with the on-balance-sheet or off-balance-sheet funds with the trust plan to dovetail.

(1) If the bank uses on-balance sheet funds, i.e., issues on-balance sheet financial products (capital preservation financial products), such financial products are managed strictly in accordance with on-balance sheet deposits in China, which are a kind of structured deposits, so on the liability side of the bank's table the capital preservation financial products are recorded, and on the asset side they are not recorded under the credit assets, but rather under accounts receivable in the second level of provisioning, at which point the bank passes through the trusted channel and bypasses the credit size and industry placement constraints.

(2) If off-balance sheet funds are used and non-principal-protected financial products are issued, it will not affect any changes in the various accounts in the table, and there is no occupation of all the regulatory indicators, so the bank is more likely to issue off-balance sheet non-principal-protected financial products to raise funds, dock with the trust plan, and go to buy the credit assets through the trust plan, which bypasses the regulation that the off-balance sheet funds can not directly buy the credit assets, and the beneficial right and management of the credit assets in essence still belong to the bank. In essence, the beneficiary rights and management rights of the credit assets still belong to the bank, and the risk is within the banking system. The profit model of China's banks is based on “rigid payment” in the form of “expected return and excess retention,” and the risk remains within the banking system. In 2008-2010, the business model of shadow banking was that banks issued off-balance sheet wealth management products to raise funds, which were ultimately invested in real estate and local platforms through the channels of trust institutions. At the end of 2009, the CBRC issued a series of provisions to regulate the “bank-trust co-operation,” with ten consecutive provisions requiring the following Compression of the “bank credit business,” the regulation of timely advancement.

In 2011, the “Bank-Small Co-operation” was launched, in which rural small and medium-sized financial institutions continued to issue loans under the name of buy-and-sell business, and in 2012, the “Bank-Securities Co-operation” was launched, in which securities institutions continued to issue loans or purchase non-standard assets under the name of asset management business. In 2013, “bank-fund co-operation” was carried out, as banks had just been approved to set up fund subsidiaries in 2013. The regulation of fund subsidiaries was more relaxed than that of trust institutions, securities institutions, and traditional fund companies, and there was no capital requirement, so they continued to do shadow banking business through fund subsidiaries as a channel banking business.

“The cooperation between banks and securities firms and banks and fund managers requires coordinated supervision by the CBRC and the SEC, which is more difficult. Until 2013, there was a “money shortage” due to a lot of channel business, maturity mismatch, short-term liquidity shortages, and money market interest rates rose; the State Council ordered the strengthening of the CBRC and the CSRC co-regulation. In 2013, the end of the People's Bank of China will be stopped for 16 years interbank certificates of deposit business restarted. 2014 to carry out the “bank-bank cooperation,” such as through the pledge of interbank certificates of deposit, etc. “Bank-bank cooperation,” such as through the pledge of interbank certificates of deposit as a channel, continued to conduct business. In 2014, the CBRC stipulated that wealth management funds should be limited to 35 percent if they wanted to invest in non-standard assets, and at the same time, they could not exceed 4 percent of the total assets of the bank so as to carry out aggregate control.

2.3 Reasons for the Formation of Shadow Banking
2.3.1 On the Source of Funds (Liability Side)
In terms of residents' and enterprises' investment in wealth management products, as well as investment in some other shadow banking products (microfinance companies, P2P platforms), data show that the balance of wealth management funds has risen from 1.7 trillion at the beginning of 2010 all the way up to 30 trillion at the end of 2016, leading to an expansion in the scale of commercial banks' interbank liabilities. The rapid growth of residents' wealth has led to a strong demand for asset preservation and appreciation. Due to the existence of long-term control of interest rates, the low degree of development of the financial market, residents, and enterprises, and the lack of good asset allocation channels, the formation of a “capital weir.” Under the background of rigid payment, the issuance of wealth management products and new financial products with higher yields can quickly raise funds. The stable and loose monetary policy since November 2014 has made the liquidity of the banking system very abundant, and the interbank business has expanded rapidly.

2.3.2 Intermediaries
Under China's current system of sectoral and institutional supervision, regulatory standards are not uniform, forming regulatory “pits,” and regulatory coordination is relatively weak, leading to the existence of regulatory arbitrage in banks. Banks will use trust institutions, securities institutions, fund institutions, and interbank as a channel for the transfer of credit assets out of the table, in the form of non-standard, etc., allocated to the existence of regulatory restrictions on the industry (local platforms, real estate) and enterprises. Moreover, in the environment of financial liberalisation, the rise of non-banking financial institutions, wealth management products, interbank certificates of deposit, and other innovative financial products was born.

2.3.3 In Terms of Fund Flow (Asset Side)

Before 2013, the funds of shadow banks mainly flowed to the real economy (real estate, local platforms, state-owned enterprises); in 2014-2016, due to the consolidation of local platform debts, the real estate market de-stocking and other factors, the demand for funds in the field sector began to shrink, and at that time, liquidity was very abundant, coupled with supply-side reforms, the bond and The stock market performed better, and the shadow banking system allocated a large amount of funds to the bond and stock sectors, forming a positive feedback mechanism, and the economy was gradually decoupled from the real to the virtual after 2016, the supply-side reforms were effective, and the economy was decoupled from the real to the virtual and then corrected again, and the shadow banking system once again allocated funds to the real economy. China's capital market development is immature, and the direct financing system is weak, so real estate, local platforms, state-owned enterprises, etc. There is a serious dependence on bank credit, and the soft budget constraints of some enterprises are further weakened. The perspective of credit rationing, funds to state-owned enterprises are over-allocated over-allocation, to small and medium-sized enterprises, do not allocate under-allocation; thus, there is a structural problem of financing difficulties and expensive financing, small and micro-enterprises financing needs can not be covered by the formal financial system.

2.4 Implications Arising from Shadow Banking

The conversion of residents' savings into investment by enterprises plays a complementary role to the formal financial system, meeting the wealth management needs of residents on the one hand and the financing needs of enterprises on the other, supporting the real economy, which also enhances the profitability of financial institutions.

However, the shadow banking system is outside of regulation, and the emergence of regulatory gaps is likely to lead to the accumulation of risks, which in turn will lead to uncontrolled regulation, easily triggering systemic financial risks and threatening the stability of the real economy. Push up the leverage of the financial system, amplify the volatility of asset prices, increase the vulnerability of the financial system, and secondly, push up the leverage of the real economy, especially the leverage of specific industries (real estate, overcapacity industry), slow down the clearing of production capacity, is not in line with our country's deleveraging, to go to the production capacity of the supply side of the reform orientation. Reduced the transmission efficiency of monetary policy and regulatory efficiency, the larger the scale of shadow banking, the stronger the interference with the transmission efficiency of monetary policy and regulatory efficiency.

2.5 Summary

The introduction of the Provisions to combat the shadow banking system so that the essence of "customer wealth management, customers are responsible for their own profits and losses," the liability side to break the "rigidity of payment"; the asset side of the fight against non-standard assets; to break the channel business and multi-layer nesting. In the medium and long term, it is conducive to regulating the development of asset management business and maintaining the stability of the financial system.

From the perspective of funding sources, the marketisation of interest rates should be promoted, the degree of market-based pricing of deposit rates should be increased, and on-balance sheet yields should be raised appropriately. From the perspective of financial intermediation, efforts to coordinate and unify supervision should be increased, regulatory shortcomings should be made up for, regulatory gaps and regulatory arbitrage under the separate regulatory system should be mitigated, and the regulatory framework should be promoted to shift from institutional to functional regulation. From the perspective of capital flow, it is important to continuously deepen the reform, build a multi-level capital market, and improve fiscal and tax reform. At the same time, it is necessary to grasp the rhythm and intensity of shadow banking governance, prevent secondary risks arising from the governance process, and prevent excessive impacts on M2, the scale of social financing, and the real economy.

3. New Types of Financial Products Relationship to Traditional Business (Using Yu'E Bao as An Example)

The most representative of the new financial products is the balance treasure, which is a financial product innovation based on the Internet platform, and from the traditional financial perspective, the balance treasure is equivalent to a money market fund (MMMF). As in the United States, commercial banks launched money fund deposit accounts to cope with the impact of money funds; funds and banks are financial intermediaries, both can play the role of aggregation, both can be used as a medium for investment and financing, and there is a competitive relationship between the two. The development of money market funds will inevitably have an impact on banks' deposit and loan business.

Specifically, the financing end of the money market fund is the surplus side of the funds such as residential enterprises, and its return, risk, liquidity characteristics, and deposits are very similar to the yield is higher than the time deposits, the risk is low, the liquidity is stronger than the liquidity of the call, so the money market fund compared to deposit products, is able to fall on top of the higher currency and other benefits curve; the investment end of the point of view, such as the United States of America's money market fund situation is buy a lot of treasury bills, as well as commercial and industrial enterprises issued notes, etc., and our country can be used as the subject of investment in less money market instruments, most of which are in the form of agreement deposits into the banking system, so the introduction of China's Yu'E Bao, CaiFuZhong wealth management products, did not like the United States as a large number of deposits moved, and in our country caused a rise in the cost of bank funds, resulting in a rise in the interest rate of the loan, making interest rates pivot up, accelerating the pace of interest rate marketisation. The entry of money market funds has created a sense of anxiety among banks, focusing on customer experience, product development, and the use of financial technology, ultimately improving the efficiency of the banking industry's services and highlighting the importance of market competition. Along with the formation of a diversified, competitive landscape, the banking industry will operate more and more efficiently, which will, in turn, promote the high-quality development of the economy.

4. The relationship between Internet Finance and Financial Stability (P2P as An Example)

4.1 Internet Finance Model

The model of Internet finance is the Internetisation of traditional financial business, Internet banking, Internet securities, Internet insurance, offline business carried online, and the emergence of new financial institutions innovation. At the same time, it is based on the Internet platform to carry out financial business. Including the sale of financial products based on the third-party payment Internet platform (Balance Treasure), the sale of financial products based on the pure Internet platform (Daily Fund), the small loan business based on the e-commerce platform (Ali Small Loan), the consumer finance business (Jingdong White Stripes), and the quasi-consumer finance business (Installment Le). This was followed by the introduction of P2P, crowdfunding, and other new Internet financial models. At present, in China, the financial support of the Internet industry includes the education industry, community-based finance, information-based services, financial management business, etc.

4.2 P2P (Person to Person)

P2P is between individuals and individuals through the Internet platform to achieve direct lending (Liu et al., 2017), belongs to the category of private lending, and P2P platform refers to specialise in network lending information intermediary business of financial information intermediary companies, the scope of services broadly including information collection, publication, credit assessment, lending and borrowing and so on.P2P is not the same as the network of small loan companies. On the one hand, the nature of the business and the source of funds are not the same. Network microfinance companies move offline microfinance companies online; network microfinance companies can use their own funds for lending. P2P is an information intermediary that is a pure Internet platform nature, and the funds are from individual investors out of money. On the other hand, the supervision is not the same. Network microfinance companies need a lending qualification licence, while the P2P platform does not need a qualification licence, and there is no regulation.

As of June 2018, there were 1,836 P2P platforms in operation in China, of which 1,376 were private platforms, 156 were venture capital platforms, and 112 were listed company platforms, with a loan balance of nearly $1.32 trillion. The credit risk indicator of P2P platforms is usually the bad debt rate, and it is more intuitive to use the exit rate and the number of platforms exiting each month since the last six months of 2018 is about 100.

4.3 P2P Thunderstorm Event

4.3.1 Direct Causes

Under the policy guidance of financial deleveraging, the implementation of a prudent and neutral monetary policy and the strengthening of financial regulation led to the ebbing of liquidity, the increase in the default rate of platform borrowers, and the rise in credit risk and liquidity risk. At the same time, the tightening of central bank liquidity, in aggregate, has led to a rise in liquidity risk across the financial system. From a structural point of view, micro and small enterprises and low- and middle-income people are at the end of the financing chain and are subject to a greater impact, while local platforms and large state-owned enterprises are at the front end of the financing chain and are subject to a smaller impact. The main businessstay of P2P platforms is the micro and small enterprises and low- and middle-income people, who are subject to a greater impact, so there will be a greater outbreak of credit risk and liquidity risk.

Due to the collapse of some platforms, the uncertainty of regulatory policies, and the over-exaggeration of the media further impacting investor confidence, amplifying the pessimism of the market, and forming a “bad expectation” in the market, aggravating the run, as seen from the data, the platform's lenders and the net inflow of funds in 2018 have seen a large number of declines, which has increased the platform's liquidity risk. In December 2017, the regulator carried out rectification and acceptance of P2P platforms, qualified one for the record, did not allow the release of new products during the filing period, and the filing process was slow. The excessive propaganda of the media and some illegal fund-raising problems are all attributed to P2P platform problems. The strengthening of the regulation of the P2P industry itself will also prompt the exit of non-compliant platforms, and the pace of market clearance will be accelerated. A notice was issued in December 2017 to strengthen the regulation.

4.3.2 Fundamental Reason

Banks are credit intermediaries to play risk conversion, term conversion, risk conversion to assume credit risk, term conversion to assume liquidity risk by assuming credit risk, and liquidity risk to obtain income; while a P2P platform is an information intermediary, an information intermediary can not replace the credit intermediary, the phenomenon of stealing concepts, and even evolved into a "Ponzi scheme. "

From the major countries to see the development direction of P2P and the previous ten ministries and commissions jointly issued the "Guiding Opinions," the formal P2P platform should implement the positioning of the information intermediary in the direct financing, i.e., to provide information services for the borrowing and lending parties and to collect part of the service fee (Chen et al., 2011). From the above perspective, P2P platforms will not bear any risk, which should be borne by investors. However, due to the development of P2P in China has long been in the regulatory gap, there are no specific legal provisions, and there is no specific department directly under the control of the P2P platform, resulting in the development of P2P platform alienation, evolved a number of violations of the model, the most important is the information intermediary in the direct financing, alienation of the credit intermediary in the indirect financing, the formation of the shadow banking system. P2P platforms generally follow the path of "banking" - "risky" - "Ponzi" to carry out the evolution of alienation. Some P2P platforms are themselves illegal fund-raising and financial fraud, and as regulation tightens, they automatically exit the market.

4.3.3 Summary

P2P platforms complement the traditional formal financial system in the economy. From the investor's point of view, it enriches the channels of asset allocation and increases the way of wealth management; from the financier's point of view, it obtains financing and plays a supportive role in the real economy, and from the intermediary's point of view, it obtains profits from the middle. With the tightening of regulations, the exit of the platform means that there is a normal clearing of the P2P industry in a more compliant direction. In the future, while strengthening regulation, we should do a good job of investor education while guiding the benign development of the P2P industry and effectively protecting the legitimate rights and interests of investors.

5. Regulatory Measures to Address Financial Risks

China's asset management business has developed rapidly in recent years, with a total scale of more than 100 trillion as of 2017 (Du, 2019). Asset management products are mainly off-balance sheet wealth management businesses of banks, trust plans, asset management plans of public and private securities companies, internet enterprises, P2P platforms, and other non-bank financial institutions that carry out asset management business. The scale of rapid expansion in the development of the market found that the regulation can not meet the needs of the market due to the lack of regulatory norms, resulting in the development of the market being chaotic exposed more problems. Among them, the asset management industry represented by off-balance-sheet wealth management of banks and P2P platforms has many problems; the shadow banking system formed hides a lot of risks, and the accumulation of risks is prone to cause systemic financial risks, affecting financial stability, and the promulgation of the Provisions is to regulate the fast-developing asset management business in a clear manner to solve the following three main problems.

5.1 Rigid Payment

Banks' off-balance-sheet wealth management realises rigid payment through the mode of "expected return and excess retention." On the one hand, the asset management relationship is converted into the debt relationship of indirect financing, and the off-balance-sheet business is internalised, and at the same time, the off-balance-sheet supervision is circumvented, forming the "shadow banking" system. On the other hand, it disturbs the market order, distorts the relationship between return and risk, and pushes up the risk-free interest rate, which increases the financing cost of the enterprises, especially small and medium-sized enterprises, and reduces the efficiency of resource allocation, and pushes up the leverage of the real economy. In turn, this has increased the financing costs of enterprises, especially small and medium-sized enterprises, reduced the efficiency of resource allocation, and pushed up the real economy's leverage ratio.

5.1.1 Reasons for Rigid Payment

The design of the previous regulation allowed for rigid payment, and the Interim Measures for Personal Financial Management Business in 2005 allowed financial products to agree on their own allocation of returns and risks. Banks use rigid payment as an incentive to attract customers and expand their scale. Rigid payment to meet the demand for low-risk financial assets can be effective in attracting customers, and non-rigid payment may have a negative impact on the bank's reputation and lead to customer loss. The perspective of the game between banks, the dominant strategy of any single bank is to be rigidly cashed, generating widespread rigidity. Asset management business is a direct financing tool; there is no debt relationship between the manager and the principal, the bank ostensibly does not bear the risk, so it faces far less regulation than the on-balance sheet business; the rigidity makes the off-balance sheet business on-balance sheet, and the source of income from bank wealth management products is still essentially the spread and still bears the risk, so it actually circumvents the regulation of the on-balance sheet business and reduces the cost of regulation.

5.1.2 Negative Impact

Rigid redemption will not reduce the total amount of risk in the whole investment process but only adjust the risk distribution structure; the risk has been within the financial system, increasing the risk of the whole financial system. Disrupting the market order, there is a “bad money expelling good money” situation, the financing side of the rigid exchange and the asset side of the rigid exchange of each other, and the formation of a “rigid culture.” In the bond market and loan market, there is a large degree of rigidity, distorting the return-risk relationship.

5.1.3 Capital Management Measures.

(Article 19 of the Provisions) For the first time, the identification standard of rigid payment is clearly defined, supplemented by punitive measures and a rewarded reporting system; the Provisions propose a unified reporting system for asset management products (Article 18 of the Provisions) netting of asset management products, the generation of net value should be in line with accounting standards, and reflect the return and risk of the underlying financial assets in a timely manner, and the return and risk are transparent, but the fluctuation of the net value will be relatively large, the and it is difficult to form a fair value for a part of the assets; appropriateness management for investors (Articles 4, 5 and 6 of the Provisions).

5.2 Non-standard and Maturity Mismatch Problems

The term of the capital pool (financial products) is relatively short; more than 90% of the current survival are financial products maturing in less than one year, and the corresponding asset pool (asset side) has a longer term, especially the expansion of non-standard assets, which is usually from one year to three years or more than five years, and about 20% of the bank's financial funds are invested in non-standard assets. Maturity mismatch exacerbated liquidity risk, appeared to be a financial product renewal problem, and aggravated market risk, causing a sudden and significant increase in the cost of renewal. Non-standardised debt assets have looser regulatory constraints, are highly customised, and information is not publicly available.

5.2.1 Negative Impacts

Regulatory efficiency is relatively low, regulatory efficiency is relatively low, and risk is relatively high. Opaque information leads to opaque credit risk; investors have no way to judge, refuse to bear the risk of demanding rigid payment, and are unable to achieve “buyer bears responsibility.” The maturity of non-standardised debt assets is relatively long, exacerbating the problem of maturity mismatch.

5.2.2 Capital Management Measures

The Provisions (Article 11) identify non-standardised debt assets as being tradable, having a market, having a sound liquidity mechanism, and full information disclosure. (Articles 10 and 15 of the Provisions) can invest in non-standardised debt assets, and it is prohibited to do maturity mismatch, open-ended financial products can not do non-standard, and closed-ended financial products to do non-standard business are also subject to great constraints, and to a large extent can not carry out non-standard business, which greatly hit the trust and entrusted loan business, and the growth rate of which has seen a substantial decline, and finally led to a decline in the scale of social financing.

5.3 Problems of Corridor Business and Multi-layer Nesting

Increases the complexity of the product and leads to a lack of clarity about the underlying assets.

5.3.1 Multi-layer Nesting Model

Interbank certificates of deposit are nested in interbank financial management for outsourced investments. The central bank transmits liquidity to large banks (2014-2016) through monetary policy tools (MLF, PSL), which was $1.7 trillion in 2015 (MLF, PSL), rising to $6.4 trillion in 2016, and MLF, PSL financing requires collateral, which is more adequate for large banks, and the leverage of large banks rises. Large banks buy interbank certificates of deposit from small and medium-sized bank A. Small and medium-sized bank A buys interbank wealth management from small and medium-sized bank B. The data shows that banks' interbank wealth management business as a share of total wealth management business rose from 3.6% in 2015 to 15.3% in 2016 from 2014-2016 and that interbank wealth management at the end of 2016 was about $6 trillion. Small and medium-sized banks invested 27 percent of their funds in the real economy, while the remaining 73 percent were invested in outsourcing, the data showed. Outsourced investments have led to an increase in the leverage of brokers, funds, and other companies.

5.3.2 Negative Impact

Accumulation of risks, increasing the vulnerability of the financial system, pushing up the leverage of the financial system, increasing the risk of horizontal contagion between institutions, while circumventing the regulation, reducing the efficiency of regulation, leading to uncontrolled regulation, easily triggered by systemic financial risks; weakening the financial system's support for the real economy, prompting the funds "off the real to the virtual" in the financial system, lengthening the capital chain, ultimately pushing up the cost of financing the real economy. Weakening the support of the financial system for the real economy, prompting the "de-realisation of funds to the virtual" within the financial system, lengthening the capital chain, pushing up the cost of funds layer by layer, and ultimately pushing up the cost of financing for the real economy.

5.3.3 Capital Management Measures

(Article 22 of the Regulation) Prohibition of channel business that circumvents controls, with a maximum of one layer of nesting (except for FOFs and MOMs); (Article 27 of the Regulation) Emphasis on penetrating regulation.

5.4 Impact of the Regulations

(1) The introduction of the Provisions plays a positive role in financial regulation, service to the real economy, and stability of the financial system. Firstly, it is conducive to enhancing the operational efficiency of China's financial system and regulating the development of the asset management industry; it makes the asset management business return to its essence, which will form a major positive in the medium and long term. Secondly, it enhances the ability of financial services to the real economy, breaks the rigidity of payment, reduces multi-layer nesting and the idle transfer of funds, and shortens the financing chain, which in turn helps to reduce the financing cost of the real economy. Thirdly, it focuses on strengthening investor protection breaking rigidity against payment while strengthening the protection of financial consumers' rights and interests, including raising the threshold of access for qualified investors and standardising the management and sale of asset management business.

By strengthening supervision, enhancing regulatory efficiency, combining macro-prudential management with micro-prudential supervision, and combining institutional supervision with functional supervision, and at the same time implementing "penetrating supervision" to achieve comprehensive, uniform, and fair coverage of asset management business carried out by all types of financial institutions, we will maximise the elimination of regulatory arbitrage, reduce leverage, and prevent risks to the financial system. financial system risks, making the healthy and stable development of China's financial system.

On the other hand, it has prompted financial institutions to achieve business transformation and improve their active management capabilities, making the asset management business move towards the path of independence, net worth, and standardisation. Improve international competitiveness and better meet the new round of financial opening. At the same time, it optimises the structure of China's financial market and gradually changes the financial system, which is dominated by indirect financing. The introduction of the Provisions has prompted some of the financing needs of enterprises to shift from indirect financing to direct financing, provided an endogenous impetus for China to further improve the multi-level capital market system and continuously enrich the financing tools of the capital market, and enhanced the effectiveness of the monetary policy regulation.

(2) However, there will be a short-term negative impact on financial institutions and the real economy. For financial institutions, on the funding side, the scale of new products will be smaller than the scale of old products, and there will be a funding gap for wealth management businesses. On the asset side, the restriction of maturity mismatches has led to a decline in non-standard, which is reflected in the scale of social financing as trust and entrusted loans, and will also decline. The allocation of low-rated credit bonds declined, resulting in a significant decline in the size of credit bond issuance, and the allocation of interest rate bonds and highly rated credit bonds rose.

As for the real economy, the scale of off-balance-sheet business back to the table is limited due to liquidity constraints on the table, limitations on the number of loans, and limitations on capital adequacy and other indicators, leading to a significant decline in the scale of social financing, a decline in the financial system's support for the real economy, and a certain amount of negative impact on the real economy, especially on small and medium-sized enterprises (SMEs).

In terms of credit risk exposure, the decline in the scale of social financing and the decline in banks' risk appetite has led to a considerable degree of credit risk exposure as many marginal borrowers with weak credit profiles, narrow financing channels, and high reliance on shadow credit are exposed to greater refinancing risks, with small and medium-sized enterprises (SMEs) predominating. From a liquidity risk perspective, there has also been a concomitant exposure of P2P platforms, resulting in a large number of platforms exiting the market.

5.5 Summary

Firstly, in the process of promotion, full consideration should be given to the affordability of the market; on the one hand, a reasonable transition period should be set up; secondly, market communication should be strengthened, market expectations should be effectively guided, and active, prudent and prudent promotion should be insisted upon.

The relationship between on-balance sheet and off-balance sheet financing should also be correctly handled, and off-balance sheet financing should be appropriately retained on the premise of meeting regulatory requirements and risk prevention and control (Sheng & Long, 2018). Finally, while deepening the reform, we should broaden the financing channels of enterprises, especially small and medium-sized enterprises (SMEs), maintain financial stability, and promote the stable and healthy development of China's economy.

6. Conclusion

This paper mainly discusses financial innovation centred on financial business innovation, financial product innovation, and financial institution innovation and further studies the relationship between financial innovation and financial stability. This paper firstly outlines the financial business innovation, takes the "bank-trust cooperation" in the shadow banking system as an example, analyses in detail the reasons for and impacts of the shadow banking system, and finds that the shadow banks are carrying out regulatory arbitrage. Secondly, it introduces the financial innovation products represented by Balance Treasure, which improve the operational efficiency of the banking industry. In the third part, the innovative financial institutions are described, and the P2P industry model and the reasons for the violent thunderstorms are analysed. P2P platforms not only complement traditional financial institutions, but also guide the P2P industry in a benign direction with the clearing of non-performing P2P platforms and the tightening of regulation, as well as the improvement of the regulatory system. Lastly, the study explored regulatory measures to resolve financial risks, centred on the promulgation of the Provisions, which mainly addressed the issues of rigid payment, non-standard and maturity mismatch, channel business, and multi-layer nesting. However, during the implementation of the Provisions, attention should be paid at all times to the degree of market tolerance, and although there will be short-term pain for the market, it will help China's financial stability and the long-term healthy development of the national economy in the medium and long term.

This paper puts forward some key practical initiatives, including breaking the "shadow banking" system, preventing secondary risks in the regulatory process, preventing excessive impact on the economic system, and maintaining financial stability; while P2P is gradually moving towards benign development, attention should be paid to the protection of the legitimate rights and interests of investors; and during the process of advancing the Regulations timely and good communication with the market, grasp the rhythm and strength, set a reasonable transition period, and maintain the stability of the financial system. However, this study also has limitations, as it is more difficult to obtain detailed data, resulting in insufficient literature, and it lacks the support of an in-depth investigation of the behaviour of individual institutions, making it difficult to establish a robust data model. Therefore, the results of this study may be affected by sample selection bias.

The relationship between financial innovation and financial stability is one of complementary and coordinated development, with comprehensive measures combining policy and practice adopted in a multifaceted and three-dimensional manner. Firstly, regulators should strengthen the monitoring and assessment of financial institutions' innovative businesses, establish and improve risk management systems and assessment mechanisms, and ensure that financial innovations undergo sufficient risk assessment and stress testing before launching. Second, financial institutions should enhance their own risk control capabilities and compliance awareness and ensure the soundness and transparency of their operations and product operations while pursuing innovation. The establishment of a sound institutional mechanism for a negative list and ex ante supervision, through three-dimensional supervision and efficient risk control mechanisms, will promote financial innovation while maintaining the sound development of the financial market and provide a solid foundation for the sustainable growth of China's economy.

Funding: This research received no external funding.
Conflicts of Interest: The authors declare no conflict of interest.
Publisher's Note: All claims expressed in this article are solely those of the authors and do not necessarily represent those of their affiliated organizations, or those of the publisher, the editors and the reviewers.

References

[1] Chen, J., Chen, J., & Zhang, X. H. (2011). Status quo, problems, and policy recommendations of private capital intermediaries. *Financial Theory and Practice,* (11), 38-42.
[2] Du, Q. (2019). Research on the transformation and development of the trust industry under the background of new regulations on capital management. *North China Finance,* (4), 52-56.
[3] Li, L., & Li, H. Z. (2014). Development and regulation of shadow banking. *China Finance,* (4), 50-51.
[4] Liu, Q., Cai, Y. P., & Luo, Y. M. (2017). Analysis of risk outbreak reasons and countermeasures of P2P platform in China. *Financial Theory and Teaching,* (2), 10-12, 38. https://doi.org/10.13298/j.cnki.ftat.2017.02.003
[5] Ma, L. X. (2014). Research on the risks and regulatory issues of shadow banking in China. *Business Economics,* (11), 118-119.
[6] Peng, J. N. (2020). Analysis of the financial function of China's enterprise group finance companies. *China Business Journal,* (16), 62-63. https://doi.org/10.19699/j.cnki.issn2096-0298.2020.16.062

[7] Sheng, S. C., & Long, Y. (2018). New regulations on capital management are significant for financial development. *China Finance,* (16), 28-30.

[8] Wang, C. H. (2018). *Research on the impact of shadow banking on the profitability of commercial banks in China* [Unpublished doctoral dissertation, Lanzhou University]. Lanzhou.

[9] Zhu, B. L. (2017). *A study of commercial banks' interbank business and liquidity risk* [Unpublished doctoral dissertation, University of International Business and Economics]. Beijing.