Chasing the Shadow in Different Worlds: Shadow Banking and Its Regulation in the U.S. and China

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ABSTRACT: Four years have passed since the G20 Leaders tolled the bell to the shadow banking system at the Seoul Summit of 2010. The war against shadow banking, however, has just started on a global scale and there is still a long way to go for the international community to develop an effective regulatory framework of use for different countries. One of the first steps of the long journey would be the conduct of comparative studies of shadow banking in major jurisdictions, such as the U.S. and China, which offer good examples of shadow banking in the advanced and emerging markets. This article presents such a study of shadow banking and its regulation in these two countries, with a view to providing findings to facilitate the international community’s policy making in this area. It is found that while shadow banking varies in the U.S. and China in terms of its definitions, scopes, risks, legal origins and regulations, there are a number of similarities in order to create credit beyond the heavy regulated section, which can be viewed via the lens of the Theory of Money and Credit and the Endogenous Money Supply Theory. The authors believe that their findings would encourage the regulators to solve shadow banking problems from the monetary perspective instead of merely an institutional one.

No man is an Island, entire of itself; every man is a piece of the Continent, a part of the main...And therefore never send to know for whom the bell tolls; It tolls for thee.

MEDITATION XVII
Devotions upon Emergent Occasions
John Donne

1. INTRODUCTION

The term ‘shadow banking’ was coined by economist McCulley in 2007 to describe the phenomenon that non-banks engage in bank-like activities, namely the maturity

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1 Ernest Hemingway, For Whom the Bell Tolls (Scribner, Reprinted edition 1995), at 1.
Shadow Banking and Its Regulation in the U.S. and China

transformation. Shadow banking, which symbolizes one of the many failings in the most recent global financial crisis attracted sharply growing attention worldwide since 2007, due to the increasing internationalization of its resulting problems. In parallel with the formal banking sector and even exceeding it in size, shadow banking is hardly a national issue in any case. It contributed considerably to the subprime crisis in the U.S. and also harassed the financial market in China, which spared from the 2007 crisis. The flow of capital makes the banking in different jurisdictions closely connected. As indicated in a recent report by the IMF, the U.S. banking sector is highly interconnected with its counterpart in Europe, which directly promotes the growth of noncore liabilities and shadow banking in the U.S. Therefore, efforts need to be made at both national and international levels in order to address the issues of shadow banking.

Among recent efforts, forty-five publications on the regulation of shadow banking have been issued by the Financial Stability Board (FSB) since the release of its first recommendation in 2011. The FSB pointed out that ‘[e]fficient monitoring ... of shadow banking are important elements for strengthening the oversight of this sector, which is a key priority for the FSB and the G20’. In addition, the IMF and World Bank have made responses to this issue.

Most such analysis and proposals, however, are focused on the shadow banking models in developed economies, in particular the U.S., which are mainly on securitization as regulatory arbitrage. Although a recent report by the IMF expanded the scope of shadow banking to include deposit-taking and/or lending by non-banks in China and other developing economies, there still lacks in-depth research of shadow banking in these countries and its policy implication, especially from the legal perspective.

The definitions of banking vary from jurisdiction to jurisdiction due to their different

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6 The authors search the publications in the FBS’s website with the ‘shadow banking’ as key words in publication’s title and find 45 publications, see www.financialstabilityboard.org/search/?q=shadow+banking&dr=1&amp=all&amp;st=false&amp;st=on&amp;c=10&amp;s=1&amp;n=30.


9 It is not surprising that the model in Western countries, especially the U.S., becomes the focus of international organizations because of the most recent financial crisis derived from the U.S. See ‘The Origins of the Financial Crisis’, *The Economist*, (7 September 2013), available at www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article.

10 Stijn Claessens & Lev Ratnovski, *supra* note 8, at 3.
cultures and traditions. So does shadow banking. Shadow banking differs in many aspects in developed and emerging markets, such as its definition, scope, institutions and instruments. In the advanced market, shadow banking involved complex links between shadow banking market and commercial banks, in which the major players are ‘money market, credit hedge, investment, exchange-trading funds, conduits or special purpose vehicles and finance, insurance, and leasing companies.’ 11 In the emerging markets, the link between commercial banks and shadow banking and the instruments is very simple.12 For instance, the shadow banking system in the U.S. is more on securitization in capital market, which is different from the Chinese model that mainly reflects the characteristics of commercial banks taking ‘deposits’ and making ‘loans’ since the capital market is undeveloped in China.13 The risks and possible regulations responses of shadow banking also differs in different jurisdictions.

The lack of sufficient knowledge of shadow banking in different markets has become a big challenge to the international organizations, like the FSB, the IMF and World Bank, to make more efficient definitions and responding commendations accordingly for different jurisdictions. For instance, the IMF’s report released the difficulty that the international organizations faced in harmonizing the concept and terms of shadow banking was caused by the lack of knowledge in comparative study:

[R]elated, most studies focus on the U.S. and say little about shadow banking in other countries where what it can take on very different forms. In Europe, lending by insurance companies is sometimes called shadow banking. "Wealth management products" offered by banks in China and lending by bank affiliated finance companies in India are also called shadow banking. It is unclear though how much do these activities have in common with U.S. shadow banking.14

To captures many of the activities that are commonly referred to as shadow banking in different jurisdictions, an in-depth comparative study in this subject between advance markets and emerging markets is needed. The international organizations began to realize the importance of such study and began to explore this subject from a global perspective. For example, the World Bank issued a short report to estimate the significances of shadow banking in emerging markets.15 The FSB began to issue Global Shadow Banking Monitoring Report in 2012.16 However, most of the reposts explored the issue of shadow banking from economic view and there was little research existing on this subject in the view of legal perspective.

The focus of this paper is on the comparison between shadow banking in China and that in the U.S., which bear many differences and also some similarities. Such research will provide implications to broadening the scope and strengthening legal efforts of international policies by

11 Swati Ghosh, Ines Gonzalez del Mazo & İnci Ötker-Robe, supra note 8, at 1-2.
12 Ibid.
13 We will further discuss the characteristics of shadow banking in the U.S. and China in Parts IV and V.
14 Stijn Claessens & Lev Ratnovski, supra note 8.
the FSB and IMF, which will contribute to improve their international impacts. The next part of this paper discusses the definitive conundrum of shadow banking by international organizations. Then, this paper goes back to the basics of the origin of shadow banking by developing the classic theories and applying them to the U.S. and Chinese shadow banking as the same origin. The U.S. Law and Chinese Law is different in the legal definition, scope, participants, instruments, legal origins and regulations. In Parts 4 and 5, this paper explores those differences. In the U.S., shadow banking is mainly about using the financial innovative and complex instruments to solve the monetary disintermediation, which is like filling the new wine into an old bottle. On the other hand, shadow banking institutions in China engage in traditional ‘deposit’ taking and ‘loan’ making with simple instruments, which is like filling the old wine into the old bottle with just a new label. The last part concludes.

2. WHAT IS SHADOW BANKING? A DEFINITIVE CONUNDRUM

‘Shadow banking’ is an expressive term. As Professor Macey commented, such a term can convey the impression that ‘it must be nefarious, somewhat clandestine and of dubious legality’.\(^{17}\) Although the term shadow banking is vivid, it fails to impart sufficient meaning for a regulatory purpose. While shadow banking is widely used in media during and after the financial crisis, there is as yet ‘no clear commonly-agreed definition’.\(^{18}\) International organizations attempted to overcome the definitive conundrum by proposing different definitions, which was the initial step for developing the regulatory framework.

The FSB is an active player in developing the regulation and monitoring framework for shadow banking. At the Seoul Summit in November 2010, the G20 Leaders requested that The FSB should collaborate with other international standard setting bodies to develop recommendations to strengthen the oversight and regulation of the shadow banking.\(^{19}\)

The FSB describes shadow banking as ‘credit intermediation involving entities and activities (fully or partially) outside the regular banking system’\(^{20}\) or ‘non-bank credit intermediation in short. Such intermediation, appropriately conducted, provides a valuable alternative to bank funding that supports real economic activity’.\(^{21}\) The FSB pointed out two major risks associated with shadow banking: the systemic risk concern and the regulatory arbitrage concern. The maturity/liquidity transformation function and the high leverage of shadow banking raise concerns of the systemic risk.\(^{22}\) The shadow banking system undertakes


\(^{23}\) Ibid.
‘bank-like’ activities without being subject to the same regulatory constraints, which will cause the concern of regulatory arbitrage risk.\textsuperscript{24} The FSB set out potential approaches for monitoring the shadow banking system by two steps: firstly, ‘authorities should cast the net wide, looking at all non-bank credit intermediation to ensure that data gathering and surveillance cover all the activities within which shadow banking-related risks might arise’; secondly, ‘authorities should then narrow the focus, concentrating on the subset of non-bank credit intermediation where maturity/liquidity transformation and/or flawed credit risk transfer and/or leverage create important risks’.\textsuperscript{25}

The FSB’s effort in defining shadow banking cannot find the echo from other international organizations. Claessens and Ratnovski from the IMF commented on the FSB’s definition of shadow banking in its staff’s working paper:\textsuperscript{26}

…but the definition has two weaknesses. First, it may cover entities that are not commonly thought of as shadow banking, such as leasing and finance companies, credit oriented hedge funds, corporate tax vehicles, etc., yet that do also intermediate credit. Second, it describes shadow banking activities as operating primarily outside banks. But in practice, many shadow banking activities, e.g., liquidity puts to securitization SIVs, collateral operations of dealer banks, repos, etc., operate within banks, especially systemic ones (Pozsar and Singh 2011; Cetorelli and Peristiani 2012). Both reasons make the description less insightful and less useful from an operational point of view.

Claessens and Ratnovski explored shadow banking from the functional perspective, which ‘stresses that shadow banking is driven not only by regulatory arbitrage, but also by genuine demand, to which intermediaries respond’.\textsuperscript{27} Based on such understanding, they proposed to describe shadow banking as ‘all financial activities, except traditional banking, which require a private or public backstop to operate’.\textsuperscript{28} Also, Kodres from the IMF criticizes that the measure of the FSB, based on a narrowed concept of shadow banking, does not gauge the risks that shadow banking poses to the financial system.\textsuperscript{29} In spite of its critique of the FSB’s definition and proposal, the IMF fails to produce a more practical one of its own.

This paper is not intended to harmonize the definitions by different international organizations and countries, it rather attempts to provide a comparative study of classic cases of shadow banking, which can provide a basis for harmonization.

In what follows, this paper takes the U.S. and China as examples. Having the most developed financial market, the U.S. is the origin of the most recent financial crisis. The concept of shadow banking was born in the U.S.\textsuperscript{30} Although the international organizations began to pay attention to shadow banking all around the world, their terms of shadow banking has a

\textsuperscript{24} Ibid.
\textsuperscript{25} Ibid, at 2.
\textsuperscript{26} Stijn Claessens & Lev Ratnovski, supra note 8, at 3.
\textsuperscript{27} Ibid, at 3.
\textsuperscript{28} Ibid, at 4.
distinct U.S. focus. The U.S. has the biggest shadow banking system in the world. At the end of 2012, the U.S. had ‘the largest system of non-bank financial intermediation with assets of $26 trillion’.31 The shadow banking system in the U.S. is a typical example for the developed market. Although lots of research has been done in the U.S. shadow banking, little existing literature has explored it in-depth from legal perspective, not to mention a comparative study for it.

Shadow banking problem in China has received considerable attention and was used by World Bank in its recent report to demonstrate the risk of shadow banking in emerging market.32 Although shadow banking in China has a small size compared to that in the U.S., it grows very fast. According to the FSB’s statistics, China helps fuel growth in global shadow banking by contributing 42 percent in expansion in 2012.33 Chinese financial market is undeveloped and its economy is in the transition from planned economy to the market economy. Most of the products in shadow banking system are simply the transformation of deposit and loans. Its financial regulators are in a dilemma: ‘[T]hey have long desired to develop deep and versatile capital markets, and shadow banking is a natural part of that’.34 Such complexity of shadow banking in China makes it a significant case for emerging market to study.

Shadow banking varies between the U.S. and China; however, they have some similarities in purpose to create credit beyond the heavily regulated section. This paper will first study the similarity of the function of shadow banking in the U.S. and China via the lens of Credit Creation Theory traced to Friedrich Hayek’s work and also the Endogenous Money Supply Theory. The two theories not only apply to shadow banking in the U.S. and China, but also help to explore shadow banking in other jurisdictions. This paper also explores the difference of shadow banking in the U.S. and China in their definition, scope, risks and regulations respectively in Parts 4 and 5.

3. GENERAL THEORIES APPLYING TO SHADOW BANKING IN THE U.S. AND CHINA: THEORIES OF MONEY AND CREDIT AND ENDOGENOUS MONEY SUPPLY

3.1. Theory of Money and Credit by Friedrich Hayek
Shadow banking was not completely unknown to the world before the most recent financial crisis in 2008. The idea of credit creation by unregulated institutions can be traced to Friedrich Hayek’s work. He broadened the definition of money and the idea of credit creation by unregulated institutions in his paper:

Now while for certain practical purposes we are accustomed to distinguish these forms of media of exchange from money proper as being mere substitutes for money, it is clear that, other things equal, any increase or decrease of these money substitutes will

33 Huw Jones, ‘China helps fuel growth in global shadow banking’, the Economist, (14 November 2013)
have exactly the same effects as an increase or decrease of the quantity of money proper, and should therefore, for the purposes of theoretical analysis, be counted as money.\textsuperscript{35} Hayek further pointed out that the demand of credit substituted for money in some way:

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\text{[I]n particular, it is necessary to take account of certain forms of credit not connected with banks which help, as is commonly said, to economize money, or to do the work for which, if they did not exist, money in the narrower sense of the word would be required.}\textsuperscript{36}
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Friedrich Hayek pointed out that banks are not the only source of credit supply. On the contrary, if there is demand by economy, other institutions will create substitutions of money ‘not connected with banks’.\textsuperscript{37} Wilmot \textit{et al.} further commented that assets can take on money like properties when they are collateralized to raise more financial assets, in a form of ‘shadow money’.\textsuperscript{38}

\subsection*{3.2. Endogenous Money Supply Theory}

Even in a heavily regulated economy, the central bank cannot precisely control aggregated money supply, due to the ‘endogeneity’ of money supply. The U.S. and China are no exception. Scholars have long realized that the aggregated money supply is determined by the demand for capital, but not by the supply from central bank. The post Keynesian economists claim that the quantity of money in existence is determined by the level of money wage, which is further ‘dependent on other economic factors’.\textsuperscript{39} As Keynes pointed out, the factors that determine the allocation of economic resource are land, capital and labour.\textsuperscript{40} When making financial decisions, entrepreneurs must predict future demand to decide their output, and accordingly make payments of these production factors to finance their investment before making real production. As entrepreneurs go to banks and require the credit lines they need, they are in fact formulating the aggregated demand for money. As Kaldor commented, ‘[I]t’s never true to say that the level of expenditure on goods and services rises in consequent of an increase in the amount of bank money held by the public. On the contrary, it is a rise in the level of expenditure which calls forth an increase in the amount of bank money’.\textsuperscript{41} For entrepreneurs, when the expected return production factors including land, capital and labour exceeds their marginal

\begin{thebibliography}{99}
\bibitem{hayek2008prices} \textit{Ibid.} at 290.
\bibitem{hayek2008prices} \textit{Ibid.} at 290.
\bibitem{wilmut2008long} Jonathan Wilmut, James Sweeney, Matthias Klein, and Carl Lantz, ‘Long Shadows: Collateral Money, Asset Bubbles and Inflation’, (‘when assets can themselves serve as collateral, allowing for leveraged purchases, then they take on money-like properties. And when financial assets serve as collateral for borrowing to purchase yet more financial assets (buying on margin) this form of shadow money can become particularly potent in driving asset price overshoots and bubbles’) www.credit-suisse.com/researchandanalytics.
\bibitem{lavioe2008endogenous} Marc Lavoie, ‘The Endogenous Flow of Credit and the Post Keynesian Theory of Money’, \textit{Journal of Economic Issues}, 1984, 18(3): 776 (‘Post-Keynesians, in sharp contrast to monetarists, regard the stock of money as being essentially endogenous, responding and accommodating to changes in the level or money wages. …dependent on, and varies with, all the forces or factors.’)
\end{thebibliography}
cost, they would raise more capital to acquire more production capital. For banks, when the
demander of capital can accept an interest rate enough to compensate the bank’s cost in
acquiring these capital, banks would ‘have incentive to lend out any reserve in excess of their
legally required minimum ratios’.42

But lending out any reserve is not yet the end of story. As Alan Holmes, the former vice
president of New York Federal Reserve Bank pointed out, ‘[I]n real world, banks extend credit,
creating deposits in the process, and look for the reserves later’.43 This statement corresponds
to the endogeneity of money supply: the total credit is not exogenously given by central bank;
instead, it is endogenously determined by the financial markets.

Why financial institutions can ignore reserve limit and determine money supply? First,
when bank and other intermediaries hold insufficient reserve, the central bank will invariably
accommodate their needs, otherwise it would ‘threaten the viability of the financial structure,
and hence of the overall economy’.44 Second, the financial intermediaries can generate
adequate money supply within the financial market itself, through ‘innovative liability
management practices’.45 Shadow banking is exactly the ‘innovative practice’. For regular
banking, the regulator’s reserve requirement can serve as a tool to expand or restrict money
supply.46 However, because shadow banking does not subject to strict reserve rate requirement
as regular banking, this tool cannot function or can only inadequately function in the
unregulated shadow banking sector. Similar as traditional banking, shadow banking can create
‘a substitute channel for bank lending’ and can ‘dramatically expand (or contract) the effective
supply of money in the economy’.47

3.3. Applying the Theories to Shadow Banking in the U.S.

In the U.S., shadow banking creates credit in less regulated financial system to provide the
endogenous money out of the central authority’s control. In a traditional banking system in the
U.S., the depositors put their saving in their saving or checking accounts in the banks and they
can withdraw their deposit at any time. The deposits become the banks’ liabilities on their
balance sheets. The deposits pile up in the banks’ balance sheets and the banks can use the fund
to make loans to borrowers and hold the loans on their balance sheet to maturity.48

The involvement of shadow banking system provided another channel of off-balance
sheet operation for the demand side in the U.S. The ‘depositor’ in former process are
institutional investors like Money Market Mutual Fund (MMMFs), from which individual

44 Ibid.
46 Morgan Ricks, ‘Money and (Shadow) Banking: A Thought Experiment’, Review of Banking and Financial Law,
2011, 31: 12 (‘Depository banks are required to hold base money equal to specified fraction of their outstanding
deposit obligations. These reserve requirements can, of course, serve as a basic tool of monetary policy. A decrease
in required reserve is expansionary; and increase is contractionary.’)
48 Ibid.
investors buy the shares. Using the funds from retail investors, the institutional investors deposit the funds in the banks. In traditional banking model, depositors get the deposit insurance to ensure the safety of their deposits, while the investors in shadow banking get the collateral instead. Banks use the funds to make the loans to borrows and sell the loans to the SPV. That is the most important step in the whole process, which moves this financing off the balance sheet of the bank and loans are pooled and securitized. The SPV issued the securitization bonds to the investors like the institutional investors. Some of the securitization bonds also work as the collateral giving to the big ‘depositors’ like the institutional investors.

3.4. Applying the Theories to the Chinese Shadow Banking

Although shadow banking in China is different from that in the U.S., it also fits in the two theories as the U.S. does. China has a heavily regulated financial market. Central Bank in China has the annual credit quota as the window guidance for commercial banks, which exists since the age of planned economy. Viewed by Endogenous Money Supply Theory, the People’s Bank’s effort in controlling money by credit quota in China has failed. For instance, People’s Bank put an upper limit of 7.5 trillion quota for bank loan growth in 2010. After the first 11 months of the year, however, this quota was used up, and the actual growth of bank loan was 7.95 trillion in 2010. The failure of credit quota is due to the fact that money supply is endogenously determined by demand. More worse is that the credit lending was not reflected by the official statistics, which composed the major part of shadow banking in China. In 2010, the size of shadow banking in China was estimated to be 20 trillion; within two years, the number has grown to 36 trillion. Taking the growth of shadow banking into consideration, the central bank has failed to control credit supply with quota.

High return of some industries in China drives the boom of credit lending, which directly promote the growth of shadow banking. In 2012, 20 trillion of the total 53 trillion Yuan of outstanding loans issued in the first nine months went to property sector, directly or through trust firms. The failure of credit quota is largely due to high return in property industry. In

49 Gary Gorton, Andrew Metrick, Andrei Shleifer & Daniel K. Tarullo, Reviewed, ‘Regulating the Shadow Banking System [with Comments and Discussion]’, Brookings Papers on Economic Activity, (Fall 2010), pp. 261-312, at p 263 (‘In practice, this transaction takes the form of a repo: the institutional investor deposits $X and receives some asset from the bank as collateral; the bank agrees to repurchase the same asset at some future time (perhaps the next day) for $Y. The percentage (Y - X)/X is called the repo rate and (when annualized) is analogous to the interest rate on a bank deposit. Typically, the total amount deposited will be some amount less than the value of the asset used as collateral; the difference is called a “haircut”. For example, if an asset has a market value of $100 and a bank sells it for $80 with an agreement to repurchase it for $88, the repo rate is 10 percent (= [88 - 80]/80) and the haircut is 20 percent ([100 - 80]/100’).


52 Grace Zhu, Chinese Think Tank Puts Shadow Banking at 40% GDP, Wall Street Journal, (9 October 2013), (‘Fitch Ratings estimated earlier this year that China’s total credit including various forms of shadow-hanking lending may have reached 198% of the country’s GDP, while J.P. Morgan estimates have put it at as much as 69% of GDP, or 36 trillion yuan.’) http://blogs.wsj.com/chinarealtime/2013/10/09/chinese-think-tank-puts-shadow-banking-at-40-of-gdp/.

53 Ibid. (‘Of China’s 53 trillion yuan of outstanding loans issued in the first nine months of this year, about 10 trillion yuan went to the property sector, the paper said, citing official statistics. China's trust firms also have about 7 percent of their outstanding lending, estimated at about 10 trillion yuan, exposed to the property sector.’)
2012, the net profit for Chinese listed property firms averaged 14.23%, and the net profit for Chinese property firms listed in Hong Kong averaged 23.96%. According to the previously discussed endogenous money supply theory, credit creation is driven by the demand for fund. As the high return on land persists, the demand for funding of property industry will provide great incentives for banks to breach credit quota evidently or lending out via secret channel. If commercial banks are unable to satisfy the demand for fund through traditional channels, the ‘animal spirits’ of entrepreneurs will drive up the credits created by shadow banking.

3.5. Summary

By developing the classic theories of credit creation by unregulated financial institutions and the Endogenous Money Supply Theory, this paper goes back to the basic of the origin of shadow banking, which is beyond the current sovereign money system. Such finding would inspire the regulation for solving shadow banking from the monetary perspective instead of just an institutional perspective. In other words, as a legal institutional, shadow banking is ‘like all legal institutions, stand in need of design’. On the other hand, exploring the similarity of the origins of shadow banking in the U.S. and China using the same theoretical framework can provide the implication for international organizations to make policy recommendations.

Despite the recognition of credit creation outside traditional banking system, the risk of such credit making functions of shadow banking has long been ignored by regulators till the outburst of financial crisis. It is after the crisis that regulators found the urgency of defining the scope of shadow banking. The U.S. Law and Chinese Law is different in the legal definition, scope, participants, instruments, legal origins and regulations. In Parts 4 and 5, this paper explores those differences. In the U.S., shadow banking is mainly about using the financial innovational and complex instruments (like the securitization of assets) to solve the monetary disintermediation, which is like filling the new wine in an old bottle. On the other hand, shadow banking institutions in China are engaging in traditional ‘deposit’ taking and ‘loan’ making with simple instruments, which is like the filling the old wine in the old bottle just with a new label.

4. Shadow Banking in the U.S.: New Wine in the Old Bottle

4.1. Definition and Scope of Shadow Banking in the U.S.

Ben Bernanke, former Federal Reserve Chair, provided a definition of shadow banking in his speech in 2012:


55 John Maynard Keynes, supra note 40, at 161-2. (‘Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities’)

56 Morgan Ricks, supra note 46, at 731, 748.

Shadow banking, as usually defined, comprises a diverse set of institutions and markets that, collectively, carry out traditional banking functions—but do so outside, or in ways only loosely linked to, the traditional system of regulated depository institutions. Examples of important components of the shadow banking system include securitization vehicles, asset-backed commercial paper (ABCP) conduits, money market mutual funds, markets for repurchase agreements (repos), investment banks, and mortgage companies.

Some scholars in the U.S. also defined shadow banking according to the net of government guarantee. For example, Adrian and Ashcraft from Federal Reserve Bank of New York defined shadow banking as the credit intermediation ‘without the direct and explicit public sources of liquidity and tail risk insurance via the Federal Reserve’s discount window and the Federal Deposit Insurance Corporation (FDIC) insurance’.  

Paul Krugman, the owner of Nobel economic prize, commented that ‘[w]hat ended the era of U.S. stability was the rise of ‘shadow banking’: institutions that carried out banking functions but operated without a safety net and with minimal regulation’. Lack of the guarantee of public safety net, shadow banking is regarded as being more fragile than the traditional commercial banks. Although shadow banking in the U.S. lacks the access to government guarantee, it does have the risks of credit, liquidity, and maturity; therefore, it always needs a back as IMF’s report indicated.

4.2. The Scope of Shadow Banking in the U.S.

When the term of shadow banking was first coined by economist Paul McCulley, it was addressed in a mysterious way that it is ‘the whole alphabet soup of levered up non-bank investment conduits, vehicles, and structures’. However, as Professor Jonathan Macey commented that ‘Given how opaquely the term shadow banking is often defined, it is hardly a wonder that shadow banks are shrouded in mystery’. Instead, it consist of an array of complicate instruments and players.

4.2.1. Financial instruments

According to the Federal Reserve Bank of New York. Shadow banking in the U.S. is composed of intermediaries ‘through a wide range of securitization and secured funding techniques such as asset-backed commercial paper (ABCP), asset-backed securities (ABS), collateralized debt obligations (CDOs) and repurchase agreements (repos)’. The instruments bear a common feature: they involve ‘maturity, credit and liquidity transformation without access to central bank liquidity or public sector credit guarantees’. Such ‘transformation’ is achieved by

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60 Ibid. Also see Paul McCulley, ‘Teton Reflections: PIMCO Global Central Bank Focus’, (September 2007) p2.
61 Stijn Claessens & Lev Ratnovski, supra note 8, at 4.
65 Ibid.
assembling loans acquired through financial intermediaries into diversified pools, and financing these pools with supposedly riskless short term debts.  

Take ABS and ABCP for example: these kinds of security binds together many small and illiquid assets, which are unable to be sold separately. This pooling process enables these assets to be sold to general investors. Through pooling and securitization, the dealers of ABS are providing liquidity to financial markets like banks. Similarly, CDO is also a pooling and securitization of bonds and assets. In early 2000s, CDOs were more diversified than before financial crisis. However, since 2006, CDO collaterals became dominated by risky parts of other ABSs, and the default risk were severely aggrandized. A repurchase agreement (repo) is type of short time loan whereby the seller of a security agrees to buy it back at a specified price and time. The difference between sale price and buy back price is the ‘interest’ of such loan.

4.2.2. Major players

The major players in Shadow banking may include investment banks, finance companies, money market funds, hedge funds, special purpose entities, and other vehicles that aggregate and hold financial assets. These players create credits by making and trading aforementioned financial instruments. Besides the independent financial institutions, governments and traditional banks could also indirectly participate in shadow banking industry through Government-Sponsored Enterprises (GSEs) and Bank-affiliated Financial Holding Companies (FHCs). The two most well-known GSEs are the Federal National Mortgage Association and the Federal Home Loan Mortgage Cooperation, also known as Fannie Mae and Freddie Mac. The two GSEs serve to channel fund between lenders and borrowers to satisfy less favorable lenders’ demand for housing loan by using implicit government guarantee to ensure low interest rate. The FHC-affiliated banks act like shadow banking by conducting lending with less capital than if they are to retain loans on their balance-sheets. With the emergence of FHCs, traditional lending that solely relied on banking had also been changed by a process of securitization by financial holding companies: their bank subsidiaries originate loans; their broker-dealer subsidiaries warehouse and accumulate loans in an off-balance sheet conduit and

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67 ‘Introduction to Asset-Backed and Mortgaged backed Securities’, Forbes, see www.forbes.com/sites/investopedia/2013/01/18/introduction-to-asset-backed-and-mortgage-backed-securities/ (ABS and its ancestor, Mortgage-Backed Security, are ‘usually backed by credit card receivables, home equity loans, student loans and auto loans’).
68 McLean, Bethany & Joe Nocera, All the Devils Are Here, the Hidden History of the Financial Crisis, (Penguin, 2010), p.120.
73 See ‘CBO Testimony Statement’ of Dan L. Crippen, the then-director of the Congressional Budget Office, (23 May 2001). (‘debt and mortgage-backed securities of GSEs are more valuable to investors than similar private securities because of the perception of a government guarantee…’)

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then securitized by ‘transferring them from the conduit into a bankruptcy-remote SPV’ and distribute them.\textsuperscript{74}

4.3. Legal Origins of Shadow Banking

Scholars believed that law played a critical role in forming the shadow banking system.\textsuperscript{75} Regulators, who persistently blamed shadow banking for causing financial meltdown, actually promotes the forming of such system. As Kling stated:

\begin{quote}
\[ \text{[t]he regulatory community refers to the investment banks and insurance companies that absorbed credit risk as the ‘shadow banking system’, suggesting a financial network that was stealthy, if not downright illicit. At the time, however, lending regulatory authorities acknowledged and even applauded the use of these techniques. In fact, regulators were proud of the role they played in stimulating and spreading these innovations.}\textsuperscript{76}
\end{quote}

The Financial Crisis Inquiry Commission wrote in its report that ‘[R]egulation of nonbanking financial institutions has tended to focus on protecting investors rather than on the safety and soundness of the financial institutions’.\textsuperscript{77} In absence of adequate government regulation, shadow banking booms and engages in more and more risky activities. From the legal perspectives, the major influences by law (regulation) on the development of shadow banking are (1) restrictions on bank activities (2) deregulation on non-banking financial activities; (3) regulatory arbitrage; and (4) welfare policy.

4.3.1. Restrictions on traditional commercial bank activities

The imbalance in regulation strength on banks and non-banking finance engaging in similar activities creates shadow banking. By providing various instruments to create liquidity, shadow banking is doing similar activities in nature as traditional banking, in the meantime face less stringent regulation. Such different treatments will force banks to engage in the non-banking finance to avoid the strict regulation. According to Professor Gorton from Yale University:

\begin{quote}
\[ \text{[H]olding loans on the balance sheets of banks is not profitable. . . . This is why the parallel or shadow banking system developed. If an industry is not profitable, the owners exit the industry by not investing; they invest elsewhere. Regulators can make banks do things, like hold more capital, but they cannot prevent exit if banking is not profitable. ‘Exit’ means that the regulated banking sector shrinks, as bank equity}\]
\end{quote}

\textsuperscript{74} The only difference between the internal shadow banking and external shadow banking is that external shadow banking ‘funding and maturity transformation of structured credit assets conducted from the U.S., but also from Europe and offshore financial centers’. See supra note 63, at 13-8.

\textsuperscript{75} Erik F. Gerding, supra note 47, at 31 (‘Instead, regulation drove the both the creation and expansion of each of these shadow banking instruments. More particularly, regulatory arbitrage, deregulation, and legal subsidies helped create and fueled the rise of each of these instruments’).


\textsuperscript{77} FCIC, supra note 70, at 10.
holders refuse to invest more equity.\textsuperscript{78}

Shadow banking provides various instruments for banks to avoid the capital requirement that aims to prevent excessive risk taking. Professor Gorton described the effects of 1981 capital requirement in U.S as ‘all banks and bank holding companies were required to hold primary capital of at least 5.5 percent of assets by June 1985. Virtually all banks did meet these capital requirements by 1986, but it is interesting how this was accomplished: banks that were capital deficient when the new requirements were announced tended to grow more slowly than capital-rich banks’.\textsuperscript{79} To avoid the cost of such regulation, ‘banks could reduce their capital requirements by transferring assets into off-balance sheet conduits, which promoted the development of the asset-backed commercial paper market and other special-purpose entities’.\textsuperscript{80} Since off-balance securitization has no capital requirements, banks would securitize their capital to circumvent the capital requirement for the commercial banking. As Kling concluded, Capital regulations is the driver that push banks to further reduce capital by undertaking the shadow banking transactions such as the securitization.\textsuperscript{81}

4.3.2. Deregulation of non-bank financial activities

Another origin of shadow banking is deregulation of non-bank financial institutions. Deregulation is ‘a process destined to improve the efficiency and competition, by which governments remove, reduce or simplify restrictions on business and individuals to encourage the good functioning of the markets’.\textsuperscript{82} Deregulation promotes competition in two ways: (1) the inefficient operations due to insulation from actual and potential competition under regulation will be curtailed;\textsuperscript{83} and (2) rents that accrued to well-organized groups benefiting from regulation (generally producers and labour) would be dissipated by unregulated competition.\textsuperscript{84}

The purpose of deregulation is to increase the liberty and competition in the market by implementing fewer and simpler regulations.\textsuperscript{85} It occurs when ‘legislatures, courts, or regulatory agencies remove or reduce the effects of a legal rule’.\textsuperscript{86} Methods of deregulation includes but is not limited to repeal of a law or regulation; it can also be done by ‘reducing the effectiveness of a legal’,\textsuperscript{87} such as lower some restrictions, like interest restrictions.

The significant events of deregulation in the U.S. financial world since 1980 include

\textsuperscript{79} Gary Gorton, Andrew Metrick, Andrei Shleifer & Daniel K. Tarullo, Reviewed, supra note 49, at 261, 274.
\textsuperscript{80} FCIC, supra note 70, at 12.
\textsuperscript{81} Arnold King, supra note 75.
\textsuperscript{84} Ibid
\textsuperscript{85} Ibid.
\textsuperscript{86} Erik F. Gerding, supra note 47, at 33 (‘Instead, regulation drove the both the creation and expansion of each of these shadow banking instruments. More particularly, regulatory arbitrage, deregulation, and legal subsidies helped create and fueled the rise of each of these instruments’).
\textsuperscript{87} Ibid.
removing the interest rate ceiling, allowing supreme mortgage, repealing Glass-Steagall and deregulate the derivative market. After the Great Depression, some strict restrictions on bank’s deposit persisted. However, they gradually faded away after Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980, which allowed depository institutions to ‘offer accounts with competitive rates of return in the market’. The Garn-St. Germain Act of 1982 spurred the market for risky lending, ‘such as adjustable-rate subprime mortgages, with no legal limit on the interest charged’. The Alternative Mortgage Transactions Parity Act of 1982 allowed ‘non-federally chartered mortgage companies to write adjustable-rate mortgages that were sold to subprime customers’. Under this act, subprime mortgage thrived and occupied the market like the bad drive out the good in currency market. The Financial Modernization Act in 1999 (also known as the Gramm-Leach-Bliley Act) removed the firewall between commerce and banking. Soon after its passage, Congress passed Commodity Futures Modernization Act of 2000, which turned the derivative trading market completely unregulated. Consequently, commercial banks, which are the main players in the derivative market, involved in more and more risky trades.

4.3.3. Regulatory arbitrage by financial institutions

Regulatory Arbitrage is a tactic to avoid legal restrictions by exploiting the gap between economic substance and its regulatory treatment. An individual or organization may use functionally equivalent (or an economic substitute) activities to avoid being subject to strict regulation or heavy legal cost. Prof Gerding described two major forms of regulatory arbitrage in financial sector: one is called ‘legal structuring’, which means individuals or financial firms ‘create transaction structures that provide the same economic functions of more regulated investments while either escaping or loosening regulation’; another is ‘investment switching’, which occurs when capital move ‘to instruments, institutions, or markets with lighter regulatory regimes’. The basis of the regulatory arbitrage is law inefficiency: law can’t precisely track the underline economic relations thus two transactions which have the same function are treated differently. The regulatory arbitrage has two necessary conditions: first, the two transactions must be similar enough to be economic and strategic substitutes; second, the two transactions should generate different regulatory outcomes.

Some scholars claimed that the ‘shadow banking’ was somehow the regulatory arbitrage

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89 Ibid.
91 Ibid, at 219.
92 Matthew Sherman, supra note 87, at p10.
93 Ibid, at p11.
95 Erik F. Gerding, supra note 47, at 32.
96 Ibid.
97 Ibid.
98 Victor Fleischer, supra note 93, at 20 and 26.
of the capital requirement. In 1981, when U.S. bank regulators released the capital requirements for the first time in the U.S. banking history, the capital requirement only exists in banking sector and only ‘crudely reflects the credit and liquidity risks of specific types of assets’. Banks found a way to game the rule ‘through off-balance- sheet securitization, which has no requirements for regulatory capital’. Such regulatory arbitrage spurred the tremendous growth of shadow banking system. Banks shifted assets to less regulated shadow banking market with the new instruments such as securitization, money market fund and broker dealers. Profit maximization incentive is the driving force for traditional banking to move to shadow banking. Pozsar et al commented that ‘[A]s well as activities which appear to have a restricted purpose other than regulatory capital arbitrage, shadow banking also includes activities which appear to have significant economic value’. Even deducting the cost of arbitrage, getting fund from securitization will bring significantly high profits. Professor Schwartz indicated the logic of shadow banking driven by regulatory arbitrage that ‘the fact that shadow banks tend to be less regulated than traditional banks inevitably means that regulatory arbitrage drives the demand for shadow banking to some extent. Therefore, increasing bank regulation will almost certainly increase shadow banking demand’. He also stated that if shadow banking was solely driven by regulatory arbitrage, it wouldn't be a public good, instead it would ‘disadvantages market participants that lack the wealth, expertise and, often, political connections to capitalize on arbitrage opportunities’. However, since shadow banking in the U.S. is also driven by social welfare policy, it can also be a kind of public good.

4.3.4. Social welfare policy

The housing policy is another driving force behind the boom of shadow banking market. In 1995, the Clinton Administration implemented a major reform of the Community Reinvestment Act (CRA), which emphasized ‘performance-based evaluation’. The reform caused the regulators to care less on equitable procedures but rather on the volume of their lending, as it stimulate banks to make more loans, even some of those might be subprime loans, to meet their political mission of helping the low income households to own their own house. CRA has also opened the door of innovative lending as it encourage the ‘use of innovative or flexible lending practices’, which means ‘reduced down payments and riskier, unsustainable lending’.

101 Supra note 98.
102 Supra note 100.
103 Pozsar et al, supra note 63, at 18.
104 Supra note 98.
106 Ibid.
108 See Appendix A to Part 345 – Ratings (b)(i)(F) ‘Extensive use of innovative or flexible lending practices in a safe and sound manner to address the credit needs of low- or moderate-income individuals or geographies’, FDIC, Amended at 4 October 2010). www.fdic.gov/regulations/laws/rules/2000-6600.html
109 Supra note 106.
The incarnations of ‘innovative or flexible lending practices’ are the Government-Sponsored Enterprises (GSE), Freddie Mac and Fannie Mae. To fulfil political mission, Freddie Mac and Fannie Mae enjoyed low capital requirement\textsuperscript{110} and they are exempt from key regulatory and market oversight.\textsuperscript{111} Also, Freddie Mac and Fannie Mae had a $2.25 billion line of credit from the U.S. Treasury.\textsuperscript{112} Using such advantages as GSE, Freddie Mac and Fannie Mae owned 2/3 shares of U.S. secondary market for prime mortgages.\textsuperscript{113} As Ely commented, ‘F&F could not have reached these extremes – in size, leverage, or maturity mismatching – absent their GSE status or maturity mismatching – absent their GSE status’.\textsuperscript{114}

4.4. Risks of Shadow Banking in the U.S.

The complex structure of shadow banking instruments in the U.S. makes it a mystery. Complexity leads to the information failure problem.\textsuperscript{115} Also, the complexity of shadow banking makes it difficult for its participants to understand its risks, which will cause the rationality failure.\textsuperscript{116} The information failure and rational failure contribute to the boom and carnival of the U.S. shadow banking, in which systematic risks lurked.

It is widely accepted that the banking system is vulnerable since it has systematic risk. The deregulation assumption before the burst of Financial Crisis 2008 believed that ‘non-banks that provide the economic functions of banks do not suffer from or create the same economic risks or impose many of the same economic externalities as banks’.\textsuperscript{117} However, such assumption was proved incorrect by the Financial Crisis 2008. With the inherent risky funding methods of shadow banking (‘shadow banks fund themselves with uninsured commercial paper, which may or may not be backstopped by liquidity lines from real banks’) and unregulated condition, shadow banking system is particularly vulnerable to runs. As Pozsar et al observed, ‘[m]aturity and credit transformation in the shadow banking system . . . contributed significantly to asset bubbles in residential and commercial real estate markets prior to the [2008] financial crisis . . .’.\textsuperscript{118} The transformation between short-term funding and the long-term capital needs by shadow banking creates a risk of liquidity discontinuities. As the head of New York Federal Rever, Mr. Geithner stated that ‘[T]he scale of long-term risky and relatively illiquid assets financed by very short-term liabilities made many of the vehicles and institutions

\textsuperscript{110} See Public Law 102-550, Sec. 1362, Sec. 1382. MINIMUM CAPITAL LEVELS. 12 USC 4612. (‘(a) In General. – For purposes of this subtitle, the minimum capital level for each enterprise shall be the sum of –
(1) 2.50 percent of the aggregate on-balance sheet assets of the enterprise, as determined in accordance with generally accepted accounting principles;
(2) 0.45 percent of the unpaid principal balance of outstanding mortgage-backed securities and substantial equivalent instruments issued or guaranteed by the enterprise that are not included in paragraph (1)’).

\textsuperscript{111} Ibid at 4.
\textsuperscript{112} Ibid, at 3.
\textsuperscript{113} Ibid, at 3
\textsuperscript{114} Supra note 98.
\textsuperscript{116} Ibid, at 634.
\textsuperscript{117} Erik F. Gerding, supra note 47, at 9.
\textsuperscript{118} Pozsar et al, supra note 63, Abstract.
in this parallel financial system vulnerable to a classic type of run’.\footnote{119}

Shadow banking faces very little surveillance or even no surveillance. As the FSB described, ‘credit intermediation takes place in an environment where prudential regulatory standards and supervisory oversight are either not applied or are applied to a materially lesser or different degree than is the case for regular banks engaged in similar activities’.\footnote{120} The inherent risky funding methods of shadow banking (‘shadow banks fund themselves with uninsured commercial paper, which may or may not be backstopped by liquidity lines from real banks’) and the unregulated condition makes the banking system particularly vulnerable to runs – ‘commercial paper investors refusing to re-up when their paper matures, leaving the shadow banks with a liquidity crisis – a need to tap their back-up lines of credit with real banks and/or to liquidate assets at fire sale prices’\footnote{121}. To be specific, the shadow banking system was extremely vulnerable in three ways: highly leveraged, short-term funding markets and no government support (insurance)\footnote{122}. Moreover, shadow banking and the regular banking system are entangled. Banks are often the important part of the shadow banking chain, which may provide funds for the maturity/liquidity transformation and even invest in the shadow banking products.\footnote{123} The interconnection between the two systems can exacerbate the systematic risk and the possibility of contagion.

\section*{4.5. Regulation of Shadow Banking in the U.S.}

Despite the systemic risk, shadow banking also has its positive part: increasing efficiency. Hence, to regulating shadow banking should not be throughout elimination or overly focused on limitation. The regulation of shadow banking should reflect this philosophy. As Schwarz pointed out, ‘[B]ecause of the potential to increase efficiency, regulation should not necessarily be focused on limiting shadow banking \textit{per se}. Instead, regulation should be focused on maximizing that increase and on minimizing shadow banking’s potential to increase risk’\footnote{124}.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) passed in 2010 attempts to achieve balance between efficiency and reducing the risk of shadow banking. In response to the complexity of shadow banking system, the Act ‘puts great stock in the idea of improving disclosure’\footnote{125}. For example, money mutual funds are required to become ‘special-purpose banks’ under prudential regulation and government insurance; or otherwise they can invest only in stable and low-risk assets.\footnote{126} The Act also appoints SEC to ensure adequate disclosure, which is authorized to issue ‘point-of-sale disclosure rules’ that require

\begin{footnotesize}
\footnote{120} ‘Shadow Banking: Scoping the Issues’ \textit{Financial Stability Board}, (12 April 2011), at 5.
\footnote{121} Pozsar et al, supra note 63, at 4.
\footnote{122} ‘Preliminary Staff Report: Shadow Banking and the Financial Crisis’, \textit{FDIC}, at 4 (‘Shadow banking refers to bank-like financial activities that are conducted outside the traditional commercial banking system, many of which are unregulated or lightly regulated’).
\footnote{123} Supra note 119.
\footnote{124} Steven L. Schwarz, supra note 114, at 16.
\footnote{125} \textit{Ibid}, at 17.
\footnote{126} Dodd-Frank Act 115(b)(1).
\end{footnotesize}
broker-dealers to notify the customer of costs, risks and conflicts of interest.  

In addition to disclosure requirements, the Act puts great emphasis on reducing systemic risk by preventing mortgage default in the first place. The Title XIV, known as the Mortgage Reform and Anti-Predatory Lending Act focuses on imposing obligations on mortgage originators to lend only to borrowers who are likely to repay their loans. To prevent the default of other asset-backed commercial papers, Dodd-Frank Act prescribes credit risk retention by setting limits of credit risk to collateralized assets. In the Title IX of Dodd-Frank Act, ‘The Investor Protection and Improvements to the Regulation of Securities’, securitizers are required to retain no less than 5% of the credit risk for an asset that is not a qualified residential mortgage.

Having learned the lessons of 2008 financial crisis, Dodd-Frank act has special implications to GSE reform. The Act ‘merges the GSEs with various government agencies’ mortgage operations to create a single dedicated mortgage securitization agency that would seek to maintain market stability, improve underwriting, and provide a long term investment return for the benefit of taxpayers’.

Dodd Frank Act is also in conjunction with the Basel Committee to post the capital requirement for the systematic important financial institutions (SIFIs). According to section 165 of Dodd-Frank Act, the bank holding companies (BHCs) with $50 billion or more in assets are subject to the oversight of Financial Stability Oversight Council (FSOC). It also requires systemically important nonbank financial companies to comply with additional capital requirement and other restrictions on activities.

To prevent the bank run in shadow banking system, the Dodd-Frank Act has expand FDIC’s receivership to the failing systematic important non-bank financial companies under Title II Orderly Liquidation Authority. The financial companies includes broker-dealers, whose failure may pose a significant risk to the financial stability of the United States.

However, scholars worry that such emphasis on risk control may hurt efficiency and create new opportunities for regulatory arbitrage. Schwarcz pointed out that, the process of identifying systemically significant firm and applying prudential regulations will ‘create a ‘boundary effect’ in determining which firms are swept into the enhanced prudential regulatory regime, thereby creating new opportunities for regulatory arbitrage’. Schwarcz has also doubted whether ‘regulating systemically important firms such as by limiting financial leverage

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127 Dodd-Frank Act Title IX, Subtitle A.
130 Dodd-Frank Act 941(b).
131 Ibid. Abstract.
132 Dodd-Frank Act 165(a)(1).
134 See Generally Title II of Dodd-Frank Act.
135 Steven L. Schwarcz, supra note 114, at 16.
can reduce systemic risk at the cost of impairing efficiency’.\textsuperscript{136} The regulatory arbitrage problem hasn’t been solved by the Dodd-Frank Act. Instead, Dodd Frank Act created the regulatory arbitrage that enables ‘a financial institution to select and/or change its charter to avoid tough regulation and supervision’.\textsuperscript{137}

The Biggest Problem of Dodd-Frank is that it actually excludes shadow banking from the regulatory regime instead of including it. As Ludwig comments that ‘[W]hile several institutions in the “shadow banking system” landed at the center of the financial crisis, Dodd-Frank excludes the shadow banking system from some of its key provisions and from bank-like regulation and supervision’.\textsuperscript{138}

5. Shadow Banking in China: Old Wine with a New Label

The size of shadow banking is enormous in China. By the end of 2013, the size of shadow banking in China has grown to over 27 trillion Yuan even according to the most conservative official estimation. The three main pillars of the immense market are property-trust (10.13 trillion), wealth management (9.92 trillion) and unlicensed private credit (approximately 3 trillion).\textsuperscript{139} Such expansion in scale has prompted Chinese regulators to revise their definition of shadow banking and develop new method of regulation.\textsuperscript{140} In this part, we will discuss the evolving definition and scope of shadow banking in China. To provide an in depth analysis of shadow banking in China, we will introduce the participants of shadow banking system and relevant regulations of them, followed by the analysis of the potential risks of shadow banking. To provide the antidote against the disease, we will explore the legal origins of shadow banking in China and commentate the regulatory response by Chinese government.

5.1. Evolving Legal Definitions and Scopes of Shadow Banking In China

The legal definition of shadow banking evolved with the change of regulator’s attitude. In the early stage (2011-12), regulator replied on the transplanting of the concept coined by the U.S. scholars or international organizations and took the definition that shadow banking is referred to the financial activities without regulation\textsuperscript{141}. The FSB’s definition of shadow banking, which is beyond the regulation, was welcomed by Chinese Banking Regulators (CBRC). They immediately adopted the FSB’s definition in their annual report of 2011, claiming that non-bank financial institutions (trust company, financial company, car finance company, money brokerage company and consumer finance company) were sufficiently regulated and were not

\textsuperscript{136} Ibid.
\textsuperscript{138} Ibid, at 190.
shadow banks. Based on such narrow definition, CBRC precluded off balance-sheet business of traditional bank from official definition of shadow banking. The purpose of CBRC to using such narrow definition is to hide the severity of commercial banks’ off-balance sheet problem and to avoid the criticism of its inefficient regulation, which is just like a cat shuts its eyes when stealing cream. However, Xiao Gang, the former CEO of Bank of China published a comment in *China Daily* in late 2012, which was like a tossed stone raising a thousand ripples to touch off many discussions on the media. Xiao had a much broader definition than the CBRC’s, in which shadow banking was referred to as ‘the system of credit intermediation involving entities and activities outside the regular banking system’. Xiao pointed out that ‘shadow banking has mainly taken the form of a large amount of wealth management products, or WMPs as they are known, underground finance and off-balance-sheet lending’.

Xiao’s comment was a warning of Laissez-faire policy of CBRC on Wealth Management Products, which grew in the wild. From 2012 to 2013, the scale of wealth management products has grown by 51.6%. As 43,000 different wealth management plans from 211 banks compete for customers by raising promised return, minor default problems occasionally came to surface. In response to critique of Laissez-faire regulation, the definition of shadow banking was broadened. In 2013 the Chinese State Council (central government) recognized shadow banking as ‘credit intermediate outside traditional banking system’, and ‘an inevitable consequence of financial innovation and a beneficial subsidiary of traditional banking’. The new definition of shadow banking includes both off balance-sheet business of traditional bank and unregulated financial institutions outside traditional banking system.

In 2014, State Council of China gave a more comprehensive definition of shadow banking in its new rule, ‘A Notice about Some Issues Related to Strengthening Shadow Banking Regulation’ (known as Document no. 107). According to Document no. 107, shadow banking in China can be categorized into three kinds: 1) those without operating license and subject to no regulations, namely, internet finance, P2P lending and underground banks; 2) those without financial operating license and faces only inadequate regulation, for example, guarantee companies, pawn shops and small lenders; 3) operations of traditional banking that avoids regulation, most typically wealth management.

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143 *Ibid*.
144 When Xiao published this comment on China Daily, he was the CEO of Bank of China.
146 *Ibid*.
150 The full text in Chinese is available at www.hbxtsw.gov.cn/show_news.asp?id=3558.
5.2. The Thirsty Market: The Demand of Shadow Banking in China

Who stand on the demand side that drives the boom of shadow banking? Small and medium sized enterprises (SMEs), local government and real estate industry are the major players on the demand side of shadow banking.151

Dwarfed by large stated-owned-enterprises with strong bargaining power over commercial banks, Chinese SMEs often seek capital from peer-to-peer (P2P) lending,152 as the upper limit of bank-loan interest rate framed by Chinese bank law has made large companies more favourable clients of traditional banks than the small ones153 and steered small entrepreneurs to non-traditional sources. Chinese banking law has excessive prudential regulation on loan making, which generally require the banks to make loans secured by guarantees or collaterals.154 Under very rare circumstance can the bank make credit lending.155 Such rule actually precludes the small enterprises to access to the bank’s loans since the small firms usually can't afford to provide the guarantees or collaterals.

Local governments are also important clients of shadow banking. As Chinese local government debt mounted to over 17 trillion,156 the central government’s disapproval of ‘wasteful’ infrastructure and heavy industry projects led to tightened fiscal control and restricted access to capital.157 As a result, alternative financial service providers stepped in to fill the vacuum by channelling credit from society to local government.

The similar reason explains why real estate companies vehemently embraced shadow banking. Due to the macro-economic control aimed at preventing housing market ‘bubble’, small and medium sized real estate developers are often denied by traditional banks.158 That’s where the market played its part: as Chinese housing industry can promise a profit margin of 16 to 30%,159 real estate developers are capable of bearing the borrowing rate higher than

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151 Shen Jianguang, ‘Shadow Banking, a Ponzi scheme?’ (December 2012), http://finance.ifeng.com/a/20121215/7437592_0.shtml . Shen Jianguang is the CEO of Mizuho Securities Co., Ltd.
152 P2P lending refers to direct loan between individuals on platforms other than traditional financial intermediary. This kind of lending usually require no collateral and demands high interest. See ‘Banking without banks’, The Economist, (1 May 2014). An example of Chines SME entrepreneurs turning to peer-to-peer lending is on ‘In China, Hidden Risk of “Shadow Finance”’, Wall Street Journal (26 November 2012).
154 Article 36 of Chinese Banking Law (‘In granting loans, a commercial bank shall require the borrower to provide guarantee…a borrower is confirmed as having excellent credibility and can truly repay the loans, it may not provide guarantee.’)
155 Ibid.
158 Commented by Sang Yufeng, the director of marketing department of Century 21 Real Estate Group.
159 However, according to a most recent report by Deloitte Consulting, over 60% of Chinese real estate companies experienced decline in profit margin last year. As reported, ‘Sampled property companies achieved an average total revenue of 7.91 billion HK dollars (1.02 billion US dollars) in the reported period in 2012, against 6.35 billion HK...
commercial bank loan, and hence can meet their demand for capital in non-traditional ways.

5.3. Playing with Fire: Participants on the Supply Side

According to ‘A Notice about Some Issues Related to Strengthening Shadow Banking Regulation’ (known as Document no. 107) released by the State Council of China, the participants on the supply side of shadow banking include three categories. Participants at the first category are non-financial companies without any financial operation license. Some of them may be legal entities, such as internet finance and P2P lending club, whose business scope are limited to internet service. Some of them may be illegal entities such as money house. None of the entities in the first category are allowed by law to involved financial activities. The first category entities are actually trespassers of financial realm. The second category are entities which engage in narrowed scope financial activities such as pawnning, guaranty or micro-lending; however, they don’t have financial operation license issued by financial regulators and not treated as financial institutions by Chinese law. They are quasi-legal financial entities. The entities in the second category are similar to ‘fringe banking’ in the U.S., which includes pawnshop. The third category are commercial banks and trust companies, which are lawful players in the financial market. The cooperation between commercial banks and trust companies to issue the wealth management products (WMPs) is similar to the credit securitization originated by commercial banks and issued by investment banks in the U.S. In what follows, this paper will discuss the participants of the three categories.

5.3.1. Bank-trust cooperation

Like many immerging financial markets, highly securitized instruments are not prevalent in China; instead, non-traditional means of financing provided by commercial banks took a dominant market share. In China, commercial banks supply funds to shadow banking system via trust and bank cooperation, which is the major channel between supply and demand sides for capital. As the group of wealthy individuals grew rapidly, Wealth Management Plans (WMPs) gained increasing significance. By the second quarter of 2013, the size of wealth management funds has reached 9.85 trillion. The WMPs become popular because of the
high return they can offer. The WMPs in China generally offer above 5% annualized return, much higher than term deposit (3% for one year).

The high return of wealth management was made possible by ‘trust and bank cooperation’. Trust company is the investment company working as the trustee holding the property for the benefits of beneficiary according to Chinese Trust Law (2001). Chinese Trust law is a transplant from Anglo-American concept, which is “fruit tree” that has come across the ocean to another shore, [which] if altered to fit China's water and soil, can produce 'clusters of fruit'.

Why banks cooperate with trust companies? The reasons are the history nexus, path dependence and incentives to making more profits from cooperation. In early 1990s, most trust companies were subsidiaries of commercial banks and earned the first barrel of gold through land speculation, but the government ordered all banks to exit trust industry in 1995 after the crisis of failure of trust companies in early 1990. The Commercial Banking Law (2003) builds the firewall between commercial banks and trust industry, which prohibits the commercial banks to engaged in the trust investment. After then, trust companies were designed by the regulators to be rich men's club, which work as intermediates linking wealthy investors to institutions and business projects while the commercial banks are open to people from different social classes. Without the retail network that commercial banks have, the trust companies can only target the wealthy individuals or institutional investors to save the transaction cost. The minimum capital requirement of clients served as the high threshold turning down middle and low class individuals to be the clients of the trust company.

The market boom in the recent year stimulated the trust companies to expand funding channel. On the other side, the constraint of credit after 2008 and the falling profits from the traditional deposit-lending business forced banks to seek more rent from non-traditional channels. Trust company and bank patched up their broken relations and circumvented the Art. 43 prohibition by Commercial Banking Law (2003) via bank-trust cooperation. In the trust and bank
cooperation model, banks aggregate individual investors via selling wealth management products and, and serve as agents between trust companies and investors.

However, the regulators are aware of banks’ circumvention under the shield of trust and bank cooperation. In July 2010, CBRC made an emergency notice to 12 major trust companies in China to halt any ongoing trust and bank cooperation projects. CRBC later released a detailed notice, urging banks to transfer previously off-balance-sheet trust assets back into balance sheet, and tightened Capital adequacy ratio (CAR) of WMPs. Despite regulatory efforts, the trust industry still lacks transparency, only one listed Chinese trust company disclosed its return of trust fund, which is barely profitable.

5.3.2. Guarantee companies
According to Chinese law, Guarantee companies are the guarantors for less credit worthy small business without sufficient collateral for bank loan. The core business of a guarantee company is to promise repayment to bank when its clients fails, and charge certain fee for this promise. The Chinese law left the power for the local government to decide who will be the regulators of financing guarantee companies. The regulators differ from area to area according to local governments’ implementing regulations, which may even be Information Technology departments and police departments. The unclear and non-professional regulators make it possible for the financing guarantee companies to go to the grey zone for higher profits, which becomes part of the shadow banking system. When the core business turned out to be unprofitable, some guarantee companies went to the ‘grey’ area and started to act like a Chinese version of AIG, selling credit default swap (CDS) to banks for a risky loan, capitalizing themselves with bank loans, and redistributing the capital in other forms.

5.3.3. Pawning companies
Pawning companies (pawn shop) have been historically known as the ‘poor man’s bank’ and its
operation can be traced back to Tang Dynasty in China.\textsuperscript{182} Shortly suspended between 1950 and 1986, now the pawning industry in China is under the regulation of Ministry of Commerce.\textsuperscript{183} The old-fashioned industry remained in existence in China, partly due to financing difficulties for Chinese SMEs, which has made pawn shops the final straw for those in dire need. In 2009, over 2,800 pawning companies are sharing the market with 36 billion yuan net asset in China.\textsuperscript{184} Of the total 84.7 billion yuan loans made by pawning companies in 2010, 63.7 billion went to SMEs.\textsuperscript{185} Compared to tradition banks, loan granting from pawning companies can be expedited for urgent need, and accepts greater varieties of collaterals. The operation of pawning companies may open the possibility for regulatory arbitrage. Although Chinese law prohibits lending between non-financial enterprises,\textsuperscript{186} pawning companies may acquire fund from institutions in form as ‘investment’, and lend out at higher rate for arbitrage profit.

5.3.4. Internet financial lenders

Among all players in Chinese shadow banking market, internet finance and peer-to-peer lending are the fastest growing and most influential participants.\textsuperscript{187} The year 2013 is known as the ‘First Year of Internet Finance in China’,\textsuperscript{188} marked by astonishing popularity of Yuebao, a fund management platform accessible to anyone with internet connection. Yuebao is introduced by the internet giant Alibaba, and offers around 6% annual return in contrast to only 0.35% demand deposit interest rate.\textsuperscript{189} High return made Yuebao an attractive alternative of bank deposit, and threatens the profitability of traditional banks. Purchasing the financial products using Yuebao is very convenient: users transfer money from Alipay to Yuebao. The pooled fund in Yuebao will be used by Tianhong Asset Management Company to buy the inter-bank products. Yuebao had the license for third party payment but not license for issuing money market fund products. But Alibaba claimed that Yuebao was just a platform and Tianhong Asset Management Company is the money market fund, which is approved by the China Securities Regulatory Commission license [2013] No.692 on 24th May, 2013. From this perspective, Yuebao is legitimate. Although the Yuebao has become a strong competitor for commercial banks in attracting the saving, the regulators took a wait and see attitude on it in 2013. The only warning from regulators was that Chinese Security Regulation Committee (CSRC) decided that Yuebao violated the Article 29 and Article 30 of Administrative Measures for the Sale of

\footnotesize{\textsuperscript{182} David Cui, Tracy Tian, & Zhen Wei, supra note 169, at 16-20.}
\footnotesize{\textsuperscript{184} See Article 4 of Measures for the Administration of Pawning (adopted by the Ministry of Commerce and Ministry of Public Security on Feb 8th, 2005).}
\footnotesize{\textsuperscript{185} Samuel Shen, ‘China Businesses Turn to Pawn Shops as Loans Dry Up’, \textit{The Reuters}, (18 February 2009) available at www.reuters.com/article/2009/02/19/us-china-pawnshop-idUSTRE51I01H20090219.}
\footnotesize{\textsuperscript{187} According to Zhou Xiaochuan, the governor of People’s Bank of China, Yuebao is licensed as ‘third party payment’ company, but not money market fund. See Li Guanglei, ‘The Attraction of Internet Finance’, \textit{Chinese Financial News}, (23 August 2013), www.financialnews.com.cn/kj/201308/t20130823_39591.html}
\footnotesize{\textsuperscript{189} Yuebao’s annual return briefly hit 7% during Chinese lunar New Year, when demand for money is high. The present (June 2014) annualized return fluctuates around 4.5% and 6%. See http://fund.eastmoney.com/000198.html.}
Securities Investment Funds and Article 9 of Interim Administrative Provisions on the Settlement Funds for the Securities Investment Fund Sales. However, CSRC only required Yuebao to register, and did not penalize or suspend the Yuebao. However, the regulators changed their attitude in 2014 due to the boom of Yuebao in 2013. The officer in central bank suggested that regulators should require Yuebao to have the deposit reserve as commercial banks did. Although central bank have not made policy to require the deposit reserve yet, it did restricted the cap of the online transfer in each account by soliciting the comments on the Measures on On-line Payment Business of Payment Institutions. The media expected that the sale of Yuebao will dramatically drop due to the new rule.

Another form of internet finance is peer-to-peer online platforms. Internet finance has become a debating issue in regulation policy making, with Chinese internet tycoons like Baidu, Tecent and Sina also promoting their fund management products, and varies of peer-to-peer online platforms are being introduced. A total of 2,000 Chinese P2P platforms currently in operation created a trading volume of 60 billion in 2013.

However, the legality of online P2P lending is still opaque. According to contract law in China, any form of private lending rate should not exceed four times of bank lending rate; otherwise, it would be illegal. Yet in practice, the wide influence of P2P platforms made it more complicated than regulating private lending. By 2014, in Zhejiang Province alone, 8 P2P platforms were sued of illegal fund-raising and forced to shut down. The challenges facing P2P lending calls for specific rules for regulation.

5.3.5. Underground banking and small lenders

Money house means a private non-bank institution absorbing deposit and making loans. Money houses have been underground since 1949, but now the legality of money house is under debate. Often disguised as legitimate investment companies and consultancy firms with organized façade, money houses compete for capital sources with commercial bank with the high interest rate they offer to savers. In fact, underground banking and traditional banking are not necessarily rivals. Sometimes, they are close friends. For instance, the commercial banks may

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192 Li Haixia, ‘Central Bank Official Proposed Reserve for Yuebao, the Return is Expected to Drop, Ren Min Web, see http://news.163.com/14/0505/08/9RFFOE5300014JB6.html.
196 Article 6 of ‘Some Advice of the People’s Supreme Court on the Trial of Lending Disputes’ (adopted by the People’s Sup. Ct. on July 2nd 1991) (No. 21 [1991]) (‘[T]he interest rate of private lending can be somewhat higher than the rate of banking…but the maximum should not exceed four times the rate in banking. An amount exceeding this limitation should not be protected (by law)’).
198 David Cui, Tracy Tian, & Zhen Wei, supra note 169, at 25.
borrow from a money house with interest at 0.5 percent per day to pass CRBC’s examination of capital ratio.  

Starting from 2008, some underground banks started to go above ground, as government grant operating licenses to small private lenders in Wenzhou. The pilot experiment is aimed at helping SMEs, who were fed by the underground money houses. It also can be viewed as a state effort to liberalize China’s financial system in addition to the pressure on reforming Chinese financial market.

5.4. Legal Origins of Shadow Banking in China

5.4.1. Financial repression and financial exclusion: the theory and reality in China

Where there is demand, there would be supply. The intervention from the state, however, may disturb the equilibrium. According to financial repression theory coined by Shaw and McKinnon, the financial repression means that state power prevents financial system from functioning at full capacity and drive money supply below effective level. Financial repression is commonly observed in countries with scarce capital and ‘ominously high’ free market rates. As bank interest rate is artificially controlled at low level to subsidize investment (in the state supported sections), the savers would be left with low deposit rate, causing less saving than optimal in financial market. As the artificially low saving and lending rate distort capital market, a gap between increased demand and limited supply will emerge. The gap will lead to credit rationing: government would direct banks to allocate scarce credit resource to fulfil industrial policy. Such rationing is described as financial exclusion, which means ‘limited access to financial services’ for individuals and enterprises. Small enterprises are often the victims of financial exclusion, since they lack sufficient assets as collaterals to get loans. Shadow banking is the direct consequence of repressed deposit and loan rate. Some borrowers, excluded by the main stream finance, need to turn to the alternative finance: shadow banking.
The aforementioned financial repression and exclusion mechanisms are manifested in China. With strong presence of state ownership and government intervention, entrance barrier for private enterprises into banking industry is almost unavoidable. Establishing a commercial bank in China requires ‘examination and approval of the banking regulatory organ of the State Council’ and is regulated under Article 12 of Chinese Banking Law. The article’s opaque words like ‘in sound condition’ means that private institutions may not enter the market without government support. As a result, the ‘Big Five Banks’ gain monopolistic position in Chinese organized financial market. Government’s leverage in controlling banking sector provides ground for interest rate manipulation in China. The People’s Bank as Chinese central bank directly controls saving and lending rates of institutional participants of deposit taking or lending and the intervention by government cause banks to favour large loans to large state-owned enterprises. Since the artificial interest rate fails to reveal true information of risk and return, ‘banks channel funds to large and well-connected enterprises, away from small and medium-sized enterprises and households’. As state-owned enterprises are guaranteed access to cheap credit, the small and medium sized enterprises (SMEs) are rationed out. According to Chinese National Bureau of Statistics, SMEs consists 99.6% of enterprises in China, contributing to 59% of GDP by the end of 2006. However, as a World Bank Investment Climate Survey revealed, SMEs in China only acquire 12% of their capital from bank loans. While accounting for more than a half of GDP, Chinese SMEs did not receive bank loans proportional to their economic significance. By May 2013, the credit balance of SMEs totalled 16 trillion Yuan, merely 22.2% of total bank credit in

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208 The World Bank and State Council of People’s Republic of China, (‘the levels of state ownership in the banking sector in China and [Chinese] government intervention in the financial system are much higher than in other countries at a similar stage of economic development that later achieved high income status.’)

209 Article 11 of Chinese Commercial Bank Law.

210 Ibid, Article 12. (‘[H]aving Articles of Association in accord with this Law and the provisions of the Company Law of the People's Republic of China; 2. Having a registered capital that meets the minimum amount in accordance with the provisions of this Law; 3. Having directors and senior management personnel with professional knowledge for holding the post and work experiences; 4. Having perfect organizations and management systems; and 5. Having a place of business accompanied with safeguard measures meeting the requirements and other facilities in relation to the business; other sound conditions shall also be met for the establishment of a commercial bank.’).

211 Ibid.

212 All the existing banks in China have the government (including state own enterprises) involved at equity holders.


215 Article 2 of Administrative Provisions on RMB Interest Rates (adopted by People's Bank of China, on 2 March 1999) (‘[A]ll financial institutions, postal savings departments, other legal persons, natural persons and other organizations that operate the RMB deposit and loan businesses within the territory of the People's Republic of China (excluding Hong Kong, Macao and Taiwan) shall obey these Provisions’).


217 Steven L. Schwarz, supra note 152, at 3.


221 Ibid.
5.4.2. Adaptive efficiency theory and market innovation

Chinese shadow banking is an innovation created by market in response to financial repression. Despite government exerts law constraints on financial institutions to gain the rent, private finance institutions will create their own solutions. Professor Douglass North called the reaction as ‘adaptive efficiency’, which helps alleviating the negative consequences of ossified institution and achieves effective resource allocation. The adaptive efficiency theory emphasizes that the economy can achieve efficiency through interaction with institutions, instead of being the products of such institutions. Social willingness of innovation calls for the adaptive efficiency; it encourages decentralized decision making and alternative ways of problem solving. The significant advantages of shadow banking are efficiency and decentralization.

In Chinese financial market, where law constraints and ossified official institutions hinder allocation efficiency, shadow banking emerges as an adaptive efficiency. Compared to traditional banking, shadow banking in China has the advantages of accessibility, flexibility and efficiency. Although commercial banks often disappoint private enterprises, they can still thrive owing to underground banks supplying necessary capital. It is a common practice for Chinese borrowers to receive delivery on 10 to 30 day credit from private lenders, when an interest rate is agreed upon. By negotiating credit terms, the small entrepreneurs are in fact creating a financial market to cater for their demand for loan. Studies have found that, in absence of credit provision through informal finance like such, only one-quarter of small business in rural areas will continue to exist. Most SMEs need small amount loan (as small as only 100,000 Yuan), which is too small that the mainstream finance do not want to offer. To achieve efficient capital allocation for small business, alternative sources are in need.

5.4.3. Theory of incomplete law and inefficient regulation

As we have discussed above, Chinese laws on financial system are not only incomplete but also ossified. Some illegal shadow banking activities are shrouded in the legitimate gown, just changing the name of the activities. Such flaws of Chinese financial law can be interpreted

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224 See North, Ibid. at 80.
225 Steven L. Schwarz, supra note 104, at 619, 626-7.
226 ‘The Wenzhou Experiment’, The Economist, (7 April, 2012). (‘Although some private banks like Minsheng do lend to small enterprises, the official banks that dominate Chinese banking prefer to lend to well-connected state firms. Many Chinese entrepreneurs have been forced to turn to shadow banks.’), available at www.economist.com/node/21552228.
228 Ibid., at 11.
230 For instance, the example we discussed above that pawnshop illegally attract the funds in the form of ‘investment’ to escape punishment.
by the Incomplete Law Theory.

The underlying assumption of Incomplete Law is that ‘law is inherently incomplete’, thus, ‘special emphasis needs to be placed on the allocation of Law Making and Law Enforcement Powers (LMLEP) to different institutions such as legislatures, courts, or regulators, in order to attain optimal levels of law enforcement’.\(^{231}\) To overcome the disadvantage of the impossibility of foreseeing, the legislators would set up ‘very general standards’ and then ‘delegates to an administrative, rulemaking body acquainted with the varying types of case, the task of fashioning rules adapted to their special needs’.\(^{232}\) The law enforcement authorities should have the ‘residual law-making power’ to remedy the flaws of incomplete law.\(^{233}\) There are two kinds of law enforcement authorities, one is judicial power and another is the administrative authority.

The court as the law enforcement institution would interpret the existing law to cover the new changing. However, court may not be the appropriate institution to react to the incomplete law as proactive law enforcement because such positive reaction will undermine their neutrality and impartiality against the rule of law principle.\(^{234}\)

On contrast to the courts, the regulators have proactive law enforcement. The regulators can ‘initiate enforcement proceedings when they find that the level of expected harm is sufficiently high’.\(^{235}\) The regulators can take various law enforcement includes various functions, ‘such as controlling entry, monitoring activities, initiating investigations, enjoining actions, and initiating the administration of sanctions against violators’.\(^{236}\) Regulators can enforce law ex ante and ex post as continuous lawmakers; thus, ‘they can change rules in response to variations in markets they observe, independent of whether violations have occurred, or when others have brought problems to their attention’.\(^{237}\)

According to the analysis above, Chinese financial regulators should have the ‘residual law-making power’ to remedy the flaws of incomplete law. Unfortunately, Chinese financial regulation is inefficient and even dysfunctional. Some experts described the Chinese Government’s attitude towards shadow banking as ‘government has almost no any regulations on (shadow banking) and only uses ex post punishment by death penalty’.\(^{238}\) Such statement may be a little bit exaggerated but it did reflect maladies of the current regulatory practice of shadow banking.

\(^{233}\) Ibid., p933.
\(^{236}\) Ibid., at 948.
\(^{237}\) Ibid., at 954.
\(^{238}\) This comment is given by Prof Wang Yong, the director of Commercial Law Center of China University of Political Science and law in the interview by Civil and Commercial Law Journal, available at http://finance.ifeng.com/opinion/zjgc/20120625/6650234.shtml.
5.5. The Risks of Shadow Banking in China

5.5.1. Maturity mismatch

Maturity mismatch is not unique in Chinese shadow banks, but is nevertheless made more seriously contagious by the emergence of shadow banking. Similar to the traditional banking, shadow banking can also issue short-term deposit-like liabilities to fund long-term projects, and ‘play a central role in transforming concerns about the credit quality of mortgage-related assets into global financial crisis’. Due to the absence of regulation, more rampant short-term debt issuance can be found in shadow banking, and trigger severe systemic consequences.

An example of the shadow banking sector exacerbating maturity mismatch problem in China is the ‘money drought’ in 2013. In June 20th, 2013, the Shanghai Interbank Offered Rate (SHIBOR) soared to astonishing 30%, a historical new height. The unprecedented high SHIBOR rate incited worries of bank default, as depositors suspected Chinese commercial banks are borrowing to meet urgent solvency problem. Signs of bank-run were observed, when rumours came out that the Industrial and Commercial Bank of China was forced to shut down its ATM system as depositors rushed for withdrawal. However, as Xinhua News, one of China’s most influential official media commented that ‘Money drought is not about the lack of money—it’s all about money in the wrong place’. In the first ten days of June 2013, Chinese financial market experienced a growth of 4 trillion in aggregated bank loan. The central bank suspected that 70% of these loans are off-balance-sheet short term papers circumventing regulation. The amount and price of short term debt issuance of shadow banking cannot be effectively regulated. As high SHIBOR rate indicates short term liquidity problems, the fear of short maturity debt default is inevitable.

5.5.2. Systemic risk

Shadow banking raises systemic risk by redistributing risk through credit, maturity and liquidity transformation. Systemic risk refers to the potential of a chain of bad consequences triggered by a single event. Under this ‘domino effect’, failure of one institution might cause significant loss to other financial institutions and ‘substantial financial-market price volatility’. In China, the following factors can potentially trigger systemic contagion:

First, the impact of housing market fluctuation on shadow banking. As previously discussed, real estate companies are the major demanders in Chinese shadow banking sector. Had they been able to remain profitable to cover high interest expense, then the win-win situation for shadow banking and housing industry can continue. However, as projected by

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242 Lingling Wei, Bob Davis, *supra* note 239.
244 *Ibid.*
mature market analysts and many consulting firms, Chinese property market is ‘looking like the Titanic headed in the direction of an iceberg’. If the property market fails to stay profitable, the default of trust products and wealth management plans based on property trust fund will occur, causing grim market expectation.

Second, being relatively immature and inexperienced in hedging risk compared to American and European counterparts, Chinese shadow banking institutions are more vulnerable to shocks in financial markets. Financial institutions in China lack variety in their portfolio, and their services are largely homogenous. With few options to hedge risk by holding diversified portfolios, shadow banking sector in China is more fragile than that in mature capital markets.

Third, the bank-trust cooperation in China makes traditional banking more susceptible to impacts of shadow banking. In theory, the separation of trust companies’ and banks’ asset pool has built a firewall between two entities. However, in reality, the two related parties will bear the risk together. In 2014, when a trust project initiated by Zhongcheng Trust Company and sold to investors by Industrial and Commercial bank of China faced default risk, both the bank and the trust company reluctantly took blame.

Other collusion between insiders of the organized market and shadow banking institutions may take forms between a loan guarantee company and a commercial bank. In pursuit for higher revenue, commercial banks will readily lend to shadow banking sectors. According to the estimation of the People’s Bank, 10 percent of shadow banking funds in Wenzhou came from bank credit in 2011.

As traditional banking and shadow banking institutions sink or swim together, traditional banks will bear the risk incurred by shadow banking sector.

5.6. Regulation of Shadow Banking in China

Shadow banking in China is a sword with two blades, which provides benefits and also poses risks to the economy. As Prof. Shaw indicated that since shadow banking is inevitable as a by-product of financial repression, the reasonable solution is have appropriate regulation on it instead of coercing it or ignoring it. However, it take a long time for Chinese government to realizing that having appropriate regulation on shadow banking is the best option. The Chinese government hadn't recognize the benefit of shadow banking till 2013 for two reasons. First, the government simples identified shadow banking as quasi-legal or illegal without acknowledging its positive effects, and without examining whether the existing laws are reasonable and fair. Second, the government relies on excessive criminal punishment to deter illegal financing.

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245 ‘Real Estate Tycoon Sees Titanic Moment for China’s Housing Market’, the Wall Street Journal, (26 May 2014), (‘Mr. Pan, the co-founder and chairman of Soho China Ltd., is taking a very bearish view on the housing market, which has struggled this year. In the first four months of the year, home sales were down 9.9% from the same period a year ago in value terms, official data shows. New construction starts – as calculated by area – were down almost 25% year over year in the same period.’)

246 Lian Ping, Chief Economic Advisor of Communication Bank comments on 2011 Chinese Financial Summit ‘The instruments and services of China’s financial industry lacks the diversity of international counterparties.’

247 In the beginning, both Zhongcheng Trust Company and the Industrial and Commercial bank of China denied to be in charge for this default. However, after prolonged dispute and bargaining, a third party stepped in to take over. The ‘Chicken Game’ that neither party refused to yield caused stress and panic among investors, and posed threat on market stability.

activities. Even without sufficient authority, the government still attempts to regulate shadow banking through coercion. The regulators began to recognize the merits of shadow banking and began to attempt to cooperate with each other since early 2014. The first part of this section will discuss the trajectory of the changing regulations of shadow banking. Although the regulations of shadow banking is going towards the right track, it still have some problems like being heavily relying on criminal punishment and the cooperative problem between different regulators, which will be discussed in the last two parts of this section.

5.6.1. Growing awareness of the need for more effective regulation

The first stage is from 2010 to 2013, when the CBRC narrowed down the definition of shadow banking and restricted the off-balance activities of commercial banks. The major regulation effort aims at cutting off the connection between shadow banking and traditional banking. In 2010, CBRC ordered that ‘Commercial banks shall recognize off-balance-sheet assets as on-balance-sheet items’ before 2011.\(^{249}\) CBRC also put restrictions the balance of wealth-management business of bank-trust cooperation.\(^{250}\) CBRC strengthened the regulation in 2013, and required direct link between wealth management product and underlying assets. The regulations aims at preventing the contagion of risk between trust company and bank.\(^{251}\)

Meanwhile, CBRC denied the institutions within its regulatory regime engaged in shadow banking, CBRC claims that non-bank financial institutions (trust companies, financial companies, car finance companies, money brokerage companies and consumer finance companies) are sufficiently regulated and are not shadow banks.\(^{252}\) Therefore, CBRC defined shadow banking as ‘credit intermediations outside regulation system of banking that can cause systemic risk and regulation arbitrage’.\(^{253}\)

The second stage is from late 2013 till May 2014, when the regulators began to recognize shadow banking in a broader scope. During 2013, Chinese government’s attitude towards shadow banking has changed gradually. Changing from denying the existence of shadow banking sector and strictly forbidding private players in financial market, Chinese government has started making efforts to effectively regulating shadow banking and turn it into ‘a beneficial complement of traditional banking’ serving to increase economic welfare.\(^{254}\) In late 2013, the State Council broadened the definition of shadow banking, and admitted CBRC regulated

\(^{249}\) China Banking Regulatory Commission, ‘Notice of the China Banking Regulatory Commission on Regulating the Relevant Matters on Wealth Management Cooperation between Banks and Trust Companies’, No.72 [2010].

\(^{250}\) Ibid. (‘the financing-type wealth management cooperation business of a trust company shall be subject to the balance proportion management, i.e. the balance of the financing-type business shall not exceed 30% of the balance of the wealth management cooperation business’).

\(^{251}\) China Banking Regulatory Commission, ‘Notice of the China Banking Regulatory Commission on Relevant Issues concerning Regulating the Investment Operation of Wealth Management Business of Commercial Banks’, No.8 [2013] (‘A commercial bank shall ensure that each wealth management product is linked to the underlying assets (subject matter) in which it is meant to invest, and is separated from other wealth management products in terms of management, account opening and accounting.’)

\(^{252}\) China Banking Regulatory Commission 2012 Annual Report, p. 44, column 11.


\(^{254}\) General office of the State Council, ‘A Notice about Some Issues Related to Strengthening Shadow Banking Regulation’, (‘As a beneficial complement of traditional banking system, shadow banking has positive effect in serving general economy an enriching investment outlets.’)
institutions (like commercial banks and trust companies) engaged in shadow banking. This change was marked by the issuance of ‘A Notice about Some Issues Related to Strengthening Shadow Banking Regulation’ (known as Document No. 107). Document No. 107 defined shadow banking as ‘credit intermediation outside traditional banking system’. In Document No. 107, State Council recognized the merits of shadow banking for the first time as it ‘plays a positive role in serving the real economy and enriching resident’s investment channels’. CBRC made a fast response to State Council and claimed that its supervision would focus on the risk of wealth management, trust, micro-loan and financial guarantee companies. The institutions mentioned by CBRC matched the three types of shadow banking in Document no.107, and hence it is inferred that CBRC has admitted State Council’s definition of shadow banking.

May 2014 is a breakthrough towards the effective regulation. The specified regulators started to working together to regulate interbank business. The central bank, CBRC, Securities Regulatory Commission (CSRC), Insurance Regulatory Commission (CIRC) and State Administration of Foreign Exchange (SAFE) issued ‘[a] Notice on Regulation of Interbank Business of Financial Institutions’. The notice aims at controlling the risk of inter-bank borrowing, inter-bank deposit, inter-bank payment and repurchase dealing. Analysts believe that this Notice will have put great restrictions on shadow banking. It forbids financial institutions to move repurchase dealings off balance sheet, and refrains third-parties to guarantee investment between financial institutions. As repurchase is a major component of non-standardized business within traditional banking, and other non-standardized trading depends on bank guarantee, this notice will have great restriction on the business of shadow banking.

5.6.2. Criminal punishments for shadow banking activities

Harsh punishment under criminal law – even capital punishment, is used to deter illegal private financing in China. The lenders who cannot pay back the funds from shadow banking usually were charged with illegal fund raising and financial fraud. The most recent famous case is Wuying case. Ms. Wu, the 6th wealthy business women, was sentenced to death for financial fraud by the Intermediate People's Court in Jinhua in 2009 and caused the nationwide cry for her and the hardship the private enterprises faced in fund raising. Under the pressure from

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255 General office of the State Council,’ A Notice about Some Issues Related to Strengthening Shadow Banking Regulation’, No.107 [2013].
256 Ibid.
259 See Article 192 of Criminal Law of the People's Republic of China (adopted at the Second Session of the Fifth Nat’l People's Cong. on July 1, 1979; revised at the Fifth Session of the Eighth Nat’l People's Cong. on March 14, 1997 and promulgated by Order No.83 of the President of the People’s Republic of China on March 14, 1997) (hereinafter Criminal Law).
260 Art.199 of Criminal Law.
261 Tang Xiangyang & Ruoji Tang, ‘Considered Opinion: The Wu Ying Case’, Eco. Observer, (22 April 2011), available at www.eeo.com.cn/ens/Politics/2011/04/19/199377.shtml (‘[R]egarding the famous case of Wuying, some scholar commented that “if Wu Ying is sentenced to death, how should we deal with other people who are illegally accepting deposits and lending at high rates? With at least one trillion yuan funds being private financing in China, how many bank employee, guarantors and public servants would be forced to go to prison?”’).
Supreme Court and the public, the High People’s Court of Zhejiang reduced her sentence to death with a two-year reprieve in 2012.\textsuperscript{262} Wuying’s case cause the debate in the inevitability of shadow banking to feed the private economy.\textsuperscript{263} Such debate somewhat gradually changed the attitude of Chinese government towards shadow banking. However, the death penalty of Zeng Chengjie for illegal raising fund indicated that the government would not give up so quickly the criminal penalty and even the death penalty for coercing shadow banking.\textsuperscript{264}

5.6.3. Coordination problems among different regulators

Document no.107 states that ‘the businesses already specified with the regulators, should be regulated by the specified regulators’.\textsuperscript{265} The State Council of China is making effort to clarify the responsibility of each regulatory branch. Document no. 107, the State Council urged the Banking Regulatory Commission (CBRC), Securities Regulatory Commission (CSRC) and Insurance Regulatory Commission (CIRC) to codify rules of regulation for their section in charge. The State Council also required the cooperation among PBOC, CBRC, CSRC and CIRC. In addition, this Notice has clarified that guarantee companies and small loan companies are regulated by CBRC, with assist from local governments.\textsuperscript{266} However, the current separation of regulation in banking, security, insurance and monetary policy may still result in coordination problems.

There is no systematic regulation of shadow banking institutions in China. Having different regulators to deal with systemic problem is not efficient. For instance, under current system, it is hard for regulators to monitor the risky business that goes on between pawnshops (regulated by the Minister of Commerce) and banks (regulated by CBRC). Efficiency of regulation will be undermined by coordination problems. As regulators pass the buck from one to another, the shadow banking market will be left inadequately regulated.

An example of regulators passing the buck is the CBRC’s passive attitude on regulating wealth management. In a notice released in 2013, CBRC defined trust asset as ‘non-standard debt assets’ and imposed rigid restriction.\textsuperscript{267} CBRC also demanded information disclosure and

\textsuperscript{262} Ms. Wu, the founder of Bense Holding Group, raised $770 million from investors between 2005 and 2007 with promise of high returns. She was arrested by the prosecutor for illegal fundraising and fraud in 2007 and only 380 millions of fund raised by her was returned to the investors. Wu was sentenced to death for financial fraud by the Intermediate People’s Court in Jinhua in 2009 and High People’s Court of Zhejiang upheld the decision of the lower court in Wu’s appeal. The major dispute of Wu’s case was that whether Wu had intent of fraud, which is punishable by death. Wu asserted that she only borrowed money from eleven friends and only invested in most profitable business. But both the Jinhua Intermediate People's Court and High People's Court of Zhejiang convicted that she had intent of fraud at the beginning of raising fund. See Illegal Fund raising and Financial Fraud of Wu Ying, China Law Info (Jinhua Intern. People’s Ct. Oct 29, 2009 [(2009) zhejinxingchuzi No.1], aff’d (Zhejiang High People’s Ct.) (2010)zhexingerzhongziNo.27] . However, The Supreme People’s Court overturned the death penalty against Wu in April 2012. While it overturned the death penalty and ordered the High People’s Court of Zhejiang to reheat the case (the penalty was reduce to death with a two-year reprieve), the Supreme People’s Court still confirm the guilty verdict of lower courts.

\textsuperscript{263} Tang Xiangyang & Ruoji Tang, supra note 260.


\textsuperscript{266} Ibid.

\textsuperscript{267} Chinese Banking Regulatory Commission, supra note 250. ('Commercial banks should control the proportion of non-standard debt asset invested in wealth management plan. The balance of non-standard debt asset in wealth
risk warning to investors. However, this regulation method puts greater weight on form over substance. According to CBRC, information disclosure mainly refers to moving wealth management asset into balance sheet. This process is like creating a ‘sandbox’ for commercial banks by keeping risky assets away from bank’s asset pool. However, CBRC made little, if any, effort to control systemic risk in other financial sectors. Simply keeping risky asset away from banks means these assets may find their place in other sectors, like trust, guarantee and insurance. In the end, the risk for whole system is not reduced, but is merely shifted to a different sector.

The coordination problems can also be observed among different local governments. In China, there is no nationwide regulator for shadow banking institutions. The regulators and rules of shadow banking institutions differ from area to area according to local regulations, and the local government usually appoints multiple regulators. As an old saying goes, too many cooks spoil the broth, having multiple regulators in one market will also spoil the market.

5. CONCLUSION

Four years have passed since the G20 leaders tolled the bell to the shadow banking system at the Seoul Summit of 2010. The war against shadow banking, however, has never ended. Instead, the war has just started on a global scale. The knowledge and monitoring techniques of shadow banking available to international organizations have become more advanced thanks to the efforts in the communication and research by scholars, practitioners and regulators in different countries. However, there is still a long way to go for the international community to develop an effective regulatory framework of use for different countries. One of the first steps of the long journey would be the conduct of comparative studies of shadow banking in major jurisdictions, such as the U.S. and China which offer good examples of shadow banking in the advanced and emerging markets.

The concept of shadow banking was born in the U.S. Up to now, the U.S. still has the largest shadow banking sector in the world. Shadow banking in China is, however, the most significant among emerging markets in many terms. Shadow banking differs in many aspects in the U.S. and China: including its definitions, scopes, institutions and instruments. In the U.S., shadow banking involves a complex link between the shadow banking market and commercial banks, in which the major players are ‘money market, credit hedge, investment, exchange-trading funds, conduits or special purpose vehicles and finance, insurance, and

management products should not exceed 35% of wealth management balance, and 4% of the bank’s net asset, based on the last financial year’s annual report.’)

Ibid. (‘Commercial banks should separately manage each wealth management product…and ensure that each product has its balance sheet, income statement and cash flow statement.’)

In Henan province, for instance, the regulator is a joint committee consisting of industry and the information technology office of the local People’s Government, the police department, the commercial department, the finance office, the tax department, and so on. ‘Interim Regulation on Financing Guarantee Companies’, Art. 3.

The term ‘shadow bank’ was coined by U.S. economist Paul McCulley for the first time in 2007. See Paul McCulley, supra note 62.

FSB, supra note 31, at 9.

Shadow Banking and Its Regulation in the U.S. and China

leasing companies’. In China, shadow banking has a smaller scale and operates in simpler forms. For instance, the shadow banking system in the U.S. is more on securitization in the capital market, which is different from the Chinese model that mainly reflects the characteristics of commercial banks that taking ‘deposits’ and making ‘loans’ due largely to the underdeveloped capital market in China.

The legal origins and potential risks of shadow banking and possible regulation responses to it also differ in the U.S. and China. In the U.S., the major influences by law (regulation) on the development of shadow banking are (1) restrictions on bank activities; (2) deregulation on non-banking financial activities; (3) regulatory arbitrage; and (4) welfare policy. In China, the growth and boom of shadow banking is driven by the purpose of achieving adaptive efficiency by the market against the financial repression. The incomplete and ossified law and the inefficient regulation also provides a hotbed of shadow banking. Both the U.S. and Chinese shadow banking has systematic risks with different causes. While the complexity, inadequate information disclosure and high leverage lead to the potential systematic risks of shadow banking in the U.S., Chinese shadow banking does not have comparably complex instruments and high leverage. Nonetheless, since shadow banking primarily focus on the real estate sector in China and due to its close connection with commercial banks, it has caused high systematic risks. Regulators in the U.S. and China both have some responses against shadow banking. Unfortunately, such regulatory responses are more stopgap measures than a radical and effective cure. The U.S. solutions are even possible to create new regulatory arbitrage and cause potential systematic risks. Compared with their U.S. counterparts, Chinese regulators are much more passive because of the dilemma that while ‘[t]hey have long desired to develop deep and versatile capital markets… shadow banking is a natural part of that’.

Shadow banking varies between the U.S. and China; however, there are a number of similarities for the purposes of creating credit beyond the heavy regulated sector, which can be viewed via the lens of the Theory of Money and Credit and also the Endogenous Money Supply Theory. Such findings would inspire the regulators to solve the problem of shadow banking from the monetary perspective, instead of merely from an institutional point of view. In other words, as a legal institution, shadow banking is ‘like all legal institutions, stand in need of design’. On the other hand, the exploration of the similarities of the origins of shadow banking in the U.S. and China within the same theoretical framework would facilitate the policy making by international organizations in this area.

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273 Ibid., at 1-2.
275 Morgan Ricks, supra note 46, at 731, 748.