I. Chinese Shadow Banking and Its Impact on the U.S. Economy

A. Introduction

As described by the Financial Stability Board, shadow banking is "credit intermediation involving entities and activities outside of the regular banking system."[1] In other words, "the shadow banking system is a set of institutions that carry out functions very similar to those of traditional banks but that are largely unregulated."[2] While shadow banking may be an additional source of credit and economic growth, the accompanying risks and regulatory arbitrage opportunities are sometimes seen as outweighing the economic advantages.[3] Haunted by the association between shadow banking and the 2008 financial crisis,[4] many have warned against the risks triggered by rapid growth of Chinese shadow banking.[5]

In China, the development of shadow banking has been primarily fueled by the demand of credit from private entrepreneurs, usually small and medium-sized enterprises (SMEs), as well as the general shortage of credit supply throughout the economy.[6] At the end

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[1] DOUGLAS ELLIOTT ET AL., THE BROOKINGS INST., SHADOW BANKING IN CHINA: A PRIMER 4 (2015), https://www.brookings.edu/wp-content/uploads/2016/06/shadow_banking_china_elliott_kroeber_yu.pdf [http://perma.cc/Y2YM-YP6K].

[2] Daniel Sanches, *Shadow Banking and the Crisis of 2007-08*, 97 BUS. REV. 7, 9 (2014), https://philadelphiafed.org/-/media/research-and-data/publications/business-review/2014/q2/brQ214_shadow_banking.pdf [http://perma.cc/W2RN-A925].

[3] ELLIOTT, *supra* note 1, at 4 (explaining "shadow banks can help spur economic growth, but usually do so at the expense of financial stability").

[4] *See* Sanches, *supra* note 2, at 12 ("The crisis in the shadow banking system has significantly reduced the ability of commercial banks to originate and renew loans, creating ongoing problems for households and firms that rely on bank loans.").

[5] *See, e.g.*, Sui-Lee Wee & Owen Guo, *'Shadow Banking' Scandal Spurs Concerns Over China*, N.Y. TIMES, Apr. 20, 2017, at B2 (discussing an investment scandal where a Beijing bank lost $400 million of investors' money in wealth management products).

[6] Gil Lan, *Insights from China for the United States: Shadow Banking, Economic Development, and Financial Systems*, 12 BERKELEY BUS. L.J. 144, 160 (2015) ("[P]rivate entrepreneurs are being starved of bank credit due to the preferential lending policies of state banks and leads to the 'irony that losing state enterprises can obtain credit more easily than profitable,

of June 2016, Moody's estimated that the size of China's shadow banking system had doubled within the last five years and made up 82 percent of China's GDP.[7] With this growth rate, a widespread mismatch between maturities of shadow banking products may result in China facing its own "Lehman moment."[8]

But is this concern towards the rapid growth of Chinese shadow banking warranted?[9] Is the Chinese government poised to contain the associated risks of shadow banking?[10] If Chinese shadow banking were to suffer widespread shocks, to what extent would the U.S. economy be affected?[11] This article aims to provide an overview of Chinese shadow banking, examine its impact on the U.S. economy, and give guidance on how the U.S. should view the future growth of Chinese shadow banking. First, Part B provides a more detailed account of shadow banking and its perceived advantages and disadvantages. Second, Part C discusses the role shadow banking plays in

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promising private enterprises'"); *see* ELLIOTT, *supra* note 1, at 6 (explaining that banks failed to fully serve small and medium-sized enterprises in the private sector).

[7] Sean Hung & Minyan Liu, *Chinese Banks Face Increasing Risks in Asset Quality and Rising Financial Sector Interconnectedness*, MOODY'S (Dec. 13, 2016), https://www.moodys.com/research/Moodys-Chinese-banks-face-increasing-risks-in-asset-quality-and--PR_359481 [https://perma.cc/G45G-4FZ6].

[8] *See* Jamil Anderlini, *Into the Shadow: Risky Business, Global Threat*, FIN. TIMES (June 15, 2014), https://www.ft.com/content/a123375a-d774-11e3-a47c-00144feabdc0.

[9] *See* Hung & Liu, *supra* note 7 (stating that the Chinese shadow banking system "has doubled in size these last 5 years with its assets equal to 82% of GDP at the end of June 2016"). *But see* Mark Mobius, *Fears About China's Shadow Banking System Are Unfounded*, BUS. INSIDER (Jan. 25, 2017, 8:16 PM), http://www.businessinsider.com/china-and-shadow-financing-2017-1 [https://perma.cc/S34F-XES7] (discussing how Chinese shadow banking is growing and "[g]iven the popularity of non-traditional lending vehicles with the public, it seems unlikely China . . . would allow major defaults").

[10] *See* Gwynn Guilford, *Five Charts to Explain China's Shadow Banking System, and How It Could Make a Slowdown Uglier,* QUARTZ (Feb. 20, 2014), https://qz.com/175590 [https://perma.cc/U3YR-HVVU].

[11] *See* U.S.-CHINA ECON. AND SEC. REV. COMM'N, ANNUAL REPORT, 114TH CONG. 113, 143 (2013) ("The opacity of Chinese corporate governance and accountability policies, as well as conflicts with U.S. securities laws and regulations, hurts investor confidence in Chinese companies trading on U.S. exchanges. The current situation threatens U.S. investors with unforeseeable and unmanageable losses . . . .").

China's financial landscape, the main types of Chinese shadow banking transactions, and the Chinese government's response to the growth of shadow banking. Finally, Part D examines the effect of Chinese shadow banking on the U.S. economy.

B. What Is Shadow Banking?

The term "shadow banking" was first coined in 2007 to describe the phenomenon of banks packaging loans into bonds for sale to third parties with the purpose of keeping credit risk off balance sheets.[12] Shadow banking activities have grown since then and now take on many different forms.[13] However, they can all still be described as "financial intermediaries that perform bank-like activity but are not regulated as one."[14] Shadow banking traditionally includes hedge funds, structured investment vehicles, special purpose entity conduits, money market funds, and repurchase agreement markets.[15] With the rise of financial technology, shadow banking now also includes mobile payment systems, peer-to-peer lending websites, and bond-trading platforms.[16] Shadow banking institutions are worrisome because they can create unregulated, excessively-risky credit growth.[17] Shadow banking institutions are also more fragile than traditional

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[12] A.A.K., *How Shadow Banking Works*, THE ECONOMIST (Feb. 2, 2016), https://www.economist.com/blogs/economist-explains/2016/02/economist-explains-0 [https://perma.cc/47Z8-6Y6B] ("The term "shadow bank" was coined in 2007 by Paul McCulley of PIMCO, a big bond fund to describe risky off-balance-sheet vehicles hatched by banks to sell loans repackaged as bonds.").

[13] *Id.* ("Today, the term is used more loosely to cover all financial intermediaries that perform bank-like activity but are not regulated as one. These include mobile payment systems, pawnshops, peer-to-peer lending websites, hedge funds and bond-trading platforms set up by technology firms.").

[14] *Id.*

[15] ZOLTAN POZSAR ET AL., SHADOW BANKING, FED. RES. BANK OF N.Y., STAFF REPORT NO. 458, 1 (2010) (listing various types of shadow banks); *see also* ELLIOTT, *supra* note 1, at 1 (discussing pawn shops as a form of shadow bank).

[16] A.A.K., *supra* note 12 (describing various forms of shadow banking).

[17] ELLIOTT, *supra* note 1, at 22 ("[R]egulators had two broad concerns: first, that an unregulated shadow finance sector could create excessive credit growth; and second, that the lack of transparency in the sources and uses of funds could create hidden risks, much as occurred in the U.S. before 2008.").

banks due to lack of access to public sources of liquidity (e.g., Federal Reserve's discount window) and insurance (e.g., Federal Deposit Insurance).[18] However, even with the associated risks and fragility of the shadow banking system, shadow banking activities stimulate economic growth by providing society with an additional source of credit.[19] They often offer greater flexibility and higher returns because they are not held to the same standards of liquidity and capital as regulated banks.[20] Nevertheless, while shadow banking may be an additional source of credit and economic growth, the accompanying risks and regulatory arbitrage opportunities are often seen as outweighing the economic advantages.[21]

C. Rise of Chinese Shadow Banking

At the end of June 2016, Moody's estimated that the size China's shadow banking system had doubled within the last five years and made up 82 percent of China's GDP.[22] Chinese shadow banking has been primarily fueled by the demand for credit from private entrepreneurs, usually small and medium-sized enterprises (SMEs), as well as the general shortage of credit supply throughout the economy.[23]

1. China's Financial Landscape

The nature of China's financial landscape has played a big part in the development of Chinese shadow banking.[24] The People's

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[18] Pozsar, *supra* note 15, at 2 ("[W]hat distinguishes shadow banks from traditional banks is their lack of access to public sources of liquidity . . . or public sources of insurance such as Federal Deposit Insurance.").
[19] ELLIOTT, *supra* note 1, at 1.
[20] *See id.* ("[B]eing outside the formal banking sector generally means [shadow banks] lack a strong safety net, such as publicly guaranteed deposit insurance or lender of last resort facilities from central banks, and operate with a different, and usually lesser, level of regulatory oversight.").
[21] *Id.* at 4–5.
[22] Hung & Liu, *supra* note 7.
[23] Lan*, supra* note 6, at 160 ("[P]rivate entrepreneurs are being starved of bank credit due to the preferential lending policies of state banks and . . . 'losing state enterprises can obtain credit more easily than profitable, promising private enterprises.'"); *see* ELLIOTT, *supra* note 1, at 6 (explaining that banks failed to fully serve small and medium-sized enterprises).
[24] *See, e.g.,* ELLIOTT, *supra* note 1.

Bank of China and the China Banking Regulatory Commission supervises and sets the monetary policy for all commercial banks in the country.[25] Under these two regulatory bodies, all other commercial banks in China can be divided into four categories.[26] First, there are three policy lending banks that focus on foreign trade, large infrastructure development, and agriculture development respectively.[27] These policy lending banks help promulgate operations and dictate policies in their respective sectors.[28] Second, there are the "Big Four" banks, and they dominate the commercial loan and deposit market (i.e., Agriculture Bank of China, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China).[29] These four state-controlled banks have strict loan to deposit ratios[30] and high reserve requirements,[31] which results in a limited supply in credit throughout the Chinese economy.[32] For example, the Big Four and other banks are prohibited from lending more than 75 percent of their deposits.[33] Third, there are 12 national joint-equity commercial banks.[34] These banks perform similar functions as the Big Four but are only about one-tenth in size.[35] Fourth, there are the even smaller urban

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[25] Viral V. Acharya et al., In the Shadow of Banks: Wealth Management Products and Issuing Banks' Risk in China 6 (Feb. 10, 2017) (unpublished draft), available at https://jrc.princeton.edu/sites/jrc/files/qian_jun-shadowbank-china-aqy-10feb17-all.pdf ("All commercial banks are under the supervision of PBOC and China Banking Regulatory Commission (CBRC).").
[26] *Id.* at 5 ("There are mainly four types of banks in China.").
[27] *Id.*
[28] *See id.* (discussing the various sectors in which state-owned policy banks operate).
[29] *Id*.
[30] ELLIOTT, *supra* note 1, at 5 ("Banks are not allowed to lend funds equal to more than 75% of their deposit volumes.").
[31] *Id.* ("[C]urrently about 19.5% of deposits must be placed with the PBOC [People's Bank of China].").
[32] Don Weinland & Liz Mak, *Decline in Loans at China's 'Big Four' Banks Show Asset-Quality Concerns*, S. CHINA MORNING POST (Nov. 17, 2015), http://scmp.com/business/banking-finance/article/1879799/decline-loans-chinas-big-four-banks-shows-asset-quality [https://perma.cc/3BEG-N8EQ].
[33] ACHARYA, *supra* note 25, at 6 ("Banks cannot lend more than 75% of their total deposits, and this upper bound on lending was also binding during our sample period especially for SMBs.").
[34] *Id.*
[35] *Id.* at 5.

and rural banks managed by provincial and city governments to serve local communities.[36]

In general, banks primarily lend to state-owned enterprises (SOEs) due to government directives and confidence in SOEs' ability to repay loans.[37] On the other hand, loans to private entities, such as entrepreneurs and SMEs, are seen by banks as riskier investments due to their lack of high-quality collateral and credit history.[38] Even when the Chinese government has been establishing measures to expand the credit supply, SOEs have been receiving most of the benefit.[39] Even from the perspective of an individual Chinese bank employee, it is safer to loan to a SOE than to a private entity.[40] In the event of a loan default, the bank employee overseeing the transaction would have to go through a longer internal investigation if the loan was made to a private entity.[41] If the loan was made to a SOE, the employee may simply write off the default as a "commercial mistake" without significant negative repercussions.[42]

As a result, private entities are usually excluded from lending and are not adequately served by traditional banks.[43] Although private

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[36] *Id.* ("The fourth is urban and rural commercial banks, which are founded by the city or the province governments. They are usually very small.").

[37] *See* U.S.-CHINA ECON. AND SEC. REV. COMM'N, ANNUAL REPORT, *supra* note 11, at 115 ("A 2013 Brookings Institution report outlines broad rationales behind the big five commercial banks' lending bias, a combination of government directives requiring them to loan to the state sector and a greater sense of confidence on their own part in the credit risks presented by state-owned enterprises (SOEs).").

[38] ELLIOTT, *supra* note 1, at 6 ("SMEs lack high-quality collateral and long credit histories and are associated with higher risk. This is particularly problematic in a banking system that relies heavily on collateral, as China's does.").

[39] Yuan Yang & Tom Mitchell, *China's Private Sector Misses Out on Credit Boom*, FIN. TIMES (July 3, 2016), https://www.ft.com/content/833c5208-3eba-11e6-8716-a4a71e8140b0 ("China's private sector has missed out on the country's credit boom . . . despite Beijing's efforts to rebalance the economy away from state-dominated heavy industry.").

[40] *Id.* (explaining the bank employee is held less culpable when he or she makes a bad loan to a SOE).

[41] *Id.*

[42] *Id.* (explaining that if an employee lends to an SOE and defaults, the employee can simply state he made a "commercial mistake").

[43] ELLIOTT, *supra* note 1, at 6 ("The bias towards SOEs is exacerbated by a clear bias against private sector entities, especially SMEs. This is unfortunate, since much of China's economic growth has come from these firms, which

entities have been unable to obtain credit and funds from traditional lending institutions in China, private entities are nonetheless responsible for 60 percent of China's growing GDP since 2012.[44] They are able to grow at this rate primarily due to credit and funds obtained through the shadow banking system.[45] Similar to the United States, shadow banking in China began growing when traditional banks began deliberately repackaging increasingly risky loans, usually made to private entrepreneurs and SMEs, into products to be sold to third parties.[46] Banks are incentivized to repackage these loans because they can conduct more business as the middleman while still in compliance with formal regulations.[47] Third parties are incentivized to buy these repackaged loans instead of putting their money in deposit because these products offer a higher return than the deposit rate.[48] Even to this day, at least two-thirds of shadow banking activities in China encompass repackaging bank loans to take advantage of regulatory arbitrage opportunities.[49] These repackaged loans may take the form of wealth management products, entrusted loans, and passageway deals, and peer-to-peer lending.[50]

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are reported to have provided 70% of employment and 60% of China's GDP in 2012, while receiving only 20% of bank loans.").

[44] *Id.* ("The bias towards SOEs is exacerbated by a clear bias against private sector entities, especially SMEs. This is unfortunate, since much of China's economic growth has come from these firms, which are reported to have provided 70% of employment and 60% of China's GDP in 2012, while receiving only 20% of bank loans.").

[45] U.S.-CHINA ECON. AND SEC. REV. COMM'N, ANNUAL REPORT, *supra* note 11, at 123 ("Chinese demand for shadow banking is largely driven by the growth of China's private sector, a sector with limited access to official bank credit . . . .").

[46] *See* ELLIOTT, *supra* note 1, at 6 (discussing Chinese banks neglecting SMEs).

[47] U.S.-CHINA ECON. AND SEC. REV. COMM'N, ANNUAL REPORT, *supra* note 11, at 123 ("Loans are often arranged by middlemen who are paid a fee, and borrowers sometimes pay interest as high as 70 percent or more per year.").

[48] ACHARYA, *supra* note 25, at 6 ("The difference between regulated deposit rate and market lending rate gives banks strong incentives to engage in excessive lending.").

[49] ELLIOTT, *supra* note 1, at 9 ("It appears that about two-thirds of shadow banking in China can be characterized as "bank loans in disguise" that result from regulatory arbitrage.").

[50] U.S.-CHINA ECON. AND SEC. REV. COMM'N, ANNUAL REPORT, *supra* note 11, at 126–27 (stating various forms of shadow banking).

2. Makeup of Chinese Shadow Banking

Chinese shadow banking transactions take on many forms, but most of them involve financial products where the bank acts as a middleman.[51] Wealth management products (WMPs), the fastest growing form of shadow banking, are undertaken by all of the largest 25 banks in China, including the Big Four banks.[52] Banks bundle loans together and often sell them to trust companies to maintain the loan-to-deposit-ratio.[53] WMPs are then sold by banks or trust companies to individual investors.[54] They are very popular among individual investors because the principal is usually guaranteed and they offer higher returns than a deposit.[55] Banks benefit from the difference between the interest charged on the loan and the interest offered to individual WMP investors.[56]

Similarly, entrusted loans are financial products that depend on banks or trust companies identifying wealthy individual investors or, in many instances, corporations, and connecting them to other corporations that are in need corporate loans.[57] Entrusted loans are essentially corporation-to-corporation lending, but since direct lending between corporations is illegal, these types of transactions have to go through an agent financial intermediary.[58] The financial intermediary does not record entrusted loans on its balance sheet but benefits from

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[51] *Id.* at 127–28 (defining the major types of Chinese shadow banking transactions).

[52] *See* ACHARYA, *supra* note 25, at 2 ("Our data set covers all the WMPs issued by the largest 25 banks in China . . . . We separate them into two categories: Big Four banks and SMBs [small- and medium-sized banks].").

[53] ELLIOTT, *supra* note 1, at 5 (discussing how banks maintain strict loan to deposit ratios).

[54] ACHARYA, *supra* note 25, at 5–9 (discussing the financing of borrowers through the issuance of WMPs).

[55] *Id.* at 6 (highlighting benefits of purchasing wealth benefit products).

[56] *Id.* ("The difference between regulated deposit rate and market lending rate gives banks strong incentives to engage in excessive lending.")

[57] *See Rising Entrusted Loans Pose Mounting Credit Risks*, BMI RESEARCH (June 20, 2016), https://www.bmiresearch.com/articles/rising-entrusted-loans-pose-mounting-credit-risks [https://perma.cc/PE5B-B66P] (defining entrusted loans).

[58] *Id.*

the transaction through fees and commission.[59] Since corporations do not completely disclose these activities, it is difficult to see how much credit risk these transactions are carrying.[60]

Passageway deals are another way for banks to get around the loan-to-deposit ratio requirement.[61] Banks make loans that are then purchased by trust companies and brokerages to avoid exceeding the lending quota.[62] Trusts companies and brokerages then sell these to individual investors.[63] Finally, peer-to-peer lending typically takes the form of online transactions, which match borrowers with lenders of both small and short-term loans. Banks are usually not involved in these transactions.[64]

The following example from the New York Times provides a comprehensive illustration of a shadow banking transaction:

> A developer approaches a bank, asking for a loan. Since the developer is unsecured, it is willing to pay a high rate of 9 percent. The bank agrees, but it must first raise the funds to proceed. To finance the loan, the bank entices depositors to make large deposits by promising them a return of 6 percent. Because that exceeds the 3.3 percent maximum allowed by China, the bank sets up a special wealth management product, which it offers via a trust company to keep the transaction off the bank's books. Again working via the trust company, the bank, now armed with the money from depositors, arranges the loan to the developer. The developer pays 9 percent interest, plus a large fee. The bank pockets the fee and the difference between the 9% it gets from the developer and the 6 percent it pays to depositors. Both sides of the transaction are kept off the bank's books—but if

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[59] *Id.* ("The agent financial institution records entrusted loans off its balance sheet and it does not assume the risks and rewards of the entrusted loans, but instead collects fees and commissions.")
[60] *Id*. (discussing the recording of loans off the balance sheets of financial institutions).
[61] U.S.-CHINA ECON. AND SEC. REV. COMM'N, ANNUAL REPORT, *supra* note 11, at 126–27.
[62] *Id.*
[63] *Id*.
[64] *Id.* at 127.

> the developer fails, depositors could be left in the lurch.[65]

As demonstrated by the above illustration, a shadow banking transaction can potentially tie four parties (i.e., borrower, bank, trust company, and third party investor) to the same loan.[66] While this transaction allows one loan to have four beneficiaries, three parties may be negatively impacted if the borrower defaults.[67]

3. Chinese Government's Response to the Growth of Shadow Banking

The Chinese government has taken a "cautiously welcoming" stance to shadow banking activities in China.[68] From the government's perspective, shadow banking has facilitated supply and demand of credit, promoted growth in the private sector, and introduced new forms of investments for the individual investor.[69] However, the interrelatedness between traditional and shadow banking transactions creates worrisome risks.[70] Since 2013, the Chinese Government has advocated for increased transparency of the composition of shadow banking assets and moderate regulation of excessive credit growth resulting from shadow banking.[71] In the last quarter of 2016, the People's Bank of China is no longer taking a neutral stance on credit

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[65] David Barboza, *Loan Practices of China's Banks Raising Concern,* N.Y. TIMES*,* July 2, 2013, at A1 (providing an illustration of questionable lending practices in China).

[66] *Id*.

[67] *See id*.

[68] ELLIOTT, *supra* note 1, at 22 ("Since the emergence of wealth management products and trust loans on a large scale in 2010, the principal financial regulators, the PBOC and the CBRC, have taken a cautiously welcoming view of the shadow sector.")

[69] *Id.* ("[S]hadow activities help satisfy the demand of investors and depositors for a wider range of financial instruments, beyond the low-yielding regulated deposits and the illiquid real-estate investments that until recently were the principal investment options for most Chinese.").

[70] *Id.* at 14 (describing the relationship between traditional and shadow banking in China).

[71] *Id.* at 22 ("The monetary tightening imposed by the new government beginning in May 2013 came almost exclusively through a slowing in the pace of non-bank lending, which brought growth in total credit down to below 15% despite virtually no change in the pace of bank lending.").

growth, and is inclined towards curbing the availability of credit.[72] For example, as of March 2017, a bank is strictly required to limit interbank loans to less than one-third of total liabilities.[73] More recently, during the National Financial Work Conference over July 14 and 15 2017, Chinese President Xi Jinping announced the establishment of a new financial regulatory commission.[74] The National Financial Work Conference occurs twice a decade[75] and is where Chinese political leaders set the pace of financial regulation for the next five years.[76] In addition to the new commission, President Xi also advocated for greater regulatory power of the People's Bank of China in order to increase risk oversight capabilities over China's financial landscape.[77] While these heightened regulations will no doubt increase scrutiny over current shadow banking activities, it is too early to tell whether the Chinese government's new commission and increased regulatory oversight can effectively manage the largely market-driven nature of shadow banking.

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[72] Huileng Tan, *China Shadow Banking is Slowing Amid More Coordinated Government Measures, Says Moody's,* CNBC (July 4, 2017), https://www.cnbc.com/2017/07/04/china-shadow-banking-is-slowing-amid-more-coordinated-government-measures-says-moodys.html [https://perma.cc/2Q3S-6UU2] ("[T]he central bank changing its monetary policy setting in the last quarter of 2016 to 'moderate neutral' from 'moderate,' which raised market funding costs and refinancing risks for banks, reducing the return from supporting long-term investments with short-term market funds . . . .").

[73] *Id.* ("In March and April, the China Banking Regulatory Commission also requested banks test whether their interbank liabilities would exceed the regulatory ceiling at one-third of total liabilities.").

[74] *Five Takeaways from China's Weekend Meeting on Financial Regulation*, BLOOMBERG NEWS (July 16, 2017, 07:56 PM), https://www.bloomberg.com/news/articles/2017-07-16/five-takeaways-from-china-s-weekend-meet-on-financial-regulation [https://perma.cc/667X-B65C].

[75] *Id.* ("For investors, possibly the most important thing that happened in China during the weekend was a closed-door conference on regulation that could set the scene for the financial sector's next five years.").

[76] Keith Bradsher, *Chinese Financial Meeting Yields Meager Results*, N.Y. TIMES, July 16, 2017, at A9 ("At past gatherings, they have created entire regulatory agencies and rearranged the rules for huge markets, almost overnight.").

[77] *Id.* ("[T]he meeting reinforced the PBOC's central position in the 'modern financial regulation framework,' and its role in defending against risks was emphasized . . . .").

In the past, the Chinese government experienced combating the negative consequences of shadow banking.[78] When a Shanghai-based solar energy and technology company defaulted on a large corporate bond in March 2014, the government waited until October to guarantee the company's debt.[79] The company's default was due to its failure to make interest payments on loans.[80] The Chinese government ultimately decided to bailout the company to calm worried investors and maintain market stability.[81] While the gap in time between the company's default and the government's rescue has been interpreted as the government's hesitation to rescue failed shadow banking transactions, the eventual rescue shows the government's awareness that such failed transactions may incite panics and bank runs.[82]

From the current state of Chinese shadow banking activities, it is not completely clear whether the Chinese government is in a good position to regulate these activities. On one hand, as of April 2017, e-commerce conglomerate Alibaba's four-year-old money market fund, Yu'E Bao, has surpassed JP Morgan's U.S. government money market as the world's biggest money market fund, illustrating the growth potential of Chinese shadow banking.[83] Yu'E Bao is a fund sold on Alipay, the most popular mobile-payment system in China, and accounts for 28 percent of money market funds in China.[84] Investors

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[78] Lan, *supra* note 6, at 176–77 (describing Chinese government's bailout of Chaori Solar Energy Science & Technology Co. in 2014).
[79] *Id.*
[80] Gabriel Wildau, *China Landmark Bond Default Heads Toward Bailout*, FIN. TIMES (Oct. 8, 2014), https://www.ft.com/content/10adc7be-4ebe-11e4-b205-00144feab7de (stating failed interest payment began Chaori's default).
[81] *See id.* ("But the apparent bailout may rekindle bond investors' appetite for riskier credit amid a revival of what local investors call the 'rigid repayment' expectations for publicly issued bonds in China.").
[82] Lan, *supra* note 6, at 177 ("Although allowing companies to default may encourage market discipline to emerge in China, allowing too many defaults could cause panic in the market and trigger a run. By delaying its rescue of Chaori for quite some time, the Chinese government may have sent home the message that reliance on government bailouts is becoming increasingly risky, while avoiding the destabilization of a default.").
[83] Louis Lucas, *Chinese money market fund becomes world's biggest*, FIN. TIMES (Apr. 26, 2017), https://www.ft.com/content/28d4e100-2a6d-11e7-bc4b-5528796fe35c ("Alibaba's four year old Yu'e Bao fund—the name translates as leftover treasure—has overtaken JPMorgan's US government money market fund, which has $150bn.").
[84] *World's Biggest Money-Market Fund Can Grow More, Fitch Says,* BLOOMBERG NEWS (Aug. 17, 2017, 12:09 AM),

find this fund especially attractive because Yu'E Bao offers the highest annual yield (3.87 percent) compared to other funds (3.74 percent on average).[85] In addition, there are also no requirements on the minimum invested amount or the minimum investment time frame.[86] On the other hand, compared to the United States and other Western European countries, China's shadow banking sector is still relatively small.[87] In addition, since shadow banking activities are closely tied to the formal banking sector, the Chinese government is in a better position to exert influence and policy decisions through the formal banking sector to regulate the former.[88] Finally, most shadow banking activities are relatively straightforward acts of lending.[89] In the case of a bank run or some other form of crisis, the Chinese government has sufficient fiscal capacity to alleviate the crisis.[90] In other words, there are enough bank deposits in the aggregate financial sector and the Chinese government is in the position to appropriately allocate deposits to cover risk exposures.[91]

D. Effect of Chinese Shadow Banking on U.S. Economy

"If China catches a cold, the rest of the world won't be sneezing—it will be headed for the emergency room."[92] In the event of a financial crisis developing from the proliferation of the risky

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https://www.bloomberg.com/news/articles/2017-08-17/world-s-biggest-money-market-fund-to-get-even-bigger-fitch-says [https://perma.cc/46XL-92EV].

[85] *Id.*

[86] *Id.* ("Yu'E Bao, which gives users a way to stash away savings with no minimum investment or time frame.").

[87] ELLIOTT, *supra* note 1, at 21 ("China's shadow banking sector, however defined, is substantially smaller (relative to GDP) than those of financially advanced countries in North America and Europe.").

[88] *Id.* (discussing how the close ties between the formal banking sector and shadow banks).

[89] *See id.* at 1 (demonstrating the techniques and instruments used in shadow banking).

[90] *Id.* at 2 ("[T]he authorities have more than enough fiscal capacity to deal with even a large shadow banking crisis, given quite low central government debt to GDP ratios, even when adjusted for off-balance sheet obligations, such as the need to rescue some local and regional governments.").

[91] *Id.*

[92] Lan, *supra* note 6, at 170 (describing the potential issues that could stem from a Chinese financial crisis).

practices of Chinese shadow banking, the U.S. economy would no doubt be threatened and affected as the U.S. and China are closely tied in trade, investments, and financial relationships.[93] However, the chance of Chinese shadow banking failure causing a full-blown financial crisis with global impact is considered quite low.[94]

Nevertheless, the U.S.-China Economic and Security Review Commission (the Commission), the agency with leading expertise on Chinese shadow banking, foresees that the opacity and riskiness of shadow banking activities in China will present challenges in the form of information asymmetry for U.S. companies and individual investors looking to participate in the Chinese market.[95] The Commission was originally formed by Congress in October 2000 to assess national security implications stemming from economic relations between U.S and China.[96] The Commission's warnings of opacity and riskiness come from the notion that consumers may be blindly trusting shadow banking products because these products are backed by banks.[97] However, if Chinese consumers begin to lose trust in shadow banking products and demand withdrawals, they can create serious bank runs, which will be especially detrimental for banks that are heavily involved in asset management.[98] In May 2017 and September 2017, Moody's and S&P, respectively, lowered China's credit rating due to

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[93] *Id.* (describing potential issues from a Chinese financial crisis).

[94] ELLIOTT, *supra* note 1, at 2 ("[I]f such a crisis did occur, say via the serial bankruptcy of several trust lenders, it is likely that the impact of the crisis could be contained and would not lead to serious contagion in the rest of the financial system.").

[95] U.S.-CHINA ECON. AND SEC. REV. COMM'N, ANNUAL REPORT, *supra* note 11, at 142 ("China's opaque policies and practices with regard to corporate accountability present serious challenges for U.S. companies and U.S. investors seeking information on the risks entailed in their transactions.").

[96] *About Us*, U.S.-CHINA ECON. AND SEC. REV. COMM'N, https://www.uscc.gov/about (last visited Oct. 8, 2017).

[97] Amie Williams, *How to Invest in the 'New China'*, FIN. TIMES (Sept. 27, 2017), https://www.ft.com/content/f4d13466-9de5-11e7-9a86-4d5a475ba4c5?mhq5j=e5&mhq5j=e5 ("[I]nvestors have been buying under the illusion that the banks are guaranteeing their returns.").

[98] *Id.* ("[T]he banks' implicit guarantee unravels, households might rush into withdrawing funds. This would force down revenues at Chinese asset managers and cause problems for smaller banks which rely on asset managers as a funding source.").

strong credit growth increasing economic and financial risks.[99] These developments all seem to suggest that U.S. investors should take a cautious approach when evaluating and making decisions with respect to investments in the current Chinese financial landscape.

E. Conclusion

Chinese shadow banking has been largely driven by China's existing financial landscape.[100] Factors that have led to its rapid growth include bank's desire to profit off more transactions, lack of credit for private entities, and individual investors' pursuit of investments with higher returns.[101] While its shadow banking system is still saturated with risks and opacity, the majority of transactions are closely tied to the formal banking sector, which is highly regulated by the Chinese government.[102] Therefore, the Chinese government is in a good position to indirectly regulate shadow banking transactions through the formal banking sector. As a method of last resort, it may continue to bailout failing companies to maintain market stability.[103] If the Chinese government is willing to step in to prevent a full-blown shadow banking crisis, the U.S. economy as a whole is not likely to be affected by negative consequences of shadow banking in China.[104] However, for U.S. companies and individual investors wishing to participate in

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[99] *China Hit by First Moody's Downgrade Since 1989 on Debt Risk*, BLOOMBERG NEWS (May 23, 2017, 8:26 PM), https://www.bloomberg.com/news/articles/2017-05-24/china-downgraded-to-a1-by-moody-s-on-worsening-debt-outlook [https://perma.cc/6HQY-NE2J] (stating Moody's downgrade in China's credit rating); *S&P Cuts China's Credit Rating, Citing Risk From Debt Growth*, BLOOMBERG NEWS (Sept. 21, 2017, 5:02 AM), https://www.bloomberg.com/news/articles/2017-09-21/s-p-lowers-china-s-rating-to-a-from-aa-says-outlook-stable [https://perma.cc/HSK5-36RV] (stating S&P's downgrade in China's credit rating).

[100] ELLIOTT, *supra* note 1 (discussing the financial landscape of China and developments of shadow banking).

[101] *Id.* (discussing the rapid development of Chinese shadow banking).

[102] U.S.-CHINA ECON. AND SEC. REV. COMM'N, ANNUAL REPORT, *supra* note 11, at 142 ("China's opaque policies and practices with regard to corporate accountability present serious challenges for U.S. companies and U.S. investors seeking information on the risks entailed in their transactions.").

[103] Lan, *supra* note 6, at 176–77 (describing the Chinese government's bailout of Chaori Technology Co. in 2014).

[104] *Id.* (stating that past Chinese government bailouts have maintained market stability).

the Chinese economy, the opacity, riskiness, and exponential credit growth of Chinese shadow banking suggest caution and careful evaluation.[105]

Helen Huang[106]

[105] U.S.-CHINA ECON. AND SEC. REV. COMM'N, ANNUAL REPORT, *supra* note 11, at 142 ("China's opaque policies and practices with regard to corporate accountability present serious challenges for U.S. companies and U.S. investors seeking information on the risks entailed in their transactions.").

[106] Student, Boston University School of Law (J.D. 2019).