The Regulation of Shadow Banking in China: International and Comparative Perspectives

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In the wake of the global financial crisis of 2008, shadow banking has been widely identified as one of the major sources of financial instability, and its regulation has become the subject of much international debate. Existing studies, however, have focused on advanced economies, such the US and EU; much less has been written about China, despite its rising economic power. This paper represents an attempt to fill this research gap, assessing China's regulation of shadow banking from international and comparative perspectives.

Shadow banking has grown rapidly in China over the past few years, which exhibits distinctive features in terms of driving forces, components, players and risk profiles. The recently issued Circular No. 107 represents a significant improvement on China's shadow banking regulation. It clarifies the regulatory arrangements for shadow banking within the existing sectoral regulatory structure. While this may work in the short term, it is argued that China should consider a more fundamental reform towards the twin-peaks model in the long term. Further, it sets out useful substantive guidance and sound regulatory approach, but its workability depends very much on implementing rules to be issued by various agencies in the future.

Dans la foulée de la crise financière mondiale de 2008, le système bancaire parallèle a été largement pointé du doigt comme étant l'une des principales sources d'instabilité financière, et sa réglementation a été fortement mise en cause à l'échelle internationale. Les principales études publiées sur la question ont trait aux économies avancées, comme celle des États-Unis et celle de l'Union européenne; le cas de la Chine, qui est une puissance économique montante, a reçu moins d'attention. L'auteur tente ici de combler cette lacune en examinant d'un

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point de vue international et comparatif la réglementation imposée par la Chine en ce domaine.

Ce système bancaire parallèle a connu une croissance rapide en Chine au cours des dernières années; il se distingue par ses forces vives, ses composantes, ses acteurs et ses profils de risque. La circulaire nº 107 qui a été publiée récemment présente une nette amélioration de la réglementation chinoise; elle précise la place des dispositifs réglementaires du système bancaire parallèle à l'intérieur de la structure réglementaire qui régit actuellement le secteur. Cette façon de faire convient peut-être pour le court terme, mais certains font valoir que la Chine devrait envisager une réforme plus fondamentale et passer à long terme au modèle bipolaire dit « Twin Peaks ». La circulaire nº 107 établit un encadrement utile et repose sur des orientations de fond et une approche réglementaire solide, mais son applicabilité dépend grandement de la mise en œuvre de règles devant être adoptées par divers organismes dans l'avenir.

1. INTRODUCTION

Shadow banking has been widely identified as one of the major causes of the global financial crisis of 2008 and as such, has become a focus of financial regulatory reform worldwide. Great efforts are being made to improve the regulation of shadow banking at a national and global level. Existing studies, however, have focused on advanced economies, such as the US and EU; much less has been written about China, despite the fact that it is now the second largest economy in the world.

This paper represents an attempt to fill this research gap, assessing China's regulation of shadow banking from international and comparative perspectives. Over the past several years, China has followed the international trend in taking steps to address the issue of shadow banking. In January 2014, the Chinese central government, namely the State Council, promulgated an important document with respect to the regulation of shadow banking in China, entitled *Guowuyuan Bangongting Guanyu Jiaqiang Yingzi Yinhang Jianguan Youguan Wenti de Tongzhi [Circular of the General Office of the State Council on Relevant Issues of Strengthening the Regulation of Shadow Banking]* (State Council Circular No. 107, 2013) (hereinafter Circular No. 107).[1] It has the highest legal force among all documents China has promulgated towards shadow banking to date, and sets out an overarching regulatory framework for shadow banking in China. Hence, the discussion of this paper will be focused on this document.

To set the stage for discussion, Part 2 of this paper will explore the various definitions of shadow banking and then look at the definition China adopts in the Circular No. 107. Then Part 3 and Part 4 will examine the development and salient features of China's shadow banking system. This can help explain why the Chinese regulation of shadow banking is the way that it is. Part 5 will conduct a comparative analysis of the regulation of shadow banking in China and overseas, covering

1 Guowuyuan Bangongting Guanyu Jiaqiang Yingzi Yinhang Jianguan Youguan Wenti de Tongzhi, *Circular of the General Office of the State Council on Relevant Issues of Strengthening the Regulation of Shadow Banking* (State Council Circular No. 107, 2013) [Circular No. 107].

both institutional structure and substantive content, and evaluate them using a market-failure-based analytical framework.

2. DEFINING SHADOW BANKING

It has been very hard to define shadow banking. Although the term "shadow banking" has become widely used, there is no consensus over its definition at the international level. The term is generally believed to be coined by economist and investment manager Paul McCulley, who used it to refer to "the whole alphabet soup of levered up non-bank investment conduits, vehicles and structures".[2] Other commentators have since redefined and expanded the meaning of "shadow banking". Economists of the Federal Reserve in the US, for instance, have broadly described shadow banking as "financial intermediaries that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector credit guarantees", so that shadow banking may include finance companies, asset-backed commercial paper conduits, limited-purpose finance companies, structured investment vehicles, credit hedge funds, money market mutual funds, securities lenders, and government-sponsored enterprises."[3] It is even argued that governments themselves are shadow banks because "by allowing excessive competition, providing downside guarantees and encouraging risky lending for populist schemes, governments can create periods of intense economic activity fuelled by credit booms."[4]

Further, some commentators have used other terms which are synonymous with shadow banking. For instance, Mr Tim Geithner, the then president of Federal Reserve Bank of New York, used the term "parallel banking system" in a 2008 speech;[5] the International Monetary Fund used the term "near-bank entities" in a 2008 report.[6] In a sense, these alternative terms are more neutral than shadow banking, as the latter has a pejorative connotation to the extent that operating in the shadows implies inappropriateness. Nevertheless, shadow banking has been used by most commentators, perhaps to highlight the problem and the need to address it.

In the newly-issued Circular No. 107, the Chinese government also uses the term "shadow banking" [Yingzi Yinhang], and describes it as "credit intermediation entities and activities outside the traditional banking system." This is broadly similar to the way Financial Stability Board (FSB) defines shadow banking.[7] Indeed, while there is no single authoritative definition of shadow banking, the defi-

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2 Paul McCulley, "Teton Reflections: Pimco Global Central Bank Focus" PIMCO (September 2007) 2.

3 Zoltan Pozsar *et al.*, "Shadow Banking" *Federal Reserve Bank of New York Staff Report No 458* (July 2010).

4 Viral V Acharya, "Governments as Shadow Banks: The Looming Threat to Financial Stability" (2012) 90 *Texas Law Review* 1745.

5 Tim Geithner, "Reducing Systemic Risk in a Dynamic Financial System", Remarks at the Economic Club of New York, New York City, June 9, 2008, online: <http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html>.

6 International Monetary Fund, *Global Financial Stability Report: Financial Stress and Deleveraging, Macrofinancial Implications and Policy* (October 2008) 19.

7 Financial Stability Board, *Shadow Banking: Scoping the Issues* (April 2011).

nition offered by the FSB has proved influential and has been used by many Chinese scholars.[8] But the FSB definition is open to interpretation because the phrase "traditional banking system" can be understood in different ways.

One might be tempted to take an institutional or entity-based approach, equating "traditional banking system" with traditional chartered banks. This means that the FSB definition of shadow banking excludes banks, no matter what they do. Not surprisingly, this understanding of the FSB definition can easily attract criticism, because many shadow banking activities operate within banks or with the assistance or participation of banks.[9] A better view of the FSB definition can be gained by way of a functional or activity-based approach. For instance, to avoid the ambiguity of the general term "traditional banking", a new term "luminated banking" has been coined to mean the traditional business model by which chartered banks provides financial mediation services, namely debt funded by the insured deposits of chartered banks.[10] The term shadow banking stands in contrast with laminated banking; hence banks can be involved in shadow banking if they engage in activities outside their traditional business model.

The Circular No. 107 seems to have taken a functional approach in its definition of shadow banking. It classifies shadow banking into three categories, covering both banks and non-bank entities. The first category is credit intermediation entities that do not have financial licenses and that are completely unregulated, such as the so-called internet financing companies (*hulianwang Jinrong* such as crowdfunding) and third-party wealth management entities. The second category includes credit intermediation entities that do not have financial licenses and that are subject to an inadequate level of regulation, such as financing guarantee companies and petty loan companies. Last but not least, it encompasses entities that hold financial licenses and that have activities which are not adequately regulated, such as money market funds, securitization and some types of wealth management businesses.[11]

It is not entirely clear about the size and structure of China's shadow banking for two main reasons. First, due to the broad nature of shadow banking, different institutions use different criteria to make estimates. Second, it is extremely difficult, if not impossible, to assess some components of China's shadow banking system, such as private lending. According to the FSB, the scale of China's shadow banking in 2011 was about RMB 4 trillion, while several Chinese institutions estimated it to be in the range of RMB 20 to 30 trillion.[12] Hence, there is a great need

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8 See e.g., Dasong Yuan, "International Financial Regulatory Reforms to Strengthen the Regulation of Shadow Banking" (2012) 2 *Faxue Yanjiu [Chinese Journal of Law]* 194 at 196.

9 Stijn Claessens & Lev Ratnovski, "What Is Shadow Banking?" Working Paper/14/25, February 2014, International Monetary Fund.

10 Edward V. Murphy, "Shadow Banking: Background and Policy Issues" Congressional Research Service 7-5700, 13 December 2013.

11 Circular No. 107 at s. 1.

12 Yingwei Zhao, "Woguo Yingzi Yinhang de Xinyong Fenxian Juji — Jiyu Lici Jinrong Weiji de Shijiao Fenxi [A Comparison of Shadow Banking Credit Risk Aggregation From the Perspective of Global Financial Crises in the Past]" (2013) 11 *Caijing Kexue [Finance and Economics Science]*.

for improvements in the availability of data and other related qualitative information. Despite the big differences in the assessment of shadow banking activities in China, there appears a consensus that China's shadow banking plays a significant role in its financial system and, if left unregulated, may become a major source of systemic risk in the future.

3. THE DEVELOPMENT OF SHADOW BANKING IN CHINA

The rise of shadow banking is one of the most important developments in China's financial system over the past few years. According to the FSB, in 2012, China has a growth rate in shadow banking asset of 42 per cent, which is the highest rate in the world.[13] China's shadow banking system has grown significantly in diversity and breadth. To understand the rapid growth of shadow banking in China, one needs to examine both supply-side and demand-side aspects.[14]

On the supply side, the contributing factors mainly include gains in efficiency and regulatory arbitrage. This needs to be assessed against the broad background of China's macro-economic policy. Although China's shadow banking system existed before the global financial crisis of 2008, it started to grow rapidly after that. This is in stark contrast with the US situation where the shadow banking system developed before, and finally contributed to, the global financial crisis of 2008. This is mainly because the Chinese government has tightened its monetary policy in the post-crisis era, making it much more difficult to get finance through the traditional loan business of commercial banks. As a result, shadow banking has become an increasingly important alternative source of liquidity in China.

The inefficiency of China's traditional banking system is a major factor behind the rapid growth of shadow banking in China. For a variety of reasons, China's commercial banking sector has a high level of monopoly. The banking market has long been dominated by large state-controlled banks, which generally favour state-owned enterprises or large firms in extending loans. Hence shadow banking is needed to supply liquidity to disadvantaged firms such as private micro and small-sized firms.

What is more, regulatory arbitrage provides incentives for banks to engage in shadow banking businesses. Traditional banks need to comply with strict prudential regulation requirements, including the capital adequacy ratio, the ratio of loan balance versus deposit balance, the deposit reserve ratio, and limits on the total loan value. But non-bank financial institutions are not subject to the same level of restriction. Traditional banks thus cooperate with non-bank financial institutions, notably trust companies, to offer wealth management products. As banks do not hold

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13 FSB, *Global Shadow Banking Monitoring Report 2013* (Basel 14 November 2013) 12.

14 See e.g., Ba Shusong, "Ying Cong Jinrong Jiegou Yanjin Jiaodu Keguan Pinggu Yingzi Yinhang [Shadow Banking Should be Assessed Objectively From the Viewpoint of the Evolution of Financial Structure]" (2013) 4 Jingji Zongheng [Economic Debate]; Chen Jiyong & Zhen Zhen, "Hou Weiji Shidai Zhongmei Yingzi Yinhang Xingcheng Jizhi, Fenxian Tezhen Bijiao ji Duice Yanjiu [Study on Formation Mechanism, Risk Characters and Countermeasures of China-US Shadow Banking in Post-crisis Era]" (2013) 11 *Wuhan Daxue Xuebao Zexue Shehui Kexue Ban [Wuhan University Journal (Philosophy & Social Sciences)]*.

these loans on their balance sheets, this business can help them enhance profit and circumvent relevant regulatory requirements.

The development of shadow banking is also fuelled by financial market innovations and technological advancements. China has been encouraging financial innovation, such as securitisation and wealth management products, in an attempt to further stimulate the development of its financial markets. Technological advancement facilitates shadow banking by expanding the time and space for conducting financial transactions, reducing transaction costs and improving the efficiency of the allocation of financial assets. The concept of internet finance has recently become a very hot topic in China, giving rise to a wide variety of related products.

The analysis of the development of China's shadow banking system would not be complete without looking at the stimulus from the demand side as well. Due to strict control over the interest rate paid on deposits by traditional banks, Chinese investors are increasingly attracted to shadow banking which can offer much higher rates of return. In 2004, China started to relax its interest rate control policy by allowing banks to set their loan rates at a discount of 10 per cent of the official base rate issued by the central bank, namely People's Bank of China. This reform process has been accelerated in recent years. The government control over the loan rate was further relaxed to allow a discount of 20 per cent in June 2012 and then 30 per cent in July 2012, culminating in a complete abolishment of the lower limit on the loan rate in July 2013. On the other hand, however, the deposit rate is still subject to tight control, because it has greater impact on the cost of capital for banks and its reform may need to take longer time than that of the loan rate. In June 2012, the deposit rate given by commercial banks was allowed for the first time to be higher than the official base rate by up to 10 per cent. As of the time of writing, this cap has remained unchanged.

4. CURRENT SITUATION OF SHADOW BANKING IN CHINA

Although shadow banking is a global phenomenon, the shadow banking system in China has distinctive features, which makes it substantially different from its counterparts overseas. This part will examine the composition, players and sophistication of the Chinese shadow banking system, and compare it with its US counterpart.

(a) Composition and Players

Some commentators have come up with a taxonomy of the shadow banking system participants, divided them into three subgroups.[15] The first is the government-sponsored shadow banking subsystem consisting of the government-sponsored enterprises such as the Federal Home Loan Bank System, Fannie Mae and Freddie Mac. The second is the "internal" shadow banking subsystem, where large banks use a range of off-balance-sheet securitization and asset management techniques to conduct lending with less capital than if they had retained loans on their balance sheets. The final subgroup is the "external" shadow banking subsystem, namely a global network of shadow banks where the origination, warehousing and

15 Zoltan Pozsar, Tobias Adrian, Adam Ashcraft & Hayley Boesky, "Shadow Banking" (2013) Federal Reserve Bank New York Economic Policy Review.

securitization of loans are conducted mainly from the US while the funding and maturity transformation of structured credit assets conducted mainly from various offshore financial centres.

Amongst the above three subgroups of shadow banking participants, the first and third subgroups are the main players in the US shadow banking, including investment banks, hedge funds, money market mutual funds, structure investment vehicles and government-sponsored enterprises. The shadow banking system in the US has long established its footprint in the capital markets. For instance, monetary market funds can operate independently from traditional banks, while repo and securitization markets are open to all participants, including banks and non-banks. The US shadow banking is therefore more market-based, operating in parallel to and to a large extent, in competition with traditional banks.

In contrast, China's shadow banking system has grown in heavy reliance on traditional banks to perform basic functions of credit intermediation. Due to historical and political reasons, traditional banks have long had a predominant position in the Chinese financial system, enjoying absolute advantages in terms of the branch network, scale and marketing channel. Without banks' active involvement in liquidity provision, product distribution, credit guarantee and investment recommendation, the shadow banking system would not have reached the level of development today. Hence, the relationship between the shadow banking system and the traditional banking system is more collaborative than competitive.

For instance, a major shadow banking activity in China is the wealth management products in China (WMPs). WMPs first emerged in China in 2004 and the primary driver has been China's low interest rate policy on deposits. WMPs offer investors, particularly small investors, an investment channel through which they can gain greater yields than these traditional deposits. This is especially so during the past few years when the rapid pickup in inflation turned real deposit rates negative and many depositors chose to move money out of banks into money markets.[16] In order to retain deposits, banks created WMPs and structured them off-balance sheet, so that WMPs are exempt from restrictions on deposits rates and their yields can move freely with market interest rates.

WMPs are usually offered under a bank-trust cooperation model which was initiated by Minsheng Bank in 2006. Trust companies create WMPs and banks use their client networks to market them in return for a commission. The proceeds raised from the WMPs are then invested by trust companies in a wide range of assets, including money market and bond funds, small and medium-sized enterprises loans, real estate loans and local government financing vehicle loans. In short, the operation of the WMPs system is bank-centric: trust companies need to cooperate with banks to obtain funding and mitigate the credibility problem in issuing WMPs.

(b) Level of Sophistication

The US shadow banking system grows in a developed financial system and utilizes highly sophisticated financial tools to offer complex financial products such

16 Cindy Li, *Federal Reserve Bank of San Francisco County Analysis Unit: Shadow Banking in China: Expanding Scale, Evolving Structure* (San Francisco: April 2013).

as securitized loans, asset-backed commercial paper, repurchase agreements and money market funds. These techniques may contribute to the build-up of high, yet simultaneously disguised, leverage in the financial system. In contrast, the Chinese financial system is far less developed than its US counterpart, and shadow banking is not dominated by complex derivatives. As the traditional banks in China cannot meet the financing need of certain kinds of firms, particularly small and medium-sized private enterprises, shadow banking mainly involves direct lending to the real economy with a modest level of leverage, such as WMPs and private lending activities.

Securitization, for instance, is a well established practice in the US financial markets, performing the important function of converting illiquid assets into liquid assets. At the moment, however, the business of securitization is still in the stage of experimentation in China. Many of shadow banking products in the US can also be seen as advanced versions of relevant products in China.[17] For example, WMPs correspond to the monetary market mutual funds (MMFs) in the US. They play a similar role in providing shadow deposits and share a common origin in regulatory arbitrage. The development of MMFs in the US started as a response to the Federal Reserve Board's (FRB) interest rate caps on savings deposits in commercial banks required under the *Glass-Steagall Act*.[18] Like WMPs, MMFs offered investors, particularly small investors, a higher return than what was available on savings deposits. MMFs have continued to grow even after the interest rate cap was abolished later. Despite their similar role and origin, WMPs are less sophisticated than MMFs which are highly liquid and use various accounting techniques to manage and report its net asset value per share.[19]

5. REGULATING SHADOW BANKING: PROBLEMS AND SOLUTIONS

As discussed above, China's shadow banking is still in the initial stage of development and is less sophisticated than its counterparts overseas, notably the US. This means that the level of risk posed by shadow banking in China may be lower than that in the US, but there are still significant risks which require adequate regulatory attention in order to reduce the likelihood of them causing a new financial crisis.[20] In September 2012, Mr Gang Xiao, the then Chairman of Bank of China and the current Chairman of China Securities Regulatory Commission, was re-

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17 Zengting Yuan, "*Zhongwai Yingzi Yinhang Tixi de Benzi yu Jianguan [The Nature and Regulation of Shadow Banking in China and Overseas]*" (2011) 1 Zhongguo Jinrong [China Finance].

18 Edward F. Greene & Elizabeth L. Broomfield, "Promoting risk mitigation, not migration: a comparative analysis of shadow banking reforms by the FSB, USA and EU" (2013) 8(1) *Capital Markets Law Journal* 6 at 38.

19 International Organization of Securities Commissions, "Policy Recommendations for Money Market Funds" (October 2012).

20 Hongqian Qi & Baomin Huang, "Woguo Yingzi Yinhang de Fazhan Jiqi Fenxian Fangfan [The Development of China's Shadow Banking and its Risk Containment]" (2013) 30(6) *Shenzhen Daxue Xuebao (Renwen Shehui Kexue Ban) [Journal of Shenzhen University (Humanities & Social Sciences)]*.

ported to opine that China's shadow banking would be the greatest risk in the Chinese financial system in the next five years.[21]

Consider WMPs which are a main component of China's shadow banking system. The total outstanding WMPs issued through banks reached RMB 7.1 trillion (roughly USD 1.1 trillion) at year-end 2012, representing a 55 percent increase from 2011.[22] WMPs are mostly closed funds and investors cannot withdraw before maturity. Nevertheless, most WMPs carry tenures of less than a year, with many being one to three months. In short, WMPs essentially use short-term financing to invest in long-term projects, and hence there is a mismatch between assets and liabilities. In principle, banks simply market WMPs to their clients, with the client, not the bank, exposed to losses if there is a default. In the eyes of banks' clients, however, banks provide an implicit guarantee for the quality of WMPs they sell. This risk misperception needs to be addressed, otherwise investors may lose confidence and a liquidity crisis may occur.

In early March 2014, China experienced its first ever corporate debt default, when a Shanghai-based solar energy company, Chaori, said it could not make bond interest payment of RMB 89.8 million.[23] This was followed by a Zhejiang property developer named Xingrun Zhiye who could not repay a huge loan.[24] These cases have become an alarm call for investors to better understand risks associated with the shadow banking products. Although they seem isolated cases and a systemic financial crisis is not in sight at this stage,[25] they highlight the importance of an effective regulatory regime for China's shadow banking system.

(a) Institutional Structure

(i) The Chinese Experience and Problems

In order to truly appreciate how China has responded to the shadow banking system and the key issues that may have an impact on China's financial regulation in the future, it is necessary first to have an overview of how China's financial regulation is structured. The current financial regulatory framework in China has the defining feature of being sectors-based, with separate regulators for banking, securities and insurance, namely the China Banking Regulatory Commission

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21 Liping Deng, "Xiao Gang: Weilai Wunian Zuida Fenxian shi Yingzi Yinhang [Xiao Gang: The Biggest Risk is Shadow Banking in The Next Five Years]" Meiri Jingji Xinwen [Everyday Economic News] (13 September 2012), online: <http://bank.hexun.com/2012-09-13/145786733.html>.

22 China Banking Regulatory Commission, 2012 Annual Report (Beijing: 6 May 2013).

23 Mengshun Ran, "Chaori Taiyang Po Ling Weiyue Shenghua [Chaori Solar Broke the Myth of Zero Default]" (14 March 2014), online: <http://www.infzm.com/content/98874>.

24 Ye Huang, "Xingrun Zhiye Daxiang Fangqi Weiyue Diyiqiang [Xingrun Zhiye Fired the First Shot of Default by Property Developers]" (1 April 2014), online: <http://house.people.com.cn/n/2014/0401/c164220-24790187.html>.

25 Circular No. 107, at s. 1 (stating that the current risk of China's shadow banking system is controllable overall).

(CBRC), the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC).[26]

Together with the central bank, the Peoples' Bank of China (PBOC), the above three highly specialised and mutually independent regulatory commissions make up China's financial regulatory framework, collectively referred to as "*Yihang Sanhui*" (one bank, three commissions). The PBOC has responsibility for monetary policy and the stability of the financial system generally. The CBRC, the CSRC and the CIRC are the authorities responsible for regulating the banking, securities and insurance sectors respectively. This sector-based regulatory model corresponds to the segmentation of financial services and markets in China, a policy commonly known as "*Fenye Jingying, Fenye Jianguan*" (separate operation, separate regulation).

Against this sectors-based regulatory background, the Circular No. 107 sets out more detailed guidance on the institutional structure of shadow banking regulation in China. In general, it adopts an entity-based approach to dividing regulatory responsibility among different regulatory bodies: whoever approves the establishment of the shadow banking entity shall be responsible for regulating it.[27]

First, for shadow banking entities which fall clearly under the statutory sectors-based regulatory framework, their shadow banking businesses shall be regulated by the sectoral regulators separately. For instance, the WMPs offered by banks are subject to the supervision of the CBRC; the WMPs offered by securities and futures firms, as well as private equity investment funds, are regulated by the CSRC; the WMPs offered by insurance companies are regulated by the CIRC. Responsibility for regulating cross-sector WMPs and third-party payment businesses falls on the PBOC.[28]

Second, some shadow banking entities are regulated by local governments in accordance with a uniform set of rules promulgated by the relevant departments of the central government. For instance, the CBRC is responsible for coordinating an inter-department meeting to make relevant rules applicable to the businesses of financing guarantee companies, while the actual supervision should be carried out by the local governments. Similarly, the supervisory rules on petty-loan companies are to be made by the CBRC in consultation with other agencies such as the PBOC, and the provincial governments are the day-to-day supervisor.[29] This central-local cooperative supervisory arrangement is also applicable to other shadow banking businesses.[30]

Finally, for shadow banking issues to which no regulatory body has been clearly designated, greater research efforts shall be made to find solutions. For instance, the PBOC is tasked with making rules, in collaboration with other relevant departments, on the WMPs offered by third parties, securitization by non-financial institutions, and internet financial businesses.

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26 Hui Huang, "Institutional Structure of Financial Regulation in China: Lessons from the Global Financial Crisis" (2010) 10(1) *The Journal of Corporate Law Studies* 219.

27 Circular No. 107 at s. 2(1).

28 Circular No. 107 at s. 2(2).

29 Circular No. 107 at s. 2(3).

30 Circular No. 107 at s. 2(4).

Although the Circular No. 107 makes great efforts to clarify the division of regulatory responsibilities, it does not come without problems however. The development of shadow banking has significantly changed the way the financial markets operate in China, posing a serious challenge to China's traditional sectoral regulation under which regulatory responsibility is divided along the traditional line of banking, securities and insurance. As discussed above, the Circular No. 107 adheres to the general policy of "separate operation, separate regulation" in establishing the institutional architecture for shadow banking regulation, but this has a number of inadequacies.

On the one hand, the same or similar financial products are subject to different regulators, creating the issue of regulatory inconsistency and thus the opportunity for regulatory arbitrage. A strong example is the regulatory arrangement for the WMPs offered by various financial institutions: albeit being similar financial products, they are subject to different regulators.[31] On the other hand, many shadow banking products, such as securitization, are cross-sector in nature, and do not fit neatly into the traditional classification of banking, securities and insurance businesses which underpin China's current sector-based regulation. This also explains why the Circular No. 107 fails to specify regulators for certain new and innovative shadow banking businesses, and calls for more research on those issues.

In short, there is a mismatch between China's regulatory structure and the underlying market it regulates, which has affected the efficacy of the regulation by creating regulatory inconsistency, gaps and overlaps. Hence, it is crucial for China to have a more effective regulatory framework for shadow banking.

(ii) International Perspectives

The preceding analysis has identified a number of structural problems with China's regulatory regime for shadow banking. In quest of a solution to the above problems, below is a comparative analysis of the three major regulatory models currently in use around the world.[32]

The sectors-based model

The US financial regulation is typical of this model, under which the different financial sectors of banking, securities and insurance are subject to separate statutes, and supervised by separate regulatory agencies, with boundaries divided institutionally or functionally.

In the wake of the global financial crisis, the US has enacted the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act)[33] which, amongst other things, establishes the Financial Stability Oversight Council (FSOC) as an important measure to safeguard US financial stability. The FSOC is empow-

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31 Dong Yang, Shichangxing Jianjie Jinrong: Jihe Touzi Jihua Tonghe Guizhi Lun [Market-based Indirect Finance: Integrated Regulation of Collective Investment Scheme] (2013) 2 *Zhongguo Faxue* [*China Legal Science*] 58 at 60.

32 For a more detailed discussion, see Hui Huang, "Institutional Structure of Financial Regulation in China: Lessons from the Global Financial Crisis" (2010) 10(1) *The Journal of Corporate Law Studies* 219.

33 Pub. L. No. 111-203 (2010).

ered to designate non-bank financial entities and identify non-bank financial activities as systemically significant. A non-bank financial company may be designated as a non-bank systemically important financial institution (SIFI), if the FSOC determines that US financial stability could be threatened by material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness or mix of the activities of the company.[34] The scope of the non-bank SIFI is broad, including: 1) any US or foreign company that is "predominantly engaged in financial activities" other than a bank holding company; 2) a foreign banking organization that is treated as a bank holding company in the US; and 3) certain other types of entities subject to bank or bank-like regulation.[35] Similarly, in identifying particular activities as posing systemic risk, the FSOC must find that "the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and non-bank financial companies, financial markets of the USA, or low-income, minority, or underserved communities."[36]

It should be noted that the entity designation has different regulatory implications from the activity designation. If a non-bank entity is designated as a non-bank SIFI, it will automatically subject to the oversight of the Federal Reserve Board (FRB) as if they were banks. In contrast, if the FSOC identifies an activity as systemically significant, this will not automatically trigger new prudential constraints on the activity. Rather, the FSOC will make non-binding reform proposals to the primary regulator or regulators that oversee the activity or to the Congress, and the latter can reject the proposals with relevant explanations.

The FSOC has so far been focused on the task of identifying SIFIs. In April 2012, it approved a rule setting forth a three-stage process by which a non-bank SIFI will be identified. This rule contains substantive criteria, including both quantitative and qualitative metrics, as well as procedural matters such as the voting mechanism the FSOC uses to make a designation decision, the right of the proposed non-bank SIFI to challenge the decision, and the procedure for holding a non-public hearing.

In sum, the Dodd-Frank Act does not fundamentally change the "sectoral regulation" model of financial regulation in the US, but just makes some technical adjustments.

The "integrated regulation" model

This model was best represented by the UK until its reform in April 2013. The UK was the first jurisdiction in the world — soon followed by some countries including Germany, Japan and South Korea — to adopt this model in setting up a powerful and nearly universal regulator for its financial services industry, namely the Financial Services Authority (FSA). The FSA was a super regulator in terms of

34 Dodd-Frank Act at s. 113.

35 Dodd-Frank Act at s. 106. It is worth noting that under s. 170 of the Dodd Frank Act, the Federal Reserve Board of Governors can promulgate regulations to exempt certain classes of non-bank financial companies from its supervision.

36 Dodd-Frank Act at s. 120.

its unusually broad regulatory mandate: it was mandated to not only regulate a diversity of businesses, including banking, securities and insurance, but was also charged with both prudential and business conduct regulation.

The "twin-peaks" model

Australia is the champion of this model, being the first to establish a financial regulatory framework comprised of two main regulators in 1998. The first regulator, the Australian Securities and Investment Commission (ASIC), has responsibility for business conduct regulation across banking, securities and insurance. The second regulator in the Australian regime, namely the Australian Prudential Regulatory Authority (APRA), is responsible for prudential regulation, ensuring the financial soundness of all licensed financial institutions except for securities firms which are regulated by the ASIC.

As the Australian regulatory regime consists of two separate regulators with different mandates in relation to prudential regulation and business conduct regulation respectively, it is vividly named the "twin-peaks" model, or the "objectives-based regulation" model. It is noteworthy that apart from the ASIC and the APRA, some other agencies perform certain regulatory functions in the financial markets, most notably the Reserve Bank of Australia, the central bank in Australia. It is responsible for monetary policy and financial stability, but no longer has any direct banking regulatory responsibilities. In this sense, the Australian financial regulatory system is composed of three regulators, namely the ASIC, the APRA and the Reserve Bank of Australia, and therefore it is sometimes classified as not two but "three-peaked".

This is in contrast with the Netherlands, which adopted the "twin peaks" model in 2002. In the Netherlands, prudential regulation is combined with financial stability regulation in a single agency (i.e. the Dutch central bank called "De Nederlandsche Bank"), with conduct of business regulation being assigned to a separate agency called "Autoriteit Financiele Markten" (Financial Markets Authority).

(iii) Suggestions for China

As shown above, there are three major structural models of financial regulation at the international arena: (1) the "sectoral regulation" model; (2) the "integrated regulation" model; and (3) the "twin-regulators" model. Naturally, each regulatory model has its own advantages and disadvantages. However, an objective assessment of each approach, in isolation from their jurisdictional financial landscapes, is hardly meaningful. Thus, this section will put the assessment into the Chinese context with a view to finding an appropriate solution to the problems confronting China's financial regulation.

The Chinese financial regulatory regime is broadly similar to the US, both adopting the traditional sectoral structure with a multiplicity of regulators. In the short term, China may learn from the US practice to improve its regulation of shadow banking without radically changing the overarching structural model. As discussed earlier, under the Dodd-Frank Act, the FSOC is created to improve inter-agency cooperation and prevent things falling down the cracks amongst various regulators. In particular, it has power to designate non-bank SIFIs for enhanced supervision and regulation by the FRB. Hence, the FRB has authority to supervise all firms that could pose a threat to financial stability, even those that do not own

banks. This effectively extends the Federal Reserve's consolidated supervision to all large, interconnected financial groups whose failure could have serious systemic effects. As a result, financial firms will not be able to escape regulatory oversight simply by manipulating their legal structure.

The above reforms seem to be a pragmatic response to the problems with the US financial regulation as highlighted by the 2008 global financial crisis. Indeed, the Dodd-Frank Act stops short of holistically addressing the structural inadequacies of the US financial regulation, and its structural model remains sectors-based with separate regulators responsible for each financial sector. But the reform has the advantage of being quick and measured to deal with the pressing issues in practice.

The US approach merits consideration in the context of China. On the one hand, the PBOC can be authorized to supervise all systemically important financial institutions; on the other hand, an interagency oversight council on shadow banking can be created to bring together regulators from across markets and other relevant agencies to coordinate and share information, and to identify gaps in the regulation of shadow banking.[37] In order to promote efficiency and continuity, the council may set up a standing committee composed of the PBOC and the three sector-specific regulatory agencies, namely the CBRC, the CSRC and the CIRC. As with the case of the Dodd-Frank Act, this solution can be a practical expedient for China in the short term.

More importantly, the short-term recommendation is based on a realistic appraisal of the present needs of China's financial markets. While the US current regulatory regime is said to be sub-optimal for its financial markets, it may well be a suitable model for the less developed Chinese markets. As discussed before, China's shadow banking system is still in its infancy on the basis of relatively unsophisticated financial tools. Thus, the US model should be adequate to meet the challenges China's financial regulatory regime currently faces.

The US reform under the Dodd-Frank Act does little more than just fine-tuning regulatory authorities within the pre-existing regulatory framework, which has proved to be an antiquated system for a well-developed economy like the US. Overall, the US financial regulatory regime is based on a complex and unworkable structure that no one would ever design from scratch — the reasons there are so many different regulators are historical and political. In fact, legitimate concerns have been raised over the US extension of banking regulation to non-bank SIFIs. First, the banking regulator, namely the FRB, has virtually no experience regulating entities that are not banks or bank holding companies. Second, as non-bank SIFIs will be regulated by both the FRB and their traditional sectoral regulators, this increases complexity and the costs of compliance, and risks imposing conflicting requirements. More regulators does not necessarily mean greater oversight: turf wars

37 Dasong Yuan, "International Financial Regulatory Reforms to Strengthen the Regulation of Shadow Banking" (2012) 2 *Faxue Yanjiu [Chinese Journal of Law]* 194, 207; Jianjun Li & Guangning Tian, "An Analysis of the Top Tier Design of the Reform of the Regulation of Shadow Banking" (2011) 8 *Hongguan Jingji Yanjiu [Macro-Economic Research]*.

and coordination failures can lead to even more gaps. In short, the US reform may make its regulatory structure even more complicated, fragmented and incoherent.[38]

In the intermediate or long run, therefore, China cannot rely on the US experience, but instead needs to consider the twin-peaks model or to a lesser extent the integrated regulation model. The twin-peaks and integrated regulation models attempt to thoroughly overhaul the regulatory structure, taking a novel approach to financial regulation. They are better adapted to the realities of modern financial markets than the sectoral structure, dispensing with the traditional boundaries between banking, securities and insurance. Both represent genuine efforts to modernize financial regulation to deal with the issues created by financial moderation and innovation as is exemplified by many shadow banking entities and activities. In this sense, they point out the right direction for financial regulatory reforms in the future.

The key difference between the integrated regulation and the twin-peaks models is that while the former assigns all regulatory responsibilities to a single regulator, the latter divides responsibilities and creates two separate regulators: one for prudential regulation and the other for business conduct regulation. Compared to the integrated regulation model, the twin-peaks model has a number of competitive advantages.[39] Due to its strengths, the twin-peaks model has attracted increasing attention as a template for reform in many countries, particularly after the global financial crisis of 2008. The US government carried out a thorough investigation into its financial regulatory regime in 2008, concluding that the ultimate reform goal for financial regulation in the US is not the integrated regulation model, but rather the twin-peaks model.[40] Most interestingly, the UK, the pioneer and symbol of the integrated regulation model, has recently carried out reform in line with the twin-peaks model: From 1 April 2013, the FSA has been abolished and its responsibilities split into two agencies: (1) the Financial Conduct Authority, which watches how financial institutions treat their customers, and (2) the Prudential Regulatory Authority, which conduct prudential regulation of financial institutions. More jurisdictions have adopted or plan to adopt the twin-peaks model, including Belgium, Italy, Spain, France and South Africa.

A final point to note is that the twin-peaks model has two versions, namely the Australian version and the Dutch version. As discussed earlier, the Australian version separates prudential responsibilities from the central bank, whereas the Dutch version does not. There are three major reasons behind the Australian practice.

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38 Edward F. Greene & Elizabeth L. Broomfield, "Promoting risk mitigation, not migration: a comparative analysis of shadow banking reforms by the FSB, USA and EU" (2013) 8(1) *Capital Markets Law Journal* 6 at 27.

39 For more detailed discussion of the advantages of the twin-peaks model vis-à-vis the integrated regulation model and the recent reforms towards the twin-peaks model in various jurisdictions such as the UK and South Africa, see Hui Huang, "Institutional Structure of Financial Regulation in China: Lessons from the Global Financial Crisis" (2010) 10(1) *The Journal of Corporate Law Studies* 219; Robin Hui Huang & Dirk Schoenmaker, eds., *Institutional Structure of Financial Regulation: Theories and International Experiences* (Routledge, 2015).

40 US Department of the Treasury, *Blue Print for a Modernized Financial Regulatory Structure* (2008).

First, the central bank is ill-equipped to deal with institutions other than banks; second, it avoids the expectation that the central bank would automatically provide liquidity support in the event of a crisis; third, separation of the central banking and prudential functions would enable each institution to become more focused and efficient. In recognition of the view that there is some degree of connection between prudential regulation and systemic stability and that the information gathered through prudential regulation is important for effective systemic regulation, the Reserve Bank of Australia has power to request the APRA to collect financial sector data for it.[41]

On the other hand, the Dutch decision to place unified prudential supervision within the central bank was based on several factors. First, this version has the potential benefit of fully integrating macro- and micro-prudential supervisions, and there are synergies between prudential and monetary policy aspects. This may create a virtuous cycle where macro-prudential analysis could be usefully fed into policy changes while prudential supervisors could benefit from the macro-economic analysis of the central bank. Second, the concern Australia has over the conflict of interest between monetary policy and financial stability objectives is limited in the Netherlands, because as an EU member state, its monetary policies have become the responsibility of the European Central bank. Finally, from a historical point of view, the Dutch adoption of the twin-peaks model was not a political response to any serious financial crisis, and its central bank has longstanding credibility which is an asset the Netherlands can use when transferring from a sector-based model to a twin-peaks model.[42]

The above analysis shows that both the Australian and Dutch versions of the twin-peaks model have their justifications. During the global financial crisis of 2008, they both seemed to have worked well. Since the twin-peaks model is the reform direction for China in the long run, there is no pressing need to provide a definitive answer to the question of which version China should adopt. In this regard, two general points can be made. First, given the short history of the twin-peaks model, we may need to observe the operation of its two versions for a longer period of time before drawing any final conclusions as to their relative strengths. Second and more important, when looking to overseas experiences for guidance, regard should be had not only to their objective advantages and disadvantages, but also to the local conditions in China. This is an area for future research.

(b) Regulatory Approach

Having examined the institutional structure of shadow banking regulation, the next logical step is to look at the substantive rules for shadow banking. It is neither necessary nor feasible to cover all relevant rules in detail here and as such, this part will focus on the overall regulatory approaches with certain rules discussed as examples.

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41 Hui Huang, "Institutional Structure of Financial Regulation in China: Lessons from the Global Financial Crisis" (2010) 10(1) *The Journal of Corporate Law Studies* 219.

42 Interview with DNB officials, 18 June 2014, Amsterdam, the Netherlands.

(i) An Analytical Framework

Like many other things, shadow banking has two sides: on the one hand, it may cause systemic risk and create opportunities for regulatory arbitrage; on the other hand, however, it also has significant benefits, including provision of additional source of funding and liquidity, risk diversification and efficient channelling of resources.[43] Hence, the guiding principle for regulating shadow banking is how to maximize those benefits and minimize shadow banking's potential to increase risks.[44]

The central purpose of financial regulation is to correct market failures. It has been argued that there are three fundamental market failures underlying shadow banking, namely information failure, agency failure and responsibility failure.[45] None of these failures is unique to shadow banking, but all can be exacerbated by shadow banking's complexity.

To start with, asymmetric information is a form of information failure and disclosure is directed at correcting that failure. But the complexity of shadow banking limits disclosure's ability to achieve meaningful investor transparency. The Lehman Minibonds saga in Hong Kong during the global financial crisis of 2008 offers a vivid example of how information disclosure failed to provide adequate protection for investors.[46] Although the Minibonds prospectus actually disclosed relevant investment risks in accordance with law, many investors did not really understand them, because the Minibonds, despite being innocuously branded as "bonds", were actually very complex structured financial instruments. Information disclosure aims to provide the market with timely, accurate and complete information, so that investors can make informed decisions. However, this mechanism works only when investors rationally digest the disclosed information and factor it into their investment activities. The effectiveness of information disclosure can thus be limited in the context of financial instruments with complex risk profiles.

Further, agency failure mainly arises from conflicts of interests between principals and their agents, such as the classic corporate conflict between owners and managers and the secondary intra-management conflict between middle managers and the senior managers to whom they report.[47] Again, the complexity of shadow banking, combined with the technology that enables it, can increase the potential for agency failure. For instance, as financial products are complex and highly tech-

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43 Edward F. Greene & Elizabeth L. Broomfield, "Promoting risk mitigation, not migration: a comparative analysis of shadow banking reforms by the FSB, USA and EU" (2013) 8(1) *Capital Markets Law Journal* 6 at 11–13.

44 Steven Schwarcz, "Regulating Shadow Banking" (2011-2012) 31 *Review of Banking and Financial Law* 619.

45 Steven Schwarcz, "Regulation Shadows: Financial Regulation and Responsibility Failure" (2013) 70 Wash & Lee L Rev 1781.

46 Hui Huang, "The Regulation of Securities Offerings in China: Reconsidering the Merit Review Element in Light of the Global Financial Crisis" (2011) 41(10) *Hong Kong Law Journal* 261 at 273-274.

47 Steven Schwarcz, "Conflicts and Financial Collapse: The Problem of Secondary-Management Agency Costs" (2009) 26 *Yale Journal on Regulation* 457.

nical and middle managers will likely know more than senior managers about them, it becomes harder for senior managers to monitor middle managers.[48]

Finally, responsibility failure is caused by a firm's ability to externalize a significant portion of the costs of taking a risky action. Compared with information failure and agency failure, responsibility failure is seen as a more important source of systemic risk, to the extent that a systemic failure of the financial system is likely to cause catastrophic harm to innocent third parties, including direct economic costs and indirect social costs in the form of widespread poverty and unemployment.[49] A primary responsibility failure in the financial system is the mismatch between short-term funding and long-term projects.[50] Although both traditional banking and shadow banking engage in the short-term funding of long-term projects, the former has presented much less of a risk of responsibility failure thanks to well-established banking regulation. Indeed, when addressing responsibility failure, financial regulation is traditionally concerned with banks, focusing mostly on bank prudential regulation and the prevention of bank runs. Shadow banking is, however, characterized by disintermediation, namely bypassing the need for bank intermediation. Also, by increasing complexity, disintermediation can amplify systemic risk, thereby increasing the potential magnitude of externalities.

(ii) Evaluating the Chinese Law

The above discussion should inform China's efforts to make rules to regulate shadow banking. In this light, the relevant provisions of the newly issued Circular No. 107 will be evaluated below.

The Circular No. 107 has a balanced view over the benefits and risks of shadow banking. It states that the advent of shadow banking is the necessary product of financial development and financial innovation, and that as a beneficial supplement to the traditional banking system, shadow banking plays a positive role in serving the real economy and enriching investment channels for Chinese people. It is also recognized that as demonstrated in the global financial crisis of 2008, shadow banking is prone to systemic risk due to the complex, hidden, vulnerable and contagious nature of shadow banking risk. Hence, the Circular No. 107 adopts the overarching policy that tries to maximize the benefits of shadow banking while at the same time minimizing its negative effects and risks.[51]

The Circular No. 107 has also responded to, albeit in varying degrees, the three fundamental market failures discussed earlier. First, shadow banking entities are required to establish proper mechanisms for internal control, risk management and risk segregation, in accordance with the principle that business scale must com-

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48 Steven Schwarcz, "Regulating Shadow Banking" (2011-2012) 31 *Review of Banking and Financial Law* 619 at 635-36.

49 Steven Schwarcz, "Systemic Risk" (2008) 97 Geo. L. J. 193 at 207 and 235.

50 See e.g., Viral V. Acharya & S. Viswanathan, "Leverage, Moral Hazard, and Liquidity" (2011) 66 J. Fin. 99, 103; Huberto Ennis & Todd Keister, "Bank Runs and Institutions: The Perils of Intervention" (2009) 99 Am. Econ. Rev. 1588 at 1590.

51 Circular No. 107 at s. 1.

mensurate with risk bearing capacity.[52] It goes to correcting agency failure in that the relevant mechanism will help senior managers control and monitor middle managers. Further, by limiting the business scale of shadow banking entities, this measure addresses responsibility failure in the sense that the shadow banking entity can bear the costs of business failure themselves.

Second, the WMPs business of financial institutions must be separated from other businesses in terms of organizational structure and accounting management. In other words, financial institutions should establish a separate department to run their WMPs business. Further, depending on the specific type of financial institution, more requirements are imposed. For instance, commercial banks must separate the WMP fund from its own fund, must not use the WMPs fund to buy its own loan products, and must not operate the WMPs with different risk levels in the same capital pool, ensuring that the funding source clearly corresponds to the funding use.[53] The above measure is conceptually similar to the Volcker rule adopted under the Dodd Frank Act,[54] with the aim of limiting the risk exposure of traditional banks to shadow banking. It intends to correct agency failure to the extent that the separate management system for WMPs makes it easier for senior managers to monitor middle managers. Also, responsibility failure is dealt with because it reduces the risk of shadow banking to traditional banks.

Third, the cross-institution financial products and cooperative activities must be based on contracts which clearly specify the risk-bearing entity and the channel-providing entity, and must be subject to the regulation of the industry regulator which has jurisdiction over the risk-bearing entity.[55] The requirement of explicit contracts helps address information failure as well as responsibility failure because it is clear to all parties as to the nature and risk profile of the cross-institution products and cooperation.

Fourth, the Circular No. 107 requires that private lending sector be properly regulated.[56] There is a high degree of heterogeneity and diversity in business models and risk profiles within this sector, but two broad categories can be drawn according to the level of regulation over them: one is underground financing, which is, by definition, almost completely unregulated; the other is subject to regulation, but the regulation needs improvement. The second category mainly includes petty-loan companies, pawn shops and financing lease companies. Petty-loan companies are prohibited from taking deposits, making shark loans and collecting loans in illegal ways. Petty loan companies can get finance from commercial banks, which must be treated as ordinary commercial loans. Pawn shops and financing leasing companies are not regarded as financial institutions in nature and thus their business scope is strictly regulated: pawn shops must increase leverage; financing leasing companies must not on-lend bank loans and relevant assets.

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52 Circular No. 107 at s. 3(1).

53 Circular No. 107 at s. 3(2). Trust companies are not allowed to carry out capital pool businesses either. Circular No. 107 at s. 3(3).

54 Dodd-Frank Act at s. 619.

55 Circular No. 107 at s. 3(4).

56 Circular No. 107 at s. 3(5).

Fifth, financing guarantee business can be carried out only by licensed financing guarantee companies. Banks are not allowed to provide guarantee for the issuance of bonds and negotiable instruments. In carrying out its business, financing guarantee companies must follow the principle that repayment capacity is commensurate with business scale and observe the ratio of guarantee liability to net asset.[57]

Sixth, private investment funds must conduct their business according to what type of funds they belong to. Private equity funds are strictly prohibited from carrying on debt financing businesses.[58] China's national law on securities investment funds, namely the *Securities Investment Fund Law of the PRC*, was first issued on 28 October 2003 and was recently revised on 28 December 2012 with effect from 1 June 2013. The revised law extends to cover private investment funds, including the qualifications of the fund manager, the process of offering fund units, information disclosure requirements and the scope of financial products private funds can invest in.[59]

Finally, the Circular No. 107 stipulates that internet finance activities be regulated. Internet finance activities are divided into two categories: 1) financial institutions conduct their business using internet technologies and platforms; and 2) non-financial institutions establish internet payment platforms, internet financing platforms and internet credit platforms. It is required that the first category must not exceed their scope of business by virtue of technological advancements and the second must not use internet technologies to engage in financial businesses in violation of law.[60]

Apart from the above measures which are directly targeted at the shadow banking system, the Circular No. 107 also provides for supporting measures in relation to the regulation of shadow banking. For instance, it requires the PBOC and relevant industry regulators to gather data and get statistics on shadow banking, report them to the State Council and when appropriate, publicly disclose them.[61] Moreover, it requires the establishment of credit checking systems covering both relevant institutions and individuals.[62] Finally, investor education must be provided by relevant bodies about the positive role as well as risks of shadow banking.[63] In practice, many investors mistakenly believe that the WMPs, particularly those sold through banks, are risk-free alternatives to bank deposits. It is thus important that the risk of the WMPs be disclosed in such a way as to make it more apparent and understandable to the investors. But due to the complexity of shadow banking products, mere disclosure may not be adequate in protecting investors. Investor education is an important way to deal with the problem of information failure which results from information asymmetry and bounded rationality.

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57 Circular No. 107 at s. 3(6).

58 Circular No. 107 at s. 3(8).

59 For more discussion of the law, see Hui Huang, *Securities and Capital Markets Law in China* (Oxford, 2014), Chapter 9.

60 Circular No. 107 at s. 3(7).

61 Circular No. 107 at s. 5(2).

62 Circular No. 107 at s. 5(3).

63 Circular No. 107 at s. 5(4).

(iii) Summary

As the preceding discussion shows, the Circular No. 107 provides substantive guidance on how to regulate the shadow banking system in China. It represents a good effort to correct all three fundamental types of market failures, namely information failure, agency failure and responsibility failure. It also covers significant components of China's shadow banking, including the WMPs offered by various financial institutions, the business of trust companies, cross-sector products and cooperation, private lending businesses, financing guarantee businesses, private investment funds and internet finance activities. It is worth noting that securitization does not feature as prominently as is the case in the Dodd-Frank Act, because as discussed earlier, securitization is still in its infancy in China and thus does not pose systemic risk.

In terms of the legislative framework, China's approach to regulating shadow banking is broadly similar to the FSB and the EU, as opposed to the US. The FSB and the EU first examine shadow banking entities and activities to determine their potential risks, and then based on such examination, come up with solutions tailored to different shadow banking issues. For instance, in October 2011, the FSB created five workstreams to study and make recommendations for regulation in relation to various aspects of shadow banking: (1) banks' interactions with shadow banking entities; (2) money market funds; (3) other shadow banking entities; and (4) securitisation and securities lending and repos.[64] Drawing upon the FSB's analytical framework, the EU published a "Green Paper Shadow Banking" in March 2012, with a view to finding suitable ways to regulate shadow banking in the EU.[65] In contrast, the US does not address various sectors of shadow banking separately, but rather uses a single non-bank SIFI regime to treat all shadow banking issues.

Several observations can be made on the differences between the FSB/EU and US regulatory approaches. First, the US Dodd-Franks Act does not actually use the term "shadow banking", and instead seeks to identify all non-bank financial entities and activities that create systemic risk. Conceptually, this approach is broader than the FSB/EU approach, as shadow banking is only a part of the non-bank financial sector that may pose significant threats to financial stability. Second, although the US approach is broad in theory, it may be under-inclusive in practice. As discussed earlier, when identifying non-bank SIFIs, the size of a non-bank financial institution is usually the key criterion. The US approach thus runs the risk of overlooking non-bank financial institutions that are too small to be systematically important but are closely interconnected so as to pose systemic risk, such as monetary market funds. Third, the FSB/EU approach may not cover some financial systems components that may pose significant threats to financial stability but that are not deemed

64 Financial Stability Board, "Shadow Banking: Strengthening Oversight and Regulation" (October 2011).

65 European Commission, "Green Paper Shadow Banking" (March 2012). Soon after this, a staff research paper of the European Central Bank was issued on the size and structure of shadow banking within the euro area, providing useful data and advice for the formation of regulatory responses. See Klara Bakk-Simon, Stefano Borgioli & Celestino Giron *et al.*, "Shadow Banking In the Euro Area: An Overview" Occasional Paper Series No 133, April 2012, European Central Bank.

to fall into the shadow banking system. This should not be a serious problem however, because the definition of shadow banking is broad and can evolve to keep up with the market developments. Last but not least, the FSB/EU approach seems more methodical and more nuanced than the US approach. As discussed above, shadow banking practices are very diverse in the form and risk profile. It is thus difficult and unwise to apply a "one size fits all" approach or make broad generalizations about policies to address shadow banking. For instance, under the US Dodd-Frank Act, all non-bank SIFIs are subject to bank-like prudential regulations. This may be inappropriate for some firms with different balance sheets such as insurance companies.

Hence, the regulatory approach China takes towards shadow banking, as laid out in the Circular No. 107, is generally sound from a comparative perspective. As discussed above, China divides shadow banking into several categories and tries to find regulatory solutions geared to the nature of the risks posed by each of them, which is in line with the FSB/EU approach. Clearly, China has benefited from the FSB's works in establishing its regulatory regime for shadow banking. The practical significance of the Circular No. 107 should not be overstated however. It is a policy document in nature, and is couched in very general terms. It basically sets out broad policies, leaving relevant agencies to make specific implementing rules in the future.[66] As the devil is always in the details, the implementing rules will be critically important in realizing the policy goals set out under the Circular No. 107.

6. CONCLUSION

This paper presents a preliminary investigation of the incidence and regulation of shadow banking in China, as a contribution to the international discourse on the important issue. Evaluating the size of the shadow banking system in China is not straightforward due to the confusion about what shadow banking is, as well as the lack of relevant data and information. Nevertheless, some tentative conclusions can be drawn from the analysis carried out in this paper.

Shadow banking has grown rapidly in China over the past few years, which exhibits distinctive features in terms of driving forces, components, players and risk profiles. Despite the various differences between China's shadow banking and its overseas counterparts, they give rise to similar regulatory concerns, including systemic risk and regulatory arbitrage. From a regulatory standpoint, however, the important benefits of shadow banking should not be disregarded.

China's regulatory responses to shadow banking, as embodied in the recently issued Circular No. 107, appear to be based on a balanced view of the benefits and risks of shadow banking. It provides for both institutional structure and substantive guidance in relation to the regulation of shadow banking in China. Specifically, it clarifies the regulatory arrangements for shadow banking within the existing sectoral regulatory structure. While this may work in the short term, China should consider a more fundamental reform towards the twin-peaks model in the long term. Further, the substantive guidance contained therein is generally sound, as it goes to correcting three fundamental market failures. It lacks details, however, and thus the implementing rules to be issued by various regulators will be very impor-

66 Circular No. 107 at s. 5(5).

tant. Overall, the Circular No. 107 represents a significant improvement on China's shadow banking regulation. It remains to be seen, however, whether it will function as effectively as expected.