11-14-2023

Out of the Shadows: The Need for Increased Scrutiny of Shadow Banking in China

Benson M. Clements
Cardozo International & Comparative Law Review, bclemen1@law.cardozo.yu.edu

CICLR Nov 14 5 min read

Out of the Shadows: The Need for Increased Scrutiny of Shadow Banking in China

By: Benson M. Clements

Zhongrong International Trust Co., a Chinese investment trust with significant real estate exposure, has missed payments on dozens of corporate trust products since late July.[1] Retail investors are left with frustration and panic as they fear they may have lost their life savings.[2] Regulators are concerned they may have to further tame an already faltering economy. It may be time to question the free reign with which shadow banks have enjoyed for decades.

The precise definition of shadow banking remains elusive. The Financial Stability Board defines shadow banking as “credit intermediation involving entities and activities outside the regular banking system.”[3] Put simply, shadow banks perform the essential functions of regular banks, i.e., they borrow short-term funds (deposits) to make long-term investments.[4] However, they operate outside the scope of banking regulation, meaning they lack any sort of social safety net, such as guaranteed deposit insurance, or lender of last resort facilities from central banks.[5] This lack of regulatory oversight and investor protections has the potential to cause monumental financial instability. The shadow banking sector in China is worth $3 trillion, roughly the size of Britain's economy,[6] and accounted for 40% of its GDP in 2019.[7] Strain in the shadow banking sector is strain on the economy itself.

A common form of shadow banking in China is where a trust company, such as Zhongrong, sells "investment products to qualified investors and use[s] the funds to invest in a wide range of financial assets, or to lend to property developers and their project companies."[8] These trust products are highly appealing to individual investors as well as to banks and financial institutions. The official interest rates on bank accounts in China were less than 1.5%, while the average interest rate on a trust product with a maturity date within two years was 6.6% in July.[9] Higher interest rates are partly due to the trust companies' ability to deploy their funds to high-risk companies or projects that are unable to obtain loans from traditional banks and financial institutions.[10] To gain exposure to these risky assets, banks and financial institutions circumvent regulation by using trust companies as a vehicle to invest off-balance sheet.[11] By buying into these trust products off-balance sheet, banks and financial institutions indirectly participate in risky lending that would otherwise be barred by regulation.[12] This is particularly true in the real estate sector.

For decades, the Chinese economy was propped up by a booming real estate sector fueled by population growth.[13] Real estate developers borrowed billions of dollars with the help of cash infusions from trust companies eager to ride the wave and pass the earnings onto their investors.[14] At its peak in mid-2019, 15% of trust company funds (roughly $408 billion) were invested in real estate.[15] The government was happy to look the other way as citizens flocked to cities, and houses could not be built fast enough. Real estate developers were taking on outsized levels of debt to keep up with demand and to pay their liabilities. Then Covid-19 happened, developers stopped building houses, and regulators stepped in to crack down on excessive borrowing,[16] leaving developers and trust companies holding the bag.

In an attempt to prevent a housing bubble, Chinese regulators implemented a 'three red lines" policy which outlined specific balance sheet conditions developers must have met if they wished to take on more debt.[17] The policy's effect was that developers could not seek outside funding to meet their maturing debt obligations which put trust companies in the precarious position of holding billions of dollars in over-leveraged debt. While well-intentioned, the timing may have exacerbated a potential financial meltdown. Most notably, China Evergrande, China's largest real estate developer, failed to make payments on some of its outstanding debt worth billions of dollars, and recently declared Chapter 15 bankruptcy in the United States due in large part to its inability to secure further funding to cover its obligations.[18] Evergrande had done business with most of the sixty-eight trust companies in China, with roughly $5 billion in trust loans maturing in 2022 and 2023.[19] Since trust companies operate in the shadows of banking regulation, their exposure, as well as banks' exposure, to risky sectors like real estate is hard to assess and thus presents challenges for a government trying to prevent a national economic crisis.

The Chinese government is faced with two options. On the one hand, it could choose to step in and provide liquidity to trust companies to quell the spread of defaults. On the other hand, the government could refuse to step in to prevent a type of moral hazard[20] for risky lending in the future. Neither solution is perfect. What is instead needed is greater monitoring and regulations governing the shadow banking sector. While the Chinese government has clamped down on the shadow banking sector in recent years[21], the potential default of Zhongrong International Trust Co. illustrates that these efforts may be too little too late.

Benson M. Clements is a Staff Editor at CICLR.

[1] *Chinese State Firms' Help to Troubled Shadow Bank Does Little to Address Investor Concerns*, Reuters (Sept. 18, 2023),

https://www.reuters.com/world/china/chinese-state-firms-help-troubled-shadow-bank-does-little-address-investor-2023-09-18/ [perma.cc/XF9L-U7Q5].

[2] Rob Garver, *Crisis in China's 'Shadow Banking' Sector Leads to Defaults*, VOA News (Aug. 31, 2023), https://www.voanews.com/a/crisis-in-china-s-shadow-banking-sector-leads-to-defaults-/7248094.html [perma.cc/K797-33BS].

[3] Douglas Elliot, Arthur Kroeber & Yu Qiao, *Shadow Banking in China: A Primer*, Brookings 1, 4 (2015) https://www.brookings.edu/wp-content/uploads/2016/06/shadow_banking_china_elliott_kroeber_yu.pdf [https://perma.cc/GC7B-A3QG].

[4] Laura E. Kodres, *What is Shadow Banking*, IMF: Fin. & Dev. (2013) https://www.imf.org/external/pubs/ft/fandd/2013/06/pdf/basics.pdf.

[5] Elliot, *supra* note 3.

[6] Reuters, *supra* note 1.

[7] Felix Kapfhammer, *Dissecting Shadow Banking and Real Estate in China,* LGT (Aug. 23, 2023), https://www.lgt.com/global-en/market-assessments/market-view/dissecting-shadow-banking-and-real-estate-in-china-167366#:~:text=40%25%20of%20its%20GDP%20in,the%20real%20estate%20sector%20since [perma.cc/HUX9-F7PN].

[8] *Heightened Risk in China's Trust Sector May Have Wider Effect on Financial Institutions,* FitchRatings: FITCH WIRE (Aug. 20, 2023), https://www.fitchratings.com/research/banks/heightened-risk-in-chinas-trust-sector-may-have-wider-effect-on-financial-institutions-20-08-2023#:~:text=Trust%20companies%20in%20China%20sell,and%20local%20government%20financing%20vehicles[perma.cc/C49H-8X3Q].

[9] *China Braces for $38 Billion in Losses in Troubled Trust Sector*, Bloomberg (Aug. 23, 2023), https://www.bloomberg.com/news/articles/2023-08-23/china-braces-for-38-billion-in-losses-in-troubled-trust-sector?leadSource=uverify%20wall [perma.cc/96SD-LUY5].

[10] Wu Yujian, Zhang Yuzhe & Zhang Yukun, *Burned by Developers, China's Trust Industry Pulls Back from Property*, Nikkei Asia: Caixin (Nov. 24, 2021), https://asia.nikkei.com/Spotlight/Caixin/Burned-by-developers-China-s-trust-industry-pulls-back-from-property [perma.cc/ATX8-ACGD] (stating banks and other formal finical institutions are barred by regulation from investing in certain high-risk assets or projects).

[11] Elwin R. Rogers & Grant Lindstrom, *Ethical Implications of Off-Balance-Sheet Financing*, 15 Bus. & Pro. Ethics J. 19, 19 (1996) ("Off-Balance Sheet Financing (OBSF) is the structuring of debt, financial instruments, business transactions, guarantees, sale of assets, and other financial activities such that these items are not included on the balance sheet of the firm. Companies engage in OBSF in a variety of ways. Examples include leases [and] project financing.").

[12] Nicholas Borst, *The Role of Trust Companies in China's Recent Credit Growth*, Peterson Inst. for Int'l Econ. (May 31, 2013), https://www.piie.com/blogs/china-economic-watch/role-trust-companies-chinas-recent-credit-growth [perma.cc/8MGS-B7HU] (stating banks are now using conduit companies and other banks to invest in trust thus avoiding the normal prudential regulations"); Yujian, Yuzhe & Yukun, *supra* note 10 ("Trust investments made on behalf of other financial institutions, which bear the investment risk themselves, are called conduit, or "channeling," business.").

[13] J. Edward Moreno, *What to Know About China's Real Estate Crisis*, N.Y. Times (Aug. 21, 2023), https://www.nytimes.com/2023/08/21/business/china-economy-real-estate-crisis.html [perma.cc/ZFL4-52T3].

[14] Yujian, Yuzhe & Yukun, *supra* note 10.

[15] Jacky Wong, *China's Shadow Banks Could Be Another Property Casualty*, Wall St. J.: Heard on the Street (Aug. 14, 2023), https://www.wsj.com/world/china/chinas-shadow-banks-could-be-another-property-casualty-3ea302ed [perma.cc/XAK8-BWGX].

[16] *China's Three Red Lines*, UBS (Jan. 11, 2021), https://www.ubs.com/global/en/assetmanagement/insights/thematic-viewpoints/apac-and-emerging/articles/china-three-red-lines.html [perma.cc/DNZ2-QAKD].

[17] Evelyn Cheng, *How Evergrande Found Itself on the Wrong Side of China's Regulators*, CNBC (Oct. 18, 2021), https://www.cnbc.com/2021/10/19/how-evergrande-found-itself-on-the-wrong-side-of-chinas-regulators.html [perma.cc/JJQ8-FBUM].

[18] Rich Barbieri, *China Evergrande, Giant Real Estate Firm, Files for U.S. Bankruptcy*, N.Y. Times (Aug. 17, 2023), https://www.nytimes.com/2023/08/17/business/china-evergrande-bankruptcy.html [perma.cc/832Q-UE5Q].

[19] *Trust Firms with Billions at Risk Brace for Evergrande Defaults*, BNN Bloomberg: Real Estate (Dec. 6, 2021), https://www.bnnbloomberg.ca/trust-firms-with-billions-at-risk-brace-for-evergrande-defaults-1.1691662#:~:text=Evergrande%20has%20done%20business%20with,company%20that%20tracks%20the%20industry [perma.cc/7SZ5-MGEQ].

[20] Daisuke Wakabayashi & Claire Fu, *Real Estate Crisis Triggers New Alarms Over China's Shadow Banks*, N.Y. Times (Sept. 22, 2023), https://www.nytimes.com/2023/09/22/business/china-economy-trusts-zhongrong-zhongzhi.html [perma.cc/AV7R-JYS7].

[21] *China Steps Up Crackdown on $1 Trillion Bank Wealth Products*, Bloomberg (June 15, 2021), https://www.bloomberg.com/news/articles/2021-06-15/china-escalates-crackdown-on-1-trillion-wealth-product-market#xj4y7vzkg [perma.cc/WK65-BEXZ].