INTRODUCTION

Shadow banking is growing rapidly in a number of developing countries, including China where it recently was estimated to increase from approximately 40% of that country’s gross domestic product at the end of 2014 to approximately 78% of GDP at


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the outset of 2016. The shadow-banking sector in developing countries is typically weakly regulated, yet the growth of the sector is thought to pose risks to financial stability. Additional regulation therefore may be needed. Any such regulation, however, should attempt to strike a balance between reducing that risk and preserving shadow banking as an important channel of alternative funding to developing economies, particularly in the face of significant retrenchment by large banks that had dominated the credit supply.

I. WHAT IS SHADOW BANKING?

Shadow banking is a loose term that refers to the provision of financing outside of traditional banking channels. Estimated at $67 trillion worldwide, shadow bank financing appears to dwarf traditional bank financing.

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4 Chinese regulators appear to follow this same definition. See, e.g., Xiao Gang, Regulating Shadow Banking, CHINA DAILY (Oct. 12, 2012) (writing that “[s]hadow banking can broadly be described as the system of credit intermediation involving entities and activities outside the regular banking system”). Xiao Gang is the chairman of the Board of Directors of Bank of China. In a recently promulgated regulation with respect to shadow banking in China, Circular No. 107, shadow banking is described as “credit intermediation entities and activities outside the traditional banking system.” See Robin
There are many ways to provide financing outside of traditional banking channels. Structured finance and securitization, for examples, raise financing indirectly through the capital markets using special purpose entities (“SPEs”) such as asset-backed commercial paper (ABCP) conduits and structured investment vehicles (commonly known as SIVs). The term shadow banking also includes the provision of financing by finance companies, hedge funds, money market mutual funds, non-bank government-sponsored enterprises, securities lenders, and investment banks. The term even includes the provision of financing by banks using non-traditional means. For example, banks sometimes create and derive fee income from SPEs, ABCP conduits, and SIVs, as well as repo markets. Banks in particular are important players in Chinese shadow banking.

II. SHADOW BANKING IN CHINA

China has the world’s highest rate of growth in shadow banking. Shadow banking has been especially important there as a source of funding to small and medium-sized enterprises (“SME”s), including entrepreneurial start-up companies, because

6 Zoltan Pozsar et al., Federal Reserve Bank of New York Staff Reports, No. 458: Shadow Banking Abstract, 4-5 (2010).
8 Huang, supra note 4, at 487. See also James T. Aredy, Risks Are Cited as Banks Blur Lines, WALL ST. J., May 16, 2016, at C3 (discussing the extension of banking in China into aggressively “selling small-time investors short-term, high-yield products on-line”).
9 Huang, supra note 4, at 485 (citing FSB’s Global Shadow Banking Monitoring Report 2013).
Chinese banks have not readily extended credit to SMEs.\textsuperscript{10} The reluctance of banks to lend may reflect, in part, an unintended consequence of Chinese banking law, which has limited bank-loan profits to percentages of the loan,\textsuperscript{11} making small and medium-sized loans much less attractive than large loans.\textsuperscript{12} The reluctance to lend might also reflect the higher risks of SME lending, which sometimes exceed Chinese bank lending standards.\textsuperscript{13}

The resulting alternative financing arrangements are deemed part of China’s shadow-banking sector. Participants in these arrangements include corporate-style entities such as property-development trusts\textsuperscript{14} as well as individuals involved in more interpersonal lending through credit associations, rural cooperative foundations, and even

\textsuperscript{10} Chinese banks tend to focus on lending to large Chinese companies and also investing abroad.
\textsuperscript{12} The People’s Bank of China may now have removed the limitation on bank lending rates, except regarding certain loans (such as residential mortgage loans). E-mail from Liu Xiaoli, Associate at the Zhong Lun Law Firm in Beijing and Duke Law School LL.M. Class of 2013, to the author, May 6, 2013.
\textsuperscript{13} Cf. E-mail from Liu Xiaoli, Associate at the Zhong Lun Law Firm in Beijing and Duke Law School LL.M. Class of 2013, to the author, Nov. 11, 2012 (observing that China’s banking industry has strict loan underwriting standards, and SMEs often cannot provide sufficient collateral to satisfy these standards). Ms. Liu nonetheless also observes that, in recent years, the State Council and financial regulators have been actively encouraging SME financing; as a result, some banks have been expanding their SME loan business. \textit{Id.}
\textsuperscript{14} See \textit{Shadow Banking Looms Over China}, REUTERS, Sept. 28, 2012, available at http://www.reuters.com/article/2012/09/28/china-trusts-banking-idUSL4E8KS50J20120928 (reporting the rise of trusts in China, and particularly their exposure to the “property, infrastructure, and financial sectors”); see also, DELOITTE TOUCHE TOHMATSU LIMITED, \textit{CHINA REAL ESTATE INVESTMENT HANDBOOK}, 51 & 81 (2012), available at http://www.deloitte.com/assets/Dcom-China/Local\%20Assets/Documents/Industries/Real\%20estate/cn_RE_REIH2012_130312.pdf. (quoting the OECD definition of a REIT as a “widely held company, trust or contractual or fiduciary arrangement that derives its income primarily from long-term investment in immovable property (real estate), distributes most of that income annually and does not pay income tax on income related to immovable property that is so distributed.”).
Pawnshops. Peer-to-peer business lending is also becoming common, in which companies lend to other companies, sometimes arranged through banks. Equipment-lease financing is increasing, sometimes arranged through the leasing subsidiaries of state-owned banks. Accounts receivable factoring is also increasing in importance, to provide liquidity to vendors of goods. As with securitization, factoring additionally enables those vendors to allocate risk on the receivables to third parties (in the case of factoring, those third parties are the “factors” who provide the financing), enabling vendors to quantify their repayment risk. Risk allocation is increasingly critical because receivables are becoming increasingly delinquent in payment.

16 See China Slowdown Stymies Plan to Curb Shadow-Banking Risks, BLOOMBERG NEWS, July 17, 2012, http://www.businessweek.com/news/2012-07-16/slowdown-threatens-curbs-on-shadow-banking#p2 (“Shadow banking, including loans changing hands between friends, families and companies seeking capital as well as the off-balance-sheet business of lenders and trust companies, totals as much as 15 trillion yuan ($2.4 trillion), about one-third the size of China’s official loan market”). Many peer-to-peer sites exist that allow small businesses to access loans from individuals and other businesses. China Shadow Bankers Go Online as Peer-to-Peer Sites Boom, BLOOMBERG NEWS, July 24, 2012, http://www.bloomberg.com/news/2012-07-23/china-shadow-bankers-go-online-as-peer-to-peer-sites-boom.html. Incongruously, peer-to-peer lending among enterprises is technically illegal (and thus risky for lenders) under Chinese financial regulatory law. E-mail from Liu Xiaoli, supra note 12. Nonetheless, courts often enforce lenders’ repayment claims for principal and, to the extent not exceeding comparable bank deposit interest rates, interest. Id.
18 Factors Chain International, Total Factoring Volume by Country in the Last 7 Years (last visited Nov. 8, 2012), http://www.fci.nl/about-fci/statistics/total-factoring-volume-by-country-last-7-years (showing the rapid growth of Chinese factoring volume to become one of the largest factoring markets in the world).
China’s shadow-banking sector also includes, as mentioned, the provision of financing by banks, using non-traditional means. Commercial banks, for example, provide wealth management plans to their customers, as investors. Customers entrust funds with their bank and join the plan; the bank uses the entrusted funds to invest in a pool of securities—functionally no different than an investment in a mutual fund. Wealth management plans have grown rapidly, estimated to grow from 8.5 trillion yuan in 2011 to 12 trillion yuan in 2012 to as much as 18.8 trillion yuan in 2015. From an investor standpoint, the reason for this growth appears to be risk aversion: investors believe, rightly or wrongly, that wealth management plans provided by banks are safe because of banks’ implicit guarantees. From a bank standpoint, the reason for this growth appears to be regulatory arbitrage: it enables banks to avoid regulation that limits, among other things, their loan-to-deposit ratios.

More recently, China’s shadow-banking sector has expanded to the Internet, inspired by the government’s “Internet Plus” initiative—a plan intended to drive

\[\text{\textsuperscript{20}}\text{ Cf. supra notes 7-11 and accompanying text (observing that the term shadow banking even includes the provision of financing by banks using non-traditional means).}
\text{\textsuperscript{23}}\text{ E-mail from Liu Xiaoli, Associate at the Zhong Lun Law Firm in Beijing and Duke Law School LL.M. Class of 2013, to the author (Apr. 16, 2013). See also Edward Chancellor, China Crunch Shows Financial Fragility, FINANCIAL TIMES, July 1, 2013, at 20 (observing that “Many [Chinese wealth management products] are kept off the balance sheets of the banks although it is widely understood that banks will make good any losses to investors.”).}
\text{\textsuperscript{24}}\text{ E-mail from Liu Xiaoli, supra note 23. See also Cai Zhen, The Features, Manifestations and Causes of the Chinese Shadow Banking System, 11 CHINESE BANKER (2012), available at http://ifb.cass.cn/show_news.asp?id=51623.} \]
economic growth by integrating Internet technologies with manufacturing and business. The scope of this initiative includes Internet Plus Finance, involving such key participants as (Alibaba affiliates) Alipay and Ant Financial which arrange for on-line collections and payments. The rapid expansion of Internet Plus Finance provides a cautionary tale, though. Because of its genesis at the highest political levels and also because Internet financial firms did not clearly fall into one of the traditional Chinese regulatory silos of banking, securities, or insurance, Internet Plus Finance was initially unregulated. After a series of prominent frauds, however, the widespread petitions for help by fraud victims to government authorities have resulted in a political backlash and potential regulatory overreaction.

The changing details of China’s shadow-banking sector are less important, however, than the fact that it—like the shadow-banking sector outside of China—reflects non-bank, or at least non-traditional-bank, intermediated financing.

25 In March 2015, Chinese Premier Li launched the Internet Plus initiative in a report to the 12th National People’s Congress. In July of that year, the State Council released “The Guiding Opinions on Promoting Internet Plus Initiative.” On Oct. 29, 2015, the Fifth Session of the 18th Central Committee of the Chinese Communist Party accepted the “internet plus” initiative as a major economic strategy.

26 See, e.g., “PBOC to Study Aliaba’s Shadow Banking Activities, Zhou Says,” BLOOMBERG NEWS, June 24, 2016 (describing Alipay as “China’s biggest internet payment service,” with 450 million users).

27 In discussions with the author, Professor Wang Zuofa analogized this regulatory lapse to the Chinese proverb, “You take home the child that you’ve spawned.” Those Internet firms were not clearly the “children” of any given banking, securities, or insurance regulator.

28 For example, a company named E-finance(BeiJing) Internet Technology Co., Ltd. is reputed to have defrauded almost a million people of more than 50 billion yuan. E-mail from Prof. Wang Zuofa to the author, Nov. 13, 2016.

29 Professor Wang Zuofa calls this type of political approach “shangfang.”

30 See e-mail from Prof. Wang, supra note 28 (also explaining that, absent harm, regulators are reluctant to respond to market innovations and would rather make their decisions and act according to the principle of “be responsible to the upper level leader, not to the market”; but when those leaders get alarmed, the regulators tend to overreact to show their political loyalty).

31 Recently, for example, Chinese shadow banking has begun to encompass “debt receivables,” referring to off-balance-sheet loans made through trust and brokerage.
In January 2014, the Chinese government released State Council Circular No. 107, which sets out an overarching framework for regulating shadow banking in China. Under this framework, the particular governmental regulator (either banking, securities, or insurance) that approves the establishment of a shadow-banking entity is theoretically responsible for regulating it. But because similar financial products are sometimes subject to different regulators, the framework may have certain inconsistencies and inefficiencies. Commentators remain dubious of the framework’s effectiveness.

III. SHADOW BANKING IN OTHER DEVELOPING COUNTRIES

The author first investigated shadow banking in China in connection with a series of lectures given there in December 2012 and May 2016. The author’s understanding of companies in order to reduce capital requirements or hide non-performing loans. Hsu, supra note 3.


Huang, supra note 4, at 482. The official name of Circular No. 107 is Guowuyuan Bangongting Guanyu Jiaqing 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].

Huang, supra note 4, at 491 (observing, among other things, that some products such as securitization are cross-sector in nature and do not fit neatly into sector classifications). Professor Huang argues that there is a mismatch between China’s regulatory structure and the underlying market it regulates. Id. To address that, he proposes the creation of an interagency oversight council on shadow banking to facilitate coordination and to share information in order to identify regulatory gaps. Id. at 494-95.

See, e.g., Hsu, supra note 3 (observing that “China’s shadow banking beast won’t be tamed anytime soon. Although it never really disappeared, there was a brief period of time from late 2014 to early 2015 when it seemed like some of the worst practices were to be regulated. This didn’t work . . . . [B]anks and local governments have become increasingly reliant on the industry, to their great disadvantage.”).

Even in that context, however, the author’s investigation was limited to conversations with Chinese financial regulatory experts as well as research of the relevant literature.
Shadow banking in developing countries outside of China (“other developing countries”) is much more limited. Nonetheless, some general observations can be made.

Although banks still dominate the financial sector in most other developing countries, shadow banking is on the rise. In those countries, however, shadow banking is “less about long, complex, opaque chains of intermediation and more about being weakly regulated or falling outside the regulatory sphere altogether.”

For example, the main shadow banking players in other developing countries tend to be “finance, leasing, and factoring companies; investment and equity funds; insurance companies; pawn shops; and underground entities.” These players overlap significantly with Chinese shadow banking market participants. Also as in China, shadow banking is important in other developing countries as a source of funding to SMEs.

Unlike China, however—and other than India—the financial markets of many developing countries are only partially integrated with global financial markets. Shadow banking in those countries therefore, at last currently, poses little systemic risk.

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39 Ghosh et al., supra note 38, at 3-4.  
40 Id. at 2.  
41 See supra notes 14-18 and accompanying text (indicating an overlap for pawnshops, investment funds, leasing companies, and factoring companies).  
42 See supra note 9 and accompanying text.  
43 Viral V. Acharya, Hemal Khandwala & T. Sabri Oncu, The Growth of a Shadow Banking System in Emerging Markets: Evidence from India, 39 J. INT. MONEY FIN. 208, 209 (2013) (finding that shadow banking provides a “completeness of credit spectrum in the economy” because of its greater ability, compared to traditional banking, in reaching out to SMEs as well as borrowers in rural areas and emerging infrastructure developers).  
IV. SHOULD SHADOW BANKING BE REGULATED?

Shadow banking tends to be much less regulated than traditional banking. This inevitably means that shadow banking is, to some extent, driven by regulatory arbitrage. But that does not necessarily indicate that shadow banking should be subjected to more regulation. It sometimes might reflect, for example, that traditional banking should be subject to less regulation. Shadow-banking financing alternatives have particular salience when traditional banking is subject to ill-inspired regulation that drives regulatory arbitrage, such as China’s banking law limits on bank-loan profits. The determinative issue is thus the consequences of the regulation.

In deciding how to regulate shadow banking, it additionally is important to acknowledge that shadow banking has the potential to increase economic efficiency but also to increase risk. Consider each in turn.

*Increasing Economic Efficiency.* Shadow banking can increase efficiency through disintermediation and decentralization. Disintermediation refers to the distinguishing feature of shadow banking: providing financing outside of traditional banking channels. This helps companies avoid having to pay the profit markup that intermediary banks

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45 *Id.*
46 The China Banking Regulatory Commission (CBRC) has begun to address regulatory arbitrage concerns, however, such as by imposing net capital regulations on trust companies (requiring them to maintain sufficient net capital to cover their potential business risks). E-mail from Liu Xiaoli, *supra* note 13.
47 *Cf.* Ghosh et al., *supra* note 38, at 3 (observing that regulatory arbitrage “played a role in the growth of (unregulated) shadow banking [in] China, Bulgaria, Croatia, and Romania”).
48 *See supra* notes 11-12 and accompanying text. *Cf.* Chancellor, *supra* note 23 (observing that a “collapse in the supply of credit . . . can also arise as a result of regulatory actions”).
49 *Cf.* Ghosh et al., *supra* note 38, at 2 (observing that it “is generally agreed that financial intermediation through nonbank channels [i.e., shadow banking] provides some benefits, and hence can constitute a useful part of the financial system”).
50 *See supra* note 4 and accompanying text.
would otherwise charge on traditional products, such as loans. That reduction in cost can increase economic efficiency.

Shadow banking can additionally increase efficiency by diversifying, and thus decentralizing, the provision of financial products and services. It also widens and deepens funding sources. This can increase consumer welfare, for example, by allowing investors to tailor financial portfolios to their own preferences. Consumer welfare can also be increased by serving underserved constituents, such as shadow banking’s providing financing to underserved SMEs in China. A decentralized financial system may also be more robust in the face of negative shocks. To the extent decentralization helps to reduce the size of firms, it also can mitigate the “too big to fail” problem.

Increasing Risk. But decentralization can also increase risk. For example, it may be relatively harder to control market failures, or there could be more such failures. Decentralization might also make it more difficult for market participants to effectively process information, allowing risks to accumulate unnoticed and unchecked. When hidden risks suddenly become apparent, market participants can panic; and panics can trigger systemic risk.

Another risk closely associated with, although not at confined to, shadow banking is the short-term funding of long-term capital needs, such as occurs when SPEs issue short-term securities (like commercial paper) to fund long-term projects or,

51 See supra note 11 and accompanying text.
53 Panics often serve as a trigger that can commence a chain of systemic failures. Steven L. Schwarcz, Systemic Risk, 97 GEORGETOWN LAW JOURNAL 193, 214 (2008).
54 Traditional banks, for example, typically fund themselves through short-term deposits and use the proceeds to make long-term loans.
55 See supra note 7 and accompanying text (discussing ABCP conduits and SIVs, which do this). See also Ghosh et al., supra note 38, at 3 (observing that “many, if not most, [shadow banks] fund themselves through short-term or callable deposit-like liabilities”).
common in China, when wealth management plans\(^{56}\) use short-term financing to fund long-term projects. This can increase risk by creating liquidity discontinuities (what economists sometimes call maturity transformation), which can have potentially systemic consequences. In traditional banking, this is labeled the risk of a “bank run.” Economists argue that equivalent types of liquidity discontinuities in shadow banking “played a central role in transforming concerns about the credit quality of mortgage-related assets into a global financial crisis.”\(^{57}\)

Additionally, because non-bank shadow banking participants are unregulated or lightly regulated compared to banks, they might be more likely to fail than banks. Their failures could impact traditional banking to the extent shadow banks and traditional banks have contractual (or other) interrelationships.\(^{58}\)

Shadow banking can also greatly exacerbate the externalities caused by corporate limited liability.\(^{59}\) In the relatively small firms that dominate shadow banking, equity investors tend to be active managers. Limited liability gives these investor-managers strong incentives to take risks that might generate outsized personal profits, even if that greatly increases systemic risk.\(^{60}\) That potentiates moral hazard and causes a misalignment of investor and societal interests.

\(^{56}\) See supra notes 20-23 and accompanying text (discussing wealth management plans).
\(^{58}\) Even given such interrelationships, however, it is unclear whether the decentralization of shadow banking actually reduces systemic risk on a net basis; a shadow bank may well be more likely to fail than a traditional bank, but the failure of a shadow bank is less likely to systemically impact traditional banking.
\(^{60}\) Id. at 1.
Shadow banking thus can operate as a double-edged sword, increasing both efficiencies and risks. The challenge for regulation is to minimize those risks while maximizing (or at least not significantly impairing) those efficiencies. Next consider how that might be accomplished.

V. REGULATING SHADOW BANKING

A. Regulation Focused on Maximizing Economic Efficiency

Regulation can maximize economic efficiency by correcting “market” failures. At least four types of partly interrelated market failures can occur within the shadow-banking sector: information failure, rationality failure, principal-agent failure, and incentive failure. None of these failures is unique to shadow banking, but all can be exacerbated by shadow banking’s complexity.

1. Information Failure.

Shadow banking can be complex and arguably is becoming more complex as economies develop. Although disclosure always will remain important and necessary, complexity limits disclosure’s ability to achieve meaningful investor transparency. A question, therefore, is whether regulators should try to simplify or standardize shadow banking to minimize its complexity. Currently, this question may be more critical in the

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61 Regulating Shadow Banking, supra note 1.
62 Cf. supra notes 38-39 and accompanying text (observing a correlation between the complexity of shadow banking and developed economies).
63 Cf. Global Shadow Banking Monitoring Report, supra note 5 (arguing for more transparency).
United States and other developed countries where shadow banking is especially complex.\(^{65}\)

2. *Rationality Failure.*

Humans have bounded rationality. And the more complex something is, the more we tend to focus on the simpler and more straightforward elements with which we’re familiar. We also tend to believe what we want to believe.

Shadow banking increases complexity. As a result, market participants sometimes act even more irrationally. For example, investors were prepared to believe, based on mathematical models they did not fully understand, that the investment-grade rated securities issued in highly complex second-generation securitization transactions,\(^{66}\) offering much higher returns than other similarly rated securities, represented good investments even though they were at least partly backed by subprime mortgage loans.

3. *Principal-Agent Failure.*

Conflicts of interest between managers and owners of firms are widely studied. At least in the shadow-banking sector, the more serious conflict appears to be *intra-firm*: secondary managers, such as analysts, are almost always paid under short-term compensation schemes, misaligning their interests with the long-term interests of the firm.\(^{67}\) This intra-firm principal-agent failure is not unique to shadow banking; but the complexity of shadow banking, combined with the technology that enables it, can exacerbate the failure. For example, the complexity of shadow banking motivated senior manager reliance on the imperfect value-at-risk, or VaR, model for measuring investment-portfolio risk, thereby enabling conflicted secondary managers to propose

\(^{65}\) *Cf.* Ghosh et al., *supra* note 38, at 3 (observing that in emerging market and developing economies, “the shadow banking sector is relatively simple, given the [lower] level of sophistication of financial markets and instruments”).

\(^{66}\) These transactions included securitizations of collateralized-debt-obligation securities, or “ABS CDO” transactions.

dangerous investment products, like credit default swaps, which had low VaR risk profiles.\(^{68}\)

4. *Incentive Failure.*

Technology has enabled the shadow-banking sector to finely disperse investment risk. In theory, that could be beneficial. But risk can sometimes be marginalized by becoming so widely dispersed that rational market participants individually lack the incentive to monitor it.\(^{69}\)

*Summary.* Shadow banking regulation should focus on maximizing shadow banking’s potential to increase efficiency and minimizing its potential to increase risk. This article has so far discussed regulation focused on maximizing economic efficiency by correcting market failures. Regulation can help to control, but it cannot completely eliminate, those failures.\(^{70}\) Next consider shadow banking regulation focused on minimizing systemic risk.

B. Regulation Focused on Minimizing Systemic Risk

Regulation should also focus on minimizing shadow banking’s potential to trigger systemic risk.\(^{71}\) One way to minimize that potential is to make panics less likely.\(^{72}\) It is impossible, however, to identify and forestall all the causes of panics. To some extent, even the market failures already discussed could trigger panics or other systemic shocks. For example, information failure, principal-agent failure, and incentive failure could, individually or in combination, cause one or more large firms to overinvest, leading to

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\(^{68}\) See id. at 460.


\(^{70}\) Professor Huang argues, however, that Circular No. 107 represents a significant improvement to Chinese regulation of shadow banking by attempting to correct these market failures. Huang, *supra* note 4, at 500-01.

\(^{71}\) Cf. Xiao Gang, *supra* note 4 (observing that “China’s shadow banking sector has become a potential source of systemic financial risk”).

\(^{72}\) Cf. *supra* note 53 (observing that panics often serve as a trigger that can commence a chain of systemic failures).
bankruptcy; and rationality failure could cause prices of securities in a large financial market to collapse.

Regulation could indirectly help by limiting the factors that give rise to shadow banking. Because the most important factor is regulatory arbitrage, another factor giving rise to shadow banking may well be technology, which facilitates ever more sophisticated financial mechanisms. However, it would almost certainly be futile, if not counter-productive, to try to regulate the use of technology.\footnote{Another factor giving rise to shadow banking may well be technology, which facilitates ever more sophisticated financial mechanisms. However, it would almost certainly be futile, if not counter-productive, to try to regulate the use of technology.} Because the most important factor is regulatory arbitrage,\footnote{See supra note 46 (observing that the CBRC has begun imposing net capital regulations on trust companies).} there is a circularity: greater regulation of shadow banks could reduce the risks of (by reducing) shadow banking, but at the possible cost of reducing efficiency. China appears to be trying to limit regulatory arbitrage by regulating at least some shadow banks.\footnote{See supra note 46 (observing that the CBRC has begun imposing net capital regulations on trust companies).} It can be difficult to know ex ante, however, whether enhanced regulation of non-banks optimally maximizes efficiency while minimizing risk.

Regulation might also be considered to reduce the interrelationships between shadow banks and traditional banks.\footnote{See supra note 58 and accompanying text. Cf. Huang, supra note 4, at 499 (arguing for separating the wealth management plan business of financial institutions into a separate department to minimize interrelationships).} That would make it less likely that the failure of a shadow bank could impact traditional banks. To the extent the interrelationships are created by contract, however, such regulation would necessarily reduce freedom of contracting. It is not clear that would be beneficial, even assuming it could be adequately monitored and enforced.

This article has also mentioned that limited liability can give investor-managers of shadow-banking firms strong incentives to take risks that might generate outsized personal profits, even if that greatly increases systemic risk.\footnote{See supra notes 59-60 and accompanying text.} Any regulation that restricts limited liability, however, would have to balance the fact that limited liability also encourages investment by addressing investor risk aversion and reducing monitoring

\footnote{Another factor giving rise to shadow banking may well be technology, which facilitates ever more sophisticated financial mechanisms. However, it would almost certainly be futile, if not counter-productive, to try to regulate the use of technology.}

costs.\textsuperscript{77} One such approach might be to restrict the limited liability protection of those investor-managers, such as capping it at two-times their investment.\textsuperscript{78}

For these reasons, shadow-banking regulation might be able to mitigate, but cannot prevent, the occurrence of systemic shocks. There therefore should be more regulatory \textit{ex post} approaches, such as trying to protect against systemic consequences that could result from these shocks.\textsuperscript{79} This regulatory approach is inspired by chaos theory, which holds that in complex engineering systems—and, the author has argued, also in complex financial systems\textsuperscript{80}—failures are almost inevitable. Therefore regulatory remedies should focus on limiting the consequences of these failures.\textsuperscript{81} In other contexts, the author has shown how regulation could accomplish this, such as by ensuring liquidity to systemically important firms and markets and by privatizing sources of liquidity in order to help internalize externalities and motivate private-sector monitoring.\textsuperscript{82}

Another question for further inquiry might be the extent to which regulation of shadow banking should tie more closely to particular factual patterns.\textsuperscript{83} For example, more regulatory attention could be given to managing the short-term funding of long-

\textsuperscript{77} \textit{The Governance Structure of Shadow Banking, supra} note 59, at 14.
\textsuperscript{78} \textit{Id.} at 25.
\textsuperscript{81} \textit{Id.}
\textsuperscript{83} \textit{Cf.} e-mail from Dan Awrey, University Lecturer in Law \& Finance, University of Oxford, to the author (Jan. 24, 2012; emphasis in original) (saying that he is “increasingly of the view that the prevailing notion of ‘shadow banking’—which throws a number of divergent institutions, instruments and markets into the same bucket—has become a meaningful obstacle to regulatory reform in a number of key areas (esp. wholesale funding markets). There are many different objects of (potential) regulation wrapped up in this definition, each manifesting different issues and requiring different regulatory responses.”).
term assets which, as mentioned, can create a risk of liquidity discontinuities with potentially systemic consequences.\textsuperscript{84} Chinese regulators appear to be very concerned about this risk.\textsuperscript{85}

The market failure underlying this risk is partly an information failure: that investors in short-term debt may not individually have enough at stake to make it worthwhile to fully evaluate the transaction. Those investors therefore will not accurately price the repayment risk.\textsuperscript{86} One possible remedy might be to encourage the development of a liquidity-support industry. Such an industry could achieve an economy of scale in which professional liquidity providers have enough at stake to make that evaluation economically worthwhile.\textsuperscript{87}


\textsuperscript{85} Xiao Gang, supra note 4. Xiao Gang observes that “China’s shadow banking is contributing to a growing liquidity risk in the financial markets. . . . [In] some cases short-term financing has been invested in long-term projects, and in such situations there is a possibility of a liquidity crisis being triggered if the markets were to be abruptly squeezed.” Id.


\textsuperscript{87} Cf. id. (arguing, among other things, that regulatory reform should focus on enabling more appropriate pricing of shadow bank liquidity arrangements). Other ways to mitigate the risk might include better standards on match-funding coverage, better internal controls on collateral valuation and margining policies, and internalizing externalities (such as mandating privately funded systemic risk funds). The international Basel III capital accord takes a match-funding coverage approach, for example, introducing a liquidity coverage requirement that banks hold sufficient high-quality liquid assets to cover their total net cash outflows over 30 days and another requirement that banks maintain minimum yearly available amounts of stable funding. Jerome Walker, Rosali
CONCLUSION

The rapid but largely unregulated growth in shadow banking in developing countries such as China can jeopardize financial stability. A regulatory balance is needed to help protect that stability while preserving shadow banking as an important channel of alternative funding.