# Conceptualizing the Regulatory Thicket: China's Financial Markets after the Global Financial Crisis

Shen Wei
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340 pp.

*Thomas H. Stanton*[*]

Professor Shen Wei has written a fascinating book that helps to explain for English-speaking readers the interplay among the Chinese government, China's banking regulators, the Chinese financial and banking systems, and economic outcomes. Some circumstances such as China's exceptional economic growth since the 2008 Financial Crisis are different from events in the West; other parts are much more familiar, notably the ability of politically powerful borrowers to gain access to credit on favorable terms. In China's case, State-Owned Enterprises (SOEs) get access to huge volumes of credit on favorable terms, while in the United States, it is the residential mortgage market that commands notably preferential access.

The book explores the fundamental tension in China between (1) the desire for state control of the economy and financial system, and (2) continuation of the market-based reforms that have helped to turn China into an economic behemoth.

Professor Shen is ideally positioned to address this tension, with strengths in law, finance, and economics, as well as knowledge of financial systems of many countries. He is KoGuan Distinguished Professor of Law at Shanghai Jiao Tong University Law School as well as Global Professor of Law at New York University School of Law.

Professor Shen's book is organized into eight chapters that essentially stand on their own. This is fortunate so that the reader can digest large amounts of information and insights about a constantly evolving financial system. The book draws upon numerous sources that are cited for readers who seek to delve more deeply into particular topics.

Chapter 1 discusses the positive effects on China's banking efficiency from the country's accession to the World Trade Organization (WTO), the dramatic growth of China's largest banks since the 2008 Financial Crisis, China's success at controlling the ratio of non-performing loans in the banking system, and the increasing focus of the financial system on providing credit to China's booming

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middle class. On the other hand, income inequality has grown dramatically in China, to the point that it far exceeds that of the United States, and the banking system largely neglects the needs of lower income people. Professor Shen observes:

> Over the past four decades, the Chinese government has put in place a large array of finance-related regulations and rules (as well as judicial interpretations) in preparation for China's economic reform, its entry into the WTO, and its more recent response to the global financial crisis. [...] As a result, China's financial system, particularly its banking system, is still a government-controlled sector given the allegations of various forms of unfair or inappropriate competition. In many ways China satisfies the thresholds of being both a regulatory capitalism economy and a police economy, where there is greater governance of all kinds, at least in the field of finance.[1]

Chapter 2 provides an overview of China's markets for debt obligations, asset-based securitization, and the stock market. The chapter presents considerable data and helpful figures showing the relationship of key players in each market. Especially in this chapter, the reader benefits from the Table of Abbreviations at the front of the book to help follow the discussion more easily. As the chapter documents, China is yet another country that relies heavily on a banking system with large firms that are "too big to fail." However, in China's case government backing extends also to key borrowers — State-Owned Enterprises — that benefit by being able to command access to large volumes of credit on favorable terms. Again, the author recommends financial sector reforms:

> Maintaining a large state-owned economy means political control may work more effectively than a policy of economic liberalization. However, it also suggests low economic efficiency and a large cost to government in allocating resources ... Any attempt to deal with China's debt burden requires hard decisions, including shuttering less productive SOEs by forcing them to realize losses, reining in shadow banking, capping credit growth, adjusting lending rates to account for risk, and accepting lower levels of GDP growth.[2]

The title of Chapter 3, "Small, Big, and Deadly: Is opening the banking sector a mission impossible?" focuses directly on the stratification of the Chinese banking sector. On the one hand, the five large state-owned banks both obtain their funding and lend to favored SOE borrowers at preferential rates. On the other hand, individuals and smaller businesses without the perception of state backing lack access to funding at reasonable rates. Indeed, the large state-backed

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1 Shen Wei, *Conceptualizing the Regulatory Thicket: China's Financial Markets After the Global Financial Crisis* (London and New York: Routledge, 2021) at 17-18, footnotes omitted.

2 *Ibid.* at 101.

banks are unable to assess the stand-alone credit risk of their state-backed borrowers, and don't need to. One hope is the advent of Fintech: high tech lenders such as Tencent and Ant Financial Group are able to derive credit scores from their operations as payment services so that they increasingly are able to extend credit on improved terms to non-SOE borrowers. Unfortunately, the recent regulatory challenge to Ant Financial Group (that took place after this book went to press) and special attention directed at the credit functions of Ant Financial, could be a cloud on this horizon. Or perhaps more than a cloud. As Professor Shen concludes,

> In a top-down, command-based Party state, state-owned banks are far easier to control to achieve the government's policy goals than privately or foreign-owned banks. As long as the Chinese government uses the banks as its cash box, efficiency, productivity, and profitability are not the key goals it (or the state-owned banks) tend to pursue. In this sense, given China's politico-economic structure, enlarging the involvement of private and foreign capital in China's banking sector is not necessarily in the best interests of either the Chinese government or its state sectors.[3]

Chapter 4 focuses on private lending and regulatory responses. The chapter begins with the case of Wu Ying, an entrepreneur arrested in 2007 and sentenced to death on charges of fraud and "illegal fundraising," i.e., violation of laws directed at underground banking, financial impropriety and loan-sharking. Ms. Wu's actions consisted of borrowing a large amount of money from 11 wealthy people to invest in a diversified business enterprise. A large outcry in China against applying the death penalty to nonviolent crimes resulted in a higher court reducing her sentence, perhaps to life-imprisonment. (The final sentence had not been determined at the time the book went to press). As the chapter notes, "The purpose of the Criminal Law and the imposition of criminal liability on illegal fundraising is not only to discourage the informal credit market, but also to protect state-owned banks."[4] And the result is "an apparent attack on the entrepreneurial sector at the grass-roots level, which can no longer fund itself through informal means and personal savings." The chapter concludes that: "Widening the channels of funding can be achieved by opening up and strengthening the capital markets or reform of the existing reform (sic) eroding the vested power of the incumbent elite groups. Deeper financial reform requires an effective institutional structure, which China does not possess right now."[5]

Chapter 5 highlights the growth of peer-to-peer (P2P) lending done over a platform that operates similar to a ride-sharing or short-term rental service. While P2P lending has grown rapidly, its volume remains at about 10% of total banking sector lending. Table 5.1 of the book shows how private enterprises, served increasingly by P2P lending, can be much more profitable and employ

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[3] *Ibid.* at 143.

[4] *Ibid.* at 151.

[5] *Ibid.* at 167-168, footnotes omitted.

many more people than the SOEs served by traditional bank lending. While regulators initially adopted a light-touch regulatory approach, they have now adopted burdensome rules including platform registration requirements, depository rules for funds, and information disclosures, that reduce the profitability of P2P lending. Professor Shen finds the rules to be unresponsive to needs of a rapidly evolving industry: "The lack of flexibility of China's P2P lending regulatory regime would, thus, probably hamper the benefits brought by the P2P lending industry, and stifle innovation in the sharing economy as a whole."[6] He recognizes the validity of regulatory concerns to protect investors, privacy, and safety in P2P lending, and also calls for "a more participant-friendly, responsive, and idle-capacity-utilization-oriented regulatory system."[7] Yet, in contrast to this sound advice, Professor Shen notes that banks are actively lobbying to impose harsher regulatory controls on P2P lending.

Chapter 6 expands the earlier discussion of P2P and other nontraditional lending to look at the shadow banking sector as a whole. The chapter cites a 2014 statement of the People's Bank of China, China's central bank, that: "As mainland banks tend to favour lending to large state-owned clients with implicit guarantees, [central bank targeted easing of regulations] has failed to offer enough support to small and medium sized enterprises [...] The shadow banking system has become an important alternative channel to finance those restricted from normal bank loans."[8]

In response, the Chinese Banking Association, a government-backed industry group, has been lobbying to impose more onerous regulations on P2P lending and other shadow banking activities, arguing that banks are subject to burdensome requirements that their nontraditional competitors should bear as well. Tension between traditional banking and shadow banks created by regulatory arbitrage is indeed a global phenomenon.

Chapter 7 describes the pragmatic steps that China is taking to increase acceptance of the Renminbi (RMB) as an international currency. These steps are appropriate given the status of the Chinese economy as the second largest in the world and use of the RMB in a substantial volume of world trade. Important steps have included the acceptance of the RMB in the basket of reserve currencies used by the IMF as its unit of account, and also expansion of China's voting rights in the IMF. In preparation for acceptance of the RMB as part of the IMF basket of reserve currencies, the Chinese central bank opened the Chinese bond market to foreign central banks and also increased the extent that the market could influence the value of the RMB. Further acceptance of the RMB will require China to liberalize its financial and currency markets so that eventually the RMB becomes freely traded. Additional economic reforms are also needed to gain international acceptance of the RMB, which currently lacks wider

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6 *Ibid.* at 198.

7 *Ibid.* at 205.

8 *Ibid.* at 216, footnotes omitted.

acceptance because of its role "as a currency of an economy with substantial party control."[9]

The conclusion of this book, in Chapter 8, brings together the themes of earlier chapters: the tension in China between (1) the desire for state control of the economy and financial system, and (2) continuation of the market-based reforms that have helped to turn China into an economic behemoth. While recognizing the tension and helping the reader to understand its contours, Professor Shen is among those who advocate further market-based reform. He concludes with a warning:

> The enormity of China's debt has created illiquidity constraints on the financial regulatory regime, which has become clear in the coronavirus pandemic ... When the claims coming to be converted into cash at a given time are much greater than market liquidity, the threat can spiral into a financial crisis [...] The solution does not seem to rest in law, regulations, or even a regulatory framework though China has them in a modern sense. The complexity and ambiguity may lie in the dynamics of China's mighty size, state capitalism, and authoritative politics.[10]

This is a masterful book that bankers, academics, and central bankers around the world may want to read to help prepare for complexities faced by China and, by extension, the rest of us as well.

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9 *Ibid*. at 282.

10 *Ibid*. at 315.