THE CONTRASTING TRAJECTORIES OF SHADOW BANKING IN INDIA AND CHINA

- *Shantanu Vyas and Anvesha Mishra*[*]

ABSTRACT

India and China demonstrate contrasting trajectories in their shadow banking industries. India is currently placing significant attention on the launch of Jio Financial Services Ltd., a separate entity derived from Reliance Industries Ltd. This has generated investor optimism, despite an initial decline in stock prices, as indicated by a valuation of $19 billion. The strong performance of Bajaj Finance Ltd. emphasises the significance of India's Non-bank lending sector, surpassing even the State Bank of India in terms of total value. China's shadow banking system emerged as a response to post-financial crisis caution. It involved a complicated network of lending through trusts, focusing on real estate and local governments. Nevertheless, nonbank issuers are currently facing a significant decline in the real estate market, as seen by recent instances of failed payments and apprehensions regarding the potential spread of financial hazards. The shadow banking crisis that occurred in India in 2018 caused a disruption in the availability of credit for the real estate sector. However, the current situation, which is influenced by the increasing digitization of the consumer economy, shows potential for improvement. Jio Financial intends to take advantage of technology in order to benefit from Ambani's extensive business network and deep understanding of consumer behavior. India's regulatory framework appears to be more conducive to the development of domestic industry leaders, in contrast to China's strict regulations. The future of India's shadow banking sector hinges on the adoption of technical advancements, digitalization of consumer services, and effective regulation to ensure sustainable expansion while avoiding systemic concerns. This might potentially lead to a preference for nonbank lenders with advanced technological capabilities, perhaps overshadowing smaller deposit-taking institutions that are government-controlled.

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I. WHAT CONSTITUTES SHADOW BANKING?

The concept of "shadow banking," which was first presented by Paul McCulley in 2007, has been interpreted in a number of ways, but its exact meaning has not been widely agreed upon and a clear consensus regarding its precise essence remains elusive.[1] There is a lack of consensus across different countries, which makes the theoretical conversation inside certain institutional contexts more difficult. For instance, in China, the phrase "shadow banking" refers to wealth management solutions given or marketed by banks, whereas in Europe, it refers to the lending operations of insurance firms. This includes loans made by financial businesses connected to banks in India. Notwithstanding these discrepancies, examining noteworthy attempts to characterize shadow banking improves comprehension of its essential traits across various conceptualizations. During the 2007 Annual Jackson Hole Conference, McCulley first characterised shadow banking as *"the entire*

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[1] Paul McCulley, 'The Shadow Banking System: The New Paradigm?' (2007) 92(4) Federal Reserve Bank of Kansas City Economic Review 5, 23.

alphabet soup of levered-up non-bank conduit systems."[2] The significance of the *"non-bank"* dimension within the realm of shadow banking was notably highlighted by the Financial Stability Board (FSB) in its 2013 report, which delineated it as *"credit intermediation involving entities (fully or partially) outside the regular banking system or nonbank credit intermediation for short."*[3] These explanations portray shadow banks as distinct from traditional commercial banks, implying that they engage in illicit financial activities such as tax avoidance and tax evasion by using unofficial and unauthorized financial networks. This sort of illegal activity is not central to shadow banking institutions, according to researchers like Guttmann (2016) and Mehrling et al. (2013).[4]

Expanding on these fundamental principles, authors such as Mitchell, Guttmann, and others identify two main definitional categories within the language of shadow banking literature.[5] The initial perspective, referred to as the "market view," focuses on the processes of securitisation and the intricate web of market-mediated financial transactions. From this perspective, shadow banks, much like traditional banks, serve as intermediaries bridging the gap between savers and investors. The shadow banking system, in conjunction with its traditional counterpart, constitutes a complex web of specialised financial institutions and vehicles that facilitate the flow of capital from savers to investors. This occurs through an array of securitisation and secured funding methodologies, all within a framework characterised by minimal regulation. These intermediary entities execute four essential transformations maturity,

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[2] ibid.
[3] Financial Stability Board, *Shadow Banking System: Scoping the Issues* (Financial Stability Board, 2013) https://www.fsb.org/uploads/r_110412a.pdf accessed 31 March 2025.
[4] Robert W Guttmann, 'The Shadow Banking System: Is It a Threat to Financial Stability?' (2016) 21 Journal of Financial Stability 1, 14.
[5] Mark Mitchell, 'Defining Shadow Banking' (2016) Journal of Financial Intermediation 15–27.

liquidity, leverage, and credit risk transfer similar to traditional banks, though lacking direct access to explicit public sources of liquidity and risk insurance from central banks or organisations such as the US Federal Deposit Insurance Corporation (FDIC).[6] The alternative approach, known as the "money view," regards shadow banking as comparable to the conventional commercial banking system. Beyond the realms of maturity and credit transformation, shadow banks engage in the issuance of *"near monies"* or *"liquid short-term stores of wealth."* Mitchell (2016) posits that traditional banking is responsible for the creation of new credit money, whereas shadow banks play a pivotal role in the dissolution of this credit money. This occurs when savers opt to exchange bank money for liabilities issued by shadow banks, which serve as a repository for credit claims that surpass the limitations of conventional bank balance sheets.[7] These sophisticated definitions clarify the many functions shadow banks play in conjunction with standard banking systems and provide a variety of insights into the process of credit creation and intermediation.

II. SHADOW BANK'S MECHANISM

The financial ecosystem, which has traditionally relied on conventional banking systems to act as mediators between savers and investors, has seen the rise of shadow banking. Shadow banking companies differ from traditional banks in that they operate in a more fragmented structure, facilitating the connection between lenders and borrowers by acting as intermediaries. A critical examination of shadow banking mechanisms is essential to elucidate their operational dynamics and systemic implications. This study adopts a dual analytical lens, focusing on market structures and monetary flows, to

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[6] GA Vento and P La Ganga, 'Bank Liquidity Risk Management and Supervision: Which Lessons from Recent Market Turmoil?' [2009] 10 Journal of Money, Investment and Banking 78–125.

[7] Mark Mitchell, 'Defining Shadow Banking' (2016) 27(1) Journal of Financial Intermediation 15–27.

comparatively assess the functioning, regulatory challenges, and economic consequences of shadow banking systems in India and China. By dissecting institutional frameworks, sectoral vulnerabilities, and technological integration, the analysis seeks to advance empirical understanding of how

These mechanisms drive financial innovation while posing risks to stability in emerging economics. Figure 1 provides a schematic illustration of this.

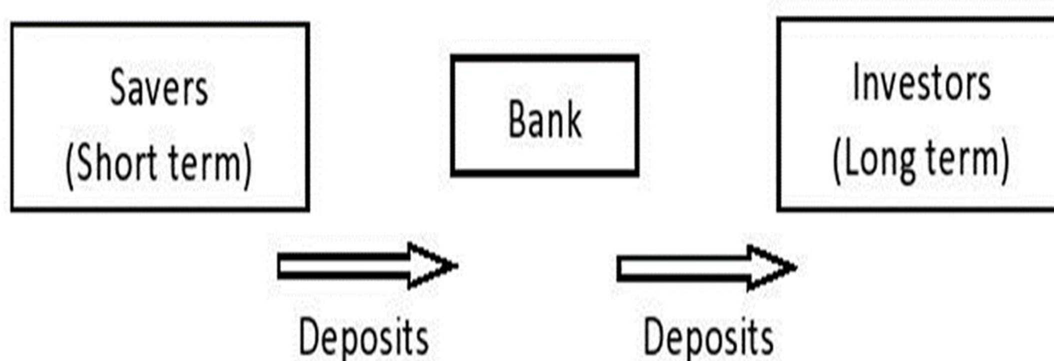

Figure 1

A. Market Analysis

Within the formal financial architecture, scheduled commercial banks (SCBs) as institutionally defined by the Reserve Bank of India[8] perform essential intermediation functions by efficiently allocating capital between surplus and deficit units while mitigating pervasive information asymmetries and transaction cost frictions inherent in financial markets. However, their core maturity transformation function, which involves the conversion of short-term, liquid deposit liabilities into long-term, illiquid loan assets, engenders

[8] Reserve Bank of India, *Report of the High Level Steering Committee for Review of Supervisory Processes for Commercial Banks* (2023) https://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=663 accessed 31 March 2025.

fundamental liquidity risk exposures and capital adequacy vulnerabilities.[9] These structural limitations of traditional banking have precipitated the organic evolution of a parallel financial ecosystem characterized by heterogeneous non-bank financial intermediaries including pension funds and insurance companies, that operate beyond the regulatory perimeter of conventional banking oversight while performing analogous credit intermediation functions.[10]

A fragmented and diverse financial structure would help in bypassing limitations of traditional banking by spreading the financial activities across multiple entities, including shadow banks. This would reduce the systemic dependency on traditional banks and would enhance the liquidity, as these entities manage large pools of capital that can be invested flexibly. Fragmentation also diversifies risk across varied financial players, minimizing vulnerabilities tied to concentrated banking systems. Specialized institutions address niche financial needs – such as long-term investments or high-risk ventures – often overlooked by conventional banks. Additionally, shadow banks operate under different or lighter regulatory frameworks, enabling them to innovate and fill funding gaps during crises or in the undeserved sectors, which ultimately fosters resilience and efficiency in the financial system.

Shadow banks function as intermediaries, amassing deposits from lenders and supplying funds to conventional banks. They also play a crucial and transformative role in credit intermediation, going beyond merely acting as intermediaries between lenders and traditional banks. They bridge the gaps in the financial system by facilitating the flow of credit directly to the borrowers, often serving sectors and markets undeserved by conventional banks.

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[9] Jean Tirole, 'Illiquidity and All Its Friends' [2011] 49(2) Journal of Economic Literature 287–325.

[10] RU Arora, 'Links between Financial Inclusion and Financial Stability' in *Handbook of BRICS and Emerging Economies* (Oxford University Press 2020) 222.

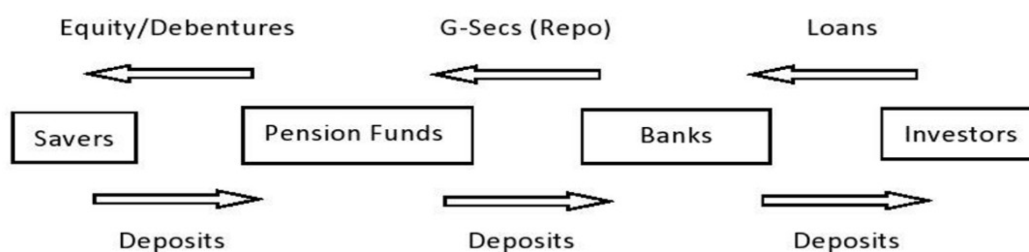
Significantly, in order to ensure the safety of these financial transactions, banks enter into repurchase agreements (repos) with shadow banks, which entail the sale of government securities. This arrangement provides lenders with security and earns cash by taking advantage of pricing differences in the repo contracts. Nevertheless, difficulties emerge, namely with the limited availability of government securities and the requirement for rigorous surveillance of security prices, prompting modifications in agreements between shadow banks and conventional banks.[11]

Figure 2 provides a schematic illustration of this-

B. Continuation of Market View Perspective

Moreover, the system's evolution entails the establishment of special purpose vehicles (SPVs) by banks. These *Special Purpose Vehicles* (SPVs) engage in the procurement of loans from banking institutions, subsequently restructuring them into *Asset-Backed Securities (*ABS). and distribute them to different market lenders, such as financial organisations like mutual funds and pension funds. While improving market liquidity, this complex system raises

issues regarding the quality of ABS and the transfer of risk from banks to SPVs and subsequently to other entities. The consequences of these intricacies

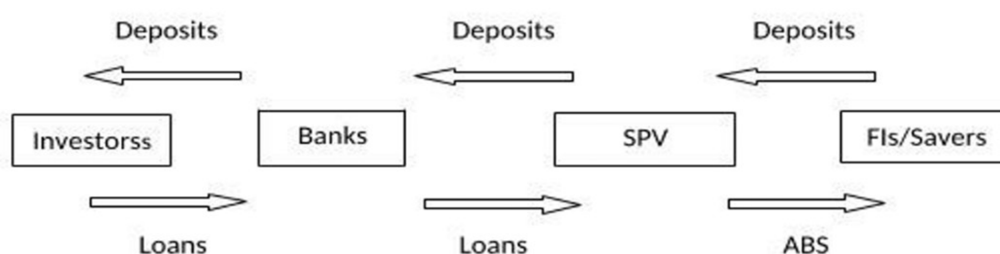


[11] VV Acharya and others, 'Shadow Banking: An Analysis of Lending Through Structured Finance Conduits and Asset-Backed Commercial Paper' (2010) 100(5) American Economic Review 2284, 2313.

became clearly apparent during the Global Financial Crisis (GFC), which played a role in a prolonged economic decline.[12] These parallels underscore the urgent need for cross-border regulatory coordination to mitigate shadow banking's systemic threats. Figure 3 provides a schematic illustration of this.

C. *Financial Viewpoint*

Figure 3



In contrast, the money view perspective defines shadow banks as firms that temporarily modify the flow of money by replacing bank deposit liabilities with loan liabilities from borrowers. This process entails banks generating currency, distributing it throughout the economy, and ultimately gathering these funds, which are then credited to deposit accounts maintained by banks. Subsequently, banks exchange these deposits for loans with shadow banks through repo transactions. This financial manoeuvre effectively renders the capital produced by banks void until the shadow banking entity retracts the repo transaction.[13] To summarise, the market perspective examines the functional mechanics of shadow banking, highlighting its ability to mitigate

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[12] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* (2011) https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf accessed 31 March 2025.

[13] S Sivramkrishna and others, 'Shadow Banking in India: Nature, Trends, Concerns and Policy Interventions' (2019) 12 Review of Economics and Business Studies 29, 46 https://www.researchgate.net/publication/338296508_Shadow_Banking_in_India_Nature_Trends_Concerns_and_Policy_Interventions accessed 30 March 2025.

the constraints of conventional banking while also raising apprehensions over the quality of assets and the transfer of risks. In contrast, the money view examines the complex financial system that encompasses deposits, loans, and transactions between banks and shadow banking firms. Gaining insight into these viewpoints establishes a strong basis for conducting thorough qualitative and quantitative assessments of shadow banking. This is crucial for fully grasping its characteristics and expansion, particularly within the framework of the Indian financial environment. Figure 4 provides a schematic illustration of this.

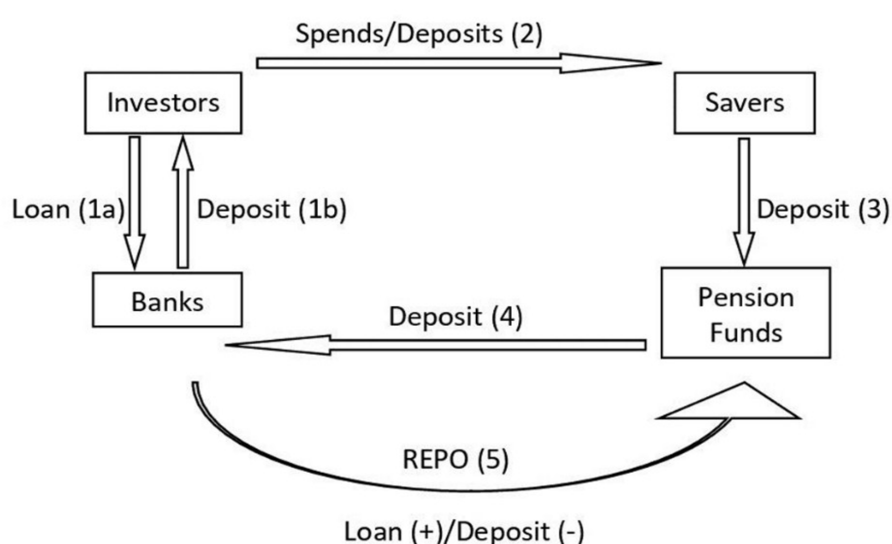
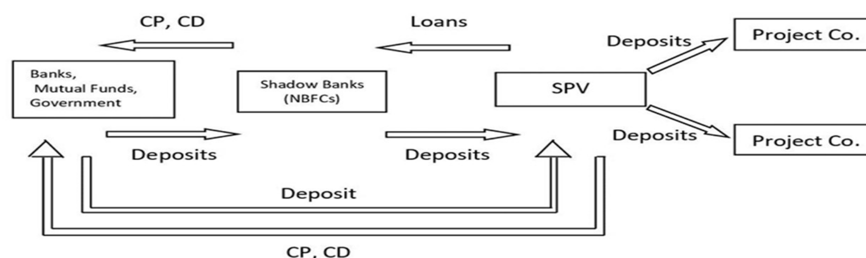


Figure 4

III. THE GROWTH AND IMPACT OF INFORMAL FINANCIAL NETWORKS IN INDIA

The standing of shadow banking in India has experienced considerable upheaval, primarily due to a series of recent high-profile scandals, notably the

collapse of Infrastructure Leasing & Financial Services Limited (IL&FS).[14] Prior to discussing concerns arising from these events, it is crucial to establish the definition of shadow banking within the Indian context. According to the Reserve Bank of India (RBI), shadow banking refers to the activities of non-banking financial companies (NBFCs) involved in lending, selling/purchasing assets, and operating revolving savings and credit societies, which are called chit funds in India.[15] India's credit environment is distinctive, marked by a substantial informal structure based on familial ties, social hierarchy, and reliance on trust. However, the available data mostly focuses on the formal sector, which is the main subject of our investigation. According to market analysis, Indian shadow banks or NBFCs function as intermediaries that facilitate the transformation of credit.[16] Their principal function involves the practice of short-term borrowing, chiefly through the issuance of commercial paper (CP), to facilitate the financing of long-term infrastructure projects, including highways, power plants, ports, and real estate endeavours. The operational mechanism of Indian Non-Banking Financial Companies



[14] V Kothari, *Shadow Banking in India: Creating Opportunity Out of a Crisis* (Vinod Kothari Consultants, 20 January 2020) https://vinodkothari.com/wp-content/uploads/2020/01/shadow-banking-in-India.pdf accessed 1 April 2025.
[15] *Business Standard*, 'Growth of Shadow Banks Poses Threat to Financial Stability: RBI Report' (5 December 2020) https://www.business-standard.com/topic/rbi-annual-report accessed 17 October 2024.
[16] Financial Stability Board, *Global Shadow Banking Monitoring Report 2017* (2018) https://www.fsb.org/uploads/R050318.pdf accessed 17 October 2024.

(NBFCs), as illustrated in Figure, revolves around utilizing short-term borrowing to finance infrastructure development.

Figure 5

This is motivated by the accessibility of cash and the cost-efficiency of short-term borrowing in comparison to issuing long-term bonds or stock. The activity appeals to individuals who save money and are looking for greater returns, even though it comes with increased dangers. This is mainly affected by the decrease in interest rates and the limited availability of government bonds. Supporting this pattern, there has been a consistent decrease in the Reserve Bank of India's benchmark repo rate, dropping from 8.5 to 5.40 per cent since 2012. Concurrently, the proportion of public debt relative to GDP has experienced a modest decrease, shifting from 69.6 to 68.7 percent during the same timeframe. Shadow banking in India, led by non-banking financial enterprises, uses short-term borrowing to fund long-term infrastructure investments and promote credit reforms. The system has attracted depositors by offering high returns despite low interest rates and limited government bonds. However, recent events, such as the bankruptcy of IL&FS, highlight potential concerns. Understanding the complexities of India's shadow banking system is crucial for recognizing its unique issues.

IV. THE EMERGENCE SHADOW BANK INSTITUTIONS IN INDIA

The tremendous rise of shadow banking in India may be linked to a variety of variables, primarily the economic reforms of 1991 that brought about liberalization, privatization, and globalisation. Financial liberalization allowed the emergence of non-banking financial companies (NBFCs) in the formal sector, which had previously been dominated by informal lenders. The reforms also fostered competition in the commercial banking industry, as private banks

entered the market in search of new lending opportunities. The reforms necessitated the exploration of alternate sources of money, going beyond the conventional commercial and informal channels.[17] The pursuit of alternative finance in India has been propelled by a transformation in its growth trajectory, the expansion of industries, and the constrained access to traditional credit for small and medium enterprises (SMEs). Moreover, the proliferation of housing and automotive loans, the increasing engagement of the private sector, constraints on budget deficits, and partnerships between private and public entities for infrastructure endeavours have created a significant demand for channelling credit towards lucrative ventures. In India, Non-Banking Financial Companies (NBFCs) are categorised into various groups according to criteria such as their capacity to accept deposits, their status as non-deposit-taking entities, and their associated risk levels.[18] Non-banking financial companies of systemic importance are required to comply with specific regulatory frameworks, which include the maintenance of statutory liquidity ratios, capital adequacy ratios, and non-performing asset ratios. The study examines the historical background of India's economic reforms, emphasizing the transition from borrowing based on production in the 1980s to a financialized economy in the 1990s, where the expansion of money exceeded GDP.[19] Throughout this timeframe, a decline was observed in the market share of public sector banks, with a corresponding increase in the prominence of non-banking financial companies and private banks. Non-Banking Financial Companies (NBFCs) exhibit a significant reliance on commercial banks for their funding needs, with their share of the total bank credit steadily increasing

[17] Prachi Agarwal, *Shadow Banking in India: Nature, Trends* (The Fair India 2019).
[18] VV Acharya, *The Growth of a Shadow Banking System in Emerging Markets: Evidence from India* (NYU Stern School of Business 2014).
[19] Reserve Bank of India, 'Non-Banking Financial Companies' (10 January 2017) https://www.rbi.org.in/commonman/english/scripts/FAQs.aspx?Id=1167 accessed 6 December 2023.

over time. The strong correlation between banks and NBFCs underscores their function as intermediaries for commercial bank lending. Furthermore, mutual funds have a substantial impact on the financing of Non-Banking Financial Companies (NBFCs), with their total investment in NBFCs amounting to almost INR 2,300 billion as of March 2018.[20] The recent surge in investments in mutual funds, particularly from private sector entities, corresponds with the expansion of non-banking financial companies (NBFCs) and the broader trend of financialisaton within the Indian economy. The article thoroughly investigates the growth of commercial paper issuance by non-banking financial companies, highlighting a remarkable tripling of the amount over a seven-year period. The employment of short-term, unsecured debt instruments raises concerns regarding the susceptibility of the financial system, given that the values of the assets backing these instruments are subject to fluctuations in market and macroeconomic conditions.[21]

V. EMERGING ISSUES PRESENTED BY THESE INSTITUTIONS IN INDIA

Despite the benefits of shadow banking in providing alternative investments, efficiently channeling resources, and diversifying risk, significant concerns have emerged regarding its potential to induce financial instability. A key issue stems from the exchange of pre-existing credit claims, which establishes a hierarchical structure of indebtedness. In this structure, the fulfillment of financial obligations depends on the accessibility and liquidity of assets positioned at the apex. This refers to the ability of financial institutions to monetize high-ranking collateralized assets and leverage them to meet obligations. When these assets become illiquid or devalued, financial

[20] Financial Stability and Development Council, *Report of the FSDC Sub-committee on Non-Bank Financial Companies* (RBI, August 2020).
[21] ibid.

distress propagates through the system, exacerbating risks of default and contagion effects across the economy.[22] This phenomenon is particularly concerning in the case of Non-Banking Financial Companies (NBFCs), which often rely on short-term funding sources to finance long-term assets. The issue discussed here pertains to asset inadequacy against NBFCs' exposure, where liquidity mismatches create systemic vulnerabilities.[23] The dependence on ephemeral financial resources to sustain enduring initiatives further compounds inherent weaknesses, as evidenced by the 2018 Infrastructure Leasing & Financial Services (IL&FS) crisis. The IL&FS crisis was marked by defaults on commercial papers, certificates of deposit, and inter-corporate deposits, exposing the insolvency of a major NBFC and triggering widespread panic in the financial markets.[24] This incident underscored the "dark" side of shadow banking, characterized by poor governance, lack of transparency, and inadequate risk management practices. The crisis necessitated government intervention to prevent a systemic collapse, revealing significant deficiencies in the regulatory oversight of shadow banking in India.[25] Another critical issue is the "greening over" of poor-quality loans, where distressed financial institutions extend new credit to borrowers to cover up non-performing assets

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[22] Financial Stability Board, *Shadow Banking: Regulatory Framework and Risk Assessment* (3 July 2017) https://www.fsb.org/uploads/P300617-1.pdf accessed 25 March 2025.

[23] VK Manda and S Rao, 'Lessons from the IL&FS Financial Crisis' (2nd International Conference on Business and Management, 2019) https://doi.org/10.17605/OSF.IO/5TZU3 accessed 23 March 2025.

[24] J Bawa, S Basu and A Saha, 'Shadow Banking in India: Do Bank Sponsored Asset Management Companies (AMCs) Perform Liquidity Transformation Through Exposure to Non-Banking Finance Companies (NBFC) in Their Debt Oriented Schemes and Will This Increase the Systemic Risk of a Bank Due to a Possible Joint Exposure to NBFCs?' (VIII Congresso de Investigacion Financiera FIMEF, EGADE Business School 2018) https://repository.iimb.ac.in/bitstream/2074/13940/1/Basu_IIBF_RP_2019.pdf accessed 1 April 2025.

[25] Reserve Bank of India, *Financial Stability Report 2020* (24 July 2020) https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=50122 accessed 25 March 2025.

(NPAs). This practice, often referred to as an inherent weakness of shadow banking, obscures the true financial health of NBFCs and weakens the stability of the financial system.[5] It creates an illusion of solvency while increasing the sector's exposure to risky assets, further exacerbating financial fragility. In response to these challenges, the Reserve Bank of India (RBI) has introduced several initiatives to inject liquidity into the NBFC sector and enhance financial stability.[26] One notable initiative is the Partial Credit Guarantee Scheme (PCGS), which aims to provide liquidity support to NBFCs through government-backed credit guarantees on asset-backed securities. Additionally, the RBI has undertaken measures such as Targeted Long-Term Repo Operations (TLTRO) to ensure that funds flow into the NBFC sector, mitigating liquidity constraints and reducing systemic risks. Furthermore, regulatory reforms, including stricter capital adequacy requirements and enhanced risk assessment mechanisms, have been implemented to strengthen the resilience of NBFCs.[27] Moving forward, policymakers must adopt a multi-faceted approach to address the risks associated with shadow banking in India. This includes enhancing regulatory oversight, strengthening corporate governance practices, and enforcing stricter risk management frameworks. A robust regulatory framework, combined with transparent financial reporting and prudent lending practices, will be crucial in mitigating the systemic vulnerabilities posed by shadow banking and ensuring long-term financial stability in India.[28]

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[26] Reserve Bank of India, *Policy Environment, Report on Trend and Progress of Banking in India 2023–24* (December 2024) https://m.rbi.org.in/Scripts/PublicationsView.aspx?id=23074 accessed 25 March 2025.
[27] T Ashokamithran, 'NBFC Stress May Lead to System Liquidity Due to Interconnectedness: IMF' *The Hindu* (Mumbai, 4 March 2025) https://www.thehindu.com/business/nbfc-stress-may-lead-to-system-liquidity-due-to-interconnectedness-imf/article69290797.ece accessed 25 March 2025.
[28] ibid.

VI. COMPARATIVE ANALYSIS WITH CHINA

A. What were the characteristics of the Chinese credit system before the emergence of shadow banking?

The development of China's credit system prior to the rise of shadow banking marked a notable shift from a government-regulated banking sector to a more varied financial environment. Prior to the emergence of shadow banking in the 2000s, banks mainly regulated the credit system in China. The development of this control was influenced by certain crucial attributes and regulatory limitations. At first, banks occupied a privileged position in the financial ecosystem.[29] They had a significant clientele, especially among State-Owned Enterprises (SOEs), who had a dominant presence in the economy. In China's tightly controlled economy, the availability of legal alternatives for finance was restricted, thereby strengthening the dominance of banks over deposits and loans. Banks also profited from implicit guarantees as the state was considered to protect depositors, promoting confidence and allowing them to amass significant deposits despite giving meagre interest rates. Furthermore, regulatory procedures effectively governed interest rates for both deposits and loans, thereby guaranteeing substantial profit margins for banks.[30]

Nevertheless, the banking system was restricted by governmental rules. The People's Bank of China (PBOC) imposed restrictions on individual banks' lending amounts in order to govern the overall money supply by controlling the quantity of loans provided. The loan allocation in smaller banks with strong government connections was significantly affected by the

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[29] K Hachem, 'Shadow Banking in China' (2018) 10 Annual Review of Financial Economics 287, 308.

[30] D Elliott, A Kroeber and Y Qiao, *Shadow Banking in China: A Primer* (Brookings Institution 2015).

excessive control and surveillance of the loan process, although this has been less common in recent years. Furthermore, loan growth was restricted by restraints such as loan-to-deposit ratios, and banks were required to retain considerable reserves with the PBOC due to elevated reserve requirements, resulting in financial pressures. Prior to the 2000s, the credit system was characterised by a limited bond market, exclusive government control of large banks, and a bias towards lending to State-Owned Enterprises (SOEs) rather than Small and Medium Enterprises (SMEs). The banks preferred state-owned businesses (SOEs) because of their perceived trustworthiness, market dominance, low loan default penalties, and the prospect of social or political pressures. Despite their major influence on employment and GDP, SMEs face bias due to a number of factors, including insufficient collateral, a poor credit history, and higher loan default penalties than state-owned businesses (SOEs). However, changes in the financial environment were occurring despite these limitations. Joint stock banks, influenced by their historical function as corporate bankers, functioned in a somewhat deregulated setting, offering loans to the private sector. Urban and rural commercial lenders had limitations in their ability to access State-Owned Enterprise (SOE) lending prospects, which forced them to provide loans to Small and Medium Enterprises (SMEs). Analysts saw advancements in targeted risk evaluation for small and medium-sized enterprises (SMEs), while acknowledging ongoing difficulties faced by SMEs when interacting with banks, which exceed those seen in other nations. The rise of shadow banking marked a transition away from conventional financial frameworks. Shadow banking firms provided alternative financial products, posing a challenge to the prevailing dominance of traditional banks. This transition was driven by the necessity for varied funding alternatives, particularly for small and medium enterprises (SMEs) that have been overlooked by the conventional banking industry. In a nutshell, the Chinese

credit system prior to the emergence of shadow banking was marked by the predominance of banks, strict regulatory measures, preferential treatment towards state-owned enterprises (SOEs), and restrictions on financing for small and medium-sized enterprises (SMEs).[31] As the traditional banking sector remained dominant, changes in financial dynamics and regulations were creating opportunities for the rise of shadow banking, which brought new aspects to China's credit environment.

B. What is the present/contemporary condition of shadow banking in China?

Stringent regulatory measures and severe economic conditions have recently brought about substantial changes in the landscape of shadow banking in China.[32] Although shadow banking has experienced a 20% decline in assets, it continues to exert significant influence in the financial sector, albeit on a smaller scale. Significantly, essential operations such as trust loans and wealth management products (WMPs) continue to exist, but they are now subjected to more stringent regulations and a heightened focus on diversification. Amid economic downturns, the e-commerce finance sector is growing and making the shifting picture more challenging for the industry. Nevertheless, despite its reduced condition, shadow banking in China still presents significant hazards to the financial system, necessitating ongoing attention and thorough regulatory supervision. Precisely defining the parameters of shadow banking in China presents a formidable challenge, as varied interpretations lead to contentious debates regarding its operations and overall magnitude. Shadow banking comprises a multitude of financial activities, each contributing to the intricate tapestry of modern finance.

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[31] D Awrey, 'Law and Finance in the Chinese Shadow Banking System' (2015) 48 Cornell International Law Journal 1, 50.

[32] ibid.

a) Trust loans and leases are financial transactions overseen by trust firms, which are a distinctive type of organisation in China that combines characteristics of both banks and fund managers. Although these businesses demonstrate adaptability, regulatory bodies are gradually imposing more stringent restrictions on their activities.[33]

b) Non-financial firms facilitate entrusted loans through banks for legal purposes, offering banks protection against the credit risk of the borrower. These loans, commonly utilised by State-Owned Enterprises (SOEs), are mostly directed within business groups, causing the line between internal and external lending to become indistinct.

c) Banker's acceptances (BAs) are documents issued by banks that provide a guarantee of future payments within a specified period of time.[34] These instruments can be employed to increase the amount of loans beyond what is shown on a bank's financial statement, however labelling all BAs as shadow banking exaggerates its scope.

d) Interbank entrusted loan payments refer to a situation when one bank lends money to a client of another bank, on behalf of the latter, and transfers both the main amount and the interest when the loan matures.

e) Microfinance institutions specialise in providing small-scale loans, primarily in rural areas, with the aim of enhancing credit availability for persons residing in these locations.

f) Financial leasing refers to the practise of leasing assets that are not included in a bank or trust company's financial statement for extended periods of time. Recently, there has been a boom in the establishment of e-commerce

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[33] Kerry Liu, 'Chinese Financial Holding Companies: A Review' (2021) 54 Chinese Economy 217, 231 http://hdl.handle.net/10.1080/10971475.2020.1848469 accessed 17 October 2024.

[34] A Gozlan, 'BA's: The Practice and Law of Bankers' Acceptance' (Master's thesis, Université de Montréal 2007) https://umontreal.scholaris.ca/items/a13fdf66-9a6a-4224-aa8f-360c597558d2 accessed 17 October 2024.

finance firms, specifically aimed at providing financial services to Small and Medium Enterprises (SMEs) associated with e-commerce platforms.

g) Guarantee companies enable shadow banking by offering financial guarantees, transferring credit risk to these corporations, and lowering capital requirements for participating banks. Certain guarantee firms may offer unlicensed direct loans.

h) Pawn shops and informal lenders serve as key financial resources for specific households and small businesses. Nevertheless, accurately assessing their impact on shadow banking is difficult due to the scarcity of available data.

i) Trust Beneficiary Rights (TBRs) are financial instruments that enable purchasers to obtain profits earned by a trust. These instruments are commonly utilised by banks to retain the economic advantages of loans without including them in their financial statements, therefore affecting their capital needs.

j) Wealth Management Products (WMPs) monitor broad portfolios and have developed to incorporate a modest equity allocation. While subject to some limitations, securities firms and asset managers provide alternative options that have less restrictions, making them attractive to investors who are looking for higher returns. Although not explicitly classified as shadow banking, activities in the interbank market exhibit similarities with wealth management products (WMPs) and enable transactions such as TBR acquisitions.

Although it has declined, shadow banking remains a prominent presence in China's financial sector.[35] Trust loans, wealth management products (WMPs), and emergent sectors such as e-commerce financing continue to

[35] J Gruin and P Knaack, 'Not Just Another Shadow Bank: Chinese Authoritarian Capitalism and the "Developmental" Promise of Digital Financial Innovation' (2019) 25 New Political Economy 370, 370–387.

exist but are now subject to more stringent rules. In order to deal with economic uncertainties and regulatory concerns, it is essential to have ongoing monitoring and efficient policy management. This is necessary to reduce possible risks related to shadow banking and guarantee the long-term stability of the financial system.

VII. CASE STUDY OF ZHONGZHI ENTERPRISE GROUP (ZEG)

The recent disclosure made by Zhongzhi Enterprise Group (ZEG) regarding its severe insolvency and inability to repay outstanding debts in China's shadow banking industry has highlighted a significant sociological intersection involving financial institutions, market dynamics, and socioeconomic repercussions. In China's dynamic financial climate, this recent occurrence highlights the delicate interplay between economic systems, institutional fragility, and the inherent complexities of asset management. ZEG's financial upheaval has far-reaching implications. It not only implies a crisis in the shadow banking industry, but it also emphasizes the impact on investor confidence, consumer mood, and the socioeconomic disparity among wealth management professionals. This situation displays a complicated social picture in which systemic weaknesses coexist with corporate malfeasance, market demands, and societal confidence in financial products. This sociological study investigates the relationship between economic systems, institutional behavior, and the societal implications. It offers an analytical perspective that may be utilised to understand the intricate network of relationships that are creating the present financial ecosystems in China and the social consequences of these ecosystems. A prominent wealth management, non-banking financial institution (NBFC), firm in China has, in

recent past notified investors of its inability to fully repay its outstanding debts.[36]

A. Broader Implications of ZEG's Crisis on China's Shadow Banking & Economy

This development has rekindled concerns that the persistent downturn in the real estate market in China may be impacting the shadow banking industry, which is estimated to have a value of approximately $3 trillion. Zhongzhi Enterprise Group (ZEG) conveyed to its investors on Wednesday that it finds itself in a state of *"severe insolvency,"* as reported by a state-owned news outlet in China.[37] The article alluded to a correspondence originating from the shadow bank, which was likewise made publicly available by the shadow bank itself. Reuters has verified that it has indeed examined the letter, which bears a striking resemblance to the report in question. CNN finds itself unable to verify the authenticity of the letter's contents, while ZEG has not provided a response to the inquiry for comment. The letter remains unverified by CNN. In the correspondence, the organisation, situated in Beijing and deeply engaged in the struggling Chinese real estate domain, characterised its liabilities as "significantly massive." The total asset value stands at 200 billion yuan, while projections suggest that total liabilities could ascend to 460 billion yuan, a figure that parallels approximately $65 billion. ZEG has conveyed that the process of collection presents significant challenges, with the anticipated recoverable amount being negligible, cash reserves having been exhausted, and the extent of asset impairment being considerable. The rationale behind

[36] D Madhok and J Liu, 'Chinese Shadow Bank Says It Has "Huge" Debt and Can't Pay Its Bills' CNN (23 November 2023) https://edition.cnn.com/2023/11/23/business/zhongzhi-enterprise-group-china-insolvent-hnk-intl/index.html accessed 17 October 2024.

[37] Huang Yujie, 'Zhongzhi Group Issued a Letter of Apology to Investors, and the Principal and Interest of Related Liabilities Were as High as 460 Billion Yuan' *Lanjinger* (22 November 2023) https://www.lanjinger.com/d/223047 accessed 17 October 2024.

this lies in the fact that the assets of the group are predominantly concentrated on debt and equity investments, which exhibit a notable duration.[38] The corporation is a prominent private conglomerate in China, with extensive activities in the mining, financial services, and electric car sectors. Initial worries regarding its financial condition were raised in August, when a trust in which it holds some ownership disclosed its failure to fulfil obligations to corporate investors. China boasts a vast number of wealth management institutions that provide investors relatively substantial returns. Zhongrong International Trust is among these companies, and as of the conclusion of 2022, it has overseen assets valued at $87 billion for corporate clients and affluent people. Analysts' estimations indicate that the trust industry, commonly referred to as the "shadow banking" sector, has a value of $2.9 trillion, surpassing the size of France's economy.[39] In essence, shadow banks serve to provide funding through mechanisms that remain unrecorded on the balance sheet or via non-bank financial entities like trust companies. China's economy is currently facing a prolonged real estate crisis, prompting concerns about its future. The "shadow banking" sector, a substantial and covert component of China's financial system, has attracted attention due to these issues. Analysts indicate that individuals from the middle and higher middle classes often constitute the majority of investors in wealth management products in China. The occurrence of late payments could potentially undermine consumer confidence, leading to defaults and worries. In the letter addressed to investors on Wednesday, ZEG expressed remorse for the financial challenges it has encountered. The corporation has recognised its

[38] Laura He and Mengchen Zhang, 'China's "Lehman Moment?" Big Investment Firm Misses Payments' CNN Business (18 August 2023) https://edition.cnn.com/2023/08/18/economy/china-zhongrong-trust-protest-intl-hnk/index.html accessed 17 October 2024.
[39] ibid.

persistent challenges with what it deems “ineffective” internal management, a situation that has endured since the passing of its founder in 2021, further exacerbated by the subsequent departures of senior executives.

VIII. CONTRASTING REGULATORY APPROACHES

The regulatory frameworks governing shadow banking in India and China are interesting examples that provide important insights into the sophisticated tactics taken by these economic powerhouses. Both nations are dealing with the intricate and hazardous nature of shadow banking. However, when comparing their regulatory solutions, it becomes clear that there are significant differences and some underlying parallels. The shadow banking sector in India is characterized by its diversity, consisting of several non-banking financial institutions such as NBFCs, NBFC-Ds, and NBFC-ND-SIs. The variety of options available in this sector demonstrates its progression in order to address the complex and diverse developmental requirements of the nation. China’s regulatory approach, in contrast, demonstrates a stricter and more formalized framework aimed at reducing the risks related to liquidity, leverage, and regulatory arbitrage. The differences in the structure and level of regulation of shadow banking companies create an opportunity for a revealing comparison. India’s regulatory evolution is characterized by a dynamic tale in which prudential regulation is carefully balanced against the demand for financial inclusion. The Reserve Bank of India’s response to the Shah Committee report in 1997 exemplifies this delicate and smart approach. Non-Banking Financial Companies - Deposit taking (NBFC-Ds) encountered rigorous regulation, but the other companies functioned under a somewhat less strict regulatory framework. In contrast, China has adopted comprehensive regulatory measures, including policy reforms that highlight a commitment to resilience in response to systemic concerns about shadow banking. The discrepancy in

regulatory evolution emphasizes the diverse philosophies that govern these states.

The comparison primarily focuses on the different strategies employed in risk management. The shadow banking sector in India, which consists of many entities, as challenges related to pro-cyclicality and liquidity issues during periods of economic growth. The regulatory response has been carefully adjusted, in accordance with the changing environment. China's focus on strict liquidity requirements and capital adequacy ratios, along with a ban on specific financial instruments such as CDOs and CDS, demonstrates a proactive strategy to manage and limit risks. The comparison illuminates the distinct risk reduction techniques implemented by the two governments. The proactive government intervention in China is notably different from the measured approach taken by India. The Chinese government's role goes beyond mere inspection, as it also includes implementing significant regulatory changes aimed at strengthening risk management and governance. The rigorous limitations on financial operations and foreign control emphasize a strong commitment to prevent any dangers linked to shadow banking. As deeply strategic and multifaceted measure involving as much as an interventionist role by government, it contrasts hugely with what was more measured and adaptive regulatory framework in pursuit of autonomous growth and higher standards of living in India. Beyond supervision, Chinese government policies are comprehensively reformative, designed to counteract systematic risk and guaranteeing the financial sector's long-term stability. Controlling liquidity through strict 'requirements on liquidity', high capital adequacy ratios and outright barring high risk financial instruments such as Collateralized Debt Obligations (CDOs) and Credit Default Swaps (CDS) is a key part of China's approach. This proactive approach represents the effort to preventively deal with vulnerabilities of the shadow banking sector instead of

responding to the crises. The Chinese government's active role in planning macroeconomy is a case of a double-edged sword. On the one hand, leading and controlling from the top down facilitates rapid and hard implementation of regulatory changes which limits the risks. It has shown flexibility, for instance, by making some of its provisions less stringent, including requirements for high loan losses, in line with international standards and encouraging conventional lending while easing tight budget constraints. Yet, this calculated compromise is of course, a delicate balancing act between keeping the option to control, and assigning it to the marketplace while keeping it within clearly defined limits. In addition, China's approach to liberalization of interest rate and currency is cautious but intentional. Market based interest rates and more flexible exchange rate are considered to be instruments to control systemic risks because market correction can be dynamically adjusted rather than reactive government interventions. Progress in this area has been slow due to the conservative position of the People's Bank of China (PBC), yet these incremental reforms signal a vision for modernizing financial systems that is of prolonged term, but not at the expense of economic stability.[40] On the other hand, India's regulatory changes seem to be more responsive, as they are adjusted in response to new difficulties rather than proactively changing the regulatory framework. At the government intervention side, both proactive and preventive measures taken in China are comprehensive and multifaceted, compared to the measured and adaptive strategies we have encountered in India. Comparing India's largely reactive regulatory adjustments to China's extensive, and leading reforms that go beyond oversight, including structural reforms focusing on strengthening risk

[40] Megan Lindgren, *Regulating the Shadow Banking System in China* (University of Chicago International Immersion Program Papers 2018) https://chicagounbound.uchicago.edu/international_immersion_program_papers/78 accessed 1 April 2025.

management and governance, thus regulation in China is proactive. The interventions are distinguished by extremely disciplined constraints on financial activities like stringent liquidity requirements, capital adequacy rules and equally active prohibition of very high-risk financial instruments (CDO and CDS). China's indication of the need to restrict foreign over control of its financial institutions reflects its emphasis on ensuring systemic stability and insulating it against the risks of shadow banking. The way the Chinese government has approached this issue, in deliberate and strategic terms, is very much in contrast to the way in which India often responds—in a more reactive fashion—to problems that have emerged.

In the end, the analysis of shadow banking regulations reveals the divergent strategies that China and India have adopted. India's strategy is distinguished by the way it successfully manages risks while giving careful consideration to a number of variables, including diversity and financial inclusion. This contrasts sharply with China's stringent and proactive regulatory strategy, which tries to get rid of potential threats before they happen.[41] The comparative study gives a complete review of existing regulatory frameworks while also demonstrating the evolving dynamics of shadow banking in two major Asian economies. Understanding these minor variations is critical for policymakers, financial institutions, and academics seeking to navigate the complicated world of shadow banking in diverse economic circumstances.

[41] Financial Stability and Development Committee, *Opinions on Promoting the Healthy Development of the Financial Market* (2018).