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HD **Shadow banks in the spotlight**

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A financial crisis occurs when people think something – Greek government bonds, US mortgage-backed securities, Cypriot bank deposits – is safe and are wrong. This means there are two ways governments can try to prevent crises: they can guarantee the nominal value of every asset believed to be "safe", or they can try to set investors straight.

The **Chinese** government has traditionally preferred option one, going to great lengths to prevent companies and lenders from failing, even if it means expropriating resources. Now it may be experimenting with option two.

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Bloomberg News reports that the Industrial and **Commercial** Bank of **China** may not protect investors from losses on "Credit Equals Gold No.1," a "trust product" it **sold** them that ended up financing an insolvent coalmining **company**. This would be the first default on this type of high-yield asset. How would the **Chinese** financial system handle the experience?

Until recently, the only way for **Chinese** households to protect their savings from confiscation by negative interest rates was to **buy property** (hence all the empty **apartment** buildings) or involve themselves with quasi-legal lenders that occupy a space somewhere between loan sharks and pawnbrokers. Innovation avoids rules In the US, punitively low interest-rate ceilings on deposits during the great inflation of the 1970s were circumvented by the new money-market mutual funds, which offered many of the benefits of traditional bank accounts but were allowed to pay fair market yields.Now **Chinese** financiers have invented a variety of "wealth management products," the core of **China**'s $US6 trillion ($6.8 trillion) shadow-banking system. These instruments are often marketed and distributed to individual savers by the big state-owned banks as alternatives to savings accounts. It's unclear what is supposed to happen if the borrowers financed by WMPs can't repay the original investors.Many people who **buy** these instruments are under the impression that the government stands behind them. Past defaults on WMPs have led to protests by angry savers. They eventually got all their money back after the government stepped in, which is good if you want to keep your citizens happy, but isn't a great way to convince people that these products are distinctly riskier than bank deposits.Tougher line

Bloomberg

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