

THE REGULATION OF PRIVATE LENDING IN CHINA

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The candidate confirms that the work submitted is his own and that appropriate credit has been given where reference has been made to the work of others.

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Abstract

This thesis mainly explores legal and regulatory issues regarding the private lending market in China, which is a vital element of the country's shadow banking system and used by millions of private businesses as an alternative financing channel. Over the past four decades, China said goodbye to the old centrally planned economy and embraced Adam Smith's free market ideology. It has witnessed the rapid growth of private capitalism as local entrepreneurs started their business ventures to pursue personal wealth. In contrast to the well-known story of China's economic achievements, how Chinese businesses are being financed remains a secret. In fact, most entrepreneurs have been facing severe financing difficulties, for the state-dominated banks often refuse to lend to the private sector. Therefore, they can only rely on private financing to borrow money, giving rise to a massive private lending market running outside of the official regulatory regime. In recent years, the shadow banking system has encountered a series of credit crises when numerous borrowers failed to repay high-cost private debts as a result of the slowdown of Chinese economy. It caused investors heavy financial losses and led to a large number of corporate bankruptcy cases. Many bosses chose to abandon their companies and run away to evade debts.

Against this background, this thesis is a timely work to investigate China's shadow banking system and answers the following questions: First, how the private lending market has evolved into a major form of alternative finance for private businesses; Second, what factors contributed to the private lending crisis, what impacts the crisis had on relevant stakeholders, and what problems were exposed during the crisis; Third, whether the current legal framework is effective and efficient in regulating private lending activities, and if not, what can be improved; Fourth, to what extent China's experimental financial reforms can solve the private financing puzzle; Fifth, whether British SMEs also face the similar financing dilemma as their Chinese counterparts do, and what alternative financing methods are available in the UK. After answering these questions, the thesis provides recommendations for China's policy-makers, in terms of how to regulate private loans and creating more financing resources for private entrepreneurs.

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List of Abbreviations

CBRC	China Banking Regulatory Commission
CNY	Chinese Yuan or Reminbi (人民币)
CPC	Communist Party of China
CSRC	China Securities Regulatory Commission
DIS	Deposit Insurance Scheme
EU	European Union
FCA	Financial Conduct Authority
FSA	Financial Services Authority
GBP	Great Britain Pound
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IPO	Initial Public Offering
NPC	National People's Congress
P2P Lending	Peer-To-Peer Lending
PBOC	People's Bank of China
PRA	Prudential Regulatory Authority
PRC	People's Republic of China
SEZ	Special Economic Zone
SME	Small and Medium-Sized Enterprises
SOE	State-Owned Enterprises
SPC	Supreme People's Court (China)
UK	United Kingdom
US	United States
USD	United States Dollar ¹
WPFI	Wenzhou Private Financing Index
WPFRR	Wenzhou Private Financing Regulation

¹ For the convenience of international readers, the Chinese currency (yuan or CNY) in this article is accompanied by a conversion into US Dollars. The exchange rate between Chinese yuan and US dollar is 6.87:1, on 28 February 2017.

Chapter 1 Introduction

1.1 Research Background

In the late 1970s, China started to launch a series of market-oriented economic reforms guided by the *reform and open-up* policy (改革开放), and gradually abandoned the planned economy model that had been implemented in the previous three decades.¹ It brought back the market discipline and established the *socialist market economy* (社会主义市场经济) where the private sector plays a larger role in the allocation of resources and economic production.² As the state slowly gave way to the market over the past few decades, China has seen the rapid growth of private capitalism as entrepreneurs started to run businesses and pursue personal wealth, leading to the fast expansion of the private sector as well as the overall economic size. From 1978 to 2012, the Chinese economy experienced a average of 9.8 per cent annual growth in its GDP.³ In 2010, it surpassed Japan as the second largest economy in the world.⁴

Apparently, the economic advancement in China can be largely attributed to the reviving private sector. It is formed by ten million privately-owned businesses which accounted for approximately 60 per cent of China's GDP in 2012.⁵ They contribute significantly to the economy by producing a variety of products and services for the general public, creating job opportunities in cities and rural areas, as well as paying considerable taxes to the state. It should be noted that the majority of private enterprises are SMEs, as they take up 99 per cent of the total number of firms in China.⁶ Clearly, the economic development has created a large amount of private wealth. According to the latest rich list, China had 594 billionaires (in USD) in 2016,

¹ The economic reform was initiated by Deng Xiaoping in the meetings of China's Communist Party at the end of 1978, who has been viewed as the architect of China's reform. For more information on China's economic reform, see Linda Yueh, *China's Growth: The Making of an Economic Superpower* (Oxford University Press 2013), p.19.

² *The Economist*, "China's Reforms: The Second Long March" (11 December 2008), p.30.

³ Jianhong Zhu, "35 Years, Chinese Economy Keep Rising" *People's Daily* (21 November 2013), p.4.

⁴ Mure Dickie and Jonathan Soble, "China Displaces Japan as Second Biggest Economy" *Financial Times* (15 February 2011), p.9.

⁵ *People*, "Private Economy Accounted for over 60% of GDP, Registered Private Enterprises Exceeds 10 Millions" (3 February 2013), available at <http://finance.people.com.cn/n/2013/0203/c1004-20414645.html>, accessed 1 January 2017.

⁶ Yijiang Wang, "The Reason to Save SMEs at First" (*Business Review*, February 2009), p.40.

outnumbering the US which had 535 billionaires.⁷ Moreover, some of China's private businesses have become global leaders in their respective fields, such as Lenovo, Huawei, Tencent, Alibaba, Baidu, and Wanda.

Behind the success story of Chinese economy, the author attempts to reveal the secret of financing difficulties faced by millions of Chinese entrepreneurs, which is rarely known to readers in the West. The limited financing resources have always been a main obstacle impeding the growth of Chinese businesses, especially SMEs.⁸ This resulted from the state monopoly in China's financial industry. Despite the proliferation of private capitalism in the country, the state monopoly still prevails in a number of industries of strategic importance, such as the banking, telecommunication, petroleum, and railway. In terms of the banking sector, most Chinese lenders have strong government backgrounds and are thus heavily influenced by the official lending policies.⁹ As a result, state lenders have a strong preference in making loans to other state-run companies or local government infrastructure projects. When it comes to private businesses, Chinese banks favour large-scale private companies which are considered as more secure as they are more likely to provide adequate collaterals and guarantees. Conversely, small and medium-sized enterprises have little chance of borrowing bank credits. In 2015, SMEs in China accounted for 60 per cent of the GDP, 50 per cent of tax revenue, and 80 per cent of urban employment.¹⁰ However, it is difficult for SMEs to pass the strict credit test and obtain a bank loan, as the loan reject rate is 72 per cent for businesses with fewer than 500 employees.¹¹

As a result, there is a huge conflict between the rising private economy and the inadequate credit amount. It can be seen as one of fundamental challenges in the Chinese economy. Accordingly, Chinese entrepreneurs in need of money are forced to

⁷ *BBC News*, "China Tops US in Numbers of Billionaires" (13 October 2016), available at <http://www.bbc.co.uk/news/business-37640156>, accessed 1 January 2017.

⁸ Emma Dong and Simon Rabinovitch, "China's Lending Laboratory", *Financial Times* (23 May 2012), p.11.

⁹ Violaine Cousin, *Banking in China* (2nd ed. Palgrave MacMillan 2011), p.56.

¹⁰ Lucy Hornby and Gabriel Wildau, "Beijing Tries to Extend Credit Lines in the Countryside" *Financial Times* (07 Aug 2015), p.2.

¹¹ Ye Huang, "What Is the Cause for SME Financing Difficulty?" *People* (25 August 2014), available at <http://finance.people.com.cn/bank/n/2014/0825/c202331-25528320.html>, accessed 1 January 2016.

look for alternative finance outside the banking sector. Meanwhile, the Chinese population have accumulated a significant amount of private wealth in the economic boom, and are seeking a way to increase the return on their savings.¹² The abundant private capitals in the society, thus, supply sufficient funds to the private lending market and contribute to its prosperity. As a result, private businesses have been reliant on private lending as an alternative form of finance. Private lending means lending and borrowing activities that happen outside the realms of the state banking system and is therefore mostly unregulated. According to one estimate, the size of informal lending market in China amounted to CNY 4 trillion (USD 582 billion), or 8 per cent of the official lending in the country.¹³

Private financing has evolved into a massive and complicated market, which is a unique product of China's special political and economic environments in the reform era. Nonetheless, there is a contradiction between the thriving private lending market and insufficient regulation. In the past, the government turned a blind eye to underground financing, as most market participants benefited to some degree from shadow banking.¹⁴ However, the advent of the global financial crisis and the slowing down of Chinese economy led to a different situation.¹⁵ It triggered a so-called "private lending crisis" across the country in 2011, as many private businesses, particularly manufacturers and exporters, fell into insolvency due to the fierce competition and the decline in sales.¹⁶ As a consequence, numerous entrepreneurs could not pay off private debts, and chose to hide, run away, or even commit suicide. The rising defaults in the

¹² In 2014, the total investable assets held by Chinese individuals reached 112 trillion yuan, with an annual growth rate of 16 per cent between 2012 and 2014. See China Merchants Bank and Bain & Company, "2015 China Private Wealth Report", p.5, available at <http://images.cmbchina.com/cmbcms/201506/b7ee1bf8-47fa-4ba7-ba99-7545a62f6ca1.pdf>, accessed 1 January 2017.

¹³ Rahul Jacob, Ping Zhou and Simon Rabinovitch, "Chinese SMEs Rely on Shadow Financing" *Financial Times* (19 Oct 2011), p.2.

¹⁴ While private entrepreneurs, through private lending, obtain sufficient credits to grow their businesses, investors who put their money into the market earn good returns which are much higher than that of bank savings and other average investments.

¹⁵ After 2008, affected by the global financial growth, China's economic growth has gradually slowed down, from double-digit growth rate to the current 6-7 per cent level. Most recently, the year-on-year GDP growth rate was 6.7 per cent. See Tom Mitchell and Yuan Yang, "China's Growth Adds to Fears on Debt Levels" *Financial Times* (20 Oct 2016), p.4.

¹⁶ Julie Ball, "China Set to Reform Illicit Private Finance Market" *BBC News* (20 April 2012), available at <http://www.bbc.co.uk/news/business-17746171>, accessed 1 January 2017.

private lending market made thousands of investors, whether professional moneylenders or ordinary households, suffer substantial financial losses. What made things worse was that many investors had borrowed money from their relatives, friends, and business partners, in order to use the leverage to increase the return of investments. Therefore, when borrowers failed to repay, the whole private lending market collapsed like a domino, leading to a severe financial crisis which undermined the financial and social stability. *People*, the official media in China, even called it the “Chinese-style subprime crisis”.¹⁷

In response to lending crunches, the Chinese authority, through a series of financial reforms, has been exploring effective methods to regulate the shadow banking system as well as how to increase the credit supply for private businesses. In 2012, the State Council set up a pilot reform zone in Wenzhou city, China’s entrepreneurship hub, in order to test a regulatory system for private financing. The reform also encourages qualified private investors to establish banks or new-type financial institutions, such as rural banks or small-loan companies, to improve SMEs’ access to finance.¹⁸ Currently, the Chinese economy has entered into a new phase of development, which is called *New Normal* (新常态) featured by a slower growth rate and the change of growth engine from manufacturing and construction sectors towards services and innovation.¹⁹ It is necessary to have a multi-level financing system comprising banking, the securities market, and private financing to support the sustainable growth of Chinese businesses and foster entrepreneurship. Moreover, the regulation of private lending echoes China’s recent “supply-side reform” (供给侧改革) that aims to let the market produce products and services that the society really needs.²⁰ Evidently, the financial industry is supposed to provide sufficient credits for businesses needing funds. Therefore, it is high time for China to find an effective way to legalise, regulate, and supervise private lending activities. The new regulatory framework shall try to

¹⁷ Simon Rabinovitch, “Lending Loses Its Lustre for China’s Rich” *Financial Times* (5 October 2011), p.22.

¹⁸ PRC State Council, “The Overall Scheme of Financial Reform Pilot Zone in Wenzhou, Zhejiang Province” (2012)

¹⁹ Martin Wolf, “China’s Struggle for A New Normal” *Financial Times* (23 Mar 2016), p.13.

²⁰ Tom Mitchell, “Beijing Struggles to Meet Needs of Middle-Class Consumers” *Financial Times* (20 Jan 2016), p.7.

control financial risks associated with the rampant underground lending practices, whilst boosts the financial availability for private enterprises.

1.2 The Scope of This Research

A. Private Lending in China's Context

The financial industry can be broadly divided into the banking sector, the securities market, and the insurance sector. However, outside mainstream financial intermediaries and activities, there exists a hidden world of informal finance which is underexplored by academics.²¹ Private lending, in this thesis, belongs to the informal financial sector in China. It should be noted that the research concentrates on private lending as an alternative form of business finance, rather than ordinary small-sum moneylending activities among our relatives, friends, colleagues, and acquaintances, which widely exist in most countries for thousands of years.²² From this perspective, individuals or corporates borrow private loans for the purpose of business operation, whilst moneylenders and investors lent out their money in exchange for interests as the financial return. Borrowers of private loans, in most cases, are Chinese entrepreneurs and their businesses, and lenders can be anyone who has spare savings or capitals and intends to invest. Despite the popularity, private financing lacks a clear legal status and proper regulation.

B. Regulation

The term “regulation” in this research is broadly conceived.²³ It roughly equals the official control over private lending activities, which includes not only the creation and formulation of policies, legislations, and other quasi-legal tools, but also the dynamic process of monitoring and supervision carried out by some official authorities.

²¹ Informal finance also contains a wide range of financial activities and markets, and for instance, lines of credit with supply chain networks, pawnshops, sharecropping, land pawning, and private lending. See Sarah Hsu, “Introduction” in by Jianjun Li and Sara Hsu (edited), *Informal Finance in China: American and Chinese Perspectives* (OUP 2009), p.5.

²² Ordinary lending activities for non-business purpose are subject to China's contract law and other legislations.

²³ Regulation is a word of ambiguity and can be understood in different ways, from the narrow definition like the making and implementation of rules by a certain authority, to any social and economic influence exerted by the state on people's behaviours. See Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation: Theory, Strategy, and Practice* (2nd Edition, Oxford 2012), p.3.

There are two points worth mentioning. Firstly, although some discussions about business insolvency will be inevitable when it comes to the private lending crisis, this research does not plan to conduct a full analysis of China's insolvency law.²⁴ Secondly, this thesis focuses on the practical side of regulation, rather than the theoretical perspective. Nonetheless, some important financial regulation theories like *public interest theory* will be mentioned in the work where it is necessary.

1.3 Research Aim and Questions

The main objective of this research is to explore a legal framework for legalising, regulating, and supervising the private lending market in China, to make it better serve the financing needs of private businesses. In order to achieve this goal, the thesis will answer the following research questions:

A. To conduct an inquiry into the nature, causes, and characteristics of private lending activities in China.

- What is the definition of private lending and its main characteristics?
- What similarities and differences can be found between private lending and other comparable concepts, such as informal finance, shadow banking, and peer-to-peer lending?
- How has private financing become an important financing method for private businesses in China in the era of *reform and open-up*?

B. To investigate the financial crisis in China's underground lending market.

- What caused the private lending crisis in 2011?
- What impacts did the crisis have on relevant stakeholders, including investors, borrowers, and the wider economy?
- What are the economic problems that need to be solved by regulatory reform?

C. To evaluate the current legal framework of private lending in China, to find out

²⁴ China's has established a comprehensive bankruptcy system for its business organisations, including three sets of insolvency proceedings: liquidation, reorganisation and reconciliation, through the implementation of PRC Enterprise Bankruptcy Law 2007. However, it does not have personal insolvency law at the moment, which results in a lot of problems in the practice and will be analysed later.

how it works, what deficiencies it has, and how to better improve it.

- What constitutes the current legal framework of private lending in China?
- It is effective and sufficient enough to deal with private lending-related issues? Any drawbacks?
- What is the role played by China's judicial authorities in the regulation of private lending?

D. To discover the most appropriate method of legalising and regulating China's private lending market, so that it is able to assist in the development of small and medium-sized enterprises.

- How does China's ongoing financial reform respond to the private lending crisis?
- To what extent can the pilot regime regulate private financing in an effective and efficient way?
- To what extent can the financial liberalisation in China alleviate the financing dilemma of private businesses? Is it able to break the monopoly of state lenders and build a fairer and more efficient financial system?
- What is the financing situation of SMEs in the UK?
- What alternative forms of finance are available for UK businesses?
- How are these non-bank lending practices regulated in the UK?

1.4 Research Methodologies

Financial law is inherently an interdisciplinary area of study. Therefore, this research contains discussions and analyses from both law and finance perspectives, as it conducts a thorough examination about how the private lending market works, as well as how it is being regulated by law. The study is carried out in a library-based manner, by collecting, assessing, and synthesising the existing literature, including but not limited to sources like journal articles, textbooks, newspapers, magazines, policies, statutes, regulatory rules, and other research reports. Considering the limited availability of the literature in this field, the researcher tries his best to explore all possible materials, and to present them in an orderly fashion.

Moreover, this research intends to employ the doctrinal method to evaluate the existing policies, laws, and regulations in China as regard to private lending. Doctrinal research lies at the centre of the work of any lawyers, as it is the process to identify and scrutinise the contents of law.²⁵ Through the analyses of current legislations and regulatory rules, the researcher attempts to examine whether the legal framework is adequate and effective to tackle private financing-related problems. In addition, it tries to find out, to what extent, the law is able to tell the difference between legitimate private financing activities and illegal (or criminal) lending practices. It also contains doctrinal analyses of the latest regulations made by China's pilot financial reform, as well as British laws and regulations in terms of SME lending. Apart from doctrinal legal research, the researcher also considers some economic theories, such as the supply and demand theory and financial regulatory theories.

Moreover, some historical and comparative analyses can be found in this research. For instance, it reviews the Chinese history relating to lending and banking, which is necessary to explain where current private lending activities come from. Furthermore, there is an entire chapter dedicated to the assessment of SME lending in the UK, which adds a comparative perspective to this study. This study includes the UK into its discussions because Britain has a thriving private sector consisting of 5.2 million businesses, and 99.9 per cent of them are SMEs.²⁶ Besides, the UK has seen a variety of alternative forms of finance for SMEs, like digital focused challenger banks and online peer-to-peer business lending. Therefore, analysing the UK's SME lending situation can offer some potential solutions to China's SME financing puzzle. However, it is worth-noting that this is not a strict comparative legal research, since the UK does not have a private lending market comparable to that of China, for the popularity of Chinese private financing activities originate from the country's unique social context.

²⁵ Terry Hutchinson, "Doctrinal Research" in Dawn Watkins and Mandy Burton (edited), *Research Methods in Law* (Routledge 2013), p.9.

²⁶ Department for Business, Innovation and Skills (BIS), "Business Population Estimates 2014", p.4. The BIS was replaced by the Department for Business, Energy & Industrial Strategy (BEIS) in July 2016.

1.5 Originality of This Research

The recent decade has seen an increasing number of academic works in terms of financial regulation in China, most of which focus on its banking sector and securities market.²⁷ When it comes to China's informal finance sector, only limited research can be found, and most works in this area are pieces of economic analyses.²⁸ Therefore, the legal and regulatory aspects of private lending have been largely underexplored. Clearly, this research aims to fill this gap in the existing literature. It is the first work to probe into China's shadow banking crisis, and to comprehensively study the legal issues and regulatory practices relating to private financing. Therefore, its originality and significance is self-evident. Furthermore, private lending is considered as an important component of China's shadow banking system. Thus, this research engages in the heated global discussion about shadow banking and its regulation.

The study also has some practical implications. Nowadays in China, as the financial industry is developing at an unprecedented speed and the private lending market has been in constant crises, the Chinese regulatory system is facing multiple challenges and expects to undergo massive transformations. Evidently, the reform of financial industry and its regulatory framework needs firm theoretical supports, so this research can benefit China's financial reform by providing valuable suggestions for the policy-makers. Last but not least, an understanding of the private lending market is essential for legal practitioners whose clients have business presence in China.

1.6 Main Difficulty of This Research

This research faces some challenges, and the biggest one is the lack of official data that the researcher can refer to. Despite the prevalence of private financing activities, there is no official monitoring over this market. Moreover, the study of China's shadow

²⁷ For example, in terms of China's banking regulation, see Violaine Cousin, *Banking in China* (2nd Edn. Palgrave Macmillan 2011); As for its securities market regulation, see Robin Huang, *Securities and Capital Markets Law in China* (Oxford University Press 2014), and Jing Bian, *China's Securities Market: Towards Efficient Regulation* (Routledge 2016).

²⁸ Professor Xuzhao Jiang was the first economist to research informal finance in China, and published the book, *The Research of Informal Finance in China* (Shandong People's Publishing House 1996). Most recently, the Oxford University Press published a selection of works titled *Informal Finance in China: American and Chinese Perspectives* (OUP 2009), edited by Jianjun Li and Sara Hsu. Despite its wide coverage on this topic, there exists limited discussion regarding legal and regulatory issues of private lending.

banking has been a relatively new subject, so the existing literature is limited. Nonetheless, the lack of data and literature can also demonstrate the originality of this work. To address this problem, the researcher endeavours to exhaust all possible sources of information in this area, such as news reports from China's official media like *Xinhua* (新华网), *People's Daily* (人民日报) and *Global Times* (环球时报), as well as articles in well-known English financial newspapers and magazines like *Financial Times*, *Wall Street Journal*, and *The Economist*. The researcher guarantees that all materials used in this thesis are authentic, reliable, and complete.

1.7 Why I Wish to Explore This Subject?

Here I will briefly explain what inspires me to conduct this research. I come from Xiamen, a commercial city located on China's southeast coastline. Xiamen, with a population of 3.5 million, has a well-developed economy and a prosperous private sector. In 2015, the city's GDP was CNY 346.6 billion (USD 50 billion), growing by 7.2 per cent from one year earlier.²⁹ In recent years, I have personally witnessed the private lending investment bubble in Xiamen and its burst in 2011. Private financing is a common way of obtaining credits for local businesses in Xiamen, and local residents are crazy about lending out their money to earn interests (the annual return rate usually stands over 20 per cent). Take my father as an example. As a practicing lawyer in China, he used to be suspicious of private lending investments due to their risky nature. However, when one of his friends kept asking him to join a lending scheme by promising a attractive return plus the personal guarantee, my father could not resist the temptation and agreed to invest a large amount of money.³⁰ Many of our friends and relatives also invested a lot in the market at that time.

After lending out the money, my father did enjoy good investment returns for one year, as interests worth 3 per cent of the principal was paid each month. However, when Xiamen faced the private lending crisis in 2011, the moneylender who looked after my father's money suddenly ceased to pay interests. My father started to realise that the

²⁹ Xiamen Statistics Bureau, "2015 Xiamen City Economy and Social Development Report", available at http://www.stats-xm.gov.cn/tjzl/tjgb/ndgb/201603/t20160322_28169.htm, accessed 1 January 2016.

³⁰ For two times, he transferred CNY 800,000 (USD 116,448) and CNY 300,000 (USD 43,668) respectively to the moneylender.

chance of getting back the principal was slim. He knew the moneylender also suffered heavy losses as a large number of its debtors defaulted. In the end, my father lost all of his money in the lending scheme. In Xiamen, there are thousands of investors like my father who experienced heavy financial losses during the crisis, and as a result, many of them tried to hire lawyers and file lawsuits against their debtors to claim back the money invested. Between 2010 and 2013, there were 17,548 private lending civil cases heard by Xiamen's courts, with a total amount of CNY 13.79 billion (USD 2 billion).³¹ Therefore, a lot of investors asked my father to be their attorney to launch the civil litigations, so he had very good businesses after the crisis. Ironically, my father, who was a victim of the private lending crisis, somehow benefited from the crisis as well.

What happened in Xiamen has triggered my interests in researching the private lending market. Besides, when I attended the university in Shanghai, I studied law as well as finance. Accordingly, I am especially interested in the interplay between law and finance. After that, I came to England and studied banking and finance law at postgraduate level at the University of Leeds. I was fascinated by the knowledge in this area, particularly the International Banking Law module taught by Professor Andrew Campbell. I wrote a master dissertation on the topic of deposit insurance. After the postgraduate education, I started to think about applying what I have learned in Shanghai and Leeds to solve China's private lending puzzle, which finally leads to this doctoral thesis.

1.8 A Summary of Chapter Outline

The remainder of this work consists of six chapters. Following this introductory chapter, the chapter two, titled "*Private Lending in China: Origin, Concept, and Characteristics*", elaborates the background knowledge of private lending, in order to provide an understanding about how the private lending market works in the Chinese context. As we know, private lending activities have developed under China's special economic and political environments, so any discussions would be incomplete without

³¹ Xiamen News, "Unveiling Four Largest Private Lending Cases in Xiamen, The Money Involved Is Over One Billion Yuan" (30 August 2014), available at http://news.xmnn.cn/a/xmxw/201408/t20140830_4030674.htm, accessed 1 January 2017.

assessing the country's social system. The chapter starts with a brief review of the history of lending and banking in China, followed by a detail explanation about how private lending has become a major form of finance for Chinese private businesses under the *socialist market economy*. Then, it tries to discuss the similarities and differences between private lending and other comparable concepts, including informal finance, shadow banking, and peer-to-peer lending. In the end, it summarises main characteristics of private lending practices. Clearly, the contents in this chapter lay a sound foundation for analyses in the rest parts of the thesis.

Chapter three, titled "*The Private Lending Crisis: Causes, Risks, and Effects*", attempts to investigate how the recent credit crisis has broken the win-win situation in the private lending market, with disastrous impacts on most market participants. It tries to expose risks and problems in the market. Firstly, it examines factors that led to the crisis, including the macroeconomic condition, overheated speculation, as well as the tightened credit policy. It reveals how high-cost private loans create a heavy debt burden for enterprises. Next, it continues to probe into the effects of the crisis on both lending and borrowing sides, by carrying out case studies of insolvent businesses, runaway bosses, fraudulent lending schemes, and investors who suffered massive financial losses. It hopes to uncover relevant financial risks and economic problems associated with underground lending.

The chapter four, titled "*The Legal Framework of Private Lending*", evaluates the existing legal framework of private lending in China, to see its effectiveness as well as deficiencies. The relevant policies, laws, and regulations as regards to private lending will be studied. At first, it briefly introduces China's legal system, and then moves on to examine the changing official attitudes towards private lending, which plays a vital role in determining the legitimacy of private financing activities and affects the policy-making process. After that, the chapter focuses on three areas of laws relating to private lending, including civil laws (mainly contract), criminal liabilities, and interest rate regulations. It also assesses how these laws are being enforced by China's judicial system, to find out whether the legal framework is sufficient and effective enough to cope with the thriving underground lending sector. Finally, it summarises the major problems and defects in the current legal system that need to be addressed in the future reform.

The chapter five, titled “*Solving The Private Lending Puzzle: Experimental Reform and Financial Liberalisation*”, explores solutions to China’s private lending puzzle. It begins with some analyses about the rationale for regulating private financing, by considering both regulatory theories and China’s practical needs. Next it studies the latest financial reform in Wenzhou, in particular, the experimental regulatory system based on loan registrations, as well as Wenzhou private financing interest index, to test their effectiveness and practicality. Moreover, the chapter probes into the process of financial liberalisation in China, featured by the opening up of banking sector to private investors. It examines, to what extent, the relevant reform measures can improve the financing conditions of private businesses.

The chapter six, titled “*SME Credit Financing in the UK: Practice and Regulation*”, investigates the financing situation of smaller businesses in the UK, as well as alternative forms of finance. Its objective is to provide a comparative view of how to address the financing difficulties faced by SMEs. It firstly points out the definition of SMEs in the British context, and their vital importance to the national economy. It continues to assess financing options for SMEs in the UK, including bank credits, to see whether British SMEs face a similar financing dilemma as their Chinese counterparts do. The remainder of this chapter presents and evaluates a number of alternative financing channels in the UK, including challenger banks, peer-to-peer lending, and consumer credits. Relevant laws and regulations are also scrutinised.

The chapter seven will be a chapter of conclusion which summarises the main findings of this thesis, and makes a final statement. It examines how the research questions have been answered throughout the work, and points out the contributions of this study. It also offers recommendations for the policy-makers in China. Finally, it states the limitations of this research, and recommends things to be done by future research.

Chapter 2 Private Lending in China: Origin, Concept, and Characteristics

2.1 Introduction

Private lending, one of the most primitive financing activities in the human history, has been regaining its popularity in modern China. In order to understand why Chinese entrepreneurs have been heavily reliant on credits from private lenders to fund their businesses, we have to explore the current economic system in China as well as the the country's history of finance, in which private financing activities have emerged and developed. Moreover, there are some concepts in the existing literature that also refer to non-bank financing activities and thus share similarities with the notion of private lending in this thesis, such as informal finance and shadow banking.¹ It is clear that the overlaps and differences among these concepts need to be clarified. In recent years, China has seen the rapid development of peer-to-peer lending (P2P lending) market, which is widely described as the “online version of private lending”.² Despite the close relationship between private lending and P2P lending, there is a distinction in terms of advertisement methods and geographical presences, which will be analysed.

The objective of this chapter is to introduce and analyse the background knowledge regarding the private lending market in China, including its conceptual definition, historical evolution, and main characteristics, which lays a sound foundation for the analyses in the following chapters. The second part provides a brief review of the history of lending and banking in China, from the ancient times to the year of 1978 when the Chinese authority decided to reform and open its economy. Then, the third part examines the revival and developments of private lending activities in contemporary China (1978 to present), with a particular focus on how the private lending market has become a major financing source for the rising private sector. After that, the parts four, five, and six investigate the similarities and differences between

¹ In the past, most credits in China's financial system came from the formal banking sector. However, now credits are available from a wide range of non-bank financiers, such as trusts, leasing companies, credit guarantee companies, and money market funds. All of these, together with private lending, constitute China's vast shadow banking sector. See *The Economist*, “Battling The Darkness: Shadow Banking in China” (10 May 2014), p.71.

² China now has the largest P2P lending sector in the world, with more than 3,000 active online lending platforms. See *The Economist*, “China's P2P Lending Boom: Taking Flight” (21 January 2016), p.69.

private lending and three other concepts: informal finance, shadow banking, and peer-to-peer lending, in order to help readers to have a better understanding about the specific definition of private lending. Finally, the part seven summarises major characteristics of private lending practices in China.

2.2 A Brief History of Lending in China

Finance plays a central role in the development of commodity economies.³ The current financial system in China, whether banking or private lending, can find their origins in the country's 5000 years of history. Therefore, the research on private lending shall start with a quick examination of the predecessors of modern Chinese lenders, and in this part, we are going to review China's lending history in three time periods: Firstly, lending in ancient and imperial China (Pre-1912); Secondly, financial modernisation in the period of Republic of China (1912-1949); Thirdly, lending and banking activities under the centrally planned economy in the early days of the People's Republic of China (1949-1978).

2.2.1 Credit, Lending, and Banking in Ancient and Imperial China (Pre-1912)

China has a prolonged history of civilisation, including its history of financing and lending. Private lending, as a simple practice of moneylending between individuals, can be traced back to the Western Zhou Dynasty (1046-771BC). At that time, the moneylending contracts were called *Fu Bie* (傅别), which was clearly documented in the book *Rites of Zhou* (周礼), a work on the official political and ritual systems of the Zhou dynasty.⁴ *Fu* means the written form of the contract, including the object of debt, as well as rights and obligations of the lender and the borrower. *Bie* means splitting the paper into two parts, which would be held by the lender and the borrower respectively. If two lending parties had any disputes regarding the contract, the official handling the case would make the judgement based on the contents written on two separate parts of *Fu Bie* provided by both parties. The existence of *Fu Bie* indicates that moneylending was a common practice in ancient China three thousand years ago, as the ruling class then already stipulated a standard form of lending contracts and its

³ Zhengping Chen, *A Brief History of Finance in China* (UK: Paths International 2014), p.1.

⁴ Huihui Wen, "Fubie and Zhiji: Two Major Forms of Contracts in the Pre-Qin Period", (2004) 12 *Shixue Yuekan (History Monthly)* 20, 20.

dispute resolution mechanism.

At the end of Eastern Zhou Dynasty (Warring States or 战国), *Qing Shi Huang* (秦始皇), the first emperor of China, united a number of separate kingdoms by force in 221 BC, marking the beginning of imperial China.⁵ After that, the agriculture-dominated Chinese economy enjoyed steady growth for a long time, under a politically stable environment. During the Han Dynasty (206BC-220AD), due to the rapid growth of the commodity economy, private lending activities and usuries were prevalent in the society, especially for businessmen.⁶ A lot of businessmen in need of capitals tried to borrow credits, whilst some rich individuals like landlords and government officials became moneylenders and earned interests on their loans. In response to the rising usuries, the imperial government of Han announced a piece of regulation for private lending, capping the interest rate at 20 per cent a year; lenders who charged interests above the limit would constitute a criminal offence, called *Qu Xi Guo Lv* (取息过律 which literally means charging interests over law).⁷ It was the first regulation of private lending in the Chinese history.

By the time of Tang Dynasty (618-907AD), the private lending market was already mature, as mortgage lending and pawn broking became popular.⁸ A variety of professional lending institutions were established at that time. For example, as the Buddhism was introduced to China and gain its popularity in Tang Dynasty, Buddhist monks often engaged in private lending business and Buddhist temples, serving as religious shrines and receiving a lot of donations from people, had an extra role as financial institutions which extended loans to individuals who wanted to borrow money.⁹ When the time came to Song Dynasty (960-1279 AD), *Jiao Zi* (交子), probably the oldest paper note in the world, was circulating in the Southwest Sichuan

⁵ Ray Huang, *China: A Macro History* (Routledge 1997), p.12.

⁶ Qin Hui, "The Classic Lending Relationship in Han Dynasty", *China Economic History Research* (1990) Vol.3, available at <http://www.hprc.org.cn/pdf/ZJSY199003011.pdf>, accessed 1 February 2017.

⁷ *Ibid.*

⁸ See Tonghua Luo, *The Research of Private Lending in Tang Dynasty* (Taiwan: Commercial Press 2005).

⁹ *Ibid.*, p.81.

region.¹⁰ Originally, *Jiao Zi* was designed as a certificate of deposit, since it was inconvenient for businessmen to carry heavy metals (like gold and silver) when they travelled. Therefore, they could deposit metal currencies at *Jiao Zi Pu* (交子铺 or Shop of *Jiao Zi*) in exchange for a paper certificate, and afterwards withdrew the same amount of medals from *Jiao Zi Pu*'s branches in the travel destination. Gradually, some merchants found it easy to make payments by *Jiao Zi* directly, instead of depositing and withdrawing medals frequently. As a result, *Jiao Zi* became a *de facto* currency in that region. It is clear that *Jiao Zi Pu* might be the earliest banking institution in China which took deposits, made loans, and issued notes.

In the Qing Dynasty (1644-1912 AD), the last imperial dynasty in the Chinese history, lending and banking businesses became more professional and institutionalised, as *Piao Hao* (票号) and *Qian Zhuang* (钱庄) emerged as initial forms of modern banking.¹¹ *Piao Hao* originated from North China's Shanxi Province, and it had functions similar to that of *Jiao Zi Pu*. Nevertheless, the system of *Piao Hao* was much more advanced as they collectively formed a national banking network, enabling merchants to transfer large amounts of silver money between towns and provinces. *Piao Hao* also issued cashable notes for businessmen and individuals, allowing people to deposit and withdraw money at any *Piaohao*'s branches across China. In contrast to *Piao Hao*, *Qian Zhuang*'s commercial banking businesses had limited geographical presence in South China. Following the Opium Wars in the middle of 19th century, some European banks in particular British banks entered into China to serve the booming trading businesses between two continents. It was the first time when modern Western banking was introduced to China. For example, the Hong Kong and Shanghai Banking Corporation, now the HSBC, was one of Western banks that began to offer trade financing services at that time.¹² The HSBC was founded in Hong Kong in 1865 and soon developed into the largest foreign lender in China. During the late 19th century, foreign banks exerted control over China's foreign trade financing and

¹⁰ John S. Bowman, *Columbia Chronologies of Asian History and Culture* (New York: Columbia University Press 2000), p.105.

¹¹ See Chengming Wu, "The Evolution of Piaohao and Qianzhuang, and the Emergence of Private Banks", in Dixin Xu and Chengming Wu (eds.), *The History of Chinese Capitalism, Volume Two* (People's Publisher 1990).

¹² HSBC, "The History of HSBC", available at <http://www.hsbc.com/about-hsbc/company-history/hsbc-history>, accessed 1 May 2016.

international remittance businesses. In addition, they also took part in commercial banking businesses like taking deposits and making loans, as foreign lenders often formed a close business partnership with local financial institutions like *Qian Zhuang*.

In summary, throughout the history of ancient and imperial China, moneylending activities could be found in most time periods as they played a vital role in the formation and development of the commodity economy and capitalism. Moneylenders and financial institutions in the past channelled spare capitals in the society to those who needed to borrow money to survive the lives or run businesses. While *Fu Bie* demonstrated the existence of lending contracts in the remote past as well as the wisdom of ancient Chinese in solving lending disputes, *Qu Xi Guo Lv*, an offence in Han's criminal code, exhibited the ruler's determination to crack down usuries and protect borrowers two thousand years ago. Moreover, the Chinese lending history reveals the trend of financial institutionalisation, like the establishments of quasi-banking institutions such as *Jiao Zi Pu*, *Piao Hao* and *Qian Zhuang*. As the Chinese economy grew and prospered, the society was in need of financial services like saving, lending, and money transferring. The demands led to the creation of early banking institutions. Finally, after the Opium Wars, the modern banking model was introduced to China as Westerners started to trade with China, representing a new era in the Chinese history of finance.¹³

2.2.2 Financial Modernisation in the Republic of China (1912-1949)

The imperial government of Qing dynasty was neither capable of modernising China's economic and political systems, nor able to defend foreign aggressions. Therefore, the *Xin Hai Revolution* (辛亥革命) in 1911, led by Mr Sun Yat-Sen, ended the ruling of the Qing Court and established the Republic of China (ROC), marking the beginning of China's republican era.¹⁴ The ROC period is perceived as a golden age for China's financial industry. In terms of the banking sector, the ROC period witnessed the establishments of hundreds of banking corporations, which were launched by the state, private domestic investors, and foreign investors. The examples of state-owned banks were the Bank of China (BOC) which focused on foreign exchange businesses, and

¹³ Zhengping Chen, *A Brief History of Finance in China* (UK: Paths International 2014), p.6.

¹⁴ Ray Huang, *China: A Macro History* (Routledge 1997), p.242.

the Bank of Communications that provided financial supports for the flourishing industries. These two banks survived several revolutions in the 20th century and are still operating today.¹⁵ The BOC was founded in 1912 when it played dual roles as being a commercial bank as well as the central bank for the Nationalist government until 1928.¹⁶ In 1928, the Nationalist government set up a specialised central bank in Shanghai where the Minister of Finance Mr Song Ziwen served as the first governor.¹⁷ Consequently, the central banking function of BOC was stopped, and it afterwards obtained an exclusive charter to conduct the businesses of international exchange and trade financing.

During the Republican era, private capitalism prospered and a large number of new Banks were established all over China. In addition to state-backed banks, Chinese entrepreneurs either set up latest banking institutions or converted traditional financial institutions like *Piao Hao* and *Qiang Zhuang* into Western style banks. Major players in North China included Yien Yieh Commercial Bank, Kincheng Bank, Continental Bank, and China & South Sea Bank, which were collectively called “Four Northern Banks”.¹⁸ Meanwhile, the so-called “Three Southern Banks” dominated banking services in South China which referred to Shanghai Commercial and Savings Bank, National Commercial Bank, and Zhejiang Industrial Bank.¹⁹ Besides, foreign banks took up leading positions in certain business areas, such as foreign trade financing, whilst ordinary banking businesses were mostly controlled by Chinese lenders.²⁰ In response to the fast expansion of banking industry, the Republican government set up the Financial Supervisory Bureau in 1927, given the power to supervise monetary and banking businesses in China.²¹ The Financial Supervisory Bureau was affiliated to the

¹⁵ More information about the Bank of China will be introduced under the “China’s State-Dominated Banking Sector” in the part three.

¹⁶ Bank of China, “History of Bank of China”, available at http://www.boc.cn/en/aboutboc/ab1/200808/t20080814_1601747.html, accessed 1 May 2016.

¹⁷ Zhaojin Ji, *A History of Modern Shanghai Banking* (Routledge 2002), p.170.

¹⁸ *Ibid.*, p.121.

¹⁹ *Ibid.*, p.114.

²⁰ Albert Feuerwerker, “The Foreign Presence in China”, in John K. Fairbank (eds), *The Cambridge History of China: Volume 12, Republican China, 1912-1949, Part 1* (Cambridge University Press 1983), p.199.

²¹ Financial Supervisory Commission (Taiwan), “The Overview of Banking Bureau Financial Supervisory Commission” (March 2014), p.3, available at [http://www.fsc.gov.tw/fckdowndoc?file=/BB-20140520BankingBureauOverview\(1\).pdf&flag=doc](http://www.fsc.gov.tw/fckdowndoc?file=/BB-20140520BankingBureauOverview(1).pdf&flag=doc),

Ministry of Finance, and it was the first official financial regulatory authority in China's modern history.

In the early 19th century, Shanghai, as China's economic centre, benefited from the country's fast growing capitalism and became the largest financial centre in the Far East, competing with other international financial centres like London and New York.²² At that time, Shanghai accommodated the headquarters of 54 Chinese banks, as well as branches and offices of 27 foreign incorporated banks. Moreover, Shanghai operated various financial markets and exchanges for the trading of securities, commodities, gold and silver. It is interesting to see that, in recent times the current Chinese government initiated a plan to build Shanghai into a first-class international financial centre before 2020, in accordance with the country's rising economic power and the internationalisation of Renminbi.²³ Shanghai, therefore, has been slowly **reiving** its status where it belonged **to** 80 years ago.

In a nutshell, the ROC period observed the emergence of a modern banking industry in China, with hundreds of banks being established to serve the ever growing financing needs of the capitalist economy under industrialisation. Government funded banks and privately funded banks flourished in most regions. In order to regulate the prosperous banking industry, the Nationalist government established China's first central bank as well as the first banking regulator. A number of national financial centres like Beijing, Tianjin, and Chongqing emerged, and in particular, the city of Shanghai obtained its reputable position as a major global financial centre. This period of time, therefore, marked a golden age of China's banking industry.

2.2.3 China's Banking Industry Under Centrally Planned Economy (1949-1978)

After the World War II, China experienced a civil war between 1946 and 1949. The war is called *Jie Fang Zhan Zheng* (War of Liberalisation or 解放战争) which was

accessed 1 May 2016.

²² *Economics & Finance Net*, "How Did Shanghai Beat Beijing to Become the Financial Centre During the ROC Period?", available at <http://finance.cenet.org.cn/show-99-67168-1.html>, accessed 1 May 2016.

²³ Shanghai Municipal Government, "Financial Centre", available at <http://en.sjr.sh.gov.cn/financial-centre/index.shtml>, accessed 1 May 2016.

fought between the incumbent Nationalist Party and the rising Communist Party. The Communist Party finally won the war, and gained the full control of most parts of China, and its leader Mao Zedong declared the founding of the People's Republic of China (PRC) in October 1949, indicating the start of Communist China.²⁴ The socialist revolution resulted in massive upheavals of the society, as the Communist Party reshaped the the free-market capitalist economy into a Soviet Union-style centrally planned economy. As a result, from 1950s to 1970s, the state played a decisive role in the economy, and most private businesses were converted into state or collective ownership. According to the socialist ideology, banks have been seen as an integral part of the socialist economy, which shall be fully controlled by the state to carry out central economic plans.²⁵ As a result, in the early years of PRC, the banking industry was the first sector to experience nationalisation, for all commercial banks were taken over by the Communist government, and being managed by the Ministry of Finance. Later, the People's Bank of China (PBOC) was established, and it was assigned with the mandate to perform the function of central banking as well as act as the sole commercial bank in the country.²⁶ Therefore, the nationalisation process led to a full stop of the once prosperous banking sector, since under the centrally planned economy there was no need for hundreds of banks competing with each other.

2.3 Private Lending in Contemporary China

However, things have changed completely again in 1978. From 1949 to 1978, China experienced economic stagnation for a long time when the centrally planned economy model was thoroughly implemented. When the reformer Deng Xiaoping took over the Communist Party after the death of Mao Zedong in the late 1970s, he was determined to bring the market discipline back to China, in order to revitalise the sluggish economy. In December 1978, the Chinese government launched a series of market-based economic reforms guided by the well-known *Gai Ge Kai Fang* (Reform and Opening Up or 改革开放) policy, introduced at the Third Plenary Session of the 11th Central

²⁴ Michael Lynch, *Access to History: The People's Republic of China 1949-76* (2nd Edition, Hodder Education 2008), p.4.

²⁵ Paul Bowles and Gordon White, *The Political Economy of China's Financial Reforms* (Westview Press 1993), p.47.

²⁶ Robin Huang, *Securities and Capital Markets Law in China* (Oxford University Press 2014), p.5.

Committee of the CPC.²⁷ One central issue on the agenda was to shift the working focus from the political movement to the economic development. The meeting is considered as a pivotal turning point in the modern history of China. Afterwards, China has established a new economic system, which is referred to as the *Socialist Market Economy*. It is featured by a mixture of the free market and heavy state intervention, which will be examined later.

The market-oriented reform turned out to be a huge success, as China witnessed a period of unprecedented economic growth from 1978 to 2012, proved by the average 9.8 per cent annual increase in its GDP.²⁸ The stories of China's economic achievements are already familiar to readers in the West, but few people are aware of the drawbacks of the current economy model in China, as the subject has remained underexplored by existing scholars. Therefore, the next part of the chapter is going to illustrate one significant flaw in the China's dual-track economic system. Despite the rapid growth of private capitalism, the country's state-dominated banking sector failed to provide sufficient credits for millions of private businesses. Thus, Chinese entrepreneurs have to seek alternative financing channels outside the banking sector, and the private lending market naturally fills the gap. Now, the author will use the supply and demand theory to explain the popularity of private lending in China.

2.3.1 The Socialist Market Economy (Post-1978)

After the initiation of market-oriented reforms in 1978, the Communist Party devised the *Socialist Market Economy*, in order to accommodate the increasing needs from people for the economic development and the improvement of life quality.²⁹ Apparently, the new economic system contradicts with the previous *Socialist Planned Economy* in which all economic decisions regarding investment, production and distribution were made according to state plans. However, it is also distinguished, to a large extent, from traditional market economies where economic activities and prices

²⁷ *Xinhua*, "Third Plenary Session of the 11th Central Committee of the Communist Party of China (1978)", available at http://news.xinhuanet.com/ziliao/2003-01/20/content_697755.htm, accessed 1 May 2016.

²⁸ *People's Daily*, "35 Years Chinese Economy Kept Rising" (21 November 2013), p.4.

²⁹ Paul Bowles and Gordon White, *The Political Economy of China's Financial Reforms* (Westview Press 1993), p.12.

of goods and services are mostly determined by the “invisible hand” of the market. In fact, China’s *Socialist Market Economy* can be viewed as a mix approach based on both the free market and the state control in various key industries. Therefore, it is also referred to as the state capitalism under which the growth of private businesses is in parallel with the prioritisation of state-owned enterprises in some crucial sectors.³⁰ The reason for Mr Deng and his successors to adopt this economic structure for China is not difficult to understand. While the Communist Party is eager to employ the market discipline to rejuvenate the economy and build an industrialised country, it has to ensure the unbreakable principle of one-party state through exerting strong influences over the country’s economic operation. Therefore, the *Socialist Market Economy* model, which is compatible with China’s political reality as well as the urgent need for economic growth, has been implemented in recent decades.

Although the Chinese economic system is defined by its own government as a variety of classical market economies, its market economy status has not been fully recognised by the international community. For instance, at a European Parliament gathering in May 2016, EU lawmakers voted against granting the market economy status to China, considering that the economy was still largely controlled by the state and a large number of firms have been heavily subsidised to lower exporting prices.³¹ However, some Chinese experts pointed out the denial of China’s market economy status was mainly due to the EU’s trade protectionism, since extra taxes can be levied at goods imported from a non-market economy country.³² Apart from the EU, major economies including the United States, Canada, Japan, and India have not yet admitted the market economy status of China.³³

Under the *Socialist Market Economy*, the state intends to remain in absolute control of a few industries having strategic importance. In 2003, the State Assets Supervision and Administration Commission (SASAC) was established, so as to represent the country

³⁰ See, for example, Kellee S. Tsai, “The Political Economy of State Capitalism and Shadow Banking in China,” (2015) 51 *Issues & Studies* 55, 55.

³¹ Viktoria Dendrinou, “Europe Opposes Market Status For China”, *Wall Street Journal* (13 May 2016), A8.

³² Qingqing Chen, “EU Should Admit China’s Market Economy Status”, *Global Times* (13 May 2016), available at <http://www.globaltimes.cn/content/982842.shtml>, accessed 1 May 2016.

³³ *Ibid.*

to perform the duty of managing and supervising the state-owned enterprises in which the central government is the majority shareholder.³⁴ The SASAC, affiliated to the State Council, enjoys powers such as appointing directors and senior managers for SOEs, approving the decisions regarding large investments, and approving resolutions of merger and acquisition. In 2006, the State Council reaffirmed that the state shall have controlling stakes in companies from seven sectors, including armament, power generation and distribution, oil and petrochemical, telecommunication, coal, aviation, and shipping.³⁵ Clearly, it shows that the Chinese government is playing a vital part in the economic operation. At present, around 106 SOEs are directly managed by the SASAC, ranging from China National Nuclear Corporation, Wuhan Iron & Steel Corporation to China Mobile, most of which are national champions in their respective sectors.³⁶ It should be noted that, despite being largely state-owned, financial institutions in China like banks, securities firms, and insurance companies have not been governed by the SASAC.³⁷

In the latest *Fortune* 500 List, a ranking of the largest 500 companies in the world, China occupied 98 positions, and 76 out of them are state-owned firms.³⁸ The Chinese SOEs, protected by favourable policies and generous financial supports, have become the largest and most profitable businesses in the world, but their business operation mostly remains limited to the Chinese borders. In contrast, in other industries which are not dominated by the state, like the Internet industry, there exist some truly global brands, such as Baidu, Alibaba, and Tencent (widely known as the “BAT”).³⁹ It is evident that the success of Chinese SOEs is mainly because of their *de facto* monopoly status. In sharp contrast, private capitalism flourished in the rest of industries where

³⁴ State Assets Supervision and Administration Commission, “Main Functions of SASAC”, <http://en.sasac.gov.cn/n1408028/n1408521/index.html>, accessed 1 May 2016.

³⁵ Huanxin Zhao, “China Names Key Industries For Absolute State Control”, *China Daily* (19 December 2006), p.1.

³⁶ State Assets Supervision and Administration Commission, “The Directory of Central SOEs”, available at <http://www.sasac.gov.cn/n86114/n86137/c1725422/content.html>, accessed 1 May 2016.

³⁷ There will be more introduction about the shareholder structure of state-owned banks later.

³⁸ Scott Cendrowski, “China's Global 500 Companies Are Bigger Than Ever—And Mostly State-Owned”, *Fortune* (22 July 2015), available at <http://fortune.com/2015/07/22/china-global-500-government-owned/>, accessed 1 May 2016.

³⁹ Yuan Li, “China Circuit: Troika Spends Big To Rule Internet”, *The Wall Street Journal* (20 October 2016), B4.

the state influences barely exist.

2.3.2 Rapid Development of Private Economy Under Market-Oriented Reform

As the state plan gave way to the market discipline, the Chinese population, who experienced poverty and limited material conditions for three decades (1949 to 1978), started to pursue personal wealth and run private businesses, leading to a period of rapid economic growth. The chart below shows the China's GDP data after the launch of economic reform. It increased 173 times in total, from CNY 365 billion (USD 53.1 billion) in 1978 to CNY 63.59 trillion (USD 9.26 trillion) in 2014. Such a high speed of economic advancement is rare to see in the global history. Consequently, in 2010 China replaced Japan as the world's second-largest economy, just next to the United States.⁴⁰

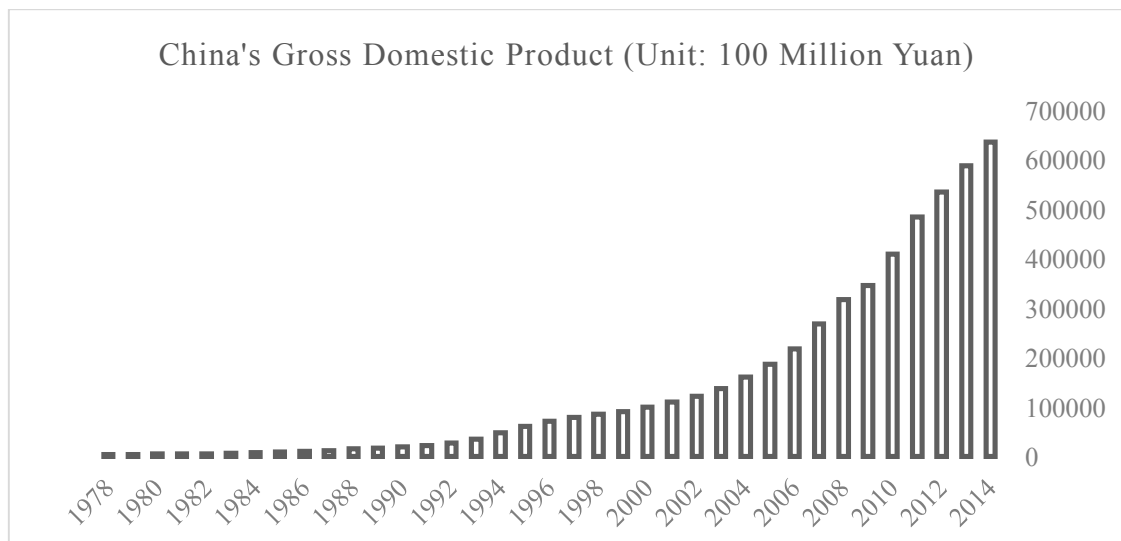


Figure 1: China's GDP Growth (1978 to 2014)⁴¹

There is no denying that the real driving force behind China's economic rise is the proliferation of private enterprises, as they have been gradually replacing low-efficient SOEs under the planned economy.⁴² Although it is unusual to see the co-existence of socialism and entrepreneurship in one country, it does happen in China. The private sector, driven by the desires of millions of Chinese entrepreneurs to pursue wealth and

⁴⁰ Mure Dickie and Jonathan Soble, "China Displaces Japan As Second Biggest Economy", *Financial Times* (15 February 2011), p.9.

⁴¹ Data source: National Bureau of Statistics, China, available at <http://data.stats.gov.cn/ks.htm?cn=C01&zb=A0501>, accessed 1 May 2016.

⁴² Ross Garnaut *et al.*, *Private Enterprise in China* (ANU Press 2012), p.15-20.

a better life, has brought competition, innovation, and productivity to the economy. As a result, the country has seen the emergence of the entrepreneurial class who endeavour to operate profit-driven firms to compete in the market.⁴³ The rapid growth of Chinese economy, to a large extent, shall be attributed to what private entrepreneurs have done over the past few decades.

In particular, small and medium-sized enterprises (SMEs) play an important and indispensable role in the economic progress. In China, the definition of SMEs can be found in a piece of regulation jointly made by four ministries in charge of economic policies.⁴⁴ The Chinese SMEs are divided into three sub-categories: small-sized, medium-sized, and micro-sized enterprises. The standards of classification were different according to the specific industry where a firm belongs.⁴⁵ A firm is categorised into different sizes based on the annual revenue, the total asset figure and/or the number of employees.

Industry	Standard (Million Yuan)	Micro Enterprise	Small Enterprise	Medium Enterprise	Large Enterprise
Agriculture, Forestry, Husbandry & Fishery	Revenue (Y)	$Y < 0.5$	$0.5 \leq Y < 5$	$5 \leq Y < 200$	$Y \geq 200$
Heavy Industry	Number of Employees (X)	$X < 20$	$20 \leq X < 300$	$300 \leq X < 1000$	$X \geq 1000$
	Revenue (Y)	$Y < 3$	$3 \leq Y < 20$	$20 \leq Y < 400$	$Y \geq 400$
Property Development	Revenue (Y)	$Y < 1$	$1 \leq Y < 10$	$10 \leq Y < 2000$	$Y \geq 2000$
	Total Asset (Z)	$Z < 20$	$20 \leq Z < 50$	$50 \leq Z < 100$	$Z \geq 100$
Other Unlisted Industry	Number of Employees (X)	$X < 10$	$10 \leq X < 100$	$100 \leq X < 300$	$X \geq 300$

⁴³ Linda Yueh, "China's Entrepreneurs" (LSE Working Paper Spring 2008), available at <http://cep.lse.ac.uk/pubs/download/cp253.pdf>, accessed 1 May 2016.

⁴⁴ See the "Regulation on the Classification Standards for Small and Medium-sized Enterprises" (GXBLQY [2011] No. 300). It was jointly promulgated and published by four ministries: Ministry of Industry and Information Technology, National Bureau of Statistics, National Development and Reform Commission, and Ministry of Finance. An electronic version of the regulation is available at <http://www.miit.gov.cn/n11293472/n11293832/n11293907/n11368223/13912671.html>, accessed 1 May 2016.

⁴⁵ In the regulation, there are 15 categories of specific industry sectors plus one category for those enterprises that are not included in any other categories.

Table 1: Selected Examples of Classification Standards for SMEs in China⁴⁶

As the market-oriented reform continues, the private sector has become a major component of Chinese economy. According to one estimate, SMEs generate 60 per cent of China's GDP and provide 80 per cent of employment.⁴⁷ It is evident that the private sector now contributes more to the national economy than its state-owned rivals do. However, for most businesses, it has been difficult to borrow credits from Chinese banks most of which are firmly controlled by the state. The research of Lin Yifu, a economist and the former vice president of World Bank, suggested that less than 1 per cent of Chinese SMEs have access to bank loans.⁴⁸ Moreover, Professor Wang Yijiang pointed out, despite the importance of Chinese SMEs, they only use 20 per cent of financing resources in the country.⁴⁹ It seems disproportionate when we compare the amount of SME lending to their economic contributions. The next part is going to find out why Chinese lenders refuse to grant loans to the burgeoning private sector.

2.3.3 China's State-Dominated Banking Sector

Due to the legacy of centrally planned economy, the state monopoly still persists in some industries including the banking sector. The ruling Communist Party, in order to maintain its political and economic influences, keeps a tight grip on the financial industry. We will take a closer look at main players in China's banking sector to see how the state influence is wielded. First of all, there are three entirely state-owned policy banks, charged with the mandate to carry out specific functions in line with the state strategies.⁵⁰ The three policy banks are: the Agricultural Development Bank of China, assigned with the task to promote the availability and quality of financial services for China's agriculture sector and rural areas; the China Development Bank, responsible for raising funds for large infrastructure projects; and the Export-Import

⁴⁶ The table is compiled by the author based on the regulation above.

⁴⁷ Emma Dong and Simon Rabinovitch, "China's Lending Laboratory", *Financial Times*, (23 May 2012), p.11.

⁴⁸ Yifu Lin, "Developing Small and Medium Bank to Improve Financial Structure", *China Centre for Economic Research* (Peking University Discussion Paper 2007).

⁴⁹ Yijiang Wang, "The Reason for Saving SMEs at First", *Business Review* (February 2009), p.40.

⁵⁰ Michael F. Martin, "China's Banking System: Issues for Congress" US Congressional Research Service (20 February 2012), p.16.

Bank of China, which provides financial supports for exporters. In practice, they have been seen as policy-oriented financial institutions rather than profit-driven commercial banks.

Major commercial banks in China include four largest state-owned banks, known as the “Big Four”, a dozen national joint-equity commercial banks, as well as hundreds of city and rural commercial banks.⁵¹ Compared to their Western rivals, Chinese banks have remained relatively intact from the Global Financial Crisis, and have become the most valuable and profitable lenders in the world. The Big Four comprises the Industrial and Commercial Bank of China (ICBC), the China Construction Bank (CCB), the Agricultural Bank of China (ABC), and the Bank of China (BOC). They are already largest banks in the world in terms of their market capitalisations and total assets. According to a global bank ranking, the Big Four takes up 4 positions of the 10 largest banks in the world.⁵² Despite China having thousands of deposit-taking institutions, its banking assets are concentrated in the hands of a few leading banks. In 2014, the Big Four along with the Bank of Communication, which is the fifth largest lender, possessed 41.21 per cent of total banking assets in China.⁵³ All of the Big Four are publicly listed on Shanghai and Hong Kong stock exchanges, which means domestic and foreign investors can trade their shares freely.

	ICBC	CCB	ABC	BOC
<i>Central Huijin Investment Ltd.</i>	34.71%	57.31%	40.03%	64.02%
<i>Ministry of Finance, PRC</i>	34.60%	0	39.21%	0
<i>Total State Shares</i>	69.31%	57.31%	79.24%	64.02%

Table 2: The Ownership Structure of the Big Four Chinese Banks⁵⁴

⁵¹ Lerong Lu, “Private Banks in China: Origin, Challenges and Regulatory Implications” (2016) 31(3) *Banking and Finance Law Review* 585, 586.

⁵² Relbank, “World’s Largest Banks 2015”, available at <http://www.relbanks.com/worlds-top-banks/market-cap>, accessed 1 May 2016.

⁵³ People’s Bank of China, “*China Financial Stability Report 2015*”, p.37, available at <http://www.pbc.gov.cn/english/130736/2946072/2015090616281480816.pdf>, accessed 1 May 2016.

⁵⁴ ICBC, “Annual Report 2015”, p.27-28, available at <http://v.icbc.com.cn/userfiles/Resources/ICBCLTD/download/2016/21A20160331.pdf>; CCB, “Annual Report 2015”, p.4, available at http://www.ccb.com.cn/investor/notice/20160330_1459333044/20160330181904680839.pdf; ABC, “Annual Report 2015”, p.6, available at http://www.abchina.com.cn/AboutABC/investor_relations/announcements/a-announcement/201603/P020160331735163226900.pdf; BOC, “Annual Report 2015”, p.62, available at <http://pic.bankofchina.com/bocappd/report/201604/P020160427506439146228.pdf>, accessed 1 May 2016.

Although the Big Four are public companies, they have China's central government as the majority shareholder. From the table above, the state owns a large percentage of shares of the Big Four, ranging from 57.31 per cent in the CCB to nearly 80 per cent in the ABC. The equities are held by either the Central Huijin Investment Company (the State Council's investment arm) or the Ministry of Finance. Obviously, this high level of state ownership raises the question about the independent operation of the Big Four. In practice, the state still exerts firm controls over these banks' day-to-day business operation. For instance, the chairmen and CEOs of the Big Four, who are appointed by the central government, enjoy vice-ministerial administrative powers and therefore are often seen as government officials rather than real bankers.⁵⁵

Next to the Big Four, there are 12 joint-equity commercial banks, such as China Merchants Bank, China Everbright Bank, and Shanghai Pudong Development Bank.⁵⁶ They are large national lenders, and most of them are publicly listed companies. Generally speaking, joint-stock banks are smaller than the Big Four in terms of size, but healthier in terms of the asset quality and profitability. Joint-equity banks were firstly initiated by provincial governments or large state-owned corporate groups, so similarly, they are subject to strong political influences from the government.⁵⁷ Nonetheless, in order to diversify the shareholding structure and improve corporate governance before the public listing, some joint-equity banks invited international banking corporations to purchase their shares. For instance, Standard Chartered holds 19.99 per cent of shares in the China Bohai Bank, and the Citigroup owns 20 per cent of stakes in the Guangdong Development Bank.⁵⁸ The only exception among national banks is the China Minsheng Bank, which was established in 1996 by a group of private investors. Until recently, the Minsheng Bank has been the only fully privately-

⁵⁵ Phoenix Finance, "The Administrative Ranking of Senior Managers of State-owned Enterprises", available at <http://finance.ifeng.com/news/special/gqybs/>, accessed 1 May 2016.

⁵⁶ Lerong Lu, "Private Banks in China: Origin, Challenges and Regulatory Implications" (2016) 31(3) *Banking and Finance Law Review* 585, 587.

⁵⁷ For example, the Industrial Bank was established by the Financial Bureau of Fujian Province, and the CITIC Bank was founded by the CITIC Group, a key state-owned investment company.

⁵⁸ China Bohai Bank, "2015 Annual Report", p.6, available at <http://www.cbhb.com.cn/bhbank/S101/attach/2015bhndbgzy.pdf>; Guangdong Development Bank, "2015 Annual Report", p.83, available at <http://www.cgbchina.com.cn/Channel/19772772>, 1 May 2016.

owned bank in China.⁵⁹ Despite being privately held, it is still subject to strict government oversight as the appointment of its senior personnel has to be approved by the authority.⁶⁰

In addition to the Big Four and joint-equity commercial banks, there are 133 city commercial banks and 665 rural commercial banks, operating a full range of banking businesses within specific regions, most of which are based on former urban or rural credit cooperatives.⁶¹ City and rural commercial banks were mostly founded and owned by municipal or county-level governments, with the mandate to finance local developing projects.⁶² In the early 2000s, most of them were restructured into modern commercial banks, and private investors have been encouraged to purchase some minority shares. They play an important role in supporting the development of regional economies, and some of them even managed to expand their businesses outside of their original bases. For example, the Bank of Beijing has presence in more than ten provinces and municipalities, including Tianjin, Shanghai, Hangzhou, and Nanjing.⁶³

In summary, the common denominator of Chinese banks is their close relationships with China's central or local governments.⁶⁴ Therefore, the Big Four and other commercial banks have long been viewed as "policy-oriented" commercial banks as they are subject to political influences and state interventions.⁶⁵ It is clear that as the regulator, the shareholder, the financier, the businessman, the guarantor and the employer, the state plays multiple roles in China's banking industry.⁶⁶ Apart from the conflict of interests, many drawbacks can be observed in the state-run banking model.

⁵⁹ See the Chapter Five, Part Seven, "Liberalising the Banking Industry".

⁶⁰ Jamil Anderlini, "China pilots project to launch five private banks" *Financial Times* (12 March 2014), p.12.

⁶¹ People's Bank of China, "China Financial Stability Report 2015", p.38, available at <http://www.pbc.gov.cn/english/130736/2946072/2015090616281480816.pdf>, accessed 1 May 2016.

⁶² Michael F. Martin, "China's Banking System: Issues for Congress", US Congressional Research Service (20 February 2012), p.4.

⁶³ Bank of Beijing's Website, available at <http://www.bankofbeijing.com.cn/branch/index.html>, accessed 1 May 2016.

⁶⁴ Lerong Lu, "Private Banks in China: Origin, Challenges and Regulatory Implications" (2016) 31(3) *Banking and Finance Law Review* 585, 587.

⁶⁵ Shen Wei, "Healthy Or Unhealthy? That Is A Problem – Unveiling The Myth Of Chinese Banks' Success" (2013) 28(2) *Journal of International Banking Law and Regulation* 81, 81.

⁶⁶ Violaine Cousin, *Banking in China* (2nd Edition, Palgrave MacMillan 2011), p.56-57.

It is widely criticised for the low efficiency and providing poor services, since Chinese lenders can make huge profits without putting in a lot of efforts by taking advantage of their monopoly status and the favourable policy supports. Moreover, the state-run banking system fails to allocate financial resources to those who need it most. In fact, most of bank loans have been given to SOEs and their financing vehicles, which often invest in large-scale infrastructure projects or heavy industries that already face the problem of over-capacity.⁶⁷ Chinese SOEs enjoy massive financial supports at very low costs, whilst the private sector receives limited credits.⁶⁸

The prejudiced credit allocation mechanism is main cause for the financing troubles of private businesses. From the start, Chinese banks have been established to help SOEs to fund their businesses. As a result, it forces millions of private businesses to search for financing methods outside the banking system, like the private lending market.

2.3.4 Private Wealth Search for Investments

The financing demands from China's private businesses can hardly be satisfied by the state-dominated banking industry, so the void is waiting to be filled by alternative finance methods. In this part, we investigate where the money in the private lending market comes from. Clearly, the Chinese people love saving, as the country has the highest gross saving rate in the world at 49 per cent, according to the World Bank.

Country	China	India	Japan	US	UK
Saving Rate (%)	49	31	22	18	12

Table 3: Gross Saving Rate of Selected Country (2014)⁶⁹

However, the real interest rate for bank savings has been negative for a long time due to the inflation, namely, Chinese depositors are losing money on every yuan they put in their bank accounts.⁷⁰ Consequently, Chinese investors who have a lot of savings

⁶⁷ Shen Wei, "Healthy Or Unhealthy? That Is A Problem – Unveiling The Myth Of Chinese Banks' Success" (2013) 28(2) *Journal of International Banking Law and Regulation* 81, 86.

⁶⁸ Carl Walter and Fraser Howie, *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise* (Wiley 2011), p.25.

⁶⁹ Data Source: World Bank, available at http://data.worldbank.org/indicator/NY.GNS.ICTR.ZS?order=wbapi_data_value_2014+wbapi_data_value+wbapi_data_value-last&sort=desc, accessed 1 May 2016.

⁷⁰ Tom Orlik, "Eating Bitterness in China's Financial System", *Wall Street Journal* (18 March 2011),

and capitals have been looking for new investments that could bring them a higher return. For instance, the Chinese stock market saw a massive speculative bubble from 2014 to 2015, as the Shanghai Composite Index was more than doubled in one year's time.⁷¹ Investors competed to use their savings to purchase stocks, even though the Chinese economy has been slowing down and the fundamentals of most public companies have been deteriorating. Moreover, the housing price in China, fuelled by the money from rich individuals, has been soaring in the past decade. For example, in 2015, the average housing price in Shanghai increased by 20 per cent, despite the city government's strict rules to curb property **speculations**.⁷²

Apparently, the equity and property bubbles demonstrate the desires of Chinese investors to increase their wealth. Therefore, the private lending market seems a perfect place for their money, as it can generate a return higher than that of most investments. Moreover, in recent years, an increasing number of manufacturers in China have been trying to diversify their business portfolios, and therefore chose to join the lending industry. Even some state-owned corporate groups, which have abundant cash reserves, took part in the moneylending businesses to make money by extending loans to private enterprises.⁷³ Clearly, the money supply from Chinese individuals and corporate investors has contributed to the prosperity of private lending market.

2.3.5 The Rise of Private Lending: Alternative Finance for Private Entrepreneurs

As stated, the financing dilemmas faced by private businesses in China to a large extent resulted from the state-run banking model. Though a small number of private lenders like China Minsheng Bank do lend to SMEs, state-owned banks grant most of their loan quotas to well-connected SOEs.⁷⁴ According to *China Economic Weekly*, a

available at <http://blogs.wsj.com/chinarealtime/2011/03/18/eating-bitterness-in-china%E2%80%99s-financial-system/>, accessed 1 May 2016.

⁷¹ Lerong Lu and Longjie Lu, "Unveiling China's Stock Market Bubble: Margin Financing, the Leveraged Bull and Governmental Responses" (2017) 32(4) *Journal of International Banking Law and Regulation* (forthcoming)

⁷² *The Economist*, "Chinese Property: For Whom The Bubble Blows" (12 March 2016), p.73.

⁷³ Shen Wei, "Shadow Banking System in China - Origin, Uniqueness and Governmental Response" (2013) 28(1) *Journal of International Banking Law and Regulation* 20, 21.

⁷⁴ *The Economist*, "Shadow Banking in China: The Wenzhou Experiment" (7 April 2012), p.84.

exporter of agricultural machines explained: “It has been difficult for SMEs to borrow money from banks, so they can only rely on private financing. When borrowing from banks, most SMEs are unable to provide valid mortgages, nor can they find qualified guarantors, so they often fail banks’ strict credit tests.”⁷⁵ Therefore, private enterprises, being refused by mainstream lenders, turn to the underground market to borrow money. At present, the private sector in China is deeply dependent on private lending. Nonetheless, even some public companies borrow money from private investors, like the Hong Kong-listed fashion retailer Fujian Nuoqi Co Ltd.⁷⁶

On the other hand, after four decades of rapid economic growth, Chinese people have amassed a large amount of private wealth and are searching for good investment opportunities. Therefore, we can see a major problem in the Chinese economy, called “two abundances and two difficulties” (两多两难), which has been frequently mentioned by government officials including Mr Zhou Xiaochuan, the central bank governor.⁷⁷ It means that there is an abundance of private businesses in China which have great difficulties in getting enough credits; meanwhile, there is an abundance of private capitals in China with the trouble to find proper investments. Therefore, the private lending market seems a perfect solution to the “two abundances and two difficulties” puzzle, as it not only provides sufficient credits for private businesses, but also offer a satisfying return for investors’ money. As a result, the private lending market, which connects money-starved businesses with cash-positive investors, has become prevalent in China. The interest rate for one-year private loan normally stands over 20 per cent, compared with 1.5 per cent for bank savings of the same period.⁷⁸

⁷⁵ Weijia Hu, “Before and After the ‘Wenzhou Private Financing Regulation’”, *China Economic Weekly* (9 December 2013), p.58.

⁷⁶ Lerong Lu, “Runaway Bosses in China: Private Lending, Credit Crunches, and the Regulatory Response” (2015) 18(9) *Financial Regulation International* 1, 1-3.

⁷⁷ *People*, “Zhou Xiaochuan: The Financial Reform Should Solve Wenzhou’s Problem of Two Abundances and Two Difficulties”, 10 April 2012, available at <http://finance.people.com.cn/bank/GB/17619788.html>, accessed 1 May 2016.

⁷⁸ The average interest rate of private financing can be found at the website of Wenzhou Private Finance Index, available at <http://www.wzpf.gov.cn>; The benchmark interest rate for Chinese banks, such as the one-year fix-term saving, is currently 1.50 per cent, available at the website of People’s Bank of China (24 October 2015) at <http://www.pbc.gov.cn/zhengcehuobisi/125207/125213/125440/125838/125888/2968982/index.html>, accessed 1 May 2016.

Private lending, as a financing method, has been widely used by Chinese entrepreneurs to borrow money from relatives, friends, business partners, professional money lenders, and other shadow lenders. The term is interchangeable with “informal finance” which means non-bank financing activities.⁷⁹ The underground lending arrangements for Chinese businesses are also called “back-alley banking” by some academics, in contrast to official bank lending.⁸⁰ Moreover, the private lending market can be perceived as a vital part of China’s shadow banking system, for shadow banking is defined by the Financial Stability Board as “the credit intermediation involving entities and activities outside the regular banking system”.⁸¹

In the recent decade, the informal lending market in China has evolved into a massive industry, and market participants include investors, lenders, borrowers, and intermediaries. Private lending can be conducted between the lender and the borrower directly, or through the brokering services provided by a third part like guarantee companies, investment companies, or underground money houses. In practice, some underground lenders even hire professionals such as bankers, accountants, and lawyers to run the lending businesses.⁸² The unregulated lenders often attract money from lots of investors to form a capital pool, and then make loans to potential borrowers. The business model is similar to that of banks. Moneylenders usually charge excessive interests for their private loans, in order to pay for investors’ returns and generate profits. The annual interest rates of private lending are generally between 14 and 70 per cent, and the high borrowing costs have caused the insolvency of many businesses during the economic downturn.⁸³

The popularity of private lending has been an open secret in China’s business

⁷⁹ Sara Hsu, “Introduction” in Jianjun Li and Sara Hsu (eds.) *Informal Finance in China: American and Chinese Perspectives* (Oxford University Press 2009), p.3.

⁸⁰ See, for example, Kellee S. Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (Cornell University Press 2002).

⁸¹ FSB, “Shadow Banking: Scoping the Issues” (12 April 2011), p.2, available at http://www.fsb.org/wp-content/uploads/r_110412a.pdf, accessed 1 May 2016.

⁸² Some lenders carry out their business in a fashion similar to formal banking corporations, thus recruit a professional team to assist in the lending procedure. See Sohu, available at <http://roll.sohu.com/20110624/n311574397.shtml>, accessed 1 February 2017.

⁸³ *BBC News*, “Fears Surface Over Chinese Debt Amid Lending Practices” (6 October 2011), available at <http://www.bbc.co.uk/news/business-15194663>, accessed 1 May 2016.

community.⁸⁴ According to a survey by the People's Bank of China, 89 per cent of households and 59 per cent of businesses in Wenzhou have been actively participating in private lending activities.⁸⁵ Due to the opaque nature of the informal lending industry, there is no official data regarding its precise size. Some estimations have been made by professional service firms and research institutions. Credit Suisse estimated that the loan total in the underground lending market amounted to CNY four trillion (USD 582.2 billion) in 2012.⁸⁶ The Southwest University of Finance and Economics predicted that the size of informal finance sector was around CNY five trillion (USD 727.8 billion) in 2014.⁸⁷ Apparently, the private lending market has become an indispensable part of the financial system in China, which merits more attentions.

2.4 Private Lending and Informal Finance

2.4.1 Informal Finance and Economic Development

Informal finance refers to financial activities and markets operating outside the realm of the official financial system including banking, the securities market, and insurance. In most cases, informal financial activities remain unregulated by a country's financial authority. According to Sara Hsu, informal finance encompasses a wide range of non-bank financing activities, whether conducted through family and friends, local money houses, or other types of financial associations.⁸⁸ Informal finance provides a large amount of credits for individuals and businesses excluded from the formal financial system. In the 1960s, economists started to research informal finance in developing countries, with the focus on what roles non-bank financial institutions played in the economic and social improvements. Clifford Geertz suggested that it is necessary for developing countries to have a middle ground between having no credit and saving institution, and establishing a modern banking system.⁸⁹ The middle ground is

⁸⁴ Lerong Lu, "Runaway Bosses in China: Private Lending, Credit Crunches, and the Regulatory Response" (2015) 18(9) *Financial Regulation International* 1, 4.

⁸⁵ People's Bank of China, "Wenzhou Private Lending Market Report" (21 July 2011).

⁸⁶ Dong Tao and Weishen Deng, "China: Shadow Banking - Road to Heightened Risks", *Credit Suisse Economic Research* (22 February 2013), p.2.

⁸⁷ *Xinhua*, "Long-term Underground Private Lending Endanger Financial Ecology" (22 September 2014), available at http://jjckb.xinhuanet.com/2014-09/22/content_521666.htm, accessed 1 May 2016.

⁸⁸ Sara Hsu, "Introduction" in Jianjun Li and Sara Hsu (eds.) *Informal Finance in China: American and Chinese Perspectives* (Oxford University Press 2009), p.3.

⁸⁹ Clifford Geertz, "The Rotating Credit Association: A 'Middle Rung' in Development", (1962) 10(3)

comprised of various types of informal financial activities and institutions, such as Rotating Savings and Credit Associations (ROSCAs), pawnshops, as well as private lending.⁹⁰ In China, informal financial activities can be categorised into six groups, according to Professor Xuzhao Jiang: *He Hui* (合会 or ROSCA), private lending, *Qian Zhuang* (钱庄 or money houses), pawn brokering, money collection, and rural cooperative fund.⁹¹ Under most circumstances, informal finance is deeply rooted in local and personal networking systems where lenders, borrowers, and brokers are familiar with each other. Besides, lending parties who are acquaintances are able to negotiate the terms and conditions of financing arrangements in a flexible and efficient way, supporting the economic advancement in developing countries without a mature banking sector.⁹² In the absence of banks, informal finance bridges the gap between people with abundant capitals and those who need money. It allows individuals to access extra credits to purchase large-amount goods, or to start their own businesses, which therefore contributes to the economic growth.

Furthermore, the existence of informal finance can be justified by some economic theories. Edward Shaw and Ronald McKinnon from the Stanford University put forward the financial repression theory to explain the causes of informal finance.⁹³ They argued that developing countries often saw their governments' interventionist approaches in the financial industry, such as the interest rate control of bank savings or the state ownership of banks, in order to direct credits to some state-backed sectors or reduce the costs of government debts. Financial repression, therefore, increases the difficulty for the private sector to obtain adequate credits, which calls for the informal financial market to fill the vacuum. Moreover, the prevalence of informal finance can

Economic Development and Cultural Change 241, 263.

⁹⁰ ROSCAs refer to a type of financial activity based in a community where members contribute money to a pool on a regular base and then take turns to use the money for consumption or economic production.

⁹¹ Xuzhao Jiang, *The Research of Informal Finance in China* (China: Shandong People's Publishing House Press 1996) p.54-168.

⁹² See Dale W. Adams and Delbert A. Fitchett (eds), *Informal Finance in Low-Income Countries* (San Francisco: Westview Press, 1992).

⁹³ See Edward S. Shaw, *Financial Deepening in Economic Development* (New York: Oxford University Press, 1973); Ronald I. McKinnon, *Money and Capital in Economic Development* (Washington DC: Brookings Institution 1973).

be explained by its advantage in solving the problem of information asymmetry.⁹⁴ In most cases, banks refuse to extend loans to SMEs, simply because lenders are unable to gain sufficient information to assess the financial conditions of potential borrowers. In contrast, lenders in informal financing arrangements who rely on traditional social networks to assess borrowers' conditions are capable of acquiring the real information of borrowers relating to business operation, asset situation, and credit background. In this regard, the common problem of information asymmetry can, to some degree, be solved by private financing practices where there is a close relationship between lending parties.

2.4.2 Previous Research of Informal Finance in China

As China started the economic reforms in the late 1970s and embraced the market discipline, the private sector has been revived with the supports from informal finance. Despite the limited literature in this field, we can still find some academic efforts to explore China's informal finance sector. Professor Jiang Xuzhao from Shandong University was the first economist to investigate the phenomenon of informal finance in China's context. In 1996, after two years' surveys, he published a book entitled "*The Research of Informal Finance in China*". Clearly, his study of informal finance was ground-breaking in the 1990s, since at that time very few people understood the nature and importance of informal finance. Besides, Professor Jiang boldly suggested the Chinese government to abandon the negative attitudes and restrictive policies concerning informal finance, in order to make it better serve the increasing financing needs of private businesses.⁹⁵ In his book, Professor Jiang introduced the background knowledge of informal finance to the academia and the public, including its definition, various forms, the historical evolution, and its impacts on the economy, marking the start of research of informal finance in China. Private lending, in Jiang's eye, has been considered as a component of the informal finance world.⁹⁶

Following that, Jiang Shuxia, professor of finance at Xiamen University, conducted

⁹⁴ Yifu Lin and Xifang Sun, "Information, Informal Finance, and SME Financing" (2006) 1 *Frontiers of Economics in China* 69, 72.

⁹⁵ Xuzhao Jiang, *The Research of Informal Finance in China* (Shandong People's Publishing House 1996), p.1-3.

⁹⁶ *Ibid.*, p.78.

extensive research about informal finance and the institutional changes of China's financial industry. In her book *"China's Underground Finance"* (2001), Professor Jiang attributed the emergence of underground finance to China's stagnant financial reform process which was largely left behind with the economic development.⁹⁷ While in most industries the market has become the dominant force, the financial industry is still being tightly controlled by the state. Therefore, the best method to solve the problems surrounding informal finance is to push forward the financial reform. In 2003, Professor Jiang published her second book regarding the research of informal finance from sociological and psychological perspectives.⁹⁸

In the late 1990s, Kellee Tsai who is professor of politics at Johns Hopkins University carried out empirical research in China's Fujian, Zhejiang, and Henan provinces. Based on the result, she published the book *"Bank-alley Banking: Private Entrepreneurs in China"* (2002). Professor Tsai indicated that, despite the extensive presence of informal finance in China, its forms and arrangements varied significantly in different regions. Tsai also pointed out the importance of informal finance to most SMEs, as less than 1 per cent of total bank credits were given to the private sector when she did the research.⁹⁹ From her interviews with private entrepreneurs, we can see the great difficulty in collecting the empirical data of informal finance, since many interviewees, who were worried about being punished by the authority due to their participation in grey-market lending activities, felt reluctant to talk about their financing methods.

Some research focused on how informal finance influenced the macro economy. For example, In the book *"Research on the Volume of Underground Financing and Its Economic Effects"* (2005), Professor Li Jianjun from the Central University of Economics and Finance analysed, to what extent, informal finance had an impact on the macro-economic environment by assessing key economic figures like GDP or

⁹⁷ Shuxia Jiang, *China's Underground Finance* (Fujian People's Publishing House 2001), p.23.

⁹⁸ Shuxia Jiang, *China Informal Credit: Analysis of the Social and Cultural Background* (China Financial and Economic Publishing House 2003)

⁹⁹ Kellee S. Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (Cornell University Press 2002), p.2.

M2.¹⁰⁰ In the second book of Professor Li, he surveyed a large number of individuals who engaged in underground financing activities, and documented vivid stories about greedy lenders, bankrupt entrepreneurs, and corrupt officers.¹⁰¹ In 2009, Professor Li and Sara Hsu edited a book with the contributions from many Chinese and American scholars, to scrutinise informal finance from multiple perspectives, including economic, legal, political, cultural, and sociologic analysis.¹⁰² The importance of this book is self-evident, as it is a summary of previous studies regarding informal finance in China, which enables future researchers to get a full picture of this subject.

So far, the majority of works in this field has concentrated on explaining the phenomenon of underground financing, such as how it works and what impacts it has on the Chinese economy and the society. However, limited attentions have been paid to legal and regulatory aspects regarding informal finance. Professor Yue Caishen from Southwest University of Politics and Law is one of few scholars who have tried to explore this area. He raised the problem concerning the legitimacy of informal finance, and urged the government to change its attitudes toward private lending and to admit the fact that private lending is an essential part of the China's financial system.¹⁰³ Professor Yue also stressed the necessity for the government to regulate private lending, either creating a specialised regulatory body or encouraging private lenders to form a self-regulatory association.¹⁰⁴ Finally, being aware of the diversity of informal financing activities, Professor Yue suggested the state to adopt multiple methods to regulate informal finance, depending on different forms of informal finance, and therefore recommended a multi-level regulatory framework.¹⁰⁵ Clearly, the works of

¹⁰⁰ Jianjun Li, *Research on the Volume of Underground Financing and Its Economic Effects* (China Financial Publishing House 2005)

¹⁰¹ Jianjun Li, *The Survey of Underground Financing in China* (Shanghai Renmin Press 2006)

¹⁰² Jianjun Li and Sara Hsu, *Informal Finance in China: American and Chinese Perspectives* (OUP 2009)

¹⁰³ Professor Yue argued that the right to choose financing methods, whether formal or informal, is a fundamental right of all citizens. In a market-based economy, informal finance should be given an equal chance to compete with formal finance. See Caishen Yue, "The Innovation and Perfection of Private Lending Regulatory System: A Research on the Rural Financial System Reform" (2009) 6 *A Symposium on Economic Law* 189, 190-195.

¹⁰⁴ Caishen Yue, Lin Yuan and Rong Chen, "Some Ideas And Points On The Innovation Of Private Lending Legal System" (2009) 1 *Economic Law Forum* 185, 199-201.

¹⁰⁵ Caishen Yue, "The Key Point Of Regulating Personal Loans And Legislation Suggestion" (2011) 5 *China Legal Science* 84, 84-86.

Professor Yue started the debate regarding whether we shall regulate informal finance and how to regulate it. Accordingly, this doctoral thesis goes a step further as it tries to explore an optimal design for the legal framework of private lending, which clearly make a lot of contributions to the existing literature.

2.4.3 Why China's Private Lending Market Is Unique?

Most academics agreed that informal finance, by serving the lower end of the financial market, plays a complementary role in the entire financial system.¹⁰⁶ In most cases, informal finance means small-amount and short-term loans which have been given to individuals who are financially excluded like rural residents or small business owners. The existence of informal finance mainly results from the underdevelopment of the formal financial industry. Apparently, private lending in China fits into the definition of informal finance, as an alternative financing channel for private businesses. However, private financing activities in China also challenge the dominant views of informal finance in two aspects, showing their special characteristics.

Firstly, according to Geertz's theory, the reason explaining the emergence and development of informal financing is the absence of formal credit and saving institutions in a certain country. However, in China's case, the expansion of private lending market is in parallel with a well-established modern banking system. The prosperity of China's private lending market is because of the legacy issue regarding centrally planned economy, as nowadays there are still state **controls** and strong **interventions** in the banking sector. As introduced, the primary function of Chinese banks is to fund other state-owned firms rather than the private sector. As a result, despite China having one of the largest banking industries in the world, it still needs a massive underground lending sector.

Secondly, the prevalence of private lending in China is contrary to the conservative assumption that informal finance serves the lower end of financial markets. In the Chinese market, private financing has been widely used by most businesses in the

¹⁰⁶ Meghana Ayyagari, Asli Demirgüç-Kunt and Vojislav Maksimovic, "Formal Versus Informal Finance: Evidence From China" (*World Bank Research Report* March 2007), p.2, available at http://siteresources.worldbank.org/INTFR/Resources/Formal_verus_Informal_Finance_Evidence_from_China.pdf, accessed 1 May 2016.

private sector, irrespective of their sizes. Apart from small enterprises, businesses at the larger end of the SME spectrum have strong demands for alternative financing.¹⁰⁷ Even public companies in China tend to the private lending market for financing. In the case of Nuoqi, the chairman and CEO Mr Ding Hui borrowed CNY 1.5 billion private loans (USD 218.3 million) to fund the rapid expansion of its business.¹⁰⁸ Hence, private lending refutes the traditional idea that informal finance is only used by marginalised borrowers and it only contains a small amount of money. In fact, the private lending market plays a vital part in China's financial system, as a major financing source for millions of businesses.

2.5 Private Lending and Shadow Banking in China

2.5.1 Revisiting Shadow Banking System

The term “shadow banking system” refers to financial institutions which act like banks but are not supervised like banks.¹⁰⁹ It has attracted a lot of media attentions as well as academic discussions in recent years, as being considered as one of major causes for the global financial crisis. In 2007, shadow banking was firstly proposed by Paul McCulley, an economist, when he gave a speech at the annual conference of the Federal Reserve Bank of Kansas City. He defined shadow banking as “the whole alphabet soup of levered up non-bank investment conduits, vehicles, and structures.”¹¹⁰ In the wake of the GFC, regulators and scholars around the world put more efforts into researching the nature of shadow banking and the appropriate approaches to monitor and supervise it. Despite shadow banking's various forms, the Financial Stability Board (FSB) summarised it as “the credit intermediation involving entities and activities outside the regular banking system”.¹¹¹ In terms of how to

¹⁰⁷ Luke Deer, Jackson Mi and Yuxin Yu, “The Rise of Peer-to-Peer Lending in China: An Overview and Survey Case Study”, Association of Chartered Certified Accountants (October 2015), p.8, available at http://www.accaglobal.com/content/dam/ACCA_Global/Technical/manage/ea-china-p2p-lending.pdf, accessed 1 May 2016.

¹⁰⁸ Shanshan Wang, “Nuoqi Collapsed as Chairman Absconded: A Curse for IPO”, *China Economic Weekly* (18 August 2014), available at <http://www.ceweekly.cn/2014/0818/90303.shtml>, accessed 1 May 2016.

¹⁰⁹ Laura E. Kodres, “What Is Shadow Banking?”, *IMF Finance & Development* (June 2013), p.42, available at <http://www.imf.org/external/pubs/ft/fandd/2013/06/basics.htm>, accessed 1 May 2016.

¹¹⁰ Paul McCulley, “Teton Reflections”, *PIMCO Global Central Bank Focus* (Sept. 2007), p.2.

¹¹¹ FSB, “Shadow Banking: Scoping The Issues” (12 April 2011), p.2, available at http://www.fsb.org/wp-content/uploads/r_110412a.pdf, accessed 1 May 2016.

identify shadow banking activities, the FSB recommended regulators to firstly cast the net wide enough to catch all possible non-bank credit intermediations, and then narrow down the scope by taking into account additional features like maturity/liquidity transformation, leverage, flawed credit risk transfer, and regulatory arbitrage concerns.¹¹² Besides, the Federal Reserve Bank in the United States and the European Central Bank also put forward similar standards to define the shadow banking system.¹¹³

Generally speaking, the origin and development of shadow banking system in Western countries resulted from the shift of banking businesses from the originate-to-hold model to the originate-to-distribute model.¹¹⁴ In the traditional banking model, banks take deposits and pool the money together, which is then used to make loans to borrowers. After that, banks hold the loans as their assets until the maturity dates. However, nowadays it has become more difficult for banks to solely rely on deposit-taking for funding, so they originate loans with the intention to sell them to other investors, rather than holding the loans on their balance sheets. This involves the concept of securitisation which means banks pack loans into securities, such as mortgage-backed securities (MBS) and collateralised debt obligations (CDO), that will be sold to potential buyers.¹¹⁵ Apparently, selling such securities can bring cashes to banks immediately, but the process of securitisation extends the traditional credit chain where there are only depositors, banks, and borrowers. In contrast, a large number of investors join the credit transformation process, prolonging the credit chain and spreading relevant risks to the whole financial system. Moreover, the off-balance sheet

¹¹² *Ibid.*, p.3.

¹¹³ Zoltan Pozsar, et al., “Shadow Banking”, *Federal Reserve Bank of New York Staff Reports* (No. 458, Revised Feb. 2012), available at https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr458.pdf; Klára Bakk-Simon, et al., “Shadow Banking in the Euro Area: An Overview”, *European Central Bank Occasional Paper Series* (No.133, April 2012), available at <https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp133.pdf?4e7d9b9457759addc96d58dd6dcf1891>, accessed 1 May 2016.

¹¹⁴ Vitaly M. Bord and João A. C. Santos, “The Rise of the Originate-to-Distribute Model and the Role of Banks in Financial Intermediation”, *Federal Reserve Bank of New York Economic Policy Review* (July 2012), available at <https://www.newyorkfed.org/medialibrary/media/research/epr/12v18n2/1207bord.pdf>, accessed 1 May 2016.

¹¹⁵ Zoltan Pozsar, et al., “Shadow Banking”, *Federal Reserve Bank of New York Staff Reports* (No. 458, Revised Feb. 2012).

businesses get around regulatory rules which are used to deal with the originate-to-hold model, leading to the problem of regulatory arbitrage.

2.5.2 Shadow Banking with Chinese Characteristics

It is time for us to examine, to what extent, the Chinese shadow banking system is similar to its Western counterparts. As stated, this term was invented to describe the problem of over-securitisation in the United States. However, currently the Chinese securities market is at a preliminary stage, since there is a limited presence of innovative structured vehicles. Therefore, people are wondering about the nature and the exact scope of Chinese shadow banking. Unlike the American shadow banking system which has a close link to its securities market, the shadow banking system in China is mostly associated with quasi-banking activities outside the banking sector. Chinese shadow banks tend to appear as an alternative solution to bank credits, like trust firms, financing companies, microcredit companies, and private money collection.¹¹⁶ It is said that some market observers just borrowed the concept of “shadow banking system” to describe the thriving social financing system in the country, which runs along with the official banking system.¹¹⁷ In the Chinese context, the concept of shadow banking shares the similar meaning of non-bank financing. Despite the fast growth of the banking sector, securities markets, and investment funds in China, a large proportion of financing needs in the society can not be fully met by the official financial system, so that’s why a shadow banking system is created. According to *Xinhua*, a decade ago bank loans accounted for over 90 per cent of the total amount of credits in China, but recently the figure fell to merely 50 per cent.¹¹⁸ Apparently, the reduced 40 per cent of bank credits have been replaced by non-bank channels such as shadow lenders. According to one estimation, the size of Chinese shadow banking stood at CNY 22.8 trillion (USD 3.32 trillion), around 44 per cent of China’s GDP.¹¹⁹ The following two sections are going to examine three components

¹¹⁶ Haibin Zhu, “The Merits and Demerits of Chinese Shadow Banking” *Financial Times Chinese* (15 July 2013), available at <http://www.ftchinese.com/story/001051405>, accessed 1 May 2016.

¹¹⁷ Keguan Luo, “What Is the Chinese-Style Shadow Banking?” *Security Times* (24 September 2012), A10.

¹¹⁸ Jingwei Zhang, “The Legalisation of Private Lending Can Release the Risk of Shadow Banking”, *Xinhua* (18 February 2014), available at http://news.xinhuanet.com/fortune/2014-02/18/c_126149597.htm, accessed 1 May 2016.

¹¹⁹ Dong Tao and Weishen Deng, “China: Shadow Banking - Road to Heightened Risks”, *Credit*

of the Chinese shadow banking system: trust loan, entrusted loan, and private lending.

	<i>Lenders</i>	<i>Borrowers</i>
Trust Loans	Investors of Wealth Management Products, Trust firms	Firms in the sectors under strict credit controls
Entrusted Loans	Cash-rich state-owned and listed companies	
Private Lending	Retail investors, professional moneylenders and informal institutions	Private-owned and unlisted enterprises

Table 4: Main Components of Shadow Banking System in China

2.5.3 Trust Loan and Entrusted Loan

Trust loans, as structured financing vehicles, have been a major form of shadow banking in China. They are extended by trust firms in cooperation with banks, with the funding coming from investors who subscribe to Wealth Management Products (WMPs).¹²⁰ From the demanding side, borrowers are mainly enterprises in industries facing the problem of overcapacity, such as coal miners and property developers, and they are subject to the government's strict credit controls.¹²¹ Borrowers can also be local government financing vehicles and any privately owned businesses. Due to the official credit restrictions, state-owned banks are not allowed to make new loans to the above firms. In the mean time, banks do not want to lose these clients, so they try to lend out the money through off-balance-sheet operation in partner with non-bank financial institutions like trust firms.¹²² From the supply side of funding, instead of taking deposits from savers, banks encourage high-net-worth individuals to buy wealth management products which offer higher returns compared with savings.¹²³ Clearly, the prevalence of trust loans and wealth management products is driven by banks' strategies to evade the official interest caps regarding bank lending and borrowing.¹²⁴ The interest levels of trust loans can better reflect the real price of credits in the

Suisse Economic Research (22 February 2013), p.2.

¹²⁰ Don Weinland and Gabriel Wildau, "China Cracks Down on Shadow Banking", *Financial Times* (03 May 2016), p.2.

¹²¹ Li Guo and Daile Xia, "In Search of a Place in the Sun: The Shadow Banking System with Chinese Characteristics" (2014) 15(3) *European Business Organisation Law Review* 387, 404.

¹²² Gabriel Wildau and Yuan Yang, "Chinese Shadow Lending Evades Regulations", *Financial Times* (30 April 2016), p.4.

¹²³ The return of WMPs is between 6 to 15 per cent annually, see *Hexun Money*, available at <http://money.hexun.com/2014-04-16/163968735.html>, accessed 1 May 2016.

¹²⁴ Haibin Zhu, "The Merits and Demerits of Chinese Shadow Banking" *Financial Times Chinese* (15 July 2013), available at <http://www.ftchinese.com/story/001051405>, accessed 1 May 2016.

financial market, whilst wealth management products are able to offer interest rates that savers desire. The money from selling WMPs then goes to trust firms through a series of complicated agreements between banks and trust firms, and it is finally lent to potential borrowers. WMPs are considered as securities products, as they are standardised investments which have been divided into small units for investors to purchase.¹²⁵

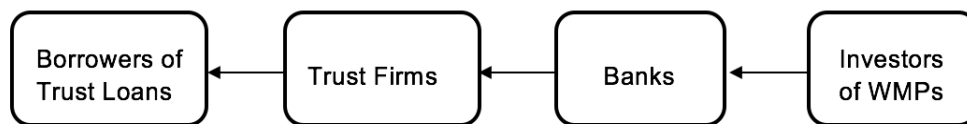


Figure 2: The Simplified Structure of A Trust Loan

The financial innovation of trust loan is a win-win situation for most market participants including banks, trust firms, investors, and borrowers. Banks, together with trust firms, can earn a large amount of administrative fees by selling WMPs, as well as retain old clients which are unable to borrow ordinary bank loans under credit controls. Purchasers of WMPs enjoy a good return on their investments compared with depositing money in saving accounts. Borrowers who have been excluded from bank credits can now have access to sufficient credits by taking out trust loans. However, trust loans running outside of banks' balance sheets are not regulated by the central bank and the China Banking Regulatory Commission, resulting in extra risks.¹²⁶ The practice of making trust loans is in essence regulatory arbitrage, which enables banks to get around official regulations relating to interest rates and loan quotas. Therefore, it is likely to undermine the present banking regulatory regime.

Other risks concerning trust loans include maturity transformation and investor protection. Maturity transformation has long been a problem in the banking sector, as traditional banks often borrow short-term deposits to fund long-term loans. Similarly, it happens in the operation of trust lending as well, since the term time of WMPs is normally between one month and one year, but trust loans are often extended for

¹²⁵ Li Guo and Daile Xia, "In Search of a Place in the Sun: The Shadow Banking System with Chinese Characteristics" (2014) 15(3) *European Business Organisation Law Review* 387, 405.

¹²⁶ Gabriel Wildau, "China Shadow-Bank Product Defaults As Coal Company Can't Repay", *Reuters* (12 February 2014), available at <http://uk.reuters.com/article/2014/02/12/china-trust-default-idUKL3N0LH1L320140212>, accessed 1 May 2016.

several years like bank loans. Secondly, it remains unclear that, when defaults happen in trust loans, whether banks are obliged to compensate investors who have bought WMPs from them.¹²⁷ From the legal perspective, banks as brokers are not directly involved in the trust lending process, and the money of selling WMPs has been transferred to trust firms' money pools. Moreover, WMPs are considered investments rather than ordinary savings, with non-guaranteed returns and the potential risk of losses. However, the reason for most investors to purchase WMPs is simply because they trust their banks which advertise WMPs as a substitute for savings. This, therefore, raises a controversial issue about to what extent banks should take responsibilities in the businesses of trust lending. Recently, China has introduced an explicit deposit insurance scheme in 2015, which does not cover WMPs.¹²⁸ Thus, although investors of WMPs enjoy good returns, they do not have any official protection over their money.

Entrusted loans are another popular form of shadow banking in China, which refer to term loans organised by an agent bank between borrowers and non-bank lenders.¹²⁹ Some cash-positive companies in China, especially state-owned enterprises or listed companies, actively engage in the moneylending businesses through special financing arrangements. For example, they often use their excessive cashes to make loans to other businesses via their financing arms including financing companies and trust companies.¹³⁰ The Chinese SOEs or public companies, favoured by the state, often receive more credits than their actual **needs**, so many of them lend the money to businesses having limited access to bank loans. For instance, as for Yangzijiang Company, a leading ship-maker in China, one third of its CNY 3 billion (USD 436.7 million) profits in 2013 came from lending to other companies via entrusted loans.¹³¹ Under an entrusted loan agreement, the agent bank is acting as the trustee, while the company providing funds is the trustor. As the trustee, banks are only responsible for

¹²⁷ Haibin Zhu, "The Merits and Demerits of Chinese Shadow Banking" *Financial Times Chinese* (15 July 2013), available at <http://www.ftchinese.com/story/001051405>, accessed 1 May 2016.

¹²⁸ Gabriel Wildau, "China to Launch Insurance for Bank Deposits", *Financial Times* (29 November 2014), p.4.

¹²⁹ Franklin Allen *et al.*, "Entrusted Loans: A Close Look at China's Shadow Banking System" (16 December 2015), p.3, available at <http://ssrn.com/abstract=2621330>, accessed 1 May 2016.

¹³⁰ Wei Shen, "Shadow Banking System in China – Origin, Uniqueness and Governmental Response" (2013) 28(1) *Journal of International Banking Law and Regulation* 20, 22.

¹³¹ *The Economist*, "Shadow Banking in China: Battling the Darkness" (10 May 2014), p.70.

administrative works like collecting the principal and interests, but do not bear any risk of defaults.

2.5.4 Private Lending's Shadow Banking Features

In addition to trust loans and entrusted loans, private lending is perceived as one vital element of China's shadow banking system. This part is going to investigate whether private lending fits into the FSB's definitions of shadow banking system, including both broad and narrow definitions which have been discussed earlier. The broad definition just requires shadow banks to be non-bank credit intermediations, while the narrow definition sets out more features for shadow banks to have, such as maturity and liquidity transformation, leverage, flawed credit risk transfer, and lack of regulation.¹³²

Non-Bank Credit Intermediation

In terms of the broad definition, shadow banking refers to non-bank credit intermediations, which includes two scenarios: first, non-bank entities doing the shadow banking businesses; second, the non-bank credit businesses of traditional banks. Obviously, private lending in this research can be defined as credit intermediations by non-bank entities. Prior to making loans, investors, moneylenders and informal institutions pool their own savings or capitals as well as solicit funds through personal networks. After that, they look for individuals and businesses who are seeking credits. After the negotiation process, the lender and the borrower sign a lending agreement and form a contractual relationship. The lender transfers the money to the borrower who is under the obligation to repay the principal and interests over a period of time. Clearly, the private lending market in China has been doing the work of intermediating credits, and thus shall be perceived as shadow banking.

Shadow Banking Features

Apart from being credit intermediations, shadow banking shall possess some specific features according to FSB's narrow definition. As stated, trust lending is facing the problem of maturity and liquidity transformation, as it is reliant on the money raised from short-term WMPs to fund long-term loans. Whether the private lending market

¹³² FSB, "Shadow Banking: Scoping the Issues" (12 April 2011), p.3.

encounters the similar problem of maturity transformation remains unclear, but it certainly has other shadow banking characteristics like high leverage rates. The term high leverage means the high debt ratio or high level of credit creation, and it is clear that a large number of Chinese moneylenders not only use their own capitals but also raise funds from the society to carry out the lending businesses.¹³³ The lending operation based on high leverage contains enormous risks, as it is likely to cause the liquidity drain and the insolvency of moneylenders if some borrowers are unable to repay debts. The defaults of borrowers can make moneylenders fail to meet their own debt obligations to investors, if the cash reserve is not adequate. It might therefore cause the collapse of the entire lending chain.

Moreover, the feature of flawed credit risk transfer can also be found in the private lending market. In the financial industry, transferring credit risks is a common strategy for financial institutions to manage risks.¹³⁴ However, the transfer of risks does not mean the disappearance of risks. Therefore, a flawed credit risk transfer in the shadow banking system means that the transfer of credit risks in fact creates other types of risks. In the practice of private lending, moneylenders often try to manage and mitigate credit risks by asking borrowers to provide collaterals or guarantees. However, this method is not always effective, for in some cases guarantors do not have enough assets to repay debts when the debtor defaults. Moreover, it is common that a group of entrepreneurs agree to provide guarantees for each other.¹³⁵ Therefore, if one business in the group fails to meet its debt obligation, others healthy businesses are liable for the debt, which has a negative impact on their own credit situations. Besides, even though mortgages are often required to secure a private loan, some borrowers mortgage **its property** for several times, and therefore, when it defaults, the mortgaged **property** has to be liquidated to compensate more than one creditor, which could be insufficient.

¹³³ The chapter three introduces several examples of this kind of moneylending model and its risks, such as the case of Mr Zhou Yunfei.

¹³⁴ Franklin Allena and Elena Carlettib, “Credit Risk Transfer and Contagion” (2006) 53 *Journal of Monetary Economics* 89, 90.

¹³⁵ Ji Tong, “The Data Analysis of Private Lending Cases Heard by All Courts in Recent Five Years”, *Legal Daily* (4 March 2014), available at http://www.legaldaily.com.cn/zbzk/content/2014-03/04/content_5330575.htm?node=25497, accessed 1 November 2016.

In summary, private lending activities have at least two shadow banking characteristics, namely, the high leverage rate and flawed credit risk transfer, which make them qualified as shadow banking. Next, it considers whether private lending possesses other attributes of shadow banks, like the lack of official regulation and systemic risks.

Lack of Regulation and Systemic Risk

The operation of shadow banking system remains outside of a country's financial regulatory regime, which distinguishes it from the regular banking sector.¹³⁶ Due to the absence of regulation, the relevant credit risks of shadow banks are difficult to monitor, detect, and control. The lack of regulation also results in the inadequate protection from the authority for the shadow banking system itself and its participants. For example, the central bank is unable to provide liquidity supports for shadow banks in the emergency situations. It probably explains why shadow banking is prone to collapse in a short time due to the liquidity drain. Moreover, investors in shadow banking, such as subscribers of WMPs and private lenders, are not protected by the deposit insurance scheme, which means they have to bear their own losses during financial crisis. Clearly, the private lending market in China at present falls out of the regulatory scope of Chinese authorities.¹³⁷ This is why we consider private lending as a part of shadow banking system.

Systemic risk refers to the potential risk of the collapse of an entire system, triggered by events like an economic crisis or an institutional failure, as opposed to the breakdown in individuals or some components of a system.¹³⁸ The problem of contagion and systemic risk has been widely observed in the banking sector. Indeed, it is the systemic risk that distinguishes banking and currency crises from most of other crises.¹³⁹ In the recent global financial crisis, the systemic risk was evidenced by a series of bank runs in many countries like the United States and the United Kingdom. The Bank for International Settlements (BIS) defined the systemic risk by focusing on the causation

¹³⁶ Peter J Wallison, "Regulation of Shadow Banking Takes a Dark Turn", *Wall Street Journal* (10 February 2015), A11.

¹³⁷ For more discussion on the lack of regulation in the private lending market, please see the chapter 4 and 5.

¹³⁸ Steven L. Schwarcz, "Systemic Risk" (2008) 97 *The Georgetown Law Journal* 193, 198.

¹³⁹ George G. Kaufman, "Banking and Currency Crises and Systemic Risk: Lessons from Recent Events' Economic Perspective" (Federal Reserve Bank of Chicago), p.14.

aspect: “the risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default with a chain reaction leading to broader financial difficulties.”¹⁴⁰ It can explain for the domino-like collapse in the banking sector.

Theoretically speaking, the direct and indirect interconnections between banks account for the systemic risk. On the one hand, banks collectively form a integrated payment system in a country.¹⁴¹ As a result, this kind of direct correlation between banks let the default of one bank have significant impacts on other banks in a short time. On the other hand, the indirect interconnection among banks has also been observed. When the depositors of a specific bank start to form a long queue outside the bank’s branches to withdraw savings, depositors of other healthy institutions, by the panic effect, would probably rush to their own banks to do the same thing, causing the insolvency of more banks. Most savers by nature are strongly risk-adverse, so they tend to remove their savings from banks if there are only remote risks emerging. In a similar fashion, systemic risk can also be found in China’s private lending market, as the close interconnection among market participants, as well as the tight money link between private lending and the formal banking sector.¹⁴² It is clear that the breaking down of one point in the lending chain could lead to the collapse of the entire lending string shortly.

After examining private lending against relevant shadow banking standards, we can come to the conclusion it has most features of shadow banking activities. The private lending market plays a vital role in credit intermediation by transferring credits from investors to the hands of business borrowers. It is also featured by high leverage and flawed credit transfer, two major characteristics of shadow banking. More importantly, the underground lending industry runs outside of the financial regulatory system, which makes it different from the regular banking sector. Last but not least, private lending activities are likely to cause systemic risks to the economy, which reinforces the viewpoint that private lending belongs to China’s shadow banking system.

¹⁴⁰ BIS, *64th Annual Report* (June 1994), p.177.

¹⁴¹ Heidi Schooner and Michael Taylor, *Global Bank Regulation* (Academic Press 2009), p.37.

¹⁴² More discussion of systemic risks in China’s private lending market will be presented in the next chapter.

2.6 P2P Lending: The Online Version of Private Lending

2.6.1 What Is Peer-to-Peer Lending?

In 2005, the first peer-to-peer lending (P2P lending) platform in the world, Zopa, was launched in the UK.¹⁴³ Since then, countries like the UK, the US, and China have witnessed rapid growth in their online lending sectors, which has been changing the landscape of the traditional financial industry. P2P lending refers to a practice of lending to unrelated individuals or businesses through online platforms, without the involvement of formal financial institutions.¹⁴⁴ Most borrowers of P2P loans are consumers or small businesses in search of credits outside the banking sector. When potential borrowers file applications online, the P2P lending platform will do the credit check and list loans on its marketplace which are going to be funded by investors registered with the platform. According to the P2P Finance Association (UK), P2P finance is defined as “a debt-based funding arrangement facilitated by an electronic platform that comprises, to a significant extent, direct one-to-one contracts between a single recipient and multiple providers of funds, where a significant proportion of lenders are generally retail consumers and where borrowers are generally retail consumers or small businesses.”¹⁴⁵ Besides, P2P lending is known as “loan-based crowdfunding” in Britain, the concept of which was put forward by the Financial Conduct Authority (FCA).¹⁴⁶

After a decade of developments, now there are around eighty P2P lending platforms in the UK, together making loans worth billions of pounds every year.¹⁴⁷ Currently, Britain has the largest alternative finance market within the EU, as it took up 74.3 per cent of the total market share.¹⁴⁸ In the United States, the online lending industry also

¹⁴³ Judith Evans, “Zopa to Target Retirement Savers Market”, *Financial Times* (03 January 2015), p.3.

¹⁴⁴ *The Economist*, “Peer-To-Peer Lending: Banking Without Banks” (1 March 2014), p.70.

¹⁴⁵ P2PFA, “Rules of the Peer-to-peer Finance Association” (May 2015), Para. 2.1.

¹⁴⁶ According to the FCA, crowdfunding is a way in which individuals and businesses are able to raise money from the public, to support a business, project, campaign or individual. The term applies to a number of internet-based business models, including donation-based crowdfunding, rewards-based crowdfunding, loan-based crowdfunding and investment-based crowdfunding. See FCA, “Crowdfunding”, <http://www.fca.org.uk/consumers/financial-services-products/investments/types-of-investment/crowdfunding>, accessed 1 May 2016.

¹⁴⁷ P2PMoney, <http://www.p2pmoney.co.uk/companies.htm>, accessed 1 May 2016.

¹⁴⁸ University of Cambridge and EY, “Moving Mainstream: The European Alternative Finance

gained its popularity and its market is dominated by FinTech giants like the Lending Club and the Prosper Marketplace.¹⁴⁹ Nonetheless, China now has the largest P2P lending industry in the world, thanks to the vast number of investors and technological advances. Evidently, P2P lending brings a better deal for both sides of lending, by increasing financing availabilities and reducing transactional costs for borrowers, and providing better investment choices with a higher return for lenders who otherwise can only deposit their money in banks. Most British P2P lending platforms like the Zopa and the Rate Setter target individual or consumer borrowers, whilst an increasing number of P2P portals such as the Funding Circle focus primarily on lending to small businesses. The later type of business model is called Peer-to-Business (P2B) lending.

2.6.2 The Rise of P2P Lending in China

In 2006, the P2P lending model was introduced to China by Mr Ning Tang, the founder of CreditEase, a leading FinTech company and wealth management platform in China.¹⁵⁰ In December 2015, Yirendai.com, the online lending marketplace of CreditEase was successfully listed on the New York Stock Exchange, which has 6 million users and an annual lending amount of over CNY 8 billion (USD 1.16 billion). Other market leaders in China include Paipaidai which is the first P2P platform to gain the official approval from the Industrial and Commercial Administration. The services of Paipaidai cover 12 million people and over 98 per cent of Chinese cities.¹⁵¹ In April 2015, Paipaidai finished the C-round financing as it attracted investments from private equity firms like the Sequoia Capital, the Legend Capital, and the Noah Private Wealth Management. Clearly, the successful story of CreditEase and Paipaidai indicates the fast developments of P2P lending industry in China.

Benchmarking Report” (February 2015), p.13.

¹⁴⁹ Peter Rudegeair, “Layoffs Mount at Online Lenders”, *Wall Street Journal* (08 July 2016), C1.

¹⁵⁰ CreditEase, <http://english.creditease.cn/about/Overview.html>, accessed 1 May 2016.

¹⁵¹ PaiPaiDai, <http://www.ppdai.com/help/aboutus>, accessed 1 May 2016.

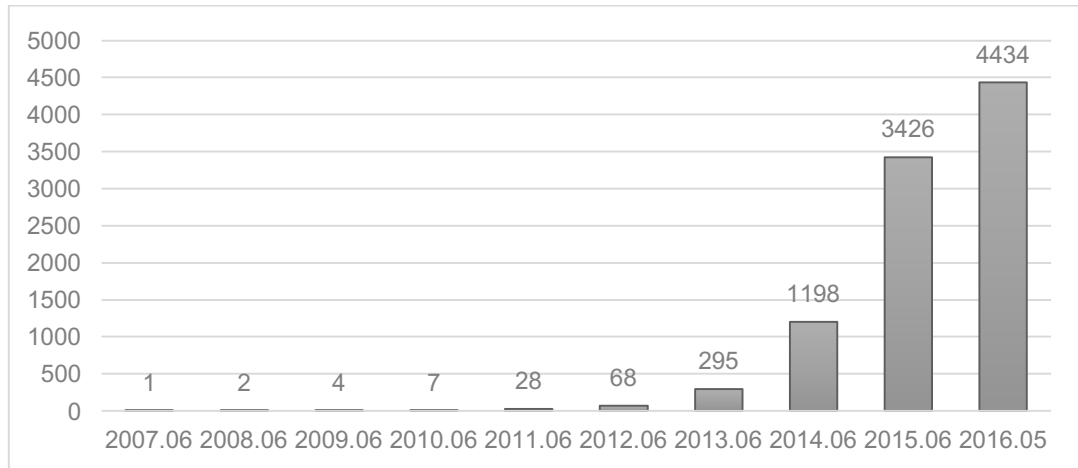


Figure 3: The Number of P2P Platforms in China¹⁵²

According to Lingyi Finance, a Beijing-based research institution, the number of active P2P lending service providers in China climbed from 28 in June 2011, to 4,434 in May 2016 (see the chart above). With more than 4,000 platforms matching the financing demands from borrowers with investors' money, the Chinese online lending market saw massive growth in the past decade. In 2015, the total lending volume reached CNY 975 billion (USD 141.9 billion), which was more than tripled from CNY 300 billion (USD 43.7 billion) in 2014.¹⁵³ More than 10 million people took part in P2P lending in 2015, including 2.8 million borrowers and 7.2 million investors.¹⁵⁴ The average interest rate of a P2P loan stands at 10.83 per cent per annum, and the average lending period is between 330 and 410 days.¹⁵⁵

Despite the popularity, P2P lending is also associated with extra financial risks and legal problems. For instance, some platforms try to solicit funds from investors and form illegal capital pools before lending out the money, which violates the principle that P2P platforms shall only be information intermediaries rather than credit intermediaries. At the end of 2015, nearly one third of P2P online lending platforms in China experienced operation difficulties due to various reasons like ceased

¹⁵² Data Source: Lingyi Finance, available at <http://data.01caijing.com/p2p/website/count.html>, accessed 1 May 2016.

¹⁵³ Lingyi Finance, "P2P Lending Industry Annual Report 2015", available at <http://01caijing.baijia.baidu.com/article/286273>, accessed 1 May 2016.

¹⁵⁴ *Ibid.*

¹⁵⁵ *Ibid.*

operations, lending disputes, frozen withdrawals, and runaway bosses.¹⁵⁶

The reason for the fast growth of the P2P lending industry in China is similar to what explains for the popularity of private lending. The market is largely driven by the strong financing demands from small businesses which have been underserved by the state-controlled banking sector. Compared with the US and the UK where the market is dominated by P2P consumer lending, in China P2B lending occupies over 40 per cent of total lending.¹⁵⁷ It shows that P2P lending, like private lending, is widely employed by Chinese businesses as an alternative form of finance. In practice, a number of leading P2P lenders like Paipaidai, Dianrong, and Jimubox started their businesses by making loans to SMEs.¹⁵⁸ Moreover, the growing peer-to-peer lending industry in China is an evidence showing the continuous evolution of private financing activities.

What is more, P2P lending is a dynamic component of the increasingly popular Internet finance sector in China. Internet finance is based on the latest information technologies as well as innovative financial services.¹⁵⁹ Internet finance can be divided into three categories: payment and settlement services, online lending, and sales of investment products.¹⁶⁰ The typical examples of Internet finance products include Alibaba's Yuebao, P2P lending, and crowdfunding.¹⁶¹ The emergence of Internet finance can be explained in two aspects. Firstly, Internet giants in China like Alibaba, Baidu, and Tencent tried to expand into the financial industry, by taking advantage of having the big data of millions of users, which could be used to evaluate credit

¹⁵⁶ *The Economist*, "China's P2P Lending Boom: Taking Flight" (23 January 2016), p.69.

¹⁵⁷ Luke Deer, Jackson Mi and Yuxin Yu, "The Rise of Peer-to-Peer Lending in China: An Overview and Survey Case Study", Association of Chartered Certified Accountants (October 2015), p.7.

¹⁵⁸ *Ibid.*

¹⁵⁹ Jing Bian, "Internet Finance in China: Half Lava? Half Ocean?" (2014) 29(12) *Journal of International Banking Law and Regulation* 743, 743.

¹⁶⁰ Takeshi Jingu, "Internet Finance Growing Rapidly in China", Nomura Research Institute (10 March 2014), p.1.

¹⁶¹ Yuebao (left-over treasure) is a fund management platform launched by the internet giant Alibaba. It is mainly available through its mobile app on Android or Apple smartphones. Users can deposit their money in the Yuebao and have the access to the money at anytime while enjoy return up to 5-6 per cent annually. Yuebao's money pool is mainly used for purchasing money market fund with very low risks. Yuebao is also an electronic wallet so its holder can use the money to purchase goods and services like the Apple Pay. Yuebao is an alternative to banks' deposits for many young people in China, and it currently has 260 million users. See Yuebao, <https://bao.alipay.com/yeb/index.htm>, accessed 1 May 2016.

situations of consumers and provide personalised services. Secondly, traditional financial institutions have been gradually moving their existing services online, such as online banking, mobile banking, and online securities broking. Internet finance is said to have some advantages over traditional finance.¹⁶² In contrast to large financial service providers that favour big clients, Internet finance is available for most ordinary consumers and smaller businesses, due to the low thresholds of their services and the ease of accessibility facilitated by latest technologies.¹⁶³ In addition, aided by big data derived from the transaction histories of individual users, Internet finance can offer tailored services to customers based on their real needs.

2.6.3 Comparing Banking, Private Lending, and P2P Lending

Banks, as credit intermediaries, play a central role in any modern economies, which take deposits from the public and make loans to individuals, businesses, and governments seeking credits.¹⁶⁴ Due to the fact that traditional banks are operating at a high-cost base since they have extensive branch networks, a large number of staffs as well as complicated IT systems, they charge a lot over the loans to compensate the costs. However, savers as the final suppliers of funds only receive limited returns. This is the indirect lending model under which savers and borrowers do not contact with each other and form their credit relationships with banks separately.

However, P2P lending removes banks from the lending chain, by serving as an information intermediary which helps potential lenders and borrowers to find each other online. It is a direct lending model where lenders and borrowers enter into lending relationships without any third parties. Most functions of a P2P lending platform are limited to lending-related services, such as advertising loans, checking credit, and collecting payment. From this perspective, P2P lending can be considered as the online version of private lending. First of all, both private lending and P2P lending have the direct lending model where two sides of lending form contractual

¹⁶² Liang Zong and Qiyue Xiong, "How the Commercial Banks Fight with Internet Finance", *Caijing Magazine* (2014 Vol.11), p.103.

¹⁶³ Thanks to the online operation, Internet finance portals are able to provide 24/7 service for customers regardless of the time and location.

¹⁶⁴ Federal Reserve Bank of San Francisco, "What Is the Economic Function of A Bank?", available at <http://www.frbsf.org/education/publications/doctor-econ/2001/july/bank-economic-function>, accessed 1 May 2016.

relationships in a direct way. However, the differences between private lending and P2P lending are, in the private lending market, lenders and borrowers approach each other through local personal networks, while for P2P lending, lenders and borrowers find each other via online platforms. Therefore, P2P lending is the upgrade of private lending, by employing modern information technologies to facilitate information exchanges between lenders and borrowers. In addition, from a functional perspective, private lending and P2P lending both serve the needs of people with restricted access to the banking sector.

Furthermore, the rise of P2P lending industry in China is partly due to the fact that some P2P lending platforms emerged from previous local informal lending businesses. In fact, only a small proportion of P2P lending platforms began their businesses as dedicated online lending portals, while the majority of them have been transformed from other similar businesses such as underground lenders or wealth management companies.¹⁶⁵ On the other hand, more private lending business will probably evolve into P2P lending service providers in the future to break the geographical boundary of their businesses and serve more customers. Therefore, from this viewpoint, P2P lending might be a future development path for the rampant underground lending market in China.

2.7 Characteristics of Private Lending Activities

The evolution of private lending industry in contemporary China is deeply rooted in its distinctive economic and political environments. Therefore, a number of special characteristics can be observed.

2.7.1 Extensive Presence in Chinese Economy

From the well-developed east coastal regions to the less developed middle and western parts of China, private lending can be found in most places as an alternative financing method for private businesses. As stated, the market scale of private lending amounted to CNY 4 or 5 trillion, marking its important position in the entire financial system. Apparently, such a huge informal finance sector can be hardly seen in any other

¹⁶⁵ Luke Deer, Jackson Mi and Yuxin Yu, “The Rise of Peer-to-Peer Lending in China: An Overview and Survey Case Study”, Association of Chartered Certified Accountants (October 2015), p.11.

countries. In most developing countries, informal finance is mainly used by deprived individuals as a way to obtain credits to buy consumer goods or invest in small ventures, but in China private lending is a fully commercialised financing method for businesses regardless of their sizes. Moreover, China has witnessed the emergence of professional moneylenders whose business models are similar to that of official banking, and these back-alley lenders also recruits professional staffs like bankers, lawyers, and accountants to run their businesses.

2.7.2 Reliance on Traditional Personal Networks

Although China underwent the rapid industrialisation over the past decades as well as the modernisation of its financial industry, it still has a massive underground financial industry. Informal financing arrangements between lenders and borrowers are mostly conducted through personal networks in secretive manners.¹⁶⁶ In a pre-industrialised society without modern banking, people tend to rely on social networks to carry out financing activities. In contrast, people in an industrialised society normally borrow money from financial institutions like banks. This marks a tendency of moving from an acquaintance society to a stranger society.¹⁶⁷ However, despite having a modern banking sector, Chinese moneylenders and borrowers still carry out lending activities in a old-fashioned way.

The reliance on personal networking leads to another feature of private lending, namely, the geographical boundaries. Despite the extensive presence, the businesses of moneylenders in most cases are confined to a certain geographic region, as transactions take place among relatives, friends, colleagues, and business partners. Therefore, unlike banks which often have widespread branch networks across cities and provinces, moneylenders operate their businesses at local level, which means they attracts funds from local households or business owners, as well as make loans to local entities in need of money. As a result, the money borrowed and lent has been circulating in a specific region, which is important to the local economy. However, as the arrival of Internet finance like P2P lending in the recent years, moneylending

¹⁶⁶ Jamil Anderlini and Henny Sender, “Chinese Finance: A shadowy Presence”, *Financial Times* (01 April 2011), p.7.

¹⁶⁷ See Lina Song, “The Nature of Acquaintance Society” (2009) 2 *Journal of China Agricultural University (Social Sciences Edition)*.

businesses have extended beyond their geographic boundaries, as they make use of the online technologies to advertise and conduct lending. Meanwhile, some moneylenders and entrepreneurs try to formalise private lending firms by setting up formal financial institutions such as microcredit companies or privately owned banks, which are regulated by the authority.¹⁶⁸ The formal lending businesses, clearly, are not limited to serve local clients. Therefore, the developments of online lending and the institutionalisation of private lending has been gradually change the the regional feature of the private lending industry.

2.7.3 Fast, Efficient, but High-Cost

As stated, one obvious advantage of informal finance over formal finance is its flexibility. Relying upon personal networks, lenders and borrowers are allowed to negotiate all the terms and conditions freely. On the contrary, most bank lending involves **stand** form contracts in which borrower are almost unable to negotiate the terms favourable to them. Moreover, private lending is considered as efficient financing models for small businesses.¹⁶⁹ It saves time and money from going through the complicated bank lending process. According to a report, a private loan can be extended within five days after the application is made, and borrowers only need to provide their identity cards, bank statements, and a copy of income certificate.¹⁷⁰ Despite the efficiency of borrowing a private loan, it can be very costly for borrowers. The annualised interest rate for private lending normally stands over 20 per cent, as moneylenders have to charge heavily to pay for their own costs.¹⁷¹ In contrast, borrowing a loan from ICBC, the largest Chinese bank, only costs borrowers 4 to 5 per cent a year.¹⁷²

¹⁶⁸ For example, qualified investors in China have been encouraged to set up new banks recently, see Jamil Anderlini, “China Pilots Project to Launch Five Private Banks” *Financial Times* (12 March 2014), p.12.

¹⁶⁹ Emma Dong and Simon Rabinovitch, “China’s Lending Laboratory”, *Financial Times*, (23 May 2012), p.11.

¹⁷⁰ Jane Cai, “Private Lenders Thrive in China as Banks Neglect Small Clients”, *South China Morning Post* (6 January 2014), available at <http://www.scmp.com/business/banking-finance/article/1398701/private-lenders-thrive-china-banks-neglect-small-clients>, accessed 1 February 2017.

¹⁷¹ *Ibid.*

¹⁷² ICBC, “RMB Loan Interest Rate Table”, available at <http://www.icbc.com.cn/ICBC/%E9%87%91%E8%9E%8D%E4%BF%A1%E6%81%AF/%E5%AD%98%E8%B4%B7%E6%AC%BE%E5%88%A9%E7%8E%87%E8%A1%A8/%E4%BA%BA%E6%B0%91%E5%B8%81%E8%B4%B7%E6%AC%BE%E5%88%A9%E7%8E%87%E8%A1%A8/>,

2.7.4 Grey-Market Outside the Regulatory Realm

From the legal perspective, private lending activities form contractual relationships between lenders and borrowers.¹⁷³ Therefore, the relevant information of a private loan, such as lending parties, the amount of money, the interest rate, and the term time, is unknown to the financial regulator. Only when there is a legal dispute and one of lending parties decides to file a lawsuit to the civil court, the private lending transaction will be disclosed to the authority. Otherwise private lending remains completely secret. That's why the private lending market has been almost unregulated due to its opaque nature.

2.8 Conclusion

This chapter explains how the private lending market fills a big gap in China's financial system and has become a major financing source for private businesses. First of all, it familiarises readers with historical evolutions of banking and lending activities in China, with a focus on the establishment of a modern banking industry. However, as the Communist Party took over the county in 1949, it decided to implement the centrally planned economy model, and thus most businesses including banks were nationalised. In 1978, Deng Xiaoping decided to reform the Chinese economy and open it up to the rest the world by bringing back the market principle. Since then, the socialist market economy model has been gradually established. Entrepreneurs are encouraged to start their businesses, while certain industries of strategic importance remain in the state's hands. As a result, Chinese banks despite experiencing the process of marketization are still subject to huge state influences, as they prefer to make loans to other SOEs and refuse to lend money to the thriving private sector. Millions of Chinese businesses in particular SMEs, therefore, can only depend on the private lending market to borrow money. In the mean time, numerous Chinese investors, who have been fed up with the low interest rates of their savings, chose to join the lending market to earn a better return. The financing demands of private businesses are satisfied by the supply of money from investors, which leads to a prosperous underground lending industry in China worth trillions of yuan. The market creates a

accessed 1 February 2017.

¹⁷³ For more discussion about the contractual relationship about private lending, see chapter 5.

win-win solution for both money-strapped entrepreneurs and their private lenders.

After examining the origin and developments of private lending activities, we draw our attentions to three concepts in the existing literature that share similar meanings with the concept of private lending: informal finance, shadow banking, and peer-to-peer lending. Obviously, private lending can be seen as a typical type of informal finance which is opposite to formal financial sectors like banking, securities markets, and insurance. In the past, some scholars have explored the informal finance in China, but most of their research focus on analysing the market from economic and finance perspectives. Consequently, this research pushes forward the boundaries of existing studies by investigating the legal and regulatory issues regarding China's private lending market. Furthermore, this chapter tests the concept of private lending against the FSB's official standards about shadow banking, and concludes that private lending is a vital part of the shadow banking system in China. It also analyses the rapid growing peer-to-peer online lending industry in the country, which bears a lot of similarities to private lending. The author argues that P2P lending in China can be considered as the online version of private lending, despite their different advertising approaches. Clearly, P2P lending overcomes the geographical limitations of private lending, and it is predicted that more private lending businesses will be moved online and become P2P lending platforms in the near future.

The final part summarises some special characteristics of private lending activities. Evidently, private lending has a wide presence in China, and in most cases it is conducted via traditional personal or business networks. The reliance on personal links can, to some extent, makes the lending process faster and more efficient, by solving the problem of information asymmetry. Moreover, the terms of private loans tend to have more flexibilities as lenders and borrowers can negotiate freely. Nonetheless, the convenience of private lending comes with other disadvantages like high costs, for the annualised interest rate of any private loans is normally over 20 per cent, which renders borrowers suffer heavy debt burdens. It is an important reason causing a private lending crisis over the past few years, which is to be presented in the next chapter.

Chapter 3 The Private Lending Crisis: Causes, Risks, and Effects

3.1 Introduction

Previously, we have discussed about the prevalence of private lending in China, which resulted from the country's malfunctioning state banking system that fails to provide adequate credits for the private sector. Therefore, millions of private businesses rely on private lenders to borrow money to fund their business ventures. Meanwhile, lots of Chinese savers decided to deposit their money in various private lending schemes to earn a better rate of return, supplying funds to the shadow banking system. Consequently, the private lending market has been growing rapidly in recent years and become a significant component of China's financial industry. It led to a win-win situation for most market participants including borrowers and investors.

However, in 2011 the equilibrium of the private lending market was suddenly broken, when a large number of borrowers started to default on their private loans, as a result of the deteriorating economic condition and the official interest rate hike. Thus, China has seen a private lending crisis happening across the country, which is referred to as the "China's subprime crisis" by some Western media.¹ After massive defaults, many businesses fell into insolvency. Some businessmen and women chose to file for bankruptcy, whilst others decided to run away to evade debts.² In a short time, the default waves resulted in the collapses of several large private lending networks in many cities. The market, in which investors used to make a great fortune in the past, has become a place without winners. Moreover, the credit crisis casted a dark cloud over the Chinese economy which has been slowing down in recent years.³

This chapter aims to discuss and analyse the causes and effects of China's private lending crisis. It proceeds as follow. The second part examines what accounts for the credit crunches, ranging from the macro economic condition to the overheated lending

¹ See, for example, Austin Ramzy, "A Credit Crisis in China's Most Enterprising City Is Making the Country Nervous", *Time* (28 November 2011), available at <http://content.time.com/time/magazine/article/0,9171,2099675,00.html>, accessed 1 July 2016.

² Lerong Lu, "'Runaway Bosses' in China: Private Lending, Credit Crunches and the Regulatory Response" (2015) 18(9) *Financial Regulation International* 1, 5.

³ Michael Pettis, "China's Economy Is Headed for a Slowdown", *Wall Street Journal* (10 Aug 2011), A13.

speculation. The third part evaluates the business structure used by most private lending schemes, to see how the interest rate levels of private lending have been pushed up by the complicated financing vehicles, and how extra financial risks have been created. Then, the fourth part investigates the impacts of the lending crisis on borrowers, with a particular focus on the phenomenon of runaway bosses. The fifth part continues to analyse the influences of the crisis on investors, by conducting case studies regarding the failures of some major lending networks as well as the real stories of ordinary investors. Finally, the sixth part summarises economic problems exposed during the crisis, awaiting solutions by the future financial reforms.

3.2 What Caused the Private Lending Crisis?

There are various reasons accounting for the private lending crisis. The discussion will start from the global and Chinese economic conditions, and it firstly concentrates on the global financial crisis (GFC) which has brought great turbulence to the world economy.

3.2.1 Global Financial Crisis 2007-08

The recent GFC has been considered as the worst one since the Great Depression in the 1930s, as it caused significant damages to most developed and developing economies around the world.⁴ The GFC resulted from the problem of over-securitisation in the United State's housing market, as the subprime mortgage crisis soon evolved into a global financial upheaval.⁵ The crisis led to the failures of large financial institutions in many countries, such as the Lehman Brothers in the US and the Northern Rock in the UK.⁶ Most of failed banks were either acquired by other financial institutions or nationalised by the official bail-out plans. Besides, the crisis produced turmoil in capital markets in America, Europe, and the Asia-Pacific region,

⁴ Miao Han, *Central Bank Regulation and the Financial Crisis: A Comparative Analysis* (Palgrave MacMillan 2016), p.40.

⁵ Jon Hilsenrath, Serena Ng and Damian Paletta, "Worst Crisis Since '30s, With No End Yet in Sight", *Wall Street Journal* (18 September 2008, A1).

⁶ Rosalind Z. Wiggins, Thomas Piontek and Andrew Metrick, "The Lehman Brothers Bankruptcy: Overview", Yale School of Management (October 2014), available at <http://som.yale.edu/sites/default/files/files/001-2014-3A-V1-LehmanBrothers-A-REVA.pdf>; House of Commons (UK) Treasury Committee, "The Run on the Rock (Volume 1)" (January 2008), available at <https://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf>, accessed 1 February 2017.

as the stock index and share prices of public companies plummeted. For instance, the Dow Jones Industrial Average in the US fell from 14,000 points in October 2007, to 6,600 points in October 2008.⁷ Accordingly, a large amount of individual and national wealth was wiped out during the stock market crash.

Afterwards, the GFC sparked a global economic recession, featured by the decline in GDP growth, the high unemployment rate as well as the falling housing price in various countries. According to the International Monetary Fund, the recent recession might be worst one after the World War II.⁸ The United States where the subprime crisis began was the first country to experience the economic decline in 2008.⁹ Another major victim of the GFC was the Europe Union where there has been an ongoing sovereign debt crisis. Since 2009, a number of countries in the Eurozone, including Greece, Portugal, Spain, and Ireland, have defaulted on their government debts, creating the bankruptcy status for their respective states. Moreover, the unemployment rate in the EU stood at 10.2 per cent in early 2016.¹⁰ In particular, Greece and Spain saw the highest unemployment level in the EU (24.2 per cent and 20.1 per cent respectively).¹¹ After the crisis, it took several years for some economies to recover to the pre-crisis level such as the US and the UK, but there are still many countries which have been stuck in the long-term economic crisis.

In the wake of the GFC, governments around the world and international organisations put forward a series of reform measures in response to the economic crisis and the problematic financial regulation. In the post-crisis era, the main challenges facing policymakers include the restructure of the financial sector, as well as the formulation of policies regarding monetary easing and fiscal stimulus.¹² In terms of regulatory

⁷ *Bloomberg*, <https://www.bloomberg.com/quote/INDU:IND>, accessed 1 July 2016.

⁸ IMF, “World Economic Outlook: Crisis and Recovery” (April 2009), p.11, available at <http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/text.pdf>, accessed 1 July 2016.

⁹ Jon Hilsenrath, Joanna Slater and Justin Lahart, “Few Good Scenarios in View as Crisis Spreads”, *Wall Street Journal* (26 September 2008), A1.

¹⁰ European Union, “Euro Area Unemployment at 10.2%” (April 2016), available at <http://ec.europa.eu/eurostat/documents/2995521/7412086/3-31052016-AP-EN.pdf/>, accessed 1 July 2016.

¹¹ *Ibid.*

¹² IMF, “World Economic Outlook: Crisis and Recovery” (April 2009).

reforms, the focus has been centred on prudential regulation and maintaining the financial stability. For instance, in the US, the Dodd-Frank Act was passed in 2010 to overhaul the country's financial regulatory regime.¹³ It intends to prevent the reoccurrence of incidents that caused the recent crisis. A number of new government agencies, such as the Financial Stability Oversight Council (FSOC) and the Consumer Financial Protection Bureau (CFPB), were established to promote the financial stability and improve the protection of financial consumers. In the UK, the Financial Services Authority (FSA), which used to be the sole regulator for the British financial industry, was replaced by a twin-peak regulatory model consisting of the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA), created by the Financial Services Act 2012.¹⁴ The new regulatory system in Britain draws more attentions to the prudential regulation of large financial institutions that are prone to cause systemic risks and threaten the financial stability. What is more, at international level, the Basel III was introduced by the Basel Committee on Banking Supervision (of the Bank for International Settlements) in response to the financial crisis.¹⁵ It promulgated stricter standards for banks concerning their capital adequacy, leverage ratio, and liquidity. Despite a lot of international efforts to improve the quality of financial regulation, their actual effects await to be seen in the future.

3.2.2 The Slowdown of Chinese Economy

Although the financial industry in China was not directly hit by the GFC and remained relatively intact, the Chinese economy, in recent years, has been facing its own challenges, such as the slowdown of the growth rate and the transformation of its current manufacture and export-based economic model.¹⁶ Some of the challenges are indeed caused by the economic recessions in the rest of the world.

¹³ The Dodd-Frank Act refers to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Effective 21 July 2010).

¹⁴ Eilis Ferran, "The Break-Up of the Financial Services Authority" (2011) 31(3) *Oxford Journal of Legal Study* 455, 456.

¹⁵ BIS, "International Regulatory Framework for Banks (Basel III)", available at <http://www.bis.org/bcbs/basel3.htm>, accessed 1 July 2016.

¹⁶ Martin Wolf, "China's Challenge to the World", *Financial Times* (30 March 2016), p.9.

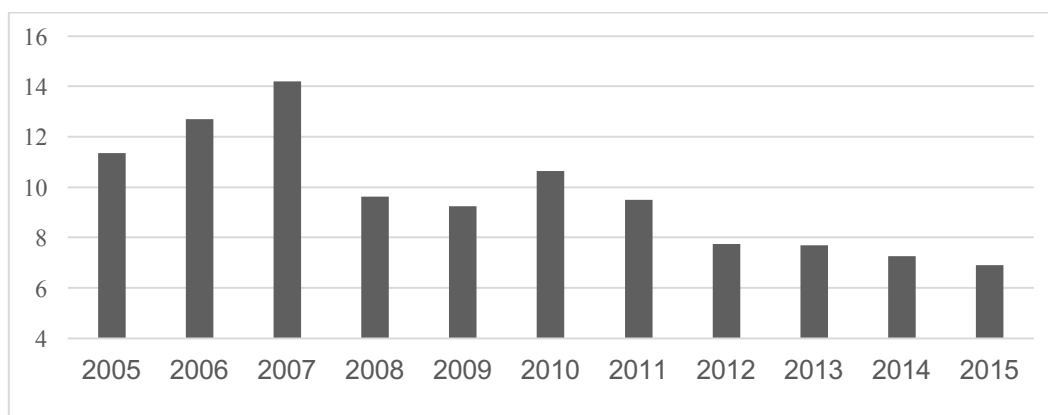


Figure 4: China's Annual GDP Growth Rate (2005-2015)¹⁷

The chart above displays the GDP growth rate in China from 2005 to 2015. Evidently, since 2008 the growing speed of the Chinese economy has been gradually slowing down. In 2015, the GDP only increased by 6.9 per cent, the slowest rate over the past three decades. The reduction in the growth speed suggests some economic problems. In the past, the manufacturing industry played a key role in the economic growth, as China has been the largest exporter in the world by selling its goods to customers all over the world.¹⁸ However, due to the GFC, the global demands for Chinese products shrank greatly, and that's why China's economic growth lost some momentums. In particular, SMEs in East China where export-oriented businesses dominate the local economy have been subject to strong influences relating to the economic conditions and relevant policies in the US and the EU.¹⁹ The *Caixin* (财新) purchasing managers index (PMI), an important indicator of manufacturing activities in China, fell below the threshold of 50 points for most months in 2015, which suggested a continuous contraction of the manufacturing industry.²⁰ Therefore, although China was not directly affected by the GFC, its economy suffered from the deteriorating economic environments in other parts of the world.

¹⁷ National Bureau of Statistics (China), available at <http://data.stats.gov.cn/ks.htm?cn=C01&zb=A0501>, accessed 1 July 2016.

¹⁸ Peter Marsh, "World's Manufacturers March into China", *Financial Times* (21 June 2004), p.11.

¹⁹ Ran Yu and Hongyi Wang, "Wenzhou Credit Crisis 'Inevitable' with Unchecked Private Lending", *China Daily* (14 October 2011), available at http://www.chinadaily.com.cn/business/2011-10/14/content_13896213.htm, accessed 1 July 2016.

²⁰ *Financial Times*, "Caixin's China PMI Contracts 10th-Straight Month" (4 January 2016), available at <http://www.ft.com/fastft/2016/01/04/caixins-china-pmi-contracts-10th-straight-month/>, accessed 1 September 2016.

Furthermore, the Chinese government has been experimenting a series of economic reforms in recent years, proposing to rebalance its economy from the overreliance on the heavy industries and construction towards the dependence on the domestic consumptions and services.²¹ Consequently, during the transitional period, the economy has been searching for new growth engines, so the growth rate will stay low for a period of time. While most economists predict a smooth transition in China's economic reform, few also expect a possible "hard landing" scenario for the Chinese economy, which adds some pressure to the world economic prospect.²²

3.2.3 Overheated Speculation in Private Lending Market

From 2008 to 2011, China saw a private lending investment mania in the country, for millions of ordinary savers and businessmen and women joined the speculation, in order to pursue hefty financial returns by making private loans. Besides, the emergence of a group of professional lending brokers has contributed to the further developments of the private lending market. The lending brokers, as underground bankers, have extended lending activities beyond the traditional acquaintance networks, by attracting funding from the public. It led to a speculative bubble as people competed to take part in lending schemes to make quick money. In the meantime, due to the tightened credit condition in 2011, it became extremely difficult for private businesses to borrow loans from the state banks. As a result, they had to borrow private loans at extremely high prices to finance their businesses during the economic downturn. However, a lot of businesses faced the declining sales and shrinking profits due to the GFC, so some of them went into financial troubles and ceased to repay their private loans.

Wide Participation in Private Lending Market: The Story of Wenzhou

Despite the worsening economic condition after 2008, observers have seen significant developments of China's shadow banking sector. Wenzhou city, a well-known entrepreneurial centre in China, is a barometer to observe the health of the private economy in the country.²³ In the late 1970s, when China started to allow individuals

²¹ Jamil Anderlini, "Chinese Rebalancing Act Leaves Spectators on Edge", *Financial Times* (09 October 2015), p.2.

²² Malcolm Scott, "A Hard Landing in China Could Shake the World", *Bloomberg* (19 November 2015), available at <http://www.bloomberg.com/news/articles/2015-11-19/a-hard-landing-in-china-could-shake-the-world->, accessed 1 July 2016.

²³ *Bloomberg*, "China May Inject Cash to Prevent Wenzhou Crisis, ING Says" (30 September 2011),

to run private businesses, people in Wenzhou were in the first place to seize this golden opportunity. They are famous for their boldness, aggressive brand of capitalism, and business acumen.²⁴ Private entrepreneurs in Wenzhou, like their peers across China, have been relying deeply on private lending to acquire funding for their businesses, due to the limited financial resources provided by the state banking sector. From the early days, they pooled money together and established informal underground lending societies based on family and community networks.²⁵ With the money from underground banks, entrepreneurs were able to establish factories, produce goods, and accumulate fortune. In a couple of decades, Wenzhou turned itself from a small fishing village to a global manufacturing hub, producing various goods from cigarette lighters, glasses and pens, to electrical equipment and sophisticated machineries. From 1978 to 2008, the comparatively low cost of labours and lands in China, coupled with strong global demands, contributed to the large profit margins of manufacturers, so they can easily pay off expensive private loans. Clearly, the prosperity of Wenzhou can only be achieved with an advanced private lending industry.

At present, there are more than 250,000 private businesses in Wenzhou, and the Wenzhou model represents a typical development path for the booming Chinese cities.²⁶ People in Wenzhou never hide their passion and eager for pursuing wealth, as one young entrepreneur said, “We appreciate money. This is not traditionally Chinese, as they prefer to be officials... Justice, kindness, and money is of the same importance.”²⁷ Owing to the rapid expansion of manufacturing activities, China has become the largest manufacturing power in the world, which is responsible for over 20 per cent of global manufacturing outputs.²⁸

Nonetheless, the business environment for manufacturers has changed significantly.

available at <http://www.bloomberg.com/news/articles/2011-09-30/china-may-inject-cash-to-prevent-wenzhou-crisis-ing-says>, accessed 1 July 2016.

²⁴ *The Economist*, “Wenzhou’s Economy: It Once Was Lost” (11 June 2016), p.61.

²⁵ *Ibid.*

²⁶ James White, “The Wenzhou Wealth Phenomenon” (7 September 2012), Commonwealth Bank of Australia, available at <https://www.commbank.com.au/blog/the-wenzhou-wealth-phenomenon.html>, accessed 1 July 2016.

²⁷ *Ibid.*

²⁸ *The Economist*, “Manufacturing: The End of Cheap China” (10 March 2012).

Apart from the GFC and weakening consumer sentiments, other factors, like the appreciation of Chinese yuan against US dollar, the rising labour cost and land price, the stricter environment and safety regulations, and the changing tax regime, resulted in a changing landscape of China's manufacturing industry.²⁹ In sum, manufacturing activities are not as profitable as they used to be, due to decreasing market volumes and the increasing production costs. As entrepreneurs in Wenzhou lost appetite of running manufacturing businesses, they tried to explore new business ventures to increase their wealth. Accordingly, they have invested across China in every industry from real estate to mining.³⁰ For example, in 1998 when China abandoned the public housing policy, the residential property market began to take off.³¹ Wenzhou quickly spotted the opportunities in the burgeoning housing market and joined the property speculation. From 2006 to 2016, the housing price in major Chinese cities rose by 500 to 600 per cent; for instance, the year-on-year price rise (March 2015 - March 2016) was 63 per cent in Shenzhen and 30 per cent in Shanghai.³² Apparently, the booming property market and the rising housing price, like manufacturing businesses in the past, can bring considerable returns for investors and offset high financing costs.

The story of Wenzhou shows that many Chinese entrepreneurs are no longer interested in the traditional manufacturing businesses. Instead, they prefer to do property or financial investments which yield higher returns. In such economic environments, a large number of businessmen and women suddenly found that moneylending seems the most profitable business. Moreover, ordinary households in Wenzhou also proactively participated in the private lending market, as people are not satisfied with the modest saving rates offered by banks. According to a PBOC report, 89 per cent of households and 59.67 per cent of businesses in Wenzhou took part in private lending

²⁹ The exchange rate between USD and CNY was 1:8.28 on 1 January 2005, and it fell to 1:6.1 on 1 January 2014. See *Bloomberg*, <https://www.bloomberg.com/quote/USDCNY:CUR>, accessed 1 July 2016.

³⁰ Austin Ramzy, "A Credit Crisis in China's Most Enterprising City Is Making the Country Nervous", *Time* (28 November 2011).

³¹ Li Pan, "The Cause and Influence of Wenzhou Private Lending Crisis", *People's Forum* (2012 Vol.2), available at http://paper.people.com.cn/rmlt/html/2012-01/15/content_1003397.htm, accessed 1 July 2016.

³² Yuan Yang, "Pace of Chinese House-Price Gains Reaches High", *Financial Times* (19 May 2016), p.3.

activities in 2011.³³ The total market volume of Wenzhou's private financing industry amounted to CNY 110 billion (USD 16 billion), equivalent to 20 per cent of the city's total bank lending figure. Clearly, private lending has become a game for everyone in Wenzhou, bringing funds into the market. However, nearly 40 per cent of the money has been circulated within the private lending market itself, rather than being extended as loans to borrowers.³⁴ It is common that moneylenders attract money from new investors to pay interests to existing investors, so in fact a large proportion of money in the market has been wasted. The reason for why so many Wenzhouers became crazy for private lending is self-explanatory, for the interest return of private lending is very tempting. Prior to the lending crisis, the average annual interest rate for making a private loan in Wenzhou was between 12 and 96 per cent (1 to 8 per cent monthly).³⁵ Drawn by excessive interests, a vast amount of money was poured into the private lending market, creating a huge speculative bubble.

The Emergence of Professional Lending Intermediaries

Due to the emergence of a group of professional lending brokers, most of whom are businessmen and women seeking extra profits in the economic downturn, the private lending market in Wenzhou and other Chinese cities became more sophisticated than ever. In the past, private lending activities were fairly simple and straightforward, as they were based on traditional personal networks at which borrowers and lenders know each other well. However, as more people join the market, traditional lending networks have been broken gradually and replaced by new forms of informal lending schemes or institutions, where most participants are strangers.

There are various forms of lending intermediaries, from the incorporated financial guarantee companies, investment companies, wealth management firms, to less institutionalised individual moneylenders.³⁶ Some money houses recruit lawyers,

³³ People's Bank of China (Wenzhou Branch), "*Wenzhou Private Lending Market Report*" (21 July 2011).

³⁴ Li Pan, "The Cause and Influence of Wenzhou Private Lending Crisis", People's Forum (2012 Vol.2), available at http://paper.people.com.cn/rmlt/html/2012-01/15/content_1003397.htm, accessed 1 July 2016.

³⁵ *Ibid.*

³⁶ Nan Ma and Gabriel Wildau, "Collapse Exposes China Shadow Banking Risks", *Financial Times* (05 December 2014), p.3; The model of financial guarantee company as a popular form of private

accountants, and bankers to carry out lending businesses in a professional way. In order to maximise the lending volume and interest revenues, moneylenders try to attract funds from individual investors in the society by offering eye-catching returns. If possible, they also borrow bank loans to increase the leverage of their lending business. In terms of making loans, they advertise private lending through business networks, online advertisements, or traditional media like newspapers and billboards. In China, there exist thousands of unregulated lending intermediaries, channelling funds from investors to borrowers. For example, the *Time Magazine* interviewed a private money broker in Wenzhou known as the “Kid”, who started his lending business in 2007 with capitals worth 1 million US Dollars, and his money pool quickly expanded to 15 million US Dollars in 2011.³⁷ The business model of Kid is not difficult to understand, for he has been gathering money from local investors, and then loaning it out to borrowers at a monthly rate of 2.5 per cent.

The existence of professional brokers in the private lending market, to some extent, gave rise to the rapid expansion of underground lending. A large number of individual investors in China who previously did not have access to the private lending market can now deposit their money into the brokers’ lending schemes. Consequently, private lending has become an extremely popular investment choice for ordinary households as well as cash-positive businesses in the recent decade. Therefore, a large amount of spare capitals in the society have been injected into the underground lending market, leading to the private lending mania in China.

3.2.4 Tightened Credit Condition in 2011

After investigating the supplying end of the market, we are going to examine borrowers in search of credits. Due to the GFC and the slowing down of the Chinese economy, Chinese manufacturing businesses not only experienced declining sales and squeezed profit margins, but also faced a deteriorating financing condition. In 2011, the working priority of the Chinese government was to control the inflation rate which

lending will be introduced in the fifth section of this chapter.

³⁷ Austin Ramzy, “A Credit Crisis in China’s Most Enterprising City Is Making the Country Nervous”, *Time* (28 November 2011), available at <http://content.time.com/time/magazine/article/0,9171,2099675,00.html>, accessed 1 July 2016.

stood at a high level.³⁸ As a result, the primary goal of monetary and financial policies was to lower the inflation rate to below 4 per cent, and accordingly, Beijing set out a strict loan quota for Chinese banks to follow, and planned to combat grey-market lending activities to limit the credit provision. Under this circumstance, private businesses had to meet extra requirements imposed by official lenders to secure credits. For example, banks often asked business owners to provide personal guarantees for corporate loans, or to offer more collaterals like lands and the factory equipment to demonstrate their creditworthiness. Some banks even required borrowers to re-deposit up to 50 per cent of the money they borrows.³⁹ It means that if a company borrows two million yuan from a bank, it needs to deposit one million yuan back in the same bank. Apparently, the extra requirements and unfair terms makes bank credits more difficult and costly to obtain. Furthermore, in 2011 the People's Bank of China raised interest rates for three times, which resulted in the surging costs of bank lending.⁴⁰ Because of the restricted availability of bank loans, more private businesses turned to the private lending market to borrow credits.

According to the *South China Morning Post*, Mr Liu Dong, the owner of a marketing company in Beijing, revealed the hardship to borrow a bank loan as well as why he opted for private loans instead.⁴¹ At first, he planned to borrow CNY 100,000 (USD 14,556) as working cash, but his loan application was turned down by several banks, as bank managers explained that there was no loan quota available. After the failed attempt to borrow bank loans, Mr Liu then tried to contact a loan guarantee company, which had sent him an advertising text message about private loans. To his surprise, he got a prompt reply from a **sale** representative, telling him that he could obtain the loan within five working days without providing collaterals. The lending procedure

³⁸ Keith Bradsher and Michael Wines, "Businesses Feel the Pinch as China Tightens Lending", *The New York Times* (7 November 2011), available at <http://www.nytimes.com/2011/11/08/business/global/chinas-businesses-find-loans-are-harder-to-get.html>, accessed 1 July 2016.

³⁹ *Ibid.*

⁴⁰ *Bloomberg*, "China May Inject Cash to Prevent Wenzhou Crisis, ING Says" (30 September 2011), available at <http://www.bloomberg.com/news/articles/2011-09-30/china-may-inject-cash-to-prevent-wenzhou-crisis-ing-says>, accessed 1 July 2016.

⁴¹ Jane Cai, "Private lenders thrive in China as banks neglect small clients", *South China Morning Post* (06 January 2014), available at <http://www.scmp.com/business/banking-finance/article/1398701/private-lenders-thrive-china-banks-neglect-small-clients>, accessed 1 July 2016.

turned out to be simple and fast, as he was only asked to provide his personal identity card, bank statement, income certificate, and a recent utility bill. Mr Liu finally managed to take a three-year loan from the private lender, at a monthly cost of 2.3 per cent, along with a one-off guarantee fee of CNY 8,000 (USD 1,164).⁴² Clearly, the story of Mr Liu shows us how the credit shortage for Chinese businesses has been bridged by the thriving private lending market.

At present, Chinese businesses experienced multiple economic challenges. In addition to the weakening global consumer demands, they have been facing limited but expensive financing options. As a result, Chinese entrepreneurs are in a financial dilemma which is described as “not borrowing (private loans) is waiting for the death, while borrowing (private loans) is looking for the death.”⁴³ It means that, if businesses do not borrow money from private lenders, they will probably go to fail due to the lack of working capitals under the deteriorating economic condition. However, if they do borrow private loans, they will survive for a short period of time, but in a long term, they are likely to become insolvent because of the high financing costs of private lending. Therefore, the woeful financial situation of Chinese businesses which rely on private lending is also described as “to quench a thirst with poison” (饮鸩止渴).⁴⁴ Moreover, some businesses, when their previous bank loans fall due, initially plan to borrow money from private lenders for bridge financing, with the expectation to renew the bank loan. However, some banks, after calling in old loans, do not make new loans due to the loan quota, which makes borrowers strapped in private lending.⁴⁵

Prior to 2011, private lending activities became prevalent in Wenzhou as well as the rest of China. While a large number of investors joined the market to pursue attractive returns, Chinese businesses facing the unprecedented financial difficulty increased

⁴² *Ibid.*

⁴³ *Xinhua*, “Let the Water of Finance Quench the Thirst of Real Economy” (19 April 2015), available at http://news.xinhuanet.com/fortune/2015-04/19/c_1115017484.htm, accessed 1 July 2016.

⁴⁴ Li Pan, “The Cause and Influence of Wenzhou Private Lending Crisis”, *People’s Forum* (2012 Vol.2), available at http://paper.people.com.cn/rmlt/html/2012-01/15/content_1003397.htm, accessed 1 July 2016.

⁴⁵ Wenzhi Guo, “Why Bosses of Public Companies in Fujian Run Away?”, *Minsheng Weekly* (Vol.20 2014), available at http://paper.people.com.cn/mszk/html/2014-09/22/content_1482723.htm, accessed 1 September 2016.

their dependence on private lending, despite the soaring interest rates. In the central business district (CBD) of Beijing, billboards advertising financial intermediary companies can be found every few metres, which promise to offer quick loans to borrowers and high-return investments to savers.⁴⁶ Xiamen, a commercial city on China's south east coastline, has been a private lending centre in the region. In 2010, there were 156 financial guarantee companies in the city, most of which have been operating shadow banking businesses.⁴⁷ In North China's Ordos city, which has rich natural resources like coal mines, 50 per cent of its urban residents participated in the underground lending and borrowing, according to an official survey.⁴⁸ People there considered private lending as the best investment which can produce 2 per cent monthly return. Therefore, when Ms Ding Hua decided to open a wealth management company in Ordos to help local residents to invest in stock, future, and foreign exchange markets, she could hardly find any clients as people prefer to invest in private lending which is considered as "safe and profitable".⁴⁹ In a word, private lending has become a national phenomenon in China, with the participation of people from different backgrounds across the country.

3.2.5 The Arrival of Underground Debt Crisis

There is a great contradiction to be found in the Chinese economy. On the one hand, businesses suffer from the slowing down of the economic growth, as well as the deteriorating financing situation. On the other hand, an increasing number of people take part in the private lending activities to make money. As a result, private enterprises have become heavily reliant on private loans to maintain operation. Clearly, the private lending bubble has raised a question regarding the sustainability of shadow banking system: whether Chinese enterprises with weak business prospects are able to repay expensive private loans? If the answer is no, the lending market will be not far from a

⁴⁶ Jane Cai, "Private lenders thrive in China as banks neglect small clients", *South China Morning Post* (06 January 2014), available at <http://www.scmp.com/business/banking-finance/article/1398701/private-lenders-thrive-china-banks-neglect-small-clients>, accessed 1 July 2016.

⁴⁷ *Week in China*, "The Run on Rongdian" (8 July 2011), available at <https://www.weekinchina.com/2011/07/the-run-on-rongdian/>, accessed 1 July 2016.

⁴⁸ *People*, "Private Lending Prevalent in Ordos" (19 September 2011), available at <http://finance.people.com.cn/bank/GB/15691104.html>, accessed 1 July 2016.

⁴⁹ *Ibid.*

collapse. According to a survey in 2011 by the *China Daily*, more than 65 per cent of entrepreneurs in Wenzhou, who had businesses with annual revenues over CNY 30 million (USD 4.37 million), believed that a credit crisis was inevitable.⁵⁰

In fact, a crisis was arriving quietly in China's underground lending market, as thousands of businesses in the private sector started to default. In 2011, Wenzhou was the first city to witness severe credit crunches, as 20 per cent of its 360,000 SMEs ceased operation due to cash shortage.⁵¹ More than 80 business owners in Wenzhou were reported to escape the city in order to evade debts, since they were unable to pay back the money owed to shadow lenders, and some entrepreneurs even committed suicide.⁵² According to the Wenzhou government, in the first eight months of 2011, the combined amount of private lending-related cases received by the city's court system surged 71 per cent to CNY 5 billion (USD 0.73 billion), as business bankruptcy spread the city.⁵³ The private lending market, once accounting for the success of Wenzhou's private sector, now poses a threat to the stability of local economy. While thousands of businesses fell into insolvency due to the heavy debt burdens, numerous investors suffered significant losses. In one year's time, the private lending crisis was occurring throughout China, which is sometimes referred to as "China's subprime crisis".⁵⁴

In addition to Wenzhou which was firstly hit by the default waves, many Chinese regions were reported with the similar credit crunches. In Fujian Province where private businesses prevail, there have been many cases of failed businesses and runaway bosses. For a long time, private lending has been a popular financing method for local businesses, so even business tycoons like Mr Ding Hui, the chairman and

⁵⁰ Ran Yu and Hongyi Wang, "Wenzhou Credit Crisis 'Inevitable' with Unchecked Private Lending", *China Daily* (14 October 2011), available at http://www.chinadaily.com.cn/business/2011-10/14/content_13896213.htm, accessed 1 July 2016.

⁵¹ *BBC News*, "Fears Surface over Chinese Debt amid Lending Practices" (6 October 2011), available at <http://www.bbc.co.uk/news/business-15194663>, accessed 1 September 2016.

⁵² *Ibid.*

⁵³ Most of these claims are the request to fulfil the contract law obligation. See *Bloomberg*, "China May Inject Cash to Prevent Wenzhou Crisis, ING Says" (30 September 2011), available at <http://www.bloomberg.com/news/articles/2011-09-30/china-may-inject-cash-to-prevent-wenzhou-crisis-ing-says>, accessed 1 July 2016.

⁵⁴ Emma Dong and Simon Rabinovitch, "China's Lending Laboratory", *Financial Times* (23 May 2012), p.11.

CEO of Hong Kong-listed Fujian Nuoqi Company, borrowed private loans worth billions of yuan to fund his fashion empire.⁵⁵ The financial scandals of Mr Ding will be studied in the part four. Besides, Fujian has seen the collapse of several large-scale lending networks in its Xiamen City, including Ms Zhong Mingzhen's complex financing guarantee business which attracted a total amount of CNY 3.7 billion (USD 0.54 billion) from private investors.⁵⁶ The case is also going to be examined in the fifth part.

In addition to Zhejiang (where Wenzhou locates) and Fujian provinces, we can also find a series of news reports covering private lending crises in other provinces including Guangdong, Sichuan, Henan, and Inner Mongolia.⁵⁷ Some of these cases will be mentioned in the rest of this chapter. The widespread debt crisis was featured by waves of private loan defaults, corporate insolvency, as well as runaway bosses. Moreover, Chinese investors who have deposited their money in different kinds of lending schemes might be the major victims, for after the crisis it is difficult for them to recover their money. The recent years saw a dramatic rise in the number of civil litigations relating to private loans, as investors filed lawsuits against debtors to claim their money back. According to Mr Du Wanhua, a senior judge at the Supreme Court, 1.02 million private lending cases were heard by the Chinese court system in 2014, making private lending disputes the second largest category of civil litigations in China, just next to the marriage and family cases.⁵⁸

⁵⁵ *China Times*, "The Hidden Rules for IPO behind The Missing Boss" (1 August 2014), available at <http://www.chinatimes.cc/hxsb/news/gongsi/140801/1408012105-136827.html>, accessed 1 September 2015.

⁵⁶ *Week in China*, "The Run on Rongdian" (8 July 2011), available at <https://www.weekinchina.com/2011/07/the-run-on-rongdian/>, accessed 1 July 2016.

⁵⁷ For Guangdong's private lending crisis, see Liping Qin, "The Investigation of Private Lending in Guangdong", *Yicai Finance* (14 October 2011), available at <http://money.163.com/11/1014/01/7G9O162K00253B0H.html>; For the crisis in Sichuan, see Yan Zhang, "The Collapse of Financing Guarantee Industry in Sichuan, Ten Billions of Investors' Money Unpaid", *NetEase Finance* (17 October 2014), available at <http://money.163.com/14/1017/08/A8OCMJ84002529T0.html>; The crisis in Henan, see *Xinhua*, "Private Lending Crisis Broke Out in Henan, Anyang" (8 November 2011), available at http://news.xinhuanet.com/local/2011-11/08/c_122250811.htm; The crisis in Inner Mongolia, see *Caijing Magazine*, "Private Lending Crisis Spreading to Ordos, Inner Mongolia" (18 October 2011), available at <http://english.caijing.com.cn/2011-10-18/110900536.html>, accessed 1 July 2016.

⁵⁸ *Xinhua*, "Private Lending Disputes Became China's Second Largest Civil Litigation Type; The Supreme Court Issued New Judicial Interpretation" (6 August 2015), available at http://news.xinhuanet.com/legal/2015-08/06/c_1116171913.htm, accessed 1 July 2016.

Finally, it should be noted that the influences of a private lending crisis, under most circumstances, are limited to a certain region. It is because the operation of most private lending networks has been based on personal networks within a number of neighbouring cities. Nevertheless, China observes the simultaneous occurrence of private lending crises in many cities, which demonstrates the universality and seriousness of the problem.

3.3 An Analysis of Private Lending's Risky Structure

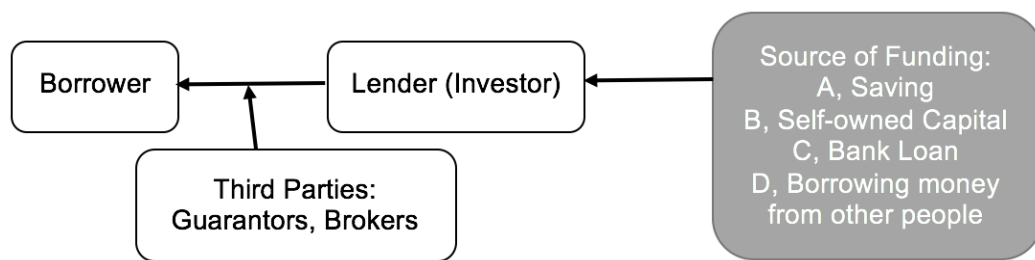


Figure 5: The Basic Structure of Private Lending⁵⁹

The basic lending structure in any private loans involves two parties, namely, the lender and the borrower. Borrowers, in this thesis, mainly refers to entrepreneurs who have their own business, particularly the owners of small and medium-sized enterprises. Private lending plays an important role in funding these businesses. Lenders could be any individuals or businesses in a society who have spare money (like capitals or savings) and would like to invest in the borrowers' businesses through lending money.⁶⁰ In practice, the source of funding for lenders can be various. Some use their own money to lend to debtors, and some have acquired bank loans before, and re-lend it to other capital-starved entrepreneurs at a higher price. In many cases, some lenders, particularly professional moneylenders, also attract funds from the public. They make profits by borrowing at lower interest rates and then giving loans at higher interest interests later. The profit margin can be large, if the lender pools together a considerable amount of money. These underground moneylenders are creditors on one side, but also debtors to their own investors on the other side, leading to potential financial risks as being money intermediaries. In addition to lenders and

⁵⁹ The chart is compiled by the author.

⁶⁰ Lenders include but are not limited to ordinary savers, companies, or professional moneylenders.

borrowers forming the basic private lending activity, there might be third parties who engage in private lending. For instance, some lending brokers, by introducing lenders and borrowers to find each other and facilitate a transaction, are able to charge fees over the lending process. In some cases, the lender will ask the broker to provide the guarantee for the payment of interests and the principal. In addition to lending brokers, any individuals or businesses can be guarantors in a private loan arrangement, and there are also professional guarantee companies which provide the service of guarantees.

Therefore, lenders, borrowers, and relevant third parties, such as brokers and guarantors, together form private lending transactions. The potential financial risks can come from several aspects. First, the source of funding for lenders is diversified. In practice, the self-owned savings and capitals only takes up a small proportion of the money pool of professional moneylenders, so they operate at a very low reserve as a large share of funding is derived from the public. This will be introduced later in detail by using the example of large lending schemes. It is an important factor which significantly increases the potential impacts of defaults. When a number of borrowers fail to repay debts to moneylenders, moneylenders will start to default to its own investors if they do not have enough capital reserves. When massive defaults happen, or when many investors try to withdraw their money from the moneylender at the same time, the liquidity will drain quickly so the moneylender becomes insolvent and the entire lending scheme collapses. In this scenario, hundreds of investors who have previously put their money in the lending schemes will suffer great losses, since the underground lending is not protected by the authority. The only legal remedy is to file a lawsuit against moneylenders to claim for the money, which in practice can only recover a very small proportion of money.⁶¹ Moreover, it is estimated that a significant percentage of moneylenders' capitals actually comes from Chinese banks. As a result, if a series of defaults happen in private lending market, banks will also face increasing bad loans subsequently. This shows the systemic risks of private lending activities.

Moreover, when the private lending crisis is arriving and borrowers become unable to

⁶¹ Most moneylenders have to wait for their debtors to pay off the loans before they are able to compensate their own investors.

pay off debts, guarantors who bear the joint liability are responsible for repaying the debt. In fact, a large number of business owners often form an alliance and provide guarantees for each other when borrowing money. However, under the current economic condition when enterprise insolvency is prevalent, the failure of one business will probably drag other healthy businesses as guarantors into insolvency.

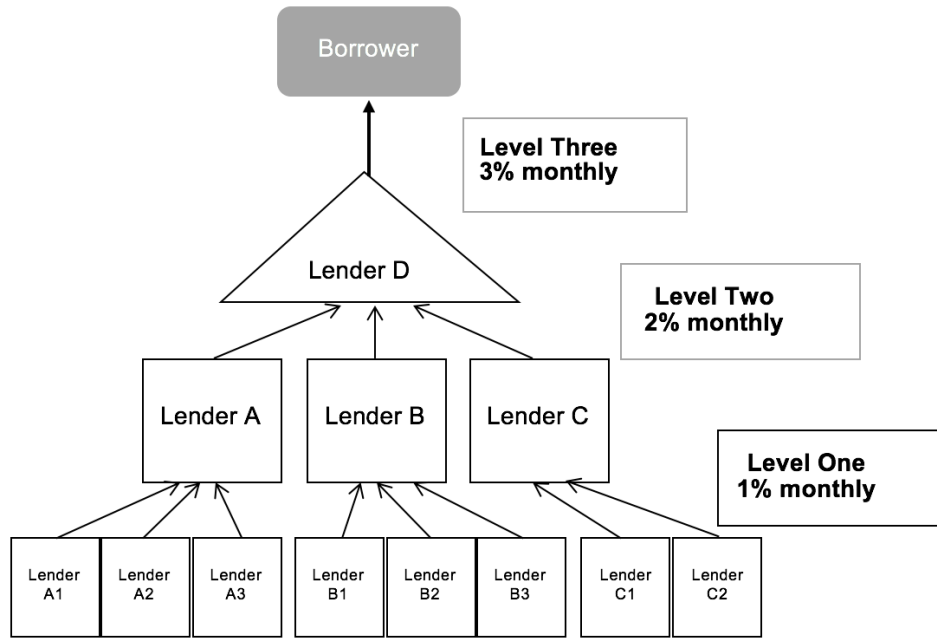


Figure 6: The Structure of A Large Lending Chain⁶²

Finally, we often see the existence of long and complicated lending chains in the private lending market, which could be extremely fragile in the event of default crisis. As discussed, moneylender plays a dual role as both a lender and a borrower, as they borrow money from investors to make private loans. As it is shown in the diagram above, the funding chain of private lending often has a pyramid-like structure involving multiple levels of lending activities. For example, at the first (lowest) level, the moneylender A borrows money from lenders A1, A2 and A3, by offering 1 per cent monthly rate. We assume lenders B and C do the same thing as A does. At the second (middle) level, the moneylender D pools the money from lenders A, B and C by promising 2 per cent monthly as the financial return. Finally, D as moneylender at the top level makes loans to entrepreneurs in need of funds. After the money goes through three levels, the interest rate at the end of the lending chain rise to 3 per cent a month

⁶² The chart is compiled by the author.

(36% annually). Therefore, the financing costs for businesses are very high since the interest rate has been pushed upward by the multi-level lending structure.

Apparently, it is not difficult to spot the risks in this pyramid-like lending organisation. As long as anyone in the chain defaults, the credit flow will stop and the chain will collapse. The real scenario is likely to be far more complicated than the one we have discussed above, as there will probably be more levels and thus more investors involved in the lending process. Unlike bank loans which are closely watched by financial regulators, private loans remain outside of the official financial system. Therefore, it is particularly difficult to control the direction of money flow in the lending chain, for any borrowers can also be a lender again by re-lending the money out to anyone. Clearly, the sophisticated lending chain not only pushes up the price of borrowing, but also adds extra risks to the financial system.

3.4 Borrowers in Credit Crisis

3.4.1 The Phenomenon of Runaway Bosses

The following part starts to present concrete cases about what has happened during the widespread private lending crisis. First of all, the problem of fugitive bosses as a social phenomenon in China will be studied. After the crisis, an increasing number of business owners ran away to avoid debt collections, as we can often see “the list of runaway bosses” compiled by Chinese media by putting together the information regarding the names of bosses, their business addresses, the time of disappearing, and the amount of debts involved.⁶³ In 2011 alone, more than 80 cases regarding runaway bosses were reported in Wenzhou, and it was usual for people to find some local entrepreneurs disappearing overnight. On the list of runaway bosses, we not only find owners of SMEs, but also some successful and famous businessmen and women who left their cities to hide from debt collectors.

For example, according to *Global Times*, Mr Liao Rongna, the chairman of Guangxi-

⁶³ For instance, a list of runaway bosses in Wenzhou (2011) can be found at *East Money*, available at <http://topic.eastmoney.com/wzjg2012/#anchor0>; for the cases of runaway bosses in Xiamen, see *Sohu*, “Focus on Runaway Bosses in Xiamen”, available at <http://fj.sohu.com/s2012/0125/s358022898/>, accessed 1 July 2016.

based private conglomerate Zhengling Group, fled the country in April 2014.⁶⁴ Established in 1982, Zhengling Group hires around 10,000 employees and operates in various industries including automobile and machinery manufacturing, property development, and financial services. It is said that Mr Liao and his family took part in illegal fundraising activities involving more than 2,000 investors. In total, he and his businesses borrowed approximately 7-billion-yuan bank loans (USD 1.02 billion) and 3-billion-yuan private loans (USD 0.44 billion), which has been the largest case of its kind in South China's Guangxi province.⁶⁵ Most recently, the news agent *Xinhua* reported that a cross-border manhunt has been underway for Mr Liao since August 2014.⁶⁶ At the request of the Chinese judicial authority, the International Criminal Police Organisation (Interpol) issued red notices, the highest level of arrest warrants, for Mr Liao and his wife, under the charge of "illegal absorbing public funds".

Moreover, in September 2014, the chief financial officer of Ultrasonic AG, a Frankfurt-listed holding company of a Chinese shoemaker, informed the company's supervisory board that he had been unable to contact the chief executive officer Mr Wu Qingyong and the chief operating officer Mr Wu Minghong (who are father and son), and most of the company's cash reserves in Mainland China and Hong Kong had gone.⁶⁷ It is apparent that the disappearance of Ultrasonic's CEO and COO had something to do with private lending. Consequently, the share price of Ultrasonic AG plummeted by around 70 per cent shortly. Evidently, the common denominator among China's most fugitive bosses in recent years is their huge debts owed to moneylenders. In the next section, we are going to conduct a detail case study over Nuoqi's missing chairman, Mr Ding Hui, which is a high-profile runaway boss in the country. The reason for selecting Mr Ding's case is two-fold. First, it can prove the prevalence of private financing in China, for even a public company and its chairman use private loans to fund the business. Second, Mr Ding's case shows a typical example of how

⁶⁴ *Global Times*, "Guangxi Conglomerate Being Investigated for Illegal Fundraising" (29 May 2014), available at <http://www.globaltimes.cn/content/862824.shtml>, accessed 1 July 2016.

⁶⁵ *Ibid.*

⁶⁶ *Xinhua*, "China Hunts Fugitive Billionaire" (12 August 2014), available at http://news.xinhuanet.com/english/indepth/2014-08/12/c_133551376.htm, accessed 1 July 2016.

⁶⁷ *Deutsche Welle*, "Ultrasonic Executives Leave Quietly in Mystery China Disappearance" (17 September 2014), available at <http://www.dw.de/ultrasonic-executives-leave-quietly-in-mystery-china-disappearance/a-17927706>, accessed 1 July 2016.

entrepreneurs disappear with a large sum of money suddenly, and what impacts a runaway boss can have on relevant stakeholders.

3.4.2 Case Study: Nuoqi's Missing Chairman

Mr Ding Hui has been depicted as a successful entrepreneur in China. He used to be the chairman, chief executive officer and executive director of Fujian Nuoqi Co Ltd, a fashion retailer listed on the main board of Hong Kong Stock Exchange (stock code: 1353.HK).⁶⁸ Founded in 2004, Nuoqi is based in Southeast China's Quanzhou city and it mainly produces and sells casual apparels for young and middle-aged men. Similar to other international clothing giants such as H&M, Zara, Gap, and Uniqlo, Nuoqi has adopted the business model called "market-driven fast fashion". The company has been on the fast track of expansion for nearly a decade after its establishment. As of October 2013, Nuoqi had more than 400 retail points across China consisting of 225 self-owned stores and 213 franchised stores.⁶⁹ Moreover, it has developed a prospering customer royalty programme which attracted nearly 1.2 million members who made a significant contribution to the company's sales and provided reliable feedbacks to improve cloth design.⁷⁰ Therefore, its outstanding customer relationship management was selected for the case study in the Executive Master of Business Administration (EMBA) programme at Northwestern University Kellogg School of Management.⁷¹ In January 2014, Mr Ding managed to float Nuoqi on the Hong Kong Stock Exchange.

Missing Chairman and Share Price Plummet

In July 2014, a rumour began to circulate in the Chinese securities market that Nuoqi's chairman and CEO, Mr Ding Hui, suddenly went missing without any advance announcement.⁷² It is said that Mr Ding and his wife, Chen Ruiying, probably owed multi-million personal debts and decided to abscond. As a result, the stock market reacted fiercely to this piece of information in a short time, for Nuoqi's share price fell

⁶⁸ Hereafter, Fujian Nuoqi Co Ltd will be referred to as "Nuoqi" or "the company".

⁶⁹ See the "Company Profile" section under Nuoqi's official website, available at <http://www.nuoqi.cn/about.php>, accessed 1 September 2016.

⁷⁰ Fujian Nuoqi Co Ltd., "2013 Annual Report", p.18.

⁷¹ *Ibid.*, p.6.

⁷² *Xinhua*, "Nuoqi's Share Slumping Reason: Chairman Ding Hui Missing" (26 July 2014), available at http://news.xinhuanet.com/fortune/2014-07/26/c_126799805.htm, accessed 1 September 2016.

by more than 50% in three consecutive days from 21 July to 23 July. Despite the speculation among investors, the company appeared to know nothing about its boss when it facing the drastic decrease in its share value. Nuoqi's board made an announcement on 21 July declaring that it was not aware of any reason for such price fluctuation or any other information which needs to be disclosed to investors according to Hong Kong's Securities and Futures Ordinance.⁷³ Later on, the trading of Nuoqi's shares was suspended on 23 July at the request of the company after the three-day catastrophic slump.⁷⁴ However, on 25 July Nuoqi confirmed that it was not able to contact Mr Ding for some days, and the company had reported this matter to the Hong Kong's police force, so Mr Ding was officially declared to be a "missing person".⁷⁵ Although the company insisted that it would try all available means to connect with Mr Ding, it still denied the allegation against Mr Ding's absconding by saying that the rumour had not been verified yet.⁷⁶ As a temporary arrangement for the management of Nuoqi, Mr Ding Canyang, an executive director who is also the elder brother of Mr Ding Hui, took charge of the company during the absence of Mr Ding Hui.⁷⁷

Unauthorised Money Activities

At the end of July 2014, the truth was gradually emerging as Nuoqi had conducted an inside investigation. Surprisingly, the result of the investigation revealed that, in early 2014, two sums of money worth CNY 50 million (USD 7.28 million) and HK Dollars 19.55 million (USD 2.52 million) separately were transferred from the bank account of a fully-owned subsidiary of the company, Nuoqi Fashion International Limited, to the account of an irrelevant company incorporated in British Virgin Islands, under the instruction of Mr Ding Hui.⁷⁸ Moreover, in January and March 2014, another two sums of money worth CNY 160 million (USD 23.3 million) and CNY 2.5 million (USD 0.36 million) respectively were transferred from Nuoqi's bank account to a related account

⁷³ Fujian Nuoqi Co Ltd., "Announcement: Unusual Price and Trading Volume Movements" (21 July 2014)

⁷⁴ Fujian Nuoqi Co Ltd., "Announcement: Suspension of Trading" (23 July 2014)

⁷⁵ Fujian Nuoqi Co Ltd., "Holding Announcement" (25 July 2014)

⁷⁶ *Ibid.*

⁷⁷ *Ibid.*

⁷⁸ Fujian Nuoqi Co Ltd., "Holding Announcement" (31 July 2014)

with the Xiamen International Bank, according to Mr Ding’s personal permission.⁷⁹ So far, it has become evident that Mr Ding did abscond with around CNY 228 million (USD 33.2 million) which is supposed to belong to the Nuoqi. Clearly, he not only breached his duty of being a director, but also committed a crime for stealing company assets. Therefore, all of his positions in the company were removed by the board of directors.⁸⁰

Worse still, the company later found that Nuoqi and its subsidiaries had allegedly guaranteed and pledged securities for several loans collectively amounted to CNY 454.5 million (USD 66.2 million) that were borrowed by certain individuals outside the Nuoqi group.⁸¹ The truth is that Mr Ding, without notifying the company, used Nuoqi’s cash deposits as collaterals for his family members to borrow a number of bank loans, so Nuoqi has become liable for those debts as Mr Ding fled abroad.

In September 2014, Nuoqi’s chief financial officer and company secretary, Mr Au Yeung Ho Yin, tendered his resignation, even if he commented that “there is no matter relating to his resignation that needs to be brought to the attention of shareholders”.⁸² However, his resignation was indeed the last blow to the company’s ongoing financial crisis, so in the same month Nuoqi appointed KPMG, a consulting firm, to assess and advise on its financial situation, in order to formulate potential restructuring plans.⁸³ The story came to an end when, in March 2015, some of Nuoqi’s creditors applied for the reorganisation of the company to the court in Quanzhou city where Nuoqi’s headquarter is located, and in the following month the application was officially accepted and an administrator was appointed.⁸⁴

Time	Event
2004	Mr Ding Hui and his elder brother, Mr Ding Canyang, co-founded the Quanzhou City Nuoqi Company.
2008	Quanzhou City Nuoqi was converted into a joint-stock limited liability

⁷⁹ *Ibid.*

⁸⁰ Fujian Nuoqi Co Ltd., “Announcement: (1) Update on Affairs of Group (2) Clarification of Press Article” (19 August 2014)

⁸¹ *Ibid.*

⁸² Fujian Nuoqi Co Ltd., “Announcement: Resignation of Chief Financial officer and Company Secretary” (8 September 2014)

⁸³ Fujian Nuoqi Co Ltd., “Announcement: Update on Affairs of Group” (24 October 2014)

⁸⁴ Fujian Nuoqi Co Ltd., “Announcement: Reorganization Procedure” (1 April 2015)

	company under the name of Fujian Nuoqi Co Ltd. It has adopted a fast-fashion mode with a membership program as the marketing approach.
2013	Nuoqi's retail points reached 438.
9 JAN 2014	Nuoqi went to IPO on the Hong Kong stock exchange.
21-23 JUL 2014	The share price of Nuoqi fell by 32.56%, 6.21% and 23.47% in three days. Trade in stock was suspended.
25 JUL 2014	Mr Ding Hui was officially declared to be "a missing person".
31 JUL 2014	Nuoqi reported four unauthorised transfers of funds.
19 AUG 2014	Nuoqi reported that it had provided unauthorised guarantees and collaterals for non-group members.
8 SEP 2014	Nuoqi's CFO, Mr Au Yeung Ho Yin, tendered his resignation.
OCT 2014	Nuoqi hired KPMG to consider potential restructuring plans.
APR 2015	The Quanzhou Court accepted the application for the reorganisation of Nuoqi.

Table 5: Timeline of Fujian Nuoqi's Runaway Boss Incident⁸⁵

Stakeholders Affected

Clearly, the story of Mr Ding sounds quite dramatic, for it is regarded as a well-prepared escaping scheme rather than a sudden disappearance. Nuoqi merely floated its shares on the Hong Kong share market in January 2014, but in the following months, Mr Ding not only transferred the money out of the company, but also borrowed various bank loans by making use of Nuoqi's cash deposits as collaterals. Shortly, he suddenly ran away, leaving behind the company with an empty shell. Apart from Nuoqi Company which was affected most by the vanishing boss, this incident had negative impacts on a number of stakeholders.

First of all, Nuoqi's shareholders and creditors were susceptible to enormous losses. Actually, it is unfortunate to be Nuoqi's shareholders as the share price lost more than half of its value in just three days as billions of HK dollars were wiped out. Moreover, the trading in shares of Nuoqi has been suspended ever since, which means shareholders have no chance to turn their shares into cash. Besides, the company also refused to pay dividends recently as it is at the edge of insolvency.⁸⁶ Similarly, a large number of Nuoqi's creditors, which are either banks or private lenders, have been

⁸⁵ Data Source: Fujian Nuoqi Co Ltd and Hong Kong Stock Exchange. The information can be accessed via Nuoqi's official website at www.nuoqi.com.hk; Hong Kong Exchanges and Clearing Limited, available at <http://www.hkex.com.hk/eng/csm/news.asp?LangCode=en&mkt=hk&StockCode=1353>, accessed 1 September 2016.

⁸⁶ Fujian Nuoqi Co Ltd., "Announcement: Postponement of Payment of Final Dividend" (4 August 2014)

exposed to great losses, since at the moment it is nearly impossible for Nuoqi to repay debts. Therefore, the only option for its creditors to claim back some money is to wait for the insolvency proceeding to go ahead.

Moreover, according to *Security Daily*, a Chinese financial media, the entire textile and apparel sector which is one of pillar industries in the Fujian Province (where Nuoqi's headquarter and main factories locate) was greatly affected by this incident, for banking institutions have tightened credit provisions to the entire industry within Fujian Province.⁸⁷ In addition, moneylenders also act with more caution when they make loans to Fujian's cloth makers. At present, they pay more attention to the cash flow situation of potential borrowers, and collaterals are heavily discounted to compensate for potential risks.⁸⁸ It is clear that Mr Ding's action damaged the reputation of the whole industry in the region, leading to more financial difficulties and higher borrowing costs for peer manufacturers.

Finally, even Nuoqi's sponsor in the IPO, the CCB International (the investment banking unit of China Construction Bank, the second-largest lender in China) was influenced by Mr Ding's incident, for in a recent IPO of China International Capital Corp, the CCB International was dropped from the list of underwriters.⁸⁹

Truth Revealed

Despite several stakeholders suffered from Mr Ding's indecent behaviour, market watchers have been curious about why Mr Ding deliberately destroyed the business empire built by him for more than a decade. It does not make any sense that Mr Ding simply wanted to make more money by prejudicing benefits of the company and relevant stakeholders, for he is already rich and successful. So what is the real story behind the scene?

⁸⁷ *Security Daily*, "Runaway Bosses in Fujian Clothing Industry: Banks Reluctant to Lend" (10 September 2014), C1.

⁸⁸ *Ibid.*

⁸⁹ Prudence Ho, "Missing Chairman Complicates IPO", *Wall Street Journal* (20 August 2014), available at <http://www.wsj.com/articles/missing-chairman-complicates-ipo-1408508339>, accessed 1 September 2016.

In fact, before Nuoqi's IPO on the Hong Kong Stock Exchange, Mr Ding had filed twice to list his company on China mainland's stock exchanges in 2011 and 2012 respectively.⁹⁰ However, the first attempt was rejected by China Security Regulatory Commission (CSRC), the securities market watchdog, for some concerns over operational risks, low expenditure on research and development (R&D), and limited geographical presence. The second time the listing failed again for the CSRC imposed a freeze on all IPOs at that time when the market was in a woeful condition. Therefore, after failing twice, Mr Ding was extremely eager to float Nuoqi's shares, and for the third time he planned to list Nuoqi on the Hong Kong Stock Exchange which has looser regulatory requirements compared with its mainland's counterparts. In the eyes of Chinese entrepreneurs, the IPO has been seen as a symbol of ultimate success for a long time, as it could bring entrepreneurs many practical benefits. For instance, a public company definitely has more access to China's state-dominated banking system.

In order to make Nuoqi go public, Mr Ding had to keep his business expanding at a considerable rate to meet regulatory standards, and apparently, the rapid expansion needed huge funding, particularly when the clothing industry has been in decline in recent years due to the slowing economy and weak consumer sentiments.⁹¹ As a result, since Mr Ding found that the amount of money borrowed from banks was not adequate to fund the fast expansion of Nuoqi's business, he decided to borrow from private moneylenders and investors to obtain extra funding. In total, he borrowed around 1.5-billion-yuan (USD 0.22 billion) private loans in the pre-IPO period.⁹² After Mr Ding Hui absconded, the municipal government of Quanzhou started to call for creditors of Mr Ding to contact the authority and report their private financing agreements, and the combined value of private loans that have been reported so far amounted to approximately CNY 400 million (USD 58.2 million).⁹³ In fact, it is private loans that is responsible for the fleeing of Nuoqi's boss, for Mr Ding found himself impossible to repay debts worth several millions of yuan, so he tried to abandon his business and

⁹⁰ *China Economic Weekly*, "Nuoqi Collapsed as Chairman Absconded: A Curse for IPO" (18 August 2014), available at <http://www.ceweekly.cn/2014/0818/90303.shtml>, accessed 1 September 2016.

⁹¹ *Ibid.*

⁹² *Ibid.*

⁹³ *China Times*, "The Hidden Rules for IPO Behind the Missing Boss" (1 August 2014), available at <http://www.chinatimes.cc/hxsb/news/gongsi/140801/1408012105-136827.html>, accessed 1 September 2016.

take whatever he can grasp when he left.

3.4.3 Why Private Lending Accounts for Runaway Bosses?

People are wondering why an increasing number of Chinese entrepreneurs chose to run away rather than file for insolvency proceedings. Without doubt, the sudden disappearance is an indecent and illegal behaviour that leaves behind unpaid workers, angry creditors, and deserted companies. In order to answer this question, the author summarises some reasons from legal, economic and cultural perspectives which can possibly explain for the choice of running away.

First of all, due to the uncertainty regarding the legal status of private loans, it is better for companies not to include private loans in the liabilities of their balance sheets. Therefore, businessmen and women often borrow private loans under their personal names, and then invest the borrowed money in their enterprises. For that reason, entrepreneurs are personally liable for all of private debts, even though the money is in fact used by their companies which enjoy separate legal entities. Moreover, currently China does not have a personal insolvency regime, as the insolvency law is only applicable to enterprise legal persons.⁹⁴ Therefore, it is impossible for individuals who become unable to repay private loans to claim bankruptcy to release them from debts, which means that debtors are permanently responsible for paying back the money to private lenders. Things might change in the future, as many experts have been calling for the establishment of personal insolvency regime when the Chinese parliament has been reviewing the draft for the upcoming civil code.⁹⁵ In 2006 the court system in China received 4,253 bankruptcy cases, but after the bankruptcy law came into effect in 2007, the number of cases have been decreasing, for in 2014 the total number of bankruptcy cases was only 2,059.⁹⁶ Clearly, one hurdle in the implementation of bankruptcy law is the lack of personal insolvency regime. In practice, as demonstrated in Mr Ding's case, it remains difficult to distinguish the

⁹⁴ PRC Enterprise Bankruptcy Law, Article 2. Where an enterprise legal person cannot pay off its debts falling due, or its assets are not enough for paying off all of its debts, or it apparently lacks the ability to pay off its debts, it could be liquidated according to relevant provisions under this Law.

⁹⁵ *Netease*, "The Debut of Civil Code Draft, Experts Called for the Establishment of Personal Insolvency System" (30 June 2016), available at <http://news.163.com/16/0630/09/BQQ4DTGU00014JB5.html>, accessed 1 September 2016.

⁹⁶ *Ibid.*

liabilities of Chinese businesses from their owners' personal debts due to the existence of a large amount of private financing. As a result, when business owners borrow money under personal names but use it for the business purpose, they bear the unlimited liability.

Secondly, the choice of running away can be justified by the tough punishment under Chinese criminal law.⁹⁷ Conducting illegal fundraising activities in China might result in criminal offences that are subject to harsh punishments by western standards. In particular, the offence of “fraudulent fund-raising” are often employed by Chinese judges to punish private financing practices, and the highest sentence for this crime used to be death penalty.⁹⁸ It is usual that when certain entrepreneurs have become insolvent and unable to repay a large group of creditors, which might have negative impacts on economic and social stability, Chinese judges will ruthlessly impose a criminal offence on borrowers in order to comfort the public and deter other fundraisers. Therefore, one important concern for Chinese entrepreneurs in the financial dilemma is about being harshly punished by the judiciary if they go into the criminal proceedings, so running away can be a good choice for escaping from severe criminal punishments.

Thirdly, Chinese moneylenders, like any loan sharks in the world, are good at employing coercive methods for illegal debt collection, because it is impossible for them to rely on the legal system to protect their business and profits. Therefore, insolvent entrepreneurs and their families are exposed to the risk of being blackmailed, illegally detained or even assaulted, and it is likely that their personal properties will be disposed by lenders in an illegal manner. According to Jiangsu High Court, in the Wujiang District of Suzhou, an affluent city in East China with more than 10 million **populations**, approximately 80 per cent of recent criminal cases regarding illegal detentions are relating to debt collection activities of private lending.⁹⁹ Therefore,

⁹⁷ A detail analysis about the application of China's criminal law in combating illegal private lending activities can be found in the next chapter.

⁹⁸ PRC Criminal Law, Articles 192 and 199. The article 199 which stipulates the death penalty was deleted by the 9th amendment of PRC Criminal Law.

⁹⁹ Jiangsu High Court, “Investigation Report on Criminal Cases Involving Usury in the Jiangsu Province under the Background of Current Macro-control” (2014) 92 *Reference to Criminal Trial* 227, 233.

being afraid of illegal debt collection activities carried out by loan sharks, entrepreneurs sometimes have no choice but to leave their businesses and hometowns to protect their personal and property safety.

Finally, there is an old saying in China called *Zou Wei Shang Ce*, which can be roughly translated into English as “running away is the best strategy”.¹⁰⁰ This proverb originated from China’s ancient war time, and it means if the current situation is to your disadvantage in a battle, the best thing you can do is to leave. It is clear that modern entrepreneurs in China stick to the wisdom of their ancestors. Owing a large amount of private loans that are nearly impossible to repay puts entrepreneurs in a vulnerable position, for they are not only facing potential severe sanctions from the state, but also susceptible to violent debt collections from moneylenders. However, if fugitive bosses manage to abscond with as much money as possible like what Mr Ding Hui has done, they are able to restart their lives in foreign countries which have no extradition treaty with China such as the United States, Canada and Australia. Undoubtedly, the economic cost of running away is the lowest among all available options, so it is often viewed as the optimal choice for Chinese entrepreneurs in financial difficulty.

3.4.4 The Effect of Crisis on Borrowing Side

Clearly, the private lending crisis has a negative impact on the borrowing side of the market who are private business depending on private financing. The most directly consequence is an increasing number of bankrupt businesses and runaway bosses. As the government tightened the credit policy in 2011, more Chinese businesses tapped the private lending market to borrow money. Meanwhile, due to the global financial crisis and the slowing down of domestic economy, Chinese businesses had fewer sales and profits than before, making them incapable of paying for expensive private loans for a long time. Worse still, some banks broke the tradition to renew old loans once being repaid. Entrepreneurs, who borrow private loans for bridge financing to secure bank loans, are trapped in private lending, as they are stopped from borrowing new bank credits. More business bankruptcy, therefore, put pressure on the Chinese

¹⁰⁰ *Zou Wei Shang Ce* refers to the Chinese proverb “三十六策,走为上策”.

economy, in terms of GDP growth and unemployment rate.¹⁰¹

3.5 Investor Losses in Credit Crisis

After discussing about how the lending crisis influenced borrowers, we now turn to the lending side of private finance market, as the crisis caused multi-billion yuan losses for investors all over China. This part investigates investor losses from several perspectives. First, there is a case study in terms of financial guarantee companies in Xiamen, operating as unregulated banks. A number of large guarantee lending networks collapsed during the crisis, resulting in heavy losses for their subscribers. Second, it studies two further cases regarding an ordinary investor and an experienced moneylender both of whom encountered enormous financial losses in the crisis. Third, it continues to analyse the differences between ordinary private lending schemes and fraudulent Ponzi schemes which use the money from new investors to pay interests to early-stage investors.

3.5.1 Case Study: Financial Guarantee Companies in Xiamen

Xiamen, like Wenzhou, has been in the spotlight due to its ongoing private lending crisis. It is a commercial city in Southeast China with a population of 3.5 million, and has been regarded as “private financing centre” in Fujian Province.¹⁰² The city has more than 2,000 investment, financing and guarantee companies, and the market volume of private financing activities was estimated to be CNY 40 billion (USD 5.82 billion).¹⁰³ In particular, “financing guarantee companies” is considered a synonym for private lending businesses, for they are often employed as a corporate platform to operate private financing businesses. In disguise, these unlicensed shadow banks take deposits from affluent individuals by offering attractive returns, and make loans to borrowers at usurious rates. In 2011, a number of private lending schemes in Xiamen went into financial difficulties, including two widely reported cases: Ms Zhong Mingzhen’s and Ms Lai Yuexiang’s lending schemes. We select these two cases due to their significance, as each of the scheme involves billions of yuan, and its failure

¹⁰¹ *BBC News*, “China’s Economic Slowdown Deepens” (12 August 2016), available at <http://www.bbc.co.uk/news/37055873>, accessed 1 February 2017.

¹⁰² Xiamen Intermediate Court, “The Investigation Report of Hearing Private Lending Cases” (2011)

¹⁰³ *Ibid.*

triggered hundreds of civil litigations that overwhelmed the city's court system.

How A Financing Guarantee Company Works?

Financing guarantee company is a special category of financial institutions in China, which needs to be authorised by the local regulatory authority.¹⁰⁴ In Xiamen, the regulatory body for financing guarantee companies is called Xiamen Financing Company Regulatory Commission, which is formed by the city's Economic Development Bureau, the Administration Bureau for Industry and Commerce, as well as CBRC and PBOC's local branches.¹⁰⁵ The minimum capital requirement for establishing such companies is CNY 5 million (USD 0.73 million), but local authorities are allowed to set a higher standard.¹⁰⁶ In terms of Xiamen, the minimum capital requirement is CNY 100 million (USD 14.6 million).¹⁰⁷ The high threshold shows the prosperity of local economy as well as its dynamic lending industry. The business scope for financing guarantee companies is providing various professional guarantee services for borrowers, such as loan guarantee, acceptance of bills guarantee, trade financing guarantee, project financing guarantee, letter of credit guarantee, and other types of financing guarantee.¹⁰⁸ Here we limit our attentions to the loan guarantee service. The original business for these companies is to offer loan guarantee services to SMEs when they borrow money from banks, in order to improve borrowers' creditworthiness by undertaking guarantees. When borrowers fail to repay bank loans, guarantee companies are responsible for fulfilling relevant debt obligations. Theoretically speaking, financing guarantee companies are not allowed to take deposits or make loans which shall only be done by banks or other financial institutions possessing related licenses.

So, in practice, how are financing guarantee companies in Xiamen doing the shadow banking business? Take Ms Zhong Mingzhen's Rongdian Finance Guarantee

¹⁰⁴ Temporary Regulation of Financing Guarantee Companies 2010, Article 8.

¹⁰⁵ Xiamen Government, *Xiamen Financing Guarantee Institutions Supervision and Management Measures* 2012[468], Article 4. The legislation is available at http://www.xm.gov.cn/zwgk/flfg/sfwj/201301/t20130104_606115.htm, accessed 1 September 2016.

¹⁰⁶ Temporary Regulation of Financing Guarantee Companies 2010, Article 10.

¹⁰⁷ Xiamen Government, *Xiamen Financing Guarantee Institutions Supervision and Management Measures* 2012[468], Article 8(2).

¹⁰⁸ *Ibid.*, Article 15.

Company as an example to show their business model and relevant risks. Xiamen Rongdian Finance Guarantee Company was established in September 2008, with a registered capital of CNY 102 million (USD 14.9 million).¹⁰⁹ Ms Zhong held 49 per cent of shares in the company, while the remaining 51 per cent are owned by Xiamen Guangyuanxin Commerce Company, another business of Ms Zhong's family.¹¹⁰ Thus, Ms Zhong was able to solely control the entire business of Rongdian Company. In search of extra profits, Ms Zhong like most owners of financing guarantee companies started to operate lending schemes, under the disguise of formal guarantee business.

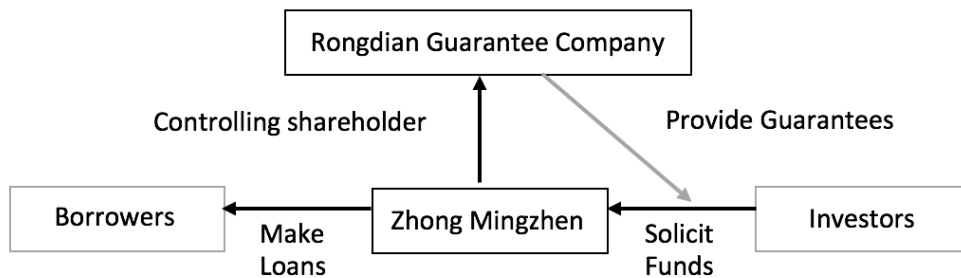


Figure 7: The Business Model of Rongdian Finance Guarantee Company¹¹¹

In China, non-banks are not allowed to engage in either deposit-taking or loan-making businesses. Therefore, Ms Zhong conducted all lending and borrowing activities under her personal name. She solicited funds from investors who were enterprises or individuals who had excessive cash, and then made loans to borrowers by charging high interests. The incorporated Rongdian Company was merely used as a trustworthy platform to attract customers, and all credit relationships were formed between Ms Zhong and other entities. Besides, when investors put money into Ms Zhong's lending scheme, Rongdian company usually provided financing guarantees for the lending contract, which indeed increased the credibility of Ms Zhong. In fact, Ms Zhong was conducting credit intermediary in a personal way, with Rongdian company as a platform as well as a third party guarantor. At the time when the Rongdian crisis broke out, the total debts owed by Ms Zhong to all of her investors amounted to CNY 3.7 billion (USD 0.52 billion), making it the largest case in Xiamen.¹¹²

¹⁰⁹ *Taihainet*, "Xiamen Rongdian Guarantee Crisis Broke Out" (15 September 2012), available at http://www.taihainet.com/news/xmnews/cjdc/2012-09-15/948076_2.html, accessed 1 September 2016.

¹¹⁰ *Ibid.*

¹¹¹ The chart is compiled by the author.

¹¹² *Week in China*, "The Run on Rongdian" (8 July 2011), available at

For a long time, Ms Zhong was considered as a reliable businesswoman by most of her investors, as she never broke her promise to pay 2 to 5 per cent of monthly return to investors on time. At the end of 2010, due to the rapid expansion of lending business, Ms Zhong established Xiamen MingYi Corporation Group, which was named after her brother Mr Zhong Mingyi. The opening ceremony of MingYi Group was a big occasion, as Ms Zhong invited a lot of celebrities to attend, such as well-known singers like Sun Nan and Aduo, as well as a number of government officials.¹¹³ After that, the office of Rongdian Company was moved to Xiamen's central business district, and Ms Zhong spent millions of yuan on decorating the new office to a luxury standard.¹¹⁴ The image building project of Ms Zhong finally paid off, as nobody in Xiamen doubted about her company's financial capacity, and more and more investors rushed to join her lending scheme.

However, the lending empire encountered severe financial difficulties in 2011, as Ms Zhong started to default on hundreds of investors. The main reason for the collapse of Xiamen Rongdian Company was that in 2010, Ms Zhong extended a loan to a cookware company in the neighbouring Longhai City.¹¹⁵ The amount of the loan was CNY 30 million (USD 4.37 million) and it was used to pay for an overdue bank loan of the borrower, a common practice of bridge loan. Normally the bank would renew its loan after borrowers paying back the principal of a previous loan. But this time it did not happen, as the bank refused to renew the loan due to the strict credit policy. Consequently, the borrower became unable to repay the money to Rongdian. After that, Rongdian and the cookware maker made a new arrangement regarding the debt to equity conversion, for Rongdian would invest another CNY 10 million (USD 1.46 million) to acquire the entire ownership. However, after the takeover, Rongdian suddenly found that the company had hidden debt obligations up to CNY 50 million

<https://www.weekinchina.com/2011/07/the-run-on-rongdian/>, accessed 1 July 2016.

¹¹³ *Sina Finance*, "3.7 billion funding black hole – Xiamen Rongdian guarantee crisis" (24 June 2011), available at http://finance.sina.com.cn/money/bank/bank_hydt/20110624/170010044349.shtml, accessed 1 September 2016.

¹¹⁴ *Ibid.*

¹¹⁵ *Ibid.*

(USD 7.28 million), which became the liability of Rongdian's group.¹¹⁶

The acquisition turned out to be a catalyst for the failure of Rongdian. The new debt obligation coming from the cookware business soon drained Ms Zhong's cash flow, and thus she became unable to pay interests to her investors. After the default crisis, many investors filed for lawsuits against Ms Zhong to demand repayments. As a result, the court seized some of Ms Zhong's luxury properties, and put them into auction to raise money for repaying debts.¹¹⁷ Nonetheless, the money of most investors have not been recovered yet. Most recently, Ms Zhong was prosecuted by Xiamen's public prosecution body under the allegation of fraud.¹¹⁸

Ms Zhong's case exposed the real business model of underground shadow banks in China. The operator often relies on a formally incorporated firm as a platform to solicit investors. Behind the facade of financing guarantee companies, it takes deposits and make loans under the operator's personal name. Apparently, the lending scheme gets rid of any official regulation, which creates huge risks as being financial intermediaries. Moreover, the case study also shows how a large lending scheme could suddenly fail as a result of the increasing defaults of its own borrowers. The collapse, therefore, affected the investors who have contributed the money to keep the system running.

3.5.2 How Defaulted Lending Business Became Ponzi Scheme?

Among thriving financial guarantee businesses in Xiamen, there have been some moneylenders who devised Ponzi schemes to lure investors and defraud their money. Ponzi scheme is a type of investment fraud which involves purported payments to existing investors with the money from new investors.¹¹⁹ The largest financial fraud so far has been the Ponzi scheme operated by New York financier Bernard Madoff,

¹¹⁶ *Ibid.*

¹¹⁷ The properties on auction include a 22-million-yuan villa and some upmarket apartments in Xiamen. See Xiamen House, http://news.xmhouse.com/bd/201210/t20121019_415758.htm, accessed 1 July 2016.

¹¹⁸ Xiamen Prosecution, http://www.xmjc.gov.cn/jwgg/ktxx/201609/t20160909_1359853.htm, accessed 15 September 2016.

¹¹⁹ Securities and Exchange Commission (US), "Ponzi Schemes", available at <https://www.sec.gov/answers/ponzi.htm>, accessed 1 September 2016.

who deceived investors' money worth USD65 billion.¹²⁰ The promoter of a Ponzi scheme often advertises investors with an investment opportunity which can yield high returns but have little or no risks. However, the investment storyline can be totally fake, or in fact only a small proportion of investors' money goes to the claimed investment, while the majority of money is used to pay for existing investors who join earlier. It creates a false image that most investors are making money from a golden investment opportunity, which draws more people to join. Clearly, the continuous operation of a Ponzi scheme needs the consistent inflow of funds from new investors, for the scheme itself does not generate profits. Therefore, when the promoter cannot recruit new investors or some existing investors decide to withdraw their money, the Ponzi scheme will probably collapse in a short time. Apparently, the business model of Ponzi schemes determines its unsustainability.

During the private lending crisis, some Chinese lending schemes bore a resemblance to Ponzi schemes. Take Ms Lai Yuexiang's lending business in Xiamen as an example. Ms Lai has been referred to as "the usury queen" in Xiamen by the local media, for she used to run one of largest underground banks in the city.¹²¹ According to a insider, Ms. Lai is good at socialising, and she often takes part in philanthropic activities to promote her image. In the past, she donated money to help students from poor background to finish study at schools and universities, as well as to the 2008 Sichuan Earthquake.¹²² Therefore, Ms Lai has been depicted as a respectable multi-millionaire and philanthropist. As a result, many high-net-worth individuals in Xiamen and other cities trusted her and contributed to her lending scheme.

Similar to Rongdian's case, Ms Lai controlled several financing guarantee and investment companies, and under the camouflage of formal businesses, she has been managing the shadow lending business. Owing to her good reputation, she established an extensive lending network and profited significantly from the interest rate margin between borrowing and lending rates. However, in 2011, the business of Ms Lai went

¹²⁰ David Gelles and Gillian Tett, "From Behind Bars Madoff Spins His Story", *Financial Times* (09 April 2011), p.14.

¹²¹ *Strait Herald*, "Xiamen's Usury Queen Was Sentenced to Life Imprisonment" (30 May 2015), p.1-2, available at <http://epaper.taihainet.com/html/20150530/hxdb560015.html>, accessed 1 June 2016.

¹²² *Ibid.*

into difficulties, and she absconded with a large sum of money. It is dubbed as the “No.1 private lending case in Xiamen” for Ms Lai owed a total amount of one billion yuan (USD 146 million).¹²³ According to Xiamen Intermediate Court, within her one-billion debt, 700 million yuan (USD 102 million) came from ordinary private lending businesses, whilst 300 million yuan (USD 44 million) was derived from fraudulent activities.¹²⁴ There have been at least 30 civil cases relating to Ms Lai to be heard by courts in Xiamen.

The following section details how Ms Lai deceived some of her investors. Ms Lai’s moneylending business has gone into crisis since June 2010, as some of her borrowers defaulted, and as a knock-on effect, she was not able to repay her own investors. In order to bring in more funds to keep the scheme running, Lai decided to make up some stories to attract new investors. At that time, Ms Lai’s company decided to subscribe new shares issued by Guangdong Development Bank, a large lender in South China, at a cost of CNY 100 million (USD 14.6 million). However, she exaggerated the fact and told her investors the subscription needed CNY 800 million (USD 116.5 million). Therefore, eight individual investors including Mr Zhuang, Mr Wu, Mr Guo, and Mr Lin collectively lent CNY 310 million (USD 45.1 million) to Ms Lai to fund the stock purchase, and she promised a monthly return from 1.5 to 15 per cent.¹²⁵ She assured investors that once she obtained new shares, she would sell them directly to repay the debts. However, she used most of the money to pay for previous investors, and her practice meets all the features of a typical Ponzi scheme. After that, Ms Lai found it was nearly impossible for her business to fulfil the debt obligations, so she decided to leave Xiamen on 16 December 2011 to hide from debt collectors.¹²⁶ After two years of hiding, Ms Lai was arrested by the Beijing’s police on 29 May 2013, and sent back to Xiamen for the criminal trial under the charge of fraud.

¹²³ *Ibid.*

¹²⁴ *Xiamen Net*, “Lai Received Life Sentence Under the Fraud Allegation, and She Still Owed 700 Million Yuan Debts”, available at http://news.xmnn.cn/a/xmxw/201505/t20150530_4495636.htm, accessed 1 February 2017.

¹²⁵ *Strait Herald*, “Xiamen’s Usury Queen Was Sentenced to Life Imprisonment” (30 May 2015).

¹²⁶ *China Daily*, “The Female Boss in Xiamen Received Life Sentence”, available at http://www.chinadaily.com.cn/hqcj/zxqxb/2015-06-03/content_13789364.html, accessed 1 September 2016.

Ms Lai's case was heard by Xiamen City Intermediate People's Court. In the first instance, the judge imposed a life sentence on her, and required her to return CNY 310 million to 8 investors who were victims of the fraud.¹²⁷ Ms Lai, with the illegal intention to occupy investors' money, was clearly aware that she lacked the capacity to pay off any further debts when she borrowed the money. Nevertheless, she made up some storylines and hid the truth of her businesses' real financial situation to deceive investors. Most of the money was then used to pay interests to existing investors. In the wake of private lending crisis, numerous moneylenders, despite being insolvent, kept borrowing money from new investors to maintain the operation of their lending schemes. Clearly, this practice shall be counted as running Ponzi scheme, and therefore constitutes the crime of fraud.

3.5.3 How Ordinary Investors Are Affected by the Crisis?

Ordinary investors who are on the lending side of the market might be the biggest loser during the crisis. In the past decade, many Chinese households moved their savings from banks to purchase properties, commodities, or to make private loans, as the inflation level, measured by the Consumer Price Index (CPI), was often higher than the deposit rate offered by banks.¹²⁸ Moreover, the woeful performance of China's stock market from 2008 to 2011 made investors look for other investment options. Therefore, millions of ordinary individuals put their money in the private lending market, whether through informal lending agencies or lent to borrowers directly, with the expectation to increase the value on their assets. Before the crisis, most investors did earn a lot of profits when the market was functioning well so borrowers could pay interests on time.

However, the arrival of the private lending crisis put ordinary investors in a vulnerable situation. For a long time, private lending has been in a grey area in China's financial system, as its legitimacy was not formally admitted by the authority. As a result, investors' money in the market were not protected by the Chinese authority. Therefore, when facing defaults ordinary investors have limited methods to remedy their hard-

¹²⁷ *Ibid.*

¹²⁸ Robert Cookson and Patti Waldmeir, "Inflation Forces China to Raise Rates", *Financial Times* (09 February 2011), p.1.

earned money, apart from private debt collection and costly civil litigation. In the past, people competed to lend out their money to earn eye-catching interests, but now they contested with each other to collect debts from borrowers. For example, in Rongdian's case, an angry investor with a hired gang crowded Rongdian's office on 1 May 2011, who used loudspeakers to make a public scene.¹²⁹ It represented a typical run of moneylenders, as investors rushed to their offices to demand repayments.

While the majority of borrowers or moneylenders in the financial difficulty felt reluctant to talk to investors, some of them did actively take part in the negotiation with investors, in order to pass a restructuring plan as soon as possible to save their businesses. On 6 November 2011, Mr Jia Jianjun, the chairman of Hanzun Group in Anyang, Henan Province, invited more than 20 investors to visit the unfinished Julong International Hotel, a project funded by private loans.¹³⁰ After the visit, the vice president of the company expressed his gratitude for investors' financial supports for the past three years, and asked investors to lend more credits to help the company to survive the current financial dilemma. Most of Hanzun's investors, however, turned down the offer directly, as they cared more about getting back the money they had invested, rather than lending more money to fund the company's unpredictable future.

In Sichuan Province, the private lending crisis broke out between 2013 and 2014 when hundreds of guarantee companies, wealth management companies, and lending companies ceased operation, which made tens of thousands of investors lose their capitals.¹³¹ In response to the crisis, many investors gathered together and formed "debt collection groups" to carry out negotiations with debtors, conduct investigations about debtors' assets, as well as seek helps from the local government. Some of them paraded on the road, hoping to attract the media attention and force the government to step in. In September 2014, Mr Chen who came from a debt collection group in Chengdu, the capital city of Sichuan, led a group of investors to siege a borrower's

¹²⁹ *Week in China*, "The Run on Rongdian" (8 July 2011), available at <https://www.weekinchina.com/2011/07/the-run-on-rongdian/>, accessed 1 July 2016.

¹³⁰ *Xinhua*, "Private Lending Crisis Broke Out in Henan, Anyang" (8 November 2011), available at http://news.xinhuanet.com/local/2011-11/08/c_122250811.htm, accessed 1 July 2016.

¹³¹ Yan Zhang, "The Collapse of Financing Guarantee Industry in Sichuan, Ten Billions of Investors' Money Unpaid", *NetEase Finance* (17 October 2014), available at <http://money.163.com/14/1017/08/A8OCMJ84002529T0.html>, accessed 1 July 2016;

office. After an overnight negotiation, a representative from the borrowing company agreed to sign a repayment agreement to pay off CNY 50 million (USD 7.28 million) to nearly 300 investors. Nonetheless, Mr Chen complained about the real effects of such agreements: “This is the sixth boss that we caught recently and we have signed dozens of repayment agreements like this, but actually we have not received a penny back.”¹³² Apparently, Mr Chen’s words demonstrated the hardship in claiming back the money from borrowers, amid the depth of credit crisis.

It is also difficult for investors to file a lawsuit to claim their money from debtors. In practice, the only formal and legitimate approach for investors to demand the repayment of the debt is to bring a civil litigation against borrowers, which thus led to an increasing number of civil cases relating to private lending in recent years. Nonetheless, the civil litigation takes a long period of time and incurs a large amount of costs for litigants. Even if investors win the case, it will be likely that they can only recover a small proportion of their loans due to the insolvency of the borrower. In many cases, borrowers even ran away or absconded with corporate assets, making the enforcement of relevant judgements impossible. Therefore, in the wake of private lending crisis, most private investors can do nothing but suffer the loss. Next, we are going to introduce a real case of an ordinary private lending investor in China, Mr Zhou Yunfei, who lost his life-time saving in the crisis.

3.5.4 Case Study: Mr Zhou - An Investor Who Lost Everything

“Every morning the first thing for me to do is to open the window and see the sun, only by doing this I can confirm that I am still alive, for another day.”¹³³ This is how Zhou described his miserable life after losing all of his savings in a private lending investment scheme. Zhou is now 55-year-old, and before he invested in the Zhongcheng Environment Technology Company, he had a personal asset worth CNY 20 million (USD 2.91 million). Clearly, this sum of money can guarantee him a very comfortable retired life. However, the investment in Zhongcheng has changed his life forever.

¹³² *Ibid.*

¹³³ Guangjing Ning, “Ups and Downs of a Private Investor”, *Phoenix Finance* (26 January 2015), available at <http://money.163.com/15/0125/15/AGQJOOB900252H36.html>, accessed 1 September 2016.

From 2010, Mr Hu Xuelin, the former Chairman of Zhongcheng Company, started to borrow private loans from a large number of investors. Mr Hu offered a good return for all investors, ranging from 1.5 per cent to 3 per cent per month. He managed to borrow a total amount of CNY 400 million (USD 58.2 million) in several times. Similar to Nuoqi's case, the main purpose for Mr Hu to borrow private loans was to support the rapid expansion of his businesses, as Mr Hu had a plan to float his business on the stock exchange.¹³⁴ Despite Mr Hu's expertise in environment technology, he was not good at capital operation. When a bank loan fell due, Mr Hu borrowed a temporary bridge loan from private lenders to repay the bank loan and waited for a new loan to be granted by the bank. However, when the bank collected the principal from Zhongcheng, it refused to grant new credit this time. It resulted in the sudden breakdown of Zhongcheng's funding chain, and the company, obviously, was not able to survive the burden of expensive private loans for a long time.

Before the insolvency of Zhongcheng, Zhou had invested CNY 23 million (USD 3.4 million) in the Company, including CNY 15 million (USD 2.2 million) of his own savings as well as another CNY 8 million (USD 1.2 million) from his relatives and friends. Zhou said, "When you make some money from private lending, most people you know want to copy you. If you advise them to be cautious about the risk, they will see you as a selfish person who just keep the investment opportunity to yourself. But when things go wrong, they will blame you for the loss and want you to pay back their money."¹³⁵ Therefore, when Zhongcheng failed, Zhou not only lost his own savings, but also had a responsibility to repay his relatives and friends who invested in Zhongcheng through him.

At first, Zhou and other private investors chose to take over Zhongcheng Company by converting the debts into equities, in the hope to save the business out of financial trouble. In their eyes, they thought the restructure of Zhongcheng would not be difficult, since the company had a promising business that focused on the application of environmental friendly materials in the agriculture industry. However, the

¹³⁴ *Ibid.*

¹³⁵ *Ibid.*

restructuring plan turned out to be a failure. When in charge of the business, investors found that Zhongcheng needed more capitals in many areas from adding production lines to marketing operation, before the company could make actual profits. Nonetheless, in the current situation, it was unlikely for Zhongcheng to borrow more money from banks or private lenders due to its financial dilemma and destroyed reputation. Moreover, Zhou and other investors could not afford to invest more money into the business, as many of them were heavily indebted and nearly bankrupt.

After one year of rescue efforts, Zhongcheng company still failed. In the end, Zhou sold his properties and cars to pay off some parts of his personal debts. He also divorced with his wife since he tried to give her a quiet life away from creditors. As a 55-year-old, it is not easy for Zhou to find a good job and start a new life, but he has to work hard to earn more money to repay debts. Currently, he is working as a sales representative and earning a monthly salary of CNY 8,000 (USD 1,165). A millionaire five years ago now has nothing but debts, and he has to struggle to make a living. This is the true story of some ordinary investors in China after the lending crunch.

3.5.5 Case Study: How Experienced Moneylender Lost Money?

In addition to ordinary investors like Zhou, many professional moneylenders also faced increasing defaults in their lending portfolios and suffered significant losses. Mr Yao Jiangjun is a veteran in the private lending market in South China's Guilin City, and recently his business encountered a loss of CNY 14 million (USD 2 million) as one of his borrower vanished.¹³⁶ Starting with a small sum of money, Yao has been an experienced moneylender for more than a decade, and nowadays, each loan he makes worth millions of yuan. Relying on his expertise, Yao is clearly aware of potential risks in making any loans. In this case, the runaway borrower was a wine maker with a good credit condition, and the reason for Yao to extend the loan was that he felt optimistic about the long-term prospect of the borrower's business. After careful consideration, Yao, along with other 21 moneylenders, lent CNY 120 million (USD 17.5 million) to the businessman.¹³⁷ However, as China launched a series of anti-corruption campaign

¹³⁶ *Shanghai Securities News*, "A Large Proportion of Bank Loans Went into Private Lending" (20 January 2015), available at <http://money.163.com/15/0120/07/AGCSL9KT0025335L.html>, accessed 1 September 2016.

¹³⁷ *Ibid.*

in recent years, the high-end wine industry has seen a sharp fall in sales. On 18 September 2014, the winemaker suddenly disappeared.

To everyone's surprise, it is Mr Yao who persuaded the boss to run away. Yao believed that the boss was a decent man, and he knew that no matter how hard he pushed the borrower, it was nearly impossible to have the debt repaid in the current environment. Therefore, Yao told the boss to leave the city as soon as possible, otherwise he might be harmed by other moneylenders. "I am not a fool", Yao explained. In fact, he had already collected interests worth CNY 10 million (USD 1.46 million) over several months prior to the crisis, so the real loss for him was CNY 3-4 million (USD 0.44-0.58 million), which just equals three-month profits for his moneylending business.¹³⁸

3.6 Major Economic Problems Revealed in Lending Crisis

During the private lending crisis, a variety of financial risks and economic problems in the underground lending market have been exposed. In the past, owing to its opaque operation, most problems regarding the private financing market were not known to outsiders. As a result, market observers had a limited knowledge about what has happened in this enormous but hidden financial world. The recent credit crisis, therefore, is a precious opportunity offering researchers an insight into how the market works and what problems it encounters. This section is going to summarise private lending's main economic problems that have been witnessed during the crisis.

3.6.1 Shall We Ban the Deposit-Taking Model?

The deposit-taking model of professional moneylenders and their money houses is controversial. Taking deposits has been a pillar of the modern banking industry, which distinguishes it from other financial services. However, in China's private lending industry, moneylenders like financing guarantee companies in Xiamen also solicit funds from the public, which makes them *de facto* banks. Clearly, these shadow banks which are not regulated by the authority raise two major problems. First, in contrast to the formal banking sector which is subject to strict regulatory requirements from the PBOC and the CBRC, shadow lenders do not have to comply with rules regarding capital adequacy, cash reserve, qualified management, corporate governance, and so

¹³⁸ *Ibid.*

on.¹³⁹ However, due to the operation of deposit-taking businesses, private lenders' businesses share risks similar to that of authorised banks. Without proper regulation, the risk levels in their businesses cannot be controlled in an effective way, and that is why so many lending networks suddenly collapsed in the crisis. Second, as stated, the deposit-taking model extends the lending chain by pulling numerous ordinary investors into the investments, which increases the complexity of lending structure and contributes to excess financial risks. Therefore, when designing the new regulatory framework, the authority shall consider to prohibit lenders from doing unlicensed deposit-taking activities. Obviously, the prohibition of such practices is able to simplify the lending chain and mitigate market risks, as well as to prevent ordinary investors from joining risky investments.

3.6.2 Ineffective Interest Rate Control Measure

The excessive interest rates of private loans have caused the insolvency of millions of private businesses during the crisis, which suggests the failure of the previous interest rate control method. China introduced an interest rate cap for private lending over twenty years ago, but clearly, it consistently failed to reduce borrower's costs, neither did it manage to combat illegal usuries.¹⁴⁰ In most cases, borrowers of private loans have to pay for monthly interests, over 2 per cent of the principal, to moneylenders. The heavy debt burdens not only reduce the profitability of private businesses, but also negatively impact their financial conditions. Arguably, the interest rate control approach needs an overhaul, in order to effectively reduce borrowing prices and protect borrowers' interests.

3.6.3 Lack of Personal Insolvency Regime

When drafting China's latest bankruptcy law, some reformers proposed to include personal insolvency into the new legislation, but failed to obtain the majority supports.¹⁴¹ Therefore, at present there are no personal insolvency regimes in China,

¹³⁹ Gabriel Wildau and Yuan Yang, "Chinese Shadow Lending Evades Regulations", *Financial Times* (30 April 2016), p.4.

¹⁴⁰ A more detail analysis regarding the interest rate rules will be carried out in the next chapter.

¹⁴¹ Haizheng Zhang and Xiaohe Tang, "Bankruptcy Petition and Acceptance" in Rebecca Parry, Yongqian Xu and Haizheng Zhang (edited), *China's New Enterprise Bankruptcy Law: Context, Interpretation and Application* (Routledge 2016), p.76-77.

which gives rise to a series of legal problems. It is one reason causing the phenomenon of runaway bosses. For many Chinese entrepreneurs, the line between owners' personal assets and corporate assets is often blurred in the day-to-day operation of their businesses. Due to the illegitimate nature of private financing, most entrepreneurs try to sign private lending agreements under their personal names, which means personal liabilities for such loans. As a result, when defaults occur entrepreneurs do not have an option to claim personal bankruptcy, so many of them choose to run away to get rid of debts. Clearly, it is an urgent call for the Chinese legislators to design a legal regime for personal insolvency in the future.

3.6.4 Lack of Investor Protection Mechanism

The lack of adequate investor protection mechanism is another issue which merits consideration. Thousands of ordinary investors move their savings out of banks and deposit the money into various lending schemes in the hope to earn better a return. Most of them consider private lending investments as a safe substitute for savings, without the notice of potential risks. However, when the crisis arrives, it is ordinary investors who suffer substantial losses but have limited remedies.¹⁴² Launching a civil litigation is expensive and slow, with limited effects on recovering their money. Besides, private debt collection is also difficult to achieve, demonstrated by the previous case studies. Therefore, in most cases investors have to absorb all the losses by themselves, which is likely to cause mass demonstrations and social unrests. Clearly, it is high time for the regulator to create an investment protection system for private lending investors when they experience frauds and defaults. The state, if necessary, can bail out some large lending schemes in the crisis and compensate ordinary investors, in order to maintain social and economic stabilities.

3.6.5 Systemic Risks of the Default Crisis

Apart from the negative impacts on relevant stakeholders, the crisis is also said to cause systemic risks to the financial system. First of all, it is clear that stock markets have been affected by a series of runaway boss incidents. In the cases of Nuoqi and Ultrasonic, the sudden disappearance of their chief executives led to a sharp fall in their share prices, giving rise to market turbulences and shareholders' huge losses. In

¹⁴² *The Economist*, "Shadow Banking in China: The Wenzhou Experiment" (7 April 2012), p.84.

addition, the systemic risks can also be witnessed in the following aspects.

As stated, the funds in a moneylender's capital pool come from a large number of individuals, households, and businesses, so its collapse can result in the actual losses of numerous investors. In the case of Xiamen Rongdian Guarantee Company, Ms Zhong had more than eighty investors, many of whom also borrowed heavily from their own relatives, friends, and business partners.¹⁴³ Thus, the number of indirect investors in a large lending scheme is difficult to count, and it is common that moneylenders borrow money from or provide guarantees for each other.¹⁴⁴ As a result, the insolvency of one moneylender could possibly cause liquidity problems for other lenders and related parties. Thus, the failure of a large lending scheme is able to trigger the financial crisis in a certain region, like a domino effect.

Second, systemic risks in the private lending market can be amplified by the closed relationships between the moneylending industry and banking sector. As we know, a considerable percentage of money in China's private lending market does come from the formal banking sector. People who are capable of obtaining bank loans can easily make money by re-lending them at a higher price to other people in need of funds. For example, in the case of the moneylender Yao, he explained that "lots of bank credits finally go into private lending through different channels. A moneylender who has other businesses can use his or her companies to apply for bank loans. If the moneylender knows the credit managers of his or her local city banks well, there will be large chances of securing bank loans."¹⁴⁵ Moreover, Chinese banks, affected by the government's credit policies, prefer to make loans to companies in certain state-supported industries, such as agriculture, environmental protection, and clean

¹⁴³ Fangsong Hu and Jianqiang Lin, *Wenzhou Private Lending Crisis* (China: Nationality Photographic Art Publishing House, 2012), p.140.

¹⁴⁴ In addition, a large number of corporate borrowers also guarantee each other's loan applications in practice, so the insolvency of one borrower could possibly render other healthy businesses go into debt crisis. See Malcolm Moore, "Credit Crisis in China's Richest Province Zhejiang", *The Telegraph* (28 August 2012), available at <http://www.telegraph.co.uk/finance/financial-crime/9504692/Credit-crisis-in-Chinas-richest-province-Zhejiang.html>, accessed 1 February 2017.

¹⁴⁵ *Shanghai Securities News*, "A Large Proportion of Bank Loans Flow into Private Lending" (20 January 2015), available at <http://money.163.com/15/0120/07/AGCSL9KT0025335L.html>, accessed 1 September 2016.

energy.¹⁴⁶ Accordingly, some moneylenders have been exploiting the policy loopholes by acquiring or cooperating with businesses in these specific industries, in order to borrow more funds from banks. That is how some bank loans eventually flow into the shadow lending industry. Apparently, when an increasing number of borrowers default on private loans, moneylenders will probably stop to repay the bank loans they have borrowed, resulting in more non-performing loans for the official banking sector.

In addition, many private enterprises in China borrow money from both commercial banks and moneylenders at the same time.¹⁴⁷ Previously, we have seen large enterprises like Fujian Nuoqi Co Ltd and Zhengling Group did this, as they considered private lending as a vital financing source which supplements bank credits. As for Nuoqi, a number of state lenders had lent money to it before, including a loan of 250 million from the Bank of China.¹⁴⁸ In addition to bank loans, Nuoqi borrowed heavily from private lenders as bank credits alone were not enough to meet its actual financing needs. As a result, when borrowers start to default on their private loans and go into insolvency, they will default on their bank loans as well, or *vice versa*.¹⁴⁹ Clearly, the interplay between the banking industry and the private lending sector is a potential source of systemic risks.

3.7 Conclusion

This chapter investigates the recent private lending crisis in China, which has been a game changer in the underground lending industry. It used to be a win-win situation for both borrowers and lenders in the market. However, after the crisis the market has become a place with no winners, as both sides of lending faced great challenges and losses. Multiple reasons that triggered the crisis have been analysed. The global financial crisis and the slowdown of the Chinese economy led to worsening business environments for Chinese companies, in particular manufacturers and exporters. At

¹⁴⁶ *Ibid.*

¹⁴⁷ Dong Yang, “The Default Rate Rise in Private Loans, Banks Wary of Potential Risks” *Security Times* (10 October 2011), available at http://epaper.stcn.com/paper/zqsb/html/2011-10/10/content_309665.htm, accessed 1 May 2016.

¹⁴⁸ *Xiamen Daily*, “Jinjiang Nuoqi Company Confirmed the Boss is Missing” (26 July 2014), A9.

¹⁴⁹ Though there is no empirical data showing whether the private lending crisis has caused a higher level of non-performing loans in the banking industry, we can predict the result from relevant news reports that we have examined.

the same time, due to the official lending curb, few bank credits were available for business borrowers, so many of them had no choice but to borrow private loans to survive the economic downturn. From the lending side, more people chose to invest in the private lending market, as professional lending brokers used eye-catching rates to solicit funds. Therefore, the costs of borrowing have been extremely high, which created heavy debt burdens on the shoulders of Chinese entrepreneurs. Finally, many borrowers were unable to fulfil their debt obligations, giving rise to the private lending crisis.

During the crisis, market participants and other stakeholders have been negatively impacted. It has studied the popular phenomenon of runaway bosses, by using the case of Mr Ding Hui and Fujian Nuoqi Company, to see why some of Chinese entrepreneurs prefer escaping rather than filing for bankruptcy, and how the decision of running away have catastrophic effects on their businesses and relevant parties. Clearly, the lack of the personal insolvency law means that businessmen and women facing defaults cannot find a legal way to free themselves from private debts. Moreover, the people who fail to repay a large amount of money to investors could be subject to harsh punishments under China's criminal code. Borrowers might also face intimidating private debt collection activities by loan sharks. As a result, running away seems the optimal choice for many bankrupt entrepreneurs. However, the increasing vanishing bosses have very negative influences on their businesses, creditors, employees, and local economies.

Apart from failing businesses, investors whether they are ordinary households or professional moneylenders suffered considerable financial losses owing to massive defaults in the private lending market. The chapter has examined financing guarantee companies in Xiamen, which are in fact shadow banks without regulation. Many of these large lending schemes collapsed during the crisis, leading to a desperate situation for their investors for there are no official mechanisms to protect investors' money. Therefore, some investors launched civil litigations against debtors, whilst others went for private debt collection. The effects of money collection, however, remained limited in most cases. It has also explored the real stories of ordinary and professional investors regarding how their lives have been changed by the lending crisis.

Apparently, the private lending crisis has endangered China's economic growth and financial stability. The final part has considered major economic problems which exist in the underground lending industry. At the moment, the primary concern for regulators shall be the illegal deposit-taking model that has been widely used by professional moneylenders, which not only increases the complexities and relevant risks in the lending businesses, but also exposes ordinary investors to additional financial risks. Moreover, the old interest rate cap seems ineffective, as it was unable to curb usuries in the market and protect the interests of borrowers. In addition, the lack of a personal insolvency regime and an investor protection mechanism needs to be addressed by the Chinese authority, in order to enhance the legal architecture for the private lending market. Finally, the problem of systemic risk has been evaluated in detail, including how moneylenders' capital pools and the close relationships between the private financing market and the banking sector leads to excessive risks. Clearly, all problems revealed in the private lending crisis call for a new regulatory framework.

Chapter 4 The Legal Framework of Private Lending

4.1 Introduction

Currently, there are no unified legislations regarding private lending activities in China, and therefore, relevant regulations spread across numerous pieces of administrative, civil, and criminal statutes, as well as certain judicial interpretations made by the Supreme Court. Clearly, the dispersed legislation model increases the difficulty in researching laws in this field. In terms of the enforcement issue, there are no specific authorities charged with the mandate to supervise the private lending market. Due to the regulatory vacuum, the authorities can only detect and react to relevant problems of the market after the outbreak of the private lending crisis. As a result, the tasks of handling private lending-related civil disputes and punishing illegal fundraising practices are mostly left to the Chinese judiciary. Apparently, the current *ex post* regulatory approach fails to protect lending parties, reduce financial risks, and maintain the market stability.¹ It also results in an overwhelming number of private lending-related civil and criminal cases to be heard by Chinese judges, which has taken up a significant proportion of the limited judicial resources.

The objective of this chapter is to present and analyse the legal framework of private lending in China, in order to observe how it works to deal with relevant civil disputes and criminal offences. First of all, it introduces the socialist legal system in China, to provide an understanding about how the judiciary system operates and what sources of law are being used in Chinese courts. Next, it is going to conduct a detail analysis about the changing attitudes of the Chinese authorities towards private financing activities, which not only determines the legitimacy of private lending, but also plays an important role in shaping relevant regulations in this area. The fourth section discusses about Chinese civil laws in relation to private lending agreements, as the underlying legal relationships of any private loans are contractual, so relevant lending parties have to comply with articles under the Chinese Contract Law. It also investigates what approaches the judiciary has been using to handle the rising private lending civil disputes as a result of the lending crunches. The fifth part continues to

¹ That is why we have witnessed so many chaos like runaway bosses and investors' discontent during the private lending crisis, as it is shown in the last chapter.

study legal methods to control interest rates, to evaluate their effectiveness in preventing usuries and protecting borrowers. Finally, the sixth part examines the criminal liabilities of conducting illegal moneylending practices, in particular, the offence of fraudulent fundraising under China's criminal code. Two criminal cases regarding Mr Zeng Chengjie and Ms Wu Ying will be analysed to explore problems in the criminal justice system.

4.2 A Overview of China's Legal System

4.2.1 Socialist Legal System with Chinese Characteristics

The current legal system in China is officially named the "socialist legal system with Chinese characteristics".² Apart from the traditional Confucian heritage and the influence of the socialist regime, its legal system mainly follows the civil law tradition derived from Japan, Germany, and France. Therefore, the Chinese legal system is very different from common law jurisdictions such as the UK and the US, in terms of the sources of law and the operation of legal system. When Chinese judges apply laws to a certain civil or criminal case, the main source is a large number of codified statutes passed by the legislature, and unlike common law countries, judicial precedents are not binding in China.³

The judicial bodies in China are composed of the People's Court System and the People's Procuratorate System, both of which are divided into four levels in parallel with the country's administrative system.⁴ Within a court of certain level, there are criminal, civil, economic, and other specialised divisions responsible for hearing different types of cases. The Supreme People's Court (SPC), as the highest level in China's Court system, is based in Beijing, and it serves as the top appellate forum of mainland China. The SPC seldom hears first instance case, except those with national interests. It also supervises the works of the entire court system, including three levels of local courts as well as three forms of specialised courts: military courts, railway

² Mo Zhang, "The Socialist Legal System with Chinese Characteristics: China's Discourse for the Rule of Law and A Bitter Experience", (2010) 24 *Temple International & Comparative Law Journal* 1, 1.

³ Library of Congress (US), "Introduction to China's Legal System", available at <http://www.loc.gov/law/help/legal-research-guide/china.php>, accessed 1 October 2017.

⁴ *Ibid.*

transport courts, and maritime courts. However, the SPC does not have jurisdiction over two Special Administrative Regions in China: Hong Kong and Macau, which have separate legal systems under the constitutional principle of “one country, two systems”. Hong Kong was a British colony whilst Macau used to be occupied by Portugal. Furthermore, the SPC has the power to approve the application of death penalty in criminal cases which are not heard by itself.⁵

In addition to the SPC, regional courts constitute the remaining three tiers of China’s court system, including High Courts at provincial level, Intermediate Courts at prefectural or municipal level, and Basic Courts at county or district level. All of them enjoy jurisdiction over civil and criminal cases of the first instance within their geographic regions. In practice, the majority of first instance cases are heard by the basic courts which are most primary in the hierarchy and have wide existence in every locality. Intermediate Courts are empowered to handle important local cases of the first instance within their realms, and to hear appealing cases from Basic Courts. High Courts are at the highest rank of the local court system, and it is responsible for hearing first instance cases of provincial importance and dealing with appeals from Intermediate Courts. Finally, it should be noted that the trial of second instance in any appellant cases will be the final judgment. Any cases will be closed after going through two adjacent levels of courts, except for the first instance case heard by the Supreme Court (which shall be the final judgement immediately).⁶

Court Level	Example
<i>Supreme Court</i>	Supreme People’s Court of China
<i>High Court (provincial)</i>	Fujian Province High People’s Court
<i>Intermediate Court (municipal)</i>	Xiamen City Intermediate People’s Court
<i>Basic Court (county/district)</i>	Siming District People’s Court

Table 6: The Structure of China’s Court System⁷

4.2.2 Sources of Law in China

As for the sources of law in China, the highest level is the Constitution of the People’s Republic of China which lays down fundamental rights and duties of Chinese citizens and the structure of the state. Next to the Constitution, there exist national laws

⁵ PRC Criminal Law 1997, Article 48.

⁶ PRC Organic Law of the People’s Courts 1979, Article 12.

⁷ The table is compiled by the author.

covering different aspects of the society which are superior to all other rules and regulations. National laws can be categorised into seven main areas: Constitution and Constitution-related, civil and commercial, administrative, economic, social, criminal, and the law on lawsuit and non-lawsuit procedures.⁸ National laws have to be passed by China's top legislature, the National People's Congress (NPC), or its standing committee.⁹ It is worth noting that national laws always have the country's name "the People's Republic of China" in their titles, which makes it easier for people to recognise and apply in practice. In addition to national laws, there are administrative regulations issued by the State Council which is China's cabinet, and local statutes enacted by regional people's congresses or their standing committees.

Apart from statutes, the SPC is entitled to make judicial interpretations which are the official opinions of senior judges sitting in the Supreme Court, and these rules are considered as official guidelines for the trial practice and thus shall be followed by the entire court system.¹⁰ For instance, the interest rate cap of private lending is stated in a piece of judicial interpretation, which will be studied later. Along with domestic legislations, international treaties signed by the Chinese government will be automatically applied in the country, which are superior to relevant provisions under domestic laws. In sum, all sources of law mentioned above can be employed by Chinese judges when hearing cases, but there is no doubt that national laws and judicial interpretations play the most significant role in any legal cases.

4.3 The Changing Official Attitudes Towards Private Lending

In the eyes of the Chinese government and judicial authority, private lending has long been viewed as the temporary moneylending activities among individuals, rather than a corporate financing method. Therefore, Chinese laws, strongly influenced by the

⁸ National People's Congress (China), "China's Legal System", available at http://www.npc.gov.cn/englishnpc/about/2007-11/20/content_1373258.htm, accessed 1 October 2016.

⁹ NPC, as China's unicameral parliament, has around 3,000 members representing different provinces and regions, who serve a term for five years and come to Beijing in every spring to attend the annual meeting session in the Great Hall of the People that usually last for 10 to 14 days and pass important bills and resolutions.

¹⁰ For more discussions about the legal status of judicial interpretations, see Shibing Cao, "The Legal Status of Decisions and Judicial Interpretations of the Supreme Court of China" (2008) 3.1 *Frontiers of Law in China* 1, 6.

official attitudes, have been responding differently to private lending agreements between two natural persons (individuals), and those involving an enterprise. The legitimacy of the former type of private lending has been fully admitted by the authority and it is protected by laws, whilst the legitimacy of the latter type has remained ambiguous. Despite the popular use of private lending for private business borrowers, its legal status has not been endorsed by the policy-makers. As a result, legislations in this area are largely lagging behind the latest developments of private lending practices. This session focuses on analysing how the official opinions about private lending as a business financing tool have been changed in the past decade, and explores how the changing official attitudes have an impact on relevant legislations.

4.3.1 The Validity of Private Lending Agreements Between Different Entities

In China, the validity of private lending agreements mostly depends on the nature of entities who enter into such agreements. Generally speaking, there are three situations: first, a lending contract between two individuals; second, a lending contract between an individual and an enterprise; third, a lending contract between two enterprises. We are going to examine these three scenarios respectively.

As for the first scenario, a private lending agreement between two individuals is, without doubt, the original and simplest form of moneylending activities. When human began to use money, they knew how to borrow and lend money to each other. Moreover, moneylending has been the foundation of the modern banking system based on deposit-taking and loan-making. Therefore, when the Chinese law-makers made laws regarding private lending in the past, they primarily defined private lending as loan contracts between two natural persons. This kind of lending agreements is featured by the small amount of money, with or without the interests being charged. Such lending activities commonly happen in our daily lives, as borrowers need some temporary loans to cope with the money shortage in a short term. Clearly, we can see how the legislature interprets the concept of private lending from China's contract law which contains a whole chapter regulating loan agreements.¹¹ Although most provisions in this chapter state rules for loans that are made by financial institutions like banks, they can also be applied to private lending agreements. However, most provisions only

¹¹ PRC Contract Law 1999, chapter 12 Loan Contract. This will be analysed in detail later.

mentions the phrase “lending between natural persons”, without saying anything about how enterprises being a potential party in lending contracts.¹² It is evident that the primary legislative purpose in the past was to regulate non-profit moneylending activities between relatives, friends, and other acquaintances, rather than private financing agreements signed by businesses. Accordingly, moneylending contracts between two individuals have been fully protected by Chinese laws, as long as a lending party is able to provide evidence to prove the existence and terms of the contract.

In terms of the second scenario, a lending agreement between an individual and an enterprise is valid under most circumstances. Although the lawmaker endorsed the legitimacy of loan contracts entered by two individuals, it also allowed one party in a lending agreement (either the lender or the borrower) to be an enterprise. According to a judicial interpretation made by the SPC in 1991 (hereafter referred to as the “1991 Regulation”), a court shall receive private lending cases in terms of disputes between (Chinese) residents, or between a resident and a legal person, or between a resident and other organisations.¹³ Clearly, the term “resident” here means a natural person, and “legal person” is mostly referred to a company. Therefore, a lending contract between an individual and an enterprise is deemed valid. This principle has been re-confirmed by another judicial interpretation in 1999, which states “a lending agreement between a (Chinese) resident and a non-financial enterprise belongs to private lending. It shall be deemed valid providing the expression of both parties’ intentions (to form the contract) is genuine.”¹⁴ Moreover, there are exceptions regarding the validity of this type of lending agreement. For example, if a company, in the name of private lending, is illegally raising funds from its own employees or from the public, or illegally making loans to the public, the relevant lending contract will be invalid.¹⁵ The logic behind this rule is simple, for if a business borrows money from a number of unspecified persons, it is in fact conducting the business of deposit-taking, a practice

¹² See, for example, PRC Contract Law 1999, Articles 197, 210, and 211.

¹³ The Regulation 1991 has been the most influential one in the judicial practice so far. Supreme People’s Court, “Some Opinions Concerning the Hearing of Private Lending Cases by People’s Courts” (13 August 1991, FAMINFA 1991 No.21)

¹⁴ Supreme People’s Court, “The Reply of the SPC on How to Determine the Validity of Lending Activities between Residence and Enterprise” (FASHI 1999 No.3)

¹⁵ *Ibid.*

which can only be done by licensed financial institutions. Similarly, if a non-financial enterprise is lending money to the public, it will violate relevant financial regulations, as according to China's banking law, the loan-making practice can only be carried out by a authorised financial institution.¹⁶

Thirdly, there is a lot of controversy regarding whether a lending agreement between two non-financial enterprises is valid or not. China's financial authority exerts strict control over its financial sector, so the loan-making business is exclusive to those financial enterprises holding a proper license, such as commercial banks, small-loan companies, and credit cooperatives. Therefore, although a non-financial enterprise can be a borrower in any private lending agreements, it is strictly prohibited from being a lender which makes loans to other entities. In the 1990s, the Chinese authority clarified the invalidity of a lending contract between two enterprises for several times. For instance, two pieces of judicial interpretations made in 1996 clearly stated that "a lending agreement between enterprises violates financial regulation and shall be seen as invalid."¹⁷ Due to the invalidity of such contracts, the principal of lending shall be returned to the lender, when a relevant case is closed by the judge. In 1998, the People's Bank of China, as the central bank and then banking regulator, also expressed its views about this issue by saying "lending activities between enterprises not only do harm to the development of market economy, but also disturb the financial stability and the implementation of credit policies. It also weakens the supervision of investment scale, and leads to the disorder of national economy. Therefore, lending agreements entered by two enterprises violate national laws and policies, which shall be deemed invalid."¹⁸ It came from a replying letter from the central bank to the Supreme Court's Economic Division, clearly showing the attitude of monetary authority. In practice, if such contracts are made, the court will compel the borrower to return the amount of

¹⁶ PRC Commercial Bank Law 1995 (amended in 2013), Article 11(2). Without the approval of the banking regulatory authority of the State Council, no entity or individual can operate businesses of commercial banks, such as absorbing public deposits, and nor shall any entity use the word "bank" in its trading name.

¹⁷ Supreme People's Court, "The Explanations Concerning Trials of Joint Operation Contract Disputes" (FAJINGFA 1990 No.27), Article 4(2); Supreme People's Court, "Reply to How to Deal with Borrowers' Defaults When Falling Due in Enterprise Lending Agreements" (FAFU 1996 No.15).

¹⁸ People's Bank of China, "The Reply of PBOC on Issues Concerning Lending between Enterprises" (16 March 1998, YINTIAOFA 1998 No.13)

principal to its lender, confiscate any interests, and even fine the private lender with an amount equal to the amount of interests.

In summary, the validity of a private lending contract between two individuals is fully recognised by the authority. However, it becomes more complicated when an enterprise is involved in the lending agreement. If only one side of a lending contract (either the lender or the borrower) is an enterprise, the agreement will be valid in most cases. If enterprises constitute both sides of a lending agreement, the contract will be seen as invalid.

4.3.2 The Legitimacy of Private Lending as A Way of Business Finance

In the past, the official attitude toward private lending as a method of business finance was almost negative, and the authority was particularly wary of lending activities between two enterprises. Despite its extensive presence, the legal status of private financing remained uncertain for a long time. As discussed, the central bank even considered the shadow lending between enterprises risky enough to endanger the financial stability. However, different views about private financing can also be found. For instance, an official document of Ministry of Justice (1992) stated: “private lending plays a role in alleviating the problem of insufficient credits in the country, which contributes to the economic development, but it is also associated with usuries and increasing civil disputes.”¹⁹ Clearly, this view seems more objective than the previous one from central bank, as it not only admits the function of private lending in terms of providing credits for borrowers, but also considers its economic and legal problems.

In the 1990s and 2000s, the Chinese authority had a mixed view of private lending. Some departments denied its legitimacy as a way of alternative finance, whilst others started to recognise its role in the financial system. However, during this time period, China did not have a formal regulatory regime for the fast growing private lending market, and therefore, the authority adopted an *ex post* approach to handle relevant problems in the market. If the market was functioning well, the government would

¹⁹ Ministry of Justice PRC, “The Opinions of Ministry of Justice on Providing Notarisation for Private Lending Contracts” (12 August 1992, SIFATONG 1992 No.074)

turn a blind eye to it, but when something went wrong, like the recent lending crunch, the authority tended to apply severe punishments to entrepreneurs or moneylenders who were unable to repay their investors. For example, in China's criminal code, there are a number of specific crimes in relation to private financing, such as the crime of illegal absorbing public deposits, and the crime of fraudulent fundraising.²⁰ In particular, people who commit fraudulent fundraising face a penalty up to life imprisonment, which is considered as extremely harsh by both Western and Chinese standards.²¹ Not long ago, the offender of such crime could even be subject to death penalty, despite the National People's Congress declared that "although China preserves the capital punishment at the present stage, it shall be strictly controlled and prudentially applied. It will only be applied to those who have committed extremely serious crimes according to the criminal law."²²

In the recent decade, through a number of amendments for the criminal law, death penalty has been gradually abolished for most economic crimes in China. Therefore, until 2015, the crime of fraudulent fundraising had been the only financial crime that could lead to death penalty. It reveals the authority's concern about the negative impacts of private lending on the financial and social stability. Moreover, in the judicial practice, we can find many examples of over-punishment, as the Chinese courts tend to apply strict criminal sanctions to borrowers who fail to repay a large amount of money, and to those who owe money to a large group of creditors in the event of crisis. The authority believes that only by punishing defaulting borrowers heavily, it can comfort the public and give a warning to other entrepreneurs, but the real effect remains very limited.

4.3.3 The Latest Change of Official Attitudes and Regulatory Approaches

After the private lending crisis, the official attitude towards private financing has been undergoing massive changes, as the authority reconsiders its regulatory approach. In

²⁰ PRC Criminal Law, Article 176 and 192.

²¹ In the remaining parts of this chapter, we will see how the judiciary deal with criminal cases regarding illegal moneylending activities.

²² National People's Congress, "NPC: Strictly Control and Prudentially Apply Death Penalty" (9 March 2014), available at http://www.npc.gov.cn/npc/xinwen/2014-03/09/content_1847078.htm, accessed 1 November 2016.

late 2011, in response to the crisis, the Supreme Court issued a new judicial interpretation (hereafter referred to as the “Regulation 2011”) which provides a guidance for the entire court system to properly handle drastically rising private lending civil disputes.²³ It is considered as a turning point of the authority’s general view about private lending. The Regulation 2011 discusses private lending activities in an objective way by saying that “private lending broadens financing channels for small and medium-sized enterprises, and it to some extent satisfies the social financing demand. It improves the function of self-adjustment and self-adaption in the economy, and contributes to the formation and development of a multi-level credit market.”²⁴ Meanwhile, the regulation also identifies some problems of private lending “in practice, private lending is known for non-transparent transactions and the regulatory difficulty in ascertaining its risks. It is likely to trigger a series of problems like usuries, SMEs’ illiquidity and insolvency problem, illegal deposit-taking, and personal injuries caused by violent debt collection. Therefore, it has some negative impacts on the financial stability, economic development, and social stability, and it also increases working tasks for people’s courts to properly handle relevant disputes.”²⁵

It is apparent that, apart from pointing out problems and risks relating to private lending, the authority finally recognises the legitimacy of private lending as a financing method for SMEs, which is a great step forward for China’s private lending industry. Along with the Regulation 2011, the Supreme Court also made several pieces of judicial suggestions to other government agencies. For instance, the SPC vows to prohibit civil servants from engaging in private lending activities or providing guarantees for profit purposes, strengthen financial regulation over the private lending market, as well as liberalise and regulate lending activities between enterprises.²⁶ It represents the latest official opinion about private lending, and after the Regulation 2011, there has been a number of further legislations and regulatory experiments for

²³ Supreme People’s Court, “Notice of the Supreme People’s Court on Legally and Properly Hearing Cases on Disputes over Private Lending to Promote Economic Development and Maintain Social Stability” (2 December 2012, FA 2001 No.336)

²⁴ *Ibid.*, Article 1.

²⁵ *Ibid.*

²⁶ *People*, “Supreme People’s Court Issued Judicial Suggestions to Regulate Private Lending” (7 December 2011), available at <http://politics.people.com.cn/GB/70731/16532052.html>, accessed 1 November 2016.

private lending²⁷.

Following the admission of private financing's legitimacy, the Chinese lawmaker abolished the death penalty for the crime of fraudulent fundraising when it passed the 9th amendment of PRC Criminal Law in 2015.²⁸ In the same year, the Supreme Court issued a judicial interpretation (hereafter referred to as the "Regulation 2015") about hearing private lending cases, to fully replace the "Regulation 1991" which was used for over twenty years.²⁹ Now the Regulation 2015 has become the most authoritative document guiding the judicial practice, and any previous rules if contradicting the "Regulation 2015" will not be applicable.³⁰ The latest regulation has seen a big change in terms of private lending between two enterprises. The Article 11 stipulates that "a private lending agreement entered by legal persons, for the purpose of production and business operation, will be considered valid by the court, provided it does not have circumstances under the Article 52 of PRC Contract Law and the Article 14 of this regulation."³¹ The Article 52 of PRC Contract Law states general situations that will lead to the invalidity of a contract, such as one party use fraudulent or coercive methods to conclude the contract, or the contract involves a malicious conspiracy that cause damages to interests of the nation, a collective, or a third party. The Article 14 of the regulation stipulates that a court shall hold a private lending contract invalid, if there is one of the following situations:

- a) When the lender fraudulently borrows a loan from financial institutions, and then re-lend the money to the borrower at usurious rate (the borrower knows it or should have known it in advance);
- b) When the lender borrows money from other enterprises or raise funds from its own employees, and then re-lend the money to the borrower for the purpose of making profits (the borrower knows it or should have known it in advance);

²⁷ Here we limit our attentions to the change of legislations only, while the tentative regulatory reform will be discussed in the next chapter.

²⁸ National People's Congress, 9th Amendment for PRC Criminal Law, Article 12, "Deleting the Article 199 of Criminal Law", available at http://www.npc.gov.cn/npc/xinwen/2015-08/31/content_1945587.htm

²⁹ Supreme People's Court, "Provisions of the Supreme People's Court on Several Issues concerning the Application of Law in the Trial of Private Lending Cases" (Issued 6 August 2015, Effective Date 1 September 2015, FASHI 2015 No.18)

³⁰ *Ibid.*, Article 33.

³¹ *Ibid.*, Article 11.

- c) When the lender knows or should have known in advance that the borrower takes the loan for criminal activities, but still provides the loan;
- d) When the contract violates the public order or good morals; or
- e) When the contract violates laws, administrative regulations, and other mandatory rules.

Therefore, as the new rules came into effective, a lending agreement between two enterprises for the purpose of doing business will be deemed valid by Chinese courts. Evidently, it suggests that the Chinese authority finally decided to admit the legitimacy of private lending as a business financing approach, and currently all private lending agreements are valid regardless of the identity of lending parties. What is more, the *Regulation 2015* loosens the rules for a lending agreement between an individual and an enterprise, as it allows a legal person or other organisation to raise funds through borrowing credits from its employees, for the purpose of its own business operation and production, provided it does not have circumstances under the Article 52 of PRC Contract Law and the Article 14 of Regulation 2015.³²

Lending Entities	Lending Contracts between Two Individuals	Lending Contracts between An Individual and An Enterprise	Lending Contracts between Two Enterprises
The Validity of Contract	<i>Valid</i>	<i>Valid</i> , except for the situations: when the enterprise illegally takes deposits from the public; when the enterprise illegally makes loans to the public; when it has circumstances under Article 52 of PRC Contract Law and Article 14 of Regulation 2015.	Old Rule: The contract will be deemed <i>invalid</i> by the court, and the principal shall be returned to the lender. New Rule: <i>Valid</i> , except for certain circumstances under Article 52 of PRC Contract Law and the Article 14 of Regulation 2015.

Table 7: A Summary of Private Lending Agreements' Validity

4.4 Private Lending Under Civil Law

4.4.1 Revisiting “Loan Contract” Under Chinese Contract Law

A loan contract is an agreement between one or more moneylenders and a borrower, which documents mutual promises regarding moneylending issues. In China, despite the large amount of money involved in private lending, any moneylending activities

³² *Ibid.*, Article 12.

essentially constitute a contractual relationship between a creditor and a debtor. Therefore, moneylenders and their borrowers have to comply with provisions under the contract law. A valid private lending contract, like any other contracts, comprises basic elements including offer, acceptance, and consideration (interest). Nonetheless, the common issues regulated by the general principles of contract law are not discussed here, whilst the attention is focused on specific provisions governing loan agreements.

In total, the codified PRC Contract Law has 428 articles under 23 chapters.³³ Chapters 1 to 8 contain general provisions in terms of the legislative purpose, and basic principles and rules that shall be followed to any contracting parties in China.³⁴ After that, Chapters 9 to 23 set out detail rules for 15 specific types of contracts that are frequently used in most economic activities, such as sales contract, moneylending contract, lease contract, brokerage contract, and so on. In particular, the Chapter 12 of PRC Contract law is entitled “loan contract”, as it lies down basic rules for all moneylending agreements in China, including bank loans, private loans, P2P online lending agreements, or any other forms of lending contracts. Now we are going to scrutinise relevant provisions in this chapter.

4.4.2 Chapter 12 of PRC Contract Law 1999

PRC Contract Law 1999 Article 196 A “loan contract” is the agreement whereby a borrower borrows money from a lender, and will repay the loan with interests when it falls due.

The Article 196 is the first provision in Chapter 12 which clarifies the definition of loan contract. A loan agreement creates legal obligations between a creditor and a debtor, where the creditor is obliged to transfer a certain amount of money to the debtor at an agreed time point. After that, the debtor is liable to repay the principal and

³³ PRC Contract Law 1999, passed by the second session of the ninth National People’s Congress on 15 March 1999, came into effect on 1 October 1999.

³⁴ For instance, Chapter 2 is about the conclusion (formation) of a contract, Chapter 3 states rules for the validity of a contract, Chapter 4 is about the fulfilment of a contract, Chapter 5 is about the modification and transferring of a contract, Chapter 6 is about termination of rights and obligations under a contract, Chapter 7 lays down liabilities for the breach of contract, and Chapter 8 are some miscellaneous provisions.

interests, if any, when the loan falls due. According to *PRC General Principles of Civil Law*, a legally made moneylending contract is protected by law.³⁵ A loan contract can either be a financial agreement between a financial institution and its borrower, or a private lending agreement between any individuals and businesses. Obviously, a bank lending agreement is subject to more official regulation, such as provisions under *General Rules for Loans*³⁶, a private lending agreement only has to comply with rules under the contract law or other civil law legislations.

PRC Contract Law 1999 Article 197 A loan contract shall be made in written form, except for those contracted between natural persons. A loan contract shall contain essential clauses like the loan's type, currency, purpose of use, amount of money, interest rate, term time, method of repayment, etc.

The Article 197 stipulates the legal format of a loan contract as well as its main clauses. Generally speaking, most loan contracts shall be documented in written form, in particular bank loans, which is able to clarify obligations of lending parties and serves as evidence if any disputes happen in the future. However, in the case where both the lender and the borrower are natural persons (under a private lending agreement), the written format is no longer compulsory. Although oral agreements are allowed for private lending, they shall not be recommended. In practice, most private lending contracts have been made in black and white, whilst some lenders merely have oral agreements with their borrowers, when both parties think they could trust each other. It is not unusual in China where personal connection and trust play a key role in doing business. The disadvantage of having an oral agreement will be the difficulty for the claimant to provide evidence when lending parties have disputes and go to a court or an arbitration panel. However, if there is only a record of money transfer but no proper lending contract, the creditor can still sue the debtor to pay back the money (principal

³⁵ PRC General Principles of Civil Law 1987, Article 90 "A legal lending relationship is protected by the law." This legislation is the most fundamental one in the area of civil laws in China, which was promulgated in 1986 by the 4th Plenary Session of the 6th National People's Congress and came into effect in 1987. It aims to make a consistent framework regarding all civil law legislations in the country.

³⁶ People's Bank of China, "General Rules for Loans" (1996 PBOC Order No.2). It is a series of rules made by China's central banks to regulate loan-making businesses of financial institutions, including rules concerning different types of loans, loan term and interest rate, loan-making procedures, supervision of non-performing loans, accountability of loan management, and so on.

only) under the civil law principle *unjust enrichment*.³⁷

PRC Contract Law 1999 Article 198 When entering into a loan contract, the lender may require the borrower to provide a guaranty. The guaranty shall comply with rules under *PRC Guaranty Law*.

The Article 198 points out that a lender, before concluding the contract and advancing money to the borrower, has the right to ask for guarantees. Apparently, requesting any forms of guarantees can make a private loan more secure for the lender, which is able to compensate some potential risks of defaults. According to *PRC Property Law*, a security interest can be created for the creditor, to protect its rights in civil activities such as moneylending or sales of goods, by asking the debtor or other third parties to provide guarantees.³⁸ In order to create a security interest, a guaranty contract shall be made in accordance with provisions under *PRC Property Law* and other legislations.³⁹ Besides, a guaranty contract will be an ancillary contract of the principal contract (in our case, the loan agreement), so if the principal contract is held invalid by the court, the guaranty contract will therefore be invalid as well, except for certain circumstances stated by the law.⁴⁰

There are three forms of guarantees under Chinese laws: surety (guaranty), mortgage, and pledge. Surety refers to an agreement pursuant to which a creditor and a surety (guarantor) who should not be the debtor agree that the surety will assume the responsibility of repaying debt in case the debtor fails to do so.⁴¹ Creating a mortgage means the situation where the debtor or a third party, in order to guarantee the repayment of debt, mortgages some properties to a creditor without transferring the possession of such properties, and if the debtor defaults, the creditor will have priority

³⁷ Unjust enrichment (不当得利) is a civil law concept derived from Roman law, which means one person has been unjustly enriched at the expense of the benefit of another person. Therefore, it arises an obligation for the enriched person to make restitution for the victim. See *PRC General Principles of the Civil Law of the People's Republic of China*, Article 92: "If profits are acquired improperly without a lawful basis, resulting in another person's loss, the illegal profits shall be returned to the person who suffers the loss."

³⁸ *PRC Property Law 2007*, Article 171.

³⁹ *PRC Property Law 2007*, Article 172.

⁴⁰ *Ibid.*

⁴¹ *PRC Guarantee Law 1995*, Article 6.

in satisfying its claim with the money from selling mortgaged properties.⁴² In practice, moneylenders often require the debtor to provide real estates, automobiles, factories, production equipment, raw materials, and products as mortgages. If the debtor defaults, the creditor enjoys the right to sell the mortgage (like on auction), and use the proceeds to repay the debt. Moreover, a pledge of movable means that the debtor or a third party transfers the possession of some movables to the creditor as a security for debt repayment.⁴³ If the debtor becomes unable to fulfil the debt obligation, the creditor will be entitled to the priority to be repaid with the proceeds of selling such pledged movable. In addition to movable properties, *PRC Guarantee Law* allows certain rights to be used as the pledge, such as bonds, shares, and intellectual properties.⁴⁴ To create a pledge of rights, relevant parties shall register with the authority in charge of the administration of such rights.

PRC Contract Law 1999 Article 199 When making a loan contract, the borrower shall, as requested by the lender, provide truthful information regarding its business activities and financial conditions relevant to moneylending.

The Article 199 has imposed an obligation on the borrower to disclose its information concerning business operation and financial statements to the lender, prior to the conclusion of a lending agreement. The lender, when doing due diligence, will consider the borrower's business model, cash flow, creditworthiness, and relevant collaterals, before it decides to offer the private loan. Clearly, the lending decision largely depends on the accurate information provided by the borrower. If the borrower violates this rule by providing fake information (which probably constitutes a fraud), the lending contract will be deemed invalid by a court.⁴⁵

PRC Contract Law 1999 Article 200 The interest of a loan shall not be deducted from the principal prior to lending. If the interest is deducted in advance, the loan shall be repaid according to the actual amount of money received by the

⁴² PRC Property Law 2007, Article 179; PRC Guarantee Law 1995, Article 33.

⁴³ PRC Property Law 2007, Article 208; PRC Guarantee Law 1995, Article 63.

⁴⁴ PRC Property Law 2007, Article 223; PRC Guarantee Law 1995, Article 75.

⁴⁵ Supreme People's Court, "Some Opinions Concerning the Hearing of Private Lending Cases by People's Courts" (13 August 1991, FAMINFA 1991 No.21), Article 10.

borrower, so shall the interest rate be calculated.

In the private lending market, some moneylenders try to deduct interests from the principal, before they transfer the money to borrowers. Two reasons can explain for this practice. First, the moneylenders charge interests which exceed the interest rate ceiling of the state. In order to get around the restriction, they choose to deduct the excessive amount of interests from the principal. Second, some moneylenders do this because they want to reduce the risk of lending by realising some interests as profits at first. Clearly, this unfair lending practice prejudices the interest of borrower who often has to accept all conditions to secure the loan. As the borrower receives fewer amount of money than what is written in the contract, the borrower will be unable to get sufficient funding to satisfy its real financing demand.⁴⁶ In response to such unfair practice, the Chinese law prohibits it to protect borrowers. If the deduction happens, the lending contract will be valid but the amount of borrowing will be automatically adjusted to the actual sum received by the borrower. Relevant interests will also be charged based on the actual sum.

PRC Contract Law 1999 Article 201 If the lender fails to offer the right amount of loan at the agreed time, which leads to the borrower's losses, it shall be liable to compensate such losses. If the borrower fails to receive the right amount of loan at the agreed time, it will still have the obligation to pay interests on time, according to provisions in the contract.

The Article 201 stipulates two situations where lending parties breach the contract and points out relevant remedies. When the lender is unable to provide the loan on time, or provides an insufficient amount of money, it will affect the business plan of the borrower and result in certain losses. Under this circumstance, the lender undertakes the liability to compensate relevant losses caused by the breach. On the contrary, if the borrower is unable to collect the money on time, which also constitutes a breach, it still has to pay interests to the lender, as what they have agreed in the contract.

⁴⁶ For example, if borrower A borrows 1 million yuan (a one-year private loan) from lender B, at an interest rate of 20 per cent. If B deducts the interest from the principal before it gives the loan, A will only receive 800,000 yuan (1 million - 1 million*20%).

PRC Contract Law 1999 Article 202 The lender is entitled to inspect and supervise how the borrower use the loan. The borrower shall provide financial statements to the lender at regular intervals as stated in the contract.

This article gives a right to lenders in terms of supervising the use of loan funds, so as to ensure that the money is used in a proper way for the purpose stated in the lending agreement. Accordingly, the lender is able to check whether the borrower fulfils its obligations under the contract, in order to reduce the loan risks and protect its own benefits. Moreover, the borrower, if requested by the lender, is obliged to provide relevant information such as the accounting statements to the lender.

PRC Contract Law 1999 Article 203 Where the borrower fails to use the loan for the prescribed purpose, the lender can stop issuing the loan, recall the loan, or terminate the contract.

In a loan agreement, the borrower has the obligation to use the money for the prescribed purpose, if there is any, otherwise it will constitute a breach of contract. The purpose of borrowing has been an important factor when the lender decides whether to make the loan or not. Therefore, the borrower shall not unilaterally change the agreement and use the money for other purposes not being stated in the contract. If this happens, the lender will be entitled to enforce any of three redresses: stop issuing the remaining part of a loan, call the loan immediately, or terminate the lending agreement. The Article 204 regulates the interest rate of bank loans offered by financial institutions, which is irrelevant to private lending, so we move to the next article directly.

PRC Contract Law 1999 Article 205 The borrower shall pay the interest at the prescribed time. Where the time of interest payment is not agreed or the agreement is unclear, nor can it be determined in accordance with Article 61 of this Law⁴⁷, if the loan term is less than one year, the interest shall be paid together

⁴⁷ The Article 61 of the PRC Contract Law 1999 is about the remedy for unclear contract clauses. It says “For a contract that has become valid, where the parties have not stipulated the contents regarding quality, price or remuneration or the place of performance, or have stipulated them unclearly the parties may supplement them by agreement; if they are unable to reach a supplementary agreement, the problem shall be determined in accordance with related clauses of the contract or with

with the principal at the time of repayment; if the loan term is one year or longer, the interest shall be paid at the end of each annual period, and where the remaining period is less than one year, the interest shall be paid together with the principal at the time of repayment.

The Article 205 specifies the rules regarding how the borrower pays interests. First of all, as for how to pay and when to pay, it shall follow relevant clauses in a lending agreement. However, if the lender and the borrower do not agree on this issue, nor the agreement is clear, both parties can further discuss about it and try to reach a supplementary agreement. If no further agreement is reached, such terms shall be determined according to relevant provisions in the contract (if there are any provisions about solving the ambiguity of terms), or to be determined by common trading practices. Finally, where there are no relevant provisions or trading practices, if the loan term is less than one year, the interest is going to be paid along with the repayment of principal at the end of contract; if the loan term is no less than one year, the interest shall be paid at the end of each annual year. Clearly, the Law fully respect party autonomy, as it only applies mandatory rules when no agreement can be made by contracting parties.

PRC Contract Law 1999 Article 206 The borrower shall repay the principal at the prescribed time. Where the time of repayment is not agreed or the agreement is unclear, nor can it be determined in accordance with Article 61 of this Law, the borrower can repay the loan at any time; and the lender can demand the loan repayment, provided a reasonable time notice is given.

The Article 206 deals with the time of repaying principal. Similar to the last article, if the relevant terms are not clearly stated in a lending agreement, lending parties can reach a supplementary agreement on this issue, or follow relevant clauses or common trading practice. Where it is still undetermined, the borrower can repay the principal at any time, whilst the lender is also entitled demand the payment at any time, as long as a reasonable period of time for preparation is given to the borrower.

trade practices.”

PRC Contract Law 1999 Article 207 Where the borrower fails to repay the loan at the prescribed time, it shall pay an overdue interest in accordance with the contract or the relevant regulations of the State.

When the borrower cannot repay the loan at the end of the contract, which leads to a breach of contract, it shall pay overdue interests as compensation to the lender. Even if the original private lending agreement (between two individuals) does not charge interest over the loan, the lender is still entitled to charge overdue interest if the borrower fails to repay.⁴⁸ If the case is heard by a court, the way of calculating late payment interest of private loans shall refer to PBOC's regulation on how financial institutions charge overdue interests.⁴⁹

PRC Contract Law 1999 Article 208 Where the borrower prepays the loan early, unless otherwise agreed by the parties, the interest shall be calculated based on the actual period of loan.

The Article 208 stipulates the rule for the early prepayment of a loan. Under Chinese laws, a debtor is allowed to pay off debts earlier than the original term, which raises an issue regarding how to calculate interests under this circumstance. Where there are any agreements on this issue, they shall be followed at first. Where there are no such agreements, the interests shall be calculated according to the actual time of borrowing, which clearly protects the borrower.

PRC Contract Law 1999 Article 209 The borrower may apply to the lender for an extension of the loan term before its maturity. Upon consent by the lender, the loan term may be extended.

In fact, the extension of the loan term is an alternation to original contract terms. Therefore, it shall be agreed by both the creditor and the debtor. The *PRC Contract Law* regulates this by asking the borrower to raise the issue of extension before the

⁴⁸ Supreme People's Court, "Some Opinions Concerning the Hearing of Private Lending Cases by People's Courts" (13 August 1991, FAMINFA 1991 No.21), Article 9.

⁴⁹ Supreme People's Court, "The Reply of SPC on What Standards Shall Be Used When Calculating Liquidated Damages of Overdue Loan Payment" (FASHI 1999 No.8)

loan falling due, otherwise it will be a new contract once the original one matures. It is at the discretion of the creditor about whether to extend the loan term or not.

PRC Contract Law 1999 Article 210 A loan contract between natural persons becomes effective at the time when the lender makes the loan amount available.

The provision of Article 210 stipulates the time when a private lending agreement comes into effect. A bank loan takes effect from the time when a bank and its borrower conclude the loan contract (a consensual contract), but for a loan contract between two individuals, it only becomes effective when the lender is ready to provide the funds to the borrower (a real contract).⁵⁰ The reason for Chinese lawmaker to make a different effective rule for such agreements is that, as for private lending, there is often some changes of circumstance before the lender finally provides the money, so it requires providing money as a compulsory element to make private lending effective.

PRC Contract Law 1999 Article 211 Where a loan contract between natural persons does not stipulate the payment of interest or the stipulation is unclear, the loan shall be deemed interest free. If a loan contract between natural persons stipulates the payment of interest, the interest rate shall not contravene relevant regulations of the State concerning the restriction on interest rates.

The Article 211 is a general principle regarding the interest rate of private lending contracts between individuals. Clearly, contracting parties have the autonomy to decide whether to charge interest and how much to be charged, providing that it does not violate relevant regulation.⁵¹ When there are no agreements about the payment of interest nor the agreement is clear, the loan will be considered as interest free by a court. This provision reflects the legislative purpose that a private lending agreement is mainly for moneylending activities between relatives and friends, so if there are no

⁵⁰ According to civil law principles, a consensual contract (诺成合同) is a contract that is founded upon and completed by the mere agreement between two contracting parties, without any external formality or action to fulfil the obligation. However, a real contract (实践合同) refer to those in which it is necessary to have something more than mere consent to conclude a contract, such as certain actions like providing the money. See Shiyuan Han, *Contract Law* (2010 Higher Education Press), Chapter 2, Section 5.

⁵¹ A detail analysis of interest rate control will be carried out later.

clear terms about interest, it is better to have no interest. Clearly, it played an effective role in protecting the benefit of borrowers in the past. However, private lending nowadays has been widely used as a method for business financing. As this rule still applies, the moneylender will not be able to collect any interest from business borrowers if the agreement is not clear enough, which seems unfair for the lender. Therefore, this rule could be revised by the legislator to reflect the current situation.

4.4.3 A Dramatic Increase in Private Lending Disputes

In the wake of private lending crisis, as introduced in the last chapter, thousands of private businesses in China faced the illiquidity problem or went into insolvency, resulting in heavy losses of moneylenders and investors. Due to a high level of default rate, a large number of investors tried to file suits against borrowers to ascertain the debt relationship and demand repayment of their principals and interests. The claims of lenders are mainly based on contract law (a creditor-debtor relationship formed by a loan contract).⁵² It, therefore, led to a surge of private lending-related civil cases that have been received and heard by Chinese courts in recent years.

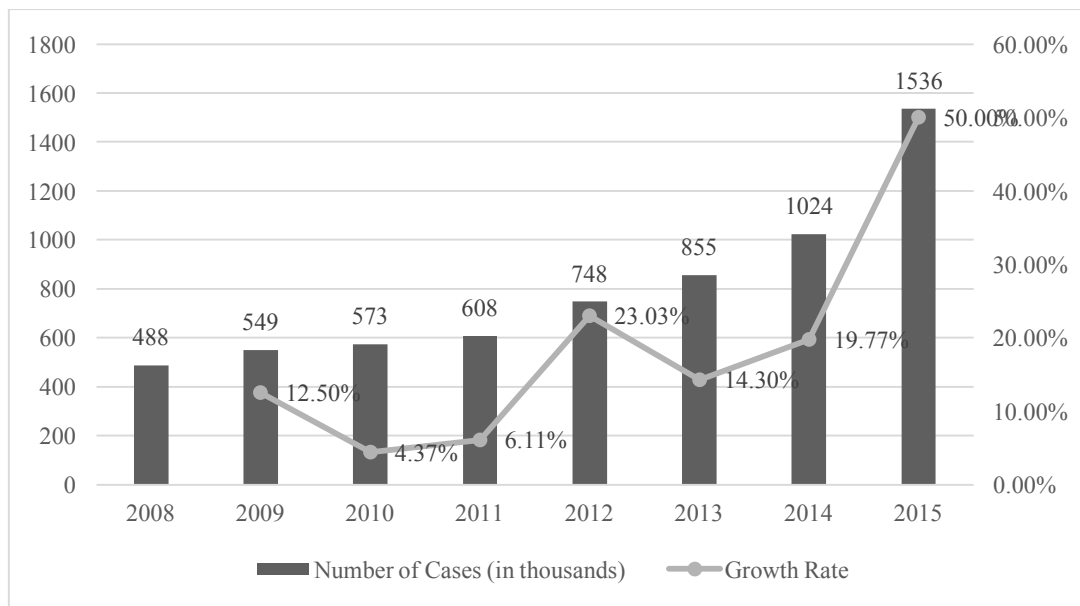


Figure 8: The Number of Private Lending Cases Received by Chinese Courts⁵³

⁵² As analysed in the last chapter, filing a legal suit has been the only legitimate way for most lenders to claim their money.

⁵³ Data: Supreme People's Court (2016), available at *Tencent News*, <http://news.qq.com/cross/20161017/8O3W92ML.html>, accessed 1 November 2016.

Before the crisis, the number of private lending civil cases received by the entire court system in China remained stable, which stood at around 500,000-600,000 cases per year between 2008 and 2011. However, the number rose rapidly to 748,000 in 2012, by 23 per cent, due to a series of credit crunch reported in China. Then, the number kept growing fast at double-digit rate in 2013 and 2014. In 2015, the number of private lending cases experienced a drastic growth by 50 per cent, exceeding 1 million to 1,536,000. The chart above clearly demonstrates that, as the crisis continues, more and more investors have been trying to bring civil litigations against their borrowers. The average amount of money in each case also witnessed a big rise, from CNY 127,500 (USD 18,562) in 2008 to CNY 316,000 (USD 56,005) in 2013, or by 147.84 per cent.⁵⁴ According to Supreme People's Court, in 2011 the provinces which received most private lending cases coincided with those with a developed private economy or a fast-growing one, such as Zhejiang, Jiangsu, Shandong, Fujian, and Guangdong.⁵⁵

The relevant data for each province remain limited, and among available resources, we can find an investigation report about the trial of private lending cases made by Xiamen Intermediate Court. Xiamen, as introduced previously, has been a private financing centre in Fujian province and was heavily hit by the credit crisis, which can be an example for studying how its courts dealt with private lending cases.

<i>Time</i>	<i>Number of Cases Received</i>	<i>Growth Rate</i>	<i>Total Amount of Money (Yuan)</i>	<i>Growth Rate</i>
2006	1,570		169,455,617	
2007	1,440	-8.00%	170,239,952	0.46%
2008	1,980	37.50%	409,793,960	140.70%
2009	2,440	23.23%	650,356,984	58.70%
2010	2,990	22.54%	956,447,761	47.10%
2011	3,528	17.99%	2,415,486,256	152.55%

Table 8: Private Lending Cases (1st Instance) Received by Xiamen Courts⁵⁶

As we can see, when the global financial crisis started to strike the Chinese economy in 2008, the number of private lending cases received by all courts in Xiamen surged

⁵⁴ *Ibid.*

⁵⁵ Ji Tong, "The Data Analysis of Private Lending Cases Heard by All Courts in Recent Five Years", *Legal Daily* (4 March 2014), available at http://www.legaldaily.com.cn/zbkz/content/2014-03/04/content_5330575.htm?node=25497, accessed 1 November 2016.

⁵⁶ Xiamen Intermediate People's Court, 'the Investigation Report for the Hearing the Private Lending Cases'

by 37.5 per cent, and the combined amount of money in all cases increased by 140.7 per cent. In the following years, either the number of cases or the total amount were rising quickly. In particular, as a result of the lending crunch, the volume of disputed loans in the city in 2011 reached CNY 2.4 billion (USD 349 million), increasing by 152.55 per cent in a year's time.

4.4.4 How the Judicial System Deals with Money-Lending Disputes?

Due to the overwhelming number of private lending lawsuits, Chinese judges, in particular those from civil courts at lower levels, have been strapped in hearing such cases in the past few years. In 2012, private lending cases accounted for 58.48 per cent of all loan contract-related disputes and 10.22 per cent of all civil cases in China.⁵⁷ Therefore, it is of great importance to for us examine the way that the judicial system handles private lending disputes, in order to promote the efficiency of using limited judicial resources. Meanwhile, in the absence of a proper regulatory regime, the court system plays a vital role in helping investors to recover their money, as well as preventing business borrowers from slipping into further debt crisis. The following part will focus on the Regulation 2011 as this SPC judicial interpretation put forward a series of rules regarding how Chinese judges shall hear private lending cases and deal with lending crisis.

First of all, when a court is receiving a private lending civil case, it shall also examine whether the civil case contains any illegal elements that will lead to a criminal offence, as well as whether a large group of investors are involved. Where there is any evidence suggesting lending parties allegedly involve in a economic crime, the court shall transfer the case to relevant authorities in charge of criminal investigation; where the case is likely to cause social instability, the court shall communicate and coordinate immediately with government departments concerned, in order to prevent the happening of mass incidents and other emergent incidents.⁵⁸ The court is required to do this because, due to the widespread lending crisis, increasing illegal lending

⁵⁷ Loan contract-related disputes also included those between financial institutions and their defaulted borrowers. See Ji Tong, "The Data Analysis of Private Lending Cases Heard by All Courts in Recent Five Years", *Legal Daily* (4 March 2014), available at http://www.legaldaily.com.cn/zbk/content/2014-03/04/content_5330575.htm?node=25497, accessed 1 November 2016.

⁵⁸ Regulation 2011, Article 2.

activities have been found. For instance, in the Xiamen report, it pointed out the rising number of economic crimes associated private lending, such as illegal deposit-taking, contract frauds, and illegal fundraising. The numbers of economic crimes (including financial frauds) heard by Xiamen's courts were 370 in 2009, 480 in 2010, and 537 in 2011, with a year-on-year growth rate of more than 10 per cent.⁵⁹ In response to this, the SPC asked all courts to closely watch illegal lending activities when they accept civil cases, such as economic crimes like illegal fundraising as well as organised crimes and violent crimes relevant to private lending activities.⁶⁰ Moreover, during the crisis, it often witnesses a large number of investors who gather together to form debt collection groups. Such groups often siege the offices of borrowers, demonstrate on the streets, or protest in front of government buildings, when they lose their money. Therefore, when receiving civil cases judges shall be extremely cautious about the situation when a debtor owes money to numerous creditors, which is prone to cause mass incidents. If there is a sign of mass incidents, the court shall report such cases to government bodies, and work closely with them.

Secondly, when solving private lending disputes, the court shall adhere to the working principle of "giving priority to mediation, combining mediation with judgment".⁶¹ Judicial mediation (司法调解) is a method of alternative dispute resolution (ADR) in China, the use of which is encouraged by all levels of Chinese courts.⁶² According to *PRC Civil Procedure Law*, courts are empowered to launch a mediation process, with the full consent of all parties, during a civil procedure.⁶³ Judicial mediation, unlike other types of civil mediation mechanisms, is considered as an integral part of China's civil litigation process in which judges often play dual roles as both a mediator and a adjudicator.⁶⁴ In practice, parties in dispute will be urged by the court to start a

⁵⁹ Xiamen Intermediate Court, "The Investigation Report of Hearing Private Lending Cases" (2011)

⁶⁰ Regulation 2011, Article 3.

⁶¹ Regulation 2011, Article 5.

⁶² See Supreme People's Court, *Notice of the Supreme People's Court on Issuing Several Opinions on Further Implementing the Working Principle of "Giving Priority to Mediation and Combining Mediation with Judgment"* (FAFA 2010 No.16)

⁶³ PRC Civil Procedure Law 2012, Article 93.

⁶⁴ China also has other mediation mechanisms like people's mediation and administrative mediation. People's mediation is a type of extra-litigation mediation and used for solving minor civil disputes that is not very necessary for parties to go to the court, and people's mediators are not professionally trained. (PRC People's Mediation Law 2011) They can be anyone in an urban or rural community or

mediation process at first. If an agreement is reached by disputed parties, the court will draft an mediation agreement to be signed by parties, which has the legal effect similar to a judgement.⁶⁵ If the judicial mediation fails, the same judge will hear the case in a formal way of civil litigation. It is apparent that Chinese judges with heavy workloads are happy to employ the judicial mediation as an effective way of managing civil disputes and mitigating social conflicts. According *Regulation 2011*, parties in private lending cases of the following situations have to attend the judicial mediation process prior to entering into the formal litigation procedure: Where there is a large number of lenders and/or borrowers involved; Where the case is likely to cause mass incidents like the protest of unpaid workers; Where there is severe emotional confrontation between lenders and borrowers; Where it is likely to have great difficulty in enforcing the judgement after the trial.⁶⁶ The court can ask for the assistance from external bodies like the government, industry associations, and relevant social groups, in order to find a best way to solve conflicts and maintain social stability.⁶⁷

Thirdly, the *Regulation 2011* also states the principle regarding how a court handles business borrowers that face the illiquidity problem. Generally speaking, it promotes the rescue culture by saying “for those borrowers who temporarily face cash flow shortage but are still in the normal course of business operation, the court shall, without the prejudice to creditors’ interests, apply property preservation methods in a flexible way, and try to help borrowers survive the temporary debt crisis.”⁶⁸ In practice, some businesses, despite being technically insolvent, can survive if given a period of time to generate revenues and repay debts, and therefore, courts are encouraged to prevent businesses from entering into insolvency proceedings. However, if the private lending dispute inevitably leads to the insolvency of the business borrower, the court which hears the civil dispute will be in charge of the insolvency case. Where the insolvent business is a SME, and its rescue is worthwhile and practical, and its business is in line

employees of a large company or a public institution. The service will be free of charge. (Article 4)
Unlike the judicial mediation, the agreement reached by parties during the people’s mediation is more like a contract, which is not directly enforceable by the authority unless it has been endorsed by a court. (Article 33)

⁶⁵ PRC Civil Procedure Law 2012, Article 97.

⁶⁶ Regulation 2011, Article 5.

⁶⁷ *Ibid.*; PRC Civil Procedure Law 2012, Article 95.

⁶⁸ Regulation 2011, Article 8.

with national industrial policies, the court shall avoid using the liquidation process in the first place.⁶⁹ Instead, reorganisation or reconciliation procedures are recommended to be launched to save the business.⁷⁰ Where the insolvent SME is not able to be rescued, the court can use the liquidation procedure with a well-rounded implementation plan, in order to minimise the negative effects of its insolvency.⁷¹

Finally, Chinese courts when handling private lending-related problems, to a certain degree, have been acting beyond what a judiciary authority is supposed to do. Under the *Regulation 2011*, the judiciary is urged to take part in the establishment of a private lending dispute preventive and resolution system.⁷² It not only needs to hear relevant civil and criminal cases properly, but also undertake extra responsibilities to assist government agents in preventing and resolving private lending crisis to maintain financial and social stability. Based on the valuable work experience regarding private lending trials, the judiciary is asked to make judicial suggestions for other authorities about how to effectively deal with private lending.⁷³ Moreover, Chinese courts shall promote the legal education by using typical cases as example, so as to help participants in the private lending market to improve their risk awareness, stick to the rule of law, and promote integrity. However, it remains controversial about whether the judiciary shall be asked to perform extra tasks apart from their ordinary works. On the one hand, due to the lack of regulatory regime over private lending, the judiciary has been the only state organ that have accumulated adequate experience in dealing with private lending. On the other hand, given the limited judicial resource, Chinese courts shall not be allocated works beyond its traditional mandates clearly stated by

⁶⁹ *Ibid.*

⁷⁰ Currently, China's bankruptcy law (PRC Enterprise Bankruptcy Law 2007) has three sets of bankruptcy proceedings for enterprises in financial trouble: liquidation, reorganisation and reconciliation. Clearly, liquidation and reorganisation procedures are known to most commercial lawyers, and reconciliation (Chapter 9 of the Law) is the process where the debtor renegotiates the terms of loan contracts with its creditors, such as reduction of the amount of loans or extension of the term time. All parties will try to reach a reconciliation agreement, which is binding upon all parties after it is approved by the creditor's meeting (by more than half of creditors and they shall represent at least two thirds of total unsecured loans) and the court. However, reconciliation can only be initiated by the debtor.

⁷¹ Regulation 2011, Article 8.

⁷² Regulation 2011, Article 9.

⁷³ *Ibid.*

law.⁷⁴

4.5 Interest Rate Controls for Private Loans

Interest is the price paid by the borrower for using the lender's money, which is at the heart of any loan agreements.⁷⁵ Similar to commercial banking, the primary aim of Chinese moneylending industry is to make profits from the interest income. Clearly, interest plays a vital role in financial markets, as it is the extra money charged for compensating credit risks (which means the potential loss of the principal) as well as the make up for the lender's opportunity cost who forgo other investments with the money lent out.⁷⁶ In the private lending market, the excessive interest has been a hot topic for a long time, and it makes people associate private lending with the notorious usury. In 2014, the average annualised interest rate for private lending in China stood at 23.5 per cent (18.9 per cent in urban area and 25.7 per cent in rural area).⁷⁷ In the previous chapter, we analyse that the high interest rate is a major cause for business insolvency and runaway bosses during the lending crash. The expensive private loans have long been a heavy burden for Chinese entrepreneurs. Therefore, regulating interest rates is an issue of great concern when we design the legal framework. This part is going to evaluate two sets of interest rate regulations in China: the first one is called "four-time red line" set out by the *Regulation 1991*, which had been used by the judiciary for 24 years until 2015; the second regulation is the new rules made by the *Regulation 2015*.

4.5.1 The Old Rule of "Four-time Red Line"

The Article 211 of *PRC Contract Law* allows the lender and the borrower in a private lending agreement to negotiate the terms of interest payment, provided it does not contravene relevant regulations. Therefore, this part will examine what the "relevant

⁷⁴ The law states the primary mandate of people's courts is the trial of criminal cases and civil cases, with an ancillary task to educate citizens about respecting the rule of law and the Constitution through its trial work. *PRC Organic Law of People's Courts 2006*, Article 3.

⁷⁵ The interest rate discussed here include the real interest charged as well as other fees and costs, implicit or explicit. Therefore, the interest rate is broadly defined, which can be seen as the Annual Percentage Rate (APR).

⁷⁶ Frederic S. Mishkin, *The Economics of Money, Banking and Financial Markets* (11th edn, 2015 Pearson), p.67.

⁷⁷ *Tencent News*, available at <http://news.qq.com/cross/20161017/8O3W92ML.html>, accessed 1 November 2016.

regulations” means, and whether the interest rate regulation is effective or not. For over two decades (from 1991 to 2015), the relevant regulations largely referred to an article under the *1991 Regulation*:

The interest rate of private lending can exceed the interest rate of banks within a certain limit. The courts, in light of local conditions, can determine a specific standard, but it shall not exceed four times of the interest rate of a bank loan of the same kind. A claim of the excessive part of interests will not be supported by courts.⁷⁸

Here “a bank loan of the same kind” means a bank loan that has the same term time as the private lending agreement does. For example, when there is a one-year private loan, its interest cap shall refer to a one-year bank loan. According to the People’s Bank of China, the interest rate of a one-year bank loan is 4.35 per cent per annum, so the corresponding interest rate cap for a one-year private loan will be 17.4 per cent per annum (four times of 4.35 per cent).⁷⁹ It should be noticed that the standard is fluctuating, as the central bank often adjusts benchmark lending rates for financial institutions. Let’s look at a scenario that A borrows 1,000 yuan for one year from B, with an annual interest of 200 yuan. If A fails to repay the loan, and B files a lawsuit to claim its money, the court will support B’s claims of the principal of 1,000 yuan plus interests up to 174 yuan (1,000 yuan*17.4 per cent). The part of interests that exceeds the cap, therefore, will not be supported by the court (200-174=26 yuan).

The so-called “four-time red line” used to be a basic principle for Chinese judiciary to determine the legitimacy of interest rates before 2015. Apart from the courts, the government and financial regulators often made reference to this criteria when they combated illegal lending activities and cracked down usuries.⁸⁰ In the past, any private lending activities which crossed the red line would be considered as usuries, which

⁷⁸ Supreme People’s Court, “Some Opinions Concerning the Hearing of Private Lending Cases by People’s Courts” (13 August 1991, FAMINFA 1991 No.21), Article 6.

⁷⁹ See the latest data of bench market interest rate (23 October 2015), People’s Bank of China, available at <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/2968725/index.html>, accessed 1 February 2017.

⁸⁰ For example, see People’s Bank of China, “The Notice of Cracking Down Underground Money House and Usury Activities” (YINFA 2012 No.30), Article 3.

were subject to administrative sanctions, if not serious enough to constitute a crime.⁸¹

Another issue which is worth discussing is the legitimacy of compound interest.⁸² The amount of debt tends to grow rapidly if the interest is compounded at small intervals like a month or a week. Therefore, when compounding is used, the fast growing debt could be unaffordable for business borrowers, resulting in the problem of insolvency. However, as compounding is only a mathematical method for calculating interests, there is no right or wrong in it. As for whether it is legitimate or not under Chinese law, the *Regulation 1991* stipulates that its legitimacy shall be considered along with the interest rate cap.⁸³ If the result of compounding interest does not surpass the limit, it will be legal, and *vice versa*. Therefore, the authority does not ban the use of compounding in the moneylending industry, as long as it complies with interest rate regulations.

4.5.2 Limitations of the Old Rule

There is no denying that the “four-time red line” played a vital role in judicial practice as well as financial regulation for over two decades. However, the Chinese economy has undergone significant changes recently, and thus, it remains unclear whether this old rule has been able to cope with the latest development of private lending market, the size of which increased hundreds of times. Clearly, a number of limitations regarding this rule can be observed. For example, it is difficult for current academics and practitioners to figure out why the Supreme Court enacted the “four-time” standard in 1991, and whether the standard passed the strict quantitative analysis at that time. Mr Mao Yushi, a well-known Chinese economist and the winner of Milton Friedman Liberty Prize in 2012, expressed his doubt about the interventionist approach of interest rate cap by stating: “In terms of private lending’s legitimacy, I don’t think the

⁸¹ Anyone that establish illegal financial institutions or carry out illegal financial activities, if constituting crimes, will face criminal prosecution; if not constituting crimes, it will be fined 1 to 5 times of illegal incomes; if there is no illegal income, it will be fined 100,000 to 500,000 yuan. See State Council, “Measures for Banning Illegal Financial Institutions and Illegal Financial Activities” (No.247 Order of State Council, Effective from 13 July 1998, Revised in 2011), Article 22.

⁸² Compound interest, in contrast to simple interest, means that the interest gained after a period of time will be added to the principal, and in the next period, the previous interest can start to earn more interests.

⁸³ Supreme People’s Court, “Some Opinions Concerning the Hearing of Private Lending Cases by People’s Courts” (13 August 1991, FAMINFA 1991 No.21), Article 7.

government has the power to intervene moneylending activities between individuals, and definitely it is obliged to protect these credit relationships...I don't understand how the four-time rule was calculated and made. In my opinion, it shall be abolished immediately, because as long as the supply of funding is sufficient (in the financial market), the interest rate will naturally go down."⁸⁴ Moreover, the four-time ceiling is in the form of judicial interpretation, which was made by the judiciary rather than the National People's Congress. Considering the wide usage of interest rate cap, the relevant rule shall be made into law by the national legislator to confirm its effectiveness.

Secondly, the four-time limitation is based on the interest rate of formal banking sector, which indicates the authority's attitude that the private lending market is to some extent affiliated to the state-run banking industry. Despite banks' dominant role in the Chinese economy, the private lending market has been operating in parallel with the banking sector, and both of them form a multi-level credit system. Therefore, it is inappropriate to link the interest rate level of private lending activities directly to that of banks, which seems to deny the independent status of private lending market.

Thirdly, it is evident that the single four-time standard ignores great differences that exist in China's lending industry. For instance, in some coastal provinces, there is huge demand for private financing due to the highly developed private economy, while in some inner parts of the country the demand is relatively weak.⁸⁵ Clearly, a stronger demand will drive the price of borrowing up. Accordingly, the actual interest rate level varies significantly in different regions which depends on the supply and demand of private credits, so the one-size-fits-all approach is not practical. Moreover, the rule does not distinguish private lending for business financing from traditional private lending activities. In terms of business financing, investors should be given more freedom in determining the lending rate, according to borrowers' actual credit status. For borrowers with lower credit rating, lenders should be allowed to charge higher

⁸⁴ Yushi Mao, "How to See Private Lending?" (23 September 2011), available at <http://news.nandu.com/html/201307/17/83989.html>, accessed 1 November 2016.

⁸⁵ For example, the GDP of East China's Zhejiang Province in 2015 was 4.3 trillion yuan, of which over 70 per cent was contributed by the private sector. In contrast, the inner region of Ningxia only had a GDP of 291 billion yuan, and the private businesses accounted for less 50 per cent of it. The data is available at National Bureau of Statistics, <http://www.stats.gov.cn/>, accessed 1 February 2017.

interest rates to compensate relevant credit risks. Clearly, the unified standard of interest rate restriction is too simple to deal with the heterogeneous market.

Finally, the effectiveness of the interest cap remains fairly limited, and sometimes it even has negative impacts on stakeholders. In practice, the four-time rule can be easily evaded by moneylenders. For instance, even though the law bans the deduction of interest from principal, it has been a popular method used by lenders who want to charge excessive rates. Moreover, the lender can find someone else to serve as a third-party broker in a lending agreement, so the excessive part of interests can be charged under the name of brokerage fee. In some cases, the interest rate regulation can even be counterproductive. It is clear that the purpose for the authority to make restrictions on interest rate is to protect borrowers, but in the eyes of some moneylenders, the interest rate cap looks like the lowest return promised by law. Since only the part above the ceiling will be held invalid by a court, moneylenders have the incentive to charge the maximum interest rate, which indeed prejudices borrowers' interests.

4.5.3 The New Rule of Interest Rate Controls

When the *Regulation 2015* came into effect, it abolished the “four time red-line” and promulgated a series of new rules for deciding the validity of interest rate:

- a) If the annual interest rate of a private loan is no more than 24 per cent, a court will support the lender's claim to ask the borrower to pay such interests;⁸⁶
- b) If the annual interest rate exceeds 36 per cent, the excessive part of interests will be deemed invalid by a court. The court will support the borrower's claim to ask the lender to return the excessive part if it has been paid;⁸⁷ and
- c) If the annual interest rate exceeds 24 per cent but is no more than 36 per cent, a court will support either the lender or the borrower's claims, depending on the specific circumstance.⁸⁸ Where the borrower has already paid the interests to the lender, the court will not support the borrower's claim to claim back the interest. Nor will the court support the lender's claim to collect interest over 24 per cent from the borrower, if the interest is still unpaid.

⁸⁶ Regulation 2015, Article 26.

⁸⁷ Regulation 2015, Article 26.

⁸⁸ Regulation 2015, Article 31.

The new interest rate restriction adopts a three-level approach. Any claims of interests under 24 per cent will be fully supported by a court, whilst any claims over 36 per cent will be considered invalid. However, the tricky part is the interests between 24 and 36 per cent, which will be treated as *naturalis obligatio*, which means an obligation which cannot be enforceable by a court. Moreover, the rules are also applicable in determining whether compounding interests and overdue interests are valid or not, which in principle shall not exceed 24 per cent.⁸⁹

4.5.4 Does the New Rule Work Better?

As the new regulation took effect not long ago, we have limited information available to evaluate its effectiveness at the moment. However, some advantages and improvements of this approach can be spotted. At the news conference for releasing the new regulation, a senior judge from the Supreme Court explained how the interest rate standard was made, “It was based on an extensive research of interest rate regulation throughout Chinese history. In the ancient time, the 2 per cent month cap was widely used by the imperial government, which roughly equals the current 24 per cent annual ceiling. Moreover, the Supreme Court analysed the benchmark interest rate of bank lending released by the PBOC from 1991 to present (which ranged from 2 to 12 per cent), and 6 per cent is the historical average. By multiplying 6 per cent and the “four-time red line”, the Supreme Court obtained the similar figure of 24 per cent.”⁹⁰ In addition, the new interest rate regulation is said to give lending parties more autonomy than the old rule did. The new regulation divides interest rates into three categories by two lines (24 and 36 per cent). Although interests over 24 per cent is absolutely invalid, the part between 24 and 36 per cent becomes a natural obligation, which is legally binding on lending parties but not enforceable by a court. As a result, lenders and borrowers are allowed to decide the interest rate with more freedom, compared with the old rule which only stipulated a single standard (four time of banking rate). Thus, moneylenders in different regions can adjust the rate based on the real situation regarding the local supply and demand of credits.

⁸⁹ Regulation 2015, Article 28 and 29.

⁹⁰ Wanhua Du, *Supreme People's Court Private Lending Judicial Interpretation: Understanding and Application* (2015 People's Court Press), p.26.

<i>Interest Rate Ceiling</i>	Old: Shall not exceed four times of a bank loan of the same kind New: if it does not exceed 24 per cent, it will be held valid by a court; if it exceeds 24 per cent but is no more than 36 per cent, it will be a <i>naturalis obligation</i> ; if it exceeds 36 per cent, it will be considered invalid.
<i>Compound Interest</i>	Allowed, but the actual interest rate after being compounded should not exceed the interest rate cap.
<i>Overdue Interest</i>	Allowed, but it shall not exceed the interest rate cap. ⁹¹
<i>Pre-deduction of Interest from Principal</i>	Prohibited, the principal should be adjusted to the actual amount of loan provided by the lender, the interest should be calculated based on the real amount lent to borrower.

Table 9: Interest Rate Regulation (Private Lending) in China

4.6 Criminal Liability of Illegal Lending Practices

The provisions under *PRC Criminal law* in terms of private lending focus on combating and punishing illegal fundraising activities, which stipulates a number of crimes relating to illegal lending practices. For example, anyone who obtains credits from a financial institution and then re-lend the money to other person, with the purpose of making profits, will face a sentence up to three years or detention, plus a fine up to five times of its illegal profits; where the amount of illegal profits is extremely huge, the offender will be subject to a sentence up to seven years, along with the fine.⁹² Moreover, where a borrower tries to defraud its lender's money during the process of signing or executing the contract and the amount of money is relatively large, the borrower could constitute the offence of "contract fraud" and face criminal sanction up to life imprisonment, depending on the amount of money defrauded, plus a fine or even confiscation of personal properties.⁹³ In addition, there is a controversial charge in China called "illegal business operation", which punishes people who conduct certain business activities disrupting the market order, such as selling restricted items and operating financial business without a license.⁹⁴ However, the charge receives a lot of criticisms from Chinese scholars and legal practitioners, as its scope seems too wide to catch some semi-legal business practices, such as private lending.⁹⁵ Therefore, it is often referred to as a "pocket crime" for anything could be

⁹¹ Regulation 2011, Article 6.

⁹² PRC Criminal Law, Article 175.

⁹³ PRC Criminal Law, Article 224.

⁹⁴ PRC Criminal Law, Article 225.

⁹⁵ Tianhong Zhang, "The Crime of Illegal Business Operation: A Perspective of the Principle of *nulla*

easily stuffed into it.

In practice, the judiciary tends to impose severe punishments on entrepreneurs who are incapable of paying off debts during the credit crisis, in particular the case involving a large number of investors. As we have discussed, the judiciary undertakes the responsibility to preserve economic and social stability through the trial of private lending-related civil and criminal cases. Therefore, when the authority tries to find someone to blame for the loss of massive investors, it often targets entrepreneurs who borrow the money but fail to repay. At present, the biggest question is, in many cases, the line between legitimate lending and illegal fundraising is very blurred, so the legal status of private lending activities is determined to the discretion of Chinese judges. The real fraudsters could be punished in accordance with law, whilst some innocent entrepreneurs might be victims and over-punished when the authority tries to crackdown shadow lending. This section will introduce two common criminal offences relating to private lending, “illegal absorbing public deposits” and “fraudulent fundraising”. Two case studies are conducted to investigate the application of criminal law in practice.

4.6.1 Crimes Relating to Private Lending Activities

The offence of “illegal absorbing public deposits” intends to punish anyone (an individual or the person in charge of an organisation) who without a financial license illegally take deposits from the general public or do so in a disguised form, which leads to the disruption of financial order.⁹⁶ The offender is subject to a fix-term imprisonment up to three years or detention, and/or a fine (CNY 20,000-200,000). Where the amount of deposits involved in the case is relatively large or other serious circumstances exist, the offender could face sentence up to 10 years, plus a fine (CNY 50,000-500,000).

The major distinction between legal private lending and illegal deposit taking is whether a borrower finds potential lenders in a public way or not. If the borrower

poena sine lege” 2004 3 *Tribune of Political Science and Law* (Journal of China University of Political Science and Law) 94, 94.

⁹⁶ PRC Criminal Law 1997, Article 176.

advertises its financing needs in newspapers, websites or through text messages and social networking, it could constitute the offence as the target is the unspecific public. However, in practice, some private lending activities are conducted in a similar way as deposit-taking. For example, professional moneylenders often gather funds from a large number of investors to form a money pool; Also, some entrepreneurs finance their business through borrowing money from many creditors in a region. Therefore, it is difficult to judge whether the borrower approaches potential lenders in a private way or in a public way. Some ordinary business borrowers could be mistaken for deposit-takers and thus face harsh punishments.

The crime of “fraudulent fundraising” (or fundraising fraud) has been in the spotlight, for numerous Chinese entrepreneurs were put behind the bar due to this offence, and it used to be the only financial crime leading to the death penalty. Whoever, for the purpose of illegal possession raises funds by fraudulent methods, if the amount involved is relatively large, faces fix-term sentence up to five years or criminal detention, plus a fine (CNY 20,000-200,000); if the amount involved is enormous or other serious circumstances exist, it faces sentence up to ten years, plus a fine (CNY 50,000-500,000); if the amount involved is particularly enormous or other particularly serious circumstances exist, it faces sentence up to life imprisonment, plus a fine (CNY 50,000-500,000).⁹⁷ Before the last amendment of *PRC Criminal Law*, it had a article stating that, “The offender of Article 192, if the amount involved is particularly enormous, which has caused heavy losses to the interests of state or people, it shall be sentenced to life imprisonment or death penalty, plus confiscation of personal properties.”⁹⁸

The difference of a fraudster and an ordinary borrower lies in the intention of borrowing money. If the borrower has the real intention to borrow credits to finance its business, the private lending agreement will be valid and the borrower will be exempted from criminal liabilities even if he or she fails to repay the loan in the future. However, if the borrower intends to illegally possess the money when he or she

⁹⁷ PRC Criminal Law 1997, Article 192.

⁹⁸ PRC Criminal Law 1997, Article 199. This article was deleted by the 9th amendment of PRC Criminal Law in 2015, which means that at present there is no death penalty for the fraudulent fundraising offence and other financial crimes.

borrowers the loan, it will be considered a fraud. In the judicial practice, it remains a challenging work for Chinese judges to ascertain the borrower's intention, so they often assume that all borrowers owing a large sum of money to several creditors are fraudsters if the loans cannot be paid on time. Next, two cases regarding the offence of fraudulent fundraising are examined.

4.6.2 Case Study: Zeng Chengjie – Die for Private Lending

Mr Zeng Chengjie, a real estate developer in Hunan province, was convicted under the offence of “fraudulent fundraising” in 2011. Zeng used to be the president of Sanguan Real Estate Development Group, and he also served as a local MP for Chinese People's Political Consultative Conference (CPPCC), the political advisory body. However, he is more well-known as China's Bernie Madoff, who defrauded billions of yuan from local investors.⁹⁹ In November 2003, in order to raise fund for some property projects, Zeng started to solicit the public to lend money to his business by promising 20 per cent annual return.¹⁰⁰ In the following years, Zeng and his company consistently used high return to lure thousands of investors to take part in private financing, and the interest rate he promised to lenders peaked at 120 per cent per year.¹⁰¹ During the fundraising process, he frequently gave financial rewarded to investors who lent most money, in order to encourage more people to join. In total, he borrowed CNY 3.45 billion (USD 0.5 billion) from private investors from 2003 to 2008.¹⁰² Zeng used the credits to build 57 developments. However, his property company encountered poor sales in 2008, so he began to default on private loans, which attracted the attention of media and local authorities.

The large-scale defaults resulted in heavy losses of Zeng's investors, which had a very wide and negative impact on the local society. Finally, the bankruptcy evolved into a social crisis, as a group of investors sieged the local government and asked the authority to step in to recover their money. Worse still, an investor burned himself in

⁹⁹ Eunice Yoon, “The Bernie Madoff of China: Con Man or Victim?”, *CNBC* (29 August 2013), available at <http://www.cnbc.com/id/100996875>, accessed 1 February 2017.

¹⁰⁰ Baidu, “Zeng Chengjie”, available at <http://baike.baidu.com/view/8159983.htm>, accessed 1 November 2016.

¹⁰¹ *Ibid.*

¹⁰² *Ibid.*

the gathering and it resulted in severe disability. As a result, the mass incident forced the government to do something to comfort Zeng's investors. In December 2008, Zeng was arrested by local police for conducting illegal fundraising activities.¹⁰³ In the trial of first instance in May 2011, Zeng received a verdict of guilty from Changsha Intermediate People's Court for committing the crime of "fraudulent fundraising", with a death penalty. In December 2011, the conviction was upheld by the appealing court, Hunan Province High Court, in the trial of second instance. In June 2013, the Supreme Court approved the application of death penalty in Zeng's case, so in the next month Zeng was executed.

Clearly, a certain proportion of money Zeng borrowed was used to repay the previous debts, and he also personally occupied some parts of the funds to invest in other projects, which was not stated in the original loan agreements with investors.¹⁰⁴ Apart from this, most of credits were invested in the estate projects, and shall not be counted as frauds. The execution of Zeng triggered a lot of shocks and outrages for the business community and ordinary Chinese people.¹⁰⁵ Some commentators said Zeng was a victim of China's flawed money system for what he did has been a common practice among Chinese entrepreneurs, and even some of his investors who lost money strongly believed he was a decent person.¹⁰⁶ It is obvious that Zeng's sentence is considered by most people as harsh, given that the crime of fraudulent fundraising is a non-violent economic crime. His execution indeed made Chinese entrepreneurs feel unsafe and panic, as most of them often use private lending to borrow money. It is clear that the law is being applied irregularly, and due to the vague concept of fraudulent fundraising, the court system has the power to punish someone who cause social unrests. Some people considered fraudulent fund-raising as a exclusive crime for Chinese

¹⁰³ Michael Schuman, "The Growing Risks of Shadow Finance in China", *Time* (17 February 2014), available at <http://content.time.com/time/subscriber/article/0,33009,2164766-3,00.html>, accessed 1 February 2017.

¹⁰⁴ Baidu, "Zeng Chengjie", available at <http://baike.baidu.com/view/8159983.htm>, accessed 1 November 2016.

¹⁰⁵ Yongqiang Gu, "Crackdowns and Executions Provoke Shock and Outrage in China's Business Community", *Time* (17 July 2013), available at <http://world.time.com/2013/07/17/crackdowns-and-executions-provoke-shock-and-outrage-in-chinas-business-community/>, accessed 1 February 2017.

¹⁰⁶ Eunice Yoon, "The Bernie Madoff of China: Con Man or Victim?", *CNBC* (29 August 2013), available at <http://www.cnbc.com/id/100996875>, accessed 1 February 2017.

entrepreneurs, which definitely discourages entrepreneurship.¹⁰⁷

4.6.3 Case Study: Wu Ying - Life and Death of a Chinese Businesswoman

Compared to Zeng, Ms Wu Ying who also committed the fundraising fraud was far luckier. Wu was born in 1981, and she is a young businessman in east China's Zhejiang Province. She became a multi-millionaire and the chairwoman of Zhejiang Bense Holding Group which controls more than ten subsidiary companies. In October 2009, Wu went for the first instance trial in Jinhua Intermediate People's Court, for the fraudulent fundraising charge. The indictment said that Wu illegally raised CNY 770 million (USD 112 million) from eleven people from 2005-2007, with the unreasonably high interest rates being promised.¹⁰⁸ She used the money to repay old debts as well as buy luxurious cars and spend on personal items. Wu received a death sentence, and the illegal income from frauds would be returned to the victims. After that, Wu appealed to Zhejiang Province High Court for the second instance trial, but the judges at High Court upheld the verdict as well as the death penalty in January 2012. When the Supreme Court reviewed the case, it considered that Wu might be over-punished, so ordered Zhejiang High Court to have a retrial.¹⁰⁹ In May 2012, Zhejiang High Court held a second hearing and decided to drop Wu's death penalty. The sentence was changed to death penalty with a two-year suspension of execution (it normally leads to life imprisonment after two-year observation), so Wu's life has been saved.¹¹⁰

The change of Wu's sentence was mainly due to a public debate in China triggered by her case. A large number of people, whether legal professionals or the general public, did not consider Wu Ying as a criminal, for what she has done is no more than

¹⁰⁷ Guochuan Ma, "Entrepreneurs of This Decade", *Caijing Magazine* (2014 Vol.11), p.42.

¹⁰⁸ Martin Yip, "Death for Fraud: China Debates Wu Ying's Sentence", *BBC* (24 February 2012), available at <http://www.bbc.co.uk/news/world-asia-china-17071311>, accessed 1 November 2016.

¹⁰⁹ *The Guardian*, "Chinese Supreme Court Overturns Tycoon Wu Ying's Death Sentence" (20 April 2012), available at <https://www.theguardian.com/world/2012/apr/20/chinese-supreme-court-wu-ying>, accessed 1 February 2017.

¹¹⁰ According to PRC Criminal Law 1997 Article 48, the death penalty shall only be applied to criminals who have committed extremely serious crimes. If the immediate execution of a criminal punishable by death is not deemed necessary, a two-year suspension of execution may be pronounced simultaneously with the imposition of the death sentence. Article 50, the person convicted with death penalty with two-year suspension will be executed if he or she is found to intentionally commit further crimes during two-year suspension; otherwise, the sentence will automatically be reduced to life imprisonment or, if he or she is found to have performed deeds of merit during the two-year suspension, the sentence will be reduced to fixed-term imprisonment.

informal financing, or private lending without banks.¹¹¹ Apparently, Wu's case is highly controversial, because she borrowed money from eleven people only, rather than raising funds from a great number of investors. Moreover, it is unclear about her intention of conducting fraud, for Wu did not make up or conceal any facts about her business, and the money was mostly used for solving the business's illiquidity problem. In fact, it is very common to see private lending activities in Zhejiang, as the province has a large and thriving private sector. Therefore, if Wu Ying dies for private lending, most business borrowers in Zhejiang are susceptible to the same punishment if being caught.

4.6.4 Some Reflections on Criminal Law

Some significant drawbacks can be found in Chinese criminal law in terms of criminal liabilities for illegal fundraisers. Apparently, when the legislator passed the current *PRC Criminal Law* in 1997, it designed a series of offences for financial crimes, with the primary objective to combat illegal financial practices and remain the financial stability. In the 1990s, private lending for business was widely perceived as illegal by the authority. That is why the criminal law has several offences relating to private financing, with heavy punishments. However, in the recent decade, the legitimacy of private financing has been gradually admitted, and the *regulation 2015* even started to recognise the validity of private lending agreements between two non-financial enterprises. Therefore, the future amendment of criminal law shall try to cut most offences in this field, as well as reduce relevant criminal sanctions. Clearly, law shall reflect the latest development of the society. As private lending gains its legitimacy, related provisions shall be revised to protect the interests of lenders and borrowers, rather than punishing them.

In addition, the threshold of illegal fundraising crimes is considered too low in legal practice, so Chinese judges possess lots of discretionary power to determine the legitimacy of moneylending in each case. As a result, the daily private financing practice of most entrepreneurs can be just one step away from committing illegal fundraising crimes. Therefore, we often see the excessive use of criminal offences to

¹¹¹ Martin Yip, "Death for Fraud: China Debates Wu Ying's Sentence", *BBC* (24 February 2012), available at <http://www.bbc.co.uk/news/world-asia-china-17071311>, accessed 1 November 2016.

punish some businessmen or women who conducted private lending with only small faults. Clearly, criminal liabilities shall only be applied where no other appropriate punishment can be found. As we know, China's criminal justice system sticks to the principle of modesty and restraint, which reflects the global trend towards decriminalisation, de-penalisation, and more lenient penalties.¹¹² The purpose of criminal law is to prevent non-criminal activities from being punished by criminal law, and thus the legislator has to strictly define to what extent criminal law shall be applied to fight illegal lending activities.

4.7 Conclusion

This chapter has presented and discussed the current legal framework regulating private lending activities in China. Recently, it has seen some fundamental changes in the official attitudes towards private lending agreements used for business financing. In the past, private financing was heavily restricted by financial regulators. In particular, the lending agreements between two non-financial enterprises were prohibited. Therefore, in contrast to the extensive use of private loans in the business community, the relevant rules seem out-of-date. The *Regulation 1991* had been playing a vital role in the judicial practice until recently. It was replaced by the *Regulation 2015*, the authority's response to the latest developments of the private lending market and the financial crisis. The new regulation not only admits the legitimacy of lending agreements between two enterprises, but also stipulates new interest rate rules that are more flexible and practical. The *Regulation 2011*, another importance piece of judicial interpretations, set the guidance for all levels of courts in terms of handling the growing number of private lending-related civil cases. Clearly, the latest two pieces of regulations have made substantial improvements in regulating private lending contracts, from the judicial perspective.

The chapter has also examined loan agreements under the *PRC Contract Law* in detail. All private lending activities, in essence, constitute a creditor-debtor contractual relationship. Therefore, any lending agreements shall be compliant with the contract law, such as the requirements for the formalities and contents of a moneylending

¹¹² Guangzhong Chen, "The Reform of China's Public Prosecution System" in Mike McConville and Eva Pils (eds.), *Comparative Perspectives on Criminal Justice in China* (Edward Elgar 2013), p.161.

agreement, the rights and obligations of lenders and borrowers, and what will lead to breach of contract and relevant remedies. Moreover, it has investigated how the Chinese court system has been dealing with massive private lending-related civil disputes. The number of such disputes accounts for over 10 per cent of total civil cases in China, creating heavy workloads for judges sitting at local civil courts. Apart from hearing private lending cases, the judicial authority has been charged with the responsibility to solve social conflicts that resulted from the lending crisis, as well as to maintain the financial and social stability along with other government agencies. Thus, the author argues that the Chinese court system has been the *de facto* regulator for the private lending market. For instance, any civil courts have to closely watch illegal elements in civil cases that could amount to criminal offences, and report the suspicious activities to the criminal investigators. Moreover, judges hearing lending disputes have to incorporate the judicial mediation process into the ordinary civil procedures, in order to ease the conflicts between borrowers and lenders, particularly when a large number of investors or a large sum of money is involved. In addition, civil courts are required by the *Regulation 2011* to cautiously deal with the private lending disputes that could give rise to the insolvency of business borrowers. The liquidation process shall only be launched after all other possible means are exhausted.

After examining civil laws, the chapter has evaluated two sets of interest rate ceilings for private lending contracts, which have been used by the judiciary and other authorities to draw the distinction between usuries and legitimate lending contracts. The repealed “four-time red line” played a vital role in regulating interest rates for over two decades, despite some deficiencies such as the lack of scientific calculation, the ignorance of the independence of the private lending market, as well as the neglect of regional and individual diversities. The *Regulation 2015* put forward a new “24/36” interest rate rule which gives more autonomy to lending parties to decide the rates. According to the new regulation, the annual interest rate between 24 and 36 per cent is not naturally invalid, which will be binding but not enforceable by courts. Whether the new rule is more effective in terms of eliminating usuries and protecting the interests of borrowers remains to be seen.

The final part of this chapter has considered criminal liabilities relating to illegal lending practices. The biggest problem facing the criminal justice system is the unclear

line between an ordinary lending activity and an illegal fundraising practice. In many cases, they share a lot of similarities when entrepreneurs borrow money from a large number of private investors. It means that judges have the discretionary power in deciding the legitimacy of certain private financing practices. Therefore, when there is a private lending crisis and many investors suffer from great financial losses, the courts tend to impose severe criminal sanctions on insolvent borrowers who fail to repay a large amount of debts. Apart from the irregularity in judgements, another issue that merits attentions shall be the problem of over-punishment in criminal cases, as some illegal lending offences could lead to a life sentence or even a death penalty not long ago. The cases of Zeng Chengjie and Wu Ying, both of whom committed the crime of fraudulent fundraising, have been studied to see the application of criminal law in practice. Most recently, the 9th amendment of the *PRC Criminal Law* ended the death penalty for fundraising fraudsters, which is considered as a big step forward.

In summary, the legal framework of private lending in China is generally considered as complete, which provides substantive laws in every aspect of private lending activities. The major problem is that most rules and regulations have been scattered around in different pieces of legislations, which not only creates inconsistencies but also makes it difficult for legal practitioners to apply such rules. Accordingly, it calls for a unified piece of legislation regarding private lending in the future, which shall combine all existing rules into one place and eradicate conflicts among different statutes. Moreover, the current legal framework can only deal with relevant problems and market failures on the *ex post* base. In the absence of an effective regulatory system, the judiciary undertakes multiple tasks to manage lending crises, solve civil disputes, and combat fundraising crimes. The limitations of this approach are self-evident: First, it occupies a significant percentage of judicial resources; Second, the *ex post* regime is incapable of monitoring the private lending market before things go wrong. Therefore, apart from existing laws, it is better to design a separate regulatory regime for private lending, with a designated regulator, to perform supervisory tasks on the *ex ante* base.

Chapter 5 Solving The Private Lending Puzzle: Experimental Reform and Financial Liberalisation

5.1 Introduction

In response to market failures during the private lending crisis, the Chinese authority has been exploring effective mechanisms to regulate the massive private financing market as well as finding solutions to provide more credits for private businesses. In 2012, it launched an experimental financial reform in Wenzhou, with the objective to create more financing channels, under an officially-controlled framework, for the city's SMEs.¹ The reform has been viewed as a unprecedented move to search for a new financial model for China's next round of economic development. In the eyes of some market observers, the Wenzhou reform has been the most influential one in the recent decade.² Pan Gongsheng, the vice governor of the People's Bank of China, praised Wenzhou's valuable experience in terms of legalising and regulating private lending, which contributes to the improvement of market transparency and efficiency.³ He also suggested that if the outcome of the Wenzhou reform turns out to be successful, its practice will be extended to the whole nation.

Accordingly, this chapter attempts to examine whether the latest financial reform has devised an effective regulatory regime for private financing and what improvements can be done. Meanwhile, it pays attention to the reform methods that could mitigate the financing difficulties of private businesses. The second section considers the logic of solving the private lending puzzle, whilst the third section investigates the rationales for regulating the private lending market, by taking account of the regulatory theories as well as China's practical needs. The fourth section studies the origin and evolution of the Wenzhou Pilot Financial Reform, representing China's recent efforts to build a more efficient financial system. Then, the fifth section assesses the Wenzhou Private

¹ Julie Ball, "China Set to Reform Illicit Private Finance Market", *BBC News* (20 April 2012), available at <http://www.bbc.co.uk/news/business-17746171>, accessed 20 December 2016.

² Emma Dong and Simon Rabinovitch, "China's Lending Laboratory", *Financial Times* (23 May 2012), p.11.

³ *Sina Finance*, "PBOC Vice Governor Pan Gongsheng: Private Finance is A Double-edge Sword" (8 October 2014 *Shanghai Securities News*), available at http://finance.sina.com.cn/money/bank/bank_yhfg/20141008/015020476685.shtml, accessed 1 November 2016.

Financing Regulation (WPFR), in order to examine whether the newly proposed registration-based regime is competent enough for regulating private loans. The sixth section continues to analyse the Wenzhou Private Financing Index (WPFI) which was invented to track the interest rate levels of private financing activities across China. The final section evaluates the reform to liberalise China’s banking sector by allowing qualified private investors to set up new banks. It focuses on if the reform is able to provide more credits for SMEs, and how the financial regulators respond to a more competitive banking industry.

5.2 The Logic of Solving Private Lending Puzzle

To understand the logic of solving the private lending puzzle, we should firstly figure out major problems that exist in the private financing industry. As we know, the problem of “two abundances and two difficulties” accounted for the emergence and popularity of private financing activities.⁴ Accordingly, the reform shall concentrate on designing an effective financial system that allows spare private capitals in the society to be invested in private businesses in need of funds. The chart below presents a visualised explanation about where the problems lie and how to solve them.

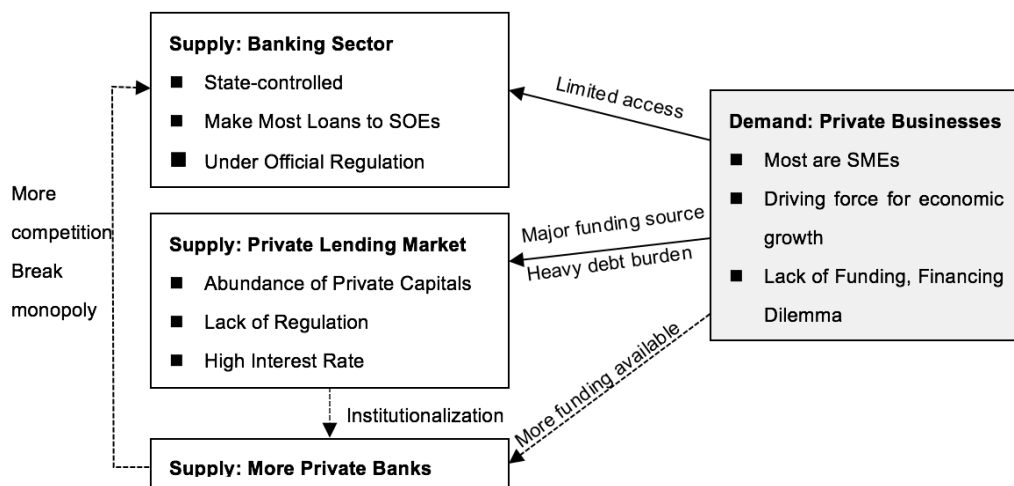


Figure 9: The Dual-Level Credit System

The grey box on the right side stands for private businesses in China which demand credits. Three white boxes on the left side presents the suppliers of money in China’s

⁴ There is too much private capital lacking good investment opportunities, whilst there are too many private businesses not having enough funding resources. See Chapter 2, Section 2.3.5, “*The Rise of Private Lending: Alternative Finance for Private Entrepreneurs*”

financial sector, including state-owned banks, the private lending market, and privately-owned banks. For a long time, as private businesses have limited access to state banks, they can only rely on the private lending market to borrow money. Thus, the official banking sector and the private financing sector have been operating in parallel to each other, which together form a dual-level credit system. However, despite the importance of private financing, its market is totally running outside of China's financial regulatory regime, which is likely to cause systemic risks and harm the financial stability.

Having realised the key problems, we have a broad idea about what the authority can do to fix the deficiencies in the financial system. First, it is high time to introduce a regulatory system for the underground lending market, as its legitimacy as a method of business finance has been admitted by the state.⁵ The regulatory reform shall centre on protecting investors, curbing excessive interest rates, and improve the financial stability. Only by doing this, the authority can prevent the occurrence of the next crisis. Second, it is urgent for the financial regulator to break the monopoly of state lenders and bring more competition to the banking industry. If more banks backed by private capitals can be established, they will be willing to lend credits to SMEs, which contributes to the sustainable development of the Chinese economy.

5.3 Rationales for Regulating Private Lending Market

The history of finance is indeed a history of messing up, as we have constantly witnessed manias, panics, and crashes in the financial market, since the Dutch tulip bulb bubble in 1636.⁶ Most recently, the global financial crisis 2008, which was triggered by the subprime home mortgage sector in the United States, led to the insolvency of large financial institutions and economic recessions across the world.⁷ It cost billions of pounds in tax-payers' money to bail out big banks and help the financial industry to recover. In terms of producing chaos and crisis, China's private lending market is no exception. As discussed, China has seen a series of credit crunch

⁵ Dinny McMahon, "China Mulls Legalizing Informal Lending", *Wall Street Journal* (15 Mar 2012), A10.

⁶ Charles P. Kindleberger and Robert Aliber, *Manias, Panics, and Crashes: A History of Financial Crises* (5th Edition, John Wiley & Sons 2005), p.9.

⁷ *The Economist*, "The Origins of the Financial Crisis: Crash Course" (7 September 2013), p.87.

since 2011, as thousands of private businesses defaulted on private loans, which resulted in a great number of business insolvency and caused huge losses to investors. Following the crisis, the issue of regulation has become a heated topic for economists and legal scholars. How to design an effective regulatory regime, which defends the market discipline and competition as well as protects market participants, remains a central issue. In addition, the new regulation shall try to avoid bureaucratic red tapes which could be costly and reduce the efficiency of economic operation.

5.3.1 Does Chinese Economy Need More Regulation or Deregulation?

In recent decades, China has adopted an economic model called *socialist market economy*, a combination of state capitalism and free market. The Chinese authority has been modernising its economy through the process of deregulation and decentralisation, by allowing private and foreign capitals to enter into a variety of industries which were previously controlled by the state.⁸ Nowadays, most economic activities in China are being carried out by individuals and businesses as market participants, instead of being operated under the state's plan like the past. Generally speaking, the economic reform in China proved a success, which has greatly improved the efficiency of resource allocation and contributed to continuous economic growth.⁹

At present, the private sector plays a vital part in various sectors within the Chinese economy. For example, it accounts for more than 70 per cent of technology and innovation companies in the country, and has produced some world-leading tech firms like Huawei, Lenovo, Alibaba, and Tencent.¹⁰ It seems that the technology industry, which receives the least regulation and intervention from the state, has achieved most. Therefore, the public opinion in China is generally in favour of deregulating businesses and financial activities, rather than adding extra regulation. In November 2013, at the

⁸ Justin Yifu Lin, Mingxing Liu and Ran Tao, "Deregulation, Decentralization, and China's Growth in Transition" in David Kennedy and Joseph E. Stiglitz (edited), *Law and Economics with Chinese Characteristics* (Oxford University Press 2013), p.467.

⁹ John Ross, "China's Economic Success Sets an Example the World Should Follow", *The Guardian* (13 July 2012), available at <https://www.theguardian.com/commentisfree/2012/jul/13/china-economic-success-example-world>, accessed 1 February 2017.

¹⁰ *China Economy*, "Private Economy Play a Leading Role in Innovation" (18 June 2016), available at http://www.ce.cn/xwzx/gnsz/gdxw/201606/18/t20160618_12979855.shtml, accessed 1 November 2016.

central committee meeting of China Communist Party, it passed an important resolution to deepen the economic reform, which pledges that letting the market force play a “decisive role” in the allocation of resources.¹¹ Under this circumstance, pushing forward market-oriented reforms has been a top priority for the current Xi-Li administration. It vows to open up more industries to private businesses, as well as eradicate unnecessary regulations and restrictions which impede competition. When Premier Li Keqiang came into office in 2013, he promised to abolish over one third of 1,700 items in terms of business and economic activities that need a administrative approval from central government.¹²

Clearly, in the current political environment, the topic of deregulation seems more favourable to Chinese reformers and the public. Therefore, it needs more justification for introducing a new regulatory scheme for private lending. The remaining parts of this section explains why we shall regulate private lending in three aspects: First, it examines theories regarding the purpose of financial regulation, in particular the public interest theory; Second, it considers a number of reasons, based on China’s practical needs, which support regulating private financing; Third, it tries to clarify the relationship between substantive laws and financial regulation, which are working together to form a complete regulatory system.

5.3.2 Financial Regulation: A Public Interest View

There is no doubt that we are currently living in a “regulatory state”, as different forms of regulation exist in nearly every domain of a country.¹³ The method of regulation has been gradually replacing other forms of state control, such as public ownership, planning, and centralised administration in the economy. Apparently, the scale and complication of regulatory systems in the modern world is such that its existence has been often taken for granted by people.¹⁴ Nevertheless, it remains difficult for most legal scholars and economists to work out a clear definition for regulation. It could

¹¹ *The Economist*, “Stocks in China: China embraces the markets” (11 July 2015), p.13.

¹² Jamil Anderlini, “China’s premier vows to cut red tape”, *Financial Times* (18 March 2013), p.7.

¹³ Giandomenico Majone, “The Rise of the Regulatory State in Europe” (1994) 17(3) *West European Politics* 77, 77.

¹⁴ Iain G MacNeil, *An Introduction to the Law on Financial Investment* (2nd Edition, Hart Publishing 2012), p.27.

generally refers to the employment of legal instruments for implementing social-economic policy objectives.¹⁵ Individuals and corporations are forced to comply with relevant rules that set prescribed behaviours, and the violation of such regulation will result in sanctions such as a fine, publicising of violation, disclosing business, disqualification or even imprisonment.

In this regard, regulation can be seen as one form of state intervention. Some scholars insisted that a clear and decentred conceptualisation of regulation is necessary for us to better understand the contemporary socio-political relations.¹⁶ Evidently, it is not sufficient if we only count state-centred intervention as regulation, but it also contains too much if we equate regulation with any forms of social ordering. According to Baldwin, Cave, and Lodge, regulation can be interpreted in three different senses, from narrow to broad.¹⁷ First, regulation is a specific set of commands, where it involves the making of a series of rules to be applied by an agent devoted to a specific purpose. Second, regulation is regarded as the deliberate state influence where it covers all kinds of state actions to have effect on certain business or social behaviours. Third, regulation can refer to all forms of social and economic influence, where any mechanisms having impacts on behaviours, whether they are state-back or market-based, can be viewed as regulatory.

What is more, a difference can be made between economic regulation and social regulation.¹⁸ In most cases, economic regulation is applied to industries where there exist natural monopolies as well as market structures with limited or excessive competition, whilst social regulation is exercised in some areas like environmental protection, labour condition, and consumer protection. Within economic regulation, a further division can be made between structural regulation and conduct regulation.¹⁹

¹⁵ Johan den Hertog, "General Theories of Regulation" in Boudewijn Bouckaert and Gerrit De Geest (editted), *Encyclopedia of Law and Economics* (Edward Edgar 1999), p.223.

¹⁶ Julia Black, "Critical Reflections on Regulation" (LSE Working Paper, January 2002), p.27, available at <http://eprints.lse.ac.uk/35985/1/Disspaper4-1.pdf>, accessed 1 November 2016.

¹⁷ Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation: Theory, Strategy, and Practice* (2nd Edition, Oxford 2012), p.3.

¹⁸ Johan den Hertog, "General Theories of Regulation" in Boudewijn Bouckaert and Gerrit De Geest (editted), *Encyclopedia of Law and Economics* (Edward Edgar 1999), p.224.

¹⁹ *Ibid.*

The former one is employed to regulate the structure of relevant markets. For example, we can see a lot of restrictions on the entrance of financial markets and legal service markets, and unlicensed people and businesses are prohibited from conducting such businesses. Also, after the global financial crisis, there is an increasing number of regulation designed to limit the range of businesses that can be done by banks, in order to reduce their exposure to excessive risks.²⁰ In contrast, conduct regulation is used to regulate behaviours carried on by participants in the market. For instance, banks are required to meet capital requirements under Basel 3, public companies are obliged to disclose their financial statements to the public on a regular base, and lawyers shall comply with the relevant code of conducts.

The economic regulation contains both positive and normative variants. The positive variant pays attentions to the economic explanation of regulation, the normative variant evaluates which type of regulation is the most efficient.²¹ Normative theories can be testified by making cost-benefit analysis for a number of different regulatory systems and instruments. Here we mainly focus on the theories relating to positive regulation, which can be divided into public interest theory and private interest theory. According to the public interest theory, the government regulators make and implement rules in order to promote the welfare of general public.²² Therefore, the regulator is viewed as a representative for the public, including taxpayers and all market participants, the duty of whom is to maximise the interests of the public by increasing market efficiency and preventing market failures. From this angle, regulators are considered as selfless and altruistic, so there is no need to take account of interests of regulators themselves. On the contrary, the private interest theory take the interests of certain groups into account, as regulation emerges in the political environment affected by various players.²³ Sometimes those who are being regulated have the strongest motive to manipulate laws and regulations for their own benefits.

²⁰ John Armour, "Structural Regulation of Banking" (June 2014), available at http://web.law.columbia.edu/sites/default/files/microsites/law-economics-studies/john_armour_structural_regulation_working_22.06.2014.pdf, accessed 1 November 2016.

²¹ Johan den Hertog, "Review of Economic Theories of Regulation" (December 2010, Utrecht University School of Economics, Discussion Paper Series 10-18), p.4.

²² Richard A. Posner, "Theories of Economic Regulation" (1974) 5(2) *The Bell Journal of Economics and Management Science* 335, 336.

²³ George J. Stigler, "The Theory of Economic Regulation" (1971) 2(1) *The Bell Journal of*

In China's case, the public interest theory can to some extent explain the reason behind the financial reform targeting private financing. It is clear that an uncontrolled marketplace, such as the private lending market in default crisis, does a lot of harm to the economy in contrast to the public interest. In response to the crisis, the State Council in 2012 decided to launch a pilot reform in Wenzhou in order to legitimise informal finance and bring it under the regulatory umbrella.²⁴ Evidently, the main objective of Chinese authority to start the reform is to repair market failures and thus protect the interests of the general public in Wenzhou which was heavily hit by the crisis. Moreover, the reform plan pledged to maintain regional financial stability and social stability, which can be understood as protecting the public interest.²⁵

5.3.3 Why Regulate Private Lending?

There is always a debate between supporters of the free market and those in favour of government intervention. After the global financial crisis and economic recession, governments around the world play an increasingly important role in the operation of economy, for more and more countries picked the model of state capitalism, rather than the free market, as a developing path for their economies.²⁶ It is clear that neither a completely free market nor a heavily controlled economy (like the USSR or China before 1980s) is ideal, so the key issue is how to strike a balance between market force and state intervention so as to help private businesses to flourish and bring sustainable economic growth. Apart from the public interest objective mentioned above, five points are presented here to support the regulation of private lending.

Information asymmetry

Like any other economic sectors, the financial industry, which is prone to excessive risks, needs government's regulation to protect consumers, stabilise the marketplace,

Economics and Management Science 3, 3.

²⁴ Lingling Wei, Dinny McMahon and Tom Orlik, "China Tests Looser Financial Model" *The Wall Street Journal* (29 March 2012), A8.

²⁵ *Xinhua*, "Zhejiang Province Introduced Implementation Rules for the Wenzhou Comprehensive Financial Reform" (23 November 2012), available at http://news.xinhuanet.com/politics/2012-11/23/c_113784140.htm, accessed 1 November 2016.

²⁶ Ian Bremmer, "The End of the Free Market: Who Wins the War Between States and Corporations?" (2010) 9 *European View* 249, 250.

and ensure market efficiency. Nonetheless, financial investment has two characteristics that distinguish it from other commercial activities in which general commercial law such as contract law and property law might be adequate. The first one is information asymmetry.²⁷ There is always some information asymmetry between investors and the business that attracts investment, since the management is more familiar with the business compared with outsiders. Therefore, in the absence of disclosure rules, investors lack essential information to make informed choices. It not only deters some potential investors, but also poses a risk to those who have invested, as they are not fully aware of the businesses' real situation and relevant risks. In order to solve the problem, in the capital market for example, there exist compulsory requirements for public companies to publish financial reporting as well as voluntary disclosure of information by the management, which helps investors to obtain necessary information to make investment choice.²⁸

Information asymmetry can also be found in the private lending market, between the business borrower and its investors. Many investors, without knowing how their money is going to be used, join an investment scheme by handing over their savings to moneylenders or to borrowers directly. Clearly, they are attracted by the considerable interest return promised by borrowers, but to a large extent underestimate potential risks in the investment. In practice, moneylenders generally introduce that the money will be invested into a lucrative business project with low possibility of default, such as a property development project.²⁹ However, after receiving the money, moneylenders can change the use of money to their discretion, without disclosing the information to investors. It is disadvantageous to investors who are not aware of where their money flows and thus bear extra lending risks than they think.

Moreover, information asymmetry can to some degree hamper the development of private financing. It is because a rational investor might simply choose not to invest in

²⁷ Iain G MacNeil, *An Introduction to the Law on Financial Investment* (2nd Edition, Hart Publishing 2012), p.20.

²⁸ Paul M. Healy and Krishna G. Palepu, "Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature" (2001) 31 *Journal of Accounting and Economics* 405, 406.

²⁹ Wen Xiu, "China's Private Loans on the Rise as Banks Freeze Lending", *Caixin* (3 August 2011), available at <http://www.cnbc.com/id/43954012>, accessed 20 December 2016.

the market, as it cannot access adequate information about the investment. During the private lending crisis, a large number of investors suffered significant losses, and therefore, Chinese investors have become more experienced and sophisticated, who learn how to evaluate expected returns against potential risks. Therefore, the new regulatory regime shall try to introduce a set of information disclosure rules, to protect the benefits of existing investors and encourage more people to invest.

Systemic risks

Investors in the financial markets are often exposed to systemic risks. A trigger event, like an economic shock or the failure of a particular financial institution, can give rise to a series of bad results including the failure of other financial institutions or markets.³⁰ It means that even though the entity in which people have invested is sound, its solvency could still be affected by the failure of another entity, as both entities have some links through the complicated financial system. In the wake of global financial crisis, national regulators and international bodies have addressed the issue of controlling systemic risks in the financial system, in particular risks resulted from systemically important financial institutions and shadow banking.³¹ Therefore, the importance of macro-prudential regulation has been recognised, as regulators want to ensure the soundness of individual banks as well as the stability of the whole system.³²

In terms of the private lending market, systemic risks clearly exist which come from the interconnection of moneylending businesses.³³ Moneylenders often lend money or provide guarantees for each other, and therefore, the failure of one major lender can cause the insolvency of other lenders in a certain region and lead to market turbulence.³⁴ Some private lenders even finance their loans through credits from official banks, which increases the interconnectedness between the private lending

³⁰ Steven L. Schwarcz, "Systemic Risk" (2008) 97 *Georgetown Law Journal* 193, 198.

³¹ Rolf H. Weber, "Addressing Systemic Risk: Financial Regulatory Design" (2014) 49 *Texas International Law Journal* 149, 152.

³² Xin Huang, Hao Zhou and Haibin Zhu, "A Framework for Assessing the Systemic Risk of Major Financial Institutions" (2009) 33 *Journal of Banking & Finance* 2036, 2036.

³³ We have discussed this topic previously, in Chapter 3, Section 3.6.5 "*Systemic Risk of Default Crisis*".

³⁴ Ji Tong, "The Data Analysis of Private Lending Cases Heard by All Courts in Recent Five Years", *Legal Daily* (4 March 2014), available at http://www.legaldaily.com.cn/zbzk/content/2014-03/04/content_5330575.htm?node=25497, accessed 1 November 2016.

market and the banking industry. Accordingly, the authority shall limit the sources of moneylenders' capital pool, cut down the sophisticated lending chain, and simplify financial links between lenders and other market participants. Only by doing this, the latest reform is able to reduce systemic risks and promote market stability.

The size matters

Sector	Size	Percentage
A (Banking)	Total outstanding loans CNY 93.95 trillion(2015) ³⁵	C/A = 5.3%
B (Stock Market)	Total market capitalisation CNY 50.7 trillion (2016) ³⁶	C/B = 9.9%
C (Private Lending)	Total outstanding loans CNY 5 trillion (SWUFE 2014)	

Table 10: The Size of Financial Industry in China

After decades of development, private financing has evolved into a massive and complex market in China. In terms of the size, the market's total outstanding loans reached CNY 5 trillion in 2014, which equals 5.3 per cent of that of the official banking sector.³⁷ Moreover, from the chart above, compared with the stock market, the private lending market is around 9.9 per cent of the total market capitalisation of all public companies listed in Shanghai and Shenzhen stock exchanges. Evidently, private lending plays a significant role in the financial industry, and considering its enormous scale, it is necessary for the authority to set up a monitoring and regulatory system for the market.

Controlling market access

Unrestricted access to the financial market could have a damaging effect if unscrupulous players are allowed to participate.³⁸ If a market is operating without

³⁵ National Bureau of Statistics, "2015 National Economy Data" (19 January 2016), available at http://www.stats.gov.cn/tjsj/zxfb/201601/t20160119_1306083.html, accessed 1 November 2016.

³⁶ This includes 22-trillion-yuan combined market capitalisation of all companies listed on the Shenzhen Stock Exchange, as well as that of 28.7 trillion yuan on the Shanghai Stock Exchange. The data is derived from Tonghuashun (同花顺) stock trading software on 12 December 2016.

³⁷ *Xinhua*, "Long-term Underground Private Lending Endanger Financial Ecology" (22 September 2014), available at http://jjckb.xinhuanet.com/2014-09/22/content_521666.htm, accessed 1 May 2016.

³⁸ Iain G MacNeil, *An Introduction to the Law on Financial Investment* (2nd Edition, Hart Publishing 2012), p.28.

regulation, there is open access for anyone wishing to make profits. Apparently, the business of private lending in essence is similar to that of formal banks, both of which include taking deposits and making loans. However, Chinese banks are heavily regulated by the state, with limited market entrance, whilst no restriction can be found in the private lending market. Therefore, dishonest moneylenders or borrowers could easily exploit the regulatory vacuum and join the market. We have observed a large number of frauds and Ponzi schemes in China's private lending market as they deceived billions of yuan from investors. For instance, in early 2016, the police arrested more than 20 people associated with EZubao (易租宝) company, a leading online and offline lending network in the country which defrauded CNY 50 billion (USD 7.3 billion) from investors all over China.³⁹ For many ordinary investors, they lack the essential knowledge and skills to identify whether an investment scheme is real or not. Therefore, the state, instead of investors, shall be responsible for selecting qualified moneylenders and financial brokers to enter the market. Thus, a regulatory regime is needed to filter market participants and it shall only allow qualified entities to conduct the lending business.

Overburden of China's judicial system

Last but not least, China's judicial system has been stuck in a great number of private lending-related cases since 2011, due to the lending crisis. As discussed in the last chapter, the current legal system leaves the duty of correcting wrongdoings and solving disputes to the court system on an *ex post* base. This approach has certain drawbacks. For example, private lending-related civil disputes take up an excessive amount of judicial resource. Clearly, this approach is ineffective in preventing disputes and lending crisis, so it calls for a specialised regulatory regime, with a professional regulator with clear mandates to supervise private financing activities. Having an *ex ante* regime means the authority is able to combat and eliminate illegal lending practices timely and reduce the number of potential disputes, which can save precious judicial resource for Chinese courts.

³⁹ Tom Mitchell, "Chinese Police Need Diggers to Unearth 'Ponzi Scheme' That Took Alleged \$7.6bn", *Financial Times* (2 February 2016), p.1.

5.3.4 Substantive Laws and Financial Regulation

Substantive laws and financial regulation are two different things but have certain overlaps. The boundary between these two concepts is often blurred, as the sources of financial regulation include legal instruments such as statutes, regulatory rules, as well as judicial opinions about the interpretation and application of such legal instruments.⁴⁰ Within financial institutions or the legal community, there are some people who specialise in regulation and compliance on the one hand, and some people who deal with substantive laws on the other.⁴¹ Clearly, substantive laws like contract law, property law, and criminal law have existed for a long time, which set out underlying rules for all economic activities and financial transactions. The enforcement power of basic laws belongs to the judicial authority. However, due to the sophistication of modern financial world, applying basic laws to financial activities is far from adequate, which calls for extra regulation to be formulated and implemented by government agencies. That is why we have a large number of regulatory rules for banks, such as the Basel Accords and deposit insurance, and why we set up specialised regulatory authorities like Financial Conduct Authority and China Banking Regulatory Commission. These authorities are the enforcement agencies for regulatory rules, which have been granted special powers by legislation. Regulatory rules, coupled with substantive laws, forms a complete system of modern financial regulation.

For the private lending market in China, the chief problem is not about substantive laws, despite the inconsistency of different legislations in practice. China already has a comprehensive legal framework providing basic legal rules for private lending. For example, under *PRC Contract Law*, there exists an entire chapter governing loan contracts, along with various pieces of judicial interpretations dealing with interest rate and other important issues. The *PRC Criminal Law* set out criminal offences relating to illegal lending activities and relevant sanctions. Therefore, it is clear that substantive laws around private financing are complete, which shall be followed by all participants in the markets. The real problem in China's underground lending market is the absence

⁴⁰ Andrew F Tuch, "Conduct of Business Regulation", in Eilis Ferran, Niamh Moloney and Jennifer Payne (edited), *The Oxford Handbook of Financial Regulation* (OUP 2015), p.539.

⁴¹ Alastair Hudson, *Law of Finance* (Sweet & Maxwell 2009), p.57.

of specialised financial regulation. As stated, the market has achieved a considerable size with a high level of complexity, which needs extra financial regulation in addition to substantive laws, to deal with matters like market entrance, information disclosure, investor protection, and crisis management. Apparently, issues like monitoring market risks and promoting prudential operation cannot be left to substantive laws and judicial authorities which mainly handle basic legal problems in our society.

5.4 How to Regulate Private Lending? A Case Study of Wenzhou Financial Reform

After examining the justifications for regulating private loans, this section continues to explore the question of how to regulate the private lending market. Clearly, there exist a variety of regulatory models and techniques designed for different types of financial activities, and there is no best but only the most suitable regulation for a particular financial practice. The following part introduces and analyses the latest financial experiment and regulatory reform in China, as it has a primary objective to bring private financing activities under the official control. Wenzhou, the hotbed of Chinese private economy, spearheads the pilot reform and will be the focus of our study.

5.4.1 The “From Point To Surface” Reform Approach in China

In the past three decades, a typical method that has been adopted in China’s economic reform is called “proceeding from point to surface” (由点到面).⁴² It means, in the beginning of a reform, the authority normally sets up some pilot reform points in a small number of cities. If the pilot reform zones prove successful, their experience will be copied by the rest of the country. This experimental approach comes with certain advantages. On the one hand, pilot reforms encourage local officials to try out any possible solutions to solve practical problems, which is able to provide policy-makers with valuable experience and novel ideas. On the other hand, experimental reforms can reduce the cost of failure to a minimum, since if pilot reforms do not achieve the original goal, they will be stopped immediately. The cost of shutting down a small regional project is relatively low, compared with economic experiments at a national

⁴² Sebastian Heilmann, “From Local Experiments to National Policy: The Origins of China’s Distinctive Policy Process” (2008) 59 *The China Journal* 1, 2.

level.

Apparently, this pervasive reform approach has been a secret behind China's successful economic transformation and development from 1978-2008. Mr Deng Xiaoping, who invented this approach, summarised it as "to cross the river by feeling the stones".⁴³ When the *Reform and Open-up* policy came into effect in the late 1970s, China's central government firstly established Special Economic Zones (SEZs) in four coastal cities to lead the market-oriented economic reform.⁴⁴ Favourable economic policies and flexible regulations were introduced to SEZs, which allowed authorities and citizens in these cities to start running private businesses and attract foreign capitals. Later on, when the experience of SEZs turned out to be successful and practical, similar economic policies were spread to the rest of China. At present, the "from point to surface" method is still widely seen in China. As of 2014, the country had a varieties of economic reform projects, including 6 SEZs, 14 open coastal cities, four pilot free trade areas, and five financial reform pilot areas, which play a leading role in the reform of their respective areas.⁴⁵ Most recently, in response to the lending crisis, the Chinese authority determined to start a new round of financial reforms, with Wenzhou city being the "point" at the forefront.

5.4.2 The Origin and Developments of Wenzhou Financial Reform

Prior to 2011, thanks to sufficient credits provided by back-alley banks, Chinese entrepreneurs could borrow sufficient credits to fund their businesses and cashed in on the rapid growth of Chinese economy. Meanwhile, investors who lent out money to businesses enjoyed great returns for a long time. However, times have changed since 2011 when Wenzhou and other Chinese cities encountered the lending default crisis. Thousands of private businesses failed to repay private debts, leading to the hefty losses of investors and breaking the win-win situation in the past. In the wake of crisis, China's then prime minister, Wen Jiabao, expressed his concern about what happened

⁴³ *Xinhua*, "The Meaning of 'To Cross the River by Feeling Stones'" (19 May 2008), available at http://news.xinhuanet.com/theory/2008-05/19/content_8167165.htm, accessed 1 November 2016.

⁴⁴ The first four SEZs include Shenzhen, Zhuhai and Shantou cities in Guangdong Province and Xiamen city in Fujian Province. Later, the whole Hainan Province has also become a SEZ.

⁴⁵ World Bank, "China's Special Economic Zones: Experience Gained", available at <http://www.worldbank.org/content/dam/Worldbank/Event/Africa/Investing%20in%20Africa%20Forum/2015/investing-in-africa-forum-chinas-special-economic-zone.pdf>, accessed 1 November 2016.

in Wenzhou, and personally visited the city in October 2011 to conduct an investigation regarding local businesses and private lending.⁴⁶ Obviously, the central government has already realised the seriousness of the crisis, as the liquidity problem facing Wenzhou's corporations could be a indicator of the woeful credit condition of the whole nation. During the PM's trip in Wenzhou, he invited local entrepreneurs, government officials, lawyers, and academics to a conference to discuss about the solution to alleviate the financing difficulty of small businesses and how to regulate the shadow banking system.⁴⁷ Zhou Dewen, who is the head of Wenzhou SME Association, suggested that the key to solve Wenzhou financing puzzle is to introduce official regulation for private lending as soon as possible.⁴⁸ PM Wen endorsed Mr Zhou's idea and pointed out the authority should play an active part in legalising and standardising private lending transactions.

The PM's icebreaking trip to Wenzhou signalled a new round of financial reform in China. On 28 March 2012, at an executive committee meeting of the State Council, PM Wen announced the cabinet's decision to initiate a series of financial reforms in Wenzhou as well as assign the city a privileged status of "Comprehensive Pilot Financial Reform Zone".⁴⁹ The principal objective of the reform is to create more funding channels for SMEs, regulate the underground lending market, and transform the traditional financial sector. Clearly, the "top-level design" made by the State Council shows the importance of this reform to China's leadership. After the launch of Wenzhou financial reform, it has been closely watched by observers around the country, since it undertakes the task to explore a new path for China's financial system.

The reason for choosing Wenzhou as the starting point for this experimental reform is obvious. The city is widely known as China's hotbed of entrepreneurial capitalism

⁴⁶ *People*, "Wen Jiabao Led Top Officials to Wenzhou Investigating Private Lending" (05 October 2011), available at <http://finance.people.com.cn/GB/8215/210272/231799/15874351.html>, accessed 1 November 2016.

⁴⁷ Emma Dong and Simon Rabinovitch, "China's Lending Laboratory", *Financial Times* (23 May 2012), p.11.

⁴⁸ Weijia Hu, "Before and After Wenzhou Private Financing Regulation", *China Economy Weekly* (9 December 2013), available at <http://www.ceweekly.cn/2013/1209/70576.shtml>, accessed 20 December 2016.

⁴⁹ Lingling Wei, Dinny McMahon and Tom Orlik, "China Tests Looser Financial Model" *The Wall Street Journal* (29 March 2012), A8.

which possesses a massive shadow banking network.⁵⁰ According to *the Economist*, the scale of Wenzhou's shadow banking system was around CNY 110 billion (USD 16 billion) in 2012, equivalent to 38 per cent of the city's GDP.⁵¹ Wenzhou has a well-developed private economy with abundant private capitals and a dynamic private financing system, making it the perfect place to implement the reform. Moreover, Wenzhou was the first city to confront the recent debt crisis, so it has more experience in dealing with relevant problems.

In the guiding document of Wenzhou pilot financial reform, the state council set out 12 general objectives:⁵²

- To regulate private financing;
- To accelerate the development of new-type financial organisations;
- To develop professional asset management institutions;
- To develop a pilot programme regarding individual foreign direct investment, by exploring standardised and convenient direct investment channels;
- To deepen the reform of local financial institutions;
- To encourage innovative financial products and services targeting small and micro enterprises and “three rurals” customers, explore the establishment of a multi-level financial system;⁵³
- To foster and develop capital markets at local levels;
- To actively develop different types of bonds products;
- To broaden the service field of the insurance industry, develop insurance products for professional markets and industrial clusters, and to encourage commercial insurance companies to take part in the social security system;

⁵⁰ Xingyuan Feng and Carsten Herrmann-Pillath, “Wenzhou: Spearhead for Financial Reform” (31 August 2012) AHK China, p.50, available at http://china.ahk.de/uploads/media/Whenzhou_-_Sparehead_for_Financial_Reform.pdf, accessed 1 November 2016.

⁵¹ *The Economist*, “Shades of Grey: Wenzhou's Shadow Banking System Has Taken a Knock” (26 May 2012), s14.

⁵² PRC State Council, “The Overall Scheme of Financial Reform Pilot Zone in Wenzhou, Zhejiang Province”. (YINFA 2012 No.188)

⁵³ “Three Rurals”, or “三农” in Chinese, refers to three most important and interactive issues relating to the development of China's rural region, namely, agriculture (农业), rural areas (农村) and farmers (农民). It has been a national strategy in China's economic development. See, for instance, *People's Daily*, “No.1 Document of Central Government Published: Using New Ideas to Solve Three Rurals Problem” (31 December 2015), available at http://news.xinhuanet.com/politics/2016-01/28/c_128679303.htm, accessed 1 November 2016.

- To establish a social credit system;
- To improve the local financial regulatory system, prevent the situation of regulatory vacuum, reduce systemic risks and regional risks; and
- To establish a risk prevention mechanism for the comprehensive financial reform.

The pilot financial reform has taken several bold steps. Generally speaking, it attempts to allow private businesses in Wenzhou, especially small and medium-sized enterprises, to have more access to a wide range of financing services, including private lending, traditional bank credits, new-type financial institutions (e.g. rural banks and small loan companies), regional capital markets (to facilitate the transfer of shares of non-public companies), bond issuance, and insurance service. Moreover, it grants local residences more investment opportunities, such as introducing more wealth management companies, allowing private capitals to invest in local businesses through various financing channels, and allowing Wenzhou people to conduct direct foreign investments. Furthermore, the State Council asked the local government to design a financial regulatory system in order to safeguard the operation of financing activities listed above.

5.4.3 Wenzhou Reform and Private Lending Regulation

Among various reform tasks, this chapter only concentrates on reform measures in relation to private lending activities. Clearly, putting creditors and debtors in the underground lending market into an officially-controlled framework tops the list of the State Council's multiple goals. After the general initiative, Zhejiang provincial government promulgated some corresponding implementation rules for achieving the above 12 general objectives made by the central government.⁵⁴ The implementation rules also contain 12 sections, with the first section addressing the regulation of private lending and asking Wenzhou's authority to "Drafting Wenzhou Private Financing Regulation, and establishing the private financing legal protection mechanism. Exploring the establishment of a recording-based management system for private financing, and encouraging financing participants especially corporates to file with the

⁵⁴ *Xinhua*, "Zhejiang Province introduced implementation rules for the Wenzhou comprehensive financial reform" (23 November 2012), available at http://news.xinhuanet.com/politics/2012-11/23/c_113784140.htm, accessed 1 November 2016.

authority. To set up pilot private lending service centres, and encourage relevant lending agencies to open businesses in the lending centre to provide services such as private lending registration, contract notary and asset evaluation, in order to help private lending activities to be legalised and standardised. To establish and improve the regulatory system of private financing, and establish Wenzhou Private Financing Comprehensive Interest Rate Index (also called “Wenzhou Index”), and to dynamically track and monitor private financing activities and do the risk warning. To increase the use of e-commerce system in the private financing sector.”⁵⁵

According to plans initiated by both central and provincial governments, Wenzhou municipal government has undertaken the responsibility to implement concrete reform measures. From the above document, the local authority has been told to complete three main tasks: setting up private lending service centres, drafting Wenzhou Private Financing Regulation, and launching Wenzhou Interest Rate Index. On 26 April 2012, the first private lending service centre opened business in Wenzhou, marking a breakthrough in the pilot reform.⁵⁶ The centre is registered as an incorporation with CNY 6 million capital (USD 0.87 million), which operates main businesses like recording private loans and providing matching service for lenders and borrowers.⁵⁷

In December 2012, the Wenzhou Index was launched by the city’s financial authority to monitor the interest rate level of local private financing activities, another milestone in the pilot reform.⁵⁸ Based on data collected from hundreds of monitoring points, the authority compiles two types of Wenzhou Index (a local version and a national version). Moreover, the local financial affair office cooperates with *Thomson Reuters* to publish the English version of Wenzhou Index for global investors who would like to join China’s lending businesses.⁵⁹ The Wenzhou Index has been an important

⁵⁵ Zhejiang Provincial Government, “Implement Rules for the Wenzhou Financial Reform Pilot Zone” (23 November 2012), Section 3(1).

⁵⁶ *CCTV*, “First Private Lending Registration Office Opens in Wenzhou” (27 April 2012), available at <http://english.cntv.cn/program/bizasia/20120427/109583.shtml>, accessed 1 November 2016.

⁵⁷ Wenzhou Private Lending Service Net, <http://www.wzmjddj.com/news/bencandy.php?fid=126&id=1435>, accessed 20 December 2016.

⁵⁸ *Reuters*, “China’s Wenzhou launches private lending index” (7 December 2012), available at <http://www.reuters.com/article/2012/12/08/china-wenzhou-shadowbanking-idUSL4N09I0G920121208>, accessed 1 November 2016.

⁵⁹ *Thomson Reuters*, “Thomson Reuters and Wenzhou Municipal Government Signed Data

indicator for the price of borrowing in Wenzhou, which provides useful data for lending parties, financial regulators, and the central bank. It also promotes the transparency of shadow banking businesses.

Furthermore, Wenzhou Private Financing Regulation (WPFR) is perceived as another major achievement of the reform. In November 2013, the WPFR was passed at the 6th meeting of the standing committee of the 12th Zhejiang Provincial People's Congress, the provincial legislator.⁶⁰ It came into effect on 1 March 2014. Later on, a detail set of implementation rules for the WPFR was approved by the 35th executive meeting of Wenzhou Municipal Government. The new regulation requires borrowers and lenders to file with Wenzhou's financial authority or its designated lending centres if the loan meets certain standards, which contributes to the effective supervision of private lending. The Wenzhou Index and WPFR will be examined in detail later.

5.4.4 The Significance of Pilot Reform

The significance of Wenzhou's experimental reform is twofold. First, it directly addressed the problem of "two abundances and two difficulties", a longstanding problem in the Chinese economy. The chief goal of Wenzhou reform is to build a multiple-level and diversified financial system which is able to accommodate the financing needs of local economy.⁶¹ The 12-point reform plan clearly suggests more financial supports for SMEs, which creates multiple channels for spare capitals in the society to be invested in businesses needing funds. The new financial model contrasts with China's current banking system that mainly serves privileged state-owned enterprises rather than private businesses.⁶² The reform aims to reverse this situation by increasing credit supply to the private sector. Second, China has used the "from point to surface" approach again to test possible solutions to the SME financing dilemma, and the experiment's potential outcome could have a profound impact on

Agreement" (9 January 2013), available at <https://www.thomsonreuters.cn/zh/about-us/press-releases/eikon-wenzhou-municipal-government.html>, accessed 1 November 2016.

⁶⁰ *Xinhua*, "China legalizes private lending in Wenzhou" (28 February 2014), available at http://news.xinhuanet.com/english/china/2014-02/28/c_133150649.htm, accessed 1 November 2016.

⁶¹ *People*, "Wenzhou Financial Reform: One Year On" (27 March 2013), available at <http://finance.people.com.cn/n/2013/0327/c1004-20936740.html>, accessed 20 December 2016.

⁶² Shang-Jin Wei and Tao Wang, "The Siamese Twins: Do State-Owned Banks Favor State-Owned Enterprises in China?" (1997) 8(1) *China Economic Review* 19, 28.

Wenzhou and beyond. Apparently, the Wenzhou reform has reached some areas that were untouched by the authority previously, such as legitimising private financing and encouraging innovative financial services. Without doubt, its experience will be a valuable asset for the future of Chinese economy.

5.5 Wenzhou Private Financing Regulation

5.5.1 An Overview of WPFR

The primary objective of the pilot financial reform is to turn the underground private lending market into an officially regulated one. Following the general scheme, the People's Congress in Zhejiang as the provincial legislator passed China's first financial regulation regarding private lending. The "Wenzhou Private Financing Regulation" came into effect on 1 March 2014, which is considered as a great breakthrough in legalising and regulating private financing.⁶³ The regulation has seven chapters and 50 articles, which enables private businesses to raise money via three types of private financing activities: private lending, private placement bond, and private equity. Here we confine our attentions to private lending, the rules of which can be found in the chapter three of WPFR. In addition, the Wenzhou government has produced detailed rules for implementing the regulation.⁶⁴ Generally speaking, the regulatory regime is based on compulsory registration of private loans that satisfy certain standards. Several lending service centres to promote and facilitate private financing activities have also been established.

According to the Article 12(1) of WPFR, private lending for commercial purposes can be used as a financing method between individuals, or between individuals and non-financial enterprises, or between non-financial enterprises (temporary lending only).⁶⁵ Article 12(1) plays a key part as it confirms the legitimate status of private lending as a financing mechanism for businesses. It should be noted that private lending agreements between two non-financial enterprises have to be temporary, as any

⁶³ Hereafter, "Wenzhou Private Financing Regulation" will be referred to as "the regulation" or "WPFR".

⁶⁴ Wenzhou Private Financing Regulation Implementation Rules (Wenzhou People's Government Order 2014 No.141), passed by the 35th executive meeting of the Wenzhou Municipal Government, came into effect on 1 March 2014.

⁶⁵ Wenzhou Private Financing Regulation (2014), Article 12(1).

enterprises that lend frequently should obtain a license from banking regulator. The implementing rule clarifies this by setting a maximum time of three months for lending between two enterprises.⁶⁶ Moreover, private lending should be conducted privately, as the new regulation prohibits private financing parties from advertising it to the public through newspaper, radio, television, internet, public lectures, seminars, leaflets, and mobile phone text messages.⁶⁷

5.5.2 Main Points of WPFR

Regulatory agencies

In the past, the lack of a named regulatory authority has caused great chaos, but the new regulation aims to rectify this situation. It authorises the Wenzhou municipal government and other county-level governments within the city to regulate private financing activities.⁶⁸ More specifically, financial affairs offices, which are financial management departments in local governments, provide guidance on the regulation and supervise private financing activities within their respective administrative regions.⁶⁹ Apparently, it is better to have local authorities, rather than national financial regulators, to supervise private lending, for underground lending businesses are normally regional and any potential risks will be confined to that region. The Wenzhou branches of national financial regulatory authorities, such as the central bank or banking and security regulators, have the power to guide the supervisory work of local financial management departments.⁷⁰

Lending service centres

According to the new regulation, the Wenzhou local government shall set up “private financing public service centres” to facilitate lending activities. The lending service centres provide a variety of lending-related services for individuals and enterprises that take part in private financing transactions. For example:

- Providing civil attestation for private financing activities;

⁶⁶ Wenzhou Private Financing Regulation Implementing Rules (2014), Article 10.

⁶⁷ Wenzhou Private Financing Regulation (2014), Article 33.

⁶⁸ Wenzhou Private Financing Regulation (2014), Article 4.

⁶⁹ Wenzhou Private Financing Regulation (2014), Article 5(1).

⁷⁰ Wenzhou Private Financing Regulation (2014), Article 5(2).

- Providing training courses for staffs in the private financing industry;
- Offering investment consulting services;
- Facilitating the assignment of creditors' rights; and
- Attracting other service bodies, such as notary offices, guarantee companies, law firms, and accounting firms, to open branches in the public service centres so as to provide support services for private financing.⁷¹

In addition, lending service centres can be entrusted by local financial management departments to carry out some regulatory tasks, including:

- Publishing information on the private financing interest rate index;
- Collecting and analysing private financing data, risk monitoring and risk assessment;
- Establishing private financing credit records and tracking money usage and loan performances;
- Receiving private lending registrations; and
- Other items entrusted by local financial management departments.⁷²

A main function of lending service centres is to match financing needs of potential lenders and borrowers.⁷³ Many businesses in Wenzhou are in desperate need of credits, so now they can resort to these lending centres and post their financing demands in the centres' online system. On the other hand, individuals and companies in the city who have spare money to invest can also use the service provided by lending centres, in order to look for investment opportunities. Therefore, being a platform to exchange financing and investment information, lending service centres act as a bridge between lenders and borrowers. Lending centres are fully funded by the fiscal budget of local governments, so they do not charge any fees for doing registration and money-matching works. In addition, lending service centres have to invite professional firms which provide lending-related services to join the centre, such as financing brokers,

⁷¹ Wenzhou Private Financing Regulation (2014), Article 8(1).

⁷² Wenzhou Private Financing Regulation (2014), Article 8 (2).

⁷³ Wenzhou Private Lending Service Net, <http://www.wzmjddj.com/news/bencandy.php?fid=127&id=1437>, accessed 1 November 2016.

law firms, accounting firms, notary offices, and asset valuation companies. It aims to create a one-stop lending and borrowing experience, which brings great convenience to lending parties as they do not need to step out of the centre to find relevant service providers.

Moreover, lending service centres, to some extent, can contribute to the effective regulation of private lending activities, as they have been granted administrative powers by local financial authorities. It is clear that all transactions facilitated and recorded by lending centres have to be legally compliant, before any lending agreements can be made. Through the registration of loans and tracking their performance situation, lending centres are able to gather useful information in the private lending market, like the daily amount of lending, interest rate level, default rates, and so on, which lays the foundation for further regulatory works.

Compulsory written format

The regulation requires that there must be a written and executed contract between lending parties.⁷⁴ It has made written format compulsory for creditors and debtors, which has had a positive impact in reducing disputes caused by the uncertainty of non-written agreements. The new rule is contrary to *PRC Contract Law* which allows private lending contracts between natural persons to be conducted without a written contract, permitting oral agreement in lending practices.⁷⁵ Therefore, it is not unusual for lenders to hand over millions of yuan to borrowers without signing an agreement, since asking for written contracts can sometimes be viewed as distrust among close business partners. However, when it comes to disputes, the oral contract is not valid as evidence.

Source of funding: self-owned capitals

In terms of lenders' sources of funding, the new regulation says that they have to use their self-owned capital or savings to finance loans.⁷⁶ As a result, it will be illegal for lenders to absorb funds from the public or borrow money from banks, and then re-lend

⁷⁴ Wenzhou Private Financing Regulation (2014), Article 12 (1).

⁷⁵ PRC Contract Law 1999, Article 197.

⁷⁶ Wenzhou Private Financing Regulation (2014), Article 12 (2).

that money to borrowers at a higher price, which is currently common practice. Money lenders often secure deposits from the public by promising an attractive return which is much higher than the interest rate offered by banks, so investors' money constitutes the majority of money lenders' capital pools and increases the leverage of the lending business. It not only helps lenders to make more money, but also leads to increased credit risks when defaults occur. Therefore, when borrowers fail to repay the money lender, the money lender is likely to default on their own investors, so the entire lending chain collapses – the domino effect. Besides, some money lenders, who have access to the state-owned banking sector, can make easy money by re-lending bank credits to cash-strapped entrepreneurs, which might cause systemic risks in the whole financial system as the default of private loans will trigger the default of bank loans. As the new regulation prohibits money lenders to solicit public money or borrow bank loans, those potential risks will be eliminated.

Interest rate

To determine private lending interest the regulation states that the lending rate shall be negotiated between the lender and the borrower, as long as it complies with relevant regulations.⁷⁷ This article formally confirms the legitimacy of charging interest in private lending transactions. In the previous chapter, we have discussed about interest rate caps for private lending, in the form of judicial interpretation made by Supreme People's Court.⁷⁸ Here, the relevant regulations refer to the "24/36" interest ceiling. In practice, a large number of money lenders who often charge interest rates beyond the state's restriction, have found some methods to evade the cap. As stated, they might deduct the excessive interest from the principal directly when they give money to borrowers. Moreover, money lenders could find someone else to be a middleman for the lending transaction, and ask him or her to charge a brokerage fee that is actually a part of the interest. In order to protect borrowers from unfair lending practices, the new regulation bans lenders from deducting any interest from the principal in advance, ensuring that the repayment of the debt is based on the actual amount received by the borrower.⁷⁹

⁷⁷ Wenzhou Private Financing Regulation (2014), Article 13.

⁷⁸ See Chapter 4, Section 4.5 "*Interest Rate Control for Private Loans*".

⁷⁹ Wenzhou Private Financing Regulation (2014), Article 12(3).

Recording system for private loans

The highlight of the new regulation is the creation of an innovative registration-based system to supervise private lending. It has imposed an obligation on borrowers to submit a copy of the contract to the local financial management department or other commissioned lending service centres within 15 days of signing the agreement. This enables the regulator to record the relevant lending transaction, when any of the following standards are met:

- A single private loan worth more than CNY three million (USD 0.44 million);
- The borrower's total loan balance of private lending exceeds CNY ten million (USD 1.46 million);
- The borrower borrows money from more than 30 individuals and/or enterprises;⁸⁰

For the remaining private lending transactions, lenders and borrowers are encouraged to report their loans to the authority on a voluntary basis.⁸¹ Although the duty of reporting relies on the borrower of a private loan, its lenders have the responsibility to supervise the borrower to do this, and are entitled to register loans if the borrower fails to do so.⁸² If there is any major change concerning the lending amount, the loan period, or the interest rate, the borrower must report relevant changes to the regulator within 15 days.⁸³ The regulator also encourages lending parties to report loan performance situations to the authority, which will be incorporated in the newly established private financing credit system.⁸⁴

Furthermore, the private lending regulator in Wenzhou has also established an online recording system to make it convenient for debtors and creditors to file lending contracts. Borrowers only need to register an online account, complete the application form, and upload relevant documents. After that, the lending transaction will be

⁸⁰ Wenzhou Private Financing Regulation (2014), Article 14(1).

⁸¹ Wenzhou Private Financing Regulation (2014), Article 14(4).

⁸² Wenzhou Private Financing Regulation (2014), Article 14(3).

⁸³ Wenzhou Private Financing Regulation Implementation Rules (2014), Article 13.

⁸⁴ Wenzhou Private Financing Regulation Implementation Rules (2014), Article 14.

verified and recorded by lending service centres. Clearly, the online reporting system is favourable to local businessmen, as more than 50 per cent of private loans related to project financing are recorded by the online system.⁸⁵

Incentives for compliance

The new regulation stipulates several incentives for lenders and borrowers to report their private loans. Generally speaking, it asks the local government to provide policy supports to those who are responsible for reporting.⁸⁶ It is evident that registering private loans with the authority is beneficial for both lenders and borrowers. For lenders, the registration material will be regarded as evidence with high probative force when courts and arbitration bodies within Zhejiang province are hearing cases relating to private lending.⁸⁷ Therefore, lenders are free from the burden of proof, which can protect their interests and rights significantly.

For borrowers, the registration of private loans exempts them from conducting illegal fundraising activities that are regarded as a severe criminal offence in China, because the regulator will admit the legitimacy of the private loans that have been reported. Moreover, the information recorded about loan performance can be used for the credit rating of the borrower, which will be shared by all financial institutions.⁸⁸ It can motivate borrowers to perform the duty of reporting, as the information accumulated in China's personal credit system enables them to have more access to the formal banking system in the future.

Legal liabilities

If anyone violates the WFPR, and the existing laws and administrative regulations already set out relevant legal liabilities, the existing rules shall be followed.⁸⁹ Therefore, borrowers should be aware of the existing administrative punishments and

⁸⁵ *Wenzhou Business Online*, "Outstanding Results for Wenzhou Private Financing Regulation" (5 March 2015), available at <http://finance.66wz.com/system/2015/03/05/104372334.shtml>, accessed 1 November 2016.

⁸⁶ Wenzhou Private Financing Regulation (2014), Article 15.

⁸⁷ Wenzhou Private Financing Regulation (2014), Article 17.

⁸⁸ Wenzhou Private Financing Regulation (2014), Article 18.

⁸⁹ Wenzhou Private Financing Regulation (2014), Article 40.

criminal offences and avoid activities such as illegally absorbing public deposits and fraudulent fundraising. The new regulation has already resulted in fines being imposed on those who fail to perform their reporting duties. If the borrower in a private lending agreement fails to fulfil the reporting obligation or provides false materials, the local financial authority will order the borrower to correct this within a specified time limit. If the borrower does not make corrections within that period, the private lending activity shall be publicised, and the borrower will be fined CNY 10,000-50,000 for an individual, or CNY 30,000-100,000 for a enterprise or other organisations.⁹⁰

5.5.3 Advantages and Disadvantages of WPFR

The WPFR has the following advantages. First of all, it clarifies the concept of private financing and private lending. The word “private financing”, despite its frequent use by the media and authority, has been a vague concept which could have various meanings in different situations. Therefore, a clear definition is necessary for the regulator to tell the difference between legitimate financial activities and other illegal practices. According to the WPFR, private financing comprises three financing practices: private lending, private placement bond, and private equity. In addition, private lending in the WPFR only encompasses lending and borrowing activities for the purpose of business financing, and thus ordinary lending agreements among friends and relatives will not be subject to the regulation. It can be demonstrated by the amount of money of a particular private loan that needs to be reported to the authority, as the WPFR requires people (who borrow more than CNY three million in a single loan, or borrow over CNY 10 million in multiple loans) to report the loan to the financial regulator. Apparently, such a large amount of money, in most cases, happens in the course of business financing.

Secondly, the WPFR invents a registration-based regulatory regime, in combination with positive and negative incentives. In the past, a major challenge for financial regulators has been how to monitor a private lending market which totally operates underground. Moneylending transactions are merely a contract entered by the lender and borrower, which makes it impossible for regulators to know the existence of such agreements, let alone the detail information of lending transactions. Things have

⁹⁰ Wenzhou Private Financing Regulation (2014), Article 41.

changed when the WPFR introduced an obligation for lending parties to report their loans to the authority, and accordingly, financial regulators have become able to monitor large-sum lending activities. In practice, lending parties have to submit personal information (Name, Gender, Marriage Status, ID Card Number, and Address) and loan information (Date of Borrowing, Amount, Interest Rate, Loan Term, Money Transfer Method, Guarantee Method, and Purpose of Using Loan) to the registration office, together with a copy of lending agreements, money transfer receipts, and personal identity materials.⁹¹ Clearly, having sufficient information of the market is the prerequisite for regulation. Moreover, the WPFR rewards people who comply with new rules, as well as punishes those who contravene the regulation. The benefits for registering loans include the exemption from illegal financing practices, improving credit rating for borrowers, as well as making the lending agreement an evidence without proof in a civil proceeding. Evidently, the carrot and stick approach supports the effective implementation of the regulation.

Thirdly, the WPFR enhances the safety of individual private lending transactions. The new regulation rectifies an article under *PRC Contract Law* which allows private lending between natural persons to be concluded with oral agreements. Therefore, now a private lending agreement (business financing) will only be effective if it is in the written form. Clearly, the new regulation to some extent improves the safety of moneylending activities since every details of private financing have to be written down. It not only protects lenders' legal rights of but also ensures borrowers' obligations not to be altered by lenders. Besides, the compulsory registration rule requires lending parties to file the loan with the authority, in exchange for official endorsement and legal protection. It greatly reduces transactional risks, for reported loans have to be compliant with regulatory rules and are under scrutiny of financial regulators.

Furthermore, the WPFR plays a vital role in eliminating systemic risks and promoting financial stability. It asks moneylenders to use self-owned capitals to make loans, which makes it illegal to finance loans from other investors and banks. During the

⁹¹ Wenzhou Private Lending Register & Record Management System, available at <http://220.191.206.27/>, accessed 20 December 2016.

private lending crisis, the “money pool” model accounted for the collapse of several large lending schemes and caused heavy losses for ordinary investors.⁹² The default of some borrowers could lead to moneylender’s defaults on their own investors, resulting in a series of credit crunch. Accordingly, the new regulation prohibits moneylenders from collecting money from the public or borrowing money from banks, which shortens credit chains in the market and thus reduces possible systemic crisis.

Apart from its advantages, the WPFR also reveals some weaknesses. For instance, it remains uncertain whether it is legal or reasonable to expose the privacy of lenders and borrowers to the authority. In the past, private lending, as a pure civil activity, has been conducted in a private way, but now lending parties are required to report their loans to the financial regulator. Some borrowers in Wenzhou complained that, “Moneylending is people’s privacy. Why shall I register with the authority?”⁹³ Therefore, the authority needs more justifications to impose an reporting obligation on citizens. Despite a rising number of registered lending activities, some people also expressed their concerns about paying extra taxes on their interest incomes.⁹⁴

5.5.4 Is WPFR A Good Model to Copy?

The Wenzhou Private Financing Regulation has been in effect for more than two years. As the first financial legislation regarding private financing in China, its birth has been perceived as an important breakthrough for the standardisation and legalisation of private lending activities. According to official data, during the first year of implementation from 03/2014-03/2015, there were 7,054 private loans in Wenzhou registered with the authority, with a combined value of CNY 9.88 billion (USD 1.44 billion).⁹⁵ On average, the amount of each loan was around CNY 1.4 million (USD 0.2 million), and the annualised interest rate was at 16.1 per cent. As of February 2016,

⁹² “Money pool” means professional lending agents or money lenders borrow money from a large number of investors or borrow bank loans, to fund their lending activities. After forming a money pool, they start to loan out the money.

⁹³ *China Economic Weekly*, “Wenzhou Financial Reform Face Challenges After Three Years: Private Lending Registration Difficult to Implement” (9 December 2014), available at <http://finance.jrj.com.cn/2014/12/09072418496533.shtml>, accessed 1 January 2017.

⁹⁴ *Ibid.*

⁹⁵ *Wenzhou Business Online*, “Outstanding results for Wenzhou Private Financing Regulation” (5 March 2015), available at <http://finance.66wz.com/system/2015/03/05/104372334.shtml>, accessed 1 November 2016.

the total amount of private loans registered was around CNY 30 billion (USD 4.37 billion), accounting for 40 per cent of all private financing activities in Wenzhou.⁹⁶ In addition, in order to facilitate and regulate moneylending activities, the municipal government has established 7 private lending service centres, 5 independent registration centres, and a wealth management centre so far.⁹⁷

Currently, registering private loans with the regulator becomes an indispensable step in the entire lending procedure, which has been gradually turning private lending in Wenzhou from underground to the mainstream. The implementation result of WPFR is generally considered satisfactory. It largely increased the transparency of the opaque lending industry and helped thousands of local businesses to borrow credits under the official supervision. With the assistance of lending service centres, private financing is no longer limited to members of a particular business community, as any individuals and corporates in Wenzhou can lend or borrow money via lending centres' online system and extensive networks. Moreover, according to Wenzhou Intermediate People's Court, the implementation of the regulation had a positive impact on reducing private lending disputes, as the court system in Wenzhou received 15,009 cases regarding private lending in 2014, which saw a year-on-year reduction of 9.81 per cent.⁹⁸ Therefore, it is clear that the implementation of WPFR relieves the heavy burden over China's judicial system. Due to the limited data available, it is impossible at the moment for the author to conduct a cost-benefit analysis to examine detail costs, benefits, and effectiveness regarding the WZPF, so the job is to be done by future research.

As the Wenzhou reform proved a success in regulating the private lending market, more than 15 Chinese provinces including Guangdong, Shandong, Hunan, Sichuan, and Guizhou, have been trying to learn from Wenzhou and set up 77 lending service

⁹⁶ Zhejiang Daily, "Financial reforms 4 years on, 'Wenzhou experience' eye-catching" (21 April 2016), available at <http://www.wzxc.gov.cn/system/2016/04/21/012330066.shtml>, accessed 1 November 2016.

⁹⁷ *Ibid.*

⁹⁸ *Xinhua*, "Compulsory Registration Improved Personal Credits, 15 Provinces Copied Wenzhou Experience" (22 March 2015), available at http://news.xinhuanet.com/fortune/2015-03/22/c_1114719233.htm, accessed 1 November 2016.

centres across the country to test the registration-based regulatory system.⁹⁹ Clearly, the Wenzhou model is being copied by local financial authorities across China. As the explorer or the first “point” in the new round of financial reform, Wenzhou’s valuable experience are extended beyond the city, which proves the effectiveness of “point to surface” reform approach.

5.6 Wenzhou Private Financing Index

5.6.1 What is Wenzhou index?

Apart from implementing the WPFR, the Wenzhou municipal government has launched the “Wenzhou Private Financing Index” (the Wenzhou Index), to track the interest rate levels of private financing activities in the city.¹⁰⁰ The Wenzhou index has been compiled by Wenzhou Financial Affairs Office, and it is constructed with rigorous statistical methods to reflect the level, tendency, and fluctuation of the price of private financing. Clearly, the compilation and release of the index is a key step in the experimental financial reform. Wenzhou index has become an important indicator for the regional lending market, which improves the transparency of transactions and increases the efficiency of the allocation of financial resources.

Currently, the index has a local version for the Wenzhou city as well as a national version for the whole country. The local version, called “Wenzhou Private Financing Comprehensive Index”, was officially released on 7 December 2012, and the Index has been updated on a daily basis since 1 January 2013.¹⁰¹ The national version of Wenzhou Index, called “China Private Financing Comprehensive Index”, has been compiled and circulated since 26 September 2013, the data of which come from monitoring points in over 40 Chinese cities.¹⁰² Unlike the local version, it is only published on a weekly base. The Wenzhou Index is further divided into several sub

⁹⁹ *Ibid.*

¹⁰⁰ See Wenzhou Private Financing Index official website, “*About Wenzhou Index*”, available at <http://wzpfj.gov.cn/About.aspx>, accessed 1 November 2016.

¹⁰¹ *Reuters*, “China’s Wenzhou Launches Private Lending Index” (7 December 2012), available at <http://www.reuters.com/article/2012/12/08/china-wenzhou-shadowbanking-idUSL4N09I0G920121208>, accessed 1 November 2016.

¹⁰² Wenzhou Municipal Government, “The Launch of the National Version of Wenzhou Index Takes the Lead in Wenzhou’s Financial Reform”. 9 October 2013, http://english.wenzhou.gov.cn/art/2013/10/9/art_12644_285017.html, accessed 1 May 2015.

index based on different financing entities and various time periods. As for different financing entities, it is made into 6 categories: rural rotating savings and credit associations (ROSCAs) index, private lending service centre index, private capital management company index, small-credit company index, direct private lending index, and other entities index. In terms of financing periods, the Wenzhou index is presented in 6 categories including 1 month, 3 months, 6 months, 12 months, and over 12 months.

Wenzhou Private Lending Comprehensive Interest Index (annualised interest rate in percentage)						15.62
Divided by entity	Private lending service centres	Small-credit companies	Private capital management companies	Direct lending	Other entities	Rural ROSCAs
	15.52	15.44	14.40	13.40	25.88	11.88
Divided by time	1 Month	3 Months	6 Months	1 Year	More than 1 year	
	24.63	16.48	14.91	12.00	13.03	

Table 11: Wenzhou Index (15 December 2016)¹⁰³

5.6.2 Data Collection of Wenzhou Index

The Wenzhou Financial Affairs Office relies on a large number of data samples to improve the validity and accuracy of the Index. The local version is based on data collected from nearly 400 monitoring sites across the city, including private lending service centres, asset management companies, microcredit companies, rural mutual financial cooperatives, some private businesses, pawnshops and credit guarantee companies.¹⁰⁴ Clearly, it covers various forms of private financing practices outside the formal banking sector. On average, approximately 300 samples of real transactions are being collected each weekday, to ensure a relatively high level of authenticity and timeliness. The data, after being verified by the financial regulator, will be employed to produce the index under a specially designed weighting algorithm.¹⁰⁵ Similarly, the compilation of national version is based on data collected from 200 monitoring sites across China, which include local financial offices, branches of Wenzhou chamber of commerce, rural banks, as well as P2P lending platforms. All data will be sent back to

¹⁰³ Data Source: Wenzhou Private Financing Index Official Website, <http://www.wzpf.gov.cn>, accessed 15 December 2016.

¹⁰⁴ For a full list of monitoring sites in Wenzhou city, see <http://www.wzpf.gov.cn/Local.aspx>, accessed 1 January 2017.

¹⁰⁵ The samples are calculated by the weighting scheme called “Delphi Method”, see <http://www.wzpf.gov.cn/About.aspx>, accessed 1 January 2017.

Wenzhou on a weekly base, and made into the Index by Wenzhou Financial Authority using the same algorithm.

5.6.3 The Application of Wenzhou Index

In practice, the Wenzhou Index has been used by a number of stakeholders, including lenders and borrowers who are market participants, financial regulators, the judicial authority, and research institutes. The Index plays an important and indispensable role in providing a guidance for the pricing of private financing activities. Nowadays, an increasing number of lenders and borrowers will check the Index before they entering into a lending agreement.¹⁰⁶ In the past, the price of borrowing was mainly determined by lenders who often charged excessive interests, in order to compensate potential risks of defaults and seek extra profits. Without an indicator like Wenzhou Index, the interest rate level varied significantly in different lending agreements, leading to an inconsistent marketplace. After the Wenzhou Index came into use, it has become a barometer for all participants in the market, as lenders can refer to the Index to set the interest rate when making loans, and borrowers are able to rely on it to assess whether they are being overly charged or not. Clearly, the Wenzhou Index contributes to a more transparent and fairer market. It also reduces the inconsistency in different transactions, making transactions more efficient. In 2015, Wenzhou government held an annual conference for Wenzhou Index and invited officials in charge of financial affair offices from 40 Chinese cities to discuss the Index's function and effectiveness.¹⁰⁷ Most of them agreed that the Index plays an active part in curbing excessive interest rates of private lending.

Moreover, the Wenzhou Index provides essential data for financial regulation. As the pilot financial reform deepens, how to effectively regulate shadowy lending practices remains an important task for Wenzhou's authorities. The data of Wenzhou index come from hundreds of monitoring sites ranging from lending service centres to micro-credit companies, reflecting the real situation of the supply and demand of money in

¹⁰⁶ Junjie Zheng, "More Than 40 Cities Added to Wenzhou Index with Increasing Influence" *Wenzhou Daily* (9 January 2015), available at <http://news.66wz.com/system/2015/01/09/104324295.shtml>, accessed 1 January 2017.

¹⁰⁷ *People*, "The Information Collecting Points of the Wenzhou Index Exceeds 40 Cities as Its Influence Expands" (9 January 2015), available at <http://wz.people.com.cn/finance/n/2015/0109/c217709-23493944.html>, accessed 1 November 2016.

the lending market. Thus, it enables financial regulators to know what happens in the market and identify potential risks. The interest rate data reveals the liquidity situation of the economy, providing useful information for the central bank to make relevant monetary policies.

Finally, the Wenzhou Index is helpful for judges hearing civil cases regarding private lending disputes. Private lending has been in a grey area for a long time, and aside from the official interest rate ceiling, civil courts lack an authoritative reference to evaluate interest rates in a certain private loan agreement. The Wenzhou Index, therefore, fills the gap by serving as a standard for judges to make judgements and issue executive orders. Moreover, if the interest rate is not clearly stated in a contract, lenders shall be allowed to claim interests based on the Index. Zhang Zhenyu, director of Wenzhou Financial Affairs Office, stressed the importance of Wenzhou Index in the judicial practice, “Wenzhou Index is becoming an essential reference for law courts when they handle private lending-related cases.”¹⁰⁸

5.6.4 The Significance of Wenzhou Index

Wenzhou Index is considered as a barometer for observing the operation and development of China’s private financing market, which is a milestone in the latest financial reform. Its wide coverage, high accuracy, and timeliness benefits most participants by offering an effective reference in terms of interest rate pricing. The data have been used by various stakeholders including lenders and borrowers, financial regulators, and courts, which demonstrates its practicability and popularity. It leads to the improvement of transparency in the private lending market, and accordingly lowers the lending costs for Chinese entrepreneurs. Besides, the publication of Wenzhou Index also enhances the city’s status as the centre of private entrepreneurship in China.

5.7 Liberalising the Banking Industry

The insufficient credit provision from the banking sector has been a main reason for causing the financing difficulties of private businesses in China. State-owned lenders

¹⁰⁸ *People*, “The Information Collecting Points of the Wenzhou Index Exceeds 40 Cities as Its Influence Expands” (9 January 2015), available at <http://wz.people.com.cn/finance/n/2015/0109/c217709-23493944.html>, accessed 1 November 2016.

lend out most of their money to other state-owned enterprises, which forces entrepreneurs to seek alternative finance outside the banking sector. Therefore, apart from regulating private loans, the second step to solve the private financing puzzle has something to do with reforming China's banking sector. At present, it seems necessary and urgent for the authority to open up its banking sector to private capitals, in order to establish more privately funded banks that really serve the financing needs of businesses. The financial liberalisation can, to a large extent, break the state monopoly, increase the competition, and provide more credits for SMEs. In doing so, China can have an efficient banking industry and reduce its reliance on informal financing channels.

5.7.1 The Official Decision to Open Up the Banking Sector

In order to mitigate the financial difficulty faced by SMEs, as well as to end the state monopoly in the banking sector, the Chinese government has launched a new round of financial reforms targeting its banking industry, which began in 2013.¹⁰⁹ In November 2013, the ruling Communist Party held an important meeting, the third plenary session of the party's 18th central committee meeting, where it passed a resolution to strengthen social and economic reforms.¹¹⁰ As one of a dozen reform tasks, it asked the current government to allow qualified private capitals to set up new banks. As a result, in 2014 the Chinese government initiated a pilot project to establish five new banks owned entirely by private investors in Shanghai, Tianjin, Zhejiang, and Guangdong.¹¹¹ In the past, the only privately owned banks used to be China Minsheng Banking Corporation, as the majority of Chinese banks enjoy certain kinds of government backgrounds. Therefore, introducing more private banks can, to a certain degree, breakup the monopoly of state-funded lenders.

Following the Party's initiative, in the government working report 2015, the current Prime Minister, Mr. Li Keqiang, promised to move ahead with financial reforms,

¹⁰⁹ Lerong Lu, "Private Banks in China: Origin, Challenges and Regulatory Implications" (2016) 31(3) *Banking and Finance Law Review* 585, 591.

¹¹⁰ Tom Mitchell, "Xi Manifesto Raises Hopes for Decade of Radical Change" *Financial Times* (16 November 2013), p.3.

¹¹¹ Jamil Anderlini, "China Pilots Project to Launch Five Private Banks" *Financial Times* (12 March 2014), p.12.

stating “We will encourage qualified private investors to establish, in accordance with the law, small and medium-sized banks and other financial institutions; there will be no quota imposed on them, and approval will be granted as long as all required conditions are met.”¹¹² Clearly, the PM’s words demonstrated the government’s determination to boost private banks and to inject more liquidity into China’s private economy.

5.7.2 Case Study: The First Group of Private Banks

The strong state support has led to the emergence and proliferation of private banks in China. In 2015, the first five pilot banks obtained banking licences and opened for business. Moreover, more than ten proposed banks are waiting for the approval from China Banking Regulatory Commission. Here we will take a closer look at the first group of private banks established recently.

In January 2015, the opening of the WeBank attracted a lot of media attentions.¹¹³ WeBank is a joint venture launched by Tencent, China’s internet giant which takes up 30 per cent of the new bank’s stake.¹¹⁴ WeBank was named after Tencent’s star product WeChat, a popular messaging app on Android and Apple smartphones. The registered capital of WeBank is CNY 3 billion (USD 437 million).¹¹⁵ To many people’s surprise, the first privately-owned bank launched this year is an online-only bank with no brick-and-mortar presence. The business model of WeBank is similar to that of the Ally Bank in the United States or the Atom Bank in the United Kingdom, which do not have physical branches and can only be accessed via their websites or through mobile apps.¹¹⁶ WeBank mainly targets Internet users, most of whom are personal consumers or small businesses that are not eligible for traditional bank loans. The operation of this kind of high-tech bank depends on the latest information technologies like face

¹¹² Li Keqiang, “Government Work Report 2015” *National People’s Congress* (5 March 2015).

¹¹³ Gabriel Wildau, “China’s First Online-only Lender Launched” *Financial Times* (06 January 2015), p.16.

¹¹⁴ *South China Morning Post*, “Tencent Ready to Launch China’s First Private Internet Bank, WeBank” (29 December 2014), available at <http://www.scmp.com/news/china-insider/article/1670474/tencent-ready-launch-chinas-first-private-internet-bank-webank>, accessed 1 November 2016.

¹¹⁵ *Ibid.*

¹¹⁶ *BBC News*, “Banking On It: Taking Your Money Off the High Street” (6 March 2015), available at <http://www.bbc.co.uk/news/business-31735979>, accessed 1 November 2016.

recognition and big data, which allows the lender to carry out credit rating and identity verification online. PM Li Keqiang was invited to Shenzhen city, a Special Economic Zone in China where Tencent Group is based, to make a keynote speech for WeBank's opening ceremony.¹¹⁷ He expressed Chinese government's resolution to accelerate the banking reform in order to bring real benefits for SMEs and the Chinese economy. During his speech, Mr. Li praised the WeBank for pushing forward the current reform, stating "It's one small step for WeBank, one giant step for financial reform."¹¹⁸

Following the WeBank, Shanghai Huarui Bank was the second privately funded bank that opened for business this year. This bank was registered in the Shanghai Free-Trade Zone, which is another pilot project in China, with CNY 3 billion (USD 437 million) worth of capital. According to the Shanghai office of CBRC, Huarui Bank is able to conduct a full range of banking services including deposits, lending, bankcards, foreign exchange and bonds.¹¹⁹ The new lender's main promoters are two private conglomerates, the cloth-making giant Metersbonwe and the Junyao Group, who own 15 per cent and 30 per cent of the new lender's shares, respectively.¹²⁰ The target clients of Huarui Bank are mostly SMEs within the free-trade zone, so the proposed banking service is mainly for the purpose of trade financing.

Wenzhou Minshang Bank is the third privately-owned commercial bank to start operation in 2015, with a registered capital of CNY 2 billion (USD 291 million).¹²¹ The city of Wenzhou has been perceived as the entrepreneurship hub in China, as it has an extremely prosperous private economy, but the local state-owned banks have never been able to satisfy the financing needs of its booming private businesses. Therefore, when Wenzhou's entrepreneurs have to raise funds, they often borrow money from local moneylenders at an expensive cost. As a result, the launch of the Minshang Bank was warmly welcomed by the local business community as the bank

¹¹⁷ Gabriel Wildau, "China's First Online-only Lender Launched" *Financial Times* (06 January 2015), p.16.

¹¹⁸ *Ibid.*

¹¹⁹ Feng Jianmin, "Shanghai's 1st Private Bank Starts" *Shanghai Daily* (29 January 2015), A10.

¹²⁰ *Ibid.*

¹²¹ *Xinhua*, "Wenzhou Minshang Bank Officially Opened" (26 March 2015), available at http://news.xinhuanet.com/fortune/2015-03/26/c_1114773816.htm, accessed 1 November 2016.

mainly provides financial services for SMEs in Wenzhou, a market that is heavily underserved by state-owned lenders. Besides, the launch of Wenzhou Minshang Bank was considered as an important achievement in the city's pilot financial reform.¹²²

The fourth private lender established this year is called the Tianjin KinCheng Bank. Similarly to Shanghai Huarui Bank, the Tianjin KinCheng Bank was introduced in the newly-founded Tianjin Free-Trade Zone.¹²³ It has raised capital of CNY 3 billion (USD 437 million) from 16 private enterprises. The Huabei Group and Tianjin Maigou Group, two largest shareholders of KinCheng, hold 20 per cent and 18 per cent of its stake respectively.¹²⁴ The Tianjin KinCheng Bank offers comprehensive financial services for the local region, with a special focus on corporate banking for SMEs and micro companies. It will not only facilitate the establishment of the latest Tianjin Free-Trade Zone, but will also widely serve clients from the Beijing-Tianjin-Hebei area, the largest economic and urban area in the North China.

The fifth pilot bank coming this year is Mybank. It is set up as an online-only bank similarly to WeBank, and its main shareholder is Alibaba, an E-commerce giant. Mybank received the approval from the CBRC to start operating in June 2015, with registered capital of CNY 4 billion (USD 582 million).¹²⁵ The Ant Financial, the financial unit of the Alibaba group, holds a 30 percent stake in Mybank, and the Fosun International Ltd and Wanxiang Group will hold 25 percent and 18 percent stakes in the new lender, respectively. Yu Shengfa, the head of Mybank, told the Reuters: "Mybank is an important milestone for Ant Financial's development to provide financial services for small and micro enterprises and individuals."¹²⁶

¹²² See Wenzhou Minshang Bank, <http://www.ms-bank.cn/about.aspx?tid=3>, accessed 1 November 2016.

¹²³ *China Daily*, "KinCheng Bank Eyes Corporate Banking with Focus on Capital Region" (28 April 2015) available at http://www.chinadaily.com.cn/business/2015-04/28/content_20563097.htm, accessed 1 November 2016.

¹²⁴ *Ibid.*

¹²⁵ *Reuters*, "Alibaba-Affiliated Online Bank Get Green Light from China Regulator" (27 May 2015), available at <http://www.reuters.com/article/us-alibaba-bank-idUSKBN0OC0SI20150527>, accessed 1 November 2016.

¹²⁶ *Ibid.*

5.7.3 Functions and Limitations of Private Banks

Being challengers to state-owned lenders, the first group of privately-owned banks have witnessed a rapid growth in the past two years. According to the CBRC, the total assets of the five newcomers reached CNY 133 billion (USD 19.4 billion) as of September 2016.¹²⁷ Nonetheless, they only represented a very small proportion of assets of CNY 168.3 trillion (USD 24.5 trillion) possessed by all commercial banks in China. It is clear that the business scope of these new lenders focus on servicing the financing needs of SME and rural borrowers, which can to some extent improve the financial situation of China's private businesses. The data also showed that the five private banks had a bad-loan ratio of merely 0.54 per cent, which was much lower than the industrywide rate of 1.76 per cent.¹²⁸ It demonstrates the relatively good level of businesses operation and risk control in new lenders.

Generally speaking, the first five pilot banks have been running smoothly so far. However, here we will evaluate some of potential challenges facing the novices in China's banking sector.¹²⁹ First of all, in terms of size, the five new banks are much smaller compared to the dominant state-owned banks. Most of these new lenders have only opened one or two branches, not to mention WeBank and MyBank, which do not have physical branches at all. In contrast, ICBC, the largest lender in China, has an extensive network consisting of more than 17,000 domestic branches, as well as 338 overseas branches or offices in 41 countries.¹³⁰ In terms of registered capital, MyBank has CNY 4 billion, each of WeBank, Shanghai Huarui Bank and Tianjin Kincheng Bank has CNY 3 billion, and Wenzhou Minshang Bank only has CNY 2 billion. At present, the capital adequacy requirement in China is 8 per cent, which means that they can only receive limited deposits according to the capital restriction. Due to the fact that they have limited capital and a limited number of branches, if any, the lending

¹²⁷ Chuin-Wei Yap, "China's Small Private Banks Find It Tough to Navigate Land of Lending Giants", *Wall Street Journal* (13 December 2016), available at <http://www.wsj.com/articles/chinas-small-private-banks-find-it-tough-to-navigate-land-of-lending-giants-1481630393>, accessed 15 December 2016.

¹²⁸ *Ibid.*

¹²⁹ Lerong Lu, "Private Banks in China: Origin, Challenges and Regulatory Implications" (2016) 31(3) *Banking and Finance Law Review* 585, 594.

¹³⁰ ICBC, "ICBC 2014 Business Overview", available at <http://www.icbc-ltd.com/ICBCLtd/About%20Us/Introduction/>, accessed 15 December 2016.

abilities of the new banks could be unsustainable.

Second, in recent years, China's banking sector has been facing shrinking profit margins due to growing internal and external competition. The latest data show that since the beginning of 2015, Chinese banks have witnessed the slowest profit growth rates in 12 years, and the growth could become even weaker in the second half of 2015.¹³¹ As China is carrying out interest rate liberalisation, the competition among existing lenders has greatly intensified. For a long time, the deposit and lending rates in China had been set by the People's Bank of China, but now it is going to let Chinese banks determine their own pricing of borrowing and lending.¹³² The PBOC already removed the restriction of lending rate, and has been trying to abolish the cap on deposit rate as well. In May 2015, when the PBOC cut the benchmark interest rate, it also expanded the deposit-rate ceiling from 130 per cent to 150 per cent of the benchmark.¹³³ As a result, many Chinese lenders chose to raise deposit rates to solicit depositors, which greatly squeezed their profit margins.¹³⁴

Furthermore, Chinese banks also encounter fresh competition coming from outside of the banking industry, such as an increasing number of internet-based financial service providers, who offer attractive returns for savers, and as a result have captured billions of yuan from the banks in respect to deposits. For instance, Alibaba's Yuebao (or "leftover treasure"), an online investment product based on money market funds, has become a popular alternative to bank deposits in China.¹³⁵ The clients of Yuebao not only enjoy the great liquidity as they can withdraw the fund at any time or use it to pay for any purchases on Alibaba's shopping platforms, but also receive an eye-catching annualised return of nearly 5 per cent, paid on a daily basis. In short, Yuebao is an E-

¹³¹ Ed Zhang, "Days of High Profit Growth Are Over" *China Daily (Europe)* (1 May 2015), p.13.

¹³² Chi Lo, "Here's What Interest Rate Liberalisation Means for China" *South China Morning Post* (9 November 2015), available at <http://www.scmp.com/business/banking-finance/article/1877144/heres-what-interest-rate-liberalisation-means-china>, accessed 15 December 2016.

¹³³ Patti Waldmeir, "China Cuts Rates for Third Time in Six Months" *Financial Times* (10 May 2015), available at <https://www.ft.com/content/f69e895c-f6fc-11e4-a9c0-00144feab7de>, accessed 1 January 2017.

¹³⁴ Gabriel Wildau, "China Lenders' Quarterly Earnings Squeezed by Rising Bad Loans and Reduced Interest Margins" *Financial Times* (2 November 2015), p.17.

¹³⁵ Simon Rabinovitch, "Alibaba's Treasure Draws in Depositors" *Financial Times* (21 December 2013), p.14.

wallet that can make money for you, so it becomes particularly popular among the young Chinese population most of whom put their money into it immediately after they receive salaries. It has already served 149 million users, and poses a big challenge for traditional lenders. Accordingly, as the competition increases for Chinese banks to maintain their clients, it does not seem as the right time for new banks to be entering the industry.

Third, the business scope of the newly established banks is considered fairly limited. As we can see, they operate in a very different way than existing lenders do. For example, WeBank and Mybank are online financial platforms that provide banking services for Internet users who would like to invest or borrow small amounts of money. As for Huarui Bank, Minshang Bank and Kincheng Bank, their business operation is confined to certain regions. Minshang Bank is said to serve small business clients in Wenzhou, while Huarui and Kincheng banks mainly offer loans to trade-related SMEs in the Free Trade Zones. Accordingly, it might take a long time for them to develop into large banking groups, in order to compete with the Big Four and other national banks. It is also clear that the priority of these new lenders is to satisfy the financing need of small businesses and personal consumers who have restricted access to the formal banking sector. Therefore, it is evident that the purpose of establishing the privately-funded commercial banks is to fill the niche in China's credit system and to supplement mainstream lenders.

The final concern for private banks is the lack of qualified professionals. Although promoters of the new banks are successful private conglomerates in their respective industries, they do not have any previous experience in running a bank. To make up for this disadvantage, they must currently recruit experienced bankers from state-owned lenders. For example, the Chairman of KinCheng Bank, Mr. Gao Degao, was the former head of the Tianjin Branch of CCB, China's second largest lender, and KinCheng's President, Mr. Wu Xiaoping, used to be a senior banker at the Shanghai division of CITIC Bank, a medium-sized national bank.¹³⁶ Similarly, the President of WeBank, Mr. Cao Tong, served as the Vice President for the Export and Import Bank

¹³⁶ *Hexun*, "Gao Degao and Wu Xiaoping Elected as Kincheng Bank's Chairman and President" (13 February 2015), available at <http://bank.hexun.com/2015-02-13/173352824.html>, accessed 15 December 2016.

of China, a policy bank. At the moment, as newly founded banks rely heavily on the supply of qualified bankers from established lenders, they need more time to cultivate their own management teams and improve corporate governance.

5.7.4 Regulatory Responses: Deposit Insurance and Interest Rate Deregulation

Generally speaking, the newly launched private banks are subject to the same regulatory requirements as any existing banks have to be, despite their differences mentioned above. In early 2015, China Banking Regulatory Commission reshaped its institutional structure and established a new department which is responsible for the supervision of private banks, city commercial banks, and city credit cooperatives.¹³⁷ Therefore, these privately-owned banks are formally incorporated into the existing banking regulatory framework.

It should be noted that the main regulatory concern is in respect of the innovative online-only banks, including Webank and Mybank. In contrast to traditional lenders, they have a distinctive business model, based on latest information technologies such as big data and cloud computing systems, which could raise certain regulatory problems. For instance, as Webank and Mybank do not have real branches, opening account and all transactions including extending loans will be done online, so the verification of users' identification remains both a technical and a legal question. Presently, WeBank is developing a complex facial recognition system to perform the identification verification, which will be incorporated with national citizen identity card query service centre (which is affiliated to PRC Ministry of Public Security), so that it can accurately identify users online by cross examining the users' online video photo from webcams, the photo on their identity cards, and other biological information provided by the query service centre, which is said to have the highest level of security.¹³⁸ However, under the current Chinese regulation, customers have to go to a bank branch to complete identity check in person if they would like to borrow a loan, so whether the new identity recognition system can replace the in-person check

¹³⁷ CBRC, "CBRC Regulatory Structure Reform" (20 January 2015), available at <http://www.cbrc.gov.cn/chinese/home/docView/67163D0D8293499BA499D2A9705C61CD.html>, accessed 15 December 2016.

¹³⁸ *Xinhua*, "Tencent's Facial Recognition Technology Development Will Be Applied in Webank for Opening Bank Account" (15 April 2015).

requirement remains to be seen.

China's Latest Deposit Insurance Scheme

As the competition increases rapidly in the banking industry, potential bank insolvency becomes possible. In fact, most Chinese savers hold a strong belief that banks will never fail since Chinese banks are mostly regarded as public agents backed by the government, so there has been an implicit guarantee that the state will bail out any banks enduring financial troubles. Indeed, China's banking sector could hardly be more stable as it has been 16 years since the last bank run.¹³⁹ Like elsewhere in the world, depositors consider the money they have deposited in a bank as "their money" being held and looked after by the bank, despite the actual legal relationship of bank and customer as debtor and creditor.¹⁴⁰ However, currently as the Chinese banking industry is moving towards an more open and competitive marketplace, which features the survival of the fittest, some protective mechanisms are urgently needed to enhance financial stability and protect consumers. Currently, China already has the People's Bank of China acting as the lender of last resort to provide liquidity supports for banks in financial distress, and it has implemented the Basel Capital Accord III to promote the solvency of Chinese banks, which are two pillars of a country's financial safety net.¹⁴¹ Therefore, the only missing thing in its financial infrastructures is a deposit insurance system, to protect depositors' money and increase their confidence in the system. As the authority is no longer aiming for the zero failure in its banking sector, it is necessary for a country to add extra protection for savers in the event of bank failures.¹⁴²

In fact, since 1993 China has been debating whether to introduce deposit insurance, but it had never been such an urgent issue until the recent establishment of privately owned banks. As a result, its state council passed the Deposit Insurance Regulation on

¹³⁹ *The Economist*, "Deposit Insurance in China: A Premium for Risk" (December 2014), p.82.

¹⁴⁰ Andrew Campbell et al., "A New Standard for Deposit Insurance and Government Guarantees After the Crisis" (2009) 17(3) *Journal of Financial Regulation and Compliance* 210, 212.

¹⁴¹ Simon Rabinovitch, "Beijing Sets Timetable for Basel Rules", *Financial Times* (8 December 2012), p.10.

¹⁴² Andrew Campbell, "Protecting Bank Depositors: Some International Comparisons" (2004) 7(2) *Contemporary Issues in Law* 140, 141.

29 October 2014, which came into effect on 1 May 2015.¹⁴³ It marked the formal launch of a deposit insurance scheme in China, covering savings in all deposit-taking institutions whether they are state-owned lenders or privately funded ones. There is no doubt that the latest deposit insurance can improve the market discipline to some extent, as more people will now be willing to put their money in smaller banks which can offer better rates, as long as their savings are protected by the state. In terms of the coverage, the new scheme will insure deposits of up to CNY 500,000 (USD 72,792) per saver per bank.¹⁴⁴ It is said to cover around 98 per cent of all deposit accounts in China's commercial banks, and the level of protection will be adjusted according to the economic development.¹⁴⁵ Moreover, the latest scheme is funded on an *ex ante* basis, namely, all deposit-taking institutions shall pay premiums to the insurer before the potential crisis happens, every 6 months, and the premium will be calculated on a risk-based standard.¹⁴⁶

Interest Rate Deregulation

In the past, China implemented a benchmark interest rate policy for its commercial banks for more than two decades, which means the People's Bank of China prescribed a set of benchmark lending and deposit rates that shall be strictly followed by all Chinese lenders. Under the benchmark mechanism, the margin between deposit and lending rate, which directly links to the profit level of Chinese banks, was artificially fixed by the central bank. As a result, massive profits are guaranteed for the state-dominated banking sector, as their combined profits equalled nearly three per cent of China's economic outputs.¹⁴⁷ Due to governments' tightly control (or we can say protection) over Chinese lenders, they enjoy excessive profits and lack incentives to compete with each other, failing to develop the range of financial products their customers actually want.¹⁴⁸ Therefore, the deregulation of banking interest rates is

¹⁴³ Wei Shen, "Is China's New Deposit Insurance Scheme a Panacea? And Why Now? A functional analysis" (2016) 31(2) *Journal of International Banking Law and Regulation* 80, 80.

¹⁴⁴ PRC Deposit Insurance Regulation 2014, Article 5.

¹⁴⁵ Gabriel Wildau, "China to Launch Insurance for Bank Deposits" *Financial Times* (29 November 2014), p.4.

¹⁴⁶ PRC Deposit Insurance Regulation 2014, Article 9 and 10.

¹⁴⁷ *The Economist*, "China's Big Banks: Giant Reality-Check" (31 August 2013).

¹⁴⁸ *The Economist*, "Bank Regulation in China: Letting Go" (31 October 2015), p.69.

considered a main task in China's financial reform, which aims to allow lenders and borrowers to determine the price of credits, spurring competition and increasing market efficiency. It also echoes the general objective of China's market-oriented economic reform, namely, let the market, rather than the state, play a decisive role in the national economy.

China's policymaker has adopted a gradual approach to liberalise interest rates, in order to minimise potential disruptions to the financial stability.¹⁴⁹ The reform began in 1996, when it removed all restrictions over interbank lending interest rates. In terms of the retail market, banks have been allowed to float lending and deposit rates within a pre-determined range set by the PBOC in recent years. In October 2004, the central bank started to grant banks some powers in setting the loan rate, which is allowed to float up to 10 per cent below the benchmark. In 2012, the floating range of lending rate was raised twice from 10 per cent to 20 per cent, and then to 30 per cent. In July 2013, the floor of lending rate was officially removed by the PBOC, marking the full liberalisation of loan pricing.¹⁵⁰ As for the deposit rate, in June 2012, the central started to allow banks to receive deposits at a rate up to 10 per cent over the benchmark. In November 2014, the flexible range was doubled to 20 per cent by the authority. In March and May 2015 respectively, the upper limit was expanded to 30 per cent over the benchmark, and then to 50 per cent.¹⁵¹ In August 2015, the ceiling for all fix-term savings (over one year) was abolished, whilst other saving rates were still subject to a cap of 50 per cent above the benchmark rate. Finally, in October 2015, the PBOC announced the removal of all resections over deposit rates, completing the whole process of interest liberalisation.¹⁵²

The deregulation of interest rate encourages the competition in China's banking sector, as an increasing number of lenders, especially the new privately owned banks, can

¹⁴⁹ Federal Reserve Bank of San Francisco, "China's Interest Rate Liberalization Reform", *Asia Focus* (May 2014), available at www.frbsf.org/banking/files/Asia-Focus-China-Interest-Rate-Liberalization.pdf, accessed 20 December 2016.

¹⁵⁰ *The Economist*, "Interest Rates in China: A Small Step Forward" (27 July 2013), p.61.

¹⁵¹ Grace Zhu, "Interest Rate Liberalization - With Chinese Characteristics", *The Wall Street Journal* (18 May 2015), available at <http://blogs.wsj.com/chinarealtime/2015/05/18/interest-rate-liberalization-with-chinese-characteristics/>, accessed 20 December 2016.

¹⁵² *The Economist*, "Bank Regulation in China: Letting Go" (31 October 2015), p.69.

raise the deposit rate to attract savers and lower the lending rate to solicit borrowers. Clearly, it also brings benefits for private businesses in China, as a result of more available credits and reduced borrowing costs. Furthermore, in the private lending market, the Wenzhou Index, at the same time, can also be seen as a way of exploring interest rate deregulation, as it represents lending rates wholly determined by lenders and borrowers in the informal market without government intervention. The interest rate level of private financing shows the supply and demand of credits outside the banking sector. Therefore, China has witnessed interest rate liberalisation in both its banking sector and private lending market, contributing to a more market-driven and effective financial system.

5.8 Conclusion

This chapter has investigated China's recent financial reforms to observe, to what extent, the latest reform measures can effectively regulate private lending activities and provide more credits for private businesses. The author argues that in order to solve the private lending puzzle, the authorities shall achieve two main tasks: first, to design a regulatory system for monitoring and supervising the underground lending industry; second, to introduce more privately funded banks as to break the state monopoly in the banking sector and serve SME borrowers. Both reform measures share the same aim to create a multi-level and diversified financing system, under the official supervision, for private businesses.

In terms of regulating private lending activities, the rationales are self-evident. Putting the private lending market under official controls can prevent market failures and protect all market participants, and therefore serves the interests of the public. As it is shown during the private lending crisis, an unregulated lending sector caused harms to both lenders and borrowers, as well as triggered systemic risks, financial instabilities, and social unrests. Moreover, a new regulatory system is urgently needed because the private lending market has become a vital element of China's financial system, in terms of its size and significant influence. An effective *ex ante* regulatory system is able to tackle technical problems such as information asymmetry, as well as reduces the workloads of Chinese courts which are stuffed with private lending disputes. Due to the enormous volume and the increasing sophistication of private financing

activities, substantive laws alone are not adequate to regulate such lending practices, which calls for extra regulatory rules and a specialised regulator with clarified mandates.

Moreover, the chapter has examined the Wenzhou Private Financing Regulation and the Wenzhou Index, two outstanding achievements of the recent financial experiments. This time, China still sticks to the gradual reform methodology to carry out trials, and has selected Wenzhou as the pilot reform area. The Wenzhou reform intends to create more financing channels for local SMEs as well as to turn the underground lending market into an officially regulated one. The WPFR proposed to establish a number of lending service centres to facilitate private lending transactions, as well as set up a registration-based regulatory system for private loans. So far, the implementation results have been considered as satisfactory, as more and more lenders and borrowers file their loans with the financial authorities, and benefit from the state protection under the new rules. Wenzhou's practice has been copied by the financial regulators from over 15 provinces in China. In addition, the Wenzhou Index serves as a barometer of the interest levels of the private lending market, which promotes the market transparency and curbs excessive interests. After its launch, the Index has been widely used by market participants, financial regulators, as well as local courts. Clearly, it helps to construct an efficient, transparent, and fair marketplace. With official regulation, private financing says goodbye to its savage growth in the past, and embraces the rational development in the future.

Finally, this chapter has assessed the financial liberalisation in China's banking sector, which is a key step in solving the private financing puzzle. The government's decision to open the banking industry to private investors has brought more competition into the state-dictated banking sector. Apparently, business borrowers certainly benefit from such move due to the increasing supply of credits. This chapter has evaluated five recently established privately-owned lenders to see their functions and limitations. Most new lenders vow to provide tailored financing services for small businesses, which can greatly alleviate SMEs' financing troubles. The rapid growth rate and the low bad-loan ratio suggests the healthy developments of private banks. However, some weaknesses can be founded in the business model of new banks, such as the limited size, the narrow business scope, and the insufficient professionals, which could impede

their further development. From this perspective, these new lenders could hardly rival traditional banks and break their monopoly status. The primary function of private lenders is, therefore, to fill the niches of the existing financial industry by serving SME borrowers. The final section has analysed the government's response to the financial liberalisation, including the introduction of a deposit insurance scheme and the interest rate deregulation process. Evidently, China's banking sector is becoming more competitive, with the improvement of financing environments for private entrepreneurs.

Chapter 6 SME Credit Financing in the UK: Practice and Regulation

6.1 Introduction

Previously, we have examined China's recent financial reforms to regulate the private lending market as well as to promote the availability of credits for the private sector. This chapter focuses on the financing situations of SMEs in the UK, adding a comparative perspective to this research. Clearly, the British government is aware of the importance of the access to finance in facilitating new business start-ups and helping existing businesses to reach their growth potentials.¹ Therefore, this chapter will examine whether bank credits for British SMEs are sufficient or not, and if not, how the financing gaps are filled by alternative forms of finance. In doing so, the author would like to find out whether SMEs in the UK face the similar financing dilemmas as their Chinese counterparts do, and thus provides some suggestions for China's financial reform. Besides, the UK's laws and regulations surrounding SME lending will be studied. It should be noted that the scope of this chapter is confined to debt financing methods rather than equity financing approaches, including bank lending, P2P lending, private lending, and consumer credits.²

This chapter consists of the following sections. The second section explores the definition of SMEs in the British context, and discovers the importance of SMEs to the UK economy. It also introduces general financing channels available for UK SMEs, and relevant government policies. The third section focuses on bank lending which is the primary financing source for UK businesses, and analyses whether mainstream banks supply enough credits to SMEs. Moreover, the rise of so-called challenger banks will be discussed, whose businesses target small business financing. This section also includes some comments on the UK's current banking regulatory framework. The fourth section probes into the fast growing P2P lending industry in the UK, and answers the question: whether P2P loans can be good alternatives to bank loans for SMEs. The regulatory framework of P2P lending, composed of the industry self-regulation and the FCA's official regulation, will be examined. The five part continues

¹ BIS, "SME Access to External Finance", *BIS Economics Paper No.16*, January 2012, p.vi.

² Since in previous chapters, we limited our attentions to debt financing channels of Chinese SMEs, including private lending, P2P lending and the latest private-owned banks. Therefore, when we look at financing channels employed by UK's SMEs in this chapter, we will evaluate the similar objects.

to assess private lending and consumer credits in the UK.³ It provides an in-depth analysis about, under what circumstances, the consumer credit regulation will be applied to protect SME borrowers.

6.2 Small and Medium-Sized Enterprises in the UK

6.2.1 The Definition of SMEs

In the UK, the common definition of small and medium-sized enterprises (SMEs) is made according to the number of employees of an individual firm.⁴ The standard is mostly used to categorise companies, but other business organisations like partnerships can also refer to this standard. According to Company Act 2006, a small-sized company should satisfy at least two of three conditions: the turnover is no more than £6.5 million; the balance sheet total is no more than £3.26 million; the number of employees shall not exceed 50.⁵ In terms of a medium-sized company, it should also satisfy at least two of three conditions: the turnover is no more than £25.9 million; the balance sheet total is no more than £12.9 million; the number of employees is shall not exceed 250.⁶ Moreover, at the EU level, the European Commission also set out a definition for SMEs by taking into consideration of the number of employees, and either turnover or balance sheet total, as SMEs could receive extra financial supports or be subject to fewer regulatory requirements.⁷ Nonetheless, under the EU definition, it involves a more specific sub-category of SMEs called micro businesses which refer to any businesses with fewer than 10 people.⁸ Therefore, in combination of both UK and EU classifications, we can come up with a general concept of SMEs meaning any businesses with fewer than 250 employees.

³ Due to the limitation of empirical data on private lending in the UK, we will pay more attentions to similar consumer credit activities that could be a potential financing tool for SMEs under certain circumstances.

⁴ If a firm belongs to a larger corporate group, it may need to calculate the aggregated data from the entire group, to judge the category that the firm falls into.

⁵ Company Act 2006, Section 382.

⁶ Company Act 2006, Section 465.

⁷ The EU provides potential benefits for those enterprises qualified as SMEs. For instance, SMEs are eligible for certain supports under many EU or national business-support programmes, such as research funding, competitiveness and innovation funding. Moreover, there could be fewer requirements or reduced fees for SMEs for EU administrative compliance. See European Commission, "What is an SME?", available at http://ec.europa.eu/growth/smes/business-friendly-environment/sme-definition/index_en.htm, accessed 1 January 2016.

⁸ EU Commission Recommendation 2003/361/EC (6 May 2003).

<i>Size of Business</i>	Micro	Small	Medium	Large
<i>Number of Employees</i>	0-9	10-49	50-249	250

Table 12: Categories of UK Businesses (Size)

In addition, according to Bank of England, in some of the central bank's statistics reports, it tells the difference between SMEs and large businesses by their annual debt account turnover, for those enterprises with an annual debt account turnover less than £25 million are considered as SMEs, and those with over £25 million are viewed as large businesses.⁹

6.2.2 SMEs' Important Role in British Economy

Business Type	Number	Employment (Thousands)	Turnover (£millions)
All Business	5,243,135	25,229	3,521,254
SMEs (0-249)	5,236,390	15,159	1,647,201
Small (0-49)	5,204,915	12,084	1,170,337
Medium (50-249)	31,475	3,075	476,864
Large (250 or more)	6,745	10,070	1,874,053

Table 13: The Number of UK businesses in the Private Sector¹⁰

It is obvious that SMEs play a vital and indispensable role in the British economy. At the start of 2014, there were approximately 5.2 million businesses across the UK, with a growth of 1.8 million from 2000.¹¹ From the table above, we know that among all privately-owned businesses in Britain, 99.9 per cent of them are SMEs. More specifically, small-sized businesses account for 99.3 per cent of total businesses while medium-sized businesses take up 0.6 per cent of them. In contrast, the number of large corporations in the UK was merely 6,700 in 2014, which fell by 500 compared to the beginning of the century. Therefore, SMEs in UK significantly outnumbered large enterprises, and they accounted for most of the 1.8 million new businesses established from 2000- 2014, which clearly shows their importance in the economic growth. Furthermore, from the table we can also know that SMEs hire a total number of 15

⁹ For example, see Bank of England, "Trends in Lending (April 2015)", available at <http://www.bankofengland.co.uk/publications/Documents/other/monetary/trendsapril15.pdf>, accessed 1 January 2016.

¹⁰ Data source: Department for Business, Innovation and Skills (BIS), "Business Population Estimates 2014", p.4.

¹¹ *Ibid.*, p.1.

million people, which is roughly 60 per cent of 25 million employees who work in the private sector. Hence, it means that nowadays there are more people working for SMEs than those employed by large corporations, which suggests that British SMEs provide the majority of working opportunities for people at working age, so they are of great importance to improve the employment rate after the hard time caused by the Global Financial Crisis. According to a survey conducted by the University of Kent, although most UK students prefer work for large household-name companies after graduation, in fact only 14 per cent of graduates finally join large firms, which means the majority of UK graduates (86 per cent) go to work for SMEs.¹² Therefore, if the government provides more supports for the development of SMEs, it will create more working opportunities for the next generation. Besides, SMEs accounted for approximately £1.65 trillion turnovers of all UK businesses, while the combined turnover of large corporations was around £1.87 trillion turnovers, so both types of businesses have generated a similar amount of revenue by providing products and services for UK and global customers. Moreover, in recent years SMEs have contributed to 49.8 per cent of UK's Gross Domestic Product (GDP),¹³ which clearly shows that British SMEs now can produce as many as economic outputs as their large corporation counterparts do. In addition to the general situation, SMEs dominate the number of businesses in most industrial sectors in the UK, despite a certain level of uneven presence. In particular, most SMEs concentrate in three industries: construction sector (18 per cent), professional, scientific and technical activities (15 per cent), and wholesale and retail trade and repair (10 per cent).¹⁴

Percentage of total -	SME	Large Companies
<i>Number of Businesses</i>	99.9%	0.1%
<i>Employment</i>	60.1%	39.9%
<i>Turnover</i>	46.8%	53.2%
<i>UK Graduates</i>	86%	14%
<i>UK GDP</i>	49.8%	50.2%

Table 14: A Comparison Between SMEs and Large Companies¹⁵

¹² University of Kent, "Working for Small Businesses", available at <http://www.kent.ac.uk/careers/sme.htm>, accessed 1 January 2016.

¹³ Matthew Ward and Chris Rhodes, "Small businesses and the UK economy" (9 December 2014), House of Common Library, SN/EP/ 6078, p.7.

¹⁴ BIS, "Business Population Estimates 2014", p.12.

¹⁵ The table is compiled by the author.

Moreover, the importance of SMEs to the economic recovery in the UK after the GFC is paramount and shall not be undervalued. According to the British Business Bank, a government-owned organisation to improve the financial access for smaller businesses, 46 per cent of UK SMEs plan to grow turnover in 2015, whilst most large businesses just plan to maintain the current market shares.¹⁶ This can demonstrate the optimism about SMEs' future prospects, which have been the driving force behind the growth of British economy recently. With the strong growth of smaller businesses, Britain's GDP managed to grow by 3 per cent in 2014, which already exceeded the pre-crisis peak and made Britain the fastest-growing G7 economy.¹⁷ Obviously, SMEs has contributed significantly to the development and recovery of UK economy in the post-crisis era.

Apart from SMEs' economic contribution, their employees generally feel satisfactory and happy about their works. According to a survey by the Trades Union Congress (TUC), people working for smaller businesses have the highest job satisfactory rate (21 per cent strongly agreeing and 41 per cent tending to agree) compared to those employed elsewhere.¹⁸ The survey also suggested small business employees are most committed (64 per cent) and loyal (58 per cent) to their employers.¹⁹ Besides, small business employees generally have been given more freedom to choose their own working patterns, so they face fewer cases of bullying at work, lower stress level, as well as have fewer complaints about overtime works.²⁰ Clearly, people who work for smaller businesses are the happiest employees and enjoy a good work-life balance, which encourages more people to start their own businesses or join smaller firms instead of large corporations.

6.2.3 The Financing Situations of UK SMEs

Despite the significance of SMEs, they have always been in a vulnerable financial situation. It becomes increasingly difficult for SMEs to obtain sufficient funding,

¹⁶ British Business Bank, "Small Business Finance Markets 2014", p.4.

¹⁷ Emily Cadman, "UK Set to Be Fastest-Growing G7 Economy", *Financial Times* (30 June 2015), available at <https://www.ft.com/content/95c6322a-1f05-11e5-ab0f-6bb9974f25d0>, accessed 1 February 2017.

¹⁸ Federation of Small Businesses, "Happiest Employees Work for Small Businesses" (02 September 2008), available at <http://www.fsb.org.uk/news.aspx?rec=4749>, accessed 1 January 2016.

¹⁹ *Ibid.*

²⁰ *Ibid.*

particularly after the GFC as bank credits have been tightened. During the crisis, nearly all businesses encountered weakening demand from both domestic and foreign consumers, leading to the plummet of sales in their products or services, and accordingly businesses have faced squeezed revenues and profit margins. In the UK, as it has a close trading and economic relation with the rest of the world, its businesses suffered greatly from negative impacts of world economic shocks through trade, finance, and other channels.²¹ In particular, the business of SMEs were heavily hit not only by the declining demand and sales but also by the decreasing number of funding available, as banks have become more risk-adverse and reluctant to extend credits to smaller businesses. Clearly, SMEs have been facing restricted access to the traditional financial industry recently. According to UK's Department for Business, Innovation and Skills, the lending towards SMEs has been in decline since the credit crunch.²² The reason explaining for the reduced credits might be that there existed intense competition in the banking industry before 2008, as banks at that time had to compete for market shares, making it easier for SMEs to obtain a bank loan. Nevertheless, in the current economic environment, banks become more cautious about risk assessment and risk-taking, so a large number of SME borrowers which lack track credit records or effective collaterals will be denied the access to bank loans. The data from the BIS showed that the volume of bank lending towards SMEs reached its peak in 2009, and then it has been declining ever since; For instance, the lending to SMEs in November 2011 was nearly 6 per cent lower than the figure one year ago.²³

Moreover, the financing difficulty of SMEs has been perceived as a European-wide issue. SMEs in the European Union also play an important role in each member state. In the EU, around 99 per cent of all non-financial companies are SMEs which account for 58 per cent of total value added and 66 per cent of jobs.²⁴ However, in the post-crisis era, new bank lending to SMEs in the euro zone fell by 35 per cent from 2008-

²¹ Bank of England, "How Have World Shocks Affected the UK Economy?", *Bank of England Quarterly Bulletin* 2014 Q2, p.167.

²² BIS, "SME Access to External Finance", *BIS Economics Paper No.16* (January 2012).

²³ *Ibid.*

²⁴ *The Economist*, "Financing Europe's Small Firms: Don't Bank on the Banks" (16 August 2014), p.57.

2013.²⁵ The reducing availability of bank loans, therefore, results in the financial difficulty of many SMEs which rely on banks for financing. Furthermore, according to an EU report, the access to finance has been considered as the second largest challenge faced by SMEs in 28 states of the European Union, which is just next to the challenge of finding customers.²⁶ The severe problem of SME financing can be attributed to the inadequate credit provision from traditional financial institutions. Unlike large companies which can issue shares or bonds in the capital markets to raise funding, smaller businesses can only rely on domestic bank lending as their major source of funding.

In response to insufficient bank lending for SMEs, the EU has witnessed a rapid growth in alternative financing markets, particularly online lending platforms. According to University of Cambridge and EY, the online alternative finance market in the Europe reached €3 billion in 2014, which grew by 144% in one year's time, and the market is expected to reach €7 billion at the end of 2015.²⁷ Therefore, apart from obtaining bank loans from mainstream lenders, SMEs in the UK and the EU have been trying to explore different ways of obtaining cash to support their businesses, including borrowing loans from challenger banks and peer-to-peer lending platforms, or receiving investments from private equity or venture capital funds. The next section will briefly discuss about general financing channels that are being used by UK SMEs.

6.2.4 External Financing Channels for UK SMEs

Generally speaking, SMEs in the UK have a variety of financial methods, whether internal financing or external financing, debt financing or equity financing, to obtain credits or capitals for their business operation and growth. Despite bank lending being the primary funding source for UK SMEs, there are several financing methods, outside the formal banking system, available for smaller businesses.²⁸ In the rest of this chapter,

²⁵ *Ibid.*

²⁶ European Commission, "Annual Report on European SMEs 2013/2014".

²⁷ University of Cambridge, "European Alternative Finance Market Could Top €7 billion in 2015", available at <http://www.cam.ac.uk/research/news/european-alternative-finance-market-could-top-eu7-billion-in-2015>, accessed 1 February 2016.

²⁸ Obtaining credits from bank is still the primary source of finance for UK SMEs, for 28% of them have used an overdraft and 11% have used a bank loan. See BIS, "SME Access to External Finance", BIS Economics Paper No.16, January 2012, p.vi.

we will point out the fact that UK SMEs, akin to their Chinese counterparts, are unable to be fully served by large banks in terms of obtaining adequate finance. As a result, SMEs' strong demand for credits, in combination with the insufficient provision of bank loans, force smaller businesses to acquire funding through some unconventional financing channels, such as a small group of SME-focused challenger banks, peer-to-peer online lending platforms, or consumer credits.

Internal Funding Vs External Funding

The funding methods for any business can be generally divided into internal funding and external funding.²⁹ The internal funding channel means that enterprises acquire capitals or credits internally, such as raising money from shareholders or using retained profits earned in previous years. In contrast, external financing means entrepreneurs obtaining money from outside investors or lenders, rather than from a business's internal reserve, which can be bank lending, peer-to-peer lending, asset financing, venture capitals, and so on. In this chapter, our discussion about SME finance in the UK will be limited to external funding resources.

Debt Finance Vs Equity finance

Moreover, according to corporate finance theories, financing approaches for any business can be broadly categorised into debt financing or equity financing.³⁰ Debt financing refers to a business borrowing a loan from an individual, another business or a bank, with the promise to repay principal and interests.³¹ Therefore, traditional bank loans, overdrafts, peer-to-peer lending, private lending, and consumer credits are typical examples of debt financing. The debt financing can have several advantages over equity financing; for instance, under debt financing agreements, the lender is unable to control the borrower's business, and the cost of borrowing is relatively predictable as the interest rate will be negotiated and made into relevant contracts. The disadvantage could be that the borrower has the obligation to repay principal and

²⁹ R. Glenn Hubbard, Anil K Kashyap, Toni M. Whited, "Internal Finance and Firm Investment" (1995) 27(3) *Journal of Money, Credit and Banking* 683, 683.

³⁰ See David Hillier et al, *Corporate Finance* (2nd European Edition, McGraw-Hill Higher Education, 2013), p.527.

³¹ Tim Parker, "Small Business Financing: Debt or Equity?", available at <http://www.investopedia.com/financial-edge/1112/small-business-financing-debt-or-equity.aspx>, accessed 1 January 2016.

interests on a regular base, even if the economic environment or business condition turns bad.

On the other hand, equity financing means a business raising money by selling its shares to other investors.³² The examples of equity financing can be private equity funds, venture capitals, and issuing shares to the public through listing in a stock exchange. The process of obtaining a listing on the London Stock Exchange can be complicated, costly as well as time-consuming, which involves a lot of financial and legal advisors.³³ Moreover, the access to security markets is more available for large companies rather than SMEs, so we only examine private equity (PE) and venture capitals (VC) here instead of public listing.

Private equity funds raise money from high-net-worth individuals or institutions, and then they invest the money in buying shares in companies with good potential to grow into prominent businesses. They will wait to exist from the investment through selling their shares at a higher price in the future, such as the initial public offer (IPO), or selling their stakes to other investors who are willing to buy. Venture capitals, to some extent, can be similar to private equity funds, but they also have major differences in several aspects.³⁴ For instance, private equity funds invest in different types of businesses, and they tend to buy shares of more mature and established businesses, whilst venture capitalists mostly invest in start-ups that have a prospect of rapid growth and good returns. According to the Small Business Service, the term venture capital is limited to describing equity investment provided in the early stages of a company's life, which particularly focuses on technology-oriented sectors.³⁵ Moreover, private equity funds prefer to buy 100 per cent of stakes in a specific firm in order to seek the full control of the business acquired, with the investment amount of more than \$100 million. The PE would like to concentrate all resources on purchasing one business, as the chance of the failure of an established business is relatively slim. However, venture

³² *Ibid.*

³³ Alan Dignam and John Lowry, *Company Law* (7th edition OUP), p.65.

³⁴ *Forbes*, "What's The Difference Between Private Equity and Venture Capital?" (1 October 2012), available at <https://www.forbes.com/sites/victorhwang/2012/10/01/presidential-debate-primer-whats-the-difference-between-private-equity-and-venture-capital/>, accessed 1 February 2017.

³⁵ Small Business Service, "A Mapping Study of Venture Capital Provision to SMEs in England" (October 2015), p.5.

capital firms, under most circumstances, only want to buy no more than 50 per cent of shares in any businesses, and try to diversify their investment portfolio by putting money in several businesses at the same time, so the failure of a certain start-up company invested by them will not have a disastrous effect on the safety of the entire fund.

The advantages of equity financing over debt financing are obvious, for equity investors, who become shareholders of the business, have to undertake all the risks of business operation, so the money invested does not need to be returned like borrowing a loan. The downside is that entrepreneurs have to share future profits with new investors, and these new shareholders will have voting rights and take part in business decision-making. In this chapter, we concentrate on debt financing rather than equity financing for SMEs in the UK.³⁶ In this chapter, we are going to examine three types of debt financing in the UK: banking lending, peer-to-peer lending, and consumer credits.

6.2.5 UK's Policies to Promote SME Finance

The financing difficulty of SMEs could prevent entrepreneurs from starting new businesses, or impede existing SMEs of further growth. In response to this problem, the UK government has put forward a series of policies to boost the availability of funding for SMEs. For instance, the government has been trying to increase bank loans for SMEs, as it initiated a financial scheme called “Funding for Lending” with the Bank of England.³⁷ The scheme enables banks and building societies to borrow credits from the central bank at a discounted rate which is lower than that of the market level, so banking institutions can use this amount of money to extend loans to SMEs at lower interest rates. The “Funding for Lending” scheme, backed by the central bank’s liquidity, can definitely inject a significant number of credits into SMEs. Moreover, the government also set up an independent body called the “British Business Bank” with the aim to bring funds from both public and private sectors to create more an effective finance market for smaller businesses in the UK.³⁸ It is noteworthy that the

³⁶ It is because the author plans to conduct some comparative studies between China and the UK, and in previous chapters, we only focus on the debt financing of Chinese private-owned enterprises.

³⁷ BIS and HM Treasury, “2010 to 2015 Government Policy: Business Enterprise” (Policy paper).

³⁸ *Ibid.*

“British Business Bank” is not a real bank, so it will not lend directly to smaller businesses, but instead it has been given the mandate to manage all government-related programmes relating to SME finance. As of the end of 2015, its programmes has already gathered funding worth £2.3 billion to support more than 40,000 smaller businesses, and it plans to facilitate a further £2.9 billion of finance to British SMEs in the following years.³⁹ By working with 80 partners including banks, leasing companies, venture capital funds, and online lending platforms, the “British Business Bank” is able to provide substantial funding supports for entrepreneurs to start a new business, grow the business to the next level, or stay ahead of the competition.

In addition, the government has introduced a series of official projects to encourage private sector investments in smaller businesses, such as the Business Finance Partnership, the Start-Up Loan Scheme and the Business Angel Co-Investment Fund.⁴⁰ In the Business Finance Partnership (BFP), the UK government has invested £1.2 billion into the project, and at least an equal amount of money will be contributed by other private investors. All of money will be directed to UK’s smaller businesses through non-bank financing channels, such as investment fund and P2P lenders like Zopa and Funding Circle. As for the Start-up Loan Scheme, it started in September 2012 with the objective to provide £82.5 million to British young entrepreneurs aged 18 to 30.⁴¹ The programme will be run by a state-owned organisation which offers initial capitals around £2,500 to each young entrepreneur who plans to start a business. Furthermore, the government has also been promoting tax-advantaged venture capital schemes for a long time, to support the development of SMEs, which include the Enterprise Investment Scheme (EIS), the Venture Capital Trust Scheme (VCTs), and the Seed Enterprise Investment Scheme (SEIS).⁴² The purpose of having these schemes is to incentivise equity investments for smaller businesses, as the tax relief plans is made to compensate the risks when investors put money in less-established or smaller businesses. As a result, it can be expected that more venture capitalists will be

³⁹ British Business Bank, <http://annualreport2015.british-business-bank.co.uk/issue/14/>, accessed 1 January 2016.

⁴⁰ BIS and HM Treasury, “2010 to 2015 Government Policy: Business Enterprise” (Policy paper).

⁴¹ Start Up Loan, <https://www.startuploans.co.uk>, accessed 1 January 2016.

⁴² HM Treasury & HMRC, “Tax-Advantaged Venture Capital Schemes: Ensuring Continued Support for Small and Growing Businesses” (July 2014).

willing to diversify a certain proportion of their fund to SMEs, which will increase their financing options.

Moreover, the UK government has been trying to encourage more individuals to put their money into innovative finance markets. George Osborne, the former Chancellor of the Exchequer, launched a programme to create a new type of Innovative Finance ISA (Individual Savings Accounts), which offers tax-free returns for British investors who wish to invest their money in the P2P lending market, which came into force in April 2016.⁴³ Clearly, the inclusion of P2P investments in the tax-free ISA schemes will definitely stimulate the further development of P2P lending industry. On the one hand, under the strong tax-saving incentive, more ordinary investors will be willing to opt for peer-to-peer lending as an investment, as they can enjoy the same tax-free policies as they save money in cash ISA accounts or buy shares under the investment ISA. On the other hand, this move could achieve a level playing field for P2P lenders and established banks, as nowadays both P2P investment or bank savings are entitled to tax-free policies, so traditional banks will no longer have an advantage over online lending platforms. However, it should be noted that P2P investments are not covered by the Financial Services Compensation Scheme, so investors are still susceptible to potential losses if borrowers default.

In summary, the UK government clearly realises the importance of SMEs in the British economy, as well as small businesses' hardship in obtain adequate funding to grow, so it has spent great efforts on improving the availability of financing resources for SMEs. It not only provides funding for SMEs directly through the Funding for Lending Scheme, but also encourages the whole society to increase investments in SMEs by promoting initiatives such as Business Finance Partnership. Besides, the government has been boosting funding for smaller businesses through both debt investment (a number of loan schemes mentioned above) and equity investment schemes (like the Seed Enterprise Investment Scheme). What is more, the government has been trying to increase traditional bank lending to SMEs, as well as to facilitate the development of other innovative financing channels, such as inventing the new ISA scheme in order

⁴³ Emma Dunkley, "P2P Isa Investments Confirmed for Next Year", *Financial Times* (10 July 2015), available at <https://www.ft.com/content/cc4ac0fe-26ee-11e5-9c4e-a775d2b173ca>, accessed 1 February 2017.

to encourage more British people to lend money to business borrowers seeking finance through online portals. Clearly, the UK government aims to build a multi-level financing channels for smaller businesses, and reduce their reliance on the traditional financial institutions, which is similar to what the Chinese government has done in its recent financial reforms.

6.3 Bank Lending for UK SMEs

UK has a well-developed and leading banking industry in the world. Applying for loans and other financing facilities from banks and building societies plays a primary role in the UK SME Financing.⁴⁴ UK-based businesses, either SMEs or large corporations, normally use bank loans or overdraft facilities to fund their business operation.⁴⁵ Despite the popularity of bank credits, it is far from easy for smaller businesses to borrow credits. It is because after the GFC, British banks have become less willing to lend to smaller businesses.⁴⁶ According to National Institute of Economic and Social Research (NIESR), the rejection rate for bank loan applications was higher in 2011-12 than that in 2008-9, as many SMEs lack track credit history and collaterals to pass the strict credit assessment of banks.⁴⁷ The higher rejection rates, coupled with higher overdraft interest rates, put great pressure on SMEs' operating conditions.⁴⁸ According to British Bankers' Association (BBA), during the second

⁴⁴ Building society is a type of financial institutions which offers banking service, such as deposit accounts or mortgage loans, to its members. Unlike banks which are mostly companies owned by shareholders, building societies are owned by their own members who have an account with or take a loan from them. In the UK, building societies are main competitors of banks.

⁴⁵ Overdraft facility is a type of short-term financing tool used by individuals or businesses. It allows bank customers to spend more than the amount of money in their bank accounts to cover temporary financing needs. Customers can negotiate with banks about the limit of overdraft, and the use of overdraft will be charged interests and probably a fee.

⁴⁶ David Milliken, "Banks Reluctant to Lend to Small Firms - Government Report", *Reuters* (12 April 2013), available at uk.reuters.com/article/uk-britain-lending-idUKBRE93B0LT20130412, accessed 1 February 2017.

⁴⁷ *Ibid.*

⁴⁸ The reluctance to lend to smaller businesses seems a rational choice for banks under the post-crisis environment. Currently, commercial banks have become relatively risk-adverse, as they have to ensure that their money is lent to borrowers which have the least possibility of default. Besides, we know that the cost for granting a loan is similar regardless the amount of money involved, but if the bank chooses to make a loan with a large amount of money to a large corporation, it will can earn more interests and fees which are based on the amount of money lent. Therefore, lending to large businesses could be low-risk and more profitable, and that's why it is more difficult for SMEs to obtain bank loans than large businesses.

quarter of 2015, there were 31,500 approved loan applications for SMEs.⁴⁹ While the approval rate for small-sized businesses applying for bank loans was approximately 80 per cent, the rate for medium-sized businesses was higher, at around 90 per cent. Therefore, it is clear that the bigger size an enterprise is, the higher chance it could get the approval for a bank loan, which demonstrates the hardship of smaller businesses in acquiring funds from banks.

6.3.1 Bank Lending Data from Bank of England

Time	Loans (excl. overdrafts)		Overdrafts		Total Loans	
	<i>SMEs</i>	<i>Large</i>	<i>SMEs</i>	<i>Large</i>	<i>SMEs</i>	<i>Large</i>
2016 Jan	150,819	247,584	12,396	26,488	163,215	274,073
Feb	149,262	253,175	12,453	26,468	161,714	279,643
Mar	149,119	251,484	12,123	25,793	161,241	277,277
Apr	149,218	250,251	12,054	25,617	161,272	275,868
May	149,728	252,812	12,172	24,584	161,901	277,396
Jun	149,473	256,544	11,984	24,996	161,457	281,541
Jul	149,746	258,530	12,213	25,144	161,958	283,674
Aug	149,385	259,281	12,113	24,831	161,498	284,111
Sep	150,689	261,264	12,983	23,386	163,672	284,650
Oct	150,456	263,246	12,861	26,153	163,317	289,399
Nov	150,724	261,899	12,804	25,153	163,528	287,052
Dec	152,056	259,215	12,527	25,259	164,584	284,474

Table 15: Outstanding Bank Loans to Non-financial Businesses (in £millions)⁵⁰

The information in the table above came from Bank of England, which reveals the inequality between SMEs and large businesses regarding bank loans obtained. In December 2016, the total outstanding loans for SMEs in the UK amounted to £164.5 billion, including £152 billion loans and £12.5 billion overdrafts. In contrast, large businesses had an outstanding loan balance of £284 billion, with £259 billion loans and £25 billion overdrafts respectively. It means SMEs received 37 per cent of total bank credits, whilst the remaining 63 per cent was granted to large corporations. As discussed, SMEs constitute 99 per cent of all UK businesses and has contributed to 60 per cent of employment opportunities and nearly half of UK's GDP, but they only obtained slightly over one third of total bank credits. The inequality of credit provision

⁴⁹ BBA, "Bank Support for SMEs" (2015 2nd Quarter), p.1.

⁵⁰ Data Source: Bank of England, "BankStats (Monetary & Financial Statistics)", Table A8.1, available at <http://www.bankofengland.co.uk/statistics/Pages/bankstats/current/default.aspx>, accessed 1 February 2017.

is therefore self-explanatory. As for the price of borrowing a bank loan, in November 2014, the overall average interest rate for SMEs was 3.42 per cent.⁵¹ More specifically, it was 4.40 per cent for small-sized businesses and 3.22 per cent for medium-sized businesses. It suggests that the larger size a business has, the lower rate it can get. Apparently, this uneven credit provision towards businesses with different sizes is partly responsible for the financing difficulties faced by smaller businesses in recent years. As a result, an increasing number of British SMEs decide to use alternative financing channels such as challenger banks.

6.3.2 The Emergence of Challenger Banks

In addition to UK's mainstream banks, there are a new breed of lenders, such as Aldermore and Shawbrook, which were established in recent years to specifically accommodate the financial needs of SMEs that are underserved by traditional lenders. They belong to a group of so-called "challenger banks" which aim to contest large and established banks in the UK, particularly the "Big Five" banks.⁵² Among challenger banks, some of them are perceived as a smaller version of dominant lenders, such as Virgin Money and Metro Bank, which offer traditional banking services; however, some of these challengers have developed innovative business models and specialise in certain unexploited areas (e.g. buy-to-let mortgages and SME financing), and examples of this type of challenger banks are Aldermore, Shawbrook, and OneSavings Bank.⁵³ We will limit our attentions to the latter, which is said to provide more financial resources for smaller enterprises in the UK. Although challenger banks are newcomers in the British banking industry, they are subject to the same regulatory framework as other lenders. Thus, challenger banks are regulated by the Prudential Regulation Authority and the Financial Conduct Authority, and registered under the Financial Services Compensation Scheme.

⁵¹ Bank of England, "Loan Pricing January 2015", Chart 2.4, available at www.bankofengland.co.uk/publications/Documents/other/monetary/loanpricingjanuary2015.xls, accessed 1 February 2017.

⁵² The "Big Five" banks refer to five largest banks in the UK, including HSBC, Barclays, Lloyds Banking Group, Royal Bank of Scotland, and the UK subsidiary of Santander.

⁵³ Richard Stovin-Bradford, "Get Rich Quick with UK Challenger Banks", *Financial Times* (11 October 2015), available at <https://www.ft.com/content/7002cbe8-6c3a-11e5-8171-ba1968cf791a>, accessed 1 February 2017.

According to a industry report by KPMG, four main differences can be observed between UK's big five banks and challenger banks, namely, the differentiation of brands, products, culture and customer service, and distribution.⁵⁴ In terms of the brand issue, it is apparent that established lenders suffered severe reputational damages during the recent financial crisis, so the new lenders have been trying to distinguish themselves from established ones by creating their own brands and reputation, which clearly gives them an advantage of having no historical legacy. As for products and services, most challenger banks, in order to solicit new customers, try to offer differentiated products and services from existing lenders, which can to some extent fill the niches of the British banking industry. A number of challenger banks focus their businesses on offering financing services to SMEs, which not only help smaller businesses to obtain funding to growth, but also win themselves numerous clients who are previously ignored or underserved by large banks. According to Andy Golding, the CEO of OneSavings Bank, these challenger banks are “dancing in the gaps” which is left by major players in the banking arena.⁵⁵ Moreover, in terms of the cultural issue, challengers have been creating an image of customer-centric business, as they emphasise the fairness and ethical culture in their banking activities. It clearly contrasts with existing lenders which primarily focus on profit-making, as there is a great incentive for bankers to earn higher salaries and bonuses associated with the performance of the bank. Last but not the least, challenger banks normally adopt distinctive ways of distribution, as they are reliant on brokers and online platforms to reach customers, rather than using traditional branch networks employed by dominant banks for several decades.

6.3.3 How Challenger Banks Serve SMEs?

Generally speaking, challenger banks have been operating in a business model similar to most banks, which take deposits from the public and then make loans to potential borrowers. However, in terms of the question of making loans to whom, most of challenger banks provide special tailored financing services for SMEs, such as asset

⁵⁴ KPMG, “The Game Changers: Challenger Banking Results” (May 2015), p.1.

⁵⁵ See Ashley Armstrong, “One Savings Bank Targets IPO Valuation of Up to £600m”, *Telegraph* (7 May 2014), available at <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/privateequity/10813002/One-Savings-Bank-targets-IPO-valuation-of-up-to-600m.html>, accessed 1 January 2016.

finance, invoice finance, SME Mortgage.

<i>Asset Finance</i> ⁵⁶	<i>Invoice Finance</i> ⁵⁷	<i>SME Mortgage</i>
Asset Finance includes leasing and hire purchase, refers to the funding for capital (asset) investments in machinery, plant and equipment. By using the asset financing, the business does not need to make the one-off and large payments to buy the relevant asset upfront. Instead, it can breakdown the payment into an affordable monthly rent or instalment, while has the right to use the asset. At the end of the asset finance agreement, the business might have the option to purchase the asset at a nominal price (hire purchase).	Invoice finance means the lending to SMEs against their outstanding invoices, which includes the forms of factoring and invoice discounting. By utilising the invoice financing tools, the business will be advanced the value of the invoices they created. In terms of the factoring, the factoring lender will collect the debt instead of you, but the invoice discounting allow you to maintain the credit control and collection facility to receive the payment from your customer.	Lending to SMEs to fund the needs of buying properties

Table 16: Challenger Banks' SME-Focused Businesses

We select the examples of Aldermore and Shawbrook, two leading British challenger lenders, to assess how they develop into large banking business in a short time by providing financial services for smaller business clients in the UK. Aldermore Bank described itself as “an SME-focused bank which operates with modern, scalable, and legacy-free infrastructure”.⁵⁸ Founded in 2009, Aldermore has been growing rapidly since its establishment, and now become one of UK’s leading alternative lenders. In 2014, its pre-tax profits doubled to £50 million, from £26 million in 2013, which indicated its quick expansion and considerable profitability.⁵⁹ In March 2015, Aldermore launched a successful IPO, and raised £75 million from selling new shares to investors.⁶⁰ Currently, its shares are listed on the main market of the London Stock Exchange, which is a constituent of the FTSE 250. Aldermore has 850 employees and around 177,000 customers in the UK.⁶¹

⁵⁶ *Startups*, “What Is Asset Finance?”, available at <http://startups.co.uk/what-is-asset-finance/>, accessed 1 January 2016.

⁵⁷ *Startups*, “Invoice Finance: What Can You Raise?”, available at <http://startups.co.uk/invoice-finance-what-can-you-raise/>, accessed 1 January 2016.

⁵⁸ Aldermore, <http://www.aldermore.co.uk/about-us/who-we-are/>, accessed 1 January 2016.

⁵⁹ Emma Dunkley, “Aldermore Shares Soar on Stock Market Listing”, *Financial Times* (10 March 2015), available at <https://www.ft.com/content/c6eb9972-c725-11e4-9e34-00144feab7de>, accessed 1 February 2017.

⁶⁰ *Ibid.*

⁶¹ Aldermore, http://www.aldermore.co.uk/media/1781/aldermore_factsheet.pdf, accessed 1 January

The rapid success of Aldermore resulted from its accurate customer focusing and low-cost operating strategy. The centre of Aldermore's business is to provide commercial finance, mortgage, and saving services for British SMEs, homebuyers and savers. It attracts deposits from British savers, and then extends loans in four specialised areas: asset finance, invoice finance, SME commercial mortgage, and residential mortgage. Instead of operating a branch network as most British lenders do, Aldermore offer services to customers online, by phone, or face-to-face at 12 offices located around the UK, which reduces costs significantly. Besides, Aldermore aims to deliver the kind of banking as it is supposed to be, which is featured for good services, full transparency, and the community focus.⁶² The better and friendly service in combination with more availability of credits for smaller businesses is no doubt a strong selling point. Moreover, Aldermore claims that they are known for customer-focused innovation.⁶³ For instance, it allows its customer to post comments about its products and services online without any editions, which provides valuable suggestions for other customers. Up to now, the market shares occupied by Aldermore is still relatively small compared to that of established lenders. As of 30 June 2015, its asset finance business took up 3 per cent of the £14 billion UK market; the invoice finance had a market share of 0.9 per cent of the £19 billion market; and its SME commercial mortgage represented 1 per cent of the £44 billion market.⁶⁴ Nonetheless, judging from its short history and strong growth prospect, Aldermore could become a large lender in the future.

Shawbrook bank also has an objective to serve the financial needs of UK SMEs and individuals. It offers a variety of lending and saving products, and its lending division is divided into five parts: commercial mortgages, asset finance, business credit,

2016.

⁶² Aldermore aims to support the communities where they operate. For example, the deposits received by Aldermore are only loaned in the UK; its premises and staffs are all located in the UK, which is close to the communities they serve; it greatly supports UK government policies and schemes, such as Help to Buy; Aldermore's corporate culture mirrors that of other UK SMEs, so it is able to appreciate the real needs of SME communities; It actively supports young entrepreneurs in UK schools to develop business skills. See Aldermore, <http://www.aldermore.co.uk/about-us/community/>, accessed 1 January 2016.

⁶³ Aldermore, http://www.aldermore.co.uk/media/1781/aldermore_factsheet.pdf, accessed 1 January 2016.

⁶⁴ *Ibid.*

secured lending, and commercial lending.⁶⁵ It has 520 staffs and operates in 10 offices throughout UK, including four principal locations and six smaller ones. In 2011, its primary investor acquired Whiteaway Laidlaw Bank, and then re-branded it as Shawbrook Bank.⁶⁶ In the following years, its investors also bought several other financial companies like Commercial First, Link Loans, Singers Asset Finance, and Centric Commercial Finance, and then incorporate them into the banking business of Shawbrook. In April 2015, the Shawbrook raised £90 million in its IPO with the admission to the London Stock Exchange, and later it was admitted to the FTSE 250 index.⁶⁷ So far it has made loans to more than 60,000 SMEs across the UK, making it a leading bank of SME financing. The success of Shawbrook within a short period of time shows the potential market scale of SME financing that has been greatly underestimated by dominant banks.

The significance of British challenger banks can be two-fold. On the one hand, they play a vital role in helping smaller businesses to obtain credits via their special services such as asset financing, invoice discounting, and commercial mortgages. On the other hand, being gap-fillers challenger banks have been enjoying fast growth and become thriving businesses, despite their short history. Due to their special focus and innovative operation, challenger banks outperformed *FTSE All Share Banks Index* in recent times and generated substantial returns for their investors.⁶⁸ Another reason explaining for the success of challenger banks is their low-cost strategy. Obviously, mainstream banks on high streets have a high level of expenses, as they have to purchase or rent offices in good locations. They also hire a large number of staffs, and have to maintain complex business structure and run the massive computer system. On the contrary, challenger banks rely on modern internet technology and have a simple and straightforward business model with limited branches as well as a small number of employees. The cost-effective operation, in combination with specialised market

⁶⁵ Shawbrook, <https://www.shawbrook.co.uk/about/welcome/>, accessed 1 January 2016.

⁶⁶ Shawbrook, <https://www.shawbrook.co.uk/about/our-history/>, accessed 1 January 2016.

⁶⁷ Denise Roland and Ashley Armstrong, "Challenger Bank Shawbrook Fetches £725m Valuation on IPO", *The Telegraph* (01 April 2015), available at <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/11508186/Challenger-bank-Shawbrook-fetches-725m-valuation-on-IPO.html>, accessed 1 February 2017.

⁶⁸ Richard Stovin-Bradford, "Get Rich Quick with UK Challenger Banks", *Financial Times* (11 October 2015).

target, bring challenger banks a lot of advantages over established lenders. In 2014, the lending assets of challenger banks increased by 16 per cent from the previous year, whilst the lending assets of the Big Five fell by 2.1 per cent.⁶⁹ Apart from expanding lending assets, challenger lenders also saw rising profitability. For Aldermore and Shawbrook, the return on equity (RoE) ratio reached 18.2 per cent in 2014, which is rare to see in the British banking industry.⁷⁰ Clearly, the success of challenger banks brings more competition to UK's banking industry, and forces mainstream lenders to pay more attentions to SME financing.

6.3.4 An Overview of UK Banking Regulation

The UK now adopts a twin-peak regulatory model for its banking sector comprising the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA), which were created by the Financial Services Act 2012 to amend the Financial Services and Markets Act 2000, a response to the global financial crisis. According to Eilis Ferran, the breaking up of the integrated regulator Financial Services Authority (FSA) into FCA and PRA was not the inevitable choice at that time but dictated by politics to some extent.⁷¹ During the crisis, UK witnessed the failure of Northern Rock in September 2007, which was the first real bank run in the country since the Victorian times.⁷² Besides, the HBOS and Royal Bank of Scotland were nationalised by the UK government to save the industry to prevent further crisis.

In order to focus on the solvency of large financial institutions in the post-crisis era, and thus maintain the financial stability of UK as a whole, the PRA was created and it is now responsible for the prudential regulation of over 1,700 banks, building societies, insurers, credit unions in the UK.⁷³ PRA has a general objective of promoting the safety and soundness of PRA-authorized person,⁷⁴ and it is empowered to make detail rules for its regulated firms which are contained in the PRA Rulebook. In the past, the

⁶⁹ KPMG, "The Game Changers: Challenger Banking Results" (May 2015), p.3.

⁷⁰ *Ibid.*

⁷¹ Eilis Ferran, "The Break-Up of the Financial Services Authority" (2011) 31(3) *Oxford Journal of Legal Study* 455, 457-458.

⁷² *The Economist*, "Britain's Bank Run: The Bank That Failed" (20 Sep 2007), p.1.

⁷³ FSMA 2000, Part 1A Chapter 2, inserted by Financial Services Act 2012, s6.

⁷⁴ FSMA 2000, s2B(2).

financial supervision of FSA was relatively light touched, so even though FSA was sceptical about the funding model of Northern Rock, it failed to force it to change it.⁷⁵ However, the PRA has been playing a more active role than its predecessor in supervising British banks. For instance, along with Bank of England and its Financial Policy Committee, the PRA carried out a number of stress-testing to see whether British banks' balance sheet can endure some hypothetical situations of economic shocks.⁷⁶ In the first round of stress testing in 2014, the co-operative bank failed the test and was asked to re-capitalise, and the Lloyds Banking Group and Royal Bank of Scotland were at a risky level when facing worst economic conditions.⁷⁷ Clearly, the PRA seems to be more capable of preventing bank insolvency and remaining the stability of UK banking sector.

On the other hand, the FCA was created to replace the FSA, and it is responsible for regulating the conducts of over 26,000 financial firms in the UK, as well as the prudential behaviours of more than 23,000 firms which are not covered by the regime of PRA. The FCA has three operation objectives: protect consumers, enhance market integrity, and promote competition.⁷⁸ In terms of banking regulation, banks are authorised by the PRA, and then regulated by both PRA and FCA, which supervise financial prudence and business conducts respectively. For example, in recent years, many UK consumers were mis-sold Payment Protection Insurance (PPI) by banks on a large scale, so the FCA imposed a fine worth more than £117 million on Lloyds Banking Group for its unfair practice regarding handling customers' complaints about PPI.⁷⁹ We can see FCA's crucial role in protecting consumers' benefits and ensure that a high standard of business conducts has been observed by banks.

In the UK, either an established lender or a challenger bank have to obtain the Part 4A permission (under the FSMA 2000) to carry out banking business from the PRA, and

⁷⁵ House of Common, "The Run on the Rock: Fifth Report of Session 2007–08" (24 January 2008).

⁷⁶ Bank of England, "The Bank of England's Approach to Stress Testing the UK Banking System" (Oct 2015).

⁷⁷ *BBC News*, "Co-op Bank Fails Bank of England Stress Tests" (16 Dec 2014), available at www.bbc.co.uk/news/business-30491161, accessed 1 February 2017.

⁷⁸ FSMA 2000, s1B.

⁷⁹ FCA, "Final Notice to Lloyds Banking Group" (4 June 2015).

a bank will be subject to prudential regulation from the PRA, and conduct regulation including consumer protection from the FCA. The regulatory rules will equally apply to all banks including challenger lenders. However, the current banking regulatory framework, to some extent, seems to favour incumbent banks rather than new challengers, particularly the capital requirement.⁸⁰ In practice, as challenger banks are new to the market, they lack of track data such as the trading record and have a more radical business model, so their businesses are considered as having more risks than established lenders do. This results in a higher risk rating and thus a higher capital requirement. It means more capitals of challenger banks shall be held in reserves rather than being extended to borrowers. Apparently, the current regulatory practice possibly prejudices the further development of emerging challengers, which shall be reformed in the future. The British Bankers' Association has already addressed this issue to the regulator, by asking them to introduce a more flexible risk assessment regime which can reduce the impact of negative rating on challenger banks.⁸¹

6.4 Peer-To-Peer Lending in the UK

6.4.1 P2P Lending: Benefits and Risks

Peer-to-peer (P2P) lending, including peer-to-business (P2B) lending, is relatively new to the lending markets around the world.⁸² P2P lending does not involve any traditional financial institutions, which brings a better deal for both sides of lending by reducing transactional costs for borrowers and improving returns for lenders.⁸³ Generally speaking, the “peers” are individual investors and borrowers, whilst smaller businesses can also raise funds through P2P lending portals. In the UK, the concept of P2P lending is interchangeable with “loan-based crowdfunding”, according to the FCA.⁸⁴

⁸⁰ KPMG, “The Game Changers: Challenger Banking Results” (May 2015), p.17.

⁸¹ BBA, “Promoting Competition in the UK Banking Industry Report” (2014).

⁸² Generally speaking, P2P lending platforms (for example, Zopa and Rate Setter) target individual borrowers, while P2B lending platforms (for example, Funding Circle) target business borrowers most of which are SMEs. Some platforms also adopt a hybrid model. In practice, people normally use the term P2P lending to refer to both P2P and P2B lending platforms and activities.

⁸³ *The Economist*, “Peer-to-peer lending: Banking without banks” (1 March 2014).

⁸⁴ According to FCA, crowdfunding is a way in which individuals and businesses are able to raise money from the public, to support a business, project, campaign or individual. The term applies to a number of internet-based business models, including donation-based crowdfunding, rewards-based crowdfunding, loan-based crowdfunding and investment-based crowdfunding. See FCA, “Crowdfunding”, <http://www.fca.org.uk/consumers/financial-services-products/investments/types-of-investment/crowdfunding>

Moreover, P2P lending has been a component of the alternative finance market, which includes financial instruments and distributive channels that emerge outside of the traditional financial system.⁸⁵ Currently, UK has the largest alternative finance market within the EU, taking up 74.3 per cent of the total market share in the Europe.⁸⁶

Traditionally, banks play a central role as financial intermediaries in the economy, which take deposits from the public and then make loans to individuals, businesses, or governments in need of funds.⁸⁷ However, P2P lending has removed banks from the conventional lending chain, as it facilitates potential lenders and borrowers to find each other directly via an online platform. In terms of interest rate setting, there are two types of P2P lending platforms.⁸⁸ For the first type, lenders offer loans at defined interest rates set by them. Another lending model is called reverse auction (or listing) where lenders have to bid on loans and those who offer lowest rates win the bid. Besides, one major difference between P2P lending and traditional private lending is that private lending is mainly operating within a certain region, namely, lenders and investors find borrowers through local and personal networks. In contrast, investors of P2P lending search for borrowers through online lending platforms, or *vice versa*.

P2P lending comes with benefits and risks. From borrowers' perspective, the lending process is not very different from applying for a bank loan, despite fast procedure and lower costs. For those businesses refused by banks, they can try to approach P2P platforms where there are thousands of potential investors across the UK who are willing to invest. P2P lending is considered as simple and affordable. Without owning a large branch networks, P2P platforms cut out costs and complexities. For instance, the Funding Circle offers a very straightforward application process, for business borrowers just need to file the application online anytime and anywhere.⁸⁹ It takes 10 minutes for borrowers to create an application and they will be allocated a specific

⁸⁵ University of Cambridge and EY, "Moving Mainstream: The European Alternative Finance Benchmarking Report" (February 2015), p.9.

⁸⁶ *Ibid.*, p.13.

⁸⁷ Federal Reserve Bank of San Francisco, "What is the economic function of a bank?", available at <http://www.frbsf.org/education/publications/doctor-econ/2001/july/bank-economic-function>, accessed 1 January 2016.

⁸⁸ P2PMoney, <http://www.p2pmoney.co.uk/companies.htm>, accessed 1 January 2016.

⁸⁹ Funding Circle, <https://www.fundingcircle.com/uk/businesses/>, accessed 1 January 2016.

fund manager. After that, it only takes 2 working days to get the approval or not from a decision maker, and finally it costs at most 7 days for the loan to be listed on the marketplace and funded by investors.⁹⁰ The 7-day lending procedure is unthinkable in the traditional banking industry where a loan application normally takes several weeks. Apart from the fast process, borrowing a P2P loan will be affordable for borrowers, for it does not involve financial intermediary and adopts an online-only business model that can cut most expenses. The lending parties only have to pay for some service fees and administrative charges for the platform they use.

From lenders' perspective, P2P lending offers them a good investment opportunity compared with bank savings, for on average a P2P loan pays investors a 5-6 per cent annual return.⁹¹ Apparently, P2P increases the investment options for ordinary people. However, there is no guarantee of repayment for making P2P loans, and investors could face frauds, potential defaults, or other investment risks. In the depth of GFC, Zopa experienced its highest default rate, 5.54 per cent of total loans, but the P2P lender managed to cope with the credit crisis; so far, UK investors have not seen the failure of a major P2P lending platform.⁹² However, investors shall be aware that, although P2P platforms are subject to FCA's official regulation, it is not covered by the Financial Services Compensation Scheme (FSCS). Thus, if a P2P portal goes into crisis, investors will encounter certain losses.⁹³ In this aspect, P2P lending investment is not as safe as bank saving.

6.4.2 Major P2P Lenders in the UK

UK was the birthplace for P2P lending. In March 2005, the first P2P lending platform in the world, Zopa, was launched in Britain, which has helped investors to lend out

⁹⁰ *Ibid.*

⁹¹ John Ficenec, "How Safe Is Peer-to-peer Lending?", *The Telegraph* (26 July 2015), available at <http://www.telegraph.co.uk/finance/markets/questor/11759729/How-safe-is-peer-to-peer-lending.html>, accessed 1 February 2017.

⁹² *Ibid.*

⁹³ The FSCS does not provide protections for peer-to-peer lending. However, if the P2P lending platform holds the investor's money in a client account opened with an FCA (or FSA) authorised bank or building society, FSCS will cover the investor up to £85,000 if the bank or building society goes bust. See FSCS, "FSCS and peer-to-peer lending sites" (4th September 2012), available at <http://www.fscs.org.uk/news/2012/august/fscs-and-peer-to-peer-lending-sites/>, accessed 1 January 2016.

more than £1.14 billion.⁹⁴ In the recent decade, the P2P lending market has seen a rapid growth. As of 2015, UK investors have made loans over £3.7 billion to consumers and small businesses, and the sector is expected to double its size every six months in the upcoming years.⁹⁵ At present, the popularity of P2P lending is spreading to the rest of the world. For instance, the US now has a prosperous P2P lending sector dominated by two largest platforms, Prosper Marketplace (prosper.com) and LendingClub, which lend billions of dollars each year. In the American market, the annual interest rate varies from 7-21 per cent, and borrowers can borrow loans up to USD25,000.⁹⁶

	Company	Loans to date	Loans outstanding
1	Zopa	£707,000,000	£335,000,000
2	Funding Circle	£479,806,000	£332,966,000
3	Rate Setter	£447,710,000	£273,677,000
4	Market Invoice	£313,513,000	Unknown
5	Lend Invest	£184,974,000	£125,000,000
6	Wellesley & Co	£144,225,000	£128,952,000
7	Thin Cats	£88,383,000	£60,000,000
8	Platform Black	£82,882,000	Unknown
9	Assetz Capital	£50,000,000	£35,000,000
10	Folk 2 Folk	£40,837,000	£35,000,000
11	Saving Stream	£15,054,000	£11,163,000
12	Funding Knight	£7,983,000	£5,710,000
13	Lending Works	£4,743,000	Unknown
14	Rebuilding Societies	£4,646,000	£3,154,000
15	Funding Secure	£3,277,000	£1,250,000
16	Money & Co	£3,250,000	£3,000,000
17	One Stop Funding	£1,060,000	£750,000
18	eMoneyUnion	£585,000	£250,000
19	YES-Secure	£547,000	£0
20	Squirrl.com	£386,000	£200,000
21	Funding Empire	£105,000	£75,000
22	Big Carrots	£94,000	Unknown
23	Quakle	£40,000	Unknown
24	YouAngel	£22,000	Unknown
	Total	£2,581,000,000	£1,409,000,00

Table 17: UK Top P2P Lending Platforms Loan Amounts⁹⁷

The table above presents largest P2P lending platforms in the UK, in terms of the

⁹⁴ Zopa, <https://www.zopa.com/about>, accessed 1 January 2016.

⁹⁵ P2P Finance Association, <http://p2pfa.info/about-p2p-finance>, accessed 1 January 2016.

⁹⁶ Eric C. Chaffee and Geoffrey C. Rapp, "Regulating Online Peer-to-Peer Lending in the Aftermath of Dodd-Frank: In Search of an Evolving Regulatory Regime for an Evolving Industry" (2012) 69 *Washington and Lee Law Review* 485, 485.

⁹⁷ Data Source: P2Pmoney.co.uk (January 2015), available at <http://www.p2pmoney.co.uk/statistics/size.htm>, accessed 1 January 2016.

amount of loans. Clearly, the British P2P lending industry has developed into a relatively mature market, with 70 active platforms that has lent a combined value of £2.58 billion to UK borrowers.⁹⁸ According to one estimate, the lending volume of all P2P platforms in Britain equalled 2 per cent of bank lending in 2014.⁹⁹ Although P2P lending constitutes a small proportion of total lending in the UK, it is expected to grow into a large industry in the future. Besides, UK's P2P lending market is very concentrated which is dominated by a few number of large platforms, for the total loans extended by the Top 4 platforms (Zopa, Funding Circle, Rate Setter, and Market Invoice) contributed to 75 per cent of total lending. Whether this high level of market concentration is good or not for the industry remains uncertain.

Moreover, some British lending platforms adopt the P2B lending model, which focuses on matching potential investors with small business borrowers looking for funding. Obviously, P2B lending allows SMEs to acquire credits directly from a large number of investors (individuals or institutions) and bypass the lengthy and uncertain bank lending procedure.¹⁰⁰ The advantages of P2B loans over bank loans are fast speed, flexible terms, transparency, and ease of use.¹⁰¹ Take Funding Circle as example. Since its establishment in 2010, Funding Circle, with the vision to revolutionise the outdated banking system and secure a better deal for everyone, has attracted 44,246 investors to provide loans worth £902.98 million to more than 12,000 British businesses.¹⁰² Now it also has presence in the US, Germany, Spain, and Netherlands. Moreover, investors on the Funding Circle's platform are not limited to individuals, as the UK Government, local councils, universities, and a number of financial organisations actively take part in P2B lending. For instance, in 2013, under the Business Finance Partnership (BFP), the UK Government lent £20m to SMEs through Funding Circle, and in 2014, the government-backed British Business Bank invested a further £40 million through Funding Circle to smaller businesses.¹⁰³ Serving as a

⁹⁸ P2PMoney, <http://www.p2pmoney.co.uk/statistics/size.htm>, accessed 1 January 2016.

⁹⁹ British Business Bank, "Small Business Finance Markets 2014", p.5.

¹⁰⁰ University of Cambridge and EY, "Moving Mainstream: The European Alternative Finance Benchmarking Report" (February 2015), p.18

¹⁰¹ *Ibid.*

¹⁰² Funding Circle, <https://www.fundingcircle.com/uk/>, accessed 1 January 2016.

¹⁰³ Funding Circle, <https://www.fundingcircle.com/uk/businesses/>, accessed 1 January 2016.

channel between investors and money-strapped SMEs, P2B contributes to UK's economic growth.

Following the rapid growth of P2P lending, in 2014 the UK authority established an official regulatory regime for the online lending market, which falls in FCA's existing financial regulatory framework. It has made P2P lending into a regulated activity, which is included in the Article 36H of the Regulatory Activities Order.¹⁰⁴ Therefore, anyone operating P2P online platforms in the UK shall apply for the authorisation from FCA and be subject to relevant regulatory rules. Currently, the regulation of P2P lending market is a combination of the industry self-regulation and FCA's official regulation.

6.4.3 P2P Lending Industry Self-regulation

Before the establishment of FCA's official regulatory regime, the industry association played a major role in the standard-setting of UK's P2P lending market. In 2011, Zopa, Funding Circle, and Rate Setter, three largest P2P lenders in UK, founded the self-regulatory body for the burgeoning online lending market, Peer-to-Peer Finance Association (P2PFA). The P2PFA aims to improve the standard of business conducts in the industry, as well as to protect investors on the lending platforms. The P2PFA has three main goals: (a) to seek to secure public policy, regulatory and fiscal conditions that enable the UK-based P2P Finance sector to compete fairly and grow responsibly; (b) to ensure that members demonstrate high standards of business conduct, to demonstrate leadership and to promote confidence in the sector; and (c) to raise awareness and understanding of the benefits and risks of P2P Finance.¹⁰⁵ Currently, members of P2PFA comprise all major P2P lenders in the UK, which representing over 90 per cent of the market share.¹⁰⁶ The importance of P2PFA is self-evident. As leading platforms adhere to a high standard of business conduct and a proper level of consumer protection, the majority of UK-based investors and borrowers will be treated fairly

¹⁰⁴ The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2013, Article 36H.

¹⁰⁵ P2PFA, "Rules of the Peer-to-peer Finance Association" (May 2015), para.3.1.

¹⁰⁶ Members include Funding Circle, Landbay, Lendingworks, LendInvest, Madiston Lendloaninvest, MarketInvoice, RateSetter, ThinCats, and Zopa. See P2PFA, <http://p2pfa.info/p2pfa-members>, accessed 1 January 2016.

with adequate information disclosure.

In order to achieve its aim, the P2PFA drafted a series of operating principles for its members to comply with, including high-level principles¹⁰⁷ and specific principles, in terms of clarity and transparency, risk management, and governance and control¹⁰⁸. For instance, P2P platforms should provide adequate information for lenders to make informed decision, such as the expected return, details of fees and surcharges, a clear warning of capital risk (not covered by the FSCS), where the money will be lent, and any “automatic” functions (auto-lend/auto-bid/auto-reinvest).¹⁰⁹ The P2PFA also asks its members to segregate the money of customers from their own funds and company assets, in a separate bank account, in line with FCA’s client money rules.¹¹⁰ It should be noted that, before the FCA’s official regulation, these operating rules were of great significance in ensuring a high standard of business conducts in the UK P2P lending industry. However, after the FCA’s regulation came into effect, these principles now play a supplementary role in assisting the official regulation. In addition, the P2PFA has imposed an obligation on its members to submit data regarding lending volume and customer complaints on a quarterly base.¹¹¹

6.4.4 FCA’s Official Regulatory Regime

Apart from having the first P2P lending website in the world, the UK was also the first country to establish a regulatory regime for the online lending sector. In October 2012, the FCA issued a consultation paper entitled “the FCA’s regulatory approach to crowdfunding (and similar activities)” (CP13/13), which proposed a set of regulatory rules to protect people investing via P2P lending portals and other crowdfunding platforms. In March 2014, the FCA released a policy statement “the FCA’s regulatory approach to crowdfunding over the internet, and the promotion of non-readily

¹⁰⁷ P2PFA, “Peer-to-Peer Finance Association Operating Principles” (June 2015), Article 3. P2PFA members must comply with the following high-level principles in all their undertakings: a) operate their business with technical and professional competence; b) run their business with integrity; c) transact with customers in an honest and fair way; d) be transparent about how their platform works; e) promote and maintain high standards of business practice; and f) commit to provide good value financial service products to retail consumers.

¹⁰⁸ P2PFA, “Peer-to-Peer Finance Association Operating Principles” (June 2015), Article 4-25.

¹⁰⁹ *Ibid.*, Article 7.

¹¹⁰ *Ibid.*, Article 13.

¹¹¹ *Ibid.*, Article 26 and 27.

realisable securities by other media: Feedback to CP13/13 and final rules” (PS14/4), which summarised the response to the consultation paper, and outlined detail rules for regulating P2P lending platforms. Therefore, the rules of PS14/4 marked the establishment of a regulatory framework for P2P lending in the UK, which came into force on 1 April 2014.

Generally speaking, it is a disclosure-based regulatory system, which intends to protect investors on P2P online portals through the way of promoting information transparency. Besides, the new regime has the objective to promote competition in the sector, help smaller businesses to have more access to alternative finance market, as well as to add more protections for financial consumers. However, despite the new regulation, P2P lending is still not included in the remit of FSCS, so lending platforms should make it clear to investors.¹¹² The new regulation contains rules in seven aspects for P2P platforms, which can be broadly categorised into operational requirements for a certain platform, as well as consumer protection rules. The relevant operational requirements including capital adequacy requirement, client money rules, how to deal with the situation of business failure, and compulsory reporting requirement.

Prudential Capital Requirement

Capital requirement or capital adequacy refers to the amount of capitals which financial institutions have to hold. As required by the financial regulator, a financial firm has to maintain a certain level of capitals against its assets, which could prevent the firm from undertaking excessive risks and reduce the possibility of insolvency. In practice, banks and other deposit-taking institutions are subject to strict capital requirements set in the Basel Accords. After the global financial crisis, the Basel II was replaced the latest Basel III which is going to be implemented by banks from 2013-2019.¹¹³ As for the P2P lending sector, the FCA also requires lending platforms to hold certain regulatory capitals, in order to withstand potential financial shocks and cover operating losses. At present, the financial resource requirement for a certain P2P

¹¹² The FCA will reconsider whether loan-based crowdfunding shall be within the remit of the FSCS, when it reviews the crowdfunding market and its regulatory framework in 2016. See, FCA, PS14/04, p.18.

¹¹³ Bank for International Settlements, “Basel III: A global regulatory framework for more resilient banks and banking systems” (June 2011).

platform will be the higher one of the following two standards:

- A fixed minimum amount of £20,000 (transitional arrangement between 1 April 2014 and 31 March 2017) or £50,000 (after 31 March 2017);
- A. 0.2% of the first £50 million of total value of loaned funds outstanding; + B. 0.15% of the next £200m of total value of loaned funds outstanding; + C. 0.1% of the next £250m of total value of loaned funds outstanding; + D. 0.05% of any remaining balance of total value of loaned funds outstanding above £500m.¹¹⁴

As a prudential standard set by the FCA, the amount of required capital is directly linked with the amount of client money that a P2P platform is holding. Similar to bank capital requirements, the capital rules for P2P lending platforms can protect the benefits of consumers, as they have to possess enough prudential capitals to cope with potential financial difficulties. It also encourages competition as P2P lending companies with different sizes are subject to different rules, according to the principle of proportionality.

Client Money Rule

According to the FCA, financial firms which hold money for their clients relating to investment business are subject to the client money rules contained in FCA's Client Assets Sourcebook (CASS).¹¹⁵ These rules ask relevant firms to have sufficient protections for the clients' money they are looking after. As P2P lending has become a significant part of UK's financial industry, the FCA requires P2P lending platforms to comply with the CASS rules, such as segregation of client money, statutory trusts in terms of client money, and retrieving information in the event of insolvency in order to achieve a timely return of client money.¹¹⁶

Protections in the Event of Failure of a P2P Lending Platform

Although the new regulation tries to reduce the possibility of the failure of P2P platforms in the UK, in practice the insolvency of some P2P lenders will be inevitable in a competitive market. As P2P loan agreements are entered by investors and

¹¹⁴ FCA, PS14/04, p.20.

¹¹⁵ FCA, "CASS Client Assets", available at <https://www.handbook.fca.org.uk/handbook/CASS/>, accessed 1 February 2017.

¹¹⁶ FCA, PS14/04, p.22.

borrowers, and the P2P platform only serves as an information intermediary which is not a contractual party, so the failure of a P2P platform does not cause direct losses for investors. However, it will be difficult for individual investors to administer their loans after the failure of their platform, since many investors do not even know their borrowers. Moreover, in many cases investors only own a small stake of a particular P2P loan which is funded by dozens or hundreds of people. Therefore, in order to protect investors' money in the event of failure, the FCA requires P2P lenders to have the following arrangements in advance regarding the administration of loans when the platform fails:

- Client money should be distributed to investors under the client money rules;
- A new client bank account should be set up to receive ongoing payments for existing loans under the client money rules;
- No new loans should be made and existing loans will remain valid under their original terms;
- The firm's arrangements to manage those existing loans, apportioning repayments to the right investors and following up late repayments or borrower defaults should come into effect.¹¹⁷

FCA Reporting Requirements

The FCA also imposed some reporting obligations on P2P lending firms for information like financial position reports, client money reports, regular reports on investments, and complaints reports.¹¹⁸ It enables the regulator to monitor the lending trend of the market, potential risks of the whole industry, as well as to check whether consumers have been treated fairly. Clearly, having sufficient information about the industry lays a sound foundation for an effective regulatory system, so the FCA by gathering information of P2P lenders hopes to achieve a high level of conduct and prudential regulation.

As for regulatory rules regarding consumer protection, it can be divided into three broad areas:

Cancellation Right

¹¹⁷ FCA, CP13/13, p.26.

¹¹⁸ FCA, CP13/13, p.34-35.

The EU Distance Marketing Directive (DMD) requires that if any financial contracts are made in a distance, customers shall be able to withdraw their money within the first 14 calendar days, without a penalty and the need to give any reasons.¹¹⁹ As most P2P loan agreements are made online, this rule is also applied to the P2P lending market. Therefore, the FCA asks P2P platforms which do not have a secondary market¹²⁰ to comply with one of the following two systems:

- A P2P firm may allow consumers to invest in loan agreements immediately but when requested it should repay consumers with their money within the first 14 days; or
- Consumers will not be able to invest money in loan agreements within the first 14 days of registering with a P2P platform.¹²¹

Information Disclosure Rules

Evidently, information disclosure has been a vital regulatory tool to protect financial consumers, for financial firms are supposed to provide accurate and adequate information for its consumers to make informed financial decisions. They should illustrate both benefits and risks of an investment, and particularly shall not downplay the potential risk of loss. Accordingly, the FCA requires P2P lending platforms to disclose relevant information to investors, including but not limited to information about the firm, information about the service, financial promotion rules, performance information, guarantees, protections and security mechanisms, comparative information, and periodic reporting information.¹²² Investors on P2P platforms are susceptible to different types of financial risks and could face financial losses when borrowers default or the platform goes into financial troubles, and hence, they should be given enough information before they put their money into to the market.

Dispute Resolution Process

Finally, it is important to have a complaint procedure for customers who feel prejudiced or unhappy about the financial service they have received. Thus, the FCA

¹¹⁹ European Union Distance Marketing Directive 2002/65/EC

¹²⁰ If the platform has a secondary market and allow investors to sell their loans to other investors, at a market price, it will be unreasonable to allow them to have a withdraw right.

¹²¹ FCA, CP13/13, p.28.

¹²² FCA, CP13/13, p.29-33.

requires P2P firms to establish a complaint handling process, and investors should make complaint to the firm, in the first instance; After the internal procedure, investors are entitled to take the complaint further to the Financial Ombudsman Service, if not satisfied with the firm's complaint handling outcome.¹²³

6.5 Private Lending and Consumer Credits in the UK

Private lending, or direct private-debt investing, has been a debt financing tool used by SMEs, which allows private investors to make loans to private businesses on a contractual base. Clearly, private financing in the UK is not as popular as it is in China where its special political and economic environments contributed to the prevalence of private loans. It is difficult to get a full picture of private lending activities in the UK due to its private nature and limited data available, but we can still discover some evidence regarding the use of private loans in the British business community.

6.5.1 Private Debt Investments: Advantages and Disadvantages

In the aftermath of GFC, the regulatory change has affected bank lending activities, which makes established lenders less willing to provide credits for smaller businesses; at the same time, it has created opportunities for non-bank lenders, such as debt fund managers, to enter into the lending industry.¹²⁴ Traditionally, when British businesses need credits, they will borrow money from banks, or issue bonds to institutional investors to raise money. However, in recent years there is a tendency that an increasing number of firms have chosen to borrow credits directly from institutional investors, at a rate from 9-12 per cent.¹²⁵ For instance, EAT, a sandwich chain store based in the UK, borrowed £40 million from the investment firm Ardian, to fund its rapid expansion.¹²⁶ Clearly, private lending has become an alternative financing tool for private companies, as banks tightened their credits under the current circumstance. It is worth noting that one major difference between private debt financing in the UK and China is that, in China individual investors and informal intermediaries dominates

¹²³ FCA, CP13/13, p.33.

¹²⁴ Preqin, "Special Report: Private Debt: The New Alternative?" (July 2014), p.2.

¹²⁵ *The Economist*, "Private-Debt Investing: Lender of First Resort" (31 October 2015), p.79.

¹²⁶ Duncan Robinson, "Sandwich chain Eat plans expansion with £40m refinancing" (13 May 2014) *Financial Times* (Online); *The Economist*, "Private-Debt Investing: Lender of First Resort" (31 October 2015), p.79.

the market, whilst in the UK institutional investors play a main role in private debt investments.

The advantage of private debt loans over bank loans is evident, for the procedure of private lending is much more flexible and less bureaucratic. All terms of a private lending agreement can be negotiated between borrowers and investors, which can be tailored to meet the actual needs of both lending parties. Apart from generating considerable returns, private debt investments can bring various benefits for investors. For example, they could help investors to add more diversification to the existing portfolio, as private lending has a low correlation to traditional income investments such as public bonds.¹²⁷ Besides, investing in private debts can also avoid daily price volatility and it is less prone to wide price swings in the capital market.¹²⁸ Moreover, investors of private lending, as creditors, can enjoy the priority claim over the cash flows of the borrower ahead of equity investors who are shareholders.¹²⁹ On the other hand, from the perspective of borrowers, private lending opens one door for them if they cannot obtain credits from traditional banks.

However, private debt investing also comes with a relatively high costs compared to bank loans. For instance, in the case of EAT, the Ardian as the lender, charged 15 per cent annual interest rate.¹³⁰ According to Preqin, European investors for private debt usually have a target return from 7-13 per cent.¹³¹ Clearly, the high interest rate of private lending is a double-edged sword. On the one hand, the attractive yield can solicit some investors who have relevant risk appetites to enter the market, and thus provide more funding for private businesses looking for funding. On the other hand, the high cost will be a heavy burden for borrowers if they cannot generate adequate revenues to pay off debts. In practice, the private debt market has seen a high level of default rates, as borrowers in the market are normally not accepted by mainstream banks as a result of their risky business models.¹³² Apart from the default issue, private

¹²⁷ CNL Security, "Private Debt: Benefits and Risks" (2015).

¹²⁸ *Ibid.*

¹²⁹ *Ibid.*

¹³⁰ *The Economist*, "Private-Debt Investing: Lender of First Resort" (31 October 2015), p.79.

¹³¹ Preqin, "Special Report: Private Debt: The New Alternative?" (July 2014), p.2.

¹³² *The Economist*, "Private-Debt Investing: Lender of First Resort" (31 October 2015), p.79.

lending also contains some other risks which need to be considered by investors. For instance, holding a private loan has limited liquidity compared with other investments like public bonds or shares which can be traded on the secondary market.¹³³ In the absence of a secondary market, it is difficult for private debt investors to sell their investments and get the cash. Likewise, credit rating agencies, like Standard and Poor's, Moody's, Fitch Ratings, only provide rating service for publicly traded debt products, rather than private loans, and therefore private lenders have to assess the creditworthiness of borrowers by themselves or hiring special experts, which will be costly.¹³⁴

6.5.2 Private Lending and Consumer Credits: A Comparative Study

The regulation of private lending in the UK, to some extent, falls into the scope of consumer credit regime, if both borrowers and lenders satisfy certain conditions. Consumer credit generally means the debt incurred by consumers for the purpose of purchasing goods or services. The time from 1980-2008 witnessed a substantial growth in both consumer and mortgage credits in the UK.¹³⁵ First of all, it is necessary for us to sort out similarities as well differences between private lending and consumer credits before we address relevant regulatory issues. As for their similarities, it is evident that, whether private lending or consumer credit, it is a lending agreement which contains the provision of credits from lenders to borrowers. Businesses, like individuals, sometimes need to borrow credits to purchase goods or services if they do not have enough cashes or want to spread the costs of purchases over a period of accounting time.

However, the significant differences between those two types of credits shall not be ignored, and the author argues that the majority of private lending activities remain outside the realm of consumer credit. First of all, the purposes of two types of borrowing are distinctive. Consumer credits are mainly employed by consumers for personal use, such as buying furniture, electrical appliances, clothing, vehicles, holidays, and home repairs and improvements.¹³⁶ In contrast, private lending is utilised

¹³³ CNL Security, "Private Debt: Benefits and Risks" (2015).

¹³⁴ *Ibid.*

¹³⁵ Ian Ramsay, *Consumer Law and Policy* (3rd edn, Hart), p.361.

¹³⁶ Geoffrey Woodroffe and Robert Lowe, *Woodroffe and Lowe's Consumer Law and Practice* (8th

by individuals or companies to raise money for the purpose of running businesses, so its nature resembles bank loans for businesses, but the credits come from private investors instead of financial institutions. Clearly, the different purposes of lending leads to the different natures of two types of credits. For instance, the amounts of money involved in them have a significant disparity. The amount of consumer credit is comparatively small; for example, a consumer buys a digital camera worth £200 on the instalment payments, or a consumer buys a car worth £30,000 by hire purchase, or a consumer uses his or her credit card to buy anything. Normally, the amount of money range from tens of pounds to tens of thousands of pounds at most. In contrast, as private lending is mainly borrowed for the business use, so the amount of money could be much larger than ordinary consumer credits. It can range from tens of thousands of pounds to tens of millions of pounds, just like the EAT's case mentioned previously, EAT borrowed a private loan worth £40 million from Ardian, so the sum of money involved are at very different levels for consumer credits and private lending.

Secondly, the nature of creditors in those two types of lending is obviously different. In terms of consumer credits, creditors are specific financial firms who provide credits to the public. Therefore, the regulation of consumer credit relies on a authorisation system, which is perceived as the lynch-pin of the whole consumer credit regulation.¹³⁷ This type of regulatory regime is only feasible as the creditor or lender is a relatively specific person who lends out on a frequent basis (lend as a business), as all of other regulatory techniques and controls are dependent on the prerequisite of authorisation. Therefore, firms offering consumer credits, which fall into the regulated activities¹³⁸, shall obtain Part 4A permission from the FCA¹³⁹. Reversely, in private lending activities, it is normally the specific borrower to solicit funds from an unspecific group of potential investors who will be creditors. Therefore, if lenders only lend out once or twice to the borrower, to increase the diversity of their portfolios, they will not be caught under the consumer credit regime, despite the amount of money is as large as hundreds of thousands of pounds. Under this circumstance, it is implausible to require

Edition Sweet & Maxwell), p.295.

¹³⁷ *Ibid.*, p.317.

¹³⁸ Financial Services and Markets Act 2000, Section 19. No person may carry on a regulated activity in the UK or purport to do so, unless he is – (a) an authorised person; (b) an exempt person.

¹³⁹ FCA took over regulation of consumer credit from Office of Fair Trading (OFT) on 1 April 2014.

creditors who are investors in the private lending to seek authorisation due to the lack of frequency and the lack of lending out by way of business. As most creditors in private lending do not need to be authorised, relevant regulatory rules of consumer credits will not apply to them.

Thirdly, a key difference between private lending and consumer credit is that which side of lending parties suffer from the problem of vulnerability. Under consumer credit agreements, it is clear that under most circumstances borrowers who are consumers are in a disadvantaged position, as they could be treated by creditors unfairly, in terms of information provision, interest rates, or complicated terms. Therefore, the primary focus of the consumer credit regime is on the protection of consumer borrowers. However, under private lending loans, both sides of lending parties could be vulnerable. For example, debtors often suffer from excessively high interest rates and unfair terms as said in previous chapters. On the other hand, creditors who are investors also struggle with high default rates and even the loss of the entire principal in the worst situation. The reason for why private lenders often charge excessive interest rates is mostly for the compensation of the potential high possibility of default, as their investments are not covered by national financial protection schemes. Therefore, it is hard to say whether creditor or debtor in the private lending is more vulnerable.

6.5.3 The Consumer Credit Regime for Protecting Small Business Borrowers

Bearing these differences in mind, we are going to take a closer look at the consumer credit regulation in the UK, to see what we can learn from it, in terms of regulating private lending and protecting borrowers. In the UK, the Consumer Credit Act 1974 (CCA 1974) provides statutory controls and protections for all consumer credit agreements which are qualified as regulated agreements. On 1 April 2014, the FCA took over the responsibility of protecting consumer interests throughout the UK from the Office of Fair Trading (OFT). According to the CCA 1974, a consumer credit agreement is an agreement between an individual (“the debtor”) and any other person (“the creditor”) by which the creditor provides the debtor with credit of any amount.¹⁴⁰ Moreover, the term of credit under the CCA 1974 refers to a cash loan, and any other

¹⁴⁰ CCA 1974, S8(1).

form of financial accommodation.¹⁴¹ Under the FSMA 2000 (Regulated Activities) Order, entering into a regulated credit agreement as lender is a specific kind of activity regulated by UK's financial regulatory regime, unless the credit agreement is an exempt agreement.¹⁴² The credit agreement refers to an agreement between an individual or relevant recipient of credit (A) and any other person (B) under which B provides A with credit of any amount.

We now evaluate what amounts to an exempt agreement in terms of borrowing for business. A credit agreement is an exempt agreement if: (a) the lender provides the borrower with credit exceeding £25,000, and (b) the agreement is entered into by the borrower wholly or predominantly for the purposes of a business carried on, or intended to be carried on, by the borrower.¹⁴³ Therefore, it means that if a borrower, for the business purpose, borrow more than £25,000 from a lender, then this agreement will not be regulated by the FCA; but if the amount of loan is no more than £25,000, the agreement will be regarded as a regulated one and thus the borrower can enjoy all kinds of protection even though he or she indeed borrows the money for business operation.

Moreover, according to the section 74 of CCA 1974, the rules regarding credit or hire purchase agreements do not apply to a "non-commercial agreement", which means a consumer credit agreement or a consumer hire agreement not made by the creditor or owner in the course of a business carried on by him.¹⁴⁴ Therefore, in order to be qualified as a regulated agreement and protected by the consumer protection regime, the borrower shall borrow the loan when the lender is doing the credit business. Besides, so as to see whether SME borrowers can fit into the concept of the individual (debtor) under this legislation, we have to look at the detail definition of the individual, which is set out in the section 189(1) as it includes (a) a partnership consisting of two or three persons not all of whom are bodies corporate; and (b) an unincorporated body of persons which does not consist entirely of bodies corporate and is not a

¹⁴¹ CCA 1974, S9(1).

¹⁴² FSMA 2000 (Regulated Activities) Order 2001/544, Section 60B.

¹⁴³ FSMA 2000 (Regulated Activities) Order 2001/544, Section 60C(3).

¹⁴⁴ CCA 1974, Section 189(1).

partnership.¹⁴⁵ Therefore, creditors lending to private persons, sole traders, or partnerships consisting of 2 or 3 persons, will be covered by the CCA 1974. Otherwise, borrowing by partnerships which have more than 3 members, or corporate bodies will not be covered.

In summary, if debtors are borrowing money for the business purpose and they would like to be protected as a consumer, they have to satisfy three requirements: First, they have to borrow money no more than £25,000, for the purposes of doing business; Second, the loan shall not be a non-commercial loan, which means borrowers should borrow money in the course of business of the creditor; Third, borrowers shall be private persons, sole traders, or partnerships consisting of 2 or 3 persons. Therefore, the coverage of consumer credits is relatively limited for all private lending activities, since the regime has been designed primarily for the protection of individual consumers, rather than business borrowers. It is an authorisation-based regime, so it requires the lender who is lending by way of business, rather than lending occasionally. However, many investors who are lenders do not perceive lending as their usual and basic businesses. Therefore, the consumer credit regime only covers a limited number of private lending transactions, and otherwise, private lending as purely contractual relationship will not be covered by consumer credit legislation. Nevertheless, some rules for protecting consumers under the CCA merit consideration in designing a regime for private lending, such as information disclosure and cancellation rights.

Financing Methods	Regulation
<i>Bank Lending (including challenger banks)</i>	- Banks in the UK are authorised by PRA and regulated by PRA and FCA.
<i>P2P Lending</i>	- P2P lending platforms now come under the supervision of FCA. All lending platforms have to be authorised by FCA. FCA set out rules in seven areas: prudential capital requirement, client money rules, protections in the event of failure of the P2P lending platform, cancellation right, information disclosure rule, dispute resolution, and FCA reporting requirements. - Industry self-regulation enforced by Peer-to-Peer Finance Association (P2PFA). P2PFA promulgated a series of operating principles for its members to follow, and it plays a vital in ensuring the high level standard of business conducts and consumer protection in the industry.
<i>Private Lending</i>	- Most private lending activities are not regulated, as they are merely private contracts entered by lenders (investors) and borrowers, and most private debt investors lend at a non-frequent

¹⁴⁵ *Ibid.*

	<p>basis.</p> <p>- When certain small business (as private persons, sole traders, or partnerships consisting of 2 or 3 persons) borrow credits from consumer credit firms which are authorised and regulated by FCA, their credit agreements will be regulated. In order to be qualified as a regulated agreement under the CCA 1974, the amount of the loan shall not exceed £25,000, for the purposes of doing business; the loan shall not be a non-commercial loan, which means they borrow the loan in the course of the business of the lender.</p>
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Table 18: UK SME Debt Financing and Regulation

6.6 Conclusion

In the UK, small and medium-sized enterprises play a vital and indispensable role in the national economy, as they account for 99.9 per cent of the number of businesses, 60 per cent of employments in the private sector, and nearly half of the UK's GDP. However, in a sharp contrast, British SMEs only obtain 37 per cent of total bank credits, whilst 62 per cent of bank loans go to large corporations. Clearly, the high level of financial inequality between smaller businesses and large companies results in the financing difficulties faced by SMEs in the post-crisis era.

It is evident that there is a big gap between SMEs' financing demands and the limited credits which can be provided by mainstream banks. It creates an opportunity for alternative finance providers that fill the voids of the financial industry. Accordingly, the recent time has seen the fast development of a group of digital focused challenger banks, whose businesses focus on providing bespoke financing services for SME borrowers and individual consumers that are underserved by dominant lenders. The specialised SME financing services include asset financing, invoice financing, and commercial mortgages, which can partly alleviate the financial difficulties of smaller businesses. Aldermore and Shawbrook are successful examples of challenger banks. Both of them were established shortly after the GFC, but in a few years, they have already become leading lenders in Britain with their shares listed on the London Stock Exchange. Apart from their special customer focus, their success also results from the low-cost operating business model. In terms of financial regulation, challenger banks and other lenders have been subject to the same regulatory rules, but some commentators said the current regulatory requirements, such as the capital adequacy rules, favour big lenders instead of challenger banks.

Since 2005, the UK has witnessed the rise of the online P2P lending industry. Dubbed as banking without banks, P2P online portals serve as information intermediaries to match lenders with borrowers online. P2P loans benefit borrowers by lowering the lending costs and increasing the availability of credits. They also bring higher returns for lenders who invest in P2P loans rather than put the money in their saving accounts. Over the past decade, the P2P lending sector has become an important component of the UK's financial industry, with over 70 active online platforms processing transaction worth billions of pounds. In particular, the peer-to-business model was invented to provide loans for business borrowers. The Funding Circle is a leading P2B lending platform in the UK. Through such lending platforms, SMEs have access to credits at an affordable price, and the terms of P2P loans are much more flexible than that of bank loans. Clearly, P2P loans are good substitutes for bank loans. Recently, a comprehensive regulatory regime over the P2P lending industry has been established, which comprises the industry self-regulation and the FCA's official supervision. P2P lenders are subject to a series of regulatory requirements to ensure their soundness, such as the capital requirement, information disclosure, consumer protection, and so on. The new regulation can improve the safety of lending activities and enhance the protection of both borrowers and investors. However, it should be noted that P2P lending are not covered by the Financial Services Compensation Scheme.

Finally, this chapter has discussed about private lending and consumer credits. Private debt investments can be found in the UK, but it is difficult to gauge its market scale due to its private nature and the lack of statistical data. In addition, we have explored consumer credits which can be used by small businesses as a financing tool. We have examined under what circumstances small businesses can be protected as ordinary consumers under the UK's consumer credit regime. In summary, apart from the credits from mainstream banks, SMEs in the UK have access to a variety of debt financing channels, most of which are under the official supervision of the FCA.

Chapter 7 Conclusion

7.1 Introduction

This is the final chapter to complete the thesis. It consists of a summary of findings, the recommendations for China's policy-makers, the limitations of this research, and the recommendations for further research.

7.2 Findings of This Research

Over the past four decades, China said goodbye to the old centrally planned economy and embraced Adam Smith's free market ideology. It has witnessed the rapid growth of private capitalism, as millions of entrepreneurs started their business ventures in pursuit of personal wealth. Clearly, the achievements of the Chinese economy have been well-known, but how Chinese businesses are being financed has remained a secret. In fact, the financing stories of most Chinese entrepreneurs are miserable. Being refused by mainstream banks, they have to rely on private financing to borrow credits, which gives rise to an enormous private lending market outside of the official regulatory regime. So far, this vast shadow banking sector has been largely underexplored by legal scholars. Therefore, this study fills this gap in the existing literature, through the analyses of laws and regulations surrounding the private lending market. The following part presents main findings of this research.

7.2.1 The Nature, Causes, and Characterises of Private Lending Activities

The chapter 2 has conducted a thorough investigation into how the private lending market works. It provides an essential foundation for the analyses in the rest of the thesis. Clearly, private lending activities flourished under China's unique political and economic environments. Thus, any discussions of private lending without mentioning China's historical and current social environments would be incomplete. This chapter has the following findings.

First of all, private lending can find its origin in the prolonged Chinese history. Nearly 3000 years ago, the Chinese ancestors already devised specialised moneylending contracts called *Fu Bie*, which not only documented detail obligations for lenders and borrowers, but could also be used as evidence during the dispute resolution process.

Throughout the history, private lending played an important role in people's lives and business activities. Imperial governments in the past promulgated laws regulating lending agreements, such as the interest rate caps and the criminal offences for charging excessive interests. During the Song Dynasty, private lending activities became more institutionalised, as it saw the oldest paper currency in the world, *Jiao Zi*, coming into use. The shops of *Jiao Zi* were established as deposit-taking institutions, which can be seen as the embryonic form of modern banking. When the time came to the last imperial dynasty Qing (1644-1912), we saw the emergence and developments of *Piao Hao* and *Qian Zhuang* which were nationwide money-lending networks, marking the peak of the private lending industry in ancient China. The late Qing Dynasty and the Republican Era (1912-1949) observed the formation of the modern banking industry in China, as the Western banking model was introduced by British merchants, and many of traditional lending institutions were converted into banks. Hundreds of banks sprung across China, including the most famous "Four Northern Banks" and "Three Southern Banks". In 1927, the Financial Supervisory Bureau was founded, the first official banking regulator in the country. Moreover, Shanghai at that time became an international financial centre like London and New York, as it held headquarters of over 80 banks as well as dozens of securities and commodities markets. The Republication age, therefore, is perceived as a golden age for Chinese banking. However, when the Communist Party took power in 1949, it adopted the centrally planned economy following the economic model of the USSR. As a result, most banks in China were nationalised or shut down during that period. The People's Bank of China was established to act as the sole commercial bank in the country as well as the monetary authority. Therefore, from 1949-1978, China had neither a banking sector nor a private lending market in a strict sense.

Second, the chapter, by using the supply and demand theory, explains how the private lending market has evolved into a massive underground financial industry and become the vital financing channel for private businesses. After the 1978, China decided to reform the centrally planned economy by allowing individuals to run businesses and attracted foreign capitals to invest. Driven by the desires to become rich, millions of people chose to start their own business ventures, leading to the rapid expansion of the Chinese economy. However, there has been a big obstacle facing Chinese entrepreneurs, as most state-owned banks feel reluctant to lend credits to the private

sector. As a result, private businesses have to look for financing channels outside the banking sector, and naturally private financing fills the voids. In practice, businessmen and women borrow funds from their family members, relatives, friends, business partners, professional moneylenders, and various types of money houses. The thriving underground lending activities have contributed to a gigantic market worth CNY 4-5 trillion, which remains outside of the official regulation. In the mean time, many Chinese prefer to put their money into the private lending market due the attractive interest rates which often stand over 20 per cent per anum. Therefore, the financing demands from private businesses have been satisfied by the supply of money from Chinese savers, which leads to a win-win situation of both lending parties.

Third, this chapter compares the term “private lending” with other similar concepts, including informal finance, shadow banking, and peer-to-peer lending. It concludes that private lending can be categorised into China’s informal financial world. Nonetheless, private lending activities are to some extent distinctive from informal finance in other countries, as they exist in parallel with China’s mature banking industry and serve a wide range of clients including big corporations. Moreover, through detail analyses, the thesis argues that the private lending market belongs to China’s vast shadow banking sector, due to being non-bank credit intermediaries and meeting some shadow banking features according to the FSB. In addition, it looks into China’s burgeoning P2P lending sector, which can be seen as the online version of private lending. These P2P lenders match the financing demands of SMEs with the money from investors online, which overcomes the geographical limitations of traditional private lending. It is predicted that more and more private lending businesses will go online in the future.

Fourth, the chapter summarises the main characteristics of private lending activities. Evidently, private lending has an extensive presence in China as lending activities have been conducted through traditional personal and business networks. The reliance on personal links, to some extent, makes the moneylending process faster and more efficient, as it overcomes the problem of information asymmetry. Compared with bank loans, the terms of private loans are more flexible which can be freely negotiated between lenders and borrowers. Nonetheless, the convenience of private lending comes with other disadvantages such as high costs and the uncertain illegitimacy. In

practice, the annualised interest rates of most private loans normally exceed 20 per cent, leading to heavy debt burdens for Chinese businesses. It is an important reason causing the private lending crisis.

7.2.2 Risks and Problems Exposed in Private Lending Crisis

The chapter 3 has examined China's private lending crisis in 2011, in order to find out problems and financial risks that exist in the underground lending sector. It is clear that the recent financial crisis broke the once equilibrium of the private lending industry, and it had very negative influences on market participants as well as the financial system as a whole. This chapter comes up with the following findings.

First, it has unveiled reasons that triggered the private lending crisis. The Global Financial Crisis led to the slowdown of the Chinese economy in recent years, which means deteriorating business conditions for most businesses, in particular manufacturers and exporters who suffered from weakening global demands. Meanwhile, in 2011, the Chinese monetary authority tightened banks' credits in order to curb the rising inflation rate, which led to the increasing financing pressures felt by numerous businesses. Under this circumstance, more and more private businesses approached private lenders for financing and had to pay for huge prices for getting credits. At the same time, professional lending brokers used attractive rates to solicit funds, so an increasing number of individuals and firms who had spare capitals competed to join the private lending investments. The private lending bubble emerged and grew in many regions in China, as people lent out their money and dreamt about getting rich quick. However, due to the worsening economic conditions, many borrowers became unable to fulfil their debt obligations, giving rise to the sudden collapse of the private lending market. Therefore, default waves struck the underground moneylending industry and caused hefty losses for investors.

Second, this chapter has analysed the impacts of the crisis on borrowers. Clearly, the lending crunches caused the bankruptcies of thousands of businesses across China. Some business owners decided to run away to evade debts. The case of Fujian Nuoqi Co Ltd and its chairman Mr. Ding Hui has been studied, to see how this kind of incidents damage the interests of shareholders, creditors, and the local clothing industry. It has answered the question that why Chinese bosses prefer to running away

rather than filing for bankruptcy. It is because many entrepreneurs have borrowed private loans under their personal names, owing to the unclear legitimacy of private financing activities. Currently China does not have personal insolvency regimes, which means businessmen and women are unable to free themselves from private debts. Moreover, failing to repay money to a large number of investors could constitute the criminal offence of fundraising frauds, and relevant penalties can be up to life imprisonment (or even death penalty not long ago). Apart from that, business borrowers could face violent debt collections from loan sharks. As a result, running away becomes an optimal choice for some bankrupt entrepreneurs.

Third, it has discussed about the financial losses of investors and their limited remedies after the crisis. Private lending investors, whether ordinary households or professional moneylenders, encountered heavy losses as a result of massive defaults. The chapter has used the examples of financing guarantee companies in Xiamen to reveal how shadow banks operate to evade financial regulations. Under the disguise of formally incorporated businesses, moneylenders take deposits from local residences and make loans to businesses in need of funds. The deposit-taking model without any regulations is indeed highly risky. When the lending crisis arrived, many of large money houses failed and their investors were not entitled to the official protections. Some investors launched civil litigations against borrowers to claim their debts, whilst others conducted private debt collection activities. However, the change of getting back the principals was very slim. We have studied two real cases of an ordinary investor and a professional moneylender, to find out how they lost most of their investments.

Fourth, the chapter has discovered major problems exposed by the lending crisis, which shall receive regulatory attentions. Apparently, the private lending crisis was a source of abruptions to China's financial stability. A major concern for regulators shall be the illegal deposit-taking model widely used by professional moneylenders. It increases the complexities of lending structures by introducing a lot of ordinary investors. It is prone to systemic risks due to the interconnects between the private lending market and the banking sector. Moreover, the interest rate caps had limited effects in the past, which failed to control usuries and protect the benefits of borrowers. In addition, the lack of personal insolvency regimes and investor protection mechanisms shall be addressed by future regulatory reforms.

7.2.3 Effectiveness and Drawbacks of the Current Legal Framework

The chapter four has evaluated China's current legal framework regulating private lending activities, in order to answer whether there are sufficient and effective rules and relevant implementation methods to cope with the popular private lending practices. Relevant findings are listed below.

First, it has analysed the changing official attitudes towards the legitimacy of private financing activities, which are critical to the making of policies and regulations in this area. In the past, private financing was largely restricted by the Chinese authorities. In particular, the lending agreements between two non-financial enterprises were totally prohibited, despite their common usages in economic activities. However, the post-crisis era has seen a big shift of the authorities' perceptions regarding private lending, as the latest *Regulation 2015* has recognised the legitimate status of private financing activities including moneylending arrangements between two corporates. Moreover, the *Regulation 2011* has clarified the judiciary's role in handling private lending disputes. Clearly, the rising private lending-related civil cases have occupied a considerable amount of judicial resources in China, and the *ex post* regulatory approach seems ineffective in preventing crises, and it is unable to detect and control financial risks of the private lending market.

Second, through the analyses of loan agreements under the PRC Contract Law, we have an understanding about what rules shall be observed by lenders and borrowers, such as the requirements for formalities and contents of a lending agreement, the rights and obligations of lending parties, and what leads to breach of contract and relevant remedies. It has also considered how the rules are being used by the Chinese court system to hear a great number of civil cases relating to private lending contracts due to the financial crisis. Apart from dealing with civil cases, the judiciary authority has undertaken additional responsibilities to solve social conflicts and maintain financial and social stabilities. For instance, Chinese judges are required to watch if there are any illegal elements in civil cases that could amount to criminal offences, and report such suspicions to the authorities in charge of criminal investigation. Moreover, judges have to cope with business borrowers who are near insolvency with extra cautions, in order to minimise the number of insolvency cases that could damage the local

economies. A liquidation process can only be started after all other possible means have been exhausted. Judging from the above evidence, the author argues that the Chinese court system has been the *de facto* regulator for the private lending market.

Third, the chapter has studied two sets of interest rate regulations for private lending agreements. The repealed “four-time red line” had been in use for more than two decades. It was criticised for drawing a simple line between legitimate lending agreements and illegal lending practices, which neglected the great diversities of lending activities in different regions and various practices of different lending entities. The *Regulation 2015* put forward the new “24/36” interest rate rule which grants lending parties more autonomy in deciding the interest rates, which is considered as a progress for liberalising the financial market.

Fourth, the chapter has assessed criminal liabilities relating to illegal lending practices. The main problem of the criminal law is the blurred line between ordinary lending activities and illegal fundraising practices, decided by the discretions of Chinese judges. As a result, if many investors suffer huge financial losses during a credit crisis, Chinese criminal courts, under great political pressures, are likely to impose severe criminal sanctions on borrowers who cannot repay debts. The over-punishment issue remains highly controversial in the judicial practice. Two criminal cases concerning the offence of fraudulent fundraising have been studied. Mr Zeng Chengjie was sentenced to death because of committing financial frauds, whilst Ms Wu Ming escaped the death penalty thanks to the public debate. Most recently, the 9th amendment of the PRC Criminal Law abolished the death penalty for the offence of fundraising fraud, marking a big step forward in the legal reform.

Finally, this chapter has drawn a conclusion that the legal framework regulating the private lending market in China is generally considered as complete, in terms of setting out substantive laws for every aspect of private lending activities, from contract law regulations, interest rate restrictions, to criminal liabilities. However, relevant problems shall not be overlooked, in particular, the inconsistencies among different pieces of legislations, which has increased the difficulties of interpreting and implementing rules for legal practitioners. Moreover, the *ex post* judicial approach to deal with the private lending market is far from adequate. It calls for the establishment

of a new regulatory framework to monitor and supervise the complicated underground lending industry.

7.2.4 How to Regulate Private Lending and Improve SMEs' Access to Finance?

The chapter 5 has answered the questions about why we need to regulate the private lending market and how to regulate, by probing into China's latest financial reforms in Wenzhou. It comes with the following findings. First of all, it suggests that the Chinese authorities shall fulfil two separate tasks to solve the private lending puzzle: first, to design an optimal regulatory system for monitoring and supervising the underground lending industry; second, to break the state monopoly in the banking industry. In doing so, the policy-makers can create a multi-level credit system to serve the financing needs of most private businesses.

Second, the chapter has pointed out the rationales for regulating private lending. Primarily, it serves the interests of the public by preventing market failures and protecting the rights of lenders and borrowers. As it was shown by the lending crisis, an unregulated lending sector caused harms to most market participants, as well as triggered systemic risks, financial instabilities, and social unrests. Moreover, the new regulatory system is desirable because the private lending market has already become a vital element of China's financial system, in terms of its enormous size and important functions. An effective *ex ante* regulatory regime is able to tackle technical problems such as the information asymmetry, as well as reduces the workloads of Chinese judges who have been busy handling private lending disputes. Due to the increasing sophistications of private financing activities, substantive laws alone are not adequate to solve relevant problems, which calls for extra regulatory rules and a dedicated regulator with clarified mandates.

Third, the chapter has studied the Wenzhou Private Financing Regulation and the Wenzhou Index. The WPFR has established several publicly funded lending service centres which provide the matching services for lenders and borrowers, as well as other supporting services to facilitate lending transactions. It has also set up a registration-based regulatory framework which requires borrowers in the private lending market to file their loans to local financial authorities if their agreements meet certain official standards, such as the amount of money or the number of lenders. More and more

people in Wenzhou decide to register their loans with the authorities in exchange for official protections. The regulatory experiments have been copied by financial authorities from more than 15 provinces. In addition, the Wenzhou Index has been made as a barometer of the interest rate levels in the private lending market, providing a guidance for lenders, borrowers, financial regulators, as well as Chinese courts hearing such cases. It has enhanced the transparency of lending activities and curbs excessive interests. Generally speaking, the financial reforms in Wenzhou turn out to be a temporary success, whilst the long term effects remain to be seen.

Fourth, the chapter has assessed the process of financial liberalisation in China's banking sector, which is said to have a positive impact on the financing conditions of SMEs. As the government loosened the restrictions to set up banks, an increasing number of private investors have been trying to begin their own banking businesses, with the primary focus on offering SME financing services. Clearly, more credits from private banks can alleviate SMEs' financing dilemma. However, the new private banks have faced some obstacles, such as the limited size, the narrow business scope, and insufficient professionals, which might impede their further developments. As the coming of a competitive banking industry, the government has introduced a deposit insurance scheme and finished the interest rate deregulation, which can help private banks to grow and provide more credits for capital-starved businesses.

7.2.5 SME Financing Situation in the UK and Alternative Finance

After finishing the studies of the private lending market in China, the Chapter 6 extends the research into the UK, to provide some comparative views about SME finance. The chapter has found out that the UK does not have a private lending market similar to that of China, but its SMEs have been facing some similar financing challenges after the Global Financial Crisis. Therefore, it has explored the alternative financing channels for British SMEs and relevant regulations. The findings of this chapter are presented below.

First of all, through the statistical analyses, the chapter has pointed out the importance of SMEs to the British economy. The UK has 5.2 million SMEs, representing 99.9 per cent of all firms in the private sector. They account for 60 per cent of employments as well as nearly half of the UK's Gross Domestic Product. But in contrast, SMEs only

receive 37 per cent of total bank credits, whilst the majority of bank loans are given to large corporations. The great inequality in terms of the credit supply leads to the financing difficulties of SMEs. Apparently, there is a big financing gap for alternative financial service providers to fill.

Second, the chapter has probed into UK's digital focused challenger banks which aim to provide financing services for SMEs and consumers who are underserved by mainstream banks. Their services include asset financing, invoice financing, and commercial mortgages, which can partly ease the financial difficulties of smaller businesses. By serving the niche market, many challenger banks have become successful businesses in a short time, such as the Aldermore and the Shawbrook, which have been listed on the London Stock Exchange and became constituents of the FTSE 250. Due to their specialised services and the low-cost operating strategy, challenger banks flourished in the post-crisis era. In terms of regulatory issues, challenger banks are subject to the same regulatory rules as all other banks, but some commentators said the current banking regulatory regime including the capital adequacy requirement favours established lenders instead of new lenders, which shall be reformed.

Third, the chapter has investigated the UK's rising P2P lending industry, which is the largest alternative financing market in the Europe. The author has found out that P2P lending (in particular P2B lending) brings benefits for both investors and business borrowers. Such lending portals offer a large amount of credits at affordable costs for SME borrowers, while the investments can provide a better return for British savers. For SMEs, P2P loans can be good substitutes for bank loans. As for the regulation of P2P lending, there is the industry self-regulation as well as the FCA's official supervision, covering the capital requirements, information disclosure, consumer protection, and so on. The official regulation can improve the safety of the online lending market and offer more protections to investors. However, investors should bear in mind that P2P investments are not covered by the Financial Services Compensation Scheme.

Finally, this chapter has discussed about private lending and consumer credits in the UK. Despite the existence of private debt investments in the UK, it is difficult for the researcher to acquire sufficient materials about its market scale and lending data, due

to the non-public nature. Therefore, we have studied consumer credits in the UK which can also be used by small businesses as a form of business finance. In particular, it has summarised under what circumstances small businesses will be protected as consumers under the UK's consumer credit regime.

7.3 Recommendations for Chinese Policy-makers

This research aims to provide suggestions for the Chinese policy-makers in terms of regulating the private lending market, so as to improve the financing conditions of private businesses, protect market participants against relevant risks and illegal lending practices, and promote the financial stability. Therefore, this section lists some important recommendations for the Chinese authorities based on the previous research findings.

7.3.1 Make A Unified Private Lending Legislation

Codified legislations play a main role in the judicial practice in China which is mainly a civil law jurisdiction. Therefore, due to the increasing importance of private lending activities, it is time for the Chinese legislature (the National People's Congress or its standing committee) to enact a specialised law in relation to private lending.¹ The new legislation will combine the relevant rules and regulations of private lending which can be found in various legislations like contract law, security law, criminal law, and judicial interpretations. A unified piece of legislation not only eliminates the inconsistencies among different statutes, but also provides a convenient and clear guidance for legal practitioners and market participants who have to refer to such rules frequently. The new legislation is recommended to cover the following issues:

- A clear definition of private lending for business financing, which distinguishes it from other moneylending activities. The standards can be set according to the identity of borrowers, the amount of money involved, and the purpose of lending. The legislature shall clearly admit the legitimacy of private lending, by writing it into the laws at national level. It can assure millions of Chinese businessmen and women who have been borrowing private loans in their daily businesses.
- Rules regarding private lending contracts. As discussed, any lenders and

¹ The new legislation can be named "PRC Private Lending Law", or "Private Lending Law" section under the "Laws of Obligations" of the proposed PRC Civil Code.

borrowers constitute a creditor-debtor contractual relationship, which means lending parties and the agreements have to be compliant with contract law regulations. Thus, the main parts of the new legislation shall focus on private lending contracts, including but not limited to the rights and obligations of both lending parties, the formats and essential elements of a valid lending agreement, the eligibility of lenders and borrowers, the situations which constitute breach of contracts and subsequent remedies, as well as rules about charging securities and guarantees.

- The Interest rate limitation. Evidently, interests lie at the heart of any private financing arrangements, which shall also be the central issue in the new legislation. The current interest rate cap in the Regulation 2015 is in the form of judicial interpretation, which lacks authority. Therefore, it is better to incorporate relevant rules into the formal legislation passed by the NPC, which have a nationwide effect and shall be followed by all market participants, the judicial system, and financial regulators in China.

- The Criminal liabilities of illegal lending activities. When including criminal offences into the new legislation, the primary concern for law-makers is to limit the use of criminal sanctions. They shall only punish illegal lending practices that have severe impacts on the market and cause great harms to the interests of other lending parties, like re-lending credits from financial institutions, fraudulent fundraising, and illegal deposit-taking. Moreover, it should try to reduce the current punishments of illegal private financing activities, which have been considered too harsh for economic crimes.

- Apart from articles governing substantive issues of moneylending, the legislature might also consider to draft a special civil procedure for private lending disputes, in order to facilitate Chinese courts in handling numerous private lending disputes. It should also address the issue as how to cope with the concurrence of civil disputes and criminal offences.

7.3.2 Introduce A Nationwide Regulatory Framework for Private Lending

Based on the experience of the pilot financial reform in Wenzhou, the State Council can introduce a national regulatory framework for private lending activities. Up to now, the implementation results of the WPFR has been mostly successful. Thus, it is the right timing for the State Council to expand the pilot reform to the rest of China, and accordingly, the author offers the following recommendations:

- Draft the National Private Financing Regulation. Currently, a number of provinces or cities have carried out their own pilot projects to regulate the private financing market, and passed several pieces of local regulations, including the WPFR. As the reform enters into the next step, the State Council should consider to ask its Legal Affairs Office to draft the National Private Financing Regulation, with the effect on the entire country. The national regulation can model on the WPFR, as most of its rules have been tested as effective. It shall give certain flexibilities to local financial authorities in terms of setting detail standards like the amount of money that needs to be regulated, based on the economic situations of respective regions.
- About the regulator. Due to the geographical boundaries of moneylending businesses, local financial authorities (financial affairs offices) shall play a main role in regulating regional private financing activities, whilst a cooperative mechanism at national level shall be established, in case of monitoring inter-provincial lending agreements. National financial regulators like the China Banking Regulatory Commission, and the People's Bank of China, shall join the operative mechanism, and be responsible for handling situations that could cause systemic risks and endanger the financial stability. The national cooperative body shall be chaired by officials selected from the CBRC due to their expertise in regulating credit and banking businesses, and the body shall set up a nationwide information sharing system regarding private loans, gathering and publishing market information for the public and financial regulators.
- The Wenzhou Private Financing Index can be extended to cover all major Chinese cities, to monitor the interest rate levels of local lending activities. It not only provides the reference for market participants and the judiciary, but also collects essential market information for carrying out further regulatory activities. The local financial authorities shall be required to set up monitoring points, and report the data to the national cooperative body regularly. The index shall be published on a daily base and released to the public free of charge, through its website, social media, and national and regional TV channels. Publishing the interest rate levels can definitely promote the transparency of lending transactions and reduce the costs for borrowers.
- More private financing service centres are recommended. With the public funding support, the local financial authorities shall establish private financing service centres in regions where the scale of the private financing industry is substantial. The lending service centres serve two functions. First, to facilitate lending transactions for local residences by providing the one-stop services including fund matching, loan

registration, collateral registration, notary, and other professional legal, accounting, and financial services. Second, to perform prescribed regulatory functions and monitor the local lending markets.

7.3.3 Deepen the Banking Reform and Push Forward Financial Liberalisation

We have seen the fast growth of digital aided challenger banks in both China and the UK, which provide a large amount of credits for smaller businesses. Accordingly, the Chinese government shall stick to its promise to further opening the banking sector by allowing qualified private investors to establish new commercial banks, without imposing the quotas on the market entrance. This move has multiple positive effects. It increases the competition and innovation in the state-dominated sector. More new lenders can break the state monopoly and improve the efficiency of allocating financing resources. Without the state's influences, new lenders are expected to inject considerable credits into the private sector, contributing to the sustainable developments of the Chinese economy. However, as a result of intensified competition, the bank insolvency and illiquidity problems might happen more frequently in the future, calling for a well-designed financial safety net to cope with potential banking crises. Recently, China has introduced a deposit insurance scheme, whilst the implementation is still in a nascent stage. Also, the authority has to pay more attentions to strengthen the central bank's function as being the lender of last resort to the banking industry, as well as draft detail rules about the bank insolvency procedure, if the state decides to let some banks to fail.

7.3.4 Promote P2P Lending as Alternative Finance for Private Businesses

The Chinese and British experience of the P2P lending industry suggests that, online lending can be employed by SMEs as an alternative financing method. Therefore, the Chinese government shall encourage the developments of its P2P Business lending industry, whilst strive to control market risks and provide better protections for investors. The FCA's current regulatory model over P2P lending can be an example to learn, but more attentions shall be paid to the specific characteristics of China's online lending industry, including its titanic size, the online-to-offline operation, as well as the risky money pool model.

7.4 Limitations of This Research

No research can be perfect, and certain limitations can be found in this thesis. One limitation results from the research method. Due to the limited time and funding, the researcher is unable to conduct empirical studies to collect first-hand materials, such as holding interviews with moneylenders, investors, business borrowers, judges, and policy-makers, which can provide a deep insight into the private lending market and how relevant laws are being used by market participants and legal practitioners. Although most resources used in this research are secondary, the researcher has tried his best to select materials that are authentic, reliable, and complete. Another limitation comes from the limited availabilities of official data. For example, the author cannot carry out a cost-benefit analysis regarding the implementation of the Wenzhou Private Financing Regulation, to identify its effectiveness and costs by using the economic method. This can only be done when there is more information released by the authorities in the future.

7.5 Recommendations for Further Research

Few studies have examined the topic of private lending regulation in China. This thesis, therefore, started the discussions in this area. Clearly, further research is needed to expand our knowledge, and the recommendations are as follows:

- More studies can be undertaken to explore different regulatory approaches of private lending, aside from the current registration-based system. The cost-benefit analysis can be used to compare the advantages and weaknesses of each regime, in order to find the best possible practice.
- It would be useful to conduct more research regarding the conduct regulation and the prudential regulation of private financing activities, two distinctive areas within the topic of financial regulation.
- This thesis has suggested that systemic risks can be found in the private lending market, due to the close relationships between private financing activities and the banking sector. It would be a good idea for finance researchers to investigate the interplay between the private lending market and the bank industry, in order to spot relevant risks and design a more effective financial regulatory system.
- Although China has already established a pilot regulatory system for private financing, it remains unclear how it fits into the existing financial regulatory

framework, which needs more research.

7.6 Final Remarks

This thesis has explained how China's private lending market works, as well as how it is being regulated by law. Moreover, it makes recommendations for China's future financial reforms in terms of regulating private financing and providing more credits for private businesses. Evidently, it has added substantive knowledge to the existing literature, in the fields of banking and finance law, Chinese studies, as well as small businesses and entrepreneurship.

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