

# THE RETURN OF PRIVATE BANKS? GRASS-ROOT LENDING INSTITUTIONS IN CHINA

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## I. INTRODUCTION

Although grass-root private lending institutions are not an idiosyncratic economic phenomenon unique to China, their ambiguous and complex legal status within China's financial system gives rise to unique legal questions that merit serious research and analysis. Assisted with firsthand operational information collected from forty-nine current and former private lenders, this paper seeks to contribute to a deeper understanding, from a legal perspective, of the current state of grass-root private lending institutions in China against a rapidly changing legal landscape, as well as to provide constructive foresight into the future development of these functionally critical but politically vulnerable institutions. And specifically, this paper will explore the prospects of certain existing grass-root lending institutions to develop into legitimate private banks, a rarity in China's state-dominated banking sector, and the likely paths for this possibility to materialize in light of the state's growing willingness to tolerate private players in its official financial system.

Institutionalized private lending practice in China merits in-depth research for at least two important reasons. First, the private sector, especially

mid-, small-, and micro-sized business (“MSM”),<sup>1</sup> relies on private lending institutions for significant proportions of their business-related financing needs.<sup>2</sup> This is because MSMs historically have a difficult time obtaining credit from the official banking sector, which almost completely consists of state-backed banks that operate with the political priority of financing state-owned enterprises (“SOE”) and state infrastructure and policy investments. MSMs, however, is the most robust component of China’s private sector and overall economy by many measures, and their difficulties in obtaining legal, affordable credit and quality financial services, especially basic commercial lending, directly bear on the economic health of China’s growing private sector.<sup>3</sup>

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<sup>1</sup> The classification of large-, mid-, small-, and micro-sized enterprises is determined by an enterprise’s employment size and annual operation revenue. For example, for the retail industry, an enterprise with less than ten employees and less than one million RMB in annual operating revenue is considered a micro-sized enterprise; large-, mid- and small-sized enterprises are similarly defined. See Tongjishang Dazhongxiaoweixing Qiye Huafeng Fanfa (统计上大中小微型企业划分办法) (国统字 [2011] 75号) [Statistical Standard on the Classification of Large-, Mid-, Small- and Micro-Sized Enterprises] (published by the National Bureau of Statistics of the People’s Republic of China on September 2, 2011), available at [http://www.stats.gov.cn/statsinfo/auto2073/201310/t20131031\\_450691.html](http://www.stats.gov.cn/statsinfo/auto2073/201310/t20131031_450691.html) (last visited Jan. 26, 2016).

<sup>2</sup> Report on Small and Micro Business Financing: 95% of Small and Micro Business Never Borrowed From Banks (小微企业融资发展报告: 95%小微企业未从银行借贷), available at <http://finance.sina.com.cn/money/bank/yhpl/20130406/125915058720.shtml/> (last visited Jan. 26, 2016).

<sup>3</sup> State Council Press Conference on May 27, 2014 (estimated that MSMs contribute to over 50% of national tax revenue, over 60% of GDP, and over 80% of non-rural employment), available at

Second and on a more macroscopic level, who will finance the continued growth of China's private sector (of which MSMs is a principal component) is an unavoidable issue faced by the state in the furtherance of its on-going and future structural political-economic reforms. The state has faced and will continue to face the challenge of how to peaceably and effectively unwind its long-standing vested interests in many industries that have seen increasing participation by private players (including the banking industry) in recent years. Regulation and state policy on banking practice influence the speed and manner this unwinding process will take place. Therefore, the existence of a sizable grass-root banking sector to serve the credit needs of MSMs not fulfilled by the official financial system is both economically and politically significant.

Existing literature however, provides inadequate legal analysis on the current status and future development of grass-root Chinese lending institutions, for at least two reasons. First, there is a general lack of relevant literature, in English or Chinese, that systematically analyzes the legal status of Chinese grass-root lending institutions, and how this status may change in light of the broader legal environment and ongoing financial reforms in China. Existing English literature tends to analyze the subject from more political science or financial economics based rather than legal perspectives.<sup>4</sup> Although Chinese literature often entails more legal discussions, much of which tends to focus on criticizing deficiencies of existing legal framework or explaining the

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<http://www.scio.gov.cn/xwfbh/xwfbh/wqfbh/2014/20140527/> (last visited Jan. 25, 2016).

<sup>4</sup> See, e.g., Kellee S. Tsai, *The Political Economy of State Capitalism and Shadow Banking in China*, HKUST IEMS Working Paper No. 2015-25 (2015); Meghana Ayyagari et al., *Formal versus Informal Finance: Evidence from China*, World Bank Policy Research Working Paper 4465 (2008); Jun Du & Sourafel Girma, *Financing Source and Firm Growth in a Hybrid Financial System: Evidence from China*, United Nations University World Institute for Development Economics Research (UNU-WIDER) Research Paper No. 2009/03 (2009).

economic benefits of standardizing private lending practice.<sup>5</sup> A valuable point of analysis that has constantly been neglected in existing literature, is the practical feasibility for certain grass-root lending institutions to convert into legitimate commercial banks and (if such feasibility exists) how the legitimization process will take place given where the current legal environment and state policy stand. The practical merit of any analysis into the social-economic benefits of having more grass-root private banks can be more or less weakened without first understanding how legitimate private banks would come into being from a legal perspective. While in some developing countries grass-root private banks have experienced robust growth from non-existence to popularity over a relatively short time,<sup>6</sup> for the same phenomenon to occur in China there is likely a much more uncertain and complex path ahead due to pre-existing legal and political barriers for private actors to engage in depository lending activities.

Second, there has been little systematic field research on the operational status of Chinese grass-root private lenders in the past ten years. Since Professor Kellee S. Tsai's fieldwork in the late 1990s<sup>7</sup> and Professor Li Jianjun's work in the mid-2000s,<sup>8</sup> there have been little known systematic

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<sup>5</sup> See, e.g., Lin Yifu, Sun Xifang (林毅夫, 孙希芳), Xinxu, Feizhenggui Jinrong Yu Zhongxiao Qiye Rongzi (信息、非正规金融与中小企业融资) [Information, Informal Finance and Financing of Mid- and Small-Sized Enterprises], *Jingji Yanjiu* (经济研究) [Economic Research], no. 7, 2005; Yue CaiShen (岳彩申), Minjian Jiedai Guizhi De Zhongdian Ji Lifa Jianyi (民间借贷规制的重点及立法建议) [Critical Elements In Private Lending System and Legislative Suggestions], *Zhongguo Faxue* (中国法学) [China Legal Science], no.5, 2011; Wang Lili (汪丽丽), Fei Zhengshi Jinrong Falv Guizhi Yanjiu (非正式金融法律规制研究) [Research on Informal Finance Legal System] (Falv Chubanshe [法律出版社] [Law Press] 2013) (2013).

<sup>6</sup> See, e.g., Muhammad Yunus, *Banker to the Poor* (1999) (Bangladesh experience); Hans Dieter Seibel, Bishnu P. Shrestha, *The Small Businessman's Informal Self-Help Bank in Nepal, Savings and Development*, Vol. 12 No.2 (1988) at 183 - 200 (Nepal experience).

<sup>7</sup> See Kellee S. Tsai, *Back-Alley Banking: Private Entrepreneurs in China* (2002).

<sup>8</sup> See Li Jianjun (李建军), *Zhongguo Dixia Jinrong Diaoyan* (中国地下金融调查) [Research on Underground Finance in China] (Shanghai Renmin Chubanshe [上海人民出版社] [Shanghai People's Press] 2006) (2006).

efforts by scholars in collecting first-hand operational information and data from grass-root lenders in mainland China.<sup>9</sup> This finding is unfortunate as despite Professor Tsai and Professor Li's enlightening work on the area, the status of private lenders, and the legal and economic environments at large, have experienced significant changes over the past decade, especially in the years since the late-2000s global financial crisis. And because of the Chinese government's policy moves in response to the financial crisis and other changes in the legal and economic environments, the status of grass-root lenders in the most recent five years probably has more relevance to the prediction of their' future state than any time before. Without more update-to-date information and data legal analysis on grass-root lenders runs the risk of having more theoretical merits than practical value.

To fill the gaps left by existing literature, this paper centers its discussions around the potential legitimization of grass-root lending institutions and any material legal obstacles that may exist considering the current legal environment. And as part of the research that supplies the main content of this paper, fieldwork was conducted in various locations in mainland China where there is robust institutionalized private lending to collect firsthand information and data from individuals who directly participate in the practice. Between May 15, 2015 and January 31, 2016 interviews and surveys were conducted with former and current private lending institution owners in Zhejiang, Shanghai, Jiangsu, Fujian, Guangdong, Guangxi, Anhui, Sichuan and Shanxi. A total of 49 responses were collected, including 19 direct interviews and 30 responses from survey questionnaires.<sup>10</sup>

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<sup>9</sup> Even these well recognized field earlier research initiatives did not specifically focus on analyzing private lending institutions' potential of developing into legitimate financial institutions, as measured by their market positioning, risk characteristics and risk management capabilities.

<sup>10</sup> The choice between conducting an interview and issuing a questionnaire survey is made based on a participant's preference and availability. To supplement lender-side information additional interviews were conducted with owners of five private enterprises that borrow substantially from private financing networks, and three risk

The interviews and surveys were designed to collect operational details to understand two main questions of interest: (1) What are the risk characteristics and risk management practice of grass-root lending institutions (especially underground banks) and how do they compare to those of official state-backed commercial banks? (2) How likely and feasible is it for competitive private lending institutions to develop into legal private commercial banks?

The structure of this paper consists of six Parts. Part I introduces the general background of the research that give rise to this paper. Part II of this paper reviews the current legal landscape surrounding private lending, including main bodies of existing laws and relevant legislative proposals. Part III introduces background information on the evolution of state policy towards private lending institutions and efforts in financial reforms. Part IV discusses the current state of grass-root private lending institutions based on information collected from fieldwork mentioned in the paragraph above. Part V identifies and analyzes three possible routes for grass-root private lending institutions to become legitimate commercial banks, and accompanying technical and legal barriers. Part VI concludes.

## **II. LEGAL FRAMEWORK**

### **A. Laws applicable to private lending activities**

During most of the last forty years there is virtually no practical route for private parties to legally establish depository financial institutions with the blessing of state approval. As a result many private lending institutions that in effect function as commercial banks are not licensed by state regulators to be formal financial institutions but exist instead as “shadow banks” with a

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management professionals who work in two state-run banks to compare the risk exposures and risk management practice between private and official lenders.

questionable legal status. Because they are not officially recognized financial institutions, these private institutions do not technically fall within the regular scope of existing bank laws and regulations. But since by nature they are private lenders, these institutions are subject to laws that have implications for private lending activities in general. Although there have been efforts in proposing legislation on the subject (as will be discussed in the next section), enacted laws that specifically govern private lending activities are scarce. Instead, the theoretical boundaries for legal rights, obligations and liabilities arising from private lending activities are provided for by a few more general bodies of law.

Some of the most relevant legal provisions that govern substantive rights and obligations arising from private lending activities are provided by the Contract Law.<sup>11</sup> The consummation of a lending arrangement necessarily requires agreement between at least two willing parties—one agrees to borrow and another agrees to lend. Therefore like other agreements between two or more parties to carry out specified conducts, lending agreements are subject to general provisions of the Contract Law. Specifically, chapter twelve of the Contract Law governs lending contracts and provides a number of basic requirements on the formation and implementation of such contracts. For example, articles 196 to 199 apply to the formation of lending contracts, requiring that to have legal effect a lending contract “must take written forms unless agreed otherwise,” “must contain detailed terms on critical information, e.g., loan types, currency, usage, quantity, interest, duration, and method of repayment, etc.,” “may require appropriate collaterals in accordance with relevant laws,” and that upon request the lender be supplied with “an accurate presentation of the borrower’s business activities and financial status.”<sup>12</sup> Additionally, the chapter contains a few specific restrictions on interest rates

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<sup>11</sup> Hetong Fa (中华人民共和国合同法) (Contract Law) (promulgated by the Standing Comm. Nat’l People’s Cong., March 15, 1999, effective October 1, 1999).

<sup>12</sup> *Id.*, art. 196 to 199.



charged in lending contracts, including article 200, which prohibits lenders from “pre-deducting interest from principal upon issuing a loan,” and article 204, which requires that interest agreed in a lending contract between financial institutions be “subject to quantitative boundaries provided by the People’s Bank of China,” and article 210, which subjects interest in lending contract between natural persons to “relevant restrictions on private lending interest imposed by the state.”<sup>13</sup>

While the Contract Law provides important legal framework and technical provisions to tackle disputes arising from private lending arrangements in a consistent manner as other contract disputes, in practice its provisions on private lending probably has greater significance for lending arrangements between individuals than institutionalized private lending practice. Although lending arrangements made with private lending institutions are of a similar contractual nature as those made between two or more individuals and should in theory be amenable to similar technical analysis under the Contract Law, in practice the crux of litigation and prosecution involving institutionalized private lending seldom rests on substantive contractual issues, but often entails much more serious criminal implications. This has much to do with the state’s caution with private depository lending practice because of the practice’s potential impact on financial and social stability, an aspect to be discussed further in Part III.

So naturally, a second body of law that has general applicability to private lending activities is the Criminal Law.<sup>14</sup> The Criminal Law provides general bases for criminal liabilities arising from serious misconducts in private lending activities. Of particular pertinence to private lending institutions are a few relatively new provisions specifically aimed at battling crimes that “disturb the order of the financial system.” Revisions to the

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<sup>13</sup> *Id.*, art. 200, 204, 210.

<sup>14</sup> Xing Fa (中华人民共和国刑法) [Criminal Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., July 1, 1979, amended March 14, 1997, effective October 1, 1997).



Criminal Law in 1997 introduced criminal liabilities for “illegally establishing financial institutions without authorization by state regulators” (Article 174), “obtaining capital from official financial institutions for re-lending as usuries” (Article 175) and “illegally absorbing deposits from the public” (Article 176), collectively known as “crimes of disturbing the order of the financial system.”<sup>15</sup> These newer financial crimes provided the bases for some of the most serious prosecutions against private lending related activities to date, including the controversial cases of Sun, Da-Wu in 2003<sup>16</sup> and Wu Yin in 2011.<sup>17</sup> The meanings of critical terms in these provisions however, are not clearly defined in concrete terms. For example, it is unclear from existing legal text or case law what levels of interest rates make a lending transaction “usury” to establish criminal liability under article 175. Although a judicial interpretation issued by the Supreme People’s Court (“SPC”) in 1991 introduced a widely cited “four-time redline,” i.e., a bright-line rule that private lending interest exceeding four times interest rates on comparable official bank loans is not protected by law,<sup>18</sup> neither the 1991 interpretation nor any other legal text explicitly equated private lending at rates above four times official benchmarks to practicing usury.<sup>19</sup> Nor is it sufficiently clear at what point a private lending arrangement

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<sup>15</sup> *Id.*, art. 174 - 176.

<sup>16</sup> In re Sun, Da-Wu, see Li Zefang (李泽方), Qianxi Feifa Xishou Gongzong Cunquanzui — Cong Sun Da-Wu An Tanqi (浅析“非法吸收公众存款罪”——从“孙大午案”谈起) [General Analysis of the Crime of Illegally Absorbing Public Deposits Based on the Basis of In Re Sun, Da-Wu], Dongfang Qiye Wenhua (东方企业文化), November, 2011.

<sup>17</sup> In re Wu, Ying, see Niu Taisheng (牛太升), Cong Wuyingan Kan Minjian Rongzi Falv Kunju (从吴英案看民间融资法律困局) [Legal Issues in Private Financing as Reflected Through In re Wu, Ying], Social Outlook (社会观察), no.10, 2011

<sup>18</sup> Guanyu Renmin Fayuan Shenli Jiedai Anjian De Ruogan Yijian (关于人民法院审理借贷案件的若干意见) [Opinion on Adjudicating Private Lending Cases by the Supreme People’s Court] (promulgated by the Supreme People’s Court, August 13, 1991, abrogated September 1, 2015 and superseded by Provisions on Several Legal Questions in Private Lending Cases, promulgated by the Supreme People’s Court, June 23, 2015, effective September 1, 2015), art. 6.

<sup>19</sup> On June 23, 2015, the “four-time redline” was officially replaced by a new 24% ceiling (to receive full legal protection on interest) as the Supreme People’s Court issued

becomes “absorbing deposits from the general public,” and who constitutes “public” within the meaning of article 176. Activities that can give rise to liabilities under this provision include employers soliciting contributions from employees to re-lend for higher interest (e.g., *In re Sun, Da-Wu*), pooling money from relatives and acquaintances for reinvestment purpose (e.g., *In re Wu, Yin*), raising fund by issuing membership cards or debt certificates, by partitioning and transferring land or property ownerships, or via business collaboration contracts such as sales agency agreements, etc.<sup>20</sup> The broad, unelaborated terms of these newer provisions provide the state convenient tools to take actions against private lending activities deemed suspicious for social or political reasons, and at the same time allows courts to easily stay in line with changing state policy and attitude towards private lending institutions.

A third law that in theory has more direct implications for private lending institutions is the Law of the People's Republic of China on the Promotion of Small- and Mid-Sized Enterprises that was promulgated in 2002 (“the SME Promotion Law”).<sup>21</sup> The SME Promotion Law was introduced with the purpose of protecting and improving the vitality of small and mid-sized private enterprises. This law specifically called for improvements in financial services to small and mid-sized enterprises, urging financial institutions to “make efforts to improve financial services, to adjust their styles of service, to enhance their awareness of the importance of their service (to small- and mid-

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Guidance on the Handling of Several Issues Relating to Private Lending Disputes (最高人民法院关于审理民间借贷案件适用法律若干问题的规定), art. 26. But since 24% is approximately five times current benchmark RMB lending rates (as of Oct. 24, 2015, the RMB benchmark lending rate is 4.90%), the new standard should not be considered a material change from the earlier “four-time redline.”

<sup>20</sup> See 关于公示非法集资特征、表现形式及常用手段的公告 (China Development Bank Announcement on Manifestations and Characteristics of Illegal Fund-raising), available at <http://www.cdb.com.cn/web/Column.asp?ColumnId=15/> (last visited Jan. 30, 2016).

<sup>21</sup> Zhongxiao Qiye Cujin Fa (中华人民共和国中小企业促进法) [Law on the Promotion of Small and Mid-sized Enterprises] (Presidential Order [2002] No. 69) (promulgated by the Standing Comm. Nat'l People's Cong., June 29, 2002, effective Jan. 1, 2003).

sized enterprises) and to improve overall service quality.”<sup>22</sup> But unlike the Contract Law and the Criminal Law, which contain relatively concrete provisions applicable in litigations and prosecutions involving private lending institutions, the SME Promotion Law, although enacted as official law, contains mostly high-level, directional guidelines and in effect posits more like an administrative policy document. Also, it can be implied from its language of this law that the legislature in passing this law was primarily addressing state-backed financial institutions (“all commercial banks and credit cooperatives”) rather than private lenders.<sup>23</sup> Because the law did not specially target private lending and contained mostly high-level precatory terms, in practice it has at best tangential impact on private lending. The SME Promotion Law may nevertheless have more ideological significance in the sense that it marks the beginning of an important shift in state policy towards private lending in general (towards greater tolerance and potentially incorporation into the official financial system). This aspect will be discussed more in Part III.

#### **B. Legislative proposals for governing laws on private lending**

Putting aside the general laws mentioned above, legislation that specifically targets private lending activities is virtually non-existent. This does not mean however, there have been little bottom-up efforts towards making governing laws for private lending.

In 2008, the People’s Bank of China (“PBC”) drafted the Lenders’ Rules with the purpose of standardizing private lending practice and establishing an official legal framework for private lending activities.<sup>24</sup> The Rules placed

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<sup>22</sup> *Id.*, art. 15 (“All financial institutions shall provide financial support to small and mid-sized enterprises, make efforts to improve financial service, . . .”).

<sup>23</sup> *Id.*

<sup>24</sup> See Yao Bin (姚斌), *Fangdai ren Tiaoli Yu Zhejiang Minjian Jiedai De Falv Wenti Yanjiu* (“放贷人条例”与浙江民间借贷的法律规制研究) [The Lenders’ Rules and the Legal Framework over Private Lending in Zhejiang], *Faxue Zhichuang* (法学之窗), no.4, 2010 at 33-34.

emphasis on the protection of capital possessors' rights to utilize capital as desired, including lending for interest, and expressly allowed any "eligible enterprise and individuals to engage in the business of lending."<sup>25</sup> The Rules basically permitted any private individual or institution to lend legally obtained and owned capital to third parties, marking a drastic deviation from existing PBC rules which limit the business of lending to state-approved financial institutions.<sup>26</sup> In 2009 the Legislative Affairs Office of the State Council started research on the proposal and eventually classified it as a tier II legislative plan.<sup>27</sup> But for unknown reasons, although the draft went through four rounds of revisions since 2008, it did not ultimately receive the state's official endorsement.<sup>28</sup>

In 2011, a state-backed research institute in Wenzhou drafted the legislative proposal of Private Lending Law, which was officially presented to the National People's Congress in 2012.<sup>29</sup> Like the proposed Lenders' Rules from 2008, the proposed Private Lending Law provides concrete definitions on the rights and obligations for participants in private lending arrangements, as well as guidelines on the standardization and regulation of private lending.<sup>30</sup> The proposed Private Lending Law also serves similar purposes as the earlier proposal of the Lenders' Rules, that is, to delineate the legal boundaries for and to facilitate the standardization of private lending activities. The status of

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<sup>25</sup> *Id.* at 34.

<sup>26</sup> Daikuan Tongze (贷款通则) [General Rules on Lending] (implemented by the People's Bank of China, Aug. 1, 1996), art. 21.

<sup>27</sup> 吴英案暴露法律真空 放贷人条例四次被否 (The Legislative Proposal of Lenders' Rules Rejected After Four Rounds of Revision), available at [http://money.163.com/12/0204/08/7PDHDK6400253BoH\\_all.html/](http://money.163.com/12/0204/08/7PDHDK6400253BoH_all.html/) (last visited Jan. 30, 2016).

<sup>28</sup> *Id.*

<sup>29</sup> 温州学者撰写《民间借贷法》上书两会 (Wenzhou Scholars Proposed to Legislature the Private Lending Law), available at <http://www.iolaw.org.cn/showNews.aspx?id=30097/> (last visited Jan. 20, 2016).

<sup>30</sup> *Id.*

this legislative proposal, however, seems to have been in a limbo during the past a few years with little update heard from the government.

These legislative proposals, with their much more relaxing provisions on private lending, if passed will lessen the legal risks and improve the legal protection for MSMs that use credit from private sources. What the legislative proposals did not address and would unlikely provide meaningful guidance for, however, is the blurry line between individual lending and “absorbing public deposit,” or “illegal fund-raising.” While one individual lending to another is clearly legal private lending, it is unclear if ten individuals lending to the same person is still legal.

The legislature’s slowness in considering these proposed private lending laws casts an interesting contrast to the state’s relative activeness in issuing policy guidance pointing to a more open banking industry for prospective private players. It is not exactly clear whether this contrast speaks more of the central government’s continued hostility towards private lending, especially underground depository institutions, or simply shows its cautiousness with taking more aggressive moves towards unlocking the banking industry. Any move or update by the state on these proposals will shed important light on its true attitude towards private lending, and in particular, will provide much more predictability on the prospect of legitimizing underground lending institutions.

### **III. POLICY DEVELOPMENT AND FINANCIAL REFORMS**

In contrast to the scarcity of black-letter laws on private lending, there is a relative abundance of pertinent administrative text on the subject. Over the past thirty years or so, the state and its agencies have issued a number of administrative documents relating to, or have implications for private lending practice. These documents depict a rather informative picture on the evolution of state policy towards private lending in general and institutionalized private players in particular. Guidance issued in the most

recent five years are of particular relevance to our discussion as it appears to signal intentions of more aggressive moves towards further financial reforms and rather drastic turns in state policy on institutionalized private lending, especially on the legitimacy of private commercial banks. The twist and turns in State policy for financial reforms often pivot on two important subjects: interest rate reforms and the entry of private capital into the banking industry.

#### **A. Interest rate regulation**

While how interest rates are determined and what their proper levels are seem to be technical inquiries in lending activities, interest rate regulation is an issue that cannot be circumvented in any serious effort to standardize private lending without eviscerating the practice of its effective economic function or beneficial social effect. This is because a critical difference between private lending and official bank lending, also a key reason why private lending plays a more efficient role in fulfilling financing needs of the private sector, is that private lenders often charge interest rates more reflective of market demands for credit and specific borrowers' actual credit risk levels. Official banks, on the other hand, are bound by interest rates set by the PBC. Efforts in legalizing private lending (as a resolution to MSMs' difficulties in obtaining affordable credit) will be short-circuited if parallel efforts are not made to at least partially protect private lending institutions' current interest rate practice. Requiring regulated private lenders to strictly apply state-pegged rates, which tend to be significantly below prevailing private lending rates, would essentially force these lenders to assume credit risks for unfairly low rates or to cease operation all together.

Benchmark interest rates on domestic RMB transactions and their legally allowed ranges of fluctuation are centrally determined by the PBC which,<sup>3</sup> pursuant to the Rules on RMB Interest Rate Management, has

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<sup>3</sup> Renminbi Lihv Guanli Guiding (人民币利率管理规定) [Rules on RMB Interest Rate Management] (published by the People's Bank of China, March 2, 1999, effective, April 1, 1999).



delegated authority to regulate interest rates “without being subject to the intervention of any individuals or institutions.”<sup>32</sup> For example, as of November 2014 the official benchmark interest rate on five-year RMB deposits was set to be 4% and during the same period the benchmark rate on five-year RMB loans was set to be 6%, providing a risk-free 2% credit spread for financial institutions that charge the benchmark rates.<sup>33</sup> A direct effect of the state’s interest rate policy is that it becomes possible for official financial institutions, especially state-backed commercial banks, to make substantial, guaranteed credit spreads by simply lending as much as they can to the state-run sector, which although may not have the soundest financial performance by objective accounting standard is nonetheless safe heaven investment for official banks due to the availability of state protection should severe financial strains occur. As a result state-backed banks have little incentive to lend to the private sector, especially the MSMs, from which the banks cannot make more interest income for bearing higher credit risks that are not insured by the state.

Over the past thirty years there have been several attempts on the part of the state to loosen the official grip on interest rates. The first wave of reforms took place during the 1980s. In 1985, in its first policy document of the year [yihao wenjian, 一号文件] the state allowed rural banking institutions such as rural credit unions and cooperatives to implement a floating interest rate system.<sup>34</sup> Wenzhou was designated the first pilot point to implement this interest rate reform.<sup>35</sup> This effort to liberalize interest rate however, never

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<sup>32</sup> *Id.*, art. 4, 5.

<sup>33</sup> The People’s Bank of China Quarterly Statistical Bulletin, Q1 2015, 76-77 (official benchmark rates of RMB deposits and RMB loans).

<sup>34</sup> Guanyu Jinyibu Huoyue Nongcun Jingji De Shixiang Zhengce (关于进一步活跃农村经济的十项政策) (中发 [1985] 1号) [Ten Policies on Further Invitalizing Rural Economy] (published by the state Council, January 1, 1985), item 7 (“Rural credit unions . . . borrowing and lending interest rates are permitted to fluctuate from official benchmarks and in some occasions approach those of market prevailing rates.”).

<sup>35</sup> Guanyu Zai Wenzhou Jinxing Lilv Gaige Shidian Gongzuo De Tongzhi (关于在温州市进行利率改革试点工作的通知) (银发 [1987] 170号) [Notice on Conducting Pilot Operation of Interest Rate Reform in Wenzhou] (published by the People’s Bank of



went beyond Wenzhou, and eventually came to a quiet end as urban credit operatives and rural cooperative funds were eliminated in the late 1990s. In 2002, the initiative to liberalize interest rate was revitalized as the PBC made eight rural credit unions in eight different localities pilot points for implementing partial floating interest rate systems.<sup>36</sup> Under this initiative interest rates on deposits were allowed to fluctuate as much as 30% above official benchmarks, and lending rates to float up to 100% above benchmarks.<sup>37</sup> Unfortunately this revitalization of interest rate reforms did not last either and was called to a stop in 2006.<sup>38</sup> More substantive progress has been made on interest liberalization since 2014, as state regulators accelerated the pace of reforms on the subject. In November 2014, the PBC increased the ceiling on interest rates paid on savings deposits to 1.3 times corresponding benchmarks. This ceiling was further raised to 1.5 times benchmarks during the first half of 2015.<sup>39</sup>

It is noteworthy that interest rates in private lending arrangements are allowed to deviate more from the official benchmarks than permitted in even the most aggressive attempt mentioned. The SPC's 1991 Opinion on Adjudicating Private Lending Cases is by far the most important guidance on the legal boundaries of interest rates charged in private lending activities. Article 6 of the 1991 Opinion provides that "interest rates in private lending can be reasonably higher than comparable bank interest rates, but may not

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China, June 5, 1985, effective, June 5, 1985) (Wenzhou made a pilot point for interest rate reforms).

<sup>36</sup> Pilot Operation for Market-based Interest Rates Fully Launched (利率市场化试点全面铺开), PEOPLE'S DAILY (overseas ed.), February 15, 2003, available at <http://www.people.com.cn/GB/paper39/8464/794954.html/> (last visited Jan. 30, 2016).

<sup>37</sup> *Id.*

<sup>38</sup> Zhou Dewen (周德文), Wenzhou Jinrong Gaige — Wei Zhongguo Jinrong Gaige Tanlu (温州金融改革—为中国金融改革探路) [Wenzhou Financial Reforms As Trail Blazer for Nationwide Reforms] at 45 (2013).

<sup>39</sup> Report on the Development of the Chinese Banking Industry (2015), China Banking Association, at 190.

exceed four times the latter,” and that interest exceeding this “four-time redline” is “not protected by law.”<sup>40</sup> This opinion is widely read as having established an interest rate ceiling for private lending. Although criticized by many as arbitrary and draconian,<sup>41</sup> no state authority has since addressed the question of what the appropriate interest rates are for private lending or clarified how the language of the 1991 Opinion should be interpreted. As will be discussed later in this paper, interviews and surveys conducted with current and former private lending institutions show that actual interest rates charged in private lending arrangements are frequently above four times comparable official bank rates, and thus lie outside the magnitude of the widest interest rate relaxations attempted thus far. If rates charged by private lending institutions represent a relatively objective market-based estimate of actual credit risks, even the state’s widest interest rate relaxation still barely captures prevailing borrowing cost on private markets, and forcing private lenders to charge rates within legally permissible ranges will likely deprive their business of economic viability.

#### **B. State policy towards private players in the banking industry<sup>42</sup>**

On the closely related subject of private players’ entry into the banking industry, state policy has gone through twists and turns over the past thirty years, showing a high level of directional vagueness during most of the time despite relatively aggressive reform moves in the most recent five years.

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<sup>40</sup> *Supra* note 18.

<sup>41</sup> See, e.g., Liao Zhenzhong & Gao Jinkang (廖振中, 高晋康), *Woguo Minjian Jiedai Lilv Guanzhi Fazhi Jinlu De Jiantao Yu Xuanze* (我国民间借贷利率管制法治进路的检讨与选择) [The Regulation of Interest Rates of Private Lending in China], *Modern Law Science* (现代法学), no.2, 2012.

<sup>42</sup> Because in most of its pre-1978 history the People’s Republic of China has only one bank, i.e., the People’s Bank of China (“PBC”), and commercial activities were in a freeze as a result of political turmoil, only policy moves that occurred since 1978 are of material relevance here.

During the early years of China's economic reforms in the 1980s, the state's attitude towards private players in the banking industry was rather vague. While official policy expressly prohibited private players from establishing commercial banks,<sup>43</sup> the 1980s saw the emergence of China's first commercial banks (although not CRBC licensed) since 1949 that were established and run entirely by private capital. During this period the state did not engage in serious efforts to crack down these institutions and many of these private banks survived well into the mid-1990s. One of the anecdotal stories about grass-root attempts to establish commercial banks told by almost every private lender interviewed in Zhejiang was that of the Fang Xing Money House (fang xing qian zhuang, 方兴钱庄). In 1984, in an official notice on promoting rural development, the state indicated that "capital held by individual peasants and rural communities are allowed to flow freely without the interference by local governments, . . . peasants and communities are encouraged to pool funds to pursue development causes and their investment in such cases are protected by the state."<sup>44</sup> Inspired by this language, Fang, Peilin, a former state employee in Cangnan county of Zhejiang province, founded the Fang Xing Money House, which was essentially a private commercial bank that operated by absorbing savings deposits from and extending loans to local communities. Fang Xing was warned by the local branches of state-run banks

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<sup>43</sup> Yinhang Guanli Zanxing Tiaoli (中华人民共和国银行管理暂行条例) [Provisional Rules on Bank Governance] (promulgated by the state Council, Jan. 7, 1986), art. 28 ("Private individuals may not establish banks or other financial institutions, and may not carry on financial business."), available at [http://www.pkulaw.cn/fulltext\\_form.aspx?Db=chl&Gid=2657](http://www.pkulaw.cn/fulltext_form.aspx?Db=chl&Gid=2657).

<sup>44</sup> Guanyu 1984 Nian Nongcun Gongzuo De Tongzhi (中共中央关于一九八四年农村工作的通知) [Notice on Rural Area Related Work for the Year of 1984] (promulgated by the St. Council, January 1, 1984), part 3, paragraph 2 ("Allow peasants' and rural communities' capital to flow freely or in organized manner without being subject to geographical restraints. . . Encourage peasants and rural communities to gather funds and establish enterprises, especially development causes. Investors' legal rights (in pursuing these causes) are protected by the state."), available at [http://www.pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=109225](http://www.pkulaw.com/fulltext_form.aspx?Db=chl&Gid=109225).

and the PBC that its existence was illegal, but no authority took any decisive move to eliminate the money house.

Going into the 1990s, the government's quiet tolerance of private lending institutions like Fang Xing diminished. Between 1993 and 2002 the state made a number of official communications to address its concerns with the "disturbing effects" of institutionalized private lending on the official financial system and crimes arising from unregulated private lending activities.<sup>45</sup> In particular, a few decisive moves were taken by the state between 1996 and 2002 to eliminate underground banks.<sup>46</sup> The force of these moves were enhanced in 1997 by the addition to the Criminal Law of the crimes of "illegal fund-raising," "illegally absorbing public deposits," or "illegally establishing financial institutions or providing financial services" (or,

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<sup>45</sup> See, e.g., Guanyu Qingli Youchang Jizi Hooding Jianjue Jingzhi Luanjizi Wenti De Tongzhi (关于清理有偿集资活动坚决制止乱集资问题的通知) [Notice on Prohibition of Illegal Fund-Rising] (promulgated by the St. Council, September 3, 1993), available at [http://www.pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=8746](http://www.pkulaw.com/fulltext_form.aspx?Db=chl&Gid=8746); Guanyu Yanjing Shanzi Pishu Jinrong Jigou, Feifa Banli Jinrong Yewu De Jinji Tongzhi (关于严禁擅自批设金融机构, 非法办理金融业务的紧急通知) [Emergency Notice on Handling Unauthorized Establishments of Financial Institutions and Illegal Operation of Financial Services] (promulgated by the People's Bank of China, September 8, 1997) (outlawing any financial institutions not sanctioned by the PBC), available at [http://www.pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=19011](http://www.pkulaw.com/fulltext_form.aspx?Db=chl&Gid=19011).

<sup>46</sup> See, e.g., Guanyu Qudi Xiren Qianzhuang De Tongzhi (关于取缔私人钱庄的通知) (银发 [1996] 230 号) [Notice on Eliminating Underground Banks] (promulgated by the People's Bank of China, July 7, 1996), available at [http://www.pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=39378](http://www.pkulaw.com/fulltext_form.aspx?Db=chl&Gid=39378); Feifa Jinrong Jigou He Feifa Jinrong Yewu Hooding Qudi Banfa (非法金融机构和非法金融业务活动取缔办法) (国发[1998] 247 号) [Measures for the Clampdown of Illegal Financial Operations] (promulgated by the St. Council, July 13, 1998), available at [http://www.pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=20777](http://www.pkulaw.com/fulltext_form.aspx?Db=chl&Gid=20777); Guanyu Qudi Dixia Qianzhuang Ji Daji Gaolidai Xingwei De Tongzhi (中国人民银行关于取缔地下钱庄及打击高利贷行为的通告) (银发 [2002] 30 号) [Notice on Eliminating Underground Banks and Usurious Activities] (promulgated by the People's Bank of China, January 31, 2002), available at [http://www.pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=39378](http://www.pkulaw.com/fulltext_form.aspx?Db=chl&Gid=39378).

collectively: “crimes of disturbing the order of the financial system”).<sup>47</sup> It is unclear exactly how many private lending institutions were eliminated during this period, but judging from the frequency of the official communications on illegal financing activities and the unusual move of adding relevant content to the Criminal Law, the sweep of the state’s hostile policy towards private lending during this time is likely very wide.

Generally, post-2004 policy appeared more lenient towards private lending institutions than pre-2004 policy. State policy started to become slightly less repressive towards private lending after the SME Promotion Law was promulgated in 2002.<sup>48</sup> Although the SME Promotion Law was not specifically enacted to address the issue of private lending, nor did it materially enhance the legal status of private lending institutions, it contained language encouraging legal financial institutions and other “public intermediaries” to provide financing services to small- and mid-sized enterprises.<sup>49</sup> Between 2006 and 2013 the State Council issued a few more specific communications on helping mid- and small-sized enterprises obtain credit via state-subsidized financial guarantors and improving rural areas’ access financing services.<sup>50</sup> Notably, in 2008 the state allowed the pilot

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<sup>47</sup> Xing Fa (中华人民共和国刑法) [Criminal Law of the People’s Republic of China] (promulgated by the Standing Comm. Nat’l People’s Cong., July 1, 1979, amended March 14, 1997, effective October 1, 1997), available at [http://pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=256346](http://pkulaw.com/fulltext_form.aspx?Db=chl&Gid=256346).

<sup>48</sup> Zhongxiao Qiye Cujin Fa (中华人民共和国中小企业促进法) [Law on the Promotion of Small and Mid-sized Enterprises] (Presidential Order [2002] No. 69) (promulgated by the Standing Comm. Nat’l People’s Cong., June 29, 2002, effective January 1, 2003), available at [http://www.pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=40271](http://www.pkulaw.com/fulltext_form.aspx?Db=chl&Gid=40271).

<sup>49</sup> *Id.*, art. 14, 15, 40.

<sup>50</sup> Guanyu Jiaqiang Zhongxiao Qiye Xingyong Daibao Tixi Jianshe Yijian De Tongzhi (关于加强中小企业信用担保体系建设意见的通知) [Notice on Enhancing Credit Guarantee Infrastructure for Small- and Mid-sized Enterprises] (promulgated by the St. Council, November 23, 2006), available at [http://www.pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=81986](http://www.pkulaw.com/fulltext_form.aspx?Db=chl&Gid=81986); Guanyu Tuijin Guoyou Shangyan Yinhang Gufenzhi Gaige Shenhua Jinrong Tizhi Gaige Gongzuo De Baogao (关于推进国有商业银行股份制改革深化金融体制改革工作的报告) [Report on

operation of a particular type of grass-root lending institutions, namely, small loans companies.<sup>51</sup> Small loans companies are non-depository private lending institutions that extend small loans (often < 1 million) to MSMs and individuals, typically within highly localized communities. In 2011, in the aftermath of a credit crisis in Wenzhou, the state moved to implement further financial reforms and Wenzhou was again made a pilot point.<sup>52</sup> A blueprint was created for the reforms outlining a number of specific objectives including the promotion of small loans companies, private capital management services, and registration services for private lending transactions, etc.<sup>53</sup>

On another dimension, state policy is more hostile towards grass-root depository lending institutions than towards individual-based lending activities. While lending agreements between individuals are not considered materially different from other agreements under contract law as long as the lending arrangements themselves are valid contracts and the agreed interest rates do not exceed relevant regulatory limits,<sup>54</sup> institutionalized private

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Promoting State-owned Commercial Banks's Transition into Stock Banks and Deepening other Reforms on the Financial System] (presented on the 25th Nat'l People's Cong. Standing Comm. Conference, December 26, 2006) (promoting rural areas' access to financial services; standardizing and guiding private lending), available at [http://www.pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=89005](http://www.pkulaw.com/fulltext_form.aspx?Db=chl&Gid=89005).

<sup>51</sup> See Zhongguo Yinhangye Jiandu Guanli Weiyuanhui, Zhongguo Renmin Yinhang Guanyu Xiaoe Daikuan Gongsì Shidian De Zhidao Fijian (中国银行业监督管理委员会、中国人民银行关于小额贷款公司试点的指导意见) [Guiding Opinions on the Pilot Operation of Small-sum Loan Companies] (promulgated by the China Banking Regulatory Commission and the People's Bank of China, May 4, 2008), available at [http://www.pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=104795](http://www.pkulaw.com/fulltext_form.aspx?Db=chl&Gid=104795).

<sup>52</sup> Zhejiangshen Wenzhoushi Jinrong Zonghe Gaige Shiyangu Zongti Fangan (浙江省温州市金融综合改革试验区总体方案) [General Plan for Piloting Comprehensive Financial Reforms in Wenzhou City] (approved by the St. Council, March 28, 2012), available at [http://www.pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=220599](http://www.pkulaw.com/fulltext_form.aspx?Db=chl&Gid=220599).

<sup>53</sup> *Id.*

<sup>54</sup> See *supra* note 11, art. 211 ("If the payment of interest is agreed upon in a loan contract between natural persons, the interest rates shall not violate relevant regulatory restrictions on interest rates.").



lending that involves fund-raising from more than a few individuals has been subject to much more restrictive scrutiny and often gives rise to more serious political concerns. At least three important factors lie behind the state's cautiousness towards institutionalized private lending.

First, there is a concern that these private lenders will disturb the order of the official financial system via their unregulated practice, most notably by absorbing public funds with interest rates much higher than comparable bank deposits and by operating in the absence of systematic risk management mechanisms. One widely recognized restriction on interest rates in private lending is that rates exceeding four times coterminous official rates for comparable bank loans are not protected by law.<sup>55</sup> What is unclear is whether lending at rates above this "four times red line" is *per se* illegal. Did the red line simply define the limit of legal protection but not the boundary of legality, *i.e.*, that a debt with interest rates above this red line would not be illegal, but would not entitle the lender to legal remedies in case of default? Responses received from interviews reflect this confusion. All nineteen private lenders interviewed indicated that they were aware of the "four times redline" but eleven of them did not view the guidance as a strict legal boundary. All nineteen institutions issued at least some of their outstanding loans above the "four times redline." A related source of crime arising from high-interest private lending is violence involved in some debt collecting activities. It was observed that in Guangxi, for example, because loans are frequently made to speculative investment as usuries, default rates tend to be higher and use of some level of coercion and force is not uncommon.

On the front of risk management, since many grass-root lending institutions are not legally recognized financial institutions and thus are not subject to general financial regulations applicable to official financial institutions, these grass-root players have limited incentive to implement risk management procedures as robust or rigorous as required under regulations of

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<sup>55</sup> See *supra* note 19.



official institutions. This is not to say, however, that grass-root lending institutions engage in no real risk management. And as will be discussed later, many grass-root lenders that have successfully existed for longer periods (especially in Zhejiang), have effective basic risk management controls that are comparative in structure and substance to official bank practice. Risk management practice by grass-root institutions overall are nevertheless less sophisticated and rigorous than regulated banks. The ability of grass-root lending institutions to absorb public funds with high interest rates without being obligated to implement proportionate risk control mechanisms can introduce substantial credit risks to the overall financial system, and in adverse scenarios, cause concerns for economic and social stability.

Second, crimes do frequently arise under the sham of institutionalized financing activities and cause significant economic losses to ordinary civilians. Here I am not talking about the fact that institutionalized private lending itself is sometimes prosecuted as “crimes of disturbing the order of the financial system,” but more substantive crimes that can occur under the cover of financing activities such as fraudulent fund-raising (*e.g.*, Ponzi schemes) and money laundering. Ponzi schemes have been a perpetual concern for those investing in private financing networks. Normally, individuals put money into a financing network through an intermediary, often a relative or acquaintance, but will not be told about the end uses for the fund. While doing fieldwork in Guangxi province, I talked to a few locals at a town in northern Guangxi who have placed good amounts of their dispensable savings with one local private financing network. Most of them were introduced to the network through relatives or friends and were generally comfortable with not knowing anything about the operating details of the network.<sup>56</sup> Some financing networks, instead of re-lending capital collected at higher rates, simply keep on absorbing new

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<sup>56</sup> Personal communication, August 29, 2015, Guangxi (“I asked how that money was used when I pledged my first contribution (to the network) but my relative said that is confidential and that I do not need to know. Since all these years they have never missed out on my interest payments I don’t inquire about that anymore.”).

fund to pay off promised interest to existing investors. Since such networks were never making any profits but were only sustaining its operation by continuously enlarging its investor base, the scheme would eventually collapse when sufficient new funds could not be secured to cover promised payments anymore or when substantial withdrawals occurred within a short time. In the 1980s, a grass-root credit association (taihui, 拾会) in a small county under the Wenzhou municipality drew participation from more than two hundred thousand local residents (about a quarter of the county's population) and was running a Ponzi scheme.<sup>57</sup> When the scheme collapsed, eighty thousand households went bankrupt, sixty-three individuals committed suicide, two hundred fled, a thousand were arrested and three were executed.<sup>58</sup> It was estimated that this network accumulated more than 1.2 billion yuan in capital, which exceeded the combined total capital held by local official banks and credit unions at that time.<sup>59</sup>

Money-laundering is another common criminal charge against private financiers, and is most rampant in areas with active cross-border commerce. Guangxi, which borders Vietnam on the south and traditionally has had sizable import-export trade with Vietnam, Laos and other southeastern countries, has seen much money-laundering through private financing networks. One former police chief at a county in northern Guangxi said that a common method to launder money across the border is by under-reporting import prices while over-reporting export prices, and that "some networks that primarily finance legitimate business investment sometimes are also involved in smuggling and money-laundering for extra proceeds."<sup>60</sup> Interviews conducted in coastal Guangdong also show that foreign exchange transactions whose monetary amounts significantly exceed the state's regulatory ceiling

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<sup>57</sup> LI YOUHUAN (黎友焕), *Jiemi Dixia Qianzhuang (揭秘地下钱庄) [DISCOVERING UNDERGROUND BANKS]* 82 (2011).

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> Personal communication, August 30, 2015, Guangxi.

occur frequently and it is not customary for the institutions that facilitated the money transfers to inquire into the purposes of the transactions.

Third, there may be an unspoken concern on the part of the state that grass-root private lending institutions may compete with official banks for public deposits. Although smaller financing networks that lack standardized practice and lend heavily to speculative investments are seldom considered alternatives to official banks to put one's savings, larger private lending institutions that have existed for longer periods and have sound credit history in localized markets can sometimes become attractive alternatives (to official banks) for local residents to put their extra money. One private lending pioneer in Wenzhou, Fang Xing Money House, for example, once posed so much competitive pressure on the local official banking sector that the local PBC branch made the unprecedented move of allowing local state-backed banks to temporarily implement floating deposit interest rates in order to regain some of their lost ground.<sup>61</sup> In the 2003 case of Sun Da-Wu, a multi-million private enterprise owner who collected deposits from employees to finance business needs, it was found that Sun's financing network had almost completely deprived local official banks of public deposits (a factor likely having contributed to Sun's conviction of the "crime of disturbing the order of the financial system").<sup>62</sup> On the demand side, MSMs and individuals sometimes also consider reputable grass-root lending institutions reasonable

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<sup>61</sup> WANG SHUGUANG (王曙光), Puhui Jinrong: Zhongguo Nongcun Jinrong Chongjian Zhong De Zhidu Chuangxin Yu Falv Kuangjia (普惠金融: 中国农村金融重建中的制度创新与法律框架) [INCLUSIVE FINANCIAL SYSTEM: INSTITUTIONAL INNOVATION AND LEGAL FRAMEWORK OF CHINA RURAL FINANCIAL SYSTEM RECONSTRUCTION] 96 (2013).

<sup>62</sup> Zhou Ze (周泽), Dui Sun Da Wu "Feifa Jizi" An de Xingfaxue Sikao - Jian Tan Feifa Xishou Gongzhong Cunkuan Zui de Rending (对孙大午“非法集资”案的刑法学思考—兼谈非法吸收公众存款罪的认定) ["Illegal Fundrasing" in In re Sun, Da-Wu form a Criminal Law Perspective, and Discussion on the Determination of the Crime of Illegal Absorbing Public Deposits], 北大法律信息网 [China Law Info] (Nov. 24, 2011, 11:00 AM), available at <http://www.chinalawinfo.com/news/NewsFullText.aspx?NewsId=10951&NewsType=0/>.

alternatives to official banks as sources of credit. This aspect will be discussed further in Part IV.

### C. Recent moves in State policy

In July 2013, the State Council published the Guiding Opinions on Adjusting and Upgrading the Economic Structure via Finance (jinshitia, “金十条,” the “Finance 10”), which encouraged “attempts by private capital in establishing private financial institutions including banks.”<sup>63</sup> Three months later on the Third Plenary Session of the 18th Central Committee of the Communist Party the government reiterated its intention of allowing qualified private players to legally establish mid- and small-sized commercial banks.<sup>64</sup>

On June 22, 2015, the China Banking Regulatory Commission (“CBRC”) issued the Guiding Opinions on Promoting Development of Private Banks (“the 2015 Opinions”), officially authorizing qualified private parties to legally establish small- and medium-sized financial institutions.<sup>65</sup> The 2015 Opinions carry the express purpose of serving the financing needs of a range of social groups whose financing needs have traditionally been inadequately served by the state-run banking sector. Such social groups include micro-, small-, and mid-sized enterprises, the so-called “three rurals” (i.e., farmers, agriculture and rural areas), and certain disadvantaged communities. The 2015 Opinions is

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<sup>63</sup> Guanyu Jinrong Zhichi Jingji Jiegou Zhuanxing Shenji De Zhidao Yijian (关于金融支持经济结构调整和转型升级的指导意见) (国办发〔2013〕67号) [Guiding Opinions on Adjusting and Upgrading the Economic Structure via Finance] (promulgated by the St. Council, July 1, 2013), art. 9, available at [http://www.pkulaw.com/fulltext\\_form.aspx?Db=chl&Gid=206236](http://www.pkulaw.com/fulltext_form.aspx?Db=chl&Gid=206236).

<sup>64</sup> Resolution at the Third Plenary Session of the 18th Central Committee of the Communist Party (十八届三中全会《决定》、公报·说明(全文)), available at [http://www.ce.cn/xwzx/gnsz/szyw/201311/18/t20131118\\_1767104.shtml](http://www.ce.cn/xwzx/gnsz/szyw/201311/18/t20131118_1767104.shtml) (last visited Jan. 30, 2016).

<sup>65</sup> Guanyu Cujin Minying Yinhang Fazhan Zhidao Yijian (国务院办公厅转发银监会关于促进民营银行发展指导意见的通知) [Circular of the General Office of the state Council on Forwarding the Guiding Opinions of the China Banking Regulatory Commission on Promoting the Development of Private Banks] (promulgated by the state Council, June 22, 2015).

significant in every aspect and most importantly, it likely represents the first step taken by Chinese government to officially open the currently state-monopolized banking sector to private players.

To be sure, this is not the first time the state issues official communications that encourage private capital to enter the banking sector. In 2006 the CBRC asked for “reasonable relaxation” of entry requirements to the banking markets in rural areas, and encouraged private capital to “invest, acquire, and establish” rural financial institutions such as village and town banks (cunzhen yinhang, 村镇银行).<sup>66</sup> Three years later in 2009 the CBRC issued notice allowing qualified small loans companies to transition into village and town banks.<sup>67</sup> In 2010, the state Council via administrative opinions (xin 36 tiao, 新 36 条, “the new 36”) again encouraging private capital to enter “industries and areas not expressly precluded by law,” including the financial services.<sup>68</sup> None of these earlier efforts in allowing private capital into banking have led to any substantial new entries. This is likely because most of these earlier documents lack implementable guidance on entry requirements, application and approval procedures, and regulatory requirements.

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<sup>66</sup> Guanyu Tiaozheng Nongcun Diqu Yinhangye Jinrong Jigou Zhunru Zhengce, Genghao Zhichi Shehui Zhuyi Xinnongcun Jianshe De Ruogan Yijian (中国银行业监督管理委员会关于调整放宽农村地区银行业金融机构准入政策、更好支持社会主义新农村建设的若干意见) (银监发〔2006〕90号) [Opinions by the China Banking Regulatory Commission on Relaxing Entry Requirements to Banking Markets in Rural Areas to Better Facilitate the Construction of Socialist New Rural Areas] (promulgated by the China Banking Regulatory Commission, Dec. 20, 2006), art. 2 (relaxing entry requirements and allowing private capital).

<sup>67</sup> Guanyu Yingfa Xiaoe Daikuan Gongs Gaizhi Sheli Cunzhen Yinhang Zanxing Guiding [中国银监会关于印发《小额贷款公司改制设立村镇银行暂行规定》的通知] (银监发〔2009〕48号) [Circular of the China Banking Regulatory Commission on Releasing the Tentative Provisions for Conversion of the Small-loan Companies' Conversion to the Rural Banks] (promulgated by the China Banking Regulatory Commission, June 9, 2009).

<sup>68</sup> Guanyu Guli He Yingdao Mijian Touzi Jiankang Fazhan De Ruogan Fijian (国务院关于鼓励和引导民间投资健康发展的若干意见) (国发〔2010〕13号) [Opinions of the state Council on Encouraging and Guiding the Healthy Development of Private Investment] (promulgated by the state Council, May 7, 2010), art. 5 (encouraging and guiding the introduction of private capital to the financial services sector).

One notable distinction of the 2015 Opinions from past communications is that it provided specific, implementable guidance to help interested private parties establish PBC-sanctioned commercial banks. For example, article 4 of the 2015 Opinions provides that every applicant is guaranteed a response by the CBRC within four months its application for incorporation is received and once approved has six months to prepare its institution for official operation.<sup>69</sup> As of this writing, five private bank pilot points have been approved by the CBRC (see table 2). Many factors likely lie behind the state's increasing tolerance of private players in the banking sector, including MSMs' increasingly critical role in domestic economy and employment, MSMs' deteriorating performance in recent years (partly due to difficulties in obtaining affordable credit and a general economic downturn since 2010) and a concern for social stability if massive unemployment results as MSMs go out of business. In other words, the state has high stakes in MSM's continued survival and growth, which leaves it with little option but to break the long-term monopolistic position enjoyed by state-run and state-backed institutions in the banking sector.

#### IV. CURRENT STATUS OF GRASS-ROOT PRIVATE LENDING INSTITUTIONS<sup>70</sup>

##### A. An initial question: Do private banks exist in China?

An interesting place to start the discussion of grass-root lending institutions' potential to become legal, regulated commercial banks is the

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<sup>69</sup> *Supra* note 65, art. 4.

<sup>70</sup> Discussions in this Part are heavily based on responses collected from fieldwork interviews and surveys. Due to limitations in the number of interviews and surveys that can be obtained, and in the width of locations covered, inferences and conclusions may not be representative of all ongoing private lending activities. Citations to specific information from interviews or surveys will be referenced by record numbers of corresponding interviews or surveys.



question of whether private banks exist in China at all. This is a complicated question to which some may answer differently and most people probably do not have an answer.

During most of China's history since 1949, the official financial system has largely been monopolized by state-backed banks, especially five large state-owned commercial banks collectively known as the "Big Five."<sup>71</sup> Beneath the big five in bureaucratic hierarchy are twelve joint-stock commercial banks and hundreds of city and rural commercial banks. The joint-stock commercial banks were initially established by state entities as China began its economic reforms in the 1980s. City commercial banks and rural banking institutions are products of financial reforms in the mid-1990s to consolidate local-government-backed urban and rural credit unions and to sever their former affiliation to the PBC (or city commercial banks) or ABC (for rural commercial banks). Over the last twenty years private capital has acquired substantial shares in some joint-stock banks and dominant ownership in many urban and rural commercial banks.<sup>72</sup> Compared to the big five, the joint-stock, city and rural commercial banks are subject to state control by a lesser extent and many of them may even ostensibly appear "private" based on technical ownership structure.

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<sup>71</sup> The "Big 5:" Industrial and Commercial Bank of China, China Construction Bank, Bank of China, Agricultural Bank of China and Bank of Communications. Official data for the first three quarters of 2015 shows that the "big five" state-run banks consistently account for more than 40% of total assets and total liabilities of the banking industry. State-backed city joint-stock commercial banks, city commercial banks and rural banking institutions account for another 47% to 60%, available at <http://www.cbrc.gov.cn/chinese/home/docView/A60C3E29C36C433D8880D45C4E8C0C6E.html> (last visited Jan. 4, 2016).

<sup>72</sup> Song Miou, *News Analysis: China ready for more private banks, Private investors have helped*, XINHUANET (June 27, 2015, 21:35:15) ("Private investors have helped 758 rural commercial banks and the ratio of private capital hit 85 percent in these lenders. Private investors took shares of 134 urban commercial banks at a ratio of 56 percent."), available at [http://news.xinhuanet.com/english/2015-06/27/c\\_134361530.htm](http://news.xinhuanet.com/english/2015-06/27/c_134361530.htm) (last visited Jan. 23, 2016).



But the issue is that none of these “denationalized” banks was initiated by private capital. As products of reform experiments on government-run institutions, these banks do not live free of the state’s residual influence. Government actors still hold substantial, sometimes dominant, shares in these banks, rendering them continue to be under close state monitoring if not direct governance. For example, three of the four largest shareholders of the China Guangfa Bank (“CGB”), a mid-size joint-equity bank, are state-owned enterprises; together the three hold 60% of CGB’s shares as of year-end 2014.<sup>73</sup> Local governments (or their agencies) tend to reserve some ownership in city and rural commercial banks, making these banks “red-hatted” lenders heavily influenced by government sway rather than completely market-oriented private banks.<sup>74</sup> On the other hand, before 2015 there is virtually no record of grass-root private capital independently entering the banking industry. Although media has for a couple times captured attempts in the early 2000s by grass-root private players to obtain official approval to establish commercial banks,<sup>75</sup> the fact that none of these applications materialized reflects the state’s continued reluctance towards allowing complete private players into the official banking market. And it is probably safe to say that truly private banks, those that are founded and run by private capital, are still scarce, if not non-existent in China.

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<sup>73</sup> See CGB website (China Life Insurance Company Limited., Yingda International Holdings Group Co., Ltd., Citic Trust Co., Ltd. each holds 20% of CGB’s shares), available at <http://www.cgbchina.com.cn/Info/13367930> (last visited Jan. 22, 2016).

<sup>74</sup> See, e.g., Wang Wei (王葳), Qianxyi Nongcun Shantey Yinhang De Shichang Dingwei (浅析农村商业银行的市场定位) [*Marketing Positioning for Rural Commercial Banks*], Finance Theory And Teaching (金融理论与教学), no. 1, 2007 at 1 (local government control over rural commercial banks); Li Tuo & Yu Man (李拓 & 余曼), Lili Shichanghua, Zhengfu Jieru Yu Chengshi Shantey Yinhang Fazhan (利率市场化、政府介入与城市商业银行发展) [*The Liberalization of Interest Rate, Government Intervention and the Development of City Commercial Banks*], Jinrong Luntan (金融论坛) no. 7, 2015 at 72 (总第 235 期) (local government control over urban commercial banks).

<sup>75</sup> See, e.g., Five Private Bank Applications Pending Final Approval (茅于軾等上谏 五民营银行等待最后审批), available at <http://finance.sina.com.cn/g/20030726/1039383139.shtml> (last visited Jan. 30, 2016).

The type of private banks that is of most interest to this research are grass-root commercial banks that are founded and run by private capital, and mainly serve the financing needs of MSMs and individuals within their respective local communities. The categorization excludes banks with any level of direct state control such as the “Big Five,” any state-backed joint stock banks, and “red-hatted” city and rural commercial banks. Because of the near absence of officially licensed banks of this type, three types of grass-root lending institutions tend to fill the gap: (1) legally recognized private lending institutions such as small loans companies and pawnshops, (2) semi-legal private loan providers such as non-depository private financing networks and credit cooperatives, and (3) illegal deposit-absorbing financing organizations such as private money houses, also known as “underground banks”.

Normally, a critical difference between the first two types of institutions and the third type is that the former does not absorb deposits from the general public whereas the latter does. But in recent years it becomes increasingly common for legally established small loans companies, pawnshops, an investment companies to engage in underground depository banking practice.<sup>76</sup> Since an important purpose of this research is to understand the potential of existing grass-root lending institutions to grow into formal commercial banks (which typically absorb public deposits), greater emphasis is placed on a private lending institution’s substantive functions rather than formalities. Therefore, for the purpose of this analysis, any grass-root lending institution that received funding more from people other than its founders and people known to the founders is considered a de-facto (unlicensed) private bank, and the three categories of private lending institutions mentioned in the paragraph above are not necessarily mutually exclusive.

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<sup>76</sup> Interview and survey responses show that some private lenders that operate as licensed small loans companies, pawnshops and investment companies list deposits for local public as a funding source.

**B. Private lending institutions tend to serve highly localized markets and the nature of their services closely reflect local market demands**

Seventeen of the nineteen institutions interviewed indicated that they lend primarily ( $\geq 70\%$  outstanding loans) within their respective provinces. Twelve of them lend primarily within their home city or township. Only two Shanghai-based lenders indicated that they lent heavily outside the Shanghai area and consistently have substantial amounts of outstanding loans ( $> 30\%$ ) in nearby provinces such as Jiangsu, Zhejiang, and Fujian. Services provided by the respondents also display highly localized characteristics.

Private lending institutions on the southeast coast (Zhejiang, Fujian, Jiangsu), especially Zhejiang-based institutions, tend to lend more heavily to support MSMs' operational needs.<sup>77</sup> The three Zhejiang-based interviewees on average see around 70% of their outstanding loans go towards financing local MSMs, of which around 40% goes towards financing production needs and around 30% towards bridging short-term funding gaps.<sup>78</sup> It is not uncommon for private lenders in these areas to develop longer-term and more stable relationships with their borrowers. Loans extended by private lending institutions in these areas, especially Zhejiang, are also at comparatively low interest rates, averaging between two to four times comparable official bank loan rates, and for longer durations, averaging nine to twelve months, compared to similar loans in hinterland provinces such as Guangxi, Anhui, and Sichuan, averaging four to eight times official rates with durations averaging three to six months. This is likely a reflection of the relatively low credit risks associated with lending to existing clients and accommodation for the manufacturing industries' relatively low profit margins. Because of the ability to secure affordable loans from acquaintance lenders, business owners in these areas seem more prone to use loans obtained from private lending

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<sup>77</sup> Record no. 1 - 10 (Zhejiang), 26 - 28 (Jiangsu), 43 - 46 (Fujian).

<sup>78</sup> Record no. 1 - 3.

institutions to finance substantive business operations, including raw materials purchases, equipment and tools investment, plant and facilities expansion, etc. Although many respondents indicated that the percentages of their loans going into substantive business investment have gone down over the years, especially since 2011 when private lending rates started to spike, these percentages remain higher than those of similar lenders in other interviewed/surveyed locations. The use of private loans for substantive business functions is less common in hinterland provinces where private lending interest rates are higher and business owners use private loans mainly to bridge gaps between loans obtained from other sources including official banks or to reinvest in speculative investment for higher return.

Private lending institutions in Guangxi, Sichuan, and Anhui lend more heavily to speculative investment.<sup>79</sup> Fourteen of the sixteen responding institutions in these three provinces indicated that they lent to business and individuals that invest in real estate and equity markets. Sichuan-based respondents lend more heavily to real estate investment than any other province interviewed or surveyed. The three Sichuan lenders interviewed reported an average of over 50% of outstanding loans in real estate related projects. At the time of the interview two of the three were in a “loan freeze,” refraining from issuing any new loans while waiting for outstanding loans to be repaid. The situation has to do with a recent downturn in the local real estate market. Respondents from Guangxi and Anhui lend more heavily to gamblers than lenders at other interviewed/surveyed areas. One Guangxi-based lender interviewed estimated that about 50% of his loans went to gamblers.<sup>80</sup> Since gambling and casinos are prohibited in mainland China, gamblers often form “backyard casinos” in the disguises of residential buildings, fruits shops, and curbside eateries, etc. Interviewed lenders seem fully aware of the high risks associated gambler loans and usually require

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<sup>79</sup> Record no. 11 - 15 (Sichuan), 29 - 36 (Guangxi), 47 - 49 (Anhui).

<sup>80</sup> Record no. 30.

collaterals more valuable than the loans themselves. These lenders are nevertheless quite flexible on their collateral requirements with gamblers, taking almost anything with “some obvious value,” including jewelries, valuable accessories such as leather bags and watches, and electronics such as laptops and cellphones. Lenders interviewed in Guangxi said that they used to lend more to finance MSMs’ substantive business needs but switched course to fund more speculative investments as a good number local MSMs went out of business in recent years. Two former Guangxi-based lenders who operated from the mid-1990s until the late-2000s financial crisis reported much higher average percentages of lending that went to substantive business development. “There used to be a lot of private farming, fishing, and lumber business going on here and those days we were able to make pretty comfortable margins lending to them,” said one of the former lenders.<sup>81</sup>

Depending on whether the lenders are located in the coastal Pearl River delta area or the other parts of the province, Guangdong-based institutions demonstrate somewhat different service characteristics. Coastal lenders, especially Shenzhen-based ones, often conduct a large amount of foreign currency exchange business and only lend as a sideline. One institution I visited in Shenzhen has been trading foreign currency (illegally) for almost ten years. The owner of this institution said that she once considered “also doing pawns and small loans” but eventually decided to stay suit as his geographical location makes it “most convenient to just trade currencies” (Shenzhen is a coastal city bordering Hong Kong).<sup>82</sup> This owner also indicated that many of her peers were simultaneously engaging in some private lending in parallel of their currency trading business, “but that business (lending) tends to stay pretty small as a lot more people come to us to exchange currencies.”<sup>83</sup>

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<sup>81</sup> Record no. 34.

<sup>82</sup> Record no. 37.

<sup>83</sup> *Id.*

Private lending institutions in some other parts of Guangdong,<sup>84</sup> on the other hand, are more comparable to those in the southeast coast provinces such as Zhejiang, Jiangsu and Fujian, in that they lend primarily to MSMs in the manufacturing industries. Like Wenzhou in Zhejiang province, areas in Guangdong such as in Shanwei, Dongguan and Zhongshan are home of many private enterprises and have over the years nurtured a rather robust private sector. Although unlike manufacturers in Zhejiang, which engage more in the production of consumer goods, business in Guangdong engage in slightly more high-tech areas such as the manufacturing of small electronic appliances, the nature of lending activities in hinterland Guangdong resemble those in Wenzhou in that significant amount of loans go towards funding substantive business. Guangdong-based lenders, however, are on average substantially smaller than their counterparts in Zhejiang, and also tend to have less institutionalized practice. The average scale of interviewed Guangdong lenders is around 10 - 20 million RMB in annual revenue, compared to 30 - 50 million in Zhejiang. Average loan size is also proportionately smaller at 0.5 - 2 million, compared to 2 - 5 in Zhejiang. This is likely because private enterprises in Guangdong tend to be smaller than those in Zhejiang.<sup>85</sup> Guangdong based lenders also seem more risk-averse than their Zhejiang counterparts. One interesting observation is that while their average default experience, around 10%, is better than that in Zhejiang, averaging close to 15%, average private borrowing costs are higher in Guangdong, averaging 3 - 5 times official bank loan rates, than those in Zhejiang, averaging 2 - 4 times.

Like private lending in Zhejiang and Guangdong, private lending activities in Shanxi tend to further more constructive ends and closely reflect characteristics of the local economy.<sup>86</sup> There are, nevertheless, a few

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<sup>84</sup> Record no. 38 - 42.

<sup>85</sup> 实力排行：广东企业多而不大浙江私企实力最强 (Private Enterprises: Guangdong Ahead in Number but Behind Zhejiang in Size and Strength), available at <http://business.sohu.com/20070201/n247979006.shtml> (last visited Jan. 26, 2016).

<sup>86</sup> Record no. 16 - 20.



observable distinctions of Shanxi based private lenders compared to their counterparts elsewhere. First, Shanxi-based lenders serve a somewhat different mix of enterprises from lenders in coastal areas. While Wenzhou and Guangdong-based institutions lend heavily to enterprises that engage in import-export business, Shanxi-based lenders' main borrowers are local enterprises that almost exclusively manufacture for and sell to domestic markets. Private enterprise that engage in coal extraction (and refining) and small manufacturers are typical clients to Shanxi's grass-root lending institutions. Therefore these lenders' financials are not as sensitive to overseas demands as to fluctuations in domestic markets. Second, responses from Shanxi-based lenders show the narrowest interest rate range among all respondents. All five interviewed lenders reported interest rates average 3 - 4 times benchmark for a duration of 6 to 12 months. And this interest rate level has stayed virtually unchanged for at least the last five years. Third, the private sector in Shanxi relies more heavily on official bank loans than other provinces surveyed, and normally only use private loans to bridge gaps in official loans rather than to finance substantive business operations.<sup>87</sup> This lesser dependence on and secondary use of private loans may to some extent explain the relatively narrow and stable interest rate range observed.

Shanghai-based institutions run the most diverse business among all respondents.<sup>88</sup> Shanghai-based respondents finance a variety of projects that do not show a clear pattern in terms of their business mix. Generally, these institutions lend less to substantive business than Zhejiang-based lenders but slightly more compared to the average interviewed Guangxi-based lender. And they also lend substantially to speculative investors, although not at the level of many Sichuan or Guangxi based lenders. Some Shanghai institutions also

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<sup>87</sup> It is observed during fieldwork that many Shanxi-based private enterprises have easier access to official bank loans than their counterparts in other surveyed provinces, a phenomenon likely having to do with the common practice of private business owners to cultural ties with local government and bank officials.

<sup>88</sup> Record no. 21 - 25.



engage in currency exchanges but currency exchange normally does not make up a significant chunk of their total business. Unlike respondents from other areas however, Shanghai-based respondents appear more oriented towards selective investment rather than general lending. It is common for institutions to receive commission for and share profits made from invested projects, in addition to ordinary lending interests for capital contributed. This can be shown from their higher average “loan” size (relative to annual revenue) and longer duration. Therefore by nature these lenders are more akin to a combination of venture capitalist and investment advisor than general community lenders like, for example, respondents from Zhejiang.

**C. Private lenders provide critical financing channels to MSMs that have difficulties obtaining credit from official banks and meaningful alternatives to bank loans in some areas**

Except for five, all other forty-four respondents identified MSMs as a primary borrower type. None of the responders lend substantially to large private enterprises (which usually have much easier access to bank credit than MSMs) or state-run enterprises. Interviews with some of the respondents reveal that credit provided by these lenders appeals to at least three types of private enterprises: (1) micro-enterprises and individuals that historically have difficulties borrowing from official banks due to their lack of reliable financial statistics and qualified collaterals, (2) mid- and small-sized enterprises that used to be able to borrow from official banks but in recent years faced greater difficulties in obtaining official credit and, (3) enterprises and individual that could have borrowed from official banks but prefer the expediency and flexibility of services provided by private lenders.

The first type of borrowers is historically shut from official loans. These parties' small size and less standardized business practice make it difficult for them to comply with official banks' highly formalized credit underwriting processes. They are frequently rejected for their inability to provide satisfactory proof of financial soundness or qualified collaterals. At the

same time it is impractical for larger banks to incur the high information costs to verify these applicants credit-worthiness via non-standardized procedures such as on-site examinations and interviews with counter-parties. These more customized underwriting procedures, however, can be much more easily performed by localized private lending institutions. All interviewed lenders indicated that at least some of their MSM borrowers had been turned down by official banks before turning to them. Yet many interviewees indicated that they were reluctant to equate past rejection by official banks with a complete lack of credit-worthiness. "That a borrower had been declined by official banks does not automatically make him less credit-worthy," one interviewed lender said, "especially when you know that borrower better than banks do."<sup>89</sup> Another interviewee believed that "it is sometimes a good thing" that a borrower had been declined by banks," as this makes him "more willing to accept the higher interest rates charged by lenders like us, and more appreciative of the flexibility and expediency of our service."<sup>90</sup>

The situation with the second type of borrowers is more complex. In recent years many MSMs find it increasingly challenging to obtain credit from official banks. Placing aside the facts that official banks tend to prioritize the financing needs of SOEs, face high information costs verifying MSMs' financial performance, and imposes stringent collateral requirements, two other factors have likely made it even more difficult for MSMs to obtain credit from the official banking sector. One is that the presence of the official banking sector itself in non-urban areas has dramatically shrunk over the last fifteen years. Starting in the late 1990s, state-backed banks are withdrawing from regions where their performance, mainly measured by profitability, does not meet State expectations. It is no coincidence that most of the regions that the banks decided to withdraw from are less developed, non-urban area in China's hinterlands where there are fewer SOEs or large infrastructure projects to

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<sup>89</sup> Record no. 1.

<sup>90</sup> Record no. 2.

generate handsome interest revenue.<sup>91</sup> The result of official banks' exodus is that many MSMs in affected areas that used to rely on bank loans become suddenly deprived of their main credit source, and had little choice but to resort to private lending to fill their gaps in funding. A second factor is the state's drastic reversal of its post-crisis quantitative easing policy in 2011. As a response to the global financial crisis in 2008, the state engaged in quantitative easing that led to a massive credit expansion. To take advantage of the easy credit made available by State policy, both the public and private sectors engaged in aggressive investment and production. But in 2011 the state reversed its quantitative easing policy. A credit contraction ensued, accompanied by sharp reduction in government investment. Official banks immediately felt the squeeze and faced a shortage of loanable funds (qianhuang, 钱荒).<sup>92</sup> Banks responded to the credit crunch by restraining lending extended to the private sector in order to continue to honor their political priority of keeping the SOEs and State projects financed.<sup>93</sup> Many private enterprises that used to rely mainly on official credit switched to private lending and private lending interest rates spiked. Private lending rates in Wenzhou, for example, which had since 2003 stayed within a relatively stable range of between 10 to 15%, spiked to nearly 20% in early 2011.<sup>94</sup>

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<sup>91</sup> Wang Jingfei (王劲斐), *Woguo Dixia Qianzhuang Hefahua Lujing Yanjiu* (我国地下钱庄合法化路径研究) [*Study of Paths Towards the Legalization of Underground Banks in China*], *J. of Chongqing U. of Sci. & Tech. (Social Science Edition)* (重庆科技学院学报: 社会科学版), no.2, 2011 at 56 ("Starting from 1999, the 'big four' state-owned commercial banks started to eliminate on a large scale infrastructure facilities at and below municipal and township levels. Up to thirty-one thousand branches were eliminated within four years.")

<sup>92</sup> Chinese Economy Threatened by Liquidity Crunch(钱荒威胁中国经济), available at <http://www.dw.com/zh/%E9%92%B1%E8%8D%92%E5%A8%81%E8%83%81%E4%B8%AD%E5%9B%BD%E7%BB%8F%E6%B5%8E/a-16898574> (last visited Jan. 30, 2016).

<sup>93</sup> Dong Yanling & Zhang Ming (董彦岭, 张明), *Woguo Minjian Jiedai De Fengxian, Qushi, Ji Duice* (我国民间借贷的风险, 趋势, 及对策) [*Private Lending in China: Risks, Trends, and Resolutions*], *Hainan Fin.*, no. 2, 2012 at 80.

<sup>94</sup> Zhang Xuechun et al. (张雪春), *Minjian Jiedai Lilv Yu Minjian Ziben De Chulu: Wenzhou Anli* (民间借贷利率与民间资本的出路: 温州案例) [*Private Lending Interest*

The third category is more common in areas with more developed and standardized private lending markets. In two of the three interviews conducted in Zhejiang, the interviewees indicated that they have some long-term customers that stay with them for their customized services. One interviewee said that his institution is able complete all necessary due diligence checks and extend loans of up to five million yuan in as little as 72 hours (whereas the same process can take a state-run bank a month or more), and smaller loans below one million yuan can usually be extended within 48 hours and those below half a million can be made available the same day.<sup>95</sup> Both interviewees indicated that they are reachable by customers for business inquiries 24 hours a days and all seven days a week, and sometimes provide “door-to-door service” (shangmen fuwu, 上门服务) at customers’ request.<sup>96</sup> To many local enterprises, the expediency of private lenders’ services make private credit a competitive alternative over bank loans, for which borrower often need to go through lengthy, formalized application processes that take weeks and even months while facing the tremendous unpredictability of the final results. Besides their simple application processes and more customized services, private lending institutions can sometimes also be cheaper alternatives to official banks. A few interviewed private business owners mentioned the occasional need to go through “unofficial channels” to obtain official loans, i.e., the need to network with bank or government officials to improve the odds of loan approvals, a process often involving much social entertainment and gift-giving. The need to go through “unofficial channels” can bring the ultimate cost of a bank loan “significantly above the 5% or so

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Rates and the Solution for Private Capital: Wenzhou as Case Study], *Jinrong Yanjiu* (金融研究), no. 3, 2013 at 7, figure 5 (weighted average sample private lending interest rates in Wenzhou).

<sup>95</sup> Record no. 3.

<sup>96</sup> Record no. 1, 2.

official bank rate,<sup>97</sup> sometimes raising the total cost so much that in effect makes the official loan more expensive than a similar loan from a reputable private lending institution.

The usefulness of private lending to local businesses and the substantial economic gains generated also help explain the relationship between private lenders and their local governments in some areas. Local governments' attitudes towards private lenders do not always align with the central government and the extent of this disconnect often influences how rigorously local governments implement the state's more repressive policies on private lending activities, especially with regard to the treatment of depository underground banking. Generally, local governments tend to be more lenient towards private lending institutions than the central government and its regulatory agencies. Figure 1 depicts a high-level view of the relationship between grass-root private lending institutions with their local governments and local MSMs in the context of the larger financial system. Local governments at three types of localities are often more tolerant of private lending institutions, especially underground banks: (1) where local governments enjoy greater latitude in implementing State policies (often as a result of the area being chosen as pilot location for financial reforms); (2) where local governments rely heavily on the private sector for tax revenue and economic growth; and (3) where local government officials have personal stakes in underground financing networks.

The first two often go hand in hand. For example, Wenzhou, a city within Zhejiang province that has historically received very low State investment,<sup>98</sup> has a highly robust private sector consisting primarily of MSMs

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<sup>97</sup> Personal communication, August 14, 2015, Zhejiang ("These out-of-pocket expenses make the actual borrowing costs much higher than the 5% or so official rate. I would rather take an 12% underground rate to save all the hassles.")

<sup>98</sup> People's Daily, October 27, 2008, page 6 (the state's total investment in Wenzhou from 1949 to 1978 was 0.595 billion yuan, or one seventh of national average), available at <http://cpc.people.com.cn/GB/64093/64387/8233452.html> (last visited January 27, 2016).

that engage in the manufacturing of consumer goods.<sup>99</sup> As local economy grows private lending has emerged as a natural by-product. MSMs in Wenzhou historically place heavy reliance on these institutions to finance many legitimate business needs. Wenzhou was also repeatedly chosen as a pilot location for the state's financial reforms, and thus enjoys somewhat greater latitude in experimenting with aggressive reform moves and has shown greater tolerance towards non-official banking activities.<sup>100</sup> In the 1980s, Wenzhou's local government has not only acquiesced the existence of some underground money houses, but has supported their continued operation with action. Although not sanctioned by the PBC, early private banking pioneers in Wenzhou such as Fang Xing and Lu Cheng were officially licensed by the Department of Industrial and Commercial Development of the Wenzhou municipal government. Lu Cheng City Credit Co-operative (lucheng chengshi xinyong hezuoshe, 鹿城城市信用合作社), in particular, operated for ten years (1986 - 1996) under local government's silent tolerance, and probably would have continued to exist if it was not affected by a State policy to consolidate urban credit co-operatives.<sup>101</sup>

Some private lending institutions in Guangxi and Sichuan fall within the third category. In three of the five institutions I visited in Guangxi, local government officials have personal investments in the networks' lending business and receive decent interest payments for their investments. It is also not uncommon for participating officials to channel long-term loans, via personal relations, from official banks to their participating networks to be relent for higher interest. Some institutions were even directly run by incumbent or former local government officials. One small loan company visited was founded and run by a retired official from a local court, who has

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<sup>99</sup> *Id.*

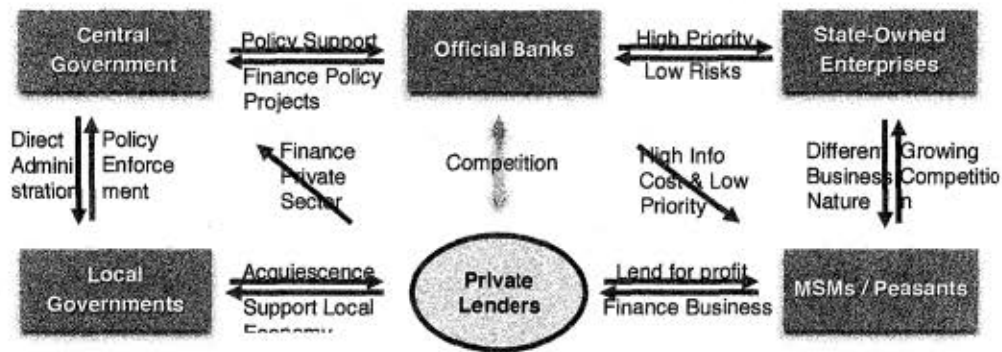
<sup>100</sup> See *supra* note 35, 52.

<sup>101</sup> Interview of Yang, Jia-xing, founder of Lu Cheng City Credit Co-operative, available at <http://renwu.people.com.cn/BIG5/n/2013/0918/c357069-22961841.html> (last visited January 30, 2016).



good knowledge of existing laws and regulations on financial institutions and maintains sound relationships with incumbent officials in the town's court system and police department. Although local officials' participation in private lending institutions may easily spur speculations of corruption and power abuse, in practice there are, maybe surprisingly, some side positive effects from official participation. Some contributors/depositors to private lending institutions believe that institutions where local officials have personal stakes tend to be more reliable and less likely to default on their principal or interest payments, as the participating officials often become the first line of defense against the lender's incentive to delay or miss payment.<sup>102</sup>

Figure 1. Relationship Chart<sup>103</sup>



**D. Private lenders that have existed for longer periods and mainly lend to substantive businesses tend to have more robust risk management practice**

One important observation from interviews and surveys with grass-root private lending institutions is that not all of them are reckless risk takers

<sup>102</sup> Personal communication, August 31, 2015, Guangxi.

<sup>103</sup> Adapted from figure 4-1, *supra* note 61, at 114.

(as they are sometimes portrayed by the media). In contrast, many private lenders have rather objective understanding of their risk profiles, realistic expectations of gains and losses, and employ fairly robust risk management techniques. This is particularly true of institutions that have existed for longer periods and lend primarily to support legitimate business needs of local MSMs. Four risk management techniques commonly employed by grass-root private lenders are discussed as follows.

(1) Loss reserves

Reserve setting is one of the most common risk management technique utilized by financial institutions to prepare ahead for expected losses arising from risk exposures. For commercial banks, reserves are normally set as capital cushion against expected losses from credit defaults. Responses collected show that, like official commercial banks, it is common for private lending institutions to set reserves against expected defaults from credit risk exposures. Because private lending institutions do not have the type of government protection enjoyed by their official counterparts, and it is uncommon for them to obtain external commercial insurance, loss reserves as a self-insurance mechanism is often the single most important risk control a lender has against adverse scenarios.

Twenty-three of the forty-nine respondents reported that they used loss reserves as capital buff against expected losses from credit defaults. Five of these twenty-three lenders indicated that they maintain dynamic reserves on an individual-loan basis that are regularly adjusted to reflect changes in default expectations on individual loans. Initial reserves are calculated as the amount of an outstanding loan multiplied by an experience-based estimate of that loan's default risk. For example, the reserve at time zero for a one-million outstanding loan with a 10% default risk will be 100,000. A lender may adjust the time-zero reserves a few times during the duration of the loan as default prospects change and maturity approaches. To make a reserve adjustment, the lender does not release the existing reserve but add or subtract from it by an

appropriate amount that quantifies the change in risk positions. Normally, dynamic reserves are only released when a loan matures and repayment is received. Sometimes when loans are repaid in fragments, a lender may choose to gradually release loss reserves in proportion to payment received.

Some interviewed lenders expressed a preference to use static reserves, which is often calculated as a fixed percentage as prior year's net income. Static reserves are not adjusted during the year and are released at year-end when new reserves are set. These interviewees prefer static reserves mainly for its simplicity, especially if they keep rather homogenous baskets of loans, which can make the calculation individual-loan-based dynamic reserves appears more onerous than necessary. A few interviewed lenders that primarily use static reserve nevertheless set dynamic reserves for larger loans whose defaults may have material impact on the institution's overall financial status.

#### (2) Due diligence

With the exceptions of five, all respondents reported that they maintain some due diligence processes on their borrowers. To determine the creditworthiness of a potential borrower, lenders often request historical financial statistics, usually for at least the past three years, from the borrower to understand the overall financial soundness of the borrower's business. For customers that also (or used to) borrowed from official banks, private lenders normally require them to file a "zheng xin" (information seeking, 征信) request with the local PBC branch to retrieve the customer's historical borrowing records with any official bank. For borrowers that do not have historical records of financial performance (or such records are deemed unreliable), the lender may collect such documents as the borrower's utility bills, sales contracts, delivery confirmations, payment records and tax filings to make sure that the borrower's business is still in running. In some cases lenders cross-check with the third parties that have business relationships with the

borrower to confirm that the borrower is actually selling its products (or services) and receiving payments in return. While purely credit-based loans are sometimes extended to long-time customers with sound financial records, collaterals are required as an extra risk buffer in most private loan contracts. To assure that a potential borrower did not repeatedly use the same asset to obtain multiple loans (over collateralization), lenders often register the agreed-upon collateral with appropriate local government authorities (e.g., the local Housing Department if the collateral is real estate) so that the lender's interest in the collateral receives legal protection in the event of default and trumps any prior or later unregistered uses of the same collateral.

### (3) Liability risk management

Interviews with private lending institutions show that it is common for private lending institutions, larger and longer-standing ones in particular, to actively monitor their liability status, especially exposures to credit and liquidity risks. In 2006, the China Banking Regulatory Commission (CBRC) mandated the monitoring of a number of core risk management indicators, including three liquidity risk indicators and three credit risk indicators.<sup>104</sup> Although it is not common for grass-root private lending institutions to systemically adopt these indicators in strict accordance with CBRC standard, many interviewed institutions do make frequent and effective use of a number of these indicators (or functional equivalents). Table 1 shows a list of the liability risk management indicators the CBRC published in 2006 and the number of private lenders that monitor each indicator (out of a total of nineteen interviewees).

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<sup>104</sup> Shangye Yinhang Fengxian Jianguan Hexin Zhibiao (Shi Xing) (商业银行风险监管核心指标 (试行)) [Core Indicators for the Risk Management of Commercial Banks (for Trial Implementation)] implemented by the China Banking Regulatory Commission, January 1, 2006, available at [http://www.cbrc.gov.cn/chinese/home/docDOC\\_ReadView/2196.html](http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/2196.html) (last visited January 14, 2016).

Table 1. CBRC Core Risk Management Indicators

<b>Core Indicator</b>	<b>Definition</b>	<b>Regulatory Requirement</b>	<b>No. of Interviewed Private Lenders that Monitor the Risk Indicator</b>
<b>Liquidity Ratio</b>	balance of current assets / balance of current liabilities	$\geq 25\%$	15/19
<b>Core Debt Ratio</b>	core debt / total debt	$\geq 60\%$	3/19
<b>Liquidity Gap</b>	on- and off-balance-sheet current asset-liability gap over a 90-day window / on- and off-balance sheet maturing current asset-liability gap over a 90-day window	$\geq -10\%$	N/A
<b>Primary Non-Performing Loan Ratio</b>	non-performing loans / total asset	$\leq 4\%$	10/19
<b>Secondary Non-Performing Loan Ratio</b>	non-performing loans / total loans outstanding	$\leq 5\%$	19/19
<b>Group Client Credit Concentration Ratio</b>	total credit amount of the largest group client / net capital	$\leq 15\%$	N/A

<b>Core Indicator</b>	<b>Definition</b>	<b>Regulatory Requirement</b>	<b>No. of Interviewed Private Lenders that Monitor the Risk Indicator</b>
<b>Individual Client Credit Concentration Ratio</b>	total credit amount of the largest individual client / net capital	$\leq 10\%$	8/19
<b>Generalized Correlation Ratio</b>	credit extended to related parties / net capital	$\leq 50\%$	N/A

The observation that some grass-root lenders actively track their credit and liquidity risks is important. As will be discussed in the next section, like the traditional commercial lending business of official banks, the most significant financial risks faced by private lending institutions are credit and liquidity risks. The ability to understand the nature of these risks and to use effective measures to monitor them not only provides some grass-root lending institutions the necessary condition for sustainable operation, but may also prepare them early on for the possibility of becoming legitimate financial institutions should such opportunities mature in the future.

#### (4) Record keeping

Thirty-five of the forty-nine respondents reported having some record keeping practice. These respondents include most of the lenders that have operated for five or more years make at least ten million RMB in annual revenue. It is common for lenders keep individual loan record for at least the past three years and for any loans outstanding for more than three years; some lenders maintain records of all loans made since the start of their operation. Files that a lender maintain in record usually includes a borrower's loan



application materials, the loan contract, any following agreements made between the lender and the borrower (often relating to change in lending terms), and all records of payments. Lenders interviewed indicated that they maintain historical loan records for two main purposes. One is to resolve disputes that can potentially arise from a lending relationship. Files on record can serve as proof of the parties' initial intent in the event of a later dispute over specific terms. A second purpose is for performance review. All record keeping lenders review loan performance, especially historical default experience, although frequencies of review vary among lenders. For example, a small loans company in Shanghai whose typical loan duration is between five months to a year tracks default status on a quarterly basis. And a private financing network in Guangxi whose loan durations average less than three months reviews default status every month.

#### **E. Risk Characteristics of Private Lending Institutions**

The Bank of International Settlements, in its Basel III prudential regulation framework for commercial banks, identified four important types of risks that a commercial bank faces: credit risk, liquidity risk, market risk and operational risk.<sup>105</sup> I will discuss the general risk characteristics of grass-root lending institutions with respect to these risk types, based on information compiled from interview and survey responses.

(1) Like the traditional lending business of official banks, the most significant components of many private institutions' risk profiles are credit and liquidity risks

Compared to their official counterparts, most private lenders' services are incredibly simple. While the former is making an increasing share of their

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<sup>105</sup> See generally Basel III: A global regulatory framework for more resilient banks and banking systems, Basel Committee on Banking Supervision, Bank of International Settlements, December 2010 (revised June 2011), available at <http://www.bis.org/publ/bcbs189.pdf> (last visited January 30, 2016).

revenues from fee-based services such as asset management, insurance, and trading, grass-root institutions tend to stay with traditional lending and live on credit spreads. This is true even for institutions that have existed for more than ten years and are making over a hundred million yuan in annual revenue. Grass-root lenders' conservative market positioning and simple service structure make them a natural fit to fulfill the basic financing needs of local MSMs, which often have the more pressing needs to keep their businesses running than to benefit from advanced fee-based financial products. And grass-root lenders' focus on traditional lending means that their main financial risks remain the most fundamental ones any commercial bank faces — credit risks that excessive defaults may occur and liquidity risks arising from the inherent duration mismatch between asset and liability cash flows.

More advanced quantitative analysis may be needed to understand how grass-root's credit risks compare to state-backed banks on a granular level. As a general analysis there are at least two reasons why some private lenders' credit risk exposure may not be significantly higher than official banks, even though they often lend to parties official banks are reluctant to serve. First, grass-root lenders incur much lower information cost in understanding the credit-worthiness of prospective local borrowers. In one interview, a lender talked about a local peasant that borrowed from him to fund an orchard business, "I have known his family for years; I know what he does for a living, that he has a daughter who is currently attending college, and how much that education costs."<sup>106</sup> In another interview, the interviewee talked about an occasion where he had to reject a local businessman's loan application, "he said that he needed the money to expand his leather plant, but I knew that he has a gambling problem."<sup>107</sup> Second, more successful private lending institutions have rather robust risk management practice over credit risk exposure. As discussed in the previous section, it is not uncommon for

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<sup>106</sup> Record no. 38.

<sup>107</sup> Record no. 40.

private lenders to set loss reserves, monitor default experience, and control loans concentration. These risk control techniques, although somewhat cruder comparing to official banks' more computationally intense versions, are sufficiently effective and robust for many private lenders' simple business.

Liquidity risk is the flip side of credit risk. While credit risks arise from the user end of credit, i.e., that a borrower may not be able to repay loans, liquidity risks arise from the supplier side of credit, i.e., that depositors may want to withdraw their money early or in massive scales. Compared to official banks a material factor that contributes to private lenders' potentially high liquidity risks is the lack of State protection should "bank runs" occur. Putting this aside, in terms of substantive liquidity risks from running a lending business, successful private lenders are not necessarily at a more vulnerable status compared to official banks. One interesting observation on liquidity risks faced by private lenders is that while these lenders may have narrower depositor/investor bases and face higher default risks than official banks, bank runs do not happen to them as frequently as one may speculate, especially with regard to more deep-rooted institutions with strong local ties. A few interviewed lenders recalled that in past situations where they face temporary liquidity challenges and were not able to honor customers' interest payments or withdrawal requests, many customers delayed their withdrawals and waited until the lenders regain normal liquidity rather than forcing a withdrawal. One possible explanation is that when a lender and its depositors live in the same community and know each other outside of the lending relationship (as relatives, friends, acquaintances, *etc.*), the depositors are more tolerant of temporary uncertainties with their capital than they would in arm-length dealings. Another reason is that depositors tend to view their money in private lending institutions somewhat differently from their ordinary bank deposits --- they view the former more as an investment in which they share risks with the lenders in exchange for higher returns rather than a safe haven to store extra cash. A few individuals I talked to in Guangxi who have deposited with private lenders said that they were only putting in money for

which they have “no immediate use” and were fully aware of the possible worst scenario — losing their entire principal. Therefore, doing business within small communities has likely reduced some of the liquidity risks private lenders would otherwise face. But this advantage will probably somewhat decrease if some private lenders become legitimate banks and start absorbing deposits from the broader public on arm-length basis.

Non-depository institutions, such as small loans companies and pawn shops, face less liquidity risks. Because such institutions often rely much more heavily on founder’s own funds and retained earnings than external investors or depositors, they do not face the challenge of having to use shorter-term liabilities (deposits) to support longer-term assets (loans) as their deposit-collecting counterparts do. Also, because such institutions often require borrowers to pledge assets of equivalent or greater value as collaterals for loans, and can hold on to such collaterals as long as issued loans are not properly returned, they may also face less credit credits.

(2) Compared to state-backed banks, private lending institutions may face more idiosyncratic market and operational risks

Due to their highly localized business underground banks may face more idiosyncratic market and operational risks. Market risks arise from changes in external market conditions including moves in macro-economic parameters. As private lenders make most of their profits catering to financing needs of local business and individuals, depending on the nature of their borrowers and the how these borrowers use obtained loans, private lenders operating at different localities are sensitive to very different types of market factors. For example, most of the Zhejiang-based respondents lend heavily to MSMs in manufacturing and wholesale. These institutions are most concerned with changes in such factors as raw material costs, export policies, and currency exchange rates, etc. Whereas Sichuan-based institutions, which lend heavily to real estate and stock investors, are more concerned with the performance of these industries. And Shenzhen-based foreign exchange

houses, whose business is predominantly currency trading, watch fluctuations in foreign exchange rates particularly closely. Because many grass-root lending institutions do not easily expand beyond their founding localities, external market factors that have generally impact on local economy are non-diversifiable, systemic risks for these lenders. This is an important reason why when substantive businesses deteriorate in recent years, private lenders tend to switch to fund more risky speculative investments rather than staying in substantive commercial lending by tapping potential clients outside their local markets. This exposure to non-diversifiable market risks is inherent in the nature of grass-root private lending, and is a principal contributor to grass-root lenders' credit and liquidity risks (discussed in the previous section) and micro-systemic significance in their local financial systems (discussed in the next section).

Operational Risks arise from the lack of sufficient, effective business processes. Compared to official banks, private lending institutions have less sophisticated business processes and cruder risk management measures. Less than one third of respondents have some standardized procedure for reviewing and processing loan applications and less than half sign formal, notarized contracts with borrowers. Although a larger percentage of respondents reported performing at least some basic due diligence on loan applications and having some record keeping practice, none of these respondents used any professional staff to perform such processes and most analytics performed are simple static ratio checks. None of the lenders interviewed have among its founders or key staff anyone with substantial previous training or experience in banking, or finance in general. But these observations do not necessarily suggest that private institutions are exposed to unacceptable operational risks, for at least two reasons.

First, private lending institutions often provide simple services to familiar customers. On small localized markets, private institutions have significant advantages over larger official banks on information costs. Private lenders' familiarity with local customers means that loan application and

approval procedures can often be minimized to facilitate more efficient lending and quicker capital turn-around. Many interviewed lenders felt that formalized processes will slow down their lending activities and make them less competitive, because in an “acquaintances-based market” (shuren shichang, 熟人市场), requiring formalized processes does not materially mitigate any risks already known to the lender. Second, sophistication and completeness of business processes vary noticeably among institutions with different business sizes and level of maturity, indicating that competitive institutions adopt more robust and comprehensive internal controls as they grow in size and sophistication. A few networks that have existed for longer period said that many of their current internal controls and risk management measures were not in place when they first started, but were gradually added as their business grew and started to cover less familiar borrowers.

(3) Grass-root private lending institutions tend to pose more micro-systemic risks to local financial systems than macro-systemic risks to the national financial system

Like the traditional lending business of official banks, private lending institutions channel capital from less productive uses to more productive uses and make most of their profits from credit spreads. Unlike their larger official counterparts, however, private lending institutions tend to serve highly localized markets and are extremely cautious with expanding beyond communities whose business behavior and credit history the lenders are already familiar with. This is true of early pioneers such as Fang Xing and Lu Cheng (which primarily served MSMs in Wenzhou), and probably remains true for most grass-root lenders today. Ninety percent of respondents do (did) business predominantly within the same province, four of whom within the same municipality, three within the same township, and one within the same village. None of the interviewed lenders made aggressive moves expanding their service beyond their current localities in the most recent five years.



Because of their highly localized business and the simplicity of their products likely mean that individual lenders normally pose very little macro-systemic risks to the state's overall financial system, as individual institution's survival and performance are determined by rather specific local market factors and the impact of single-case bankruptcies does not easily spread to localities not served by the troubled institutions. But via their localized business private lenders can impose significant micro-systemic risks to their local financial systems. And this is especially true of underground banks. Many underground banks started as personal financing networks consisting mostly of relatives, friends and acquaintances. These networks often grow by spread-of-words and can quickly mobilize a significant amount of local savings. When a sufficiently large amount of local households were drawn into such networks as contributors or depositors, these networks become systemically important with respect to their local financial markets. A few private lending crises that occurred in Wenzhou during the 1980s illustrated such micro-systemic risks imposed by larger depository private lending institutions.<sup>108</sup>

## V. THE RETURN OF PRIVATE BANKS?

### A. Some grass-root lending institutions are interested in becoming legal commercial banks

When asked whether they are interested in becoming legal commercial banks, only seven of the forty-nine respondents answered affirmatively. Twelve institutions said they were uncertain mainly because the unpredictable nature of the regulatory environment. Three lenders did not respond to the question and the remaining twenty-seven said they were not interested. Most institutions that provided non-negative responses to the question have existed for at least five years lend on more flexible terms and

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<sup>108</sup> See *supra* note 57.

lend primarily to finance substantive businesses. Notably, two institutions that expressed interest in becoming legitimate banks operate as private money houses, or underground banks.

Interviews with three of the lenders that are interested in becoming commercial banks reveal that they are not particularly concerned with entry requirements or deposit-absorbing capacity (than smaller private lenders) as they have accumulated good amounts of capital from past operations and also have a relatively stable local investor/depositor base and thus have more realistic understanding of local deposit market and the extent of competition they will likely face once they are legalized. Nor are these institutions particularly concerned with the costs and burden associated with complying with existing prudential regulation on official banks. They are, however, more concerned with the changing regulatory environment and with the lack of consistent, specific laws and regulation to protect their legitimate business interests once they become licensed banks. The two private money houses, in particular, are concerned with political risks associated with their past illegal existence. "It is unclear if the regulator will ignore once and for all our history as an underground bank if we become legalized," one of them said.<sup>109</sup>

#### **B. Technical barriers to become legitimate commercial banks are not high**

Over the past twenty years the state has on a number of occasions defined technical requirements for entry into the banking industry. Although these guidelines did not lead to many actual entries by private players, their existence can be a useful basis to understand some private lending institutions' readiness to overcome the most basic thresholds to become legitimate banks.

There are two general types of technical requirements: one on general financial strength and the other on prudential risk management. The first type

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<sup>109</sup> Record no. 2.

normally includes the requirements of a minimum registered capital, or the “seed money” for the resulting bank should an application go through, and of continuous profitability over a specified number of years. A principal component of the second type is typically a requirement that the applicant holds a risk capital cushion no lower than a minimum percentage of its total risk-weighted assets.

The most generally applicable technical entry requirements (to the banking market) were provided by the Commercial Banking Law in 1995, which requires a minimum registered capital of 1 billion RMB for national banks, 100 million for city commercial banks and 50 million for rural commercial banks.<sup>100</sup> The Commercial Banking Law further requires that a commercial bank maintain a minimum capital ratio of 8%, a maximum loans-to-deposit ratio of 75%, a minimum current ratio of 25%, and a maximum loan concentration ratio (on single borrower) of 10%.<sup>101</sup>

Later as the state experiments with financial reforms, it redefined some of these general technical requirements to make it easier for grass-root players to enter the market. In 2007, to encourage the establishment of village and town banks, the PBC required an applicant to have a minimum required registered capital of only three million for operation at township level, or as low as one million for operation at village level.<sup>102</sup> Village and town bank applicants must also demonstrate that it has operated profitably during at least the two most recent consecutive fiscal years.<sup>103</sup> The prudential capital

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<sup>100</sup> Shangye Yinhang Fa (中华人民共和国商业银行法) [*Commercial Banking Law of the People's Republic of China*], (promulgated by the Standing Comm. Nat'l People's Cong., May 10, 1995, revised on Dec. 27, 2003, Aug. 29, 2015), art. 13.

<sup>101</sup> *Id.*, art. 39.

<sup>102</sup> Chunzhen Yinhang Guanli Zanxing Guiding (村镇银行管理暂行规定) [*Provisional Guidance on the Governance of Village and Town Banks*] (implemented by the China Banking Regulatory Commission, Jan. 22, 2007), art. 8, par. 3, available at [http://www.cbrc.gov.cn/chinese/home/docDOC\\_ReadView/20070129B3A3723DBDD5B764FF791DE6A05E4D00.html/](http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/20070129B3A3723DBDD5B764FF791DE6A05E4D00.html/) (last visited Jan. 24, 2015).

<sup>103</sup> *Id.*, art. 3, para. 2.

adequacy requirement on village and town banks stayed at the same 8% level as the general requirement under the Commercial Banking Law.<sup>14</sup> The 2015 Opinions that authorizes pilot operation of private commercial banks largely follow the Commercial Banking Law's entry standard for new banks, and introduced few new items besides the requirements of three years of continuous profitable operation, a minimum net asset ratio of 30% over total asset, and a maximum 50% equity investment ratio over net asset.<sup>15</sup>

Because many existing grass-root private lending institutions operate at township or village levels, the entry requirements for rural commercial banks and town/village banks may be more meaningful reference for localized private lenders. Depending on the exact size of the bank a grass-root lender wants to establish and the conditions of the target market, reasonable registered capital thresholds for entry lie between the requirements for village/town banks and those for rural commercial banks under the Commercial Banking Law. Most of the interviewees have total assets at or above the 10-15 million range and can easily meet the registered capital requirements for village and town banks. The larger private lenders interviewed, with total assets typically in the 50-100 million range, will also unlikely be overwhelmed by the registered capital requirements for rural commercial banks. Nor do most interviewees consider the prudential risk management requirements formidable barriers should then become legitimate banks. The interviewees also do not consider it an excessive burden to comply with existing prudential regulatory requirements such as putting aside 8% of risk adjusted assets as risk capital (although they expect some impact on profitability as a result of regulatory compliance).

### **C. Three possible paths for grass-root private lending institutions to become legitimate commercial banks**

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<sup>14</sup> *Supra* note 110, art. 21, para. 1.

<sup>15</sup> *Supra* note 65, art. 3, para. 2.

While technical threshold may not be insurmountable obstacles for private players interested in entering the banking industry, policy or political factors can pose more serious hurdles. Whether a particular route towards becoming legitimate private banks exist, or can potentially become available, may ultimately turn on whether there is either existing policy endorsement for that route or a plausible chance of future policy endorsement for it. And the practical feasibility of potential routes can differ quite substantially depending on the strength of top-down policy support and the maturity of relevant legal framework. Based on earlier discussion of legal and policy development on private lending, and the status quo of grass-root private lending institutions, there may be three possible routes for private players, including existing private lending institutions, to become legitimate commercial banks: (1) small loans companies to become village and town banks, (2) private capital to enter the banking industry de novo, and (3) underground banks to go “above ground.”

The current status of state policy on this subject manifests a structural paradox: routes already made available fail to accommodate for the most suitable candidates whereas potential routes for the most suitable applicants have been made unpromising (if not completely foreclosed) by political complexities. I will explain this misalignment of possibility versus feasibility (or suitability) as each of the three potential routes is explored.

(1) Small loans companies to become community banks

The first possible route is for successful existing small loans companies to convert into regulated village and town banks. Two manifest advantages of this route are support from express state policy, and low technical entry barriers.

As discussed in Part III, small loan companies are themselves the product of recent financial reforms. In 2008 the PBC allowed for pilot

operation of small loans companies.<sup>116</sup> Private capital responded enthusiastically to the opportunity. By the end of 2010 a total of 2614 small loans companies had been established.<sup>117</sup> In 2009 the CBRC issued tentative provisions permitting and guiding the conversion of eligible small loan companies into community banks.<sup>118</sup> The 2009 provisions expressly created a route for eligible small loans companies to develop into legitimate community banks that may legally absorb public deposits and conduct banking activities.<sup>119</sup> The technical entry thresholds for entry, as discussed in the previous section, generally do not pose too great a hurdle for small loans companies that have operated profitably for a few years. Most of the small loans companies interviewed for this project indicated that they were aware of such requirements and were confident that their financial performance should allow them to meet these technical requirements should they apply to become community banks.<sup>120</sup>

Despite express policy support and relatively low technical entry requirements, the 2009 provisions did not receive even close to as much response from existing small loans companies as the 2008 Guiding Opinions allowing for pilot operation of small loans companies. Except for media coverage of a few sporadic, fruitless applications,<sup>121</sup> I did not find any reliable

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<sup>116</sup> See *supra* note 51.

<sup>117</sup> 2010 Statistical Report on Small Loans Companies by the People's Bank of China (2010 年小额贷款公司数据统计报告) (estimating a total of 2614 small loans companies with a total outstanding loan balance of 197.5 billion RMB), available at [http://www.gov.cn/gzdt/2011-03/22/content\\_1829438.htm/](http://www.gov.cn/gzdt/2011-03/22/content_1829438.htm/) (last visited Jan. 25, 2016).

<sup>118</sup> *Supra* note 67.

<sup>119</sup> *Supra* note 112, art. 38 ("Subject to approval by proper branch of the CBRC, village and county banks may engage in absorbing public deposits. . .").

<sup>120</sup> Record no. 20, 23, 31, 32, 38.

<sup>121</sup> Zhao Zhenyan & Li Xiaoping, *Prospects Still Unclear for Small Loans Companies to Become Village and Town Banks*, SINA FINANCE (Feb. 1, 2013, 01:40) (two Wenzhou-based small loans companies turned in applications to become village and town banks), available at <http://finance.sina.com.cn/money/bank/yhpl/20130201/014014468932.shtml/> (last visited Jan. 26, 2016).



data, official or unofficial, on the number of applications filed under the 2009 Provisions or the status of filed applications. Behind the lackluster turnout of the 2009 Provisions are at least two caveats that tend to weaken the practicality for small loans companies to become community banks.

The first caveat is administrative requirements under the 2009 Provisions of participation by official financial institution in the application process and ownership in the resulting bank thereafter. Specifically, the 2009 Provisions require that a small loans company's application to become community bank must be initiated by "eligible banking institutions" in accordance with the 2007 Tentative Provisions on the Management of Community Banks,<sup>122</sup> which require that "the largest or sole shareholder of a proposed community bank must be a banking financial institution that holds no less than 20% of the proposed community banks' total shares,"<sup>123</sup> and that "no single (other) shareholder may hold more than 10% of the bank's total shares."<sup>124</sup> Reading the 2007 and 2009 provisions in conjunction it can be reasonably inferred that small loans companies interested in becoming community banks may not initiate the application process themselves but must resort to an existing official commercial bank to lead the application, and this lead institution will become the dominant shareholder of the resulting bank should the application goes through.

Such administrative requirements add much complexity and unpredictability to small loans companies' application to become community banks. Although requiring participation by existing commercial banks may to

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<sup>122</sup> *Supra* note 67, art. 4, 8.

<sup>123</sup> In 2012 the requirement that the initiating financial institutions hold at least 20% of the resulting bank's shares was reduced to 15%. See Guanyu Guli He Yindao Minion Ziben Jinru Yinhangye De Shishi Jijian (关于鼓励和引导民间资本进入银行业的实施意见) [Implementation Opinions on Encouraging and Guiding Entry of Private Capital to the Banking Industry] (issued by the China Banking Regulatory Commission, May 25, 2012), available at [http://www.cbrc.gov.cn/chinese/home/docDOC\\_ReadView/35AF2AE678A0439BA5E296C3137A5652.html/](http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/35AF2AE678A0439BA5E296C3137A5652.html/) (last visited Jan. 26, 2016).

<sup>124</sup> *Supra* note 112, art. 25.

some extent help bolster the credibility of the applying small loans company and protect the interest of depositors in the absence of a deposit insurance system, this requirement likely makes the prospect of becoming licensed banks much less practically feasible or appealing for interested small loans companies. Find a willing existing bank to initiate an application can be difficult when legitimate commercial banks are predominantly state-backed and likely lack incentive to assist grass-root players to enter the banking market. Even when willing existing banks can be found, the need to coordinate the application can significantly slow down the conversion process. And most importantly, the mandate to make the leading bank the largest shareholder of the resulting community bank may discourage interested small loans companies from initiating the application process at all as their control over the resulting bank will be severely restrained.

And a second reason that so few small loans companies actually turned into village and town banks is a lack of economic incentive. None of the six small loans companies interviewed ever attempted an application under the 2009 Provisions. When asked why such attempts were not made, one common concern expressed by the respondents is uncertainties around their capabilities of absorbing sufficient public deposits as small community banks. In theory, becoming banks allows a former small loan company to legally raise funds from the public, which a private lending institution is not allowed to do wearing the hat of a small loans company, and this creates the potential for business expansion and greater profitability. But in practice, small village and town banks frequently experience difficulties in absorbing sufficient public deposits to back often robust local demands for their loans.<sup>125</sup>

Most of the interviewed small loans companies believed that becoming village and town banks will not make them more profitable, at least

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<sup>125</sup> Village and Town Banks' Crisis: Easy to Lend Hard to Borrow (放贷容易吸储难, 村镇银行闹钱荒), available at [http://finance.sina.com.cn/money/bank/bank\\_hydt/20091125/04117011724.shtml/](http://finance.sina.com.cn/money/bank/bank_hydt/20091125/04117011724.shtml/) (last visited January 30, 2016).

in the foreseeable future. It is not uncommon for successful small loans companies to achieve annual net margins in the 30 - 40% range, whereas many existing village and town banks are struggling in the red.<sup>126</sup> And at the same time, as officially recognized financial institutions, village and town banks are required to comply with vernal banking regulation, which can further limit their latitude in pursuing profitable endeavors.

Therefore, this first route is a door wide open but has few enterers. The theoretical soundness of the proposal of letting small loans companies become community banks to better serve the basic financing needs of their own communities is to a large extent defeated by the impracticability introduced by its own terms. From another standpoint, as a path to create more grass-root private banks this route is arguably "crippled" from the start. Requiring the participation of existing commercial bank more or less compromises the "privateness" of the converted community banks. The required participation of existing financial institutions, which are predominantly state-owned or state-backed, in the application process, and in cases of successful applications their dominant shareholding of the resulting community banks can place the resulting banks under greater state control than the small loans companies from which the banks are converted. This caveat implies that the conversions of small loan companies into community banks under the 2009 provisions do not necessarily lead to a greater number of genuine private banks to serve the financing needs of grass-root private businesses. But still, this route has normative significance as a cornerstone in financial reforms achieved thus far, and as a step towards greater liberalization of the banking industry. Also, as financial reforms deepen, it is not unlikely that adjustments will be made to the 2009 Provisions to endow the route with more practicability.

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<sup>126</sup> Village and Town Banks' Dilemma: Behind Small Loans Companies in Profitability and Some in Red (村镇银行的烦恼:盈利不敌小贷公司部分亏损), available at [http://finance.sina.com.cn/money/bank/bank\\_hydt/20140528/015519244349.shtml/](http://finance.sina.com.cn/money/bank/bank_hydt/20140528/015519244349.shtml/) (last visited January 28, 2016).

## (2) Private capital to enter the banking industry de novo

A second route is for private capital to enter the banking market de novo. Like the first route, this option is supported by the presence of express policy endorsement. An advantage of this route over the first one is its much wider applicability and lower administrative barriers. Unlike the 2009 Provisions, which specially target small loans companies, the 2015 Opinions apply to any private party, regardless whether it is already a financial services provider. The 2015 Opinions also do not require a prospective private player to find an existing financial institution to initiate the application or to hold dominant ownership in the resulting bank. And as discussed in the previous section entry requirements under the 2015 Opinions are mostly technical in nature and will unlikely pose formidable barrier for serious private applicants.

This route is not without caveats, some of which it shares with the first route. Like the 2009 Provisions, the 2015 Opinions does not in itself provide greater incentives to lawful existing private lending institutions such as small loans companies and pawn shops to become commercial banks. The same concern with difficulties in absorbing sufficient public deposits and with reduced profitability (as result of becoming legitimate banks) expressed for the first route continue to hold back many existing lawful grass-root lending institutions from initiating an application. Whereas for depository institutions that would be less concerned with deposit-absorbing ability and have stronger economic incentives to apply, the 2015 Opinions do not in itself provide an outlet to relieve them from their embarrassing legal status. Eligible private actors that see the most promise in the 2015 Opinions tend to be large private enterprises that have little prior experience in financial services but whose existing business has much to gain from having a banking arm.

This tendency can be shown from approved applications under the 2015 Opinions. Table 2 shows the five pilot private banks that were approved

by the PBC and the CRBC and had started operating in 2015. All five banks were established by large private enterprises that have put together capital in the billions to initiate each of the applications. Among the five enterprises only one has some prior experience with financial services (Ant Financial, an Alibaba affiliate that specializes in small and micro financial services).

Table 2. Five approved private bank pilot points

Bank Name	Location	Approval Date	Capital (billion RMB)	Market Positioning	Business Model	Dominant Shareholder/Industry
WeBank	Shenzhen	12/12/2014	3	Individuals, small- & mid-sized enterprises	large deposits w/ small loans, deposit floor + loan ceiling	Tencent/Internet
Huaibei Bank	Shanghai	1/27/2015	3	Individuals, high-tech industries, free trade initiatives	service only available at specified areas; defined service scope	Juneyao/Airline
Mingshang Bank	Wenzhou	3/20/2015	2	MSMs, community residents	service only available at specified areas; defined service scope	Zhengtai/Electrical Equipment
Jincheng	Tianjing	3/27/2015	3	Substantive business	institutional lending, no	Huabei/Electric Cable

Bank Name	Location	Approval Date	Capital (billion RMB)	Market Positioning	Business Model	Dominant Shareholder/Industry
Bank				investment, small- & mid-sized enterprises	retail banking & service	
Wangsha ng Bank	Hangzhou	5/27/2015	4	Small- & mid-sized internet merchants, start-ups, urban & rural consumers	small deposits w/ small loans, deposit ceiling + net wealth floor	Ant Financial (Alibaba affiliate)/small and micro financial services

Large private enterprises' enthusiastic response to the 2015 Opinions may entail rather complex motivations. Besides the appeal of banking business's relatively high profitability, there is also likely some expectation on the part of the applicants that having a banking arm would provide cheaper and more convenient financing services for their existing business, or even create the potential of accessing the broader secondary market by listing the banking business on equity exchanges. These complex motivations, if proven true, should cause at least two concerns for the state. One is the risk that significant proportions of resources of resulting banks will be allocated to nurture related party transactions. The other concern is that the embryonic private banking market will quickly be dominated by large private

conglomerates that lack general incentives to serve the basic financing needs of MSMs, a phenomenon that occurred in Taiwan's experience in privatizing its banking market in the 1990s.<sup>127</sup> These risks, if materialized, will cause the actual effect of the reform to misalign with its initial purpose of providing the grass-root private sector easier access to affordable credit.

Some structural weaknesses can also cause the 2015 Opinions to deviate further from its original goals. First, it is unclear whether private banks since have a stable, permanent legal status. Approved private banks are pilot points that operate under a limited license (as opposed to full licenses granted to state-backed banks), with their performance under close state monitoring and continued survival subject to state discretion. Therefore the pilot banks are not yet on equal footing with their state-backed counterparts. Second, without downstream support such as further interest rate liberalization and flexibility of regulatory compliance, pilot banks may have difficulties finding a competitive position for public deposits and withstanding compliance costs. Absent such structural support new private banks can be placed at a vulnerable position where they are subject to the official bank regulation to the same extent as state-backed banks but do not have the benefit of state protection in adverse scenarios (as do state-backed banks).

Therefore, while the 2015 Opinions marked a high point in the state's policy moves in recent years, the route to the official banking sector it has made available for private players suffers from an anti-selection dilemma and some structural infirmity. And it is unclear whether this route will provide an immediate solution to the shortage of grass-root credit providers in the legal banking sector.

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<sup>127</sup> See WEN YUECHUN (闻岳春), *Taiwan Kaifang Minying Yinhang Wenti Yanjiu (台湾开放民营银行问题研究)* [ISSUES IN TAIWAN'S EXPERIENCE IN ALLOWING PRIVATE BANKS INTO THE BANKING INDUSTRY], *Yatai Jingji (亚太经济)* [Asia-Pacific Economics], no. 4, 1993.



(3) Underground depository lending institutions to become legitimate banks

A third possibility is for underground banks to go "above ground," and be transformed into legitimate banks. This route can not only provide a highly efficient and effective route to resolve the grass-root private sector's difficulties in obtaining easy and affordable credit, but can also create a number of accompanying social benefits.

In terms of practical plausibility, this option permits private players with the desired capability, experience and incentives to enter the banking industry at a low social cost. Some underground banks are more suitable candidates to become legitimate banks than other private lender types such as small loans companies and pawn shops. Despite their problematic legal status, some successful underground banks have operating experience comparable that of official banks, and are potentially more competitive in terms of their abilities to serve the financing needs of smaller, localized markets because of their more market-oriented practice. Underground banks also tend to have the stronger incentives to become legitimate banks than other types of private lenders, not only because their existing practice allows their transition into official banks at low business risks, but also because obtaining the legal status as a legitimate bank will significantly reduce their legal risks thus further enhancing their business robustness.

This route will also bring about a few important social benefits. First, allowing underground banks to become legitimate banks will also help bifurcate successful, constructive private lending institutions from struggling or destructive ones. As discussed earlier, not all grass-root lending institutions exist to serve socially beneficial ends. Private lenders engage in socially destructive acts when they use their capital to facilitate smuggling, money-laundering, or to fund Ponzi schemes. Only private lending institutions that have operated profitably and serve mainly productive ends will likely find becoming licensed banks an appealing and feasible pursuit. Second, the legalization of some underground banks with sound business practice

introduces healthy competition to official banks, especially smaller state-backed banks that operate at more local levels. As discussed in Part IV, it is not uncommon for underground banks to provide more efficient, customer-oriented services than official banks, making them a realistic alternative to the latter in some areas. The legitimization of these underground lenders can place pressure on official banks to improve service quality and thus enhance at least the local benchmark for banking practice. Third, even in the absence of complete interest rate liberalization, allowing underground banks to become legitimate banks will likely somewhat help drive down private lending interest rates, which have spiked since 2011. Almost every depository lending institution interviewed acknowledged that legal risks associated with the questionable legality of their practice was a factor persistently priced into their lending rates. Obtaining a legal status means such risks can be substantially discounted, if not eliminated, from loan pricing. And this discount can itself introduce competitive pressure on other private lenders to lower lending rates.

The obstacle of pursuing this route however, lies not in practice, but in theory. At present there is no express state policy that provides a solid basis for this option. State policy has historically been more cautious with, and hostile towards grass-root depository lending institutions than non-depository ones. Although as financial reforms further, the state has opened the door to the banking market a lot wider for private capital, it remains silent on the treatment of underground depository institutions. Possible reasons for this tendency have been discussed in Part III. Without the support of express state policy, this route remains in the air.

Some substantive legal barriers also exist for the legalization of underground depository lending institutions, largely because of the introduction of the “crimes of disturbing the order of the financial system” in the 1997 revisions to the Criminal Law. Historically, there have been cases where private depository lending institutions successfully obtained licenses from local governments to operate as commercial and industrial enterprises,

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banks face the dilemma of not coming to the table with “clean hands.” This third route, although mainly aspirational for now, merits continued attention, not only because underground banks are particularly suitable candidates to become legitimate private banks, but also because the progress of their legitimization can serve as an important yardstick to measure the extent of liberalization of the broader banking industry. In other words, the development of prospects on this third route will likely be the ultimate test on the boundaries of the state’s willingness to de-monopolize the official financial system, and its success in resolving the MacMillan Gap problem for the grass-root private sector. For now, by providing routes to other less suitable private players to enter the official banking sector but excluding more promising underground depository institutions the state has created for itself an anti-selection dilemma. But it is not without a chance that the state may correct its own course for the pursuit of more substantive good, considering how far it has gone from prohibiting private players from establishing banks in 1986 to expressly encouraging them to enter the banking market in 2015.

## VI. CONCLUSION

Grass-root private lending institutions in China face a complex legal environment. State policy on private lending has undergone dramatic and rapid changes over the past thirty years. Generally, post-2004 state policy has become more lenient towards private lending, and the state is becoming increasingly willing to allow private players, including some private lending institutions such as small loans companies, into the banking industry.

Interviews and surveys with private lending institutions lead to a few important observations. First, private lenders provide critical financing channels to MSMs that are not able to obtain credit from official banks and meaningful alternatives to bank loans in some cases. Second, some private lending institutions that have successfully existed for relatively long periods tend to lend on more affordable terms and often have rather robust risk

management practice comparable to official commercial banks. And third, the risk characteristics of many grass-root private lending institutions are not fundamentally different from the traditional commercial lending business of official banks, although the former runs more localized business and tend to pose much less macro-systemic risks to the overall financial system although than micro-systemic impact on local financial systems.

Three routes likely exist for competitive grass-root private lending institutions to become legitimate banks: (1) small loans companies to become village and town banks, (2) private capital to enter the banking industry de novo, and (3) underground banks to go "above ground." The first two routes have the advantage of express policy support, but may fall short of the state's goal, at least in the short term, of alleviating the grass-root private sector, especially MSMs' difficulties in obtaining affordable credit. Due to some administrative barriers and a general lack of economic incentive among eligible applicants, the first route has not generated much observable effect. The second route as it currently exists tends to provide greater incentives for large, private enterprises to establish banking arms that will likely prioritize the founding enterprises' own financing needs over those of more grass-root MSMs still lower in the food chain for credit. The third route, while likely a more effective solution to MSMs' difficulties in obtaining affordable credit, has been made less promising by legal barriers and political complexities.

In short, the state, although has opened the door for private players to the banking sector wider than any time before, may have at the same time created an anti-selection dilemma for itself—that available routes to the banking industry ushers in less suitable candidates whereas some candidates most capable of achieving the reform's objectives are still shut outside the door by political barriers. This misalignment of possibility versus suitability, if a manifestation of the state's ultimate reluctance to more systematic financial reforms, is an unfortunate paradox. On the other hand, if the phenomenon is only the reflection of a cautious first step towards more decisive, ground-

braking reforms, then the private sector and their grass-root lenders still have much to expect in the time to come.

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