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Financial Regulation international

Worldwide regulatory developments and their implications for the financial services industry

'Runaway bosses' in China: Private lending, credit crunches and the regulatory response

In recent years, the term '*pao lu lao ban*', or 'runaway bosses' in English, has drawn intense attention from Chinese and Western media.[1] In China, it has been difficult for privately owned businesses to obtain loans from the state-run banking sector, as Chinese banks tend to make loans to other state-owned enterprises (SOEs) and refuse to lend to what they perceive as risky start-ups. Even though small and medium-sized enterprises (SMEs) generate 60 per cent of the region's economic output and 80 per cent of all jobs, they have received only a fifth of bank loans.[2] Therefore, a large number of Chinese entrepreneurs rely on the shadow banking system to acquire funding for their business ventures, and many of them have borrowed heavily from professional money lenders, or underground money houses, which often charge excessive interest of more than 20 per cent annually. With the Chinese economy gradually slowing down after the global financial crisis, many borrowers have found it nearly impossible to repay private loans, as their declining businesses have been unable to generate enough profit to compensate for the high cost of private lending.[3] As a result, China has recently witnessed frequent waves of private lending defaults, which have led to thousands of insolvent enterprises, and their management, who are heavily indebted, often choose to run away to evade debts. However, why those entrepreneurs regard running away, instead of staying and filing for insolvency, as an optimal choice remains unknown.

The objective of this article is to explore the prevailing phenomenon of China's runaway bosses. The first section examines China's fugitive bosses, with particular reference to one case regarding a high-profile business tycoon, Ding Hui. The second section will detail why Chinese private enterprises depend so much on private lending as a vital financing source, and how private lending has resulted in 'disappearing bosses' in the economic downturn. The third section will introduce a pilot for financial reform in east China's Wenzhou city, and a newly invented registration-based system for regulating private lending transactions. The final section will provide some closing thoughts.

Nuoqi's missing chairman: A case study

Ding Hui has been depicted as a successful entrepreneur in China. He used to be the chairman, chief executive officer and executive director of Fujian Nuoqi Co Ltd, a fashion retailor listed on the main board of the Hong Kong stock exchange (stock code: 1353.HK).[4] Founded in 2004, Nuoqi is based in south-east China's Quanzhou city and it mainly produces and sells casual apparel for young and middle-aged men. Similar to other international clothing giants such as H&M, Zara and Gap, Nuoqi has adopted the business model known as 'market-driven fast fashion'. The company was on a fast-track expansion course for nearly a decade following its establishment. As of October 2013, Nuoqi had more than 400 retail points across China consisting of 225 self-owned, and 213 franchised, stores.[5] Moreover, it had developed a

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prospering customer royalty programme that has attracted nearly 1.2 million members who made a significant contribution to the company's sales and provided reliable feedback to improve clothing design.[6] As a result, its outstanding customer relationship management was selected as a case study in the Executive Master of Business Administration (EMBA) programme at the Northwestern University Kellogg School of Management.[7] In January 2014, Ding Hui managed to float Nuoqi on the Hong Kong Stock Exchange.

Missing chairman and share price plummet

In July 2014, a rumour began to circulate in the Chinese security market that Ding Hui, had gone missing.[8] It is said that Ding Hui and his wife, Chen Ruiying, probably owed multimillion-dollar personal debts and decided to abscond. As a result, the stock market reacted fiercely and Nuoqi's share price fell by more than 50 per cent between 21 July and 23 July. Despite the speculation among investors, the company appeared to know nothing, as Nuoqi's board made an announcement on 21 July declaring that it was unaware of any reason for the share price fluctuation or any other information which needed to be disclosed to investors according to Hong Kong's Securities and Futures Ordinance.[9] Later, on 23 July, the trading of Nuoqi's shares was suspended at the request of the company after the catastrophic three-day slump.[10] However, on 25 July Nuoqi confirmed that it had not been able to contact Ding Hui for a few days, and the company had reported this to the Hong Kong police force. Ding Hui was officially declared a 'missing person'.[11] Although the company insisted that it would try all available means to connect with Ding Hui, it continued to deny allegations of his absconding by saying that the rumour had not yet been verified.[12] As a temporary arrangement for the management of Nuoqi, Ding Canyang, an executive director who is also the elder brother of Ding Hui, took charge of the company.[13]

Unauthorised financial activities

By the end of July 2014, the truth gradually emerged following an internal investigation by Nuoqi. The investigation revealed that, in early 2014, two sums of money – 50 million yuan (US$8.06 million) and HK$ 19.55 million (US$2.52 million) – were transferred from the bank account of a subsidiary of the company, Nuoqi Fashion International Limited, to that of an irrelevant company incorporated in the British Virgin Islands., The transaction was instructed by Ding Hui. Ding Hui[14] Moreover, in January and March 2014, another two sums of money worth 160 million yuan (US$25.79 million) and 2.5 million yuan (US$403,000) respectively were transferred from Nuoqi's bank account to a related account with the Xiamen International Bank, with Ding Hui's personal permission.[15] So far, it has become evident that Ding Hui absconded with around 228million yuan (US$36.75million) which is supposed to belong to Nuoqi. He not only breached his duty as director, but also stole company assets. Therefore, all of his positions in the company were removed by the board of directors.[16]

Worse still, the company later found that Nuoqi and its subsidiaries had apparently guaranteed and pledged securities for several loans, which collectively amounted to 454.5 million yuan (US$73.26 million) and had been borrowed by certain individuals outside the Nuoqi group.[17] Ding Hui, without notifying the company, had used Nuoqi's cash deposits as collateral against bank loans for his family, so Nuoqi had become liable for those debts when Ding Hui fled abroad.

In September 2014, Nuoqi's chief financial officer and company secretary, Au Yeung Ho Yin, tendered his resignation, despite commenting that: "there is no matter relating to his resignation that needs to be brought to the attention of shareholders".[18] However, this was the final blow to the company's ongoing financial crisis, thus, in the same month Nuoqi appointed KPMG to assess and advise on its financial situation, in order to formulate potential restructuring plans.[19] The story ended when, in March 2015, some of Nuoqi's creditors applied to the court in Quanzhou city, where Nuoqi is headquartered, for a company reorganisation. In the following month the application was officially accepted and an administrator was appointed.[20]

Table 1: Nuoqi timeline

Time	Event
2004	Ding Hui and his elder brother, Ding Canyang, co-found the Quanzhou City Nuoqi Company.
2008	Quanzhou City Nuoqi is converted into a joint-stock limited liability company under the name of Fujian Nuoqi Co Ltd. It adopts a fast-fashion model with a membership programme as its market approach.
2013	Nuoqi's retail points reach 438.
9 January 2014	Nuoqi floats as an IPO on the Hong Kong stock exchange.
21–23 July 2014	The share price of Nuoqi falls by 32.56%, 6.21% and 23.47% over three days. Trade in stock is suspended.
25 July 2014	Ding Hui is officially declared 'a missing person'.
31 July 2014	Nuoqi reports four unauthorised transfers of funds.
19 August 2014	Nuoqi reports that it has provided unauthorised guarantees and collateral for non-group members.

8 September 2014	Nuoqi's CFO, Au Yeung Ho Yin, tenders his resignation.
October 2014	Nuoqi hires KPMG to consider potential restructuring plans.
April 2015	The Quanzhou Court accepts the application for the reorganisation of Nuoqi.

Data Source: Fujian Nuoqi Co Ltd and the Hong Kong Stock Exchange.[21]

Stakeholders affected

The story of Ding Hui is regarded as a well-prepared escape scheme rather than a sudden disappearance. Nuoqi only floated its shares on the Hong Kong Stock Exchange in January 2014, but in the following months, Ding Hui not only transferred the money out of the company, but also borrowed various bank loans by making use of Nuoqi's cash deposits as collaterals. Shortly thereafter, he suddenly absconded. Aside from the effects on the company itself, this incident had a negative impact on a number of stakeholders.

First, shareholders and creditors are susceptible to enormous losses and Nuoqi's share price decreased by more than half in just three days, with billions of Hong Kong dollars wiped out. Trading of Nuoqi has been suspended ever since, which means shareholders have had no opportunity to turn their shares into cash. The company also recently refused to pay dividends as it is on the edge of insolvency.[21] Similarly, a large number of Nuoqi's creditors, which are either banks or private lenders, have been exposed to great losses, since it is currently nearly impossible for Nuoqi to repay debts.

Moreover, according to *Security Daily*, the entire textile and apparel sector, which is one of the pillar industries in the Fujian Province (where Nuoqi's headquarters and main factories are located) has been greatly affected by the incident, as banking institutions have tightened credit provisions to the entire industry within Fujian Province.[23] Money lenders also act with more caution when they make loans to Fujian's clothes makers, paying closer attention to the cash flow situation of potential borrowers, and collateral is heavily discounted to compensate for potential risks.[24]

Nuoqi's sponsor in the IPO, CCB International (the investment banking unit of China Construction Bank, China's second-largest lender) has also been affected. In a recent IPO of China International Capital Corp, CCB International was dropped from the list of underwriters due to the incident.[25]

Truth revealed

Despite several stakeholders suffering as a result of Ding Hui's behaviour, market watchers are still curious about why he would deliberately destroy his business empire. It makes no sense that Ding Hui simply wanted to make more money, prejudicing company benefits and relevant stakeholders, as he was already rich and successful, so what is the real story?

In fact, before Nuoqi's initial public offerings on the Hong Kong stock exchange, Ding Hui had filed to list the company on China's mainland stock exchanges, in 2011 and 2012 respectively.[26] The first attempt was rejected by the China Security Regulatory Commission (CSRC), the security market watchdog, over concerns about operational risk, low expenditure on research and development, and limited geographical presence. The second time, CSRC had imposed a freeze on all IPOs as the market was weak.

Therefore, Ding Hui was extremely eager to float Nuoqi's shares, and for the third time he planned to list Nuoqi on the Hong Kong stock exchange, which has a lower regulatory requirement than its mainland counterparts. In the eyes of Chinese entrepreneurs, the IPO has been seen as a symbol of ultimate success for a long time, as it could bring business owners many practical benefits. For example, a public company will have more access to China's state-dominated banking system.

In order to make Nuoqi public, Ding Hui had to keep his business expanding at a considerable rate to meet regulatory requirements and, undoubtedly, the rapid expansion needed huge funding, particularly when the clothing industry had been declining due to the slowing economy and weak consumer sentiments.[27] As a result, since bank loans were not adequate to fund the rapid expansion of Nuoqi's business, Ding Hui borrowed heavily from private money lenders and investors – around 1.5 billion yuan (US$242 million), in the pre-IPO period.[28] After Ding Hui absconded, the municipal government of Quanzhou started to call his creditors to contact the authority and report their private lending. The combined value of private loans that has been reported so far amounts to approximately 400 million yuan (US$64.56 million).[29]

Runaway bosses: A popular phenomenon

Ding Hui is not alone; an increasing number of Chinese bosses have run away to avoid debt collection. This is perceived as a widespread social phenomenon in China, where private lending crises have frequently occurred in recent years. In 2011, Wenzhou was the first city in China to experience a severe credit crunch caused by underground private lending, and bosses started to flee the city, after 20 per cent of Wenzhou's 360,000 SMEs ceased operation owing to cash shortages.[30] Some successful capitalists, as well as small business owners, have left the city – such as Hu Fulin, the owner of Zhejiang Centre Group, a leading spectacles manufacturer.[31] From 2011 to 2014, 'runaway bosses' cases have been constantly reported by the Chinese media, and it is normal for people to find that entrepreneurs around them have 'evaporated' overnight. Particularly, 2014 was highlighted by the disappearance of several high-profile entrepreneurs including, but not limited to, Ding Hui.

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For instance, according to *Global Times*, Liao Rongna, the chairman of Guangxi-based private conglomerate Zhengling Group, fled the country in April 2014.[32] Established in 1982, Zhengling employs around 10,000 employees and operates in several industries including automobile and machinery manufacturing, property development and financial services. It is said that Liao Rongna and his family took part in illegal fundraising activities with more than 2,000 lenders involved, and in total he borrowed approximately seven billion yuan in bank loans (US$1.13 billion) and three billion yuan in private loans (US$0.48 billion), which is the largest case of its kind in south China's Guangxi province.[33] Xinhua, China's official news agency, reported that a cross-border manhunt has been underway for Liao Rongna since August 2014.[34] At the request of the Chinese judicial authority, the International Criminal Police Organisation (Interpol) issued red corner notices, the highest level of arrest warrant, for Liao and his wife, under the charge of "illegal absorbing of public funds".

Moreover, in September 2014, the CFO of Ultrasonic AG, a Frankfurt-listed holding company of a large Chinese shoemaker, informed the company's supervisory board that he had been unable to contact the CEO, Wu Qingyong, and the COO, Wu Minghong (father and son); and that most of the company's cash reserves in mainland China and Hong Kong were gone.[35] Apparently, the disappearance of Ultrasonic's CEO and COO had something to do with private lending. Consequently, the share price of Ultrasonic AG rapidly plummeted by around 70 per cent.

It is evident that the common denominator among China's most fugitive bosses is private lending, an underground financing mechanism for Chinese businesses. Therefore, the next section of this article will examine why private enterprises in China are heavily reliant on private lending to obtain funds, and how it has led to credit crises and runaway bosses in recent years.

The prevalence of private lending

Private lending refers to a widely employed financing method by Chinese entrepreneurs who borrow money from relatives, friends, professional money lenders, or other 'shadow banks' to fund their business ventures. The term is interchangeable with 'informal finance' (also known as non-bank financing activities).[36] This underground financing mechanism is referred to as 'back-alley banking' by Kellee Tsai, in contrast to China's official banking system.[37] According to the Financial Stability Board's definition, shadow banking means that: "the credit intermediation involving entities and activities outside the regular banking system", so the private lending industry can be considered as an important component of China's shadow banking system.[38]

In recent years, the non-bank lending market in China has evolved into a fully commercialised sector and professional money lenders and informal financial intermediaries play a central role in the lending business. These intermediaries include guarantee companies, investment companies, pawn shops and underground money houses, which are either prohibited to engage in money lending by the authorities, or are not formally incorporated. However, the underground lenders are never amateurs and many of them hire a group of bankers, accountants and lawyers to operate the shadow banking business. Their business model is similar to formal banks in first taking deposits from the public, and then making loans to capital-starved entrepreneurs. The return they promise for investors is often attractive compared to the saving rate offered by state-owned banks, which struggle to beat the inflation rate. As a result, they charge heavily on the interest of their private loans in order to compensate for the high financing cost and make profits. It is reported that the annual interest rate of private loans normally ranges from 14 per cent to 70 per cent.[39]

The financing dilemma of Chinese private businesses is largely a result of its state-run banking sector. Although a few private banks, such as Minsheng, do lend to small firms, the state-owned banks that dominate China's banking arena prefer to lend to other, well-connected, state-owned enterprises.[40] One agricultural machine exporter told the *China Economic Weekly*: "It is very difficult for SMEs to get loans from banks, so they rely mostly on private lending for financing. SMEs are neither able to have enough fixed assets that can be used for mortgage, nor able to find qualified guarantors, so they often fail to meet strict standards set by banks".[41] As a result, private enterprises that are refused by mainstream lenders are forced to turn to shadow banks for financing. Currently, the majority of business ventures in China, from start-ups to private conglomerates, are heavily dependent on private lending for raising funds, and it is common for business tycoons (like Ding Hui) to borrow private loans.

The popularity of private lending should not be underestimated. According to the People's Bank of China, its central bank, 89 per cent of households and 59 per cent of enterprises in Wenzhou have taken part in private lending activities.[42] Since private lending operates outside the realm of China's formal lending industry, it is currently almost unregulated by the state. Therefore, no one knows the exact size of this underground market due to the lack of official data. However, some organisations have estimated its enormous scale. According to Credit Suisse the total outstanding loans in China's underground lending market stood at four trillion yuan (US$ 644.8 billion) in 2012.[43] Moreover, a recent study by China's Southwest University of Finance and Economics has estimated the total market volume of informal finance at five trillion yuan (US$ 806 billion).[44]

Money supply and demand

The fact that private lending has developed into a financial market worth trillions of yuan can be briefly explained by the demand and supply of funding. From the demand side,

the revival of private enterprise in China from the late 1970s has called for a great amount of capital to fund new business ventures. In 1978, China started a series of market-oriented reforms guided by the well-known policy, *gai ge kai fang* (reform and opening up), after its economy had stagnated for three decades under the Communist party's centrally planned economic system. As the state plan gave way to the market discipline, the Chinese population started to set up private businesses and pursue personal wealth, leading to a rapid expansion of China's economy. The country experienced unprecedented economic growth from 1978 to 2012, which is demonstrated by the average 9.8 per cent annual increase in gross domestic product (GDP).[45] In 2010, China surpassed Japan as the world's second-largest economy, after the US.

There is no denying that the real driving force behind the Chinese economy is the development of private enterprises that account for 60 per cent of the country's economic output and most job opportunities. However, the difficulty of obtaining loans from state-owned lenders has always been a nightmare for Chinese entrepreneurs. According to Professor Wang Yijiang, only 20 per cent of financial resources in China are used by SMEs.[46] It means most major lender credits are granted to other state-owned enterprises or few privately owned business giants. Therefore, as the funding demand of the growing private sector cannot be satisfied by the formal banking sector, Chinese entrepreneurs have to rely on shadow lenders to fill the financing gaps.

On the other hand, from the money-supply side, the accumulation of private wealth in China has contributed sufficient funds to the prosperity of the money lending industry. Compared to investors in developed economies, Chinese residents have a limited choice of investments owing to the underdeveloped capital market. China is regarded as a country with one of the highest saving rates, with a saving to income ratio of 40 per cent.[47] Nonetheless, the interest rate for bank deposits (the nominal rate minus the inflation rate) has remained negative for many years, which means Chinese savers are actually losing money on every yuan they put in banks.[48] As a result, a large number of households that have abundant savings are seeking a way to increase returns on their money and private lending has become a good investment option as it can generate considerably high returns.[49] What is more, due to China's slowing economy following the global financial crisis, an increasing number of entrepreneurs, especially those who are running export-oriented or manufacturing businesses, have diverted their money into the lending industry to increase profit. Some state-owned enterprises have also joined the lucrative money lending business, using their cash reserves to lend to other companies short of money.[50]

While cash-strapped businessmen have called for more funding, the amassment of private wealth and limited investment choices have resulted in large sums of money being made available for investment. Therefore, private lending has become a thriving industry in China, and currently many Chinese enterprises are either partly or fully funded by private loans. A businessman from Wenzhou talked about the prosperity of underground financing in his city, saying that there are around 100,000 people in Wenzhou, each of whom is able to raise one billion yuan (US$161.2 million) within 48 hours.[51] Given this liquidity, entrepreneurs can obtain capital without resorting to borrowing from state-owned banks. Private lending is no doubt beneficial for the development of China's private economy, but it also comes at a price.

Credit crisis and fugitive bosses

Due to the double-digit growth of the Chinese economy over the past three decades, the private lending business has been a win-win solution for both capital-starved entrepreneurs and greedy lenders. On one hand, most entrepreneurs have obtained adequate capital from private financing to fund their ventures and thus enjoyed substantial growth as the economy has soared. In the past, huge profit margins generated by thriving businesses could easily offset the high cost of private lending. On the other hand, investors have also earned a considerable return by financing the money lenders.

However, more recently, the year-on-year GDP growth rate in the first quarter of 2015 was only seven per cent – the lowest level since the crisis in 2009.[52] Owing to weakening demand for Chinese goods in the post-crisis era, a number of industries, particularly manufacturers and exporters, have found themselves in a difficult financial situation. The property market, which powers nearly a fifth of the economy, has reached the end of a decade long boom, with house prices falling six per cent in the past year, the steepest drop since records began.[53] Under these economic circumstances, defaults in the private lending market have become quite common, as borrowers find themselves unable to repay expensive private loans. The shortage of cash flows has led to the insolvency of thousands of private enterprises.

When the private lending bubble finally burst in 2011, many regions in China witnessed a widespread lending crisis, particularly Wenzhou city. In March 2011, the monthly rate of private lending in Wenzhou peaked at 15.38 per cent, with some loans having an annual rate of more than 180 per cent.[54] In August 2011, the lending crisis hit, and an increasing number of borrowers were unable to repay their interests to lenders. Therefore, thousands of businesses failed and lending defaults became prevalent. Between August 2011 and May 2012, the Wenzhou courts received around 22,000 cases regarding private loans, and the total amount involved in disputes was 21 billion yuan (US$3.39 billion).[55] According to Fujian High Court, in the first six months of 2014, the number of cases heard relating to private lending within the Fujian Province (a prosperous region with a well-developed private economy) had reached a record high of 37,000.[56]

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In order to evade their debt, a large number of entrepreneurs across China were reportedly deserting their companies and factories taking whatever they could and hiding elsewhere. Some of them have even fled abroad, leaving behind unpaid workers and creditors. In 2014, the phenomenon of runaway bosses reached its peak as more high-profile entrepreneurs disappeared, including chairmen and CEOs of public companies such as those discussed in the first section of this article.

The absence of regulation

The laws and regulations concerning private lending are neither coherent nor sufficient. The current rules regulating private loans are spread over various pieces of legislation including property law, contract law, security law, criminal law and judicial interpretations.[57] Generally speaking, private loans are contractual relationships between lenders and borrowers, so their transactions mostly remain outside state intervention, except for complying with a few provisions in private and public laws. In China's contract law code, there is an entire chapter regarding loan contracts that sets out basic requirements for the formation and content of lending agreements to be followed by all money lenders.[58] If borrowers are asked to provide securities and pledges for private loans, they are subject to the People's Republic of China Guaranty Law 1995. As for the interest rate, China's supreme courts have imposed a limitation on the interest rate of private loans, which should not exceed four times that of bank loans for the same period.[59]

However, there is no authority responsible for the enforcement of regulations. Who the regulatory body for private lending should be, and its powers and obligations, remains uncertain. While some local governments have authorised their financial affairs offices to deal with the lending crisis, China Banking Regulatory Commission (CBRC), the banking watchdog, has also tried to step in as it has administrative power over all lending businesses. As a result, no body is accountable for supervising this enormous market. This exacerbates issues when borrowers are unable to repay their debts, and money lenders in turn cannot fulfil their obligations to their own investors. The lack of a regulatory body makes local courts in China the *de facto* regulators, with judges at the front line tackling private lending disputes.

Furthermore, when the market crashes, such as when a large group of investors has suffered great losses due to a wave of defaults, the Chinese authorities tend to solve the problem by over-punishing some borrowers. There are several criminal offences relating to private lending, such as re-lending at higher interest rate, illegally absorbing public deposits and fraudulent fundraising.[60] The law has imposed severe sanctions on illegal lending activities; in particular, someone suspected of fraudulent fundraising can be sentenced to life imprisonment or the death penalty in some cases. However, the line between legal and illegal lending is blurred, providing great discretional powers to the Chinese courts, which can be affected by the government.

We will take the cases of Zeng Chengjie and Wu Ying as examples. Zeng Chengjie, a property developer from South China's Hunan province, was found guilty of illegally raising money in 2013. He was known as 'China's Bernie Madoff' in the state media, as he reportedly defrauded thousands of individual investors of billions of yuan.[61] From 2003 to 2008, in order to raise capital for developing new property projects, he privately borrowed 3.45 billion yuan (US$556 million) from thousands of investors in his city, promising annual returns from 20 to 120 per cent.[62] However, as his company encountered poor sales in 2008, he began to default on the sums owed to a large number of investors. This led to a social crisis as investors implored the local authorities to help them reclaim their money. After the first and second instance of criminal trials in the Hunan province, the Supreme Court found Zeng Chengjie guilty of 'fraudulent fundraising', and he was executed in 2013.

Wu Ying is a young multimillionaire from the Zhejiang Province. According to her indictment, between 2005 and 2007, she illegally raised 770 million yuan (US$124 million) from 11 people with the promise of unreasonably high interest rates.[63] The money she borrowed was used to repay old debts, pay for interest, buy luxurious cars and personal spending. She was sentenced to death under the fraudulent fundraising charge in her first and second instance trials, in 2009 and 2012. There was public debate about her case throughout its duration. Many legal professionals and members of the general public did not consider Wu Ying to be guilty, as they regarded what she had done to be no more than informal financing, which is simply private lending without bank involvement.[64] The Supreme Court in China upheld the guilty verdict but referred her for a retrial in her home province of Zhejiang, taking her off death row.[65]

Why private lending accounts for fugitive bosses

People have been wondering why an increasing number of Chinese entrepreneurs choose to run away rather than file for insolvency. Without a doubt, sudden disappearance is an indecent and illegal behaviour which leaves behind unpaid workers, angry creditors and deserted companies. Some legal, economic and cultural contributing factors are considered in the remainder of this article.

First, due to the uncertain legal status of private loans, they do not appear in the balance sheet of a formal business. Therefore, businessmen often borrow under their own names and then invest the borrowed money in their enterprises. Thus, entrepreneurs are personally liable for all private debts, even though the money is actually used by their companies, which are separate legal entities. Moreover, China currently has no personal insolvency regime, so individuals who are unable to repay private loans cannot claim bankruptcy in order to release them from

their debts. As a result they are permanently responsible for giving back money to underground lenders.

Second, the severe punishment under Chinese criminal law can make running away an attractive option. As mentioned, the illegal fundraising activities results in criminal offences that are subject to harsh punishments by Western standards. In particular, the offence of 'fraudulent fundraising' is often employed by Chinese judges to punish private financing practices, and the two cases of Zeng Chengjie and Wu Ying demonstrate the severity of punishment. When certain entrepreneurs become insolvent and are unable to repay a large group of creditors, which might have a negative impact on economic and social stability, Chinese judges will ruthlessly impose a criminal offence on such borrowers.

Third, Chinese money lenders, like any loan sharks, are adept at employing coercive methods for illegal debt collection, because it is impossible for them to rely on the legal system to protect their business and profits. Therefore, insolvent entrepreneurs and their families are exposed to the risk of being blackmailed, illegally detained or even assaulted, and it is likely that their personal property will be disposed of by lenders in an illegal manner. According to the Jiangsu High Court, in the Wujiang District of Suzhou, approximately 80 per cent of recent criminal cases of illegal detentions are related to debt collection activities through private lending.[66] Therefore, illegal debt collection sometimes forces entrepreneurs to leave their businesses and home towns to protect themselves and their property.

Finally, there is an old saying in China, *zou wei shang ce*, which can be roughly translated, as 'running away is the best strategy'. This proverb originated during China's ancient wartime and it means if the current situation is to your disadvantage in a battle, the best thing to do is to leave. It is clear that modern entrepreneurs in China still stick to the wisdom of their ancestors. Owing to a large amount of private loans that are nearly impossible to repay, entrepreneurs find themselves in a vulnerable position in that they not only face potentially severe sanctions from the state, but are also susceptible to violent debt collections from money lenders. However, if fugitive bosses manage to abscond with as much money as possible, as Ding Hui has done, they are able to restart their lives in oversees countries that have no extradition treaty with China, such as the US, Canada and Australia. Undoubtedly, the economic cost of running away is the lowest of the available options and is often viewed as the optimal choice for Chinese entrepreneurs in financial difficulty.

The pilot financial reform

The problems of limited investment and funding opportunities have existed in China for several years, which has unavoidably led to the prevalence of private lending that channels spare capital from investors to entrepreneurs. However, due to the lack of regulation, the underground lending market in China has encountered frequent credit crises since 2011. It has caused thousands of business insolvencies and 'vanishing bosses', which has had a detrimental impact on economic and social stability.

As a governmental response, China has been exploring effective approaches to regulate private lending as well as to solve the financial puzzle for small businesses. In March 2012, the policymaker in Beijing initiated a series of financial reforms that established a pilot reform zone in Wenzhou.[67] The state council set out 12 general objectives for financial reform and, undoubtedly, putting creditors and debtors in the private lending market into an officially controlled framework was top of the list. [68] The reason for choosing Wenzhou as the starting point for the reform is self-evident, as the city has been considered as an entrepreneurial hub and it has a huge shadow-banking network. According to one estimate, the scale of Wenzhou's shadow banking system amounted to 110 billion yuan (US$17.73 billion) which is equivalent to 38 per cent of its GDP.[69]

Wenzhou private financing regulation

Accordingly, the People's Congress in Zhejiang, the provincial legislator, has passed China's first financial regulation regarding private lending. The 'Wenzhou Private Financing Regulation' came into effect on 1 March 2014 and is regarded as a great breakthrough in legalising and regulating private financing activities. [70] The regulation has seven chapters and 50 articles, and enables private businesses to raise money through three types of private financing: private lending, private placement bonds and private equity. For the purposes of this article, we will focus on private lending, which is covered in chapter 3 of the regulation. In addition, the Wenzhou government has produced detailed rules for implementing the regulation. Generally speaking, the regulatory regime is based on the compulsory registration of private loans that meet certain standards. Several lending service centres to promote and facilitate private financing activities have also been established.

According to article 12(1) of the regulation, private lending for commercial purposes can be used as a financing method between individuals, or between individuals and non-financial enterprises, or between non-financial enterprises (temporary lending only).[71] Article 12(1) plays a key part as it confirms the legitimate status of private lending as a financing mechanism for businessmen and enterprises. It should be noted that private lending agreements between two non-financial enterprises should be temporary, as any enterprise that lends frequently should obtain a license from the financial regulator. The implementing rule clarifies that such temporary lending between two enterprises should not exceed three months. [72] Moreover, private lending should be conducted *privately*, as the new regulation prohibits private financing parties from advertising it to the public through newspaper, radio, television, internet, public lectures, seminars, leaflets and mobile phone text messages.[73]

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Regulatory agencies

In the past, the lack of a named regulatory authority has caused great chaos, but the new regulation aims to rectify this situation. It authorises the Wenzhou municipal government and other county-level governments within the city to regulate private financing activities.[74] More specifically, financial affairs offices and financial management departments in local governments provide guidance on the regulation and supervise private financing activities within their respective administrative regions.[75] Apparently, it is better to have local authorities, rather than national financial regulators, to supervise private lending as underground lending businesses are normally regional, and any potential risks will be confined to that region. The Wenzhou branches of national financial regulatory authorities, such as the central bank or banking and security regulators, have the power to guide the supervisory work of local financial management departments.[76]

Lending service centres

According to the new regulation, the Wenzhou local government shall set up "private financing public service centres" to facilitate lending activities. The lending service centres provide a variety of lending-related services for individuals and enterprises that take part in private financing transactions. For example:

- Providing civil attestation for private financing activities;
- Providing training courses for staff in the private financing industry;
- Offering investment consulting services;
- Facilitating the assignment of creditors' rights; and
- Attracting other service bodies, such as notary offices, guarantee companies, law firms and accounting firms, to open branches in the public service centres so as to provide support services for private financing.[77]

In addition, lending service centres can be entrusted by local financial management departments to carry out some regulatory tasks, including:

- Publishing information on the private financing interest rate index;
- Collecting and analysing private financing data, risk monitoring and risk assessment;
- Establishing private financing credit records and tracking money usage and loan performances;
- Receiving private lending registrations; and
- Other items entrusted by local financial management departments.[78]

Compulsory written format

The regulation requires that there must be a written and executed contract between lending parties.[79] It has made written format compulsory for creditors and debtors, which has had a positive impact in reducing disputes caused by the uncertainty of non-written agreements. Previously, China's contract law allowed private lending contracts between natural persons to be conducted without a written contract, permitting oral agreement in lending practices.[80] Therefore, it is not unusual for lenders to hand over millions of yuan to borrowers without signing an agreement, since asking for written contracts can sometimes be viewed as distrust among close business partners. However, when it comes to disputes, the oral contract is not valid as evidence.

Source of funding: Self-owned capitals

In terms of lenders' sources of funding, the new regulation says that they have to use their self-owned capital or savings to finance loans.[81] As a result, it will be illegal for lenders to absorb funds from the public or borrow money from banks, and then relend that money to borrowers at a higher price, which is currently common practice. Money lenders often secure deposits from the public by promising an attractive return which is much higher than the interest rate offered by banks, so investors' money constitutes the majority of money lenders' capital pools and increases the leverage of the lending business. It not only helps lenders to make more money, but also leads to increased credit risks when defaults occur. Therefore, when borrowers fail to repay the money lender, the money lender is likely to default on their own investors, so the entire lending chain collapses – the domino effect. Besides, some money lenders, who have access to the state-owned banking sector, can make easy money by relending bank credits to cash-strapped entrepreneurs, which might cause systemic risks in the whole financial system as the default of private loans will trigger the default of bank loans. As the new regulation prohibits money lenders to solicit public money or borrow bank loans, those potential risks will be eliminated.

Interest rate

To determine private lending interest the regulation states that the lending rate shall be negotiated between the lender and the borrower, as long as it complies with relevant regulations.[82] This article formally confirms the legitimacy of charging interest in private lending transactions. At present, there is an interest rate cap for private lending in China, a judicial interpretation made by China's Supreme Court, requiring that the interest rate for private lending should not exceed four times the interest rate of bank loans for the same period of time.[83] Accordingly, the benchmark interest rate for a one-year bank loan in China is 5.1 per cent, so the corresponding interest rate cap for a one-year private loan is 20.4 per cent.

In practice, a large number of money lenders who often charge interest rates beyond the state's restriction, have found some methods to evade the cap. For instance, they might deduct the excessive interest from the principal directly when they give money to borrowers.

Moreover, money lenders might find someone else to be a middleman for the lending transaction, and ask him or her to charge a brokerage fee that is actually a part of the interest. In order to protect borrowers from unfair lending practices, the new regulation bans lenders from deducting any interest from the principle in advance, ensuring that the repayment of the debt is based on the actual amount received by the borrower.[84]

Recording system for private loans

The highlight of the new regulation is the creation of an innovative registration-based system to supervise private lending. It has imposed an obligation on borrowers to submit a copy of the contract to the local financial management department or other commissioned lending service centres within 15 days of signing the agreement. This enables them to record the relevant lending transaction, when any of the following standards are met:

- A single private loan worth more than three million yuan (US$ 483,600);
- The borrower's loan balance regarding private lending exceeds ten million yuan (US$1.61 million);
- The borrower borrows money from more than 30 individuals and/or enterprises;[85]

For the remaining private lending transactions, lenders and borrowers are encouraged to report their loans to the authority on a voluntary basis.[86]

Although the duty of reporting relies on borrowers of the relevant private loans, lenders have the responsibility to supervise borrowers' activities, and are entitled to register loans if borrowers have not done so.[87] If there are major changes concerning the lending amount, the loan period or the interest rate, borrowers must report relevant changes to the regulator within 15 days.[88] The regulator also encourages lending parties to report loan performance situations to the authority, which will be incorporated in the newly established private financing credit system.[89]

Furthermore, the private lending regulator in Wenzhou has also established an online recording system to make it convenient for debtors and creditors to file lending contracts. Borrowers only need to register an online account, complete the application form and upload relevant documents, then the lending transaction will be verified and recorded by lending service centres. Clearly, the online reporting system is favourable to local businessmen, as more than 50 per cent of private loans related to project financing are recorded by the online system.[90]

Incentives for compliance

The new regulation stipulates several incentives for lenders and borrowers to report their private loans. Generally speaking, it asks the local government to provide policy support to those who are responsible for reporting.[91] It is evident that registering private loans with the authority is beneficial for both lenders and borrowers. For lenders, the registration material will be regarded as evidence with high probative force when courts and arbitration bodies within the Zhejiang province are hearing cases relating to private lending.[92] Therefore, lenders are free from the burden of proof, which can protect their interests and rights significantly.

For borrowers, the registration of private loans exempts them from conducting illegal fundraising activities that are regarded as a severe criminal offence in China, because the regulator will admit the legitimacy of the private loans that have been reported. Moreover, the information recorded about loan performance can be used for the credit rating of the borrower, which will be shared by all financial institutions.[93] It can motivate borrowers to perform the duty of reporting, as the information accumulated in China's personal credit system enables them to have more access to the formal banking system in the future.

Legal liabilities

If anyone violates the regulation, or the existing laws and administrative regulations already laid down by the relevant legal liabilities, the existing rules shall be followed.[94] Therefore, borrowers should be aware of the existing administrative punishments and criminal offences and avoid activities such as illegally absorbing public deposits and fraudulent fundraising. The new regulation has already resulted in fines being imposed on those who fail to perform their reporting duties. If the borrower in a private lending agreement fails to fulfil the reporting obligation or provides false materials, the local financial authority will order the borrower to correct this within a specified time limit. If the borrower does not make corrections within that period, the private lending activity shall be publicised, and the borrower will be fined between 10,000 and 50,000 yuan (US$1,6118,055) for an individual, or between 30,000 and 100,000 yuan (US$4,83316,110) for enterprises or other organisations.[95]

Wenzhou private financing index

In addition to the latest regulation, the Wenzhou municipal government has launched a new index, called the 'Wenzhou Private Financing Index' (the Wenzhou Index), to track the interest rate levels of private financing activities.[96] The new index has been constructed with rigorous statistical methods, which can reflect the level, tendency and fluctuation of the price of private financing. The compilation and release of the index is a key step in the pilot for financial reform, as the government aims to build an indicator for the regional lending market, and promote the transparency of transactions, as well as increasing the efficiency of the allocation of financial resources. Currently, the index has a local version for the Wenzhou city and a national version for the whole country. The local version was

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officially released on 7 December 2012, and the Index has been updated on a daily basis since 1 January 2013.[97] The national version of the Wenzhou Index was published on 26 September 2013.[98] The Wenzhou Index has established a cooperative relationship with Thomson Reuters and the China Securities Index, which publishes the well-known CSI 300 Index, to help it to compile and publish data.

In terms of data sources, the local version is compiled by Wenzhou's financial affairs office based on data collected from nearly 400 monitoring sites across the city. The monitoring sites include private lending service centres, private capital management companies, microcredit companies, rural mutual financial cooperatives, certain enterprises, pawn shops and credit guarantee companies. Clearly, it covers a variety of forms focusing on private financing outside the formal banking sector. On average, approximately 300 samples from real transactions are collected daily, to ensure a relatively high level of authenticity and timeliness. The national version is compiled based on data collected from more than 200 monitoring sites in 22 Chinese cities. The Wenzhou Index can be divided/categorised into periods of one, three, six, 12 and in excess of 12 months.

Table 2: The Wenzhou Index (May 18, 2015)

Wenzhou Private Lending Comprehensive Interest Index						19.17
Divided by entity	Private lending service centres	Small-credit companies	Private capital management companies	Direct lending	Other entities	Rural ROSCAs
	16.02	17.35	18.00	15.52	26.29	11.43
Divided by time	1 month	3 months	6 months	1 year	More than 1 year	
	18.53	16.30	15.59	15.50	18.26	
Notes	1. All indexes refer to annualised interest rate. 2. ROSCAs is the abbreviation for rotating savings and credit associations.					

Data Source: Wenzhou Private Financing Index Official Website.[99]

Implementation results

The Wenzhou Private Financing Regulation has been in effect for more than a year. As the first financial legislation regarding private financing in China, its birth has been perceived as an important breakthrough for the standardisation and legalisation of private lending activities. According to official data, during the first year of implementation from March 2014 to March 2015, there were 7,054 private loans in Wenzhou being reported to the authority, with a combined value of 9.88 billion yuan (US$1.59 billion).[100] On average, the amount of each loan is around 1.4million yuan (US$225,540), and the annualised interest rate is approximately 16.1 per cent. It is clear that the registration of private loans with the regulator has become one indispensable step for the entire lending procedure, which has gradually moved private lending in Wenzhou from underground to the mainstream. According to Wenzhou Intermediate People's Court, the implementation of the regulation has had a positive impact on reducing private lending disputes, as the court system in Wenzhou received 15,009 cases regarding private lending in 2014, which is a year-on-year reduction of 9.81 per cent. .[101] The Wenzhou Index has provided important guidance for lenders and borrowers in deciding the interest rate for lending transactions. As the Wenzhou reform has proved to be successful in regulating the private lending market, more than 15 provinces in China, including Guangdong, Shandong, Hunan, Sichuan and Guizhou, have been trying to learn from Wenzhou and have already set up 77 lending service centres across the country to test the registration-based regulatory system.[102] However, even though an increasing number of lenders and borrowers have started to comply with the new regulation, some business owners still have concerns over the exposure/loss of privacy to the authority, paying additional taxes, and so on.

Conclusion

When people talk about China as the world's second-largest economy, they pay most attention to the double-digit GDP growth, large state-owned enterprises listed in the Fortune Global 500 or, more recently, the internationalisation of the Chinese yuan. However, the financing difficulties of millions of privately owned businesses, which have been the real driving force behind the Chinese economy, are often overlooked. Therefore, this article has demonstrated how Chinese entrepreneurs depend largely on private lending to obtain capital for their business ventures, which has resulted in credit crunches and runaway bosses over the past few years; while the growth of the Chinese economy has gradually slowed down. In 2014, the disappearance of several high-profile entrepreneurs, which included chairmen and CEOs of public companies, attracted extensive media coverage.

In response, the Chinese authorities have launched a series of financial reforms aimed at supervising the rampant lending market and alleviating the funding difficulties of private companies. A pilot reform zone has been established in Wenzhou, and the local legislature

came up with a new registration-based regulatory regime for private lending. After one year of experimentation, the overall result seems satisfactory for the new regulation, which is aimed at being beneficial to both lenders and borrowers, and more local authorities in other provinces are working to replicate Wenzhou's example. Hopefully, private lending under the officially controlled framework, can be utilised to serve the sustainable growth of China's dynamic private economy.

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Turning the compliance straitjacket into a bulletproof vest

In the last few years, several banks have received some of the largest fines ever issued by regulators as a result of manipulating systemically important interest benchmarks (SIIB) – think LIBOR and EURIBOR – and the Payment Protection Insurance (PPI) mis-selling scandal has cost a number of banks more than £18 billion. People across industries are definitely aware of, and thinking about, regulation and compliance.

The latest Timetric industry report on Governance, Risk and Compliance (GRC) in the UK has indicated that the regulatory landscape is tightening, so financial institutions need to continue to be alert and leverage all possible avenues to ensure they are compliant. With Solvency II expected to be implemented in the UK from 1 January 2016, there are even more risk management standards for companies to get to grips with.

This is why demand for enterprise GRC solutions is growing. Risk management is playing an especially important role in industries where management of Big Data is crucial, such as companies involved in grid computing, financial services, network security and cloud services. These companies face growing business risks from an increasing number of data breaches and security thefts, such as cyber attacks.

However, as recent events have shown, any company holding customer data – whether it is a telco company like Talk Talk, or Marks and Spencer – is at risk. Such data breaches can destroy confidential information and business processes within seconds, and can cause massive financial losses as well as public disgrace. Thus there is a tremendous reputational risk. There are already calls for regulators to be given significant new powers to tackle the escalating problem of online fraud in the wake of the cyberattack that potentially compromised the security of millions of TalkTalk customers, but what can the companies themselves do to avoid these kinds of situations?

A risk-based approach

Two years ago, the Financial Services Authority was replaced by two new regulatory bodies, the Prudential Regulation Authority and the Financial Conduct Authority, which increased GCR requirements across the board, but demand for an industry shift towards more proactivity and transparency from financial institutions is not only coming from the regulators. Consumers want to ensure the banks with which they have entrusted their financial stability are not culpable.

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