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Shadow Banking for Cash-Strapped Entrepreneurs: A Study of Private Lending Agreements Under Chinese Contract Law

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Abstract

This article discusses and analyses one of the most popular commercial contracts in China: the private lending agreement. It refers to moneylending arrangements between a business borrower and its debt investors. Millions of private businesses in China, having limited access to the state-dominated banking sector, rely on private financing to borrow funds. The market volume of the private lending sector amounts to CNY 4 trillion (US\$580.6 billion). In 2014, there were 1.02 million private lending-related civil cases heard by Chinese courts.

Introduction

Private lending (or private financing) agreements have been one of the most popular commercial contracts in China.¹ This refers to moneylending arrangements between a business borrower and its debt investors. Major state banks in China, including the Big Four, prefer to make loans to other state-owned enterprises (SOEs) and local government financing vehicles rather than private businesses.² As a result, Chinese entrepreneurs in need of funds have to seek financing channels outside the banking sector, and most of them borrow money from their family members, business partners, professional moneylenders, underground money houses, and other private investors. The strong financing demands have contributed to the formation and prosperity of a massive private lending market in China, which is considered as a vital element of the Chinese shadow banking system. According to one estimation, the underground lending sector was worth CNY 4 trillion (US\$580.6 billion).³

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¹ In Chinese, private lending agreements are called “*Min Jian Jie Dai He Tong*”. For the convenience of international readers, the Chinese currency (CNY) in this article is accompanied by a conversion into US dollars. The exchange rate between CNY and USD was 6.89:1 on 22 March 2017.

² The Big Four in China's banking sector refers to the Industrial and Commercial Bank of China, the China Construction Bank, the Agricultural Bank of China, and the Bank of China.

³ Dong Tao and Weishen Deng, “China: Shadow Banking - Road to Heightened Risks”, *Credit Suisse Economic Research* (22 February 2013), p.2.

In contrast to the wide popularity of private loans, relevant laws and regulations governing private financing transactions have remained underexplored. Therefore, this article aims to fill this gap in the literature, and provides a detailed analysis of Chinese laws relating to private lending agreements. It gives useful guidance for legal practitioners dealing with Chinese businesses, and for researchers who have an interest in Chinese commercial law.

The article proceeds as follows. The first section explains in detail why private lending contracts have gained great popularity in China's commercial world, while the second section examines the private lending crisis in 2011, which is often dubbed "China's subprime crisis". After introducing the background knowledge of private lending market, the remainder of this article focuses on the doctrinal analysis of legal rules regarding private lending contracts. The third section evaluates provisions under the People's Republic of China (PRC) Contract Law 1999, regarding rights and obligations of contracting parties of a private lending agreement.⁴ Next, the fourth section continues to study the latest judicial interpretation made by the China's Supreme Court in 2015 about private lending agreements, while the fifth section pays attention to the official interest rate cap. The sixth section considers some illegal lending and borrowing practices that could constitute a criminal offence under the Chinese criminal code. After that, the seventh section points out further compliance issues that merit attention from lending parties and their legal advisers. Finally, a conclusion will be drawn.

Why is private financing so popular in China?

Over the past four decades, owing to China's market-oriented economic reform, millions of entrepreneurs have established their own businesses in pursuit of personal wealth and a better quality of life. This led to the rapid growth of the Chinese economy. In 2010, China replaced Japan as the world's second-largest economy in terms of gross domestic product (GDP), just after the US.⁵ In 2016, China's economy grew by 6.7 per cent, a key driver of the global economic growth.⁶ There is no denying that the real driving force behind China's economic rise is the proliferation of private capitalism and entrepreneurship, as newly established privately owned businesses have been gradually replacing low-efficient and bureaucratic SOEs that have dominated the economy for several decades under the state planned economy. As of June 2016, China had a total number of 80.78 million registered enterprises, 90 per cent of which were privately owned.⁷ The private sector has contributed to 65 per cent of China's GDP as well as 80 per cent of employment, but, in sharp contrast, private businesses only received 20 per cent of total bank credits.⁸

Therefore, a large number of private businesses have been facing financial difficulties for a long time. This is because the state has exerted strict controls over

⁴ PRC Contract Law 1999 was passed by the second session of the ninth National People's Congress on 15 March 1999, came into effect on 1 October 1999.

⁵ Mure Dickie and Jonathan Soble, "China Displaces Japan as Second Biggest Economy", *Financial Times*, 15 February 2011, p.9.

⁶ "China's economy grows 6.7% in 2016" (20 January 2017), *BBC News*, <http://www.bbc.co.uk/news/business-38686568> [Accessed 1 March 2018].

⁷ "Private Businesses Exceed 90%" (25 July 2016), *China Business Time*, http://epaper.cbt.com.cn/epaper/uniflows/html/2016/07/25/01/01_87.htm [Accessed 1 March 2018].

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

China's banking sector through majority ownership. For instance, the Central Huijin Investment Ltd, the investment arm of China's Central Government, owns over 60 per cent of stakes in each of the Big Four banks in China.⁹ As a result, the state lenders, influenced heavily by the Government's credit policy, tend to allocate most of their loan quotas to SOEs. Thus, it remains difficult for private businesses to borrow sufficient credit from the banking sector, which forces them to look for alternative form of finance. The private lending market seems a perfect choice for entrepreneurs to raise funds, as in practice many of them raise money from their relatives, business partners, underground money houses, or other informal financial institutions. The contracts they sign to borrow money are the private lending agreements we discuss here.

On the other hand, savers and investors have been searching for good investment opportunities that can increase the return on their money. The Chinese people are famous for being avid savers, so the country has the highest gross saving rate in the world (49 per cent), according to the World Bank.¹⁰ However, the real interest rate for bank savings has often remained negative owing to the high inflation rate, which means that Chinese savers are gradually losing money on every yuan in their bank accounts. Consequently, a large number of ordinary households and business owners who have spare savings or capital are looking for good investments that can bring satisfactory returns. For instance, in 2015, the stock market in China saw a huge speculative bubble, as the Shanghai Composite Index more than doubled in one year.¹¹ Driven by the desire to make money quickly, people rushed to purchase shares in public companies and some even borrowed heavily from securities brokers and shadow banks to fund the investment, despite the deteriorating economic situation after the global financial crisis. Besides, the housing price in major Chinese cities, fuelled by the money from rich individuals, has been soaring in the past decade. In 2015 alone, the average housing price in Shanghai increased by 20 per cent, even though the Government has set strict rules to curb property speculation.¹² Apparently, the recent equity and property speculation demonstrates the desire of Chinese investors to find good investments. Similarly, they also compete to lend their money out to money-starved private businesses, in order to earn eye-catching interests. Even some SOEs having abundant cash reserves try to take part in the moneylending business by extending loans to other businesses in need of funds.¹³

Clearly, the money supply from individual and corporate investors, coupled with the strong financing demand from private businesses, has contributed to a thriving private lending market in China. According to a survey by the People's Bank of China, 89 per cent of households and 59 per cent of businesses in Wenzhou, a Chinese city well known for its entrepreneurship, have been actively participating in private lending activities.¹⁴ In the recent decade, private financing has evolved

⁹ Lerong Lu, "Private Banks in China: Origin, Challenges and Regulatory Implications" (2016) 31 *Banking and Finance Law Review* 585, 586.

¹⁰ World Bank, "Gross savings (% of GDP)", http://data.worldbank.org/indicator/NY.GNS.ICTR.ZS?order=wbapi_data_value_2014+wbapi_data_value+wbapi_data_value-last&sort=desc [Accessed 1 March 2018].

¹¹ Lerong Lu and Longjie Lu, "Unveiling China's Stock Market Bubble: Margin Financing, the Leveraged Bull and Governmental Responses" (2017) 32 *Journal of International Banking Law and Regulation* 146, 146.

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

¹³ Shen Wei, "Shadow Banking System in China - Origin, Uniqueness and Governmental Response" (2013) 28 *Journal of International Banking Law and Regulation* 20, 21.

¹⁴ People's Bank of China, "Wenzhou Private Lending Market Report" (21 July 2011).

into a massive financing sector. As stated, the market scale was around CNY 4 trillion (US\$580.6 billion) in 2012. More recently, the Southwest University of Finance and Economics predicted that the size of informal financing industry can be as much as CNY 5 trillion (US\$725.7 billion) in 2014.¹⁵ However, obtaining a private loan can be extremely costly for business borrowers, for the annualised interest rate is normally from 14 to 70 per cent.¹⁶ It is evident that the high borrowing cost creates a heavy debt burden for lots of Chinese businesses, in particular when the economic growth has been slowing down after the financial crisis.

China's subprime crisis and rising private lending disputes

Since 2011, China has witnessed a series of credit crisis in its private lending market, as a large number of business borrowers failed to repay private debts owing to their worsening financial conditions in the economic downturn. According to a survey in 2011, more than 65 per cent of entrepreneurs in Wenzhou, who had businesses with annual revenue of over CNY 30 million (US\$4.35 million), believed that a financial crisis would be inevitable.¹⁷ Soon afterwards, Wenzhou was the first Chinese city to face a severe credit crunch, as 20 per cent of the city's 360,000 SMEs ceased operation owing to a cash shortage.¹⁸ More than 80 business owners in Wenzhou were reported to have escaped the city to evade debts as they were unable to pay off the money owed to private lenders, and some entrepreneurs even committed suicide under the pressure from debt collectors.¹⁹ In the first eight months of 2011, the combined amount of money in private lending civil disputes received by the city's court system surged by 71 per cent to CNY 5 billion (US\$728.9 million), as corporate bankruptcy spread the city.²⁰

In one year, the private lending crisis swept across China, often referred to as "China's subprime crisis" by the media.²¹ For example, in Fujian Province where the private sector dominates the economy, there have been numerous companies falling into bankruptcy, while many entrepreneurs abandoned their companies and fled their home towns to hide from debt collection. In July 2014, Mr Ding Hui, the chairman and CEO of Fujian Nuoqi Company Ltd, a fashion cloth retailer listed on the Hong Kong Stock Exchange, suddenly went missing, as he could not repay multi-billion-yuan private debts owed to moneylenders.²² Accordingly, the share price of Nuoqi Company slumped and lost almost 50 per cent of its value in

¹⁵ "Long-term Underground Private Lending Endanger Financial Ecology" (22 September 2014), *Xinhua*, http://jckb.xinhuanet.com/2014-09/22/content_521666.htm [Accessed 1 March 2018].

¹⁶ "Fears Surface Over Chinese Debt Amid Lending Practices" (6 October 2011), *BBC News*, <http://www.bbc.co.uk/news/business-15194663> [Accessed 1 March 2018].

¹⁷ Ran Yu and Hongyi Wang, "Wenzhou Credit Crisis 'Inevitable' with Unchecked Private Lending" (14 October 2011), *China Daily*, http://www.chinadaily.com.cn/business/2011-10/14/content_13896213.htm [Accessed 1 March 2018].

¹⁸ "Fears Surface over Chinese Debt amid Lending Practices" (6 October 2011), *BBC News*, <http://www.bbc.co.uk/news/business-15194663> [Accessed 1 March 2018].

¹⁹ "Fears Surface over Chinese Debt amid Lending Practices" (6 October 2011), *BBC News*, <http://www.bbc.co.uk/news/business-15194663> [Accessed 1 March 2018].

²⁰ Most of these claims are the request to fulfil the contract law obligation. See "China May Inject Cash to Prevent Wenzhou Crisis, ING Says" (30 September 2011), *Bloomberg*, <http://www.bloomberg.com/news/articles/2011-09-30/china-may-inject-cash-to-prevent-wenzhou-crisis-ing-says> [Accessed 1 March 2018].

²¹ Austin Ramzy, "A Credit Crisis in China's Most Enterprising City Is Making the Country Nervous" (28 November 2011), *Time*, <http://content.time.com/time/magazine/article/0,9171,2099675,00.html> [Accessed 1 March 2018].

²² Lerong Lu, "Runaway Bosses' in China: Private Lending, Credit Crunches and the Regulatory Response" (2015) 18 *Financial Regulation International* 1, 1-3.

three trading days. Moreover, Fujian has seen the collapse of several large-scale informal private lending networks, which includes Ms Zhong Mingzhen's giant financing guarantee business that has attracted CNY 3.7 billion (US\$537 million) from private investors.²³

Apparently, the widespread financial crisis had a catastrophic impact on relevant stakeholders and the financial stability. In particular, as business borrowers could not fulfil their debt obligations, moneylenders and investors suffered great financial losses. Since the private lending market has been operating outside China's financial regulatory system, private debt investments do not receive any kind of official protection. Therefore, the only legitimate way for debt investors to claim back their money is to file a civil lawsuit against borrowers. Such legal claims are based on the creditor-debtor contractual relationship. Thus, following the crisis, massive private lending-related civil cases overwhelmed China's court system. According to Mr Du Wanhua, a senior judge at the Supreme Court, there were 1.02 million private lending cases in 2014 heard by all Chinese courts, making private financing the second-largest category of civil litigation in the country, just next to marriage and family cases.²⁴

Loan agreements under PRC contract law

A loan contract is a moneylending agreement between a borrower and one or more moneylenders, which documents mutual promises regarding moneylending issues. In China, despite the large amount of money involved in private lending, any moneylending activities essentially constitute a contractual relationship between a creditor and a debtor. Therefore, lending parties have to comply with provisions under the PRC Contract Law 1999. A valid private lending agreement, like any other contract, comprises basic elements including offer, acceptance and consideration (interest). Nonetheless, the common issues regulated by the general principles of contract law are not discussed here, while the attention is focused on specific provisions governing loan agreements.

The codified PRC Contract Law has 428 articles under 23 chapters. Chapters 1 to 8 contain general provisions in terms of the legislative purpose, and basic principles and rules that shall be observed in any contracts concluded in China.²⁵ After that, Chs 9 to 23 set out detailed rules for 15 specific types of contracts that are frequently used in commercial practices, such as sales contracts, moneylending contracts, lease contracts, brokerage contracts, and so on. In particular, Ch.12 of the PRC Contract Law is entitled "loan contract", as it lays down basic requirements for formalities and contents of a lending agreement, legal rights and obligations of lending parties, and situations that lead to a breach and relevant remedies. It should be noted that such rules were primarily designed for contracts relating to bank loans, but they also apply to all moneylending agreements in China including

²³"The Run on Rongdian" (8 July 2011), *Week in China*, <https://www.weekinchina.com/2011/07/the-run-on-rongdian/> [Accessed 1 March 2018].

²⁴"Private Lending Disputes Became China's Second Largest Civil Litigation Type: The Supreme Court Issued New Judicial Interpretation" (6 August 2015), *Xinhua*, http://news.xinhuanet.com/legal/2015-08/06/c_1116171913.htm [Accessed 1 March 2018].

²⁵For instance, Ch.2 concerns the conclusion (formation) of a contract; Ch.3 lays down the rules for the validity of a contract; Ch.4 concerns the fulfilment of a contract; Ch.5 concerns the modification and transferring of a contract; Ch.6 concerns the termination of rights and obligations under a contract; Chapter 7 lays down liabilities for the breach of contract; and Ch.8 contains some miscellaneous provisions.

private lending and online peer-to-peer lending. The following scrutinises the relevant provisions under Ch.12:

- **Definition of loan contract:**

A “loan contract” means the agreement whereby a borrower borrows funds from a lender, and repays the loan with interests when it falls due.²⁶

- **Form requirement and main clauses:**

A loan contract shall be made in written form, except for lending agreements between natural persons. A loan contract shall contain essential clauses including the loan’s type, currency, purpose of use, amount of money, interest rate, term time, and method of repayment.²⁷

- **Contract guarantee:**

When entering into a loan contract, the lender may require the borrower to provide a guarantee. Creating a guarantee shall be compliant with rules under the PRC Guaranty Law 1995.²⁸ Apparently, requesting any forms of guarantees can secure the performance of a private loan for the benefit of the lender, which is able to compensate some potential risks of defaults. There are three forms of guarantees under Chinese laws: surety (guarantee), mortgage and pledge.²⁹

- **Borrower’s obligation to disclose financial information:**

When making a loan contract, the borrower, as requested by the lender, shall provide truthful information regarding its business activities and financial conditions relevant to money lending.³⁰

- **Prohibition of deducting interest in advance:**

The interest of a loan shall not be deducted from the principal prior to lending. If the interest is deducted in advance, the loan shall be repaid according to the actual amount of money received by the borrower, so shall the interest rate be calculated.³¹ In practice, many moneylenders try to deduct interests from the principal, before they transfer the money to borrowers. Two reasons can be given for this. First, certain moneylenders charge interest which exceeds the official ceiling set by the state. In order to get around the restriction, they choose to deduct the excessive part of the interest from the principal in advance. Secondly, some moneylenders do this to reduce the risk of lending by realising interest incomes at first. Clearly, this unfair lending practice prejudices the interest of borrowers who in most

²⁶ PRC Contract Law 1999 art.196.

²⁷ PRC Contract Law 1999 art.197.

²⁸ PRC Contract Law 1999 art.198.

²⁹ In Chinese surety (guarantee) is “*Dan Bao*”, mortgage is “*Di Ya*”, and pledge is “*Zhi Ya*”.

³⁰ PRC Contract Law 1999 art.199.

³¹ PRC Contract Law 1999 art.200.

cases are in a vulnerable position and have no choice but accept all conditions.

- **Liability for breach of contract:**

If the lender fails to offer the right amount of loan at the agreed time, which leads to the borrower's losses, it shall be liable to compensate such losses. If the borrower owing to its own fault fails to collect the loan at the agreed time, it still has the obligation to pay interest.³²

- **Lender's right to inspect loan performance:**

The lender is entitled to inspect and supervise how the borrower uses the loan. The borrower shall provide financial statements to the lender at regular intervals as stated in the contract.³³

- **Remedy for violating the use of loan:**

Where the borrower does not use the loan for the prescribed purpose, the lender can stop issuing the loan, recall the loan or terminate the contract.³⁴

- **Interest payment:**

The borrower shall pay the interests at the prescribed time according to the contract.³⁵ Where the time of interest payment is not agreed or the agreement is unclear, or cannot be determined in accordance with art.61 of this Law (which is about the remedy for unclear contract clauses), if the loan term is less than one year, the interest shall be paid together with the principal at the end of the contract; if the loan term is one year or longer, the interest shall be paid at the end of each annual period, and where the remaining period is less than one year, the interest shall be paid together with the principal at the end of the contract.

- **Principal repayment:**

The borrower shall repay the principal at the prescribed time.³⁶ Where the time of repayment is not agreed or the agreement is unclear, nor can it be determined in accordance with art.61 of this Law, the borrower can repay the loan at any time; and the lender can demand the loan repayment at any time, provided a reasonable notice period is given to the borrower.

- **Overdue interest:**

Where the borrower fails to repay the loan at the prescribed time, it shall pay overdue interest in accordance with the contract or relevant

³² PRC Contract Law 1999 art.201.

³³ PRC Contract Law 1999 art.202.

³⁴ PRC Contract Law 1999 art.203.

³⁵ PRC Contract Law 1999 art.205.

³⁶ PRC Contract Law 1999 art.206.

regulations of the state.³⁷ Failing to pay the loan constitutes a breach of contract, so the Law enables the lenders to charge overdue interest as financial compensations.

- **Early repayment:**

Where the borrower prepays the loan early, unless otherwise agreed by the parties, the interests shall be calculated based on the actual period of borrowing.³⁸ A debtor is allowed to pay off debts earlier than the original term, and the Law protects the debtor's rights by asking it to pay interests based on the real time of borrowing.

- **Loan extension:**

The borrower can ask the lender for an extension of the loan term before its maturity date.³⁹ Upon the lender's consent the loan term may be extended.

- **Time of taking effect for loans between natural persons:**

A loan contract between natural persons becomes effective at the time when the lender makes the loan amount available.⁴⁰ It means that the action of drafting and signing the loan contract does not guarantee its effectiveness, unless the lender provides the money for the borrower. However, if the lending contract involves a legal person as one of its contracting parties, the loan agreement will take effect when it is signed.

- **Interest rate for loans between natural persons:**

Where a loan contract between natural persons does not stipulate the payment of interest or the stipulation is unclear, the loan shall be deemed interest-free; if a loan contract between natural persons stipulates the payment of interest, the interest rate shall not contravene relevant regulations of the state (which will be discussed later).⁴¹ This provision has reflected the legislative purpose in the 1990s that private lending agreements are mainly conducted between relatives, friends and acquaintances in our daily lives, for non-profit purpose, so if there is no clear term about interest, it is better to have no interest to protect the interest of borrowers. However, private lending nowadays has been widely used as a method for business financing. As this rule applies, the individual moneylender or investor will not be able to collect any interest from an individual borrower if the agreement is not clear enough, which seems unfair for the lender.

³⁷ PRC Contract Law 1999 art.207.

³⁸ PRC Contract Law 1999 art.208.

³⁹ PRC Contract Law 1999 art.209.

⁴⁰ PRC Contract Law 1999 art.210. According to civil law principles, a consensual contract (*Nuo Cheng He Tong*) is a contract that is founded upon the mere agreement between two contracting parties, without any external formality or action to fulfil the obligation. However, a real contract (*Shi Jian He Tong*) refers to those in which it is necessary to have something more than mere consent to conclude a contract, such as certain actions like providing the money.

⁴¹ PRC Contract Law 1999 art.211.

Latest judicial interpretation for private lending contracts

Apart from the PRC Contract Law, there are several pieces of judicial interpretations made by the Supreme Court regarding private lending contracts, which enjoy the status of laws and are binding on all court decisions in China. Clearly, these judicial interpretations provide additional rules for parties of a private lending agreement to follow. In August 2015, the Supreme Court published the latest interpretation entitled “The Provisions of the Supreme People’s Court on Several Issues Concerning the Application of Law in the Trials of Private Lending Cases”, which is widely known as “Provision 18”.⁴² It was issued on 6 August 2015, and took effect from 1 September 2015. According to Provision 18, private lending refers to moneylending activities among natural persons, legal persons and other organisations; however, it does not apply to lending disputes involving financial institutions and their branches.⁴³

The PRC Contract Law has already set out general situations that result in the invalidity of a contract, such as one party using fraudulent or coercive methods to conclude the contract, or the contract involving a malicious conspiracy that will cause damages to interests of the nation, a collective or a third party.⁴⁴ In addition, Provision 18 stipulates the following circumstances where a court will consider a private lending contract as invalid:

- when the lender borrows a loan from financial institutions at first, and then re-lends the money to the borrower at a higher rate (the borrower knows or should have known in advance);
- when the lender borrows a loan from other enterprises or raise funds from its own employees, and then re-lends the money to the borrower for the purpose of making profits (the borrower knows or should have known in advance);
- when the lender knows or should have known in advance that the borrower takes the loan for criminal activities, but still provides the loan;
- when the contract violates the public order or good morals; or
- when the contract violates laws, administrative regulations, and other mandatory rules.⁴⁵

In the past, the validity of a private lending contract largely depended on the identity of the lending parties. For a long time, the Chinese authority only admitted the legitimacy of moneylending agreements between two individuals (natural persons), and it remained very sceptical about loan contracts involving a non-financial enterprise. This is because the primary concern of the authority was to combat illegal financial practice: in particular, some enterprises that make loans and take deposits without a banking licence. Therefore, in judicial practice, a private financing contract between two non-financial enterprises would be deemed null

⁴² Provision 18 was passed by the 1655th meeting of the Judicial Committee of the Supreme People’s Court in 2015.

⁴³ Supreme People’s Court, “The Provisions of the Supreme People’s Court on Several Issues Concerning The Application of Law in the Trials of Private Lending Cases” (2015, FASHI No.18) art.1.

⁴⁴ PRC Contract Law 1999 art.52.

⁴⁵ Supreme People’s Court, “The Provisions of the Supreme People’s Court on Several Issues Concerning The Application of Law in the Trials of Private Lending Cases” (2015, FASHI No.18) art.14.

and void by a Chinese court, which would ask the borrower to return the principal to the lender.

However, the latest judicial interpretation has seen a big shift in the official attitude towards private lending between two non-financial enterprises. Provision 18 states that,

“a private lending agreement entered by legal persons and other organisations, for the purpose of production and business operation, will be held valid by a court, provided that it does not have circumstances under the Article 52 of PRC Contract Law and the Article 14 of this regulation”.⁴⁶

Clearly, it legalises the private financing activities between two companies or other business organisations, without the need to have a bank as the intermediary. It allows Chinese businesses in need of funds to borrow money directly from other corporate and individual investors, which can to some extent alleviate the financing difficulty faced by entrepreneurs.

Interest rate ceiling

From 1991 to 2015, China implemented a strict set of interest rate regulations for private lending contracts, which was referred to as the “four-time red line”. Any lending practices crossing this line might be declared as usury, and, as a result, lenders could be subject to heavy administrative or criminal sanctions. The four-time red line means that the interest rate of private lending should not exceed four times the interest rate of a bank loan of the same kind.⁴⁷ For example, if the interest rate of a one-year bank loan is 5 per cent (which depends on the benchmark rate set by the People’s Bank of China), the corresponding interest rate cap for a one-year private loan will be 20 per cent.

In 2015, the four-time red line was officially abolished and replaced by new regulations under Provision 18:

- if the annualised interest rate of a private loan does not exceed 24 per cent, it will be held valid by a court⁴⁸;
- if the annualised interest rate exceeds 36 per cent, the excessive part of the interest will be deemed invalid by a court, and will be returned to the borrower upon request⁴⁹; and
- if the annualised interest rate is more than 24 per cent but less than 36 per cent, a court will make judgments depending on the specific circumstance.⁵⁰ Where the borrower has already paid the interests to the lender, the court will not compel the lender to return the excessive part of the interest. Nor will the court support the lender’s claim for

⁴⁶ Supreme People’s Court, “The Provisions of the Supreme People’s Court on Several Issues Concerning the Application of Law in the Trials of Private Lending Cases” (2015, FASHI No.18), art.11.

⁴⁷ Supreme People’s Court, “Some Opinions Concerning the Hearing of Private Lending Cases by People’s Courts” (1991, FAMINFA No.21) art.6.

⁴⁸ Supreme People’s Court, “The Provisions of the Supreme People’s Court on Several Issues Concerning the Application of Law in the Trials of Private Lending Cases” (2015, FASHI No.18) art.26.

⁴⁹ “The Provisions of the Supreme People’s Court on Several Issues Concerning the Application of Law in the Trials of Private Lending Cases” (2015, FASHI No.18) art.26.

⁵⁰ “The Provisions of the Supreme People’s Court on Several Issues Concerning the Application of Law in the Trials of Private Lending Cases” (2015, FASHI No.18) art.31.

the borrower to pay interests over 24 per cent when the interest is unpaid.

The new rule adopts a three-level approach. Any claims of interest under 24 per cent will be fully supported by a court, while any claims over 36 per cent will be declared null and void. The tricky part is the interest between 24 per cent and 36 per cent, which will be treated as *naturalis obligatio* by a court, namely a legal obligation which is unenforceable. Compared with the old four-time red line, the new regulation gives more autonomy to lending parties regarding the interest rate, which indicates the less interventionist approach of the authority.

When lending parties set their interest rate in a private financing agreement, they can refer to the Wenzhou Private Financing Index, which is official guidance concerning the interest rate level of private financing activities in China.⁵¹ The Wenzhou Index has been compiled by Wenzhou City's Financial Affairs Office, and it is constructed with rigorous statistical methods to reflect the level, tendency and fluctuation of the price of private financing. It has become an important indicator for market participants, financial regulators as well as judicial authorities, which improves the transparency of transactions and increases the efficiency of the allocation of financial resources.

Currently, the Index has a local version for investors in Wenzhou City as well as a national version for the whole country. The local version, entitled the "Wenzhou Private Financing Comprehensive Index", was officially released on 7 December 2012, and the Index has been updated on a daily basis since 1 January 2013.⁵² The national version of Wenzhou Index, entitled the "China Private Financing Comprehensive Index", has been compiled and circulated to the public since 26 September 2013, the data of which come from monitoring points in more than 40 Chinese cities.⁵³ Unlike the local version, it is published on a weekly basis. The Wenzhou Index is further divided into several sub-indexes based on different financing entities and time periods. As for different financing entities, they are divided into six categories: the rural rotating savings and credit associations (ROSCAs) index; the private lending service centre index; the private capital management company index; the small-credit company index; direct private lending index; and other entities index. In terms of financing periods, the Wenzhou Index is presented in six categories including 1 month, 3 months, 6 months, 12 months, and over 12 months.

⁵¹ Wenzhou Private Financing Index Official Website, "About Wenzhou Index", <http://wzptf.gov.cn/About.aspx> [Accessed 2 March 2018].

⁵² "China's Wenzhou Launches Private Lending Index" (7 December 2012), *Reuters*, <http://www.reuters.com/article/2012/12/08/china-wenzhou-shadowbanking-idUSL4N0910G920121208>, [Accessed 2 March 2018].

⁵³ Wenzhou Financial Affairs Office and Thomson Reuters Jointly Launched Wenzhou Index Globally" (10 January 2014), *Caijing Finance*, <http://finance.caijing.com.cn/20140110/3190929.shtml>, [Accessed 14 March 2018].

Table 1: Wenzhou Index (23 March 2017) ⁵⁴							15.64
Wenzhou Private Lending Comprehensive Interest Index							
(Annualised interest rate in percentage)							
<i>Divided by entity</i>	Private lending service centres	Small-credit companies	Private capital management companies	Direct lending	Other entities	entire	R u r a l ROSCAs
	14.78	16.06	16.63	13.95	23.80		12.26
<i>Divided by time</i>	1 month	3 months	6 months	1 year	More than 1 year		
	20.09	18.20	14.98	12.59	12.50		

Illegal moneylending offences

Lending parties and their legal advisers should be wary of certain illegal lending and borrowing practices resulting in criminal offences under the PRC Criminal Law 1997. For example, the offence of “illegal absorbing public deposits” punishes anyone (an individual or the person in charge of an organisation) who, without a financial licence, illegally takes deposits from the general public or do so in a disguised form, leading to the disruption of financial stability.⁵⁵ The offender is subject to criminal detention or imprisonment up to three years, or/and a fine (CNY 20,000-200,000; US\$2,900-29,000). Where the amount of deposits is relatively large or other serious circumstances exist, the offender could face sentence up to 10 years, plus a fine (CNY 50,000-500,000; US\$7,257-72,570).

The purpose of these penalties is to penalise individuals and corporates who conduct deposit-taking businesses without a financial licence from the China Banking Regulation Commission, the banking watchdog. The major distinction between private financing and illegal deposit-taking depends on whether the borrower approaches potential investors in a public way or not. If the borrower solicits funds from a large number of unspecific people, such as making advertisements in newspapers, billboards, websites, text messages, and social networking, this will constitute the offence. Therefore, businesses in China that would like to borrow funds from private investors should avoid advertising in public, as private lending has to be done in a “private” way.

Moreover, borrowers have to be cautious about the offence of “fraudulent fundraising”, as over the past few years many Chinese entrepreneurs have been put behind bars owing to this offence.⁵⁶ Whoever, for the purpose of illegal possession, raises funds by fraudulent methods, if the amount involved is relatively large, will face criminal detention or a fixed-term sentence up to five years, plus a fine (CNY 20,000-200,000; US\$2,900-29,000); if the amount involved is enormous or other serious circumstances exist, it will face sentence up to 10 years, plus a fine (CNY 50,000-500,000; US\$7,257-72,570); if the amount involved is particularly great or other particularly serious circumstances exist, it will face

⁵⁴ Data Source: Wenzhou Private Financing Index Official Website, <http://www.wzpfi.gov.cn> [Accessed 2 March 2018].

⁵⁵ PRC Criminal Law 1997 art.176.

⁵⁶ PRC Criminal Law 1997 art.192.

sentence up to life imprisonment, plus a fine (CNY 50,000-500,000; US\$7,257-72,570).

In practice, if the borrower has a real intention to borrow money to finance its business venture, the relevant lending agreement will not constitute a criminal offence, even if the borrower defaults in the future. Conversely, if the borrower intends to illegally possess the money when it borrows the funds, this will be considered as a fraud. However, it remains a challenging task for Chinese judges to ascertain the borrower's real intention when borrowing money, so in many cases they just presume that borrowers owing large sums of money to several investors are fraudsters, if they fail to repay loans on time. Clearly, the offence of "fraudulent fundraising" has raised a lot of controversy owing to its vagueness. For instance, in *R v Wu Ying* (2009) ZJJH, Ms Wu Ying was a young multi-millionaire in Zhejiang Province, who was sentenced to death because of defrauding CNY 770 million (US\$111.8 million) from 11 people, with unreasonably high interest rates being promised.⁵⁷ This case triggered a public debate in China, as many people including legal experts did not consider Wu as a criminal, since what she did is no more than informal financing, or private lending without banks.⁵⁸ Finally, the Supreme Court ordered a re-trial for this case, and Wu's life was saved.

Further compliance issues

Some regional governments require private loans meeting certain standards to be registered with local financial authorities. Therefore, lending parties and their legal consultants have to check with local financial authorities about detailed compliance requirements. For example, in Wenzhou, there is a piece of local financial regulation entitled "Wenzhou Private Financing Regulation 2014".⁵⁹ 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. Any of the following situations have to be reported:

- a single private loan worth more than CNY 3 million (US\$435,400);
- the borrower's total loan balance of private lending exceeds CNY 10 million (US\$1.45 million);
- the borrower borrows money from more than 30 individuals and/or enterprises.⁶⁰

For the rest of private lending transactions, lenders and borrowers are encouraged to file their loans with the authority on a voluntary basis.⁶¹ Although the duty of reporting rests on the borrower, the lender has the responsibility to supervise the borrower in doing this and is entitled to register loans if the borrower fails to do so.⁶² If there are any major changes to the lending agreement concerning the lending amount, the loan period, or the interest rate, the borrower must report the relevant

⁵⁷ The first instance of *R v Wu Ying* (2009) was heard by Zhejiang Province Jinhua City Intermediate Court. The appeal case, or second instance, was heard by Zhejiang Province High Court.

⁵⁸ Martin Yip, "Death for Fraud: China Debates Wu Ying's Sentence" (24 February 2012), *BBC News*, <http://www.bbc.co.uk/news/world-asia-china-17071311> [Accessed 2 March 2018].

⁵⁹ Wenzhou Private Financing Regulation (2014) was passed at the 6th meeting of the standing committee of the 12th Zhejiang Provincial People's Congress on 22 November 2013, and came into effect on 1 March 2014.

⁶⁰ Wenzhou Private Financing Regulation (2014) art.14(1).

⁶¹ Wenzhou Private Financing Regulation (2014) art.14(4).

⁶² Wenzhou Private Financing Regulation (2014) art.14(3).

changes to the regulator within 15 days.⁶³ Besides, the private lending regulator in Wenzhou has established an online recording system to make it convenient for debtors and creditors to register lending contracts. Borrowers need to register an online account, complete the application form and upload relevant documents. After that, the lending transaction will be verified and recorded by lending service centres. Clearly, the online reporting system is favourable to lots of businessmen and women, as nowadays more than 50 per cent of private loans related to project financing have been recorded via the online system.⁶⁴

Failing to comply with the reporting requirement will lead to administrative penalties. If the borrower in a private lending agreement does not fulfil the reporting obligation or provides false material, the local financial authority will order the borrower to correct the wrongdoing within a specified time-limit. If the borrower does not make any correction within that period, the private lending activity will be publicised, and the borrower, if it is a natural person, will be fined CNY 10,000-50,000 (US\$1,450-7,250) for an individual, or CNY 30,000-100,000 (US\$4,350-14,500) if the borrower is a enterprise or other organisation.⁶⁵

Conclusion

Over the past few years, the Chinese authority has gradually admitted the legitimacy of private lending as a financing method for Chinese businesses. Therefore, businesses in need of funds can utilise private lending agreements to borrow funds from private investors. When doing this, corporate managers and legal consultants have to ensure that their lending agreements are compliant with provisions under the PRC Contract Law as well as rules contained in Provision 18, in particular the latest “24/36” interest rate cap. Moreover, lending parties should try to avoid illegal lending practices such as advertising the financing need to the public and using funds for other purposes not stated in the contract. Currently, there are over 1 million private lending-related civil cases received by Chinese courts each year, which could be a potential source of business opportunities for commercial lawyers. Clearly, this massive shadow banking sector merits more attention from legal practitioners and scholars.

⁶³ Wenzhou Private Financing Regulation Implementation Rules (2014) art.13.

⁶⁴ “Outstanding Results for Wenzhou Private Financing Regulation” (5 March 2015), *Wenzhou Business Online*, <http://finance.66wz.com/system/2015/03/05/104372334.shtml> [Accessed 2 March 2018].

⁶⁵ Wenzhou Private Financing Regulation (2014) art.41.