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Institutionalizing Informal Finance in China: Status and Outlook

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Informal finance, also known as private finance, refers to financial activities and services associated with underground banks and organizations which operate beyond the scope of formal financial institutions. Together with off-balance sheet activities and non-banking lending (e.g. Wealth Management Products), informal finance constitutes what is commonly termed 'shadow banking.' In contrast to formal financial institutions which lend money at low interest rates primarily to firms in public sectors in China, informal financial institutions serve to ease financial troubles of private enterprises that received little or no benefit from government policies and thus have poorer access to finance. Since the mid 2000's when usury lending activities by underground banks began to emerge as a significant issue in society, tackling the issues associated with informal finance took on great importance because it caused financial difficulties to many small and medium-sized companies in China.

Given these circumstances, the Chinese government began to allow establishment of various new types of financial institutions (i.e. small-sum loan companies, community banks and private-sector banks) in the late 2000s in order to institutionalize informal finance.

First, the Chinese government established a new system for small-sum loan companies in 2008, allowing natural persons to set up small-sum loan companies which can mobilize and manage funds. The number of small-sum loan companies increased from 1,940 in June 2010 to 8,394 in June 2014. During the same period, the amount of loans also grew 62.9 percent per annum from RMB 125 billion to RMB 881 billion. Given that lending by financial institutions as a whole grew at an annual average rate of 14 percent from the end of 2010 to November 2014, lending by small-sum loan companies had grown 4.5 times faster than that of the financial institutions in general. However, small-sum loan companies have their limitations in satisfying the financial needs of local private companies, and they frequently experience fund shortages since they are prohibited from taking deposits. In recognizing these difficulties, the Chinese government announced measures in 2009 to allow small-sum loan companies to become community banks which perform lending and at the same time take deposits. Due to strict standards involved, however, there is not a single successful case of transformation of a small-sum loan company into a community bank to date.

Second, China laid the regulatory foundation for community banks. Community banks are financial institutions offering banking services to local farmers and companies. Since 2008 when the first community bank was founded, the number of community banks in operation has grown to 823 as of May 2014. Community banks, however, has a precondition which requires a state-owned commercial bank to participate as the initiator and the largest shareholder. In other words, no purely private financial institution is allowed to set up a community bank on its own.

Third, the Chinese government allowed the foundation of fully private banks on a trial basis in March 2014. As a requirement for setting up a private bank, the Chinese government stipulated that at least two private capital entities shall participate as the initiator. When one carefully examines the private companies approved as initiators, one can easily see they are all large companies. For example, Alibaba is the largest online shopping mall in China and Tencent is the largest internet portal in China. A close observation of the shareholder composition of Webank, which began pilot operations in December 2014, reveals that key initiators – i.e. Tencent, BaiYeYuan, and the LiYe Group, hold 70 percent of the total shares, while the remaining 7 firms own 30 percent. Most of the shareholders are investment firms and not a single private financial institution, such as a community bank, owns a share. This may be an inevitable consequence of selecting companies based on their ability to cope with all potential risks that may arise in the process of setting up and operating a private bank. However, this also can be interpreted as ruling out the possibility of allowing transformation of an informal financial institution into a formal one through the development process that begins with a 'Small-sum Loan Company', followed by a 'Community Bank' and ultimately a 'Private Bank.'

Given the aforementioned instances, China has yet to implement radical measures to incorporate informal finance into formal financial system, which meant that progress in terms of institutionalizing informal finance has been slow. Fundamentally, such slow progress is attributable to lukewarm reform efforts on the part of the Chinese government. The Chinese government claims that the ultimate goal of institutionalizing informal finance is to develop SMEs. But the actual facts indicate that institutionalizing informal finance is neither the top priority nor a sole option in meeting the financial needs of SMEs.

First, development and growth among private companies in China have been significantly greater when compared to the 1990s and there are many private companies who can utilize equity capital or have the capability to reinvest through various financing means at home and abroad. As a result, the share of fixed asset investment by the private sector which consists of private enterprises and self-employed individuals has gone up from 22.2 percent in 2006 to 29.9 percent in 2013. On the other hand, the share of investment by state-owned and collective-owned enterprises declined from 33.2 percent to 27.6 percent during the same period.

Second, formal financial institutions are extending loans to SMEs. The share of loans to large companies fell from 43 percent in 2009 to 35.5 percent in 2014. Meanwhile, the share of loans to SMEs is trending upward. Lending to small companies, in particular, rose from 21.2 percent to 29.3 percent during the same period. Therefore there is little incentive for the Chinese government to urgently institutionalize private finance so as to ease the credit crunch of SMEs.

Given the 35-year history of Chinese reform and liberalization, Chinese government's effort to institutionalize informal finance is a relatively recent one and therefore it is too early to fully assess the outcome. However, reforming the financial system to institutionalize informal finance has been slower than expected and considering the Chinese government's lack of initiative, it is difficult to expect that the reform efforts will gain momentum in the near future. This brings us to the conclusion that there is still much to be done in terms of institutionalizing informal finance in China. KIEP