

Shadow Bankers Vanishing Act Leaves China Victims Crying ‘Scam’

By Luo Jun • Bloomberg News

September 13, 2012 – To live out his retirement years, He Zhongkui was counting on steady income from an investment that promised interest payments five times higher than what he could earn in a Chinese bank.

Now He, a 62-year-old former municipal official in Wenzhou who rides a rusty bicycle, is cutting back on food and gasoline, having found himself one of a growing number of victims of China’s nebulous world of shadow banking. A “friend,” who he said had been paying him 2,400 yuan (\$379) a month after He gave him one-third of his 600,000-yuan life savings to invest in real estate, suddenly disappeared. So did the payments and principal.

“I called, but the number was no longer in existence,” said He, who worked for the Water Resources Bureau in Wenzhou, a city of 9 million people on China’s east coast. “I went to his home, but nobody was there. “I was even invited to his daughter’s wedding, for heaven’s sake. It was all a scam.”

China’s slowest economic growth in three years and a slumping property market, where many so-called shadow-banking investments are parked, are squeezing millions of Chinese who have invested the money of friends and acquaintances chasing higher yields to honor those payments. The slowdown also is putting pressure on the government to rein in private lending to avoid a spate of defaults that could increase the number of victims and lead to social unrest.

Suicide, Bankruptcy

The shadow bankers are now disappearing, committing suicide or reneging on agreements, leaving thousands of victims in their wake. In the first half of the year, more than 58,000 lawsuits



Pedestrians and shoppers walk down Wu Ma Jie, or Five Horses Street, in Wenzhou, Zhejiang Province, China.

Photographer: Qilai Shen/Bloomberg

involving disputes over 28.4 billion yuan in private lending were filed in Zhejiang province, where Wenzhou is located, up 27 percent from the same period in 2011 and the most in five years, according to the provincial supreme court. One-fifth of the cases were in Wenzhou, where authorities have set up a special court to handle the surge.

Private-lending victims nationwide filed more than 600,000 lawsuits valued at 110 billion yuan in 2011, an increase of 38 percent from the previous year. In the first half of 2012, the number of filings rose 25 percent to 376,000, according to People’s Court, a newspaper run by China’s Supreme Court.

In Wenzhou, an export hub where almost 90 percent of families have taken part in underground lending, more than 100 people have fled, committed suicide or declared bankruptcy since August 2011, and at least 800 lending brokers have gone bankrupt, Xinhua News Agency reported in May. Home prices there declined 16 percent in July compared with a year

earlier, the fifth consecutive monthly decline, according to the National Bureau of Statistics of China.

Payback Time

“It’s time for payback for the unchecked growth of China’s shadow-banking activity,” said Yao Wei, a Hong Kong-based economist at Societe Generale SA, who estimates that as much as 2 trillion yuan of underground lending may default eventually. “The risks are culminating, and part of the system is doomed to collapse. On the flip side, this gives policy makers an opportunity to put in place oversight for a sector that should have been regulated a long time ago.”

A trial project in Wenzhou, first mentioned by Premier Wen Jiabao and designed to ease funding for small companies and monitor underground financing, was announced in March.

Private lending between Chinese individuals is believed to be worth \$1.3 trillion, according to Boston-based research firm IHS Global Insight, the equivalent of the 2011 U.S. federal budget deficit. Interest rates can reach as high as 100 percent.

Banks Pinched

The lending is part of a shadow-banking system that also includes the off-balance-sheet business of banks and trust companies and totals as much as \$2.4 trillion, about one-third of China’s official loan market, according to estimates by Societe Generale. Shadow banking is prevalent in China because more than 90 percent of the nation’s 42 million small businesses are unable to get bank loans, while such investments offer returns at least several times higher than deposits.

China’s economy grew 7.6 percent in the second quarter, the slowest pace since 2009. Barclays Plc, Deutsche Bank AG and Bank of America Corp. last month cut their forecasts for third- quarter growth, while UBS AG and ING Groep NV on Sept. 7 lowered forecasts for expansion this year to 7.5 percent.



Buildings stand in the Lucheng District of Wenzhou, Zhejiang Province, China
Photographer: Qilai Shen/Bloomberg

Banks also are feeling the pinch. The industry’s nonperforming loans increased for three consecutive quarters through June to 456.4 billion yuan, the longest streak of deterioration in eight years, according to the China Banking Regulatory Commission.

Loans overdue more than one day jumped 27 percent in the first half at the nation’s five largest lenders, including Industrial & Commercial Bank of China Ltd., the country’s biggest, and Bank of Communications Co., according to data compiled by Bloomberg based on semi-annual earnings statements.

Bad Debt

Lenders in Wenzhou, sometimes called the epicenter of China’s private economy, have been hardest hit, as bad debt at the city’s banks more than doubled in the first half to 18.1 billion yuan.

Zhou Dewen, head of the Wenzhou Small and Medium-Sized Enterprises Development Association, estimated that the city has about 800 billion yuan of idled private capital as investors have become wary following the rise in defaults. The value of private lending fell by a one-third to about 80 billion yuan in the first six months of the year, he said. Average borrowing costs dropped to 21.6 percent in April, down from 25.5 percent in August 2011, according to the local central bank.



Scores of factory workers cycle home after working at Baotou Iron and Steel in Baotou, Inner Mongolia.

Photographer: Natalie Behring-Chisholm/Bloomberg

Spreading Gloom

The gloom has spread as far away as Baotou in Inner Mongolia, a region in northern China known for its rich resources of coal, iron ore and rare-earth metals.

Wei Gang, who owns the largest property developer in the city, hung himself at a hotel in June after amassing about 700 million yuan of debt, twice the assets he controlled, the National Business Daily reported. Wei promised an interest rate of more than 5 percent a month to his lenders, most of whom had borrowed money from others at a monthly rate of 2 percent to 3 percent, the paper said.

About one in 10 households in Baotou, a city of 2.5 million people, still have savings in the underground banking system, earning 1 percent to 1.5 percent a month, according to Ma Weimin, deputy head of the Baotou Federation of Industry & Commerce. That's half of what they earned when China experienced a credit crunch eight months ago. The total amount in shadow banking in Baotou is about 30 billion yuan, or 25 percent of the city's official loan market, he said.

'Abysmal Point'

"Private lending has hit an abysmal point because the trust is gone," said Zhou. "The difficulties faced by small businesses have never been greater after their only access to funding is now shut to them. I hope this is temporary."

Another Wenzhou shadow-banking victim, Mao Renye, said he took out a 700,000 yuan bank loan last year at 10.8 percent annual interest, using his home as collateral, to help his son's struggling clothing business. Enticed by a 36 percent interest rate promised by a city resident who ran a nationwide pharmacy chain, the 69-year-old former farmer-turned-businessman said he invested 550,000 yuan, only to find that the borrower's company was on the brink of bankruptcy and dozens of creditors were chasing him for repayment. Mao didn't get any money back.

"They claimed that it's as safe as banks," he said in a phone interview. "I can only blame myself for being greedy."

The nightmare didn't end there. As his bank loan matured in October, Mao had to borrow from friends, relatives and loan sharks to pay back the debt so his home wouldn't be seized. Now he's seeking to sell his 2 million-yuan home to pay off his borrowings. No buyer has shown interest, he said.

Unusual Greeting

In Erdos, about 150 kilometers (93 miles) south of Baotou, 80 percent of housing-construction projects are halted after home prices tumbled to 3,000 yuan per square meter from a record 20,000 yuan per square meter, *Caijing* magazine reported Sept. 3. The biggest source of funds was private lending, and as defaults surged this year people began greeting each other by asking how much savings they were able to retrieve from their shadow-banking investments, the report said.

The Chinese government has been stepping up efforts to regulate underground lending and guide private capital toward serving the economy instead of speculating on real estate and commodities. Since the State Council, China's cabinet, selected Wenzhou for a trial program in March, it has allowed the nation's private investors into some state-controlled strategic

industries, including health care, railways, telecommunications, water resources and banking.

Deposit Flight

The central bank in June gave banks more freedom over pricing by allowing them to pay 1.1 times the benchmark deposit rate of 3 percent annually to retain savers.

Still, households and families nationwide withdrew 500.6 billion yuan of saving from banks in July, or 0.6 percent of the total. Chinese savers seeking higher returns have triggered swings in deposits during the past year as they've shifted funds among savings accounts, higher-yielding wealth-management products and shadow-banking investments.

About 619 million yuan of capital has been registered at the Wenzhou Private Lending Registration Center, which was set up in April to help control shadow lending by matching individuals holding excess capital with small businesses in need of funds. As of July, less than 10 percent of that was loaned out, even with collateral, according to the city government.

While China's savings rate of more than 50 percent of gross domestic product is the highest among major economies, exceeding India's 34 percent and 12 percent in the U.S., according to a June 2010 Bank for International Settlements report, people have few legitimate investment options for their deposits.

Inadequate Pensions

Retirees such as He can't take advantage of annuities, IRAs or other such products to derive income in their old age. China's pension program, like Social Security in the U.S., typically provides payments that don't meet monthly expenses.

The nation's stock market also is lackluster, and the bond market is largely off-limits to individual investors. The Shanghai Composite Index has declined 3.3 percent this year after losing 14 percent in 2010 and 22 percent in 2011.

"There isn't much the government can do, as

it's ultimately about higher returns," Baotou Federation's Ma said in a telephone interview. "There is nothing wrong with private lending itself, because it has helped so many small enterprises and made many families better off. The problem is you need a real viable business that can generate enough profit to pay off the debt. That's not the case for most borrowers now."

Profit Declines

Net income in the first half declined from the same period last year for almost 50 percent of China's more than 2,300 publicly traded companies that have announced results so far, the Nanfang Daily reported this month, citing data supplier Hexin Flush Information Network Co. In the southern province of Guangdong, about 22 percent of industrial firms had losses through June, according to the provincial statistics bureau.

Only 30 percent of the funds in Wenzhou's shadow-banking market have gone to finance small companies, while 60 percent went to property speculation and re-lending, pushing up the cost of funds by end-users, the Wenzhou branch of People's Bank of China said last year. The city's economy expanded 5 percent in the first half, the slowest in three years.

In Baotou, most families' underground money is channeled through informal lenders to cash-strapped real estate developers unable to get loans from banks, Ma said. The city sold less than one-third of the apartments it built in 2011, leaving it with 30 million square meters of unsold properties, according to Ma.

Starving Developers

"The central government for a couple of years has been trying to starve property developers, in particular, for credit," said Charlene Chu, a Beijing-based senior director of financial institutions at Fitch Ratings. "But the fact that the property developers are alive is because we've had so many informal channels behind the scenes that the government does not have as much influence

over extending money to these institutions.”

Private lending is legal as long as borrowing and investing are voluntary and the interest rate doesn't exceed the ceiling imposed by law, currently 24 percent.

“There are some people who have very high risk appetite,” Chu said. “But ultimately, it does lead to a question of what if that doesn't get repaid? Is the government really willing for those people to take losses? We don't know really.”

Not everybody is spooked by the risks of shadow banking. Jennifer Ji, 33, a sales manager in Shanghai, has been earning 1 percent monthly interest on her family's 400,000 yuan of savings since late 2010 by entrusting the money with a friend of her sister-in-law's in Ningbo, 160 kilometers south of Shanghai.

After she transferred the money via her bank account, Ji received an IOU with the amount, the monthly interest rate and the signature of the borrower – a document recognized in China's courts in case of dispute. She didn't ask how the money would be invested.

‘Sounds Scary’

“It sounds scary at the beginning, but then I found it's common in many places, and my sister-in-law has been doing it for a long time,” said Ji, who supports a 2-year-old son and a paralyzed father. “I'm counting on the money. They've never

missed a payment, and my money is protected by law.”

Ningbo was the site of the latest reported suicide, when a businessman from a town south of the city killed himself at a hotel on Sept. 3, according to a news portal run by the local branch of the Communist Party. Police said a preliminary investigation indicated that the man ran a company with 6 million yuan in revenue. He took his life after a separate private-lending business failed, leaving debts of 27 million yuan and owing employees about 2 million yuan in wages, the report said.

After at least a dozen trips to Pingyang, where He's borrower lived, and almost a year chasing claims in court, He received 40,000 yuan of the man's leftover assets seized by authorities. It was about 20 percent of his total investment.

“I should have asked for collateral, but then I thought we knew each other for so long,” said He, adding that his hair had turned completely gray during the ordeal.

“I have learned a lesson with blood and tears,” he said. “I will never lend my hard-earned money to anyone.”

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