

## Reflections on perfecting China's folk financial system

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**ABSTRACT:** Folk finance has experienced a long history of development in China, and the state has gradually standardized its policy from the initial suppression. Folk finance plays an important role in promoting economic growth and increasing the main income of small and medium-sized enterprises and farmers. However, it is not fully incorporated into the national financial supervision system, so the folk finance is lack of standardization in the development process in China. Therefore, based on Marx's theory of interest-bearing capital, with a "runway incident in Wenzhou as an entry point, this paper reflects the lessons in China's folk financial development process, accumulates experience in China's folk financial development process, and learns from the experience in the international folk financial development, in order to guide the healthy development of China's folk finance.

**Keywords:** theory of interest-bearing capital; folk finance; problems; experience

### 1 MARX'S THEORY OF INTEREST-BEARING CAPITAL

Marx's theory of interest-bearing capital provides an important theoretical basis for the research of folk financial system. The interest-bearing capital generally exists in the form of monetary capital. In Volume 3 of *Capital*, Marx writes: "the use value of currency is just converting to capital and producing profits. In terms of its property, as the means of producing profits, it becomes a commodity, a special commodity." Different from the general commodity, its use value itself is the value. It transfers "the ability to produce the average profit", which is also "expressed as the capital's ability to produce value and increase value".

The main source of folk lending capital is as follows: the first is the part of income used for consumption, that is, in a certain period before the consumption, as a bank deposit or cash, it is manifested as the accumulation of lending capital. The main source is that a part of the monetary capital dissociates out from the cycle process due to the decline in the price of production factors; after the completion of a series of transactions by commodity capitalists, the business is temporarily interrupted, and then new transactions can be done again after a certain period, so that the achieved currency can dissociate out from the capital cycle and

convert into the lending capital. With the development of credit relations, it accelerates the concentration of all kinds of idle funds in society by the enterprises, thus exceeding the concentration limitations of the existing capital, making the expansion of a single capital have a broader capital source, and greatly promoting the development of folk lending activities.

The source of lending capital accumulation is interest. Interest is the result of the development of the reproduction process, just a deduction of the surplus value squeezed by the capitalists who are engaged in reproduction. Its movement is "G-G-W-G'-G". In the chapter of "interest and main income of enterprise", Marx writes: for the productive capitalist who are engaged in business with the borrowed capital, the total profit is divided into two parts: interest and balance that is more than interest. He must pay the former to the lender, while the latter forms a part of his profits." It indicates the rationality of payment for loan interest and limit of interest rate.

### 2 CONCEPT OF FOLK FINANCE

Domestic and foreign researches on the folk finance have a long history, and the concept of folk finance has been controversial, which has not yet reached a unanimous definition. In foreign countries, folk finance is defined as informal finance, which refers to a

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financial behavior that is dissociated on the edge of the existing rules and regulations and exists outside the financial activities that are approved and supervised by the government. The domestic academic circles also define informal finance as folk finance. Tan Ruyong divides the financial system into two parts: the one is formal, registered, controlled and recorded part, which is called as formal finance, and regulated by the national financial institutions; the other is informal, unregistered, unregulated and unrecorded part, which is called as an informal part, and called as informal finance, but not regulated by the national financial institutions.<sup>1</sup> In the work - *Research on China's Folk Finance*, written by a domestic expert, Jiang Xuzhao, folk finance is defined as a funds movement in all non-public ownership elements of the folk economic financing. In *China Regional Financial Operation Report in 2004* published by the People's Bank of China in 2005, the name of China's folk finance is rectified in the form of a column: relative to the financial institutions approved by the State in accordance with the laws, folk finance refers to the value transfer and principal and interest payment between the natural persons of non-financial institutions, enterprises and other economic entities with the monetary capital as an object.

### 3 EVOLUTION OF CHINA'S FOLK FINANCIAL POLICY

The development of China's folk finance has experienced the process of being suppressed by the government under the "underground" and "illegal" state in the early period, and then being gradually recognized by the government, and developed in a standardized way. Therefore, China's folk financial policy also manifests two stages - opposition and support.

#### 3.1 Reorganization stage

In the 1990s, since China's folk financial order was in a chaos, the central government adopted the suppression policy, and aimed at limiting its development. Relevant laws and regulations are as follows:

On September 8, 1997, the People's Bank of China issued an Emergency Notice Concerning Prohibition of Arbitrarily Approval for Establishment of Financial Institutions and Illegal Transaction of Financial Business. In 1998, the State Council promulgated the Measures for the Restriction of Illegal Financial Institutions and Illegal Financial Business Activities and the Notice of the General Office of the State Council on the Reorganization of Capital Raising and Approval for Establishment of Financial Institutions and Im-

plementation of the Financial Business of the People's Bank of China. On January 27, 1999, the People's Bank of China issued the Notice of Relevant Issues Concerning the Restriction of Illegal Financial Institutions and Illegal Financial Business Activities, and further clarified some problems in the implementation of the Measures for the Restriction of Illegal Financial Institutions and Illegal Financial Business Activities promulgated by the State Council by some of the branches.

#### 3.2 Standardization and guiding stage

In the 21<sup>st</sup> century, with the accelerated pace of financial reform, the central government's attitude towards folk finance has converted from suppression to standardization and guiding:

In 2006, the China Banking Regulatory Commission (CBRC) issued the Several Opinions on Adjusting and Enlarging the Access Policy of Banking Financial Institutions in Rural Areas to Better Support the Construction of New Socialist Countryside. In early 2007, CBRC respectively issued the Interim Provisions on the Administration of Rural Loan Society and the Standard Construction of Rural Loan Society. In March 2007, the People's Bank of China set up a research group based on the Legislation Research of the People's Republic of China on the Regulations of Lender. On May 4, 2008, CBRC and the central bank issued the Guiding Opinions on Pilot Project of Small Loan Company. On June 12, 2009, CBRC issued the Interim Provisions on Restructuring and Establishment of Village Bank by Small Loan Company. On July 23, 2009, CBRC issued the Overall Work Arrangement of New Rural Financial Institutions in 2009 to 2011. On March 8, 2010, approved by the State Council, the China Banking Regulatory Commission, the National Development and Reform Commission, Ministry of Industry and Information Technology, Ministry of Finance, Ministry of Commerce, the People's Bank of China and the State Administration of Industry and Commerce jointly issued an Interim Measures for Management of Financing Guarantee Corporate. On May 7, 2010, the State Council promulgated Several Opinions of the State Council on Encouraging and Guiding the Healthy Development of Private Investment. On May 26, 2012, CBRC issued the Implementation Opinions of CBRC on Encouraging and Guiding Folk Capital into Banking Industry. On August 14, 2015, the Legislative Affairs Office of the State Council published the Non-deposit Lending Organization Rules (Draft for Comment), and also published the Financing Guarantee Company Management Regulations (Draft for Comment) in the same day. The publication of the above documents marks the determination of China's management layer to regulate the development of non-deposit organization.

<sup>1</sup> Tan Ruyong. 2000. *Financial Development and China's Financial Development*, Beijing: China Economic Publishing House, pp: 9.

#### 4 PROBLEMS IN THE PROCESS OF CHINA'S FOLK FINANCIAL DEVELOPMENT

A recent survey of the Supreme People's Court showed that, a coefficient of correlation between the number of China's folk lending cases and the size of GDP in provinces and cities was 0.75. In 2011, the folk lending cases in Zhejiang Province where GDP ranked the fourth nationwide ranked the first nationwide.<sup>2</sup> In 2012, in Wenzhou City, the courts accepted a total of more than 18,000 folk lending cases, with the subject amount of CNY 21.9 billion; in 2013, the courts accepted a total of more than 16,000 folk lending cases, with the subject amount of CNY 18 billion.<sup>3</sup> Due to the lack of standardization of the folk lending, there is a great vulnerability in the folk financial development process.

##### 4.1 *Folk financial intermediary inducing folk capital into the field of speculation contains vulnerability*

Since April 2011, the factory closed down, entrepreneurs ran away and other events have almost become daily news in Wenzhou, and the national debate caused by the case of Wu Ying has even made the folk finance become a national focus. In addition, the size of folk capital beyond imagination has casted Erdao into a city of legend, and later a large-scale runaway incident happened in this city.<sup>4</sup> The reason for outbreak of these risks in a centralized way was the pursuit of usury and even illegal fund-raising speculative activities by the folk capital. The traditional industrial development was weak, more and more folk capitals flowed to the real estate, financial markets and other speculative activities, and the increase in speculative demand stimulated the rise in lending rate. In 2011, the annual interest rate of folk lending even reached 30%, while the interest rate of bank lending was between 8% and 12%. In the period of relatively rapid economic growth and good enterprise operation benefit, the vulnerability of folk capital in the speculative field has been alleviated. However, once the economy went down, and there was a difficulty in the development of enterprises, the vulnerability of folk finance would break out in a centralized way after accumulation to a certain extent. In 2014, Huitong Guarantee Company - the largest folk guarantee enterprise in Sichuan suffered from capital chain cracked and executives fled abroad, followed by continuous outbreak of illegal absorption of public deposits and crime in Essence, Aobang, National Security and other more than ten well-known large-scale folk security companies, collapse of Fortune Union - the Southwest's largest

Investment and Financial Management Company. Frequent raised-funds chain broken and runaway news of the investment and financial management companies and guarantee companies, resulting in heavy losses to a large number of investors and increase in the group events. The reason is simply because the real economy goes down, and the risks of speculative funds in the real estate, financial markets and other capital-intensive industries increase, so that the financing body has to use high-interest loans, borrowing for repaying and other ways to make up for financing gaps, and it is prone to capital chain crack, bankruptcy or entrepreneur runaway, endangering financial security.

##### 4.2 *High leverage and capital maturity mismatch of the folk financial intermediary contains vulnerability*

The existence of folk finance mainly depends on the form of association, folk cooperation fund and so on. These intermediary organizations rely on their own credits to absorb idle folk funds, with the lack of system and legal protection, and lack of normative operation of the absorbed capital. In recent years, with prosperous development of small and medium-sized enterprises, financing problems have not been resolved in a reasonable manner. The existence of folk finance makes the small and medium-sized enterprises have the chance to reach purpose of fund mismatch for short-term lending and long-term use between the formal finance and folk finance. Due to its small size and large risks, the small and medium-sized enterprise usually obtains very few short-term loans from the formal financial institution. Obviously, such short-term loans are not sufficient for the demand of long-term operation of small and medium-sized enterprises for funds. Therefore, the enterprises usually return funds by lending a certain amount of folk capital upon expiration of short-term loans, so the short-term lending and long-term use becomes a common phenomenon, while the credit chain of the capital mismatch is extremely fragile. According to the statistics of the Finance Office in Wenzhou, in 2012, the proportion of short-term loans in bank loans is 40% of the national average level, while the proportion of short-term loans of the banking industry in Wenzhou in all new loans is up to 82%.<sup>5</sup> A high yield of on-lending model makes many guarantee companies, pawn shops and investment companies joined in the short-term, frequent and fast capital maturity mismatch. It solves the problem of cash flow turnover of small and medium-sized enterprises, but we have to admit that this model hides a large liquidity

<sup>2</sup> Tong Ji. Data analysis of folk lending cases tried by the national court in recent five years. *Legal Daily*, 2014-02-19 (9).

<sup>3</sup> Wang Chun. How does folk lending become "Sunshine Avenue". *Legal Daily*, 2014-03-03 (4).

<sup>4</sup> <http://www.ce-china.cn/article/1698.html>

<sup>5</sup> Anonymity. 2012. Research on financing of small and medium-sized enterprises in Wenzhou. Reform Experimental Area for Comprehensive Financial Reform in Wenzhou, Phase 77, Brief Report, December 25, 2012.

ty risk, and is prone to financial credit chain break. In the economic downturn period, due to the short-term loan financing difficulties to the bank financing, most of the small and medium-sized enterprises in Sichuan Province have to resort to security companies, small loan companies and other folk financing channels. High capital costs often lead to the enterprise collapse, and systemic risks of other financial institutions on the financing chain.

#### 4.3 *Non-normative nature of folk financial operation contains vulnerability*

At present, China's folk finance is still in the state of covert operation, and lack of supervision and protection of the corresponding legal systems. Therefore, only relying on an IOUs of folk lending fails to afford the function of contract rules and regulations that are necessary for the financial activities. Once there is credit risk, it is difficult for the folk finance to only rely on its own rules to protect the interests of investors. In 2011, in Wenzhou City, 48 financing guarantee companies have obtained a financing guarantee license issued by the Municipal Commission of Economy and Information Technology, and a lot of companies involved in folk financial lending have been canceled. By the end of 2013, only 36 companies can operate normally.

According to the statistics of CBRC in Sichuan, at present, there are four types of manifestations for non-normative business behavior in the folk financial operation in Sichuan, which are P2P that is not approved or filed by the financial management department, folk financing on behalf of the non-financing guarantee enterprises to carry out guarantee business, sale of financial products in the name of loan guarantee, or absorption of funds in the name of providing loan guarantee and so on, with an urgent need for the relevant departments to regulate and guide.

### 5 DOMESTIC AND FOREIGN EXPERIENCE AND POLICY SUGGESTIONS FOR IMPROVEMENT OF CHINA'S FOLK FINANCIAL SYSTEM

(1) An improved financial system is a basic condition for elimination of financial suppression and innovation of regulatory model

Taiwan's financial system is not sound, and the private economic services of small and medium-sized banks are relatively small, so that the emergence of folk financial expansion makes the financial market confusing. In the United States, there is a sound financial system and a high level of market, and the access and exit mechanism of small and medium-sized banks is healthy, which meets the financing needs of small and medium-sized enterprises, thus achieving the rap-

id development of folk finance. Thus, to incorporate informal finance into the formal financial system is a feasible, urgent and effective alternative solution. The key is to use formal financial markets to replace the folk financial markets, which will reduce the risks of folk finance. However, there is a need to first improve China's financial system, change the original concept and abandon the old financial suppression policy, in order to relax the corresponding control policies and control of the market access mechanism and interest rate policy, improve the market access and exit mechanism of the folk financing intermediaries, legitimacy provisions of the business scope and business behavior, promote the development of financial markets, and encourage the folk capital to establish innovative small and medium-sized financial institutions to serve for small and medium-sized economic entities. Only in this way, can we make the folk financial activities successfully enter the scope of the financial supervision and the formal financial system, thus basically controlling the risks faced by folk finance on the financial market. Secondly, there is a need to innovate supervision methods and speed up the change of supervision pattern, strengthen the management of capital adequacy ratio, asset quality and liquidity of the folk financing intermediaries, and effectively prevent and mitigate folk financing risks.

(2) Promoting interest rate marketization of folk finance is the core goal

Viewing from the domestic and foreign situations, the marketization of the loan interest rate is a major trend in the formal finance, quasi-formal finance or folk finance. According to the judicial interpretation of the Supreme People's Court in 1991, the maximum interest rate of folk lending shall not exceed four times the interest rate of similar loans in the bank. The interest in excessive parts is not protected by laws. The provision of "four times" needs to be further relaxed. For example, in the medium term, "the maximum interest rate shall not exceed six times and even eight times the interest rate of similar loans" shall be applicable, in order to provide the folk lending a looser policy and law environment. China's long-term abolition of interest rate ceiling of the folk lending is a development direction. Developed countries do not set up an interest rate ceiling of the folk lending, but tend to use the contract laws to regulate the behavior of the parties. High-interest folk lending is first a financial service, but it is possible to bring some negative social consequences, especially when the debtor is difficult to repay debts on time. Therefore, the abolition of interest rate ceiling of the folk lending needs to have a series of social policy mechanisms and legal mechanisms as its supporting measures.

(3) There is a need for policy support corresponding to folk finance

At present, China's micro-loan companies and pawn shops are troubled by many adverse factors, such as the lack of follow-up funds, small operating space and poor profitability. Especially when the demand for folk finance declines, policy support for these industries is particularly important. Policy support determines the future development trend of folk finance to a certain extent. The lack of policy support can only hinder the sunshine process of folk finance, which will be in the "underground" state for a long term and unable to "go up" and enter into the formal financial system. According to the statistics of credit guarantee associations of small and medium-sized enterprises in Sichuan Province, from 2007 to June 2015, ten thousands of entities have been served by the guarantee companies registered in Sichuan. As of the end of December 2013, Sichuan has had 509 financing guarantee companies, and the annual cumulative financing guarantee balance in Sichuan has reached CNY 233.84 billion, involving in 730,000 companies, ranking the second nationwide, and providing a great credit support for the development of small and medium-sized enterprises in Sichuan Province. Therefore, for the development of folk finance, we could not blindly curb and suppress, but should continue to improve, guide and support, which is a better way for the development of China's folk finance. Firstly, the government should appropriately relax the control of folk finance, reduce the high-cost and inefficient control activities of government departments, appropriately reduce the access conditions, and on the financial, promote capital flow, improve the efficiency of capital use and optimize the allocation of resources. Secondly, there is a need to establish a credit deposit insurance system and guarantee mechanism to prevent moral hazards. Finally, there is a need to develop a preferential tax policy and interest rate subsidy policy to promote the folk financial institutions to provide loans for rural farmers, and provide construction funds for some folk financial institutions with mutual assistance nature as much as possible. Similar policy support for the development of folk finance has been effectively verified in the United States, Bangladesh and Taiwan. Therefore, in the process of promoting China's folk financial development, to give some policy support for the folk finance is particularly urgent. Thirdly, there is a need to promote the credit service innovation of credit information institutions in an orderly manner, meet the needs of social multi-level, diversified and specialized credit service, and further expand the application for credit reports in the field of folk finance, promote the folk financial service platform and other credit information systems and authorized access to public credit information management system according to the law, in order to achieve information exchange and sharing.

(4) More initiatives are taken to strengthen guiding and standardization of folk finance

Firstly, there is a need to guide the investment direction of funds. Folk capital is manifested as the characteristic of profitability, gradually separate from the real economy, and keen on the "real estate speculation" and other "money brings money" games. For example, a "ghost town" in Kangbashen of Inner Mongolia is the result of "real estate speculation" with the folk capital. Therefore, there is a need to strengthen the guidance of folk funds by the government. On the one hand, the government can guide the folk capital to invest in construction projects that are in line with the national industrial policies and key support projects, such as some agricultural leading projects, and give some preferential tax policies for the benefits obtained from the investment in these funds; on the other hand, a certain size of enterprise is allowed to issue corporation bonds and privately raised bonds of small and medium-sized enterprises, guide folk capital to invest in the industrial production, and prevent "hollow" investment of funds. Secondly, there is a need to guide the interest rate. The interest rate of folk financial market is generally affected by the supply and demand of funds. China has not yet formed a market-oriented interest rate, and the state has a certain degree of control of the market interest rate, leading to deviation of the two interest rates, and affecting the implementation effect of the national interest rate policy. It requires that the state appropriately controls over the interest rates on the folk financial markets, expand the floating range of interest rates, and actively promote the reform of interest rate marketization, so that the two interest rates tend to be consistent. Moreover, there is a need to guide the operating mechanism. The folk lending activities are flexible and easy to operate, but there are many problems, such as incomplete lending procedures, informal loan contracts and so on, easily leading to financial risks. We should strengthen the supervision of folk lending activities, improve the lending procedures, standardize the operation process, and establish and improve the folk lending information registration center, so that the regulators can easily access the information of lending parties, in order to facilitate macro-control and promote the healthy development of the entire financial market. Finally, there is a need to guide the masses who participate in folk investment and financing, increase the investor risk education and law-related education of the masses, guide scientific and rational investment, offer risk tips and help the market entities and the public to establish a concept of preventing financial risks.

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