Efforts to Lower Maximum Legal Private Lending Interest Rates Need to Respect Market Rules[1]

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Abstract: On August 20, China's top court cut the upper limit on private lending interest rates protected by law, capping it at four times China's one-year LPR. The ceiling should not be lowered by too much too fast, though, reminds the author, stressing that private lending should also respect market rules. The main reasons behind high private lending rates are the high risks involved and the huge gap between money demands and supplies. If we forcefully repress the legal cap without solving the underlying problems, we would be holding back the development of private lending, which is not beneficial, if not detrimental, to meeting the financing demands of small- and micro-sized enterprises. Efforts to adjust the cap need to strike a balance between lowering financing costs for small- and micro-sized enterprises and energizing private lending.

On August 20, the Supreme People's Court of China issued *the newly revised Provisions on Several Issues Concerning the Application of Law in the Trial of Private Lending Cases* (the "Decision"), amending the judicial interpretations of private lending that were released and put into effect in 2015.

A highlight in the revision is the substantially slashed ceiling on private lending interest rates under judicial protection which is now set at four times China's one-year loan prime rate (LPR). The amendment replaced previous stipulations which permitted the courts to enforce the rights of borrowers or lenders based on

[1] This article first appeared in Chinese on CF40's Wechat blog on August 21.

whether the disputed interest rate fell into the ranges of below 24%, above 36%, or in between (commonly referred to as 'two lines and three zones based on 24% and 36%', see details hereinafter).

Private lending serves as an important supplement to formal financing channels. China has a large financial system, but structurally insufficient supply has been a prominent problem. For example, about half of the SMEs in UK have access to bank loans, while the proportion in China is merely one-fifth.

Private lending can satisfy part of the unfulfilled financing demands of SMEs, but could also incur huge risks because it has not been placed under the formal regulatory framework. Malicious defaults by borrowers are common, while it is no news that lenders seek to increase financing costs by all means, even through loan sharking. Therefore judicial intervention plays a crucial role, especially in cracking down on frauds and ensuring fair transactions.

According to the *Provisions of the Supreme People's Court on Several Issues Concerning the Application of Law in the Trial of Private Lending Cases*, where the annual interest rate agreed upon by the borrower and the lender does not exceed 24%, and the lender requests the borrower to pay interests at the agreed rate, the People's Court shall support the lender's request; where the annual interest rate agreed upon by both parties exceeds 36%, the agreed interests in excess of 36% shall be null and void, and if the borrower requests the lender to return that part of interest payment, the People's Court shall support the borrower's request.

The purpose of the above stipulations is to protect legitimate private lending while cracking down on usurious loans so that borrowers' rights and interests are secured, as loan sharking practices could provoke vicious debt cycles or even endanger **economic and social stability.**

However, it was widely complained recently that the ceiling of 24% is too high and should be slashed, because it would be hardly possible for most of the businesses in normal operations to bear such high financing costs.

Lowering the ceiling is a reasonable request and is in line with the policy goal of reducing costs of social financing. With the support of the regulatory authorities, the average loan interest rate for SMEs fell significantly in 2018 and 2019, going further down by 0.8 percentage points in the first half of 2020.

Lowering the judicially protected ceiling would help drive down the interest rate in private lending. Over the past half year, SMEs have been in deep trouble due to the pandemic's blow. Lowering the costs of private lending could support them to weather through and stabilize employment, the economy and the society.

However, the ceiling should not be lowered by too much or too fast. As part of the informal financial market, private lending should respect market rules. Efforts to adjust the cap on the interest rates need to strike a balance between lowering financing costs for SMEs and energizing private lending.

At the end of the day, a basic condition for the financial system to work soundly is market-based risk pricing. SMEs face great uncertainty in operations, are dispersedly located, have neither standard financial data nor required collaterals. As a result, banks have much difficulty in client acquisition and risk control when serving SMEs. High financing cost for these enterprises is a natural result and determined by market rules.

In the past, Chinese banks were not allowed to decide their loan interest rates on their own, and the lending rates could not cover the credit risks of SMEs. This has made financing for these businesses even harder. Over the past few years, regulators have required commercial banks to increase the proportion of loans to SMEs in their total lending while lowering the interest rates for them, which may prove to be ineffective or even counterproductive.

The legally-protected interest rate applies to private lending rather than commercial banks or bond markets. The rate seems high, but it actually respects the logic of the financial market.

First, borrowers are mostly those the banks are unwilling or unable to serve, it's only natural that interests on money lent to them should be set at a high level to reflect the risks.

Second, private lending is not covered by the current regulatory framework. The lenders cannot use the credit information system of the People's Bank of China to do their risk assessment nor can they have the liquidity support from the central bank. These borrowers bear much higher risks than financial institutions in the formal financial sector, so the lending rates they offer will have to cover the risk premium. That means the costs of private lending will be higher than bank loan rates even if both lenders are to serve the same SME clients.

Lastly, most loans in private lending are small in amounts, short in duration with many being emergency loans. For the lenders, if the interest rate is too low, they won't be able to cover the costs or make a profit. While for the borrowers, if the annualized interest rate is relatively high, the financing costs will still be acceptable because the borrowing period is rather short.

Over the past year, the composite interest rate for private lending in the city of Wenzhou has remained around 16%, about 2 percentage points lower than in the first half of 2016. A result of joint force of market activities and policy efforts, the rate decline shows that **the legally-protected interest rate cannot be slashed by too much because that would dissuade lenders from the private lending market and further widen the**

gap between demand for and supply of funds.

A reason behind the shadow banking boom in previous years is that shadow banks were free of the interest rate control that the traditional banking sector is subject to. In essence, their interest rates are totally market-based, which was why they could provide strong support for SMEs. Later, regulators took measures to bring off-sheet lending under supervision. The move was necessary in that it helped prevent against financial risks, but on the other side of the coin, **the flexibility of pricing associated with private lending is lost , exacerbating the financing difficulties faced by SMEs.**

Some say that setting the legally-protected interest rate too high would breed loan sharks and cause funds to turn away from the real economy. That is putting the cart before the horse, to say the least. **The main reason behind the high interest rate of private lending is the high risks involved and the huge gap between money demand and supply. If we forcefully repress the legal cap on interest rates without solving the underlying problems, the development of private lending could be held back, which is not beneficial, if not detrimental, to meeting the financing needs of SMEs.**

Finally, it's important to understand that the legally-protected interest rate is the ceiling, not the benchmark lending rate. Under this framework, there are a lot of cards to play to lower the level of private lending rates.

On one hand, easing monetary policies will help close the gap between money supply and demand, including that in the private lending market. This will drive down interest rates, including the rate of private lending.

On the other hand, the formal financial sector should make more efforts to improve financial inclusion, so as to relieve the financing pressure of SMEs in the private lending market and lower financing costs.

What these measures have in common is that they respect market rules. Only with this approach, can we lay the groundwork for further reduction of the legally-protected interest rate.

In summary, the Supreme People's Court's move to lower the ceiling on legally protected private lending interest rates will leave a positive impact on the sound development of the private lending market.