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A Study on the Development Status of Private Credit in China and Countermeasures Summary

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Absract: *With the increase in the number of small, medium and micro enterprises, the demand for private credit is also expanding. As an important form of private finance in China, the private credit business has to a certain extent made up for the lack of bank capital supply and is an indispensable driver of economic growth. However, there are also many problems with private credit, and failure to address these existing problems will pose a great threat to the existing capital market in China. It is therefore a matter of urgent research to identify the root causes of the problems of private credit, so that corresponding countermeasures can be put forward to solve them.Through the comparison and analysis of the current situation of private lending in China and abroad, this paper summarises the problems and the directions that can be learnt from private credit in China. By analysing the game-like income between private capital, banks and owners of SMEs, it is concluded that the main reason for the problems of the phenomenon of private lending in China is the adoption of a dual-track interest rate system. The dual-track interest rate system has created huge risks for SMEs and the market. Therefore, it is necessary to set standardised interest rates, reform and improve the financial system to fundamentally solve the problems in China's private credit and promote the healthy development of our economy and market.*

Keywords: *Private Credit; Interest Rate Marketisation; SMEs; Financial System*

1. Introduction

In recent years, private small and medium-sized enterprises have developed rapidly, and small and medium-sized enterprises need a lot of funds for the production and operation of enterprises. However, at the same time, objective factors such as poor market competitiveness of SMEs, low credit ratings, and backward equipment production lines of SMEs have caused the problem of financing difficulties for SMEs in formal financial institutions. The mismatch between supply and demand for SME financing has given rise to a new financing channel: private credit. Private credit has the advantages of simple procedures, fast financing speed, flexible loan term and diversified subjects, which provides strong support for the development of small and medium-sized enterprises in China. The development of private credit has not only been invested in enterprises, and the proportion of individuals or collectives using private credit has also increased year by year, but due to the imperfect supervision of national laws and regulations, the short development process, and the frequent occurrence of chaos in the development of private credit, which has become a major hidden danger in China's financial development. Therefore, it is necessary to provide relevant normative suggestions for the development of private credit to help small and medium-sized enterprises progress.

2. Current situation and problems in the development of private credit

2.1. The current development of private credit in China

2.1.1. Diversification of credit entities

Traditional private lending is mainly financed by private idle funds. It is mainly structured as an exchange of funds between relatives. It is usually a temporary turnover of funds carried out through channels such as referrals from relatives or acquaintances. However, as private credit continues to develop and demand grows, the institutions providing private credit are not only limited to this, but the subjects tend to diversify. Natural persons, commercial banks, private enterprises, pawnbrokers and private lending institutions are all providing and using private credit funds, and the growth in the number of private credit providers is an indication of the prosperity of the private credit market.

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2.1.2. Simplification and standardisation of credit procedures

In the days of traditional private credit, monetary credit transactions between acquaintances were usually carried out by means of IOUs and other commitments, with simple procedures but prone to defaults and bad debts. With the development of private credit, however, the diversification of credit entities and the inclusion of multiple institutions has made the process of securing private credit more standardised and simpler. Guarantees are usually in the form of mortgages, including pledges of cash equivalents, easily realisable financial assets and real estate. The standardisation of the guarantee process safeguards the security of both parties to the credit transaction.

2.1.3. Private credit funding in a triangular fashion

The private lending is triangular in shape, with most of the companies at the top being underground money changers, etc., whose interest rates also tend to be set at usurious rates; some private credit intermediaries in the middle, who absorb idle private funds and then lend them to SMEs in need; and retail investors at the bottom, who hold idle funds in their hands and usually lend them to familiar relatives, friends, etc.

2.2. Problems of private credit in China

2.2.1. Inadequate legal basis

The basis for the performance of private credit is trust, as private credit is primarily a lending transaction between acquaintances and trust is the foundation. Due to the lack of solvency reviews by formal financial institutions, the risk of bad debts in private credit is high and a crisis of trust occurs when there is a risk of uncollectable funds in private credit[1]. As for the risk of bad debts in private credit, there is no standardised and effective ex ante prevention mechanism and expost remediation mechanism. In terms of our current legislation, the legal provisions on the protection of private credit rights holders are rather limited. Although relevant laws have been introduced, the existing legal provisions are currently insufficient for the complex and realistic private credit market. Special provisions should be made for specific private credit events.

2.2.2. High interest rates on credit

Another major problem with private credit is the high interest rates on credit, as there are no uniform regulations on lending rates in the private credit market in China. Unlike formal financial institutions, which are regulated by the national financial system, interest rates for private lending are not the same and vary greatly from region to region and from one specific event to another[2]. The lending rate of social finance intermediaries is around 40%, the current interest rate for general social lending is around 18% and the lending rate of microfinance companies is close to 20 % . As most users of private credit have difficulty borrowing from banking institutions, the interest rates on private credit borrowing have been alienated in some areas into usurious lending in response to the urgent demand. The high interest rates of private lending attract a large amount of idle capital, but behind the high interest rates there is also a huge risk of a break in the capital chain, which is an important problem facing private credit in China[3].

2.2.3. Complex use of funds

Formal financial institutions are regulated by the state's financial institutions and are responsible for depositors' funds, thus focusing on the direction of the borrower's use of funds in the loan approval process[4]. Private credit, on the other hand, does not focus too much on the direction of use of funds, but more on the return on the use of funds. In the eastern coastal region, the type of private credit is mainly business-oriented private credit, mainly used for the turnover of funds for trade and commerce transactions; the type of private credit in the slightly less economically advanced regions such as Egan, Gan and Xiang is mainly productive private credit, mainly to meet the needs of living and production[5]. At the same time, the funds from private lending will also flow to industries such as real estate with higher returns, or even to highly polluting industries restricted by the national industry. The irregularity of the use of private credit funds may hinder the good development of our economy and lead to the problem of wasted capital in our capital market[6].

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3. Comparative analysis of the current state of development of foreign private credit

3.1. The development of private credit in major developed countries

3.1.1. Current status of private credit in the US

The United States, as the primary developed country, has a long and well-developed financial system, which is a favourable reference for the development of private credit in China. The United States has perfect laws and regulations on the development of private credit, mainly in the control of interest rates, which are mainly regulated in the Consumer Credit Protection Act enacted by the US Congress in the early days. The US private credit practice is based on a two-pronged approach of interest rate regulation and prevention of illegal means in order to regulate the good development of private credit.

The United States is currently experiencing rapid growth in consumer credit, with strong demand for private production and consumer lending[7]. The United States consumer credit currently has the following characteristics: 1. credit information system is perfect, for personal credit and credit rating management, lending institutions for personal credit rating to choose whether to lend, to a large extent to reduce the risk of credit; 2. the establishment of a legal system of credit services, the introduction of a number of regulations on credit services, to ensure that borrowers are not discriminated against because of external conditions; 3. loans and The combination of the insurance industry, the securitisation of loans, the collateralisation of loans in packages, etc., has led to the securitisation of loans and the reduction of their riskiness; 4. The use of credit products has been regulated to ensure the openness and transparency of information from credit institutions, but the illegal dissemination of consumer information has been eliminated.

3.1.2. Current status of private credit in Japan

Japan's economy was severely damaged after the Second World War and was in need of rehabilitation. In this context, the Japanese economy is loan-dependent due to the unstable and fragmented nature of its operations. In particular, Japanese small and medium-sized enterprises (SMEs) have the same problem of difficulty in obtaining financing, and the Japanese authorities have therefore introduced a number of policy measures: the legal construction of financial institutions of a mutual nature to increase support for SMEs from the ground up; the legal construction of the establishment of regional banks to favour individuals and SMEs in terms of policy bias and financial support; the legal construction of policy financial institutions, which are an important complement to private financial institutions, to provide SMEs with policy support and financial flow support.

Another feature of Japanese financial practice is the trend towards conglomerate operations. Japan has been affected by the US sub-prime crisis and the financial system is in urgent need of reform, with conglomerate characteristics evident[8]. The cross-shareholding and interconnectedness of private financial institutions has created close financial ties, which is conducive to competitiveness and risk prevention, and is a major trend in the future development of private lending institutions.

Another feature of the current state of financial practice in Japan is the law-based model of regional financial diversification, which emphasises national regional development to help SMEs. The diversification strategy of national regions, through strategic identification and functional zoning, which enables financial institutions to perform their respective roles and work together to provide support for the development of SMEs, is also an important inspiration for the future development of private credit in the country.

3.2. Learning and Insights

3.2.1. Regulating the setting of interest rates

In comparing the private credit practices in the US and Japan, it can be seen that both the US and Japan have regulated the interest rates on private credit. There are also many developed countries, such as Germany, which have also regulated the interest rates on private credit[9]. In some parts of the country, as there are no mandatory legal restrictions, the interest rates on private lending even reach 30%, with the risk of tending towards usury, which is a huge hidden danger to both the private credit market and the financial market in China[10]. Therefore, by drawing on the interest rate setting situation in developed countries, it is important for China to introduce relevant regulations to limit the interest rate and strictly prevent its trend towards usury.

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3.2.2. Improving the legal system

The US and Japan are among the developed countries where private credit has emerged earlier, and in the process of development, some problems have coincidentally emerged, such as high interest rates and high degree of liberalisation, and the government has actively introduced relevant regulations to address and improve the problems[11]. The relevant authorities in China should learn from the development experience of Europe and the United States and introduce a legal system to regulate the development of private credit in China in order to avoid the emergence of the same problems.

3.2.3. Optimising the development structure of private credit organisations

The conglomeration of non-bank institutions in Japan has also provided a new way of thinking for the development of private credit in China. At present, China's private credit institutions are relatively fragmented, usually with small-scale own registered capital, unevenly developed and risky. The conglomeration of Japanese private credit organisations can generate intra-corporate linkages through mutual shareholding, etc., thereby improving competitiveness and resisting risk, and is a good model for the development of the structure of private lending organisations in China[12]. Grouping allows for the divestment of non-performing capital through restructuring, while increasing its own competitiveness and market share and reducing the chances of possible risks.

4. Game theory analysis of the causes of private credit distress

4.1. Subjects of game analysis, strategy choice and interest analysis

4.1.1. The concept of a gaming subject

Banks, representing formal financial institutions. Banks raise funds for loans mainly by taking deposits, are regulated by government financial institutions and usually choose less risky borrowers in order to protect residents' deposits.

Private lending capital providers, representing informal financial institutions. The owners of private lending funds mainly by taking in private idle funds and providing loans to those in need of funds. The risk tolerance is high due to idle funds and the expectation of greater profitability.

SME borrowers, representing the demand side of private credit funding. Due to their own development constraints, they are unable to receive financial support from formal financial institutions and have to turn to private lending channels.

4.1.2. Strategic choice and interest analysis of game subjects

Banks are more comfortable lending to large state-owned institutions than to SMEs. This is because state-owned enterprises have larger assets and are backed by the government and have good solvency. Although the return on lending to SMEs is higher, the risk of lending is greater and jeopardises the stability of the banking institution, thus banks are more willing to lend to large state-owned enterprises, which have guaranteed solvency and greater stability, than to SMEs[13].

For private fund holders, there are three combinations of strategies: one is to deposit idle funds in banks; one is to invest idle funds in popular investment projects; and one is to provide private loans to small and medium-sized enterprises. The benefits of the three strategies are analysed as follows: private fund holders are generally reluctant to deposit their idle funds in banks because of the low interest rates on bank deposits and the fact that after a number of years of depositing idle funds in banks, their purchasing power will be significantly reduced compared to that of today, thus most private fund holders will not choose this strategy. The second is to invest idle funds in popular investment projects, such as investing in stocks, funds and real estate. Although equity funds offer higher returns, they are more risky and most inexperienced people find it difficult to ensure that their capital is not lost. Private fund holders also do not have a lot of confidence in them due to the choice of rational economic people. In contrast, private loans to SMEs are the optimal choice in comparison, as they offer higher and more profitable lending rates to maximise the return on idle capital, making the choice of private loans to SMEs the strategy of choice for private money holders.

For SME borrowers, there are usually two channels to finance the development of their enterprises: one is to borrow from formal financial institutions; the other is to borrow from private lending organisations[14]. Loans from formal financial institutions have lower interest rates and less capital pressure, but the scrutiny of formal financial institutions is more stringent, with strict requirements on

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their financial status and capital chain. Borrowing from private institutions, on the other hand, is simple and the funds can be made available quickly. Although the interest rate is relatively high, it saves time in financing and, in comparison, SME borrowers choose to borrow from private lending institutions.

4.2. Constructing a static game model

4.2.1. Game assumptions premise

The static game model is based on the following assumptions: the SME can repay the loan on time, regardless of the impact of factors other than revenue; the strategy is based on the above game context analysis, only two strategies are analysed, and the value of revenue is also based on the game context analysis; the game is a static game between two parties, there is no question of who is first and who is second; the problem of capital growth due to economic development is not considered.

4.2.2. Constructing a game model

The strategy of SMEs is to lend to banks or to private institutions, and the strategy of banks is to provide loans to SMEs or to large state-owned enterprises. The game payoff matrix is as follows:

When a commercial bank lends to an SME and the SME chooses to borrow from the bank but the bank does not lend, the bank gains 0. When the SME does not lend to the bank and the bank does not lend to the SME, the bank can lend to a large state-owned enterprise and gains 1. And when the bank lends to the SME and the SME does not lend, the bank can still lend to a large state-owned enterprise and gains 1(*Table1).* . And if the SME accepts the loan, the bank gains 2, more than if it lends to a state-owned enterprise.

Table1. SME-bank game

	Commercial Banks		
Small and medium-sized enterprises		Yes	No
	Yes	(2, 3)	(0, 2)
	No	(1, -1)	(1, 2)

The strategy of the private capital owners is to lend to the SME or to deposit the funds in the bank, and the strategy of the SME is to borrow from the private lender or from the bank. The game payoff matrix is as follows:

When private funds do not lend to SMEs, the benefit is 0 because SOEs usually do not absorb idle personal funds; when private funds lend to SMEs and SMEs agree to lend, the benefit to SMEs is 1, but private funds make a huge profit of 4; and when SMEs lend to banks and do not borrow from private funds, the benefit is 2, at which point the benefit to private funds is -1(*Table2)*, because idle private Funds can only be absorbed by banks.

Table2. SMEs and private fund holders game

	Private Fund Holders		
Small and medium-sized enterprises		Yes	No
	Yes	(1, 4)	(0, 0)
	No	(2, -1)	(2, 0)

4.2.3. Model analysis and Nash equilibrium analysis

Banks and SMEs choose a "yes, yes" strategy and their strategic choices lead to a Nash equilibrium.

SMEs benefit more from choosing a 'no' strategy than a 'yes' strategy, and when SMEs choose a 'no' strategy, the optimal strategy for private fund holders is also to choose not to When the SME chooses the "no" strategy, the optimal strategy for the private fund owner is also to choose not to lend. Therefore, banks provide more and more formal lending funds and less and less private credit funds. The strategy equilibrium reached is (3, 2, 0), which means that the private fund owner provides the SME and the bank with a zero return, which is not valid in rational economic man theory. All subjects of economic decisions are rational economic man and try to maximise their own interests. Therefore, in order to maximise their own interests, private capital providers will definitely try to break the strategic equilibrium and find a new strategic equilibrium to maximise their own interests. Therefore, the above strategic equilibrium is extremely unstable in reality.

Banks do not lend to SMEs, SMEs borrow from private institutions, and the flow of private funds to

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private institutions will further reduce the funds available to banks, creating a vicious circle, thus creating the current "prisoner's dilemma", where banks and SMEs make self-serving choices that make the current situation of the three parties in the game worse. Therefore, the current state of the capital market is not conducive to the development of private credit in China in the long run. The strategic choice of the three parties in the game will lead to a greater flow of private capital to private credit institutions, which is detrimental to the long-term development of banks and poses a huge risk to our capital holders, and is a financial situation that needs to be addressed in China.

5. Suggestions for countermeasures

5.1. Promoting the strengthening of private credit regulations and the integrity of SMEs themselves

5.1.1. Promote national economic control and regulatory improvement of informal finance

The short history of the development of private credit in China has led to many shortcomings in the setting of the legal system[15]. In particular, there are lax regulations on the reasonable setting of interest rates and the manner in which private credit can be used to collect money. At the same time, the vagueness of the concept and treatment of private fundraising and private credit has also created a huge obstacle to private credit in China[16]. Different standards should be set according to their specificity and the boundaries between the two should be clearly defined to prevent the occurrence of law enforcement and judicial injustice. Improve China's economic control system for non-financial institutions and bring the operation of private credit within the economic supervision system to prevent the emergence of private lending chaos.

5.1.2. Increase the promotion and cultivation of a sense of integrity in SMEs

The public should be made aware of responsibility, honesty and financial risk. Educate and instruct both parties to private credit to sign legal and compliant written contracts to protect the legal rights and interests that both parties need to assume from infringement, and to interview and warn enterprises that offer usurious loans and illegally collect them; for loan enterprises, they should also be educated about integrity, and through various media and publicity means, cultivate a sense of responsibility to repay loans in a timely manner, so that enterprises are clear about the dangers of defaulting on loans[17]. Enterprises should also be reminded of the interest rate standards for private credit to prevent them from falling into the trap of loan sharks.

5.2. Promoting financial system reform, Synergy between market and government

5.2.1. Promote financial system reform and interest rate marketization

China should gradually push forward the process of reforming its financial system and break the "double-track interest rate system" that has brought difficulties to our capital market[18]. Let the formal benchmark interest rate and the private interest rate be put on a market track, determined by market supply and demand, and adjust themselves according to market changes. Only by devolving the power to set interest rates to the market can we maximise the economic benefits and achieve a reasonable allocation of resources among the various market players. At the same time, the government should also strengthen its supervision of the financial system, control unreasonable interest rate settings and interest rate fluctuations that occur in a state of market failure, reasonably regulate interest rates and exercise appropriate government control on the basis of marketisation of interest rates, so that interest rates tend to be rationalised.

5.2.2. Promote financial system reform and increase support for SMEs from formal financial institutions

Improving the financial system of SMEs and promoting the reform of the financial system[19]. The unstable financial situation of SMEs is mainly caused by problems such as inefficient use of funds and more confusing administration. Some SMEs adopt a family management model and personal assets are confused with business assets, leading to a high risk factor. Improving the internal management structure and financial system of enterprises, promoting the reform of the financial system, appropriately relaxing the lending criteria of banks for SMEs, and introducing financial support programmes for SMEs, the government and financial institutions should increase their support for SMEs to help them get out of their lending difficulties[20].

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6. Conclusion

The "two-track interest rate system" is an important cause of the private lending crisis. Only by moving away from government or private manipulation of interest rates and allowing interest rates to adjust themselves in line with the current state of the capital market can profits be distributed rationally among the various sectors and the maximum benefit of capital be achieved.

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