The Ezubao scam: A sign of deeper problems in China’s financial system

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The exposure of Ezubao, a high-profile Internet lending site, as a racket that allegedly raked in $7.6 billion from some 900,000 investors has not only cast a pall over China’s burgeoning online finance industry but raised questions about the broader stability of the country’s debt-laden financial system.

The state-run Xinhua news agency announced on Monday that Chinese police had arrested 34-year-old Ezubao founder Ding Ning and 20 others associated with the company, which shut its doors in December. Police reportedly used two excavators to recover hundreds of account books that were buried deep underground.

Ezubao was one of the more prominent peer-to-peer (P2P) lending sites that match lenders and borrowers over the Internet, and have branched out into other financial products. The company offered high-yield investments of between 9 and 14.6 percent and projected an image of wealth and stability. It paid out 800 million yuan ($US121 million) to staff in November to ensure they wore designer clothes and expensive jewellery. It advertised on high-speed trains and prime time on the state-owned CCTV channel, leading investors to believe that it was government-backed.

In reality, Ezubao was in the words of former company executive Zhang Min, “a complete Ponzi scheme.” It made few real investments but relied on the constant flow of incoming funds to pay off those seeking to withdraw their money. Yong Lei, former director of the company’s risk management department, was quoted by Xinhua as saying that “95 percent of Ezubao’s investment projects were fake.”

Many of those who were duped into handing their savings over to Ezubao were reportedly small investors from rural areas. More than 1,000 sales agencies were established across China to promote the company.

Angry investors began protesting in December after the company was shut down. A recent online post declared: “We need to rise up across the country and let the government know that the people’s bottom line is the return of their capital.”

To forestall social unrest, Chinese authorities detained demonstrators and clamped down on discussion in Internet sites. At the same time, officials announced this week that Ezubao clients could register their grievances on the Ministry of Public Security web site.

The government announced draft regulations for P2P lending sites in late December, limiting their operations to acting as intermediaries between borrowers and investors, and banning them from selling wealth management products, insurances and trust products. Even if the regulations come into effect, companies will have a grace period of 18 months to comply.

The online finance industry boomed over the past two years as China’s speculative property bubble stalled and investors began looking for high rates of return elsewhere. The slump in share prices last year only further fuelled the growth of P2P lending, which nearly quadrupled in 2015 to reach 982 billion yuan ($149 billion), up from 253 billion yuan in 2014. Ezubao was only launched in July 2014.

According to the China Banking Regulatory Commission, as of November, 2,612 P2P lending firms were operating normally, but more than 1,000 additional lenders were considered problematic. The New China News Agency reported that around 800 Internet lenders shut down last year, three times the figure for 2014. In December alone, 106 online P2P lenders absconded, suspended business, suffered liquidity problems or were subject to investigations.

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In its latest report on China's shadow banking, the credit rating agency Moody's identified P2P lending as a "fast-growing component" of the sector. While downplaying its potential for posing "systemic risks" because of its relatively small size, the agency did note that it had "attracted attention for its high default rates and because it carries the risk of social tensions given the large presence of retail investors."

The highly volatile and speculative character of the online finance sector raises questions about the stability of the broader shadow banking system, which in turn is intimately connected to the banking and financial sector as a whole. According to a report last year by the US-based Brookings Institution, the size of shadow banking sector in China is estimated at anything from $769 billion to $7 trillion.

P2P lending is not the only area that rests on shaky financial foundations. A UBS analysis last month highlighted the growing practice of mid-tier Chinese banks packaging loans into complex financial instruments known as Directional Asset Management Plans or Trust Beneficiary Rights that are shown on their books as low-risk loans to mask rising levels of bad debt as the economy slows.

UBS estimated that the size of the "shadow loan" book rose by a third in the first half of 2015 to $1.8 trillion. UBS financial analyst Jason Bedford told Reuters: "These are now the fastest growing assets on the balance sheets of most listed banks, excluding the Big Five [state-owned banks], not just in percentage terms but absolute terms. The concern is that the lack of transparency and mis-categorisation of credit assets potentially hide considerable non-performing loans."

Shadow banking's expansion has been fuelled by the vast expansion of cheap credit by the Chinese regime following the 2008–09 global financial crisis. Lacking any profitable outlet in productive activity, the money was used by speculators, local and regional governments and companies to speculate in the property market, in particular. With restrictions on lending by state-owned banks, the shadow banking system facilitated the speculative binge.

Now the property market is cooling, concerns are being expressed about the potential for a systemic crisis. Writing in *BloombergView*, commentator Noah Smith warned: "This shadow banking system has enabled a large buildup of bad debt, much of it related directly or indirectly to real estate. If property prices fall, trust companies will go broke, and banks—having invested in the trust companies—will be on the hook. That will create the conditions for a really destructive crash."

While the collapse of Ezubao or other P2P lenders might not be the trigger for a meltdown, it could well be a harbinger of far deeper problems in the Chinese financial system.

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