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Henan protests: the “Chinese dream” in tatters?

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- China's financial services sector is showing signs of a looming crisis: the establishment of rural regional banks, which started in 2006 and account for 36% of the country's financial services sector, is becoming an increasing burden and challenge for the central government.
- The protests in Henan have shown that corruption is entrenched in the local government and has been looked down upon for years.

Key highlights:

- The Code Red scandal, which has sent shockwaves through Chinese society, has shown that rapid digitalisation and the government's overwhelming influence in the technology sector can be used against people.
- The hunt for the guilty is ongoing, but some of the key figures in the scandal, who are linked to criminal groups, have suddenly disappeared and reportedly fled the country.
- Severe penalties for local high-ranking politicians play a more symbolic role in reassuring the public. The decision not to expel from the party means that corrupt politicians will be able to continue to hold political office in the future.

Henan rural regional bank crisis

The establishment of rural regional banks (RRBs) started in 2006 with a law aimed at accelerating the availability and development of financial services in the country's regions. Banks of this type were set up on a massive scale and soon became the main financial institutions in the region, with a very significant impact on the economic situation. By 2022, the number of rural regional banks in China had reached 1,651, accounting for 36% of the country's financial services sector. There are 86 such banks in Henan province. Although public confidence in banks is high, concerns about the situation of rural regional banks have been raised following a report released by the China Banking and Insurance Regulatory Commission (CBIRC)¹, which stated that 122 rural regional banks had entered the high-risk zone in the second half of 2021. According to an analysis by China Economic Weekly², the high riskiness of this type of financial institution is due to the following factors:

- a) these small institutions are increasingly unable to compete with the big banks, especially given the recent acceleration of financial technology, and their competitiveness has been severely reduced;
- b) these types of banks are often not managed effectively enough and supervisors do not closely monitor and scrutinise their performance and financial situation;

- c) corruption in regional financial institutions has recently increased markedly, often involving local officials and criminal gangs.

Banking confidence in China is quite high, so people often keep their savings only in banks. As for the rural regional banks, deposits carry a relatively attractive annual interest rate (around 4%). The first warning signs of China's growing financial sector problems have begun to emerge in Henan province. In April, four rural regional banks in Henan³ unexpectedly announced at the same time restrictions on customer withdrawals due to "system upgrade work".



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Fig. 1. Customers of the banks involved in the scandal were greeted by almost identical "system upgrade" messages in their e-banking, which lasted for several months. Source: "Baidu Pictures"



Fig. 2. Protests outside the Zhengzhou branch of the People's Bank of China. One of the posters announces: "The "Chinese dream" of 400 000 depositors in Henan has been shattered". Source: CNN⁴

Henan depositors, having received no help and no explanation for the situation, started to organise protests in Zhengzhou, the capital of Henan province. On 10 July, perhaps the largest protest ever was held in front of the main branch of the People's Bank of China (the country's central bank) in Zhengzhou. Protesters held placards in English as well as Chinese. Most of them criticised the city authorities for corruption and links to criminal groups. Interestingly, while the protesters were very open and harsh in their accusations against the local authorities, they were very cautious in their approach towards the central government. A portrait of Mao, hung during the protests, is a particularly important detail. This can be seen as an open demonstration of reluctance to confront the central government and show loyalty to the Chinese Communist Party. The protest, which was very widely covered on Chinese social media, did not last long. As soon as it started, a squad of uniformed and plain-clothed people arrived on the scene and detained the protesters.

Code Red scandal

The Henan protests have received a lot of attention from the Chinese public and media, but most of the anger has been caused by the so-called Code Red scandal, which has shown that the Chinese government's influence in all areas of life can be used against the people.

The crisis involving Henan's banks was exacerbated and aggravated by a very strange event: the electronic COVID health code of some depositors, which gives access to public buildings and freedom of movement, was suddenly red-coloured, i.e. invalid. This has led to severe restrictions: these people have been classified as high risk and restricted access to public spaces. According to Shichang Cai-jing⁵, 1317 depositors were red-coded for no reason at all, most of them on their way to Zhengzhou. The event has been widely covered in the Chinese media, in an attempt to find out who made the decision.

The main provincial authorities have been engaged in a manhunt for the perpetrators. The findings published after the investigation showed⁶ that the decision to change the health code was taken by the

Deputy Secretary of the Zhengzhou City Policy and Law Executive Committee, the Director of the COVID-19 Management Public Control Department and several other representatives of the city authorities. The decision was implemented by the Head of the Social Stability Support Unit of the City Committee, specialists from the City's Data Department, the Head of the COVID Management Health Code Management Team and the Deputy Director General of a private urban data development company. This chain shows that the decision was taken at the highest level: by high-level local politicians from different departments.

The hunt for the guilty

The China Banking Regulatory Commission (CBRC), together with other central authorities, has launched an in-depth investigation. As it turned out, the scale of corruption and illegal activities was enormous. According to the Chinese media, the mastermind behind this financial scheme was Lu Yi, who ran the Henan New Fortune Group (now dissolved), through which he allegedly manipulated Henan's rural regional banks' wire transfer systems, made fake loans and pocketed funds. Earlier, Lu Yi was detained for giving a bribe of 23 million yuan (€3.4 million) to a vice-president of a bank in Zhengzhou. In June this year, it emerged that he belonged to a criminal group with links to rural regional banks. Lu Yi was detained but disappeared after his sudden release, reportedly to the USA⁷. Chinese internet users were angered that the well-publicised policy of strict travel restrictions did not apply to everyone: one of the main instigators of the crisis managed to leave without any major problems.

One of the main shareholders directly involved in the banks caught up in the scandal was Sun Zhenfu, who had already been arrested a few months earlier for serious financial crimes⁸. The situation is particularly strange for Zhenfu, especially given the severe travel restrictions due to the COVID pandemic: after his sudden release in March, he disappeared and presumably also fled the country. In addition to the above, other individuals are also under pre-trial investigation, such as the current probe into the activities of Li Huanting, the head of the Henan Banking and Insurance Regulatory Commission, who used to work for the rural regional bank watchdog.⁹

Local high-level politicians have also escaped accountability for corruption and for altering depositors' health codes through the use of their official position. Two high-level politicians who took the decision have been suspended from the party and removed from political office. Lower-ranking politicians involved in the decision and its implementation were subject to penalties approved by the Chinese Communist Party: "severe warning", "demotion", and others to "disciplinary penalties". However, these official disciplinary actions against CCP members, which are enshrined in specific party regulations, although they may seem very harsh at first sight, do not mean the end of a career: each sanction has a specific validity period, for example the "expulsion from party office" imposed on the aforementioned high-ranking local politicians is only valid for two years. The harshest possible punishment is "expulsion from the party", but all the corrupt politicians caught up in the scandal have avoided it.

The public has continued asking questions, even after the findings of the study came out. There are still some important unanswered questions that are highlighted by the local press:

- a) How was depositors' personal data obtained? Without the cooperation of the banks, it is not possible to obtain such data, so why have the banks not suffered any consequences?
- b) Have affected customers regained their green code? When will there be an official apology for the Code Red, which caused extreme inconvenience?

China's Banking and Insurance Regulatory Commission has taken initial steps to address the crisis, although it is not clear whether depositors caught up in the scandal will get all their money back. On 12 July, the Commission announced that it would start compensating customers with deposits of up to 50,000 yuan (around €7,200). On 21 July, the threshold was raised to 100,000 yuan (around €14,000)¹⁰. Although the authorities reportedly managed to freeze around 39 billion yuan (around €5.6 billion), the Henan Banking Regulatory Authority did not disclose the source of the recovered money. This crisis in Henan's rural regional banks is a major blow to the country's entire financial services sector, which until then had enjoyed a high level of public confidence.

The erosion of public confidence in banks as a result of the Henan banking crisis has led some customers of other rural regional banks to increasingly

choose to withdraw their deposits for fear of new banking crises. To address the crisis of confidence in financial institutions, the central government and the country's major banks have started issuing announcements that risks related to the real estate sector and insolvency are "under control and manageable"¹¹. The mood of anxiety spread beyond Henan: on 14 July, protesters gathered in front of the Shaanxi branch of the China Banking and Insurance Regulatory Commission (CBIRC) to demand a thorough investigation into the activities of property developers, some of whom are allegedly shifting some of their funds offshore. The central government has encouraged local governments to launch investigations into the activities of developers and rural regional banks to prevent new crises. As SinolInsider,

a US risk consultancy, points out¹², the Henan protests are the tip of the iceberg of serious systemic and financial risks associated with small and medium-sized financial institutions. If Evergrande Group's debt crisis spreads to other real estate developers, smaller banks could face serious problems. In addition, the country's major banks are also facing growing problems: a large part of the billions of euros in loans to developing countries under the Belt and Road Initiative may not be repaid. The economic meltdown in Sri Lanka is one example of a country that is unable to meet its financial obligations, and Chinese banks may be forced to write off some of their debt, reducing their ability to help smaller financial institutions in China.

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