Where should the folk financing (Private lending) heading

——A possible model: P2P lending platform

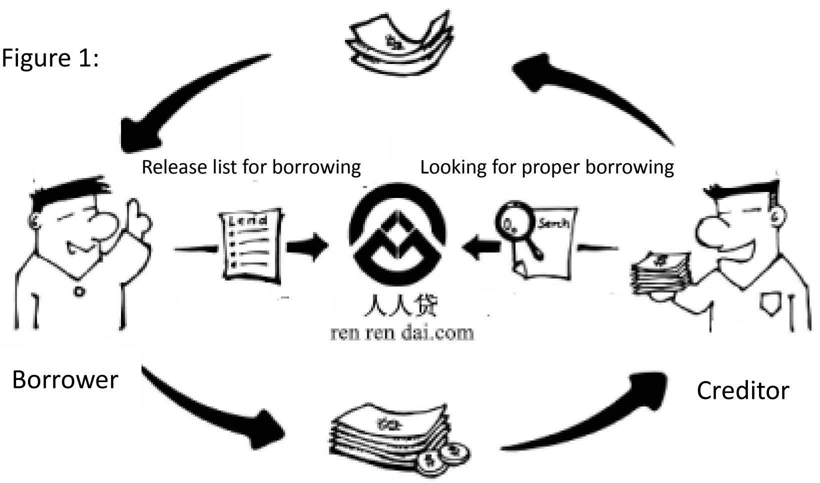
The Wenzhou "private lending" credit crunch in 2011 has attracted public attention to the folk financing. Since then, the government and regulatory institutions are struggling to tame this part of shadow banking system, to guard against systematic risk. One way to end the private lending's grey status is to bring sunlight into this financing sector: the P2P online lending might be one of the solutions to satisfy the financing need of SME and self-employed business people, as well as to meet the requirement of regulation in folk financing sector. The marketization mechanism, credit system and technical support P2P lending are employing will serve as great reference for the undergoing financial reform in China

**<u>What is P2P lending</u>**

Peer-to-peer lending is the practice of lending money to unrelated individuals, or "peers", without going through a traditional financial intermediary such as a bank. This form of lending takes place at peer-to-peer lending websites (platforms), which involve credit checking and other lending services.

The lending platform is crucial, which lower the information asymmetry by providing information assertion and service to facilitate "transactions". And P2P platform is not the creditor. Figure 1 illustrates how P2P platform works with example of renrendai.com

Figure 1:



**Growth and Drivers of P2P lending platforms**

In recent years (after 2007), P2P lending platforms have been developing rapidly. By the end of 2012, the number of P2P lending platforms has reached more than 200. Statistics indicates that 2012 P2P online turnover exceeded 10 billion RMB, and the registered investor exceeded 50 thousand people. If we take offline P2P lending into consideration, the scale of P2P transaction will be doubled.

The following figure (figure 2) shows the number of P2P lending platforms from 2009 to 2013Q1. P2P platforms are growing tremendously, at almost 300% growth rate.

The fast growth of P2P lending may result from these drivers:

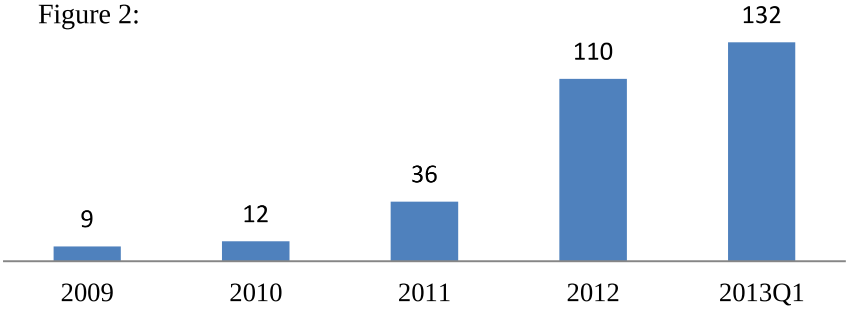
Firstly, the increasing need for small loans: Almost 1/3 financing need from the small and medium-sized enterprise (SMEs) is satisfied by informal financial resources (Zhu and Cai, 2013). SMEs are mostly private companies whose cash flow is not stable and scale is relatively small. That's why many formal financial institutions reject their loan application. Then SMEs try to finance from informal financing channels such as small loan companies. P2P lending has many merits such as simple formalities and quick operation, serving as important supplement for formal banking system to satisfy temporary demand of SMEs.

Secondly, low entry barrier and no special regulation: There's little restriction on the P2P lending companies in China: No legal codes, no nationally established or recognized alliance, no unified business scope or qualification standard for practitioners.

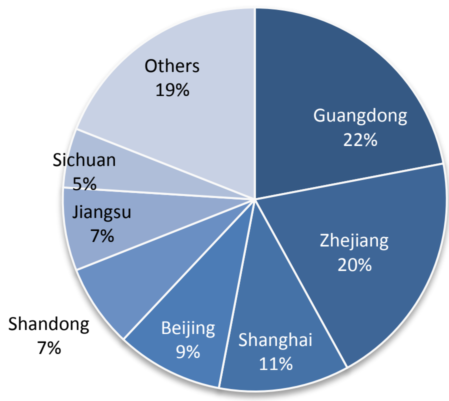
Thirdly, the support of internet technology, data mining and easily-established credit system guaranteed the smooth operation of the platform.

Other drivers include low channel cost for lenders and borrowers and no geographical restrictions.

Figure 2:




2009-2013Q1 Number of P2P lending institutions




Geographic distribution of P2P lending institutions

According to the Business Registration Address of 132 P2P lending companies, Guangdong and Zhejiang province have the most P2P companies, the number of which is 29 and 26, respectively. The companies comprise 22% and 20% of the total 132 companies, respectively. As showed in figure 3, the development of P2P platform spread from the congested coast to the poorer inland regions, from more developed region to the underdeveloped region. And the development of P2P lending is closely related to the prosperity of private economy (the SME and self-employed business).

**Traits of P2P lending**

Compared with traditional bank loans, the P2P lending has the following traits:

Firstly, broader participation of creditors and borrowers: As stated above, participants in P2P lending are highly decentralized. Currently, the borrowers are mostly private enterprises and working-class, who finance to deal with current capital turnover. The "broadness" of participants results from low entry barrier (for borrower and lender) and the flexibility of platform. With good credit, borrowers can get financed without collateral. And investors with limited capital and strict time restrictions can still find suitable borrowers.

Secondly, the flexibility and efficiency of trading: P2P platforms offer various design of loan contract, including various interest rate, ways to repay and the payback deadline. In addition, the P2P lending simplifies the complex approval procedures loans. As long as the credit of the borrower meets the requirement, the lending procedure will be quite simple and efficient.

Thirdly, high risk and high return: On the one hand, borrowers employing the P2P platform are those who cannot get financed from traditional bank system and lack valid collateral or guarantee.

So these people are willing to get the loan at the cost of higher interest rate. One the other hand, P2P marketplaces do not offer the same assurance against loan defaults as banks. The P2P lender should deal with the deficiency of offline borrower investigation. The lenders merely rely on the limited online information. The trustworthiness of the online information is doubtful, which imposes high risk on lenders.

Fourthly, the application of internet: the development and operation of P2P platform relies heavily on the internet technology such as data mining and information integration.

These traits make P2P a good complimentary part for the traditional banking system. But the high risk, broader participants and flexibility also cause problems for the regulatory administration.

**Primary P2P lending business model**

After looking into the operating practice of both domestic and foreign market, we can divide P2P lending into three models according to the role platform played in the lending and borrowing process. These three models are:

1. Mere Intermediary:

   Under the “mere intermediary” business model, the P2P platforms only serve as information communication platform. They are not liable for the loan defaults. Their revenue generates from service charge and commission from sale of repayment insurance with insurance companies.

   Prosper in US, the largest global P2P platform in the world, is a typical mere intermediary. U.S citizen with Social Security Number, personal tax ID, bank account and a credit score more than 520 can register as a member, who can apply for loan ranging from $1000 to $25000 without guarantee. And Prosper introduced bidding mechanism: firstly, the borrower sets the highest interest he is willing to pay, then list the loan demand on the platform. And lenders bid on the loan with their desirable interest rate and the bidder with lowest interest rate wins.

   The Chinese counterpart will be Paipaidai (拍拍贷 ppdai.com), established in 2007. It matches online borrowers and lenders by the same bidding mechanism. The interest rates are set by market supply and demand. Profit comes from service fee charged from success transaction.

2. Composite intermediary

   "Composite intermediary" may serve as guarantee, help to recover arrear and set interest rate for loans in addition to mere platform to exchange information. Some platforms assure lender that if borrower defaults the loan, the platform will pay principal to lender. Some platforms set fixed interest rate according to borrower's credit score. In this model, the revenue comes from service fee, third party transfer fee and collection fee.

   Zopa in UK, the first Online P2P platform is an example of "composite intermediary". Credit rating (A*, A, B or C level) of borrowers is made by Equifax, a credit rating agency cooperated with Zopa. The interest rate is then set accordingly. Lender can choose borrowers by viewing their credit rating and repayment maturities. After investigation and approval, Zopa matches lender and borrower. Zopa has various duties to perform in the loan procedure: Zopa take the responsibility to complete pertinent legal document, conduct borrower's credit check and hire agencies to recover arrear. It is essentially playing the role of traditional bank.

   CreditEase (宜信贷) in China uses Zopa Mode. CreditEase mainly provide small loans for farmers, wage earners, university students and self-employed businessmen. It rates borrowers credits and set interest rate. It also matches a borrower with multiple lenders to lower risk.

3. Non-profit (social welfare)

   This model put more emphasis on the demand from vulnerable groups, who are provided with loans with lower risk.

To better control risk and make profit, the Chinese P2P online platforms deviates from traditional concept of "online P2P lending". Here are the three main aspects

1. Interaction between online and offline P2P lending service

In western countries, credit system is well established and P2P lending platform can easily access to it, which enable P2P platforms and lenders make good decisions based on data online. In China, however, PBOC is not sharing the credit information with P2P lending platforms. It's hard for them to assess the loan risk merely from data online. So offline face-to-face review and contract signing can effectively reduce this risk.

CreditEase (宜信), Zhengda e-credit(证大 e 贷) are operating like this. According to the estimation made by CITICS, corporations employing the "combination of online and offline" model managed lending more than 20 billion RMB in 2012. Take CreditEase as an example, its P2P business has increased 300 times from 2008 to 2012. It has more than 50,000 investors and 250,000 borrowers, according to Financial Times.

2. “Professional lenders” and assignment of debt (债权转让)

In the offline part of P2P lending platforms, the service extends to “professional lenders”. The platforms not only provide network connecting lenders and borrowers, but also reconcile money mismatch and repayment deadline. The “professional lender” provides credit assertion and liquidity, playing the role of commercial banks. Correspondingly, to circumvent the restriction of law, P2P lending platform assign debt (transfer creditor rights) to investors.

3. The usage of SNS (social networking services)

Some online P2P lending companies also use the information in social network such as Weibo, Renren as basis for credit checking. RenrenDai (人人贷) does ID authentication in social media. It requires members have real name, avatar and connect with more than 100 friends on Renren (人人 social media). PaipaiDai (拍拍贷) gets information on Renren by sharing accounts with it. Personal and friends’ information will be part of the basis for credit rating.

**Potential problems of P2P lending**

Although P2P lending platform is flourishing for now, problems such as regulatory gap lies underneath. Without reasonable and clear rules or regulations, P2P market chaos will be unavoidable. The problems hidden in the shadows of P2P financing are coming to the surface：

1. Legitimacy of P2P lending, especially the boundary of illegal fund raising:

Illegal fund-raising was made in the forms of joint breeding or planting, underground banking, and illegal financing and bond-issuing[1]. If P2P platforms get capital from investors and directly make investment (without knowledge of investors), or even use capital for other purposes, the platforms are suspected of illegal fundraising. The key determinant is whether the capital transfer happens prior to the investment of members.

One of the P2P models suspected of illegal fund raising is the “Composite intermediary” model mentioned before when P2P platform assign the debt to investors. Although this model might match the demand and supply of capital more efficiently, this model is vulnerable to legal risk.

[1] http://news.xinhuanet.com/english/2007-03/12/content_5834634.htm

2. Ponzi scheme

In 2011 and 2012, at least 16 online P2P lending companies were closed. The main reasons are poor operation and fraud. The amount of money involved is more than 300 million RMB. Several online P2P platforms have committed fraud, causing great loss to investors and damage to P2P lending reputation.

Table 1 shows information of platforms closed in recent years: For investors, fraud might be a greater concern. To avoid fraud, Investors should be more careful especially when the model of P2P platform is “Composite intermediary”, in which platforms serve as “professional lenders” who collect capital from investors and make decisions for them. “Professional lenders” are vulnerable to great liquidity risk due to maturity mismatch and amount mismatch.

**Table 1 Information of platforms closed in recent years (part)**

| **Name** | Chinese | Region | Time of close | People and money involved | Nature |
|---|---|---|---|---|---|
| **Bell VC** | 贝尔创投 | Jiangsu | 2011 | < 100 people, 5 million Yuan | Fraud |
| **Angel VC** | 天使计划 | Yunnan | 2011 | < 100 people, 5 million Yuan | Fraud |
| **Ant VC** | 蚂蚁贷 | Chongqing | 2012 | 20~ people,0.5 million Yuan | Fraud |
| **Taojin VC** | 淘金贷 | Gansu | 2012 | 100~ people,1.3 million Yuan | Fraud |
| **Hahadai** | 哈哈贷 | Shanghai | 2011 | Lack details, great social influence | Poor operation |
| **Youyi VC** | 优易贷 | Jiangsu | 2012 | < 100 people, 13 million Yuan | Fraud |
| **AntaiZhuoyue** | 安泰卓越 | Beijing | 2012 | 30~people，1 million Yuan | Pyramid sale and Fraud |

3. Nature of guarantee and risk fund pool

To meet capital security demand of investors, many P2P lending platforms added disguised clauses to guarantee the principal for investors. If borrowers and lenders sign the contract and P2P platform guarantees the principal for investors, the platform will be considered as small loan guarantee company. The guarantee service is beyond business scope of P2P lending platform. The legitimacy of guarantee and the risk fund pool is disputable and hard to verify

**Risks of P2P marketplace (for investors)**

1. Risks from operating small loans

There are some inherent risks of providing loan service to mainly SME and self-employed businessmen. A large proportion of the loans have no collateral or guarantee. Although small loans can bring higher return, they have higher risk. To minimize loss from default, the platform should rely on proper measurements such as cross check and social index system, to make up for the lack of financial data and collateral.

In fact, even the more mature P2P online platform in US and UK are exposed to high rate of late and default (over 3%). China's credit system is far less developed and it's very hard to eliminate information asymmetry and verify creditability merely via online information.

In practice, two problems remains in risk management for the platform: Firstly, whether platforms can measure credit of borrowers in a proper way; secondly, whether the platform can bear the high cost of offline investigation on borrowers.;

For the first issue above, the main concern is lack of client data, especially data completeness and accuracy. Since P2P platforms cannot get access to credit system from bank, they have to conduct a lot of offline investigations. But they cannot bear high cost of borrower investigation.

2. Lack of regulation on "intermediate account"

One main concern of investors is whether the P2P lending platform will commit fraud. The intermediate accounts gathering capital from investor are not under proper regulation. For now, most intermediate accounts lack regulation and P2P platform has right to dispose money in the account. If there's no strict control on that capital and account, the ethical risk such as capital embezzlement will be high.

Therefore, it is necessary to regulate the intermediate account. It may be probable for regulators to appoint a particular institution to manage the intermediate account. P2P companies will be only permitted to view account details. By regulating cash inflow and outflow and conducting detail analysis on P2P loans, regulators can deter fraud and illegal fund raising of P2P platforms.

3. Risk from guarantee and related services

Some P2P lending companies simultaneously operate regular (lender borrower match) and guarantee businesses on their platforms. Some other companies use related companies guarantee for investors' principal. In these two cases, the guarantee may lead to further leverage risk.

According to legal rules[2], leverage of guarantee companies should not exceed 10. While P2P companies have outstanding loans amount to tens of millions, their net assets are usually several millions or less. Thus, they usually fail to meet the leverage requirement and 10% of bad debt will drag them to bankruptcy. The reliability and trustworthiness of guarantee made by these companies is in question.

4. Liquidity risk

For the "professional lenders", the liquidity pressure is high due to maturity mismatch and amount mismatch as mentioned above. If claims(债权) cannot be assigned to other investors before they are due, the "professional lender" might face with cash crunch.

Securitization might be a way out for the P2P professional lenders. A successful case is the Lending Club, a leading P2P lending platform. Lending club make loans into financial products and control the risk in a reasonable range. (But securitization is not allowed under Chinese law)

**<u>Future Regulations on P2P lending industry</u>**

To better facilitate the development of P2P lending online platform, the regulators might consider the following aspects:

1. To avoid possible frauds committed by P2P platforms, regulators should pay attention to intermediate accounts of P2P platform. The capital in the intermediate account should be managed and supervised by an authoritative third party. This action will also effectively lower the risk of money laundering and illegal fund raising.
2. Set a higher entry barrier for P2P online lending companies. The market chaos in the P2P lending industry is due to the low entry barrier (no requirement for the registered capital, no approval needed to do business, lack of proper regulation). The regulatory committee should set requirement for registered capital, which will serve as a risk control method for the P2P lending platforms.
3. Establish risk rating and risk control system for the P2P lending platforms. Regulatory committee could set credit risk rating system and publicize the rating of platforms to investors. At the same time, regulator might also introduce taxation policies and policies to protect

[2] Related law: Interim Measures for the administration of a financing Guarantee Corporation （融资性担保公司暂行管理办法）

investors, encouraging risk management of P2P lending companies.

Permit some access to credit system of bank. If P2P platform providing financial services are allowed to use the credit system, they will be able to better assess the borrowers' ability to pay. However, since these platforms are not under strict regulation, there is high risk of information leakage and other illegal practice using the confidential information. One possible solution is: permit P2P lending companies some access to credit system, and monitor them closely. If any platform leak information or use information for other purpose, regulator can permanently deny its access to credit system.

**Reference:**

1. Chinese regulator comes with new rules to tame shadow banking' 2013, Global Banking News (GBN), Regional Business News, EBSCOhost, viewed 10 January 2014
2. Greiner, M, & Hui, W 2010, 'Building Consumer-to-Consumer Trust in E-Finance Marketplaces: An Empirical Analysis', International Journal Of Electronic Commerce, 15, 2, pp. 105-136, Business Source Premier, EBSCOhost, viewed 12 January 2014
3. 中国 P2P 借贷服务行业白皮书（2013）第一财经新金融研究中心 中国经济出版社
4. 陈宇. P2P 网贷:危机还是商机?[J]. 社会观察,2013,12:62-63
5. 朱珺 蔡珉. 我国民间金融的发展现状及规范化管理 中国市场 2013,18: 70-73
6. 中国人民银行广州分行课题组. 从民间借贷到民营金融:产业组织与交易规则[J]. 金融研究,2002,10:101-109
7. 钱金叶,杨飞. 中国 P2P 网络借贷的发展现状及前景[J]. 金融论坛,2012,01:46-51