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Risks and opportunities in China's growing P2P lending market

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Executive Summary

Online P2P lending is growing in China. If China's P2P lending industry can successfully control risk while capitalizing on innovation, it should help alleviate SMEs' chronic funding difficulties.

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NOTE

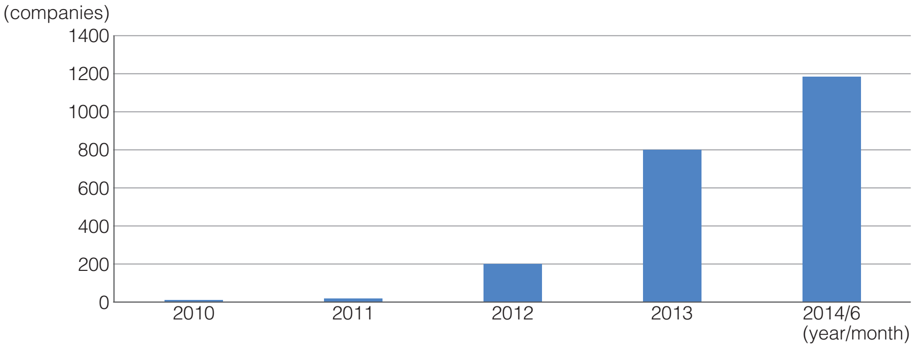
1) Yu'E Bao is a service of Alibaba, China's biggest e-commerce company. It allows customers of Alipay, Alibaba's online payment service, to invest their idle Alipay account balances in a money market fund. See "Internet finance growing rapidly in China" (http://www.nri.com/~/media/PDF/global/opinion/lakyara/2014/lkr2014189.pdf).

P2P lending is on the rise in China

Internet finance's domain in China is expanding into peer-to-peer (P2P) lending and crowdfunding against the backdrop of Yu'E Bao's[1] widespread popularity. P2P lending in particular has recently been growing rapidly.

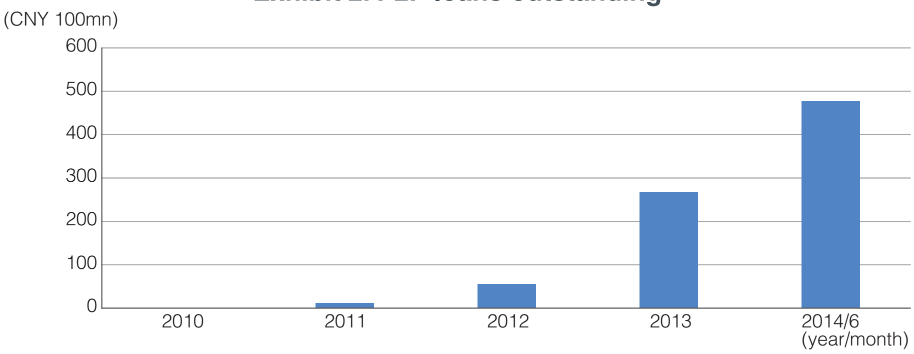
P2P lenders provide a platform for individuals to lend to and borrow from each other online. P2P lending has been growing in China since around 2010. Although an exact count of P2P lenders (platform providers) is unavailable, the People's Bank of China

Exhibit 1. Number of P2P lenders



Source: NRI, based largely on Wangdaizhijia data (see footnote 2)

Exhibit 2. P2P loans outstanding



Source: NRI, based largely on Wangdaizhijia data (see footnote 2)

(PBoC) reported that over 350 were in existence as of year-end 2013. According to the P2P portal site Wangdaizhijia, the number of P2P lenders at end-June 2014 was 1,184, up from roughly 800 as of year-end 2013[2]. The best known P2P lenders include Paipaidai, Lujinsuo and Yixin.

2) According to Wangdaizhijia's 2014 first-half report on P2P lending in China.

According to Wangdaizhijia, 189,000 P2P borrowers borrowed a total of approximately CNY81.8 billion from 443,600 investors at an average interest rate of 20.17% in the first six months of 2014. P2P loans outstanding at 30 June 2014 totaled CNY47.7bn. Online investment products that offer liberalized interest rates have become widely popular in the wake of last year's Yu'E Bao boom. P2P lending is a key driver of market-led interest rate liberalization.

Recently, however, many P2P lenders are broadly gathering funding via the Internet and lending those funds to individuals or small businesses instead of merely serving as a platform to facilitate lending and borrowing between individuals. Some are even ambitiously scaling up their operations through such means as telephone sales. P2P lenders are now competing for borrowers with incumbent microfinance companies. Conversely, some P2P lenders have started to form alliances with microfinance companies in the aim of combining their microfinance partners' lending know-how with a P2P funding model.

P2P lending's risks and opportunities

The fact that P2P lending is basically unregulated in China has long been a concern. Last year, as restrictions on bank lending to finance local governments' projects were tightened, funding for such projects started to flow through P2P channels to circumvent the restrictions. Such circumventive lending, one form of shadow banking, is a problem.

Additionally, some P2P lenders are essentially loan sharks that utilize the Internet to access funding. In 2014 in particular, there has been an increase in P2P lenders abruptly closing up shop and vanishing after becoming unable to collect from borrowers amid China's economic slowdown. Egregious fraud has also been reported, including cases where P2P fraudsters absconded with investors' money on the first day that they opened for business.

Some have questioned P2P lending's legality, given that pooling and lending funds gathered through P2P channels is tantamount to gathering deposits from the public without a banking license. Another point that has been raised is that providing principal guarantees to investors, as some P2P lenders do, normally requires regulatory authorities' approval.

On the positive side, P2P lending has the potential to alleviate SMEs' chronic funding difficulties. By utilizing the Internet, P2P lenders can advantageously obtain funding on a large scale and at low cost. If they adroitly pair this online funding model with credit-screening and lending know-how, as some of them are already endeavoring to do by partnering with microfinance companies as mentioned above, they would be able to provide a new funding channel to SMEs hitherto unable to borrow from banks.

Future issues: regulation and infrastructure development

Chinese financial regulators fully recognize P2P lending's potential to benefit SMEs. They are not inclined to categorically ban P2P lending just because it entails risk. In fact, the China Banking Regulatory Commission (CBRC) is currently researching how to rationally regulate P2P lending.

Recent developments in Internet finance have led to fragmentation of financial services hitherto vaguely regarded as banking services. Regulations consequently need to be based on a functional classification of financial services instead of on whether they are provided online or through traditional channels. Regulators are committed to fairness as a regulatory principle, implying that they intend to apply identical rules to online and offline financial services that are functionally equivalent[3)]. Regulators must also ensure that new channels for lending to SMEs take root.

Given that P2P lending's risks are currently exacerbated by a complete absence of regulatory barriers to entry, regulators are likely to set market-entry standards such as minimum capital requirements. Other potential regulatory initiatives include a qualified investor program, which some P2P lenders have already voluntarily implemented, and mandatory reserves against loan losses and other risks.

In terms of infrastructure, the P2P lending industry needs to develop credit information systems because it serves borrowers that banks are loath to lend to. China's existing credit information services include the PBoC's Credit Reference Center (CRC). CRC subsidiary Shanghai Credit Information Services (established in July 1999[4)]) has built a nationwide P2P credit information system, the Net Financial Credit System (NFCS) (June 2013). The CRC and NFCS are currently independent of each other but if they

3) In the PBoC's 2014 China Financial Stability Report, fair competition was cited as one of five major principles for regulation of Internet finance. Specifically, the report said that online financial innovations should (1) contribute to the real economy, (2) be consistent with overall requirements of macroeconomic regulation and financial stability, (3) protect consumers' legal interests, (4) preserve a market order of fair competition and (5) contribute to industry autonomy.

4) It did not become a CRC subsidiary until April 2009.

were to link up, credit information would become more readily available throughout China.

In sum, P2P lending in China is a mixed bag of risks and opportunities at present. The Chinese P2P lending industry is in its infancy, unregulated and without adequate infrastructure. How successfully the industry channels funding to SMEs while keeping risks under control bears watching going forward.

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