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Internet lending in China: Status quo, potential risks and regulatory options

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A B S T R A C T

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Internet lending or P2P lending is excessively popular in China compared to other economies. However, this sector is still largely free from regulatory oversight. A consequence is that P2P platforms lack sufficient supervision and information disclosures and involve high-risk loan business with sometimes fraudulent activities. This article investigates China's growing P2P platforms and the dangers if this new form of lending is left unregulated. Regulators need to take a coordinated approach tackling potential risks endogenous in this sector.

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P2P lending, Internet lending or person-to-person online lending,¹ involves individuals or “peers” who use online platforms without the involvement of a financial institution as a middle man. The platforms originate the loans by matching lenders and borrowers, who usually are individuals and small business owners. P2P lending enables individuals to lend and small firms to each other over the Internet, thereby cutting banks and other financial institutions out of the lending process. According to the International Organization of Securities Commission, the size of the global P2P sector's loan originations reached US\$2.8 billion in 2013.² Together with equity crowdfunding, the capital origination reached US\$6 billion in 2014.³ The development of the online lending market also brought out not only new products and commercial needs but also regulatory challenges and uncertainties in the online business environment.

P2P lending centred Internet finance is popular both globally and domestically, and represents a new wave of Internet revolution. The emergence of P2P lending as a popular credit alternative to mainstream lending represents a regulatory challenge to the financial regulators not only in China but also abroad. Some regulatory moves have been made in a number of jurisdictions. For instance, “operating an electronic system in relation to lending” has been added into the activities regulated by the UK's Financial Services and Markets Act (2000) since 1 April 2014. Accordingly, the P2P lending platforms within Art 36H need to comply with prudential and other standards affecting their structure and operation as well as conduct of business rules affecting their deals with lenders and borrowers.⁴ In the US, the SEC has asserted jurisdiction over the P2P lending by requesting the platform to be registered as a public company with the SEC and to sell notes through a pro-

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¹ It is also termed as marketplace lending or loan-based crowdfunding, one subcategory of crowdfunding. Other subcategories of crowdfunding include donation-based crowdfunding, rewards-based (or pre-payment) crowdfunding and equity (or investment-based) crowdfunding. Both P2P lending and equity crowdfunding are collectively referred to as financial return crowdfunding. Eleanor Kirby and Shane Worner, “Crowd-funding: An Infant Industry Growing Fast”, Staff Working Paper of IOSCO Research Department [SWP3/2014], p. 4.

² Tracy Alloway and Arash Massoudi, “P2P Lenders Install ‘Speed Bumps’”, Financial Times, 11 February 2014, p. 20.

³ Eleanor Kirby and Shane Worner, “Crowd-funding: An Infant Industry Growing Fast”, Staff Working Paper of IOSCO Research Department [SWP3/2014], p. 12.

⁴ Emily Reid and James Black, “The Future for Peer-to-peer (P2P) Lending: the Proposed Regulatory Framework for Lending Platforms”, (2014) 29(1) Butterworths Journal of International Banking and Financial Law 37–39.

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spectus with an effective registration statement.⁵ In New Zealand, the Financial Markets Conduct Act 2013 was enacted to specifically deal with the P2P lending with the aim of facilitating financial market activity by promoting the confident participation of businesses, investors and consumers in financial markets and the development of a fair, transparent and efficient capital markets.⁶ In China, the P2P lending is largely unregulated, which presents a couple of puzzling questions – why an interventionist government such as the Chinese government has been less proactive this time?⁷ Does this suggest a more encouraging approach taken by the Chinese government to tackle lending platforms?⁸

This article attempts to understand this business phenomenon as well as these puzzling legal issues in the Chinese context, with a particular focus on the causes, effects, potential risks and possible regulatory movements. The article proceeds as follows. Section 1 gives a brief account of the P2P lending sector followed by the introduction of China's P2P lending sector in Section 2. Section 3 looks into the causes behind the popularity of China's P2P lending business followed by an investigation of potential risks in this business in Section 4. Further, Section 4 looks into various regulatory options necessary to combat the potential risks in China's P2P lending business. Section 5 makes sense of the market trend of involving conventional industrial sectors in the P2P lending sector. Section 6 points out the impact the P2P sector is bringing to China's banking system. A conclusion briefly rationalises China's tolerant attitude towards the P2P lending sector.

1. Global popularity of P2P lending

P2P has gained popularity in advanced economies in the wake of scaled back lending from traditional banks since the outbreak of the latest financial crisis. In January 2014 in the UK, Lendinvest, a UK-based P2P lender, co-ordinated hundreds of private investors in making the world's largest P2P loan by lending £4 million to a property developer in the south London suburb of Croydon.

[LendingClub.com](#) and [Prosper.com](#) are the two largest platforms in terms of loan volumes. These two websites essentially bring together the people who can lend and the people who need money. LendingClub, for instance, differs from tradi-

tional lenders in that many of its loans are funded by individuals who buy portions of each loan. The two dominant US P2P lending sites originated US\$2.4 billion in new loans in 2013, up from US\$870 million in 2012.⁹ [LendingClub.com](#), the leading US-based P2P lender, expanded its loan book at an annualised rate of 150% in 2013. It has issued US\$4 billion in loans since 2006¹⁰ and reached a valuation of US\$2.3 billion in late 2013¹¹ and US\$3.8 billion after its completion of the major acquisition of Springstrone.¹² It transitioned from a start-up company worth a few million dollars to a public company worth US\$8.9 billion, in a few short years.¹³

Crowdfunding platforms like Kickstarter, Seedrs and Indiegogo, notably, have used the power of the Internet and social networks to create a place where people can contribute or donate money to start-ups and other projects. Different from P2P lending, crowdfunding allocates stock equity to investors with the financial return generated in the form of dividends and/or capital growth. They are developing momentum and are providing investors with potential hefty returns, with the support of new US regulation and the advances of modern technology. Crowdfunding platforms represent the democratisation of a financial sphere previously reserved exclusively for professional investors. Crowdfunding can be viewed as a new paradigm, in which incumbent financial institutions provide new opportunities.

In cases in which a myriad of loans, as well as debt and land purchases are up for grabs, the crowdfunding possibilities are limitless. The leading crowdfunding platforms have helped investors and campaigners raise billions of dollars for projects. The New York City Opera, a 70-year old Manhattan institution, turned to crowdfunding to raise US\$1 million through a 22-day Kickstarter campaign.¹⁴ Crowdfunding platforms featuring lending, rather than offering equity are more effective for projects offering a cheap product and related intangible benefits to donors. The product's popularity makes crowdfunding useful for investors, but its limitations are also apparent. The money collected through the crowdfunding platform may not be sustainable for startups, which usually need active and continuous investment in order to stay afloat. Unlike private equity and venture capital investment, crowdfunding platforms are unable to offer skills and managerial supports which are also crucial to startups.

Other platforms offer different services. [SoFi.com](#) specialises in student loans from alumni. [LoanBack.com](#) allows users to create legally binding loan agreements to lend to friends or family. [Kiva.org](#) enables lending to needy entrepreneurs in developing countries. Springstone lends money to individuals

⁵ Andrew Verstein, "The Misregulation of Person-to-Person Lending", (2011) 45 U.C. Davis Law Review 445–530.

⁶ Financial Markets Act 2013, s. 3(a) and (b); s 390.

⁷ China is not the only jurisdiction which lacks regulatory oversight over P2P lending. In Brazil, Ecuador, Egypt, South Korea, and Tunisia, either the regulation has classified P2P lending as an exempt market or there is a lack of definition in legislation. Eleanor Kirby and Shane Worner, "Crowd-funding: An Infant Industry Growing Fast", Staff Working Paper of IOSCO Research Department [SWP3/2014], p. 32.

⁸ A more encouraging approach is being adopted by various governments in order to enable funds for small businesses and individuals to be raised in Internet-based market places. See the New Zealand Government, Building Capital Markets Report part of the Business Growth Agenda, available at <http://www.mbie.govt.nz/pdf-library/what-we-do/business-growth-agenda/bga-reports/Capital-Markets-report.pdf>.

⁹ Andrew Blackman, "Who's Your Banker? Who Isn't?", The Wall Street Journal, 10 February 2014, R2.

¹⁰ Telis Demos, "LendingClub Raises Infusion of Capital", The Wall Street Journal, 18 April 2014, C5.

¹¹ Elaine Moore and Arash Massoudi, "P2P Group Zopa Secures £15m", Financial Times, 30 January 2014, p. 15.

¹² Telis Demos, "LendingClub Raises Infusion of Capital", The Wall Street Journal, 18 April 2014, C5.

¹³ Tracy Alloway and Eric Platt, "Investors Bank on Lending Club Success", Financial Times, 15 December 2014 (online).

¹⁴ Doing a successful crowdfunding campaign involves lots of work including creating a compelling video, building a prototype, and bringing the investor's own network.

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