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P2P With Chinese Characteristics

Development Regulation and Outlook

By Martin Chorzempa

July 2015

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P2P With Chinese Characteristics: Development, Regulation, and Outlook

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Introduction

Chinese P2P is now the largest in the world by far, at over $53 billion in loans intermediated in 2014.[2]This rapid financial development might seem surprising, as the typical view among China watchers has been that finance has lagged behind development in other sectors and is dominated by large state-owned banks. Literature on Chinese finance in the West has focused on "financial repression" in its highly regulated financial markets, but fundamental changes in China's financial system are underway.These changes have weakened existingregulations and opened up the playing field to a diverse body of new financial institutions.

In this report, I analyze the factors that led to the explosive growth of P2P in China, including a long history of interpersonal lending, thriving informal finance, an immense buildup in household wealth, and limited investment channels. Then, I outline the P2P market in China and associated issues, including credit rating and guarantees.

[2] Source: Payments and Clearing Association of China, http://www.crowdfundinsider.com/2015/05/68230-china-association-of-payment-settlement-places-number-of-p2p-platforms-at-over-2300/

Thirdly, I outline the existing regulations, regulators, and likely upcoming regulatory measures. Fourth, I predict how this industry will evolve and explore the role it will play in the broader Chinese financial system.

It is important to note that the author uses the term "P2P" here solely for convenience. Chinese sources tend to use P2P interchangeably with other terms that mean, "online lending," and the US and Europe have now coalesced around the term "marketplace lending" as more inclusive than "peer-to-peer." P2P has often been understood to be individual-to-individual, which would not accurately describe the lending on platforms like Lending Club and Prosper now mostly funded by institutional investors. It also would not accurately describe the thousands of new entrants to the online lending market in China, which have expanded their lines of business into business credit, wealth management, asset exchanges, information provision, credit rating, and many more. In this report, the author therefore will use the terms "online lending," "marketplace lending," and "P2P" interchangeably to more broadly include loans made over platforms that connect borrowers and lenders. [3]

[3] This definition is suggested by Foundation Capital, http://blog.lendit.co/the-evolution-of-p2p-lending-a-new-frontier-for-finance/

Why Does P2P Exist in China?

Chinese P2P has taken off, leaving US and UK marketplace lending in the dust. In 2014, the China Payments and Clearing Association estimated total P2P lending at $53.76billion. By contrast, the UK industry association P2PFA estimates the UK total at just under $1.9b in 2014, and Foundation capital estimated 2014 US marketplace lending at $8.8b.[4] With such a new industry involving many smaller players, there is bound to be a large margin of error in these estimations, but even so, Chinese P2P appears to be doing about five times the volume of its counterparts in the US and UK combined. Although the first P2P platform in China was founded two years after Prosper emerged in the West, since 2006-7Chinese P2P growth has outpaced others. To understand why P2P has thrived in China, we need to understand the context behind it in different aspects: cultural, economic, and technical.

[4] "Strong Growth Continues in Peer-To-Peer Lending Market" 30 April 2015 http://p2pfa.info/strong-growth-continues-in-peer-to-peer-lending-market Accessed 27 June 2015.

Technical Progress Is Laying The Foundation

Technology is the backbone of P2P, as well as its main competitive advantage versus more established financial institutions. The most important technical requirement for P2P to gain rapid adoption is Internet usage, which provides a low-cost marketing and distribution channel for platforms as well as the necessary sources of data for credit rating. Although the Internet came late to China, its adoption has been rapid, especially for mobile Internet. Official statistics as of December 2014 from the China Internet Information Center puts mobile Internet users at 557 million, which puts China's online population far larger than the entire population of Europe or the US.

Even more interesting is that mobile users make up over 85% of total Internet users in China. In the author's experience, even rural areas of Tibet, one of China's poorest and sparsely inhabited provinces, provided reliable 3G coverage, meaning even a shepherd could apply for loans and invest funds through a P2P platform despite being a day's journey or more from the closest bank branch. All they would need is a smartphone. Although these numbers are large, they have the potential to become far larger in the coming years. According to the Internet Society, China's Internet penetration rate is 45.8%, putting it in 86th place, behind countries like Moldova and Trinidad and Tobago. [5] But China is unlikely to remain 86th for long.

An often-essential piece of the infrastructure required to run a P2P platform in China is third-party payments. P2P platforms tend to be registered and regulated as informational intermediaries or asset exchanges, but parts of their business model such as guarantees and loan loss reserves mean that many are effectively credit intermediaries. One of the greatest legal risks for P2P operators has been being declared "illegal fundraisers," a conviction that could mean a figurative death sentence for their companies as well as a literal death sentence for those convicted of the crime. One way to reduce this risk is to route investor funds and borrower payments through third parties to reduce ambiguity about how who is raising funds.

In fact, just like the P2P industry today, the third-party payments industry operated in a legal limbo for about 12 years, beginning in 1999 but taking off after Alibaba's launch of its Alipay service to facilitate online shopping transactions on its TaoBao platform at the end of 2004.Alipay and 26 other companies received licensesfor third-party payments services on May 26, 2011, which marked the beginning of clearer regulatory rules for the industry.[11] According to iResearch, Internet payments reached 2.4 trillion RMB in value in Q1 2015, up almost 30% year-on-year. While 24.3% of these payments were for online shopping, a large and growing share of 18.9% went to funds like Alibaba's Yu'E Bao. Alibaba is the clear market leader in 3rd party payments with its Alipay product, now at 48.9% market share. The second place player, Tencent with Tenpay, reached just under 20% of the market by transaction value.[6]

Although a few large players dominate the market, the long tail of the industry has also grown rapidly, buoyed by a stream of licenses provided by the central bank for new entrants to the market. By July 2014, the PBC had issued 269 licenses for third party payments providers.[7]Some of these providers, like Huifutianxia, provide specialized account management services to P2P companies. These third party services have facilitated the market entry for P2P platforms, as each does not need to build its payments and account management

[5] Internet Society Global Internet Maps: Internet User Penetration. http://www.internetsociety.org/map/global-internet-report/ Accessed 27 June 2015.

[6] "iResearch Views: Q1 2015 China Third-Party Internet Payment GMV Attain 2.4 Tn Yuan 4 June 2015." iResearch. http://www.iresearchchina.com/views/6472.html. Accessed 15 June 2015.

[7] "Central Bank Issues More Third-Party Payment Licenses" Caixin. 16 July 2014. http://english.caixin.com/2014-07-16/100705011.html. Accessed July 27 2015

infrastructure from scratch. It also provides more support to the platforms' assertion that they do not function as credit intermediaries. Platforms claim that they do not touch funds managed by the third parties, including any loan-loss reserve funds.

Another benefit to the migration of payments online is the creation of data that can be used for credit rating. Since relatively few Chinese have accessed credit from banks in the past, platforms in China have struggled with a paucity of data from which one can create risk models, an issue less salient in the United States due to its long history of consumer credit and well-established credit bureaus. Some platforms worry about the concentration of this data at third-party payments providers (which may have data from numerous client platforms) and the risk that this may lead the payments companies to enter the market as competitors themselves.

Third party payments have also led to broader public acceptance of online, mobile financial services. Alipay reported over 300 million real-name registered users, implying that over 50% of Chinese mobile Internet users had an account.[8] If one feels secure making payments by phone, why not lend, invest, or borrow as well?

[8] As of 8 February 2014. http://ab.alipay.com/i/dashiji.htm. Accessed 27 July 2015.

However, not all platforms are continuing to use these relatively new payments providers for their account management. A recent trend in the past year has been for some of the larger platforms to eschew third-party payment services and instead place their accounts at banks like Minshengor CitiBank.[9] Why would a platform choose a more costly, much more highly regulated solution to manage their accounts? One reason is that in a crowded field with tens of new platforms being created every day and tens failing, with no standardized disclosure, working with a bank sends a strong signal about the risk management and reliability of a platform. This signal then in turn may provide the platform with a comparative advantage in marketing to China's stability minded investors.

In sum, China'srapid technological development has provided a strong basis for P2P companies' existing position and future growth. Internet penetration, though low as a percentage of the population, is rising rapidly. With this rise come hundreds of millions of new potential customersfor online lenders as well as new sources of data

[9] "P2P Lenders Partner with China Minsheng Bank to Manage & Safeguard Client Funds." Crowdfund Insider. 14 February 2015. http://www.crowdfundinsider.com/2015/02/62747-p2p-lenders-partner-with-china-minsheng-bank-to-manage-safeguard-investors-funds/. Accessed 2 July 2015

to evaluate credit risk. Other financial innovations like third party payments have allowed P2P to reduce their risk of running afoul of illegal fundraising laws.

Government Policy Is Helping Push Internet Finance

In March 2015, the Chinese government unveiled its official "Internet plus" strategy that clearly supports the development of P2P and e-commerce more broadly. The strategy aims to drive economic growth by developing the combination of Internet technology like big data with manufacturing and commerce. The accompanying investment in Internet infrastructure will get more people online as well as improve speeds and cut costs for those who already have access, expanding the potential market for online P2P platforms. For example, in May, Premier Li Keqiang called on mobile providers to make mobile data cheaper and faster. They responded almost immediately with 20-35% cuts in mobile Internet speeds, a move which will put mobile Internet closer to reach for the poorest sectors of the population like migrant workers and small-scale farmers.[10]

[10] "China's Telcos Heed Premier's Call to Cut Internet Fees." South China Morning Post. 17 May 2015. http://www.scmp.com/news/china/economy/article/1799149/chinas-telcos-heed-premiers-call-cut-internet-fees Accessed 17 May 2015.

Local governments have also been eager to attract Internet finance businesses like P2P to their jurisdictions. Shanghai was the first to roll out supportive policies, but seven other cities followed, including Beijing and Shenzhen, in 2014. For example, Shanghai's municipal government launched an Internet Finance Park in 2014 and filled the space with companies like Dianrong in only 3 months. In August 2014, it issued official support measures for Internet finance companies, including tax incentives and streamlining certain types of registration.[11] The accommodative attitudes both the central and local governments have taken towards Internet finance broadly have had a powerful effect in encouraging companies to enter the industry. It signals official recognition of P2P's legitimacy and recognition of its long-term potential.

The Economics are Right for P2P

Economic factors, both at the household level and for businesses have contributed to healthy supply and demand for P2P loans. Among households, the proportion needing credit is high and the search

[11] "Shanghai Pledges Support for Internet Finance," China Daily. 8 August 2015. http://usa.chinadaily.com.cn/business/2014-08/08/content_18276025.htm Accessed 3 July 2015.

for yield among wealthier households has provided ample funds as P2P gains wider acceptance. For businesses, the growth in private enterprise and entrepreneurship has created a need for business loans, often smaller loans than banks tend to provide.

Households Need Better Credit and Investment Opportunities

The conventional wisdom about Chinese households in the West as thrifty savers with little need for credit and low consumption, investing solely in homes and bank deposits hides a much more complicated reality.In fact, this reality is ideal for the development of P2P. The China Household Finance Survey results indicated in 2012 that around 50% of surveyed households reported consumption either equal to or larger than their income.[12] This result implies an enormous demand for credit from the 650 million or so Chinese who would by implicationbe net borrowers. Of the rest of the population, though they may be net lenders, many millions will still take out loans for mortgages, tuition, cars, and other large purchases. In fact, 50% of Chinese households reported owning less than 405,000 RMB in assets, or about 65,000 USD. Since this includes housing assets, these households would likely need to borrow to cover unexpected expenses or make large purchases. Since banks have only a limited capacity to expand lending and tend to prefer large loans to SOEs, many of these consumers could turn to P2P.

Businesses Need Capital to Continue Growing

Both supply and demand for capital are growing rapidly in China, which has created borrower and investor needs that the giant state-owned banks have not satisfied. In the past, when state planners ran China's economy, the government budget would allocate capital directly to businesses according to the economic plan, and any "profits" by state owned enterprises would be remitted directly back to the central government. China's households had little capital of their own, and private business was discouraged if not outright forbidden, especially during the Cultural Revolution from the mid-1960s to the mid-1970s. Reform and opening revolutionized China's economy, creating both an enormous stock of household wealth and profitable investment opportunities.

[12] Gan, Li. "Findings From the Chinese Household Finance Survey," September 2012. Southwestern University of Finance and Economics.http://chfs.swufe.edu.cn/upload/files/Report-English-Sep-2012-2.pdf Accessed 29 July 2015

We can see the rapid growth in Chinese private business since China joined the WTO in 2001. The decade from 2002-2012 saw the number of registered private enterprises in China more than quadruple from 2.6 million to 10.9 million, and individual businesses almost double from 23.8 million to 40.6 million.[13] The China Household Finance Survey notes that in 2014, 14.1% of the Chinese population was self-employed, almost double the US's 7.2%. Such small businesses are either underserved by existing official financial institutions or not served at all, and are thus ideal customers for P2P platforms. In a survey of entrepreneurs in Henan province, Kellee Tsai found that 93% never had bank loans, but 60% had obtained credit from non-banks.[14] The rise of private business needs capital, and the millions of individual businesses who were previously unable to get credit from banks can now turn to P2P.

[13] Lardy, Nicholas, 2015, "Markets Over Mao" Peterson Institute for International Economics. Washington, DC. P.70

[14] Tsai, Kellee. 2001. "Beyond Banks: The Local Logic of Informal Finance and Private Sector Development in China. "http://www.hks.harvard.edu/m-rcbg/Conferences/financial_sector/BeyondBanks.pdf Accessed 18 June 2015.

Interest Rate Controls and Liberalization

The famously high savings rate in China is actually driven by the large proportion of income for those in the upper reaches of the income distribution and companies. With slowing housing price growth, an volatile stock market, and low interest rates for deposits, the stable, high investment yield offered by P2P is very attractive, often much higher than comparable wealth management products offered by banks and trust companies. Lower minimum investments as low as 100 Yuan attract investors who may lack the investable funds to reach investment thresholds for investments in wealth management products and trust products. A comparison with the US shows just how much room Chinese households may have to diversify their financial assets. US households held only 12.7% of their financial assets in bank savings, but the corresponding share for Chinese households was almost 58%.[15] Cash was another large component, at 17.93%, meaning that over 75% of Chinese household financial assets were invested in products with either low or no yield. Hopefully P2P can help these households gain a better return on their hard earned savings.

[15] Ibid.

One byproduct of China's highly regulated banking system h[...] been financial repression of Chinese households. The Chinese centr[...] bank sets benchmark deposit and lending rates for banks, from whic[...] rates offered can deviate by set amounts. While permitted deviatio[...] from official rates have been increasing over the past few year[...] amounting to some de facto rate liberalization, these rates are stil[...] very low. Lardy calculates that average real deposit rates in Chin[...] from 2002-2008 was negative .3%, and that real demand deposit rate[...] in mid-2008 were -7.18% as the benchmark rate failed to rise wit[...] inflation. He estimates that earning real rates similar to those in 200[...] (still far below today's P2P rates) would have netted Chinese savers a[...] extra RMB 690 billion more for the first half of 2012 alone.[16] Clearl[...] there is an unmet need for both loans and investment products that P2[...] is ideally suited to fill.

Chinese Culture: A History of Interpersonal Lending

Finally, Chinese culture surrounding lending is one explanatio[...] for the explosive growth of the industry. This culture is rooted i[...]

[16] Lardy, Nicholas, 2012. "Sustaining China's Economic Growth after the Crisis" Peterson Institute for International Economics. Washington, DC.

[...]housands of years of Chinese individuals and businesses lending between one another rather than through banks. This phenomenon is especially pronounced in rural areas, which until very recently made up the vast majority of Chinese society. Results from the Southwest University of Finance And Economics' Chinese Household Finance Survey show that this informal lending dominates official financial institutions in rural areas, and banks are in the minority even in urban areas where visiting a bank branch is much easier.

Among rural households surveyed in 2012, 48.3% reported using informal finance to borrow, but only 14.1% reported loans from official institutions. Urban household numbers were 28% and 15.9%, respectively. These informal lenders comprise a vast world of credit providers at highly varied interest rates and legality. Much informal lending for rural households has been at either low or no interest, lent between friends and family.[17] The shared social bonds and likely deep knowledge of the others' finances allowed both an assessment of repayment risk and a powerful social incentive to repay. Just as in

[17] Guo, Pei and Guangwen He. 2005, "Estimation on the Aggregate of China's Rural Informal Finance," Center for Rural Finance and Investment Research, China Agricultural University.

every society, the Chinese also have high-interest lenders who wou be called "loan sharks" in the west. In 2012, 11.9% of househol reported lending money directly themselves, while 33% borrow money, over 1/3 of which was for business or agriculture. Su borrowing comes at a high cost; the average rate paid by rural inform borrowers was 26.47%. [18]

This cultural predilection for interpersonal lending applies companies as well, though regulation means they generally need go through banks. The Wall Street Journal estimated that China 10 largest banks brokered 3.7 trillion RMB in so-called "entruste loans" in 2013, in which Chinese companies lend to each other i a deal organized through banks.[19] In these transactions, the ban functions somewhat like a P2P platform would. Its own capital is no supposed to be at risk, and the loans do not show up on their ow balance sheet.

[18] Gan, Li, "Findings from the China Household Finance Survey." Southwest University of Finance and Economics. September 2012. http://chfs.swufe.edu.cn/upload/files/Report-English-Sep-2012-2.pdf. Accessed 27 June 2015.

[19] "Entrusted Lending Raises Risks in Chinese Finance." Wall Street Journal. 1 May 2014 http://www.wsj.com/articles/SB1000142405270230416360457953138371229024 Accessed 29 June 2015.

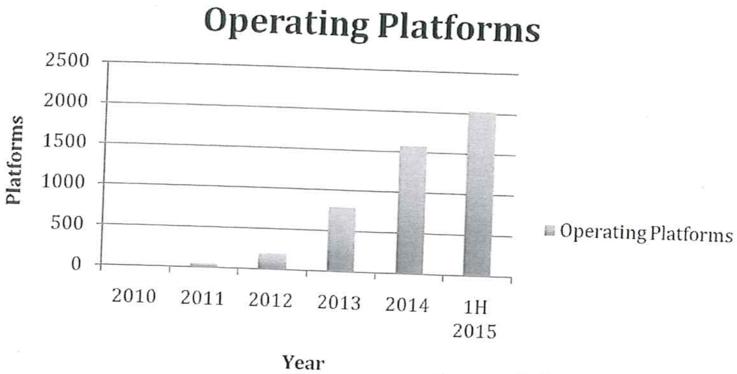
Unlike in the West, well-established cultural norms around lending by individuals and companies in China accelerated the acceptance of investors and lenders for P2P. It is one of the reasons retail investors dominate Chinese P2P, while in the West it is institutional investors doing so.

An Overview of Chinese P2P Today

Platforms

P2P in China is currently a sort of "wild-west" of finance. Tens of firms come online and tens more fail every month, loan intermediation has skyrocketed, and regulations seem to be a minimal constraint.In their report on the first half of 2015, Online lending house and Yingcan grouppput the number of operating platforms at2,028 by the end of June 2015.[20]

[20] "73 Platforms Reach Balances in Excess of 500 Million RMB, Numbers Double." Online Lending House. 1 July 2015. http://www.wangdaizhijia.com/news/hangye/20697-all.html. Accessed 2 July 2015.



Source: Online Lending House

Just under 900 of these platforms came online in the first si months of 2015 alone, and 73 leading platforms have alread intermediated 500 million RMB or more.[21] According to thes statistics, Guangdong'sHongling Capitalintermediated just short of l billion RMB in June and July of 2015.To put this in internationa perspective, the loans intermediated by this one platform in the la two months is approximately equal tothe total intermediated by th UK's entire P2P industry in 2014.

But with the proliferation of business models, such as that o CreditEase that focus on sourcing borrowers and investors offline

[21] "73 Platforms Reach Balances in Excess of 500 Million RMB, Numbers Double." Onlin Lending House. 1 July 2015. http://www.wangdaizhijia.com/news/hangye/20697-all.html Accessed 2 July 2015.

he data from Online Lending House may be missing significant mounts of P2P loans originating offline but still going through 2P platforms. For example, CreditEase works with FICO's could-ased Alternative Lending Platform but originates the vast majority f its loans through an offline sales force. Its P2P platform Yirendai s only a part of a massive company. It also maintains and staffs enters across China. In April 2015, a CreditEase representative informed the author that it is now present in 180 cities and 40 rural areas, with plans to expand into 1000 rural areas in the next five years.It certainly has been active in hiring. In May 2015, CreditEase reported a total workforce of 46,000 employees. [22] Although it has such a large footprint and has been reported by companies like Lend Academy to intermediate loans of $6 billion in 2014 (see chart below), Online Lending House only reports its loans through its online Yirendai platform, putting it at 4th place after Lufax, Hongling Capital, and Renrendai. The expansion of P2P companies into wealth management and a plethora of other services means one cannot use any single metric to compare platforms. Shanghai Finance

[22] "Happy 9th Birthday to Creditease." Creditease Company News. 28 May 2015. http://www.creditease.cn/news/gongsixinwen/2015/0528/2478.html Accessed 3 July 2015.

Institute, China Finance 40 Forum, and CF City jointly conduct a survey of 19 platforms, of which 12 reported offline locations credit checks and business development. Of those 12, the number offline locations doubled from end 2013 to end Q1 2015, when th ranged from 2 to 512 locations. In fact, the fastest growing platfor registered an astounding 15x growth rate over this period.

Top Ten Largest P2P Firms in 2014

1	CreditEase	China	$6,000
2	Lending Club	US	$4,400
3	Lufax	China	$2,300
4	Prosper	US	$1,600
5	SoFi	US	$1,300
6	OnDeck	US	$1,200
7	CAN Capital	US	$1,000
8	Avant	US	$500
9	RateSetter	UK	$457
10	Funding Circle	UK	$432

Source: Lendit China Webinar, 5 June 2015.

Investor and Loan Characteristics

By the end of June 2015, P2P platforms had 2.18 million investo and 1.06 million borrowers. While that would be a large number people for most countries, in China less than .2% of the population

n investor and less than .08% are borrowers. The room to grow this umber remains enormous despite the already breakneck growth of 2P in China.

Source: Online Lending

Loan intermediation growth has been rapid and accelerating. Chinese P2P loan balances have already doubled since the beginning of the year and now stand at 200 billion RMB, or 32 billion USD.

Box 1: Data Issues

Online lending house obtains its data directly from P2P platforms and supplements that information with a team of researchers as well as collaboration with Yingcan group for reports. The number quoted here is lower than that from the China Payment and Clearing Association cited in the introduction and measures total intermediation, not just loan balances. Therefore, the former would involve more dou counting.

There are, however, concerns about the accuracy a completeness of the data from Online Lending House. For exam some experts informed the author that platforms have two sets books: one for Internal management and another that is "revise for public consumption and reporting to Online Lending Hou Outstanding loans could be overestimated due to exaggerat reporting by platforms, but could also be underestimated becau of lack of coverage of small regional platforms. Despite its flaw it is one of the most comprehensive estimates for the industr and is thus used here. The author anticipates that data quality w increase significantly after regulation mandates and standardiz disclosure.

By the end of Q1 2015, Online Lending House reported that, 80 of P2P loans are concentrated in just four highly urban province Guangdong, Zhejiang, Beijing, and Shanghai. The concentration i urban areas means P2P is still not reaching rural areas to the exte that should be possible with its electronic distribution methods, bu expansion of rural Internet access should help drive growth in rura

P2P lending going forward.

Average investor returns have been stable around 15% for the past three years. Maturities tend to be short, with an average of around six months, butalmost 60% of loans mature in 1 to 3 months after issuance. Just as it is with wealth management products and bank loans, long-term loans from P2P are scarce; only 1.27% of loans were for one year or greaterat the end of 2014. This is in contrast with Lending Club's focus on loans of 3 years or more. With such short maturities, it is likely that most borrowers depend on the ability to continue to roll over their loans, whether businesses or consumers. P2P companies report default rates below 2%, and one company the author interviewed that reported intermediating billions of RMB in loans even claimed they had never had a "bad debt."

Such claims seem impossible, but with no mandatory disclosure and no official definition of default, the P2P firms are for now free to post just about any number they wish. In a Q&A session with Lend Academy in March 2015, Lufax estimated its charge-off rate on unsecured loans at 4% and predicted a rate going forward of 6%. [23] One

[23] "Lufax: The World's Fastest Growing P2P Firm." Lend Academy. 27 March 2015. http://www.lendacademy.com/lufax-p2p-firm-china/ Accessed 5 July 2015

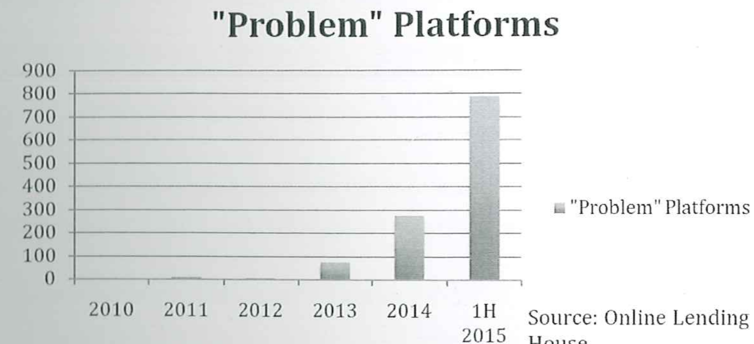
expert interviewed with direct knowledge of multiple platforms' l performance estimated the true default numbers at 15%, and potenti much higher for some less sophisticated platforms without effect risk management. In fact, default rates for originations have a differ meaning depending on the firm's business model.

Although the loans may have relatively high default rate, 3rd pa guarantee companies and other financial institutions that backed loans may step in to ensure that the P2P platform investors do not any losses. Other small losses may be absorbed by loan loss reserv and yet others may be hidden if the platform uses its own capi to pre-pay investors. On secured loans, borrowers may default b forfeit collateral that can be sold for enough to reimburse invest in full. However, such repossessions are costly and often length The platform would need to decide whether to impose those cos on investors to show up as a sort of default, which is unlikely in t current environment. This differs from the US. For example, Lendi Club makes it clear that any losses are borne by the investor, and th funds collected later on overdue loans will be net of the expens incurred by the loan servicer. There is hope that regulation wi standardize disclosure for defaults in a way that allows us to analyz it, but even highly regulated Chinese banks have been accused

porting impossibly low default numbers in the past, so this is not sured.

raud and Failure

The dark side of P2P has been insolvencies, failures, and outright auds. In June 2015 alone, Online Lending House reported 125 new problem platforms," 43 of whichinvolved platform owners/managers unning off with funds invested over the platform.[24] In total they report 86 problem platforms since 2011, of which almost half directly ran ff with client money.



Source: Online Lending House

[24] Online Lending House Data: http://www.wangdaizhijia.com/zhuanti/sswd34/ Accessed 2 July 2015.

Some were scams from the very beginning. For example, Hu ShunchangCaifu[25] started in June 2015, registering capital for business at 10 million RMB. It thenattracted 222,000 RMB f 125 investors before taking down the site and running off less t a month into its operations. [26] Others like Jingyu Loans opera their platforms for not even a full day before running off with cl money.[27] Another scam targeted senior citizens, running off w over 100 million RMB.[28] These scams damage the reputation of t industry as a whole. Coming regulation or self-regulation throu industry associations with certification processes must find a way reduce the prevalence of these scams to keep the industry on a heal development track. The new regulation should give more resourc

[25] The first two characters are for a location, but are pronounced similarly to the Chin word for "smooth" as in to go smoothly. Investors who lost funds may not appreciate irony.

[26] "ShunchangCaifu 2015-06-25 Hubei Changsha Closes Site and Cannot be Reache P2Peye. http://www.p2peye.com/thread-430132-1-1.html Accessed 30 June 2015.

[27] "National 'Problem' P2P Platforms exceeds 100, Jingyu Loans Goes Online and Ru Off Same Day. Netease Money. 8 October 2014. http://money.163.com/14/1008/1 A81DD3CM00253B0H.html Accessed 30 June 2015.

[28] "'Warm' Invesment Company Runs Off, 300 Elderly Cheated out of over 100 millio Online Lending House. 3 July 2015. http://www.wangdaizhijia.com/news/hangye/207 html. Accessed 5 July 2015.

al and human, to regulators to educate investors on how to avoid ing cheated and shut down such illegal financing schemes before ey can get large.

usiness Models and Guarantees

Chinese P2P companies' product offerings is distinguished from ose offered to European or American customers in the volatility of turns, or lack thereof. The management of P2P companies in China plained to the author that this is due to a risk aversion shared by many hinese investors. Volatility, most often due to visible defaults, makes far more difficult to attract investors, so the platforms use a variety f methods to smooth out the returns. None of these methods would ikely be permissible in the highly regulated US and European markets. ne reason for the difference may be that the investor base for Chinese 2P is almost exclusively retail, while that of western "marketplace enders" is now mostly institutional investors. Another is a lack of risk ifferentiation common across the Chinese financial system. Until ecently, Chinese investors had access to a very limited set of options ike bank deposits and stock investments. In contrast to the United States, few retail investors hold bonds, and money market accounts and wealth management products are all relatively new phenomena.

Some platformslike put a portion of the interest paid, equiva
to about 3-6% of the loan balance, into a loan loss reserve f
Platforms then maintain the funds in an account at a third p
bank. When a borrower defaults or is late on his/her payme
the platform uses funds in the reserve to continue payments
the investor as if the borrower were not late.[29] The hope is
the delay is only temporary, and that resumption of payme
or collections then replenish the reserve. Such a practice c
into question the platforms' stated role solely as "informat
intermediaries."Completely stable returns, promises of 10
safety, and prepayment seem like a high-interest bank deposit,
would be difficult to differentiate for an average retail investor.
example, when asked what distinguished their product from a nor
bank deposit, one platform manager pointed out that the for
lending party on the contract included every purchaser of the onl
investment product, rather than the platform itself.

Other platforms, like Jimu Box, use 3rd party guarantee compan
and other financial intermediaries to provide guarantees. A comm
business model is to accept borrowers on referral from these compani

[29] The platforms call this 垫付 (dianfu), roughly translated as an advance.

ich come with a guarantee of repayment if the borrower defaults.
e management of Aitouzi noted in an interview that they cooperate
th over 90 financial institutions for business. In fact, there are a
ethora of companies who provide guarantees, including guarantee
mpanies, factoring companies, financial leasing companies, and
hers. Though the regulation is not yet official, CBRC officials have
ated that P2P firms should not use guarantee companies "linked"
ith themselves so the platforms are not themselves required to repay
the event of defaults. However, these distinctions, like many, are
urred in China. For example, the Lufax platform is part of the giant
ing An Insurance Group, whose credibility, brand recognition, and
etwork has helped the platform grow rapidly. The guarantor for its
ans also is part of Ping An, but Lufax management has insisted that
t does not qualify as a "linked" guarantor because it is a separate legal
ntity.

Companies that have not used one of these methods have not
fared as well. Paipaidai, the first P2P company in China, has not
offered guarantees and runs a purely offline model. Despite being
an early mover, it has grown more slowly than companies offering
fixed returns. In October 2012, the FT reported that CreditEase,,
with its extensive offline business and guaranteed returns had by

then intermediated 2-3 billion USD in loans versus Paipaida 200 million RMB.[30]

While Chinese retail investors clearly prefer the guaran options, such models carry a great deal of risk, especially in event of a sharp economic downturn. Without experiencing defa investors are unable to directly see the risks they are undertaking investing in a high-interest product. Each company is careful to that despite marketing materials with phrases such as "100% sa and "guaranteed principal and interest," exhaustion of their l loss reserves not make them legally liable to compensate inve losses from their own capital. Despite these assurances, multi P2P companies have privately acknowledged that they occasiona make advances out of their own capital if large borrowers experie payment delays in order to maintain investor confidence. If losses became large enough, it is easy to imagine a platform falli into bankruptcy after using up its capital to provide "advances" investors.

[30] "China Needs a Robust Credit Infrastructure" Financial Times. 16 October 2012. htt www.ft.com/intl/cms/s/0/fc84c4c8-0e13-11e2-8b92-00144feabdc0.html#axzz3eqBG6dL Accessed 3 July 2015.

The 3rd party guarantee model is not without its flaws either. e 3rd party guarantee industry is relatively young and often dercapitalized. For example, Hebei Financing Investment Guarantee oup Co. Ltd., a large state-owned guarantee company based in ebei province that backed around 50 billion RMB in loans,suspended business in April 2015.The provincial government founded it to ck SME loans, but the worsening economy led to defaults that uickly exhausted the capital it had to back its guarantees, leaving 2P firms and other financial institutions with the dilemma of what do with the defaults. It is yet to be seen who will ultimately be on e hook for the losses. More failures to pay by guarantee companies ould put the P2P platforms in a bind, as they would have to decide hether to pass losses onto investors, which would risk shaking onfidence in their platforms, and providing advances from their own unds, which would risk the solvency of the platform and potentially e illegal.

Credit Rating

In discussions with industry participants and regulators, one of the most urgent worries about online lending is China's credit rating system. China's credit rating system became the largest in the world

only three years after establishing its centralized system, with over
million entries today.

China’s first credit bureau was the still-operating Shanghai C
Information Services (CIS), which started as a platform under
central bank that included data from state-owned banks in Shang
Banks were ordered to report all lending and credit events to CIS.
People’s Bank of China’s credit rating data center, depends on l
from banks for rating of individual and business credit. Interestin
loans from other sources, like informal loans, small loan compa
pawn banks, and peer-to-peer lending companies are not inclu
Though the data is not complete, it is the most comprehen
nationwide source of data and is actually the largest credit system
the world with 830 million records for individuals.

For certain small business loans, Alibaba arguably has the m
valuable data due to its dominance of the ecommerce field. I
certainly one of the few Chinese companies that can truly sa
has access to “big data.” Alibaba runs an online marketplace ca
Taobao and other platforms over which the vast majority of Chi
ecommerce runs. For any company whose business sells over th
platforms, Alibaba has real-time access to its sales numbers, as w
as customer reviews that might provide an early warning that qua

service is slipping. Based on these metrics, as well as those it gains ough its Alipay payments service, it can make almost instantaneous cisions on small loans to these companies.

Just as credit bureaus in the early days of the United States veloped out of local and then regional groups of lenders, local edit evaluation companies have sprung up all across China. Such formation sharing has grown in importance as the platforms erating in China expand both within jurisdictions and across em. The US market leader in credit scoring, Fair Isaac Corp, has so entered the Chinese market aggressively. In June, Bloomberg ported it already has over 40 customers for its Alternative Lending latform, which allows companies like P2P platforms to analyze eir loan book,rate credit, and also share some credit data using a oud-based service.[31] FICO is used for the vast majority % of credit ecisions in the US and is often touted prominently on P2P websites s a metric for the quality of its borrowers. It has, however, been the rget of criticism in developed markets for its traditional approach credit rating, which might seem to make itan odd partner for P2P.

“US Credit Score Firm FICO Betting on China Surge in P2P Loans.” Bloomberg News. 7 June 2015. http://www.bloomberg.com/news/articles/2015-06-16/u-s-credit-score-firm-ico-betting-on-china-surge-in-p2p-loans Accessed 24 June 2015.

However, the lack of US-style credit bureaus in China has necessit
expansion into data sources for credit rating that include phone
third-party payments operators, and even pawnshops, which are
not included in US credit reports.

Applications for loans on major Internet lending platforms req
loan seekers to provide a scanned copy of their individual credit re
from the central bank's system as part of their application, but
firms are not able to access the records directly themselves. Des
this, P2P platforms are often able to gain access to the records thro
cooperation with more established, licensed financial instituti
with access, like guarantee companies with whom they collabor
However, at the present, the lack of information sharing means
individual or business could potentially apply for loans at the sa
time from hundreds of P2P platforms, without it showing up on t
credit report, a recipe for fraud and abuse. The lack of reporting
means low costs in the case of default, as unlike in the US it may
not show up on the credit report when applying for future loans.
the future, Chinese P2P will certainly need a centralized platform
loans to which it can report not only a "black list" of defaulters,
also loans issued and to whom. Only with comprehensive informat
sharing can P2P clamp down on this fraud and reduce "evergreenin

ereby insolvent borrowers take out loans from one platform to pay
ck maturing debt.

Regulation

One of the most difficult considerations for regulators is how to deal
ith industries undergoing rapid change and innovation like that of the
2P industry and Internet finance more broadly. The United States and
hina have not yet issued regulations specific to P2P, but the results
ave been night and day. It seems that existing regulations in the
nited States have been mostly sufficient in ensuring P2P platforms
bide by the regulatory norms followed by more established financial
stitutions. For example, companies like Lending Club are subject to
thicket of national and state regulations.

S Regulation

In the United States, platforms must ensure they are in compliance
ith a host of regulatory bodies. Federal provisions such as the Truth
n Lending Act and others related to collections ensure P2P loans are

able to meet stringent requirements for disclosure to borrowers w it comes to their final cost, including fees and interest. They also l the actions creditors can undertake when a loan goes overdue and collections.

State laws then add another layer of regulation. Some platf cannot issue loans in some states because they have been unabl fulfill those states' regulatory requirements, and each state may h its own format for disclosures with its own formulas for calculatio numbers like APR and finance charges. Many states also have us laws that set an upper limit on interest rates, though there are w to "export" the lack of such limits if a bank registers in certain sta Since the loans are generally originated at banks, the issuing ban subject to regulations by the FDIC and other bodies like the OCC.

Once the loan is issued, the platforms face disclosure requireme mandated by the SEC for the loan securitization. One of the b regulatory changes related to P2P in the US was permission to issu new type of security, and there was a real risk then that the applicat would be rejected. These regulations, mostly designed for traditio financial institutions with their own capital at risk, facing ret investors, have slowed the growth of marketplace lending in the and added to compliance costs. This regulatory environment is lik

grow only more difficult to navigate as the Consumer Financial otection Bureau issues more regulations designed to protect rrowers and retail investors in the platforms. Numerous provisions the Dodd-Frank Act have yet to come into play, as concrete rules r implementation by regulatory agencies are not settled. In short, spite not being designed for P2P, the US regulatory environment has nerally ensured adequate disclosure and protected both investor and rrower interests.

hinese Regulation and Policy Recommendations

In contrast, China's P2P companies operate in a regulatory mbo, facing few restrictions as of today. As the industry began take off in 2013, discussion about the proper way to regulate it eated up. Many worried that imposing specific regulation too early ould choke off its development and reduce the capacity of market ompetition to separate platforms that are able to compete from hose who will fail. Another issue is the capacity to regulate. China's nancial regulatory system is separated into sometimes-overlapping ilos, with regulatory responsibilities split between the "one bank nd three commissions," including the central bank, Banking Regulatory Commission, Securities Regulatory Commission, and

Insurance Regulatory Commission. These bodies make ru
implement legislation, but also delegate certain responsibil
for implementation to local government offices. One exampl
financial services offices in municipal governments who ha
illegal fundraising cases.

However, P2P has challenged and outgrown this regula
apparatus in its current form. These companies are opera
seamlessly between lending, wealth management, leasing, insura
payments, and many others, integrating them and easily cross
jurisdictions. How can a local government be expected to effecti
regulate a company sourcing funds across the country for project
numerous provinces? Adapting to the new reality will be one of
defining challenges of financial regulation in China for the com
years. So far, regulators have expressed positive sentiments ab
Internet finance and P2P in general but have done little to interven
A senior policymaker explained to the author that once
government regulates P2P, it is also taking on responsibility for
industry in the eyes of ordinary people. The last thing a regula
wants is protests outside their offices and societal instability d
to the collapse of a P2P platform. Despite over 600 platfor
becoming "problem platforms" with solvency problems or frau

s has not yet happened. Regulators will therefore tread lightly. en if regulators were to find out that many of the smaller, less phisticated platforms may well be insolvent as well due to higher an expected defaults and payments to clients out of platform pital, they may still be hesitant to intervene and face the ire investors claiming that it was closed prematurely. In illegal ndraising cases, there generally needs to be a complaint from sing investors to justify government intervention, and Chinese P2P yet to arrive at this situation.

In fact, the hands-off approach in the initial stages is similar to that ken with shadow banking, which began to take off noticeably in 011. It began on the margins or outside of the existing regulatory pparatus,but it grew rapidly to become a significant part of total social nancing in China.[32] When policymakers understood it better and it rew large enough to pose important risks to the financial system, they egan to regulate it more strictly. Interestingly, the final rules and the ivision of responsibility for enforcing them was not made public.

[32] The PBC estimated shadow banking's (entrusted loans, trust loans, and undiscounted bankers' acceptances) contribution to total social financing at 18% in 2014. People's Bank of China News. 29 January 2015, available at http://www.pbc.gov.cn/publish/english/955/2015/20150129085803713420369/20150129085803713420369_. html.

Though its growth has slowed, it is here to stay. P2P will likely fo in the same vein.

Although the government has decided to put P2P platforms u regulation by the China Banking Regulatory Commission (CBRC has not yet released industry rules. As of this writing, CBRC offi have made two main speeches outlining suggestions for the indu On April 21, 2014, Liu Zhangjun, a CBRCofficial leading its offic illegal fundraising, laid out "red lines" for the industry, including:

1. Clarify the intermediary role of the platform
2. The platform itself cannot provide guarantees to those who u the platform to invest
3. The platform cannot create "fund pools"
4. Platforms cannot illegally raise funds from the public

These basic red lines were then followed by a more extensive se ten principles laid out by another CBRC division on Septembe 2014 at the China Internet Financial Innovation and Developm Forum. Wang Yanxiu of the CBRC's Banking Innovation Supervis Department laid out the following ten principles for the industry:

1. Platforms cannot possess investor funds or establish fund po
2. Real-name registration for users is required
3. Platforms are information intermediaries only

4. The field needs thresholds for entry
5. 3rd parties should handle the funds and be audited
6. Platforms should not supply guarantees
7. Clarify the fee mechanisms and avoid seeking only projects with highinterest rates
8. Comprehensive information disclosure
9. Reinforce self-regulation
10. Focus on small loans

Looking at each principle as well as its broader context can give an idea of the regulation to come and measures platforms need to o to prepare, as well as ensuring they do not run afoul of the illegal ındraising provisions. The author also provides some regulatory ecommendations in this section.

Platforms can easily comply with the first principle by using third-arty payments providers (see previous section on third-party payment evelopment) or banks to provide the account management, with the latform only handling the information, pricing, and credit rating. The fifth also fits here, but the meaning of "audit" in this case needs o be clarified. Does this mean that the platform must do proper lue diligence and regularly check on its account manager or that a specialized independent audit is necessary for these accounts, in which case costs would rise significantly.

On the second part of principle one, the currently widespread m
of pre-paying investors when borrowers are behind on payme
using either platform funds or a loss reserve may violate the f
pool principle, though the platforms would claim otherwise. L
regulation will need to clarify the definition of “fund pool” to pro
clearer guidance. This relates to the second too, as informa
intermediaries should match borrowers and lenders as well as perf
pricing/risk management rather than crossing the line to become cr
intermediaries.

Thresholds for entry are an excellent idea, but it much more diffi
to determine fitting criteria. Most of the existing players started sm
so thresholds based on volume and registered capital would h
precluded many from entering the industry. Setting the criteria
high would create an undesired reduction in competition by putt
up a barrier to entry,which benefits incumbents who have reach
large volumes and already. Only companies flush with capital wo
then be able to become new entrants, such as many listed compani
However, barriers to entry could be the key to reducing the hundr
of cases of frauds in which platform managers “run off” with fur
from those who invested on their platforms. The CBRC could cre

nimum standards for the security of IT architecture, management
perience in relevant fields, and equity capital to ensure that industry
rticipants have the expertise and resources necessary to be trusted
ith directing investor funds through their platforms. The sheer
mber of industry participants would make enforcement of any
andards a time-consuming task, but the CBRC should be given the
sources necessary to complete it.

The sixth point on guarantees has been much debated since it
as released, and is especially relevant to companies like Lufax,
hich uses a guarantee company also part of the Ping An group. The
romises of safety in platform marketing materials and websites (for
xample, many platforms guarantee principal and interest, and even
nore guarantee at least investor principal) would seem to imply a
uarantee. Platforms claim that onlythird parties and loan-loss reserves
f applicable) are the only resources backing these guarantees, and
hat they are not legally liable to step in with platform capital for
nvestors if one or both of these proves insufficient. For this principle
o become effective regulation, the CBRC needs to make a clear
formula for what constitutes a guarantee, including limits on marketing
claims by platforms that would violate regulations issued on the past
year for wealth management products. It should encourage companies

to reduce their reliance on guarantees, which would then help imp
investors' ability to differentiate risk.

It must also establish standards for the relationship betw
platforms and their guarantee companies to ensure that, for exam
the guarantees are not made through a company connected with
platform owners. Such connections could create a dangerous con
of interest. China also needs clear-cut procedures for what happ
to loans if the guarantee company fails. The platforms should in
case not be able to step in with their own capital to reimburse lo
backed by the now-defunct guarantor. If they did so, they would
a dangerous precedent that would invalidate any claims that
function as only informational intermediaries.

Clarifications of these relationships and disclosure of the guara
company's financial health are especially important for Chinese
because of the prevalence of retail investors. Retail investors are ra
equipped to evaluate the financial health of guarantee companies back
their loans on their own, and it is misleading to create a perception
carrying a guarantee makes the loans risk free. Unlike the US, China
yet to experience a major round of defaults or economic downturn si
these guarantee companies were established. A large round of defau
even concentrated in one region, could bring down enough guaran

mpanies that work with P2P platforms and shake investor confidence
st as investors lost confidence in formerly triple-A rated subprime
ortgage securities in the financial crisis.This, however, is a worst-case
enario that can be avoided through effective regulation, extensive
sclosure, and continued efforts to educate investors about the risks of
2P, risks that justify the high returns they earn in good times.

As for principle seven on fees, the CBRC should create standardized
isclosure forms for fees. One for investors should clearly indicate
e interest rate spread, origination fees, servicing fees, transfer fees
f applicable), and any other applicable costs that may be incurred by
e investor. For borrowers, platforms should disclose a total annual
ercentage rate that shows the total cost of the loan if paid on time,
hich includes any fees and interest. The standardization would allow
egulators and/or thirdparties to make meaningful comparisons that
elp investors and borrowers find the best fitting products. It would
lso award more efficient platforms that charge lower fees.

Of all the principles, disclosure may be the most important.
Transparency in investing and platform management is a key factor
differentiating P2P from banks. It is fundamental to equipping investors
to make their own properly informed decisions of which platforms
to choose and which loans on a given platform they decide to fund.

Although platforms voluntarily disclose a great deal of inform in order to reassure borrowers and investors they are making a informed decision, the lack of standards and required disclo means it is difficult to analyze and draw meaningful comparisons between platforms and about theindustry as a whole.

For example, platforms are eager to report their total loan vol which implies that they are a leading company. However, the not tend to report their average outstanding loans, resulting in counting.[33] Platform executives explained to the author that wanted to prevent calculations of "leverage ratios" based on loan P2P capital, though leverage should be irrelevant if they are stick to informational intermediary status and not risking their own cap Conversely, they are not obligated to report any to the third par who estimate the total industry size,let alone accurate informat meaning our estimates may also be overstated. Smaller platfo concentrated in a provincial city may have upwards of 100m R in loans and still not be counted in data from Online Lending Ho

[33] Just under 60% of P2P loans mature 1-3 months after issuance, so any repeat borro of these maturities who roll over their loans would be counted 4-12 times in one year total issuance. The average amount outstanding, however, would be lower.

aving a long "tail" of P2P invisible to national authorities and dustry analysts. A compulsory disclosure regime for platforms would low much more accurate analyses of the industry and its risks.

Self-regulation for the industry for many oversight functions is nsible when one considers the extent of work required to regulate ch a rapidly growing industry with so many players. In fact, dustry associations in cities like Beijing and Shanghai are already in lace. Platforms requesting to join the association in Shanghai must ndergo an audit thatverifies the accuracy of the amounts they claim intermediate. They also must publish their reserves and place them n banks. These are good first steps, but self-regulation should also nclude certification procedures to help investors avoid platforms with neffective risk management, insufficient capital to keep the platform unning, or outright fraud.

Self-regulation should also include mandatory information sharing on loans across China, not only within individual cities. At the present, insufficient information sharing and the fact that P2P platforms cannot report to the central bank's credit rating system mean that defaults on one platform may not necessarily reflect poorly on an individual or business' creditworthiness indicators. This leaves the platforms and other financial institutions vulnerable to fraud. Borrowers in financial distress may also take out new loans on another of the 2000 platforms to pay back the others in a dangerous game of "hot potato, making defaults appear lower than they ultimately will turn out to be. Fraudsters may simultaneously take out small denomination loan from numerous platforms to amass loans in the hundreds of thousand or more RMB, but the cost of tracking them down discourages an individual platform from vigorous pursuit in collections. Although ther are "black lists" of fraudulent borrowers, real-time, comprehensi information sharing is necessary to ensure the continued health development of P2P lending in China.

The last principle, to focus on small loans has been much mor controversial. Although the definition of "small" may be up for debat platforms like Hongling Capital who have funded single projects up t 200 million RMB[34] are unlikely to fit under most definitions. Rumo earlier this year emerged that the CBRC was considering a cap o a few million RMB (less than 1 million Dollars), but most of th companies the author spoke with predictably found it to be too low.

In any case, the goal of a cap should be to ensure that any platfor

[34] "100 Million RMB Bad Loan Experienced by Hongling Capital Enters P2P Records Xinhua News, http://www.xinhuanet.com/fortune/cyjj/15.htm, Accessed 29 June 2015.

does not have excessively concentrated risk in one firm or group of firms. To avoid conflicts of interest, platforms should not be created to funnel money into one company, and excessive concentration goes against the spirit of P2P, a spirit that facilitates decentralization and diversification. However, caps should not be used to shield banks and other large lenders from competition. One P2P executive told the author, "Regulation should not force us to make small loans just for the sake of being small." The goal should be to permit P2P to lend reasonable amounts to companies in the lower end of "S" to the upper end of the "M" in SME, but only if they are large enough to continue operation in the event of default.

These guidelines, while a good start, need the force of law and accompanying penalties for non-compliance. Servicing and platform resolution are two more areas that future regulation must address. Some industry participants predict 90% or so of the firms currently operating will fail in the coming years, especially after the industry is regulated.[35] While nowhere near as difficult to deal with as bank failures, regulators must be prepared to deal with

[35] "CBRC States P2P Cannot Provide Guarantees. Industry Insider: 90% of P2P will fail. Xinhua News.9 July 2014. http://news.xinhuanet.com/fortu... htm. Access...

platform bankruptcies. In conversations with regulators, scholars, and industry participants, none was able to provide the author with a clear answer as to who would be responsible for servicing the loans going forward. The CBRC's upcoming regulations should make clarification of the loan servicing arrangement and fees a priority. With clear responsibilities and fees, it will be much easier to, for example, transfer those servicing rights to another entity and avoid a disruption of payments for borrowers who are able to continue payment. Platform resolution would then be much simpler as well.

Regulators should ensure maximum effort is made to ensure loans made by defunct platforms remain to be serviced. If not, it may be difficult to assert later that when it comes to systemic risk such platforms are not just unregulated banks. Failure of the P2P information intermediary should not mean a disruption in all the credit it helped arrange. If the industry undergoes a major round of consolidation without massive losses to those who invested over the platforms, then P2P will continue to gain acceptance among the Chinese public and government. This confidence can then become the foundation for aggregate growth even more rapid than the present for the remaining platforms and continued encouragement by regulators.

Outlook for P2P in China

P2P has incredible potential to remake the way finance is done in China if it is done right. As the Internet reaches more of the population, accumulated data on consumers and businesses improves risk modeling, regulation helps control risks, and the platforms themselves improve, Chinese households and businesses will find themselves with many more attractive choices for investment and borrowing. That is not to say that this is right around the corner and that the route is not fraught with risk. The market today is mostly untested by economic downturns, regulatory compliance, and large scandals. In fact, there is a consensus among experts the author interviewed for this report that the majority of platforms are likely to fail in the coming years; especially once the field becomes regulated.

Short Term

In the short-term, P2Pfaces many challenges. The nascent industry mustearn the confidence of the public and government through the coming industry consolidation, which some predict will lead to bankruptcy of over half to 90% of today's platforms. Those who

ot compete or comply with coming regulation must exit the
et in an orderly fashion and make efforts to ensure the loans they
nediated remain serviced.

nother challenge is to retain this trust while gradually reducing
ole of guarantees. While platforms may be right that guarantees
he appearance of unvarying returns is important at this stage
t investors familiar with P2P, the industry should shift the risk
vestors over the medium-term. It is dangerous to create the
on that P2P returns are "guaranteed," especially considering
forementioned gaps in credit data and short history of both P2P
uarantee companies. Investors in Lending Club's platform see
y varying returns based on their portfolio, but it has still grown
ssively. Sufficient diversification, not guarantees, should reduce
lity for investors. P2P would then be part of showing investors
ixed income instruments are not riskless, but can still provide
returns. In any case, coming regulation may prohibit some of
arantee and prepayment practices prevalent in the industry, so
should prepare for this possibility.

e initial round of regulations will likely set off the first round
ustry consolidation. It will put poorly run, uncompetitive firms
business and demonstrate the ability of those who remain to

stay competitive despite higher compliance costs. Most importantly, the barriers to entry will make setting up a fraudulent platform to run off with client money more difficult. Compulsory disclosures will shed light on the true size and risk of the industry, especially non-performing loans (NPL).

Dominant E-commerce companies will leverage their advantages in data, name recognition, and distribution channels to enter the market, challenging the fledgling smaller and medium-sized platforms. Alibaba's Zhaocai Bao platform created a 14 billion RMB marketplace in its first six months of operation alone and has set a goal to transact P2P loans of 163 billion USD by the end of next year. [36]

Medium and Long Term

Beyond the short term, when it has a firmly established record of reliability, effective credit rating, solid regulatory compliance, and established a cost advantage versus other players due to its embrace of technology, P2P's outlook looks very bright. Consolidation and higher barriers to entry in the future may pare down the number of platforms

[36] Smith, Tharon and Lew, Christopher. 2015 "Peer-to-Peer Lending in China: Investment Environment." Strontium Group.

icantly from today's around 2,000, but the market could continue pport hundreds of thriving platforms, from all-around service ders with their own asset exchanges to niche players with an ıtage intermediating loans in specific industries.

lthough China may not see days of 10% real economic th again in the near future, the potential size of the market an increased focus on domestic consumption and continued preneurial activity will drive continued growth in the small and ım loan market. This is P2P's sweet spot, and it could far outpace th in the broader economy.

adual opening of China's financial markets to foreign investment elaxation of restrictions on who can lend also present a medium- opportunity for P2P. If the low yield environment continues, gn institutional investors will jump at the opportunity to gain ble, high returns by investing over P2P platforms, just as US- l venture capital firms have been among the primary investors in ese P2P platforms whose total VC investment take in 2014 was billion USD according to the Strontium Group. [37] The rise in y of funds would then reduce funding costs for enterprises and help alleviate the much maligned "difficult and expensive financing" for SMEs and consumers in China. It would also contribute to the internationalization of the RMB as foreign institutional investors flocked into these high-yielding RMB-denominated assets.

Though it may seem unlikely at the present, the author believes that some of the leading P2P companies will become banks in the long run, and banks will also begin to look more like P2P companies. Approval to become banks may not be as far off as it may appear. Companies like Alibaba and Tencent have already been approved to set up banks in a new pilot program to open up the banking sector to private banks. Although it will take time, successful operation of these banks will encourage the government to continue to expand the program. Regulation that increases compliance costs for P2P companies like CreditEase, with offline branches across China and a wide variety of wealth management services beyond its P2P platform Yirendai, may decide to take this step so they can take in deposits and participate in the official credit rating system.

Conclusion

P2P in China encompasses a wide variety of financial and
ormational intermediaries, from pawnshops and small loan
npanies banding together online to asset exchanges run by one of
na's most respected financial institutions. For now, firms number in
thousands and loans intermediated are in the tens of billions of US
lars. Development at this pace does not come by chance. P2P has
erfectly into cultural predilections for lending between individuals,
nological progress allowing it to leverage the Internet to both reach
e people and eventually cut costs of providing financial services.
pportive government policies and an economic environment ripe
new ways to borrow and invest played key roles as well for the
nand side, the supply side, and the flexibility to satisfy those needs.

Just as in any new industry, but especially for finance, there are
wing pains. Hundreds of platforms have already failed, and
dreds more may collapse in the coming years as regulation, stiffer
npetition, and slower economic growth challenge their business
dels. While the failure of smaller players will probably help funds
v to larger players, the failure of a large platform due to excessive

"prepayments" for late borrowers out of its own capital, stepping in for a failed guarantee company to back the loans, exhaustion of its loan-loss reserves, or some other unforeseen factor could be much more damaging to the industry's image. It would be all the more severe if no arrangements were made for continuing to service the loans, leaving investors on their own with the impracticable task of collecting on the small fraction of loans they own. To reduce this risk, P2P will need to focus more on the pure informational intermediary role and allow investors to absorb the risk.

Regulation should focus on a rigorous, standardized disclosure regime that includes bad/overdue loans and effective oversight of companies, whether they call themselves P2P or not, matching borrowers and lenders. Sufficient resources must be devoted to verifying this disclosure and presenting it in a way that allows investors and borrowers to find the most fitting option. Rules should allow continued experimentation in business models while protecting investors as well as maintaining overall financial and economic stability. As P2P gets larger, getting these rules right will only increase in importance. Chinese P2P differs from that in other markets in the scale it has achieved in a remarkably short period and the freedom it has had from regulatory restrictions. While regulation is on the

zon, the government's consistent support means it is unlikely to
ose regulation too restrictive for P2P to continue its development.

Despite these challenges in operation and regulation, P2P has ight future in China. The underlying factors behind its rise not going anywhere. It has the potential to provide a much-ded liberalization of China's financial sector with market-based rest rates for borrowers and investors, directing capital to areas China's economy previously spurned by big banks like small nesses and consumer credit. While the costs remain high for today for customer acquisition, credit rating, and collections, nological developments and accumulation of data will increase ompetitiveness.More established financial institutions with legacy s and less ability to adaptwill lose market share if they do not up. Today's P2P players are already exploring private bank nsing and forays into wealth management businesses. Banks are ly opening up their own P2P platforms, sometimes with the help urrent platforms. Thus, activities performed by different types of ncial institutions will converge even as business models diverge become more specialized. It is important to note that these trends not unique to China. They will challenge the existing regulatory lels around the world.

China has learned and continued to learn from the West from the beginning of its Reform and Opening Up in 1978, but tables have been turning since the subprime and Euro crises. Its regulation specifically designed for P2P will emerge and likely serve as a reference for P2P regulation that eventually emerges in the US and elsewhere. Its companies may create a set of best practices that it exports abroad through expansions and eventual IPOs in the US. When it comes to P2P, the rest of the world may well soon be learning from China.