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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

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.

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.

http://dx.doi.org/10.1016/j.clsr.2015.08.005
0267-3649/

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 traditional 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 2006[10] and reached a valuation of US$2.3 billion in late 2013[11] 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

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[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.

seeking elective medical procedures and to parents paying for private school education.[15]

Internet finance, P2P per se, satisfies its customers' needs through increased convenience, customer service, resource and incentives. Standardised and automated lending or funding processes built upon digital technology help reduce marketing, distribution and transaction costs. However, the popularity of the P2P sector has disrupted the world of traditional bank and credit card lending. The key innovation behind the P2P platforms is their efficient method of matching borrowers and lenders. The P2P platforms directly match borrowers with lenders without the involvement of the banks acting as a credit intermediary, enabling them to extend credit at lower rates than those charged by banks and financial institutions. To some extent, these platforms are really speciality finance companies even though they would characterise themselves as technology disrupters who disrupt the conventional financial sector. The existence of crowds in this sector means self-vetting and transparency without credit intermediation. With more P2Ps in the marketplace, the banking sector becomes more competitive[16] and marginalised.[17] These loans are priced so competitively that they can compete with loans offered by the banks in the market. Financial industry professionals are hopeful that the longer-term disintermediation by P2P platforms will complement the existing business rather than disrupt it.

2. P2P's popularity in China

In China, P2P platforms have gained popularity and market recognition in recent years. The first P2P lending platform was established in 2007. Pandai, a major peer-to-peer lending website, was also established in 2007, enabling individuals with surplus funds lend to others who want money. The number of P2P platforms has increased since then. The P2P lending industry explosion began in 2013, when there was a surge in the number of P2P platforms. Approximately 150 platforms were set up in 2013, accounting for 50% of the total number of P2P platforms in China. The P2P sector continued to mushroom in 2014; about 900 platforms were set up in 2014, which constituted a record. More than 2000 platforms are now in operation by the mid-2015, with loans outstanding reaching Renminbi 209 billion.[18] Online payments are expected to hit Renminbi 11.8 trillion by 2015, up from Renminbi 8.1 trillion in 2014.[19]

The underground lending crisis in Wenzhou did not lead to a halt in P2P lending. In response, P2P micro-finance platforms have promoted lending through the non-banking system. However, P2P loans of all type still only comprise a tiny fraction of the Renminbi 65 trillion outstanding in the formal banking system.

In 2013, more than 200,000 people lent a total of 105.8 billion yuan on approximately 800 P2P lending platforms. In 2014, there were 1.16 million investors and 0.63 million borrowers involved in the P2P lending sector. Compared to 2013, this means a 364% and 320% increase respectively for participating investors and borrowers on a yearly basis. More than 1500 P2P online platforms in China are currently involved in matching lenders and borrowers. Loans via P2P platforms reached Renminbi 252.8 billion by the end of 2014, which spiked 2.39 times of the transactional volume in 2013.[20] The Chinese market now accounts for 28% of the global market, right after the US which makes up over a half at 51%, and before the UK at 17%. China and South Korea make up 95% of the total Asian market. The conservative estimated market value for China is half of the US, that is, US$1.8 billion.[21]

As a middleman bringing people who want to borrow money together with those who want to lend, the lending platforms obtain their revenues through origination fees collected from the matchmaking business. P2P players in China usually set up and register themselves as consultancy firms and may charge service fees ranging from 1 to 10%. P2P platforms primarily get their profits from charging service fees. In China, P2P platforms' fees consist of three parts: fees paid by the lenders, fees paid by the borrowers, and fees charged from the assignment of debts between lenders. Fees paid by the borrowers occupy 70% of the revenues generated from the lending business. However, only the fees paid by the lenders are transparent; the exact nature of the other two types of fees is unknown to industry outsiders. This portion of fees is composed of contribution fees, withdrawal fees, VIP fees and management fees. More than 80% of P2P platforms do not charge contribution fees from lenders.[22] Actually, some platforms charge for account management fees based on the number of registered users (or investors) apart from the service fees paid by both borrowers and lenders.

3. Causes of P2P's popularity in China

Consumers maximise utility based on such desired attributes as cost and convenience, within constraints relating to wealth, time, importance and the availability of payment instruments and related infrastructure. Furthermore, consumers, being responsive to market signals, make rational choices. The fact that investors are rushing to online investment products exposes weaknesses in China's financial system, where investors have fewer options than in Western countries. The

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

16 "P2P Lending: Peer Less", Financial Times, 24 January 2013 (online).

17 The blurb of Lending Club says: Lending Club is an online marketplace that facilitates loans to consumers and businesses and offers investors an opportunity to fund the loans. Our goal is to transform the banking industry to make it more cost efficient, transparent and consumer friendly. We replace traditional bank operations with an online marketplace that uses technology and a more efficient funding process to lower operational costs and deliver a better experience to both borrowers and investors.

18 Gabriel Wildau, "China Seeks to Tame Online Finance Risks", Financial Times, 27 July 2015 (online).

19 Ibid.

20 The statistics were from the Online Lending House, a web portal that racks the industry.

21 Eleanor Kirby and Shane Worner, "Crowd-funding: An Infant Industry Growing Fast", Staff Working Paper of IOSCO Research Department [SWP3/2014], pp. 14–15.

22 China's Internet Lending Business Annual Report 2014.

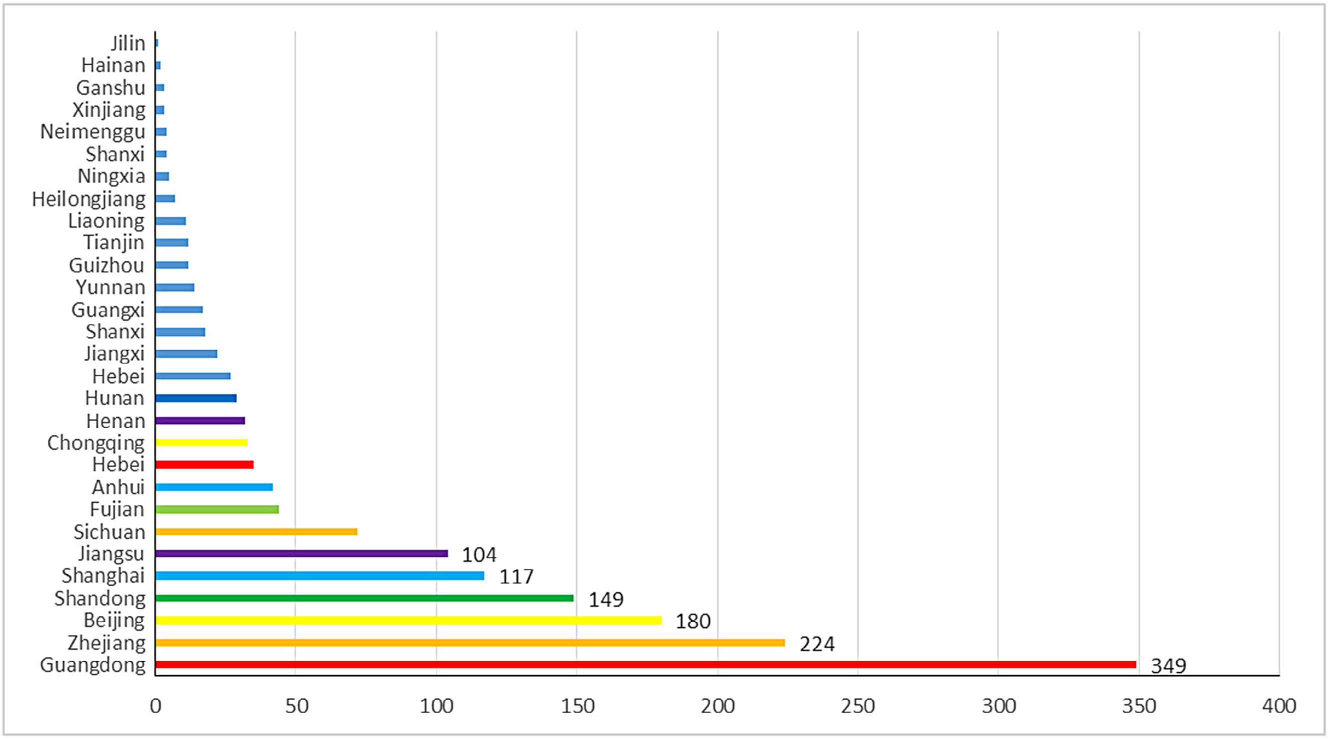

Chart 1 – Number of P2P platforms in each province (compiled by the author). Information is available at China's Internet Lending Business Annual Report 2014.

implication is that consumers are not arbitrarily predisposed to cash, checks, or credit cards or disposed against debit cards, e-cash and smart cards. Rather, consumers are driven by the attractiveness of the financial instruments or products.

P2P's popularity results largely from China's unbalanced financial and economic system. The wide use of P2P companies is a result of combined factors such as the need of capital starved small and medium sized businesses, the lack of funding from the State-owned banks and the existence of underground lending market. [23] Technology has allowed downtrodden banking customers to slip large financial institutions' shackles and deal directly with each other as lenders and borrowers. P2P platforms used this narrative to market themselves as modest community operations with sound underwriting and low defaults. Both the borrowers and lenders benefit from the P2P sector and contribute to its booming.

3.1. *Alternative financing*

P2P can provide a vital source of funding to cash-starved small businesses and individuals, which always encounter tremendous difficulty in borrowing money from the state-owned banks, partly due to the limited scale of collateral assets and in part because the banks' tendency to lend money to better connected state-owned enterprises. Obtaining sizable and stable loans from commercial lenders involves a complicated and costly vetting process, an extended approval and waiting period and demanding lending standards. In addition, commercial banks are usually less keen to lend money to private enterprises due to their lack of valuable assets for collateral purposes. These practical difficulties push away private enterprises, which have had to turn to other means for funding. The growth of the P2P sector satisfies the financing needs of small and medium sized enterprises.

The positive correlation between P2P platforms and entrepreneurship can be illustrated by P2P platforms' geographic distribution in China. By the end of June 2014, the P2P platforms widely dispersed across 30 provinces in China. Chart 1 indicates the number of P2P platforms in each province.

Tibet and Qinghai are the only two provinces that do not have P2P platforms yet. Guangdong is the province that hosts 349 platforms, accounts for 22.15% of the total platforms in China, far outpacing other provinces, followed by Zhejiang, Beijing, Shandong, Shanghai and Jiangsu. The P2P platforms incorporated in these six provinces accounted for 71.30% of the total platforms. Guangdong and Zhejiang are well known for their strong private sectors. Accordingly, they are called as private sector hubs. One feature that private enterprises possess is their small size and hunger for funding. Logically, these two provinces have naturally become the hub for P2P platforms as well. In contrast, the northeastern and western parts of China have relatively fewer online platforms, due in part to the domination of the local economies by state-owned enterprises.

Chart 2 further indicates the outstanding loan with the P2P platforms in key provinces in 2014. The fact that the value of outstanding loans incurred in Beijing was much larger than

[23] In the US, P2Ps are used to borrow money to consolidate debt or pay off their credit cards. Lending Club for example reported that 83% of borrowers using loans to do so. Andrew Blackman, "Who's Your Banker? Who Isn't?", The Wall Street Journal, 10 February 2014, R2.

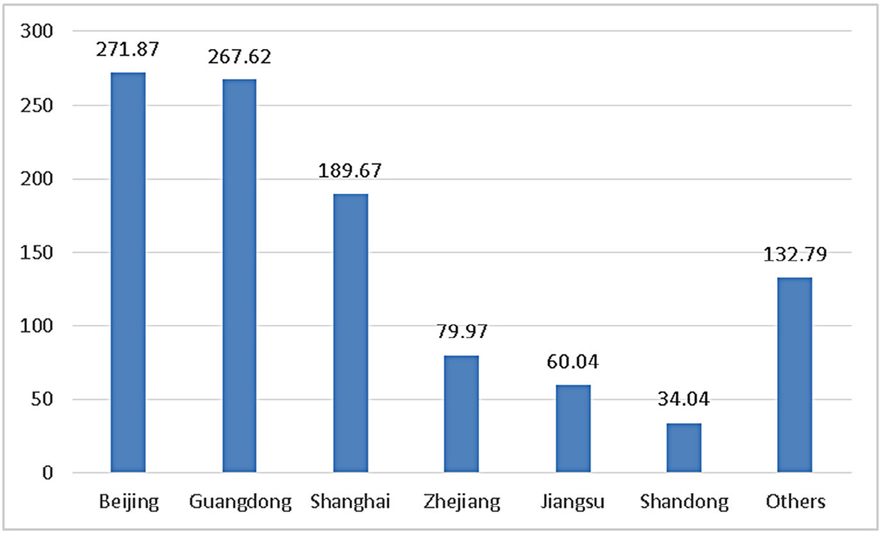

Chart 2 – Outstanding loans of P2P platforms in key provinces (Renminbi 100 million, 2014) (compiled by the author). Information is available at China's Internet Lending Business Annual Report 2014.

that in Guangdong and Zhejiang, considering that more P2P platforms are being operated in Guangdong and Zhejiang, means that P2P platforms in Guangdong and Zhejiang probably serve more small and medium sized enterprises than those in Beijing and the borrowing size of these enterprises from the platforms is relatively small. This again confirms the business model of P2P platforms in China, which is largely used to help finance private enterprises and entrepreneurs.

The lending services P2P platforms engaged in are more diversified even though these platforms may mainly target individuals and micro-enterprises as their clients. People usually borrow money from the P2P websites for consumer financing or sometimes merely for extra capital. As indicated by the 300 lending platforms carefully monitored by Rong 360, the lending platforms can be categorised into five types in terms of their key services: personal credit (targeting individual borrowers), micro credit (targeting small and medium sized enterprises), automobile mortgage loan, housing mortgage loan, and mixed businesses.

It has been estimated that 53% of loans via the P2P platforms in July 2014 were less than Renminbi 50,000. The loan amount per individual varies significantly depending on the business scope of each platform. A real estate affiliate of Ping An Insurance offers loans up to 36 months and boasts that a borrower can receive funds in as little as five hours. The business scope of the platform also decides the level of risks. P2P platforms may encounter manageable risks if they offer personal or micro loans as the amount is usually in a small size. Those platforms offering loans for the purchase of houses or cars may be opposite as the lending amount may be relatively substantial.

3.2. *High return in short term*

The P2P model offers new options to financial consumers due to slender costs. P2Ps do not involve regulatory costs as they are exempted from regulatory oversight. The technological advancement makes market-based P2P lending viable through reducing transaction costs associated with providing financial services. Cutting out the middleman, consumers, i.e. lenders and borrowers, can save costs and secure better and more competitive interest rates. It is the market practice that the interest rate is higher than the savings rate available to the lender but lower than a traditional loan available to the borrower, depending on the borrower's evaluated risk. Therefore, while returns for lenders are satisfactory, costs for borrowers are also acceptable. In the US, for instance, both LendingClub.com and Prosper.com demonstrate that historic annual returns range from 5% (for the safest loans) to 10% (for riskier loans).[24]

Although the investment yield of the P2P platforms varies, the relatively high level of average returns well explains why the P2P lending platforms have been so attractive to investors. Chart 3 below shows the average annual yield of P2P platforms in China. Forty percent of China's P2P platforms have their average annual yields in the range between 12% and 14% or between 16% and 18%, which are much higher than through using traditional avenues of credit provision such as banks. This reaffirms the strong demand side of borrowers for funding as well as their difficulty in financing from conventional banks. Those platforms with insurance companies being the majority shareholders have an average annual yield of 8.61%, lower than the whole industry. Similarly, the platforms involving the state-owned companies as shareholders have an average annual yield of 9%, lower than the whole industry. These two lower yields may suggest that institutional investors may not necessarily bring positive returns to the sector, probably due to their insensitivity or remoteness to the P2P lending market. Privately held platforms have a much higher average annual yield of 15.57%. In any event, even the lowest annual yield is higher than the deposit rate offered by the commercial banks and the capital markets.

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

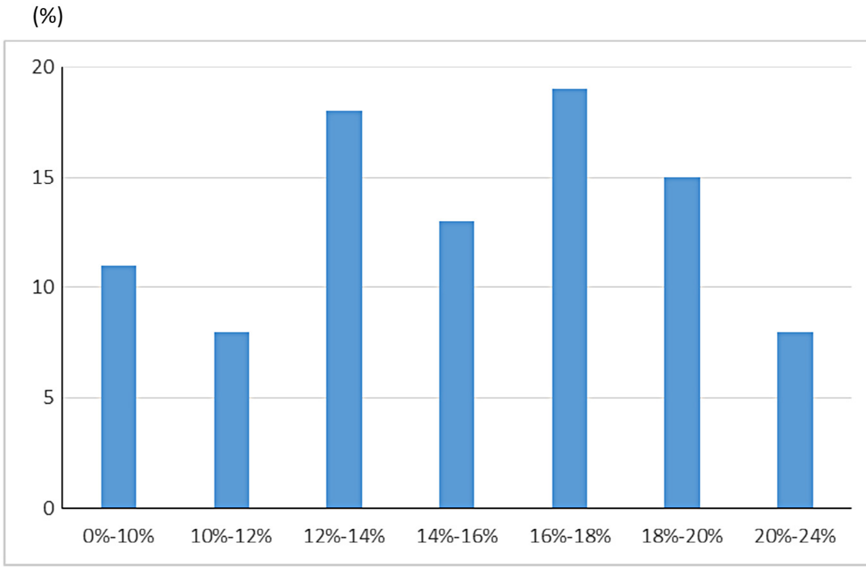

Chart 3 – Yield of P2P platforms (compiled by the author). Information is available at China's Internet Lending Business Annual Report 2014.

Nonetheless, there has been a decline of monthly yield since March 2014 despite the fact that average annual yield stood at 17.86% in 2014. The last month of 2014 saw a 16.08% yield. Currently, the interest rate of main P2P platforms vacillates between 12% and 14%.[25] More than 36% of platforms decreased their high interest rates in 2014 compared to previous years. The number of platforms, utilising relatively high rates to attract popularity, decreased as well. Meanwhile, following a series of scandals and "closures", investors become more skeptical and less enthusiastic towards those platforms offering higher rates, and have turned their investment to other platforms with safer returns and more established brand names.

High yields are closely related to the lending rates in the P2P sector. Annualised lending rates are roughly maintained at the rate of 15% in the small-loan sector, more than twice the benchmark bank loan rates. Large Chinese Internet companies are following suit and offering higher returns than Yu'E Bao, a serious blow to the banking sector, one of the crucial instruments the Chinese government uses to manage the economy. The winners are Chinese savers who now earn up to 7% annually on cash deposits compared to 3.3% paid by commercial banks. However, after the People's Bank of China, China's central bank, loosened its grip on the interbank market as its effort to push down the currency, yields have fallen as more cash flooding into the market. The decline shows the mounting complexity of the regulators' efforts to control China's financial system, making it harder for money funds to lock in competitive yields.

[25] These interest rates were much higher than those offered by Prosper and LendingClub, which reported that lenders received average net annualised returns exceeding 11% and 9% for loans respectively. Lenders have the potential to earn higher returns than their returns for savings accounts and certificates of deposit. US Government Accountability Office, Report to Congressional Committees: Person-to-Person Lending, New Challenges Could Emerge as the Industry Growth (July 2011), p. 9 (footnote 22) and p. 18.

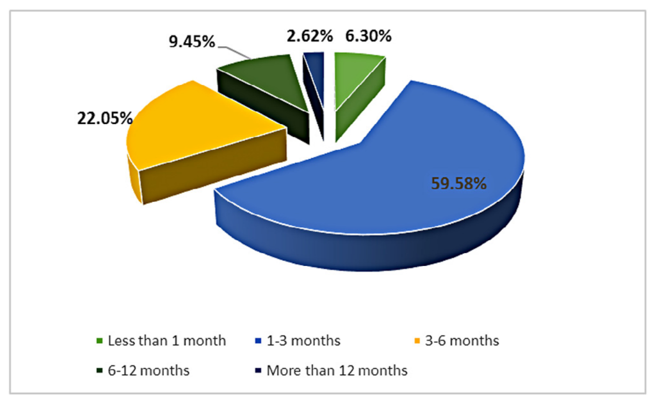

Fig. 1 – P2P platforms' range of lending terms (compiled by the author). Information is available at China's Internet Lending Business Annual Report 2014.

The largest group of borrowers is small and medium sized enterprises, which make use of the P2P lending platforms to arrange short-term financing in order to fill the financing gaps for their business operations. Fig. 1 shows the portion of lending transactions according to a variety of lending terms. The majority of lending transactions have a short term between 1 and 3 months. Very few loans were granted in a longer term of more than 12 months. In this sense, P2Ps are alternative investment platforms for investors.

Lending terms are gradually being extended. [26] In the first half of 2014, the average term for P2P lending was 4.75 months. Still, over half of the lending transactions had a shorter term of 3 months or less. Due to the involvement of larger platforms in the lending business, more longer-term loans may be offered. Lufax.com, renrendai.com and Jimubox.com are the main players to offer longer-term loans in the market.

[26] Ibid.

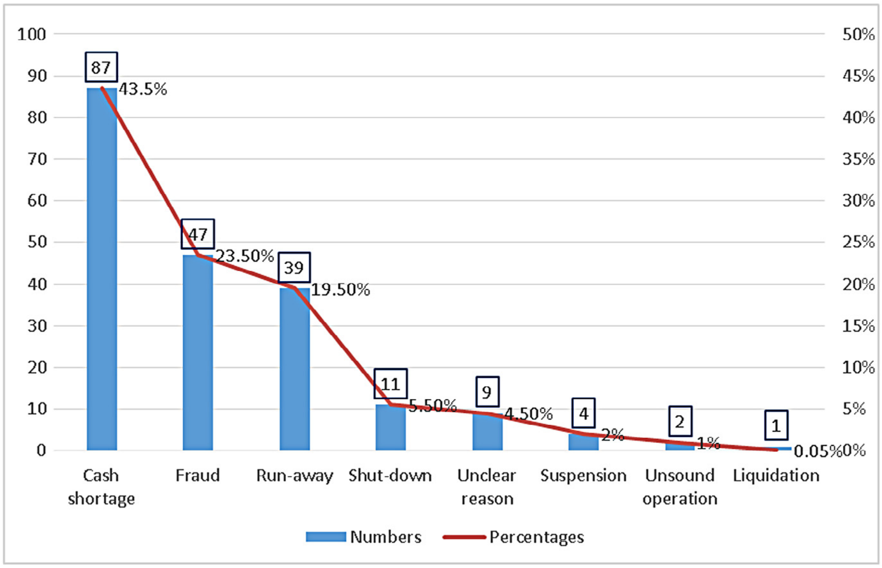

Chart 4 – "In-trouble" P2P platforms (2011–2014) (compiled by the author). Information is available at China's Internet Lending Business Annual Report 2014 as well as some newspapers.

The average lending term in 2014 was 6.12 months. The average lending term increased from 5.37 months in January 2014 to 6.88 months in December 2014. With the exception of February and December, the trend in 2014 was to see longer-term loans offered in the market. The availability of longer-term loans in the market depends on various factors. Loan term is usually interconnected with not only to the loan amount but also the interest rate. Sohu's P2P platform offers loans as small as Renminbi 30,000, at rates as high as 12%. Sina's platform offers interest rates of 7.5–8% for 12-month loans ranging from Renminbi 200,000 to Renminbi 500,000. Sohu's platform also allows lenders to resell their loans before maturity to other investors, increasing the liquidity of their products. Along with the declining interest rate, the platforms are likely to increase the lending requirements for longer term loans. The increasing borrowing costs may also affect the lending term.

4. Potential risks and regulatory moves

Because a default affects the P2P borrower's credit score, borrowers have every single incentive to repay their debts. Default rates among small Chinese lenders are low, only about 1% of their total loan books, which is much lower than the overall default rate in the range of 0.2–7% in the US.[27] Disputes over defaults may end up in courts, which are often hostile to the enforcement of private loans with higher interest rates. P2P funds are mainly used as a replacement for grey-market lending. Investors are under no illusion that these products carry an implicit government guarantee. However, this does not suggest that the P2P lending sector is risk free. Higher defaults could quickly diminish P2P appeal to lenders.

4.1. *Scandals in the market*

Dealing directly with strangers carries its own risks. P2P lending platforms started to mushroom in China in 2006. These platforms have not been well regulated. When borrowers renege, the owners of the platforms have to step in and compensate lenders. Scandals involved three P2P lending platforms in Hangzhou, Shanghai and Shenzhen, collapsing under the weight of combined outstanding loans of 231 million yuan, and the owners fleeing the obligations.[28] Recently, defaults have surged and sparked concerns over social unrest as protests have been the only way for lenders to express their anger over their lost investment, and to attract the government's attention for a possible rescue scheme. Increasingly, reported cases of fraud and huge losses have led to calls for tighter regulation.

In the past two years, there have been more reported cases that some platforms were experiencing "run-away" or "closure" in which the owners of platforms ran away without leaving any trace or the platform had to be closed due to cash shortage, poor management or even fraud. In 2014, the number of "in-trouble" P2P platforms reached 275. [29]

Among others, these "in-trouble" platforms encounter such problems as cash shortage, fraud, run-away and shut-down. Run-away (or flight) is close to a "bank run", in which the owners of the platform run away leaving the platform behind which in turn is no longer able to pay off outstanding debts or to continue to serve clients. Most "in-trouble" platforms are short of cash, owing to the fact that the platforms themselves were invested with small capital contributions as indicated in Chart 4. Fraud also exists in this sector and some owners may use the platforms to solicit money without having the intention of staying in the lending business. Seventy-four percent of the P2P platforms in 2013 reported "operational difficulties, cash squeezes or owners' run-away" and, more im-

[27] Eleanor Kirby and Shane Worner, "Crowd-funding: An Infant Industry Growing Fast", Staff Working Paper of IOSCO Research Department [SWP3/2014], p.23.
[28] National Business Daily, 21 January 2014.
[29] China's Internet Lending Business Annual Report 2014.

portantly, 1.2 trillion yuan of their money was lost.[30] One hundred eighty-four platforms were in trouble in 2014,[31] and 115 P2P companies were reported to have gone bust in 2014, compared with 1438 still in operation.[32]

Fraud seems to be a major risk in this sector. The inherent anonymity of Internet offers and heavier reliance on Internet portals or websites in this sector create a higher chance of fraud. Likely, the sector may encounter such fraudulent activities as identity theft, consumer privacy and data protection violations. More traditional loans – such as credit cards – are typically originated, managed, and serviced by a single entity, retaining the risks and balancing costs and benefits from longer-term relationships. This helps to promote more consistent underwriting and collateral performance, particularly in stressful economic conditions. The whole P2P structure is built around getting investors to do the due diligence themselves owing to the transparency provided by the platforms in the first place. Although the platforms verify the identities of borrowers and control the process, monitoring the lending practices is not sufficient. As the P2P lending is conducted online, as S&P's points out, fraud is a key significant risk. Therefore, the ongoing concern relates to the quality and consistency of the loan underlying process as well as to the substance of the data that such systems collect and maintain.

One of the main reasons why the platforms are not able to fence off potential risks is their small capitalisation. Shareholders merely contribute a small amount of registered capital into the platforms, most of which are incorporated as limited liability companies.

Up to mid-2014, the average registered capital of China's P2P platforms was Renminbi 23.7 million. The majority of China's P2P platforms have the registered capital between Renminbi 5 million to Renminbi 20 million, accounting for 63% of all P2P platforms. Some earlier platforms fall into this category. For instance, the registered capitals of paipaidai.com and renrendai.com were Renminbi 10 million and Renminbi 6.16 million respectively. Platforms with large registered capital are rare in the market. The largest platform, in terms of its registered capital, is Lufax.com, one of its key shareholders is Ping An Group, which owns China's insurance giant, Ping An Life Insurance. Lufax.com's registered capital is Renminbi 837 million.

The small capitalisation is reflective of the involvement of relatively smaller investors in this sector, different from the conventional banking sector which features large state-owned enterprises. This also shows the function of the P2P lending sector which is used to finance small and medium sized enterprises or private enterprises. In response to the small capitalisation, one possible regulatory instrument taken up by the regulators is to impose an "aggregate limit" on the lending amount incurred by the platform. For instance, a platform in New Zealand may not raise more than NZ$2 million from the public in any 12-month period.[33] In the US, there is also a limit placed by the JOBS Act on the percentage of an investor's money allowed in any particular loan.[34]

However, there has been a trend of increasing P2P platforms' registered capital. Among 900 platforms which were incorporated in 2014, their average registered capital was Renminbi 27.84 million, which was almost double the average registered capital of those P2P platforms incorporated in 2013. Around 61% of platforms set up in 2014 had registered capital in the range of Renminbi 10 million and 50 million. Among them, 48 platforms had more than Renminbi 100 million in registered capital. This matches the market trend that more state-owned enterprises, private equity firms and financial institutions are gradually being involved in the P2P lending sector by investing into the P2P platforms.

4.2. *Regulatory vacuum and responses*

In China, P2P lending is currently unregulated. P2P platforms cannot be easily classified as conventional commercial lenders as their main function is to facilitate lending by providing credit-related information rather than credit itself. Therefore, requirements relating to the form and content of lending agreements and provisions under the Commercial Banking Law and the General Lending Provisions do not apply. As a result, platforms do not need to be licensed credit-brokers.

The P2P sector at least raises significant investor (or financial consumer) protection issues, particularly in relation to retail investors who do not have a sufficient level of understanding and experience. As P2Ps have been supportive to small and medium sized businesses, the government has been tolerant and encouraging. The government believes that Internet finance may have the potential to force the state-owned banks out of their lethargy. The immediate consequence is that P2P platforms lack sufficient supervision and information disclosures and involve high-risk loan business and occasionally fraudulent activities. Investors usually do not know where their money is being placed and are vulnerable to theft of personal information. There is a possibility that tens of billions of dollars have been flowing into largely unregulated and untested investments. As part of shadow banking, P2P lending also brings systemic risks to the formal banking sector.

Regulators are well aware of the potential risks that are likely to arise from uncontrolled growth of P2P platforms. However, they have not crafted detailed policies on regulating the P2P lending sector. The major potential pitfall is credit risk, the management of which relies upon the vast amount of digital information. Few platforms have grasped the vast data or the technology or methods to apply borrowers' data for their credit ability appraisal. In theory, the technology can help assess the repayment capability based on the track record of consumption, payment and other historical transactional behaviours. The technology can even help calculate the possibility of default. Most platforms, however, still rely on traditional means to do business. Another difficulty is the lack of uniform business rules on the borrower's assets and liabili-

[30] Jane Cai, "Online Lending Risks Escalate on Mainland China Amid Scandals", South China Morning Post, 10 February 2014 (online).
[31] Jiefang Daily, 15 January 2015, p. 9.
[32] Gabriel Wildau, "China Online Lenders Offer Mortgage Loans", Financial Times, 19 October 2014 (online).
[33] FMC Regulations reg. 186(1)(g).
[34] SEC. 302 (a) (6) (B). OSC Consultation Paper on Exempt markets, 2012, available at: http://www.osc.gov.on.ca/documents/en/Securities-Category4/sn_20121214_45-710_exempt-market-review.pdf.

ties and loan-grant in the marketplace, which reduce the online loan quality.

Other possible risks include the potential for money laundering and fraud, poor administration and/or platform failure (closure), illiquidity and cyber-attack. Some risks are unique to the P2P lending sector. The illiquidity risk, for example, refers to the non-existence of a credible secondary market on which investors can sell their loan portfolios. Nor is there a secondary market for shares in start-ups through equity crowdfunding. The illiquidity risk makes loan portfolios or equity stakes illiquid and then creates a barrier for investors to liquidate positions. The investors therefore are locked into a contract and have no effective way to get out of it unless they accept a significant discount to the face value. This illiquidity risk is technically different from the liquidity risk in the conventional banking sector. Bank liquidity is affected or constrained by various monetary policy movements and regulatory changes such as capital adequacy rules.

The regulation of P2Ps across the world is in the flux. In the UK, the Financial Conduct Authority began oversight in April 2014. This move encourages more interest from investors and borrowers. In the US, most states allow borrowers to participate in P2P lending, but the rules for investors vary. Residents of some states are not allowed to participate while other states have minimum-income or net-worth requirements.[35] Both the LendingClub.com and Prosper.com are required to register by SEC. However, treating P2P lending as issuing securities may encounter several obstacles in China. The biggest one is that the statutory types of securities are limited under the Securities Law and the P2P loan cannot be characterised as any of them.

The good news is that some initiatives have been put forward. The PBOC has made suggestions to the State Council that all P2P firms should set up capital custody systems. A deputy to the Shenzhen People's Congress has called for legislation to regulate P2P companies. The regulation can govern P2Ps' business scope and risk control measures.[36] China's banking regulator, the China Banking Regulatory Commission (CBRC), has warned Chinese banks of the mounting risks surrounding this popular P2P lending and indicated its regulatory outline to the public.

4.2.1. *Potential risks*

P2P lending provides some benefits into the market including the availability of more channels for capital-raising, the spreading of risk, the higher return for low cost capital and the boost to the real economy via encouraging the growth of entrepreneurship and small and medium sized enterprises. All these benefits justify and determine the continuous growth of P2P firms. Nevertheless, as far as the Chinese market is concerned, P2P lending may evolve into illegal financial institutions that may illegally take deposits and make loans, crossing the boundary set by CBRC. Without effective risk controls, 70–80% of the existing P2P players may go bust in the next several years.

Investor protection is a thorny topic in relation to P2Ps. There is no deposit insurance for P2P investors. Nor are there capital reserve requirements or any other equivalent rules P2P lending platforms have to comply with. Lenders and borrowers, however, face similar risks that are currently overseen by a complex regulatory regime in the conventional banking sector. Lenders risk losing their principal and interest on their investments while borrowers may suffer from unfair lending and collection practices, such as potentially unclear or misleading lending terms, predatory or discriminatory credit decisions, and abusive or deceptive servicing acts. In addition, borrowers may face some privacy issues unique to the P2P lending platforms. Meanwhile, lenders are exposed to operational risks associated with the platform's screening loan applicants and service and enforcing collection of the loans.

Some P2P lenders hold "provision funds" to cover losses arising out of various risks such as credit risk, liquidity risk, operational risk, market risk and legal risk. However, there are two-pronged limitations. First, contingency funds for loan-based platforms may not provide as much security as investors reasonably expect if the default rate dramatically increases and ultimately exhausts the fund.[37] Second, as the use of these funds is entirely at the full discretion of the organisers of the P2P platforms, the risk is beyond control. The possible regulatory instrument is to have higher capital (or financial resources) requirements for firms operating contingency funds or have the entire sector voluntarily covered by the financial service compensation scheme (given the regulatory and compliance costs and economies of scale) in order to help platforms withstand financial shocks and relevant risks.

More importantly, the money acquired from the banks can easily flow to the grey market through the P2P platform, which may accumulate systemic risks. It has been estimated that 3 trillion yuan of bank loans have been channeled into underground lending in Jiangsu and Zhejiang Provinces.[38] Some players are like loan sharks as they use the platforms to raise funds while lending to businesses and individuals at lofty interest rates. The annualised interest rate on the P2P platforms could hit as high as 15%, five times the benchmark rates guided by the PBOC.[39]

In a larger context, private loans through P2P platforms are largely channeled into the property market and energy-guzzling industries other than the real economy. This is also the case in the UK. For example, 75% of LendInvest's £26 million loan portfolio goes to property developers.[40] In the US, 83% of LendingClub.com's loans are used to refinance other loans other than new companies.[41] In China, the property and other industries are heavily monitored by the Chinese government. Any

[35] Andrew Blackman, "Who's Your Banker? Who Isn't?", The Wall Street Journal, 10 February 2014, R2.
[36] Jane Cai, "Online Lending Risks Escalate on Mainland China Amid Scandals", South China Morning Post, 10 February 2014 (online).

[37] UK Financial Conduct Authority, "The FCA's Regulatory Approach to Crowdfunding over the Internet, and the Promotion of Non-readily Realisable Securities by Other Media, Feedback to CP 13/13 and Final Rules" (14 March 2014) p. 14.
[38] Jane Cai, "Banks Warned on Risk of Underground Lending," South China Morning Post, 15 September 2011, B3.
[39] Daniel Ren, "Non-bank Lenders Back in the Game," South China Morning Post, 16 December 2013, B2.
[40] "P2P Lending: Peer Less", Financial Times, 24 January 2013 (online).
[41] Ibid.

change to government policy in these sectors may severely escalate systemic risks to a higher level.

The Internet financial products have the potential to topple the Chinese financial system into the abyss and could pose risks to China's debt-laden economy. But both interest rate liberalisation and deregulation of China's monopoly in financial sector would be beneficial for China's economic reform. Therefore, the State Council pledges to promote the healthy development of Internet banking. Technically, this policy means that all the benefits P2P lending brings to the market must be balanced with the risks posed by this innovative industry.

4.2.2. "Firewall" approach

CBRC has recommended that Chinese banks take cautious measures to strengthen internal controls by setting up "firewalls" or ring fencing to isolate themselves from P2P companies. The firewall may cut the channelling of bad loans into the banking system when borrowers in the underground market defaulted. In China, it is inevitable that lending standards may slip as competition intensifies via new entrants.

Having "firewalls" is of great importance under the current circumstance, for some Chinese P2Ps are venturing into mortgage loans with the aim of drawing mainstream investors into an industry often viewed as the domain of speculators and hucksters. These P2Ps are partnering with real estate developers and financial institutions to offer loans to homebuyers so that the latter can satisfy the 30% down payment requirement[42] in order to obtain a commercial bank mortgage. Regulations forbid conventional banks from offering down payment loans. P2P platforms are not under legal obligations to enforce this 30% rule due to the fact that they are not classified as financial institutions. The same freedom from legal obligations applies to inter-personal lending and micro-lending.

4.2.3. Information or credit intermediary?

CBRC also has been in an attempt to crack down on intermediary lending with the goal of removing the grey market in the end. The possible rule is a so-called "red-line" approach distinguishing credit intermediary and information intermediary.

The CBRC seems to allow P2P platforms to act as information intermediary only without being engaged in the credit business. In other words, under this "red-line" regime, any P2P platform engaged in transmitting credit is to be equated with crossing the line and violating the existing banking regulations, which do not allow a non-bank or financial institution to conduct lending or banking business. Therefore, if implemented, being information intermediaries, P2P platforms can only act as business consultancy firms by introducing and transmitting lending information and matching lenders and borrowers. As the P2P platforms may channel funds into various sectors, regulators may need to take a coordinated stand.

This regulatory movement may affect the P2P platform's safety mechanisms. Internet finance bears credit and other risks. Although the online deposits are promoted as if they were savings accounts that carry risk, the principal is not guaranteed. This suggests that if consumers were to begin to suffer losses, there could be a floor of redemptions. When coming to the safety mechanisms, the P2P platforms in China choose a totally different approach from that in the overseas markets. The P2P platform itself will not be involved to shoulder responsibilities if bad loan appears. If the CBRC's design is implemented, the question will arise whether an information intermediary is able and entitled to continue to reply on the existing safety models in the marketplace.

In overseas markets, both LendingClub.com and Prosper.com look at potential borrowers' credit histories and other factors and assign them risk scores. Then two sites decide the interest rate of the loan. For instance, on Prosper.com, someone with the best rating, AA, could get a three year unsecured loan with an annual percentage rate as low as 6.73%. A low-rated borrower could pay more than 20%.[43] After borrowers get a rating, they create a listing on the site explaining why they need the loan and detailing their financial situation. Potential investors browse and choose which loans to invest in. The funds are transferred to the borrower's bank account within a few days after a loan is completely funded.

P2P platforms effectively provide investors with a new type of assets in the form of uncollateralised debt. This innovation enables investors to diversify their portfolios, which in turn reduces the possibility of a build-up of systemic risk. However, unsecured loans do not give lenders any distribution preference under the bankruptcy law when the debt goes wrong. The nature of unsecured loan calls for a variety of security mechanisms the platforms need to put in place. Some platforms involve outside institutions for debt collection so as to offer some protections to lenders. Other mitigating methods include a pooled insurance fund that provides compensation in the event of a borrower default.

P2P platforms in China have different safety models, the underlying rationale of which is to reduce business risks. These platforms can be grouped into the following safety modes: non-advance payment mode, security mode, risk-deposit mode and security plus risk deposit mode. Fig. 2 indicates that the security mode is the most popular safety scheme taken by most P2P platforms in relation to investor protection. The risk deposit mode ranks next. Few platforms will prefer the non-advance mode, which is apparently not safe to protect the investors and lenders.

The security model is operated in a variety of ways. Under Jimubox.com's business model, no transactions can be conducted without a loan guarantor. The use of the guarantor incurs extra costs on the borrowers as they have to pay the guarantor's fees. This arrangement may help rule out the possibility of defaults. Since it started operation in August 2013, it has conducted total lending business worth more than 100 million yuan. Its main targets in 2014 were businesses worth more than 1 billion yuan. Customers with collateral can borrow at lower rates.

[42] China's central bank requires commercial lenders to enforce a 30% down payment requirement for standard mortgage loans. This requirement becomes a major hurdle for most homebuyers.

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

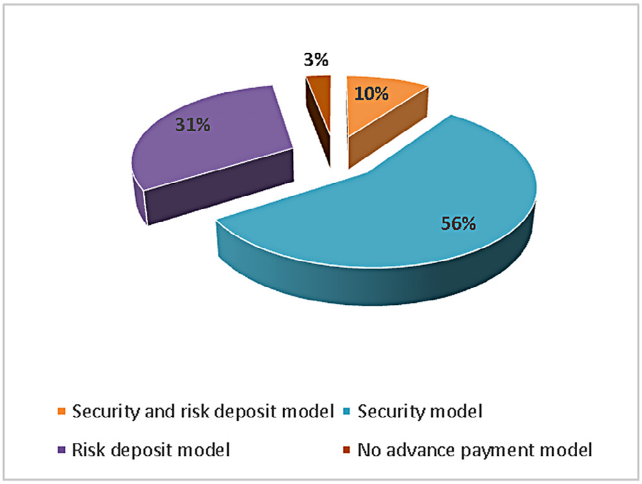

Fig. 2 – P2P platforms' major safety mechanisms (compiled by the author). Information is available at China's Internet Lending Business Annual Report 2014.

Down payment loans offer lenders lower yields than other P2P products. The trade-off is that such loans offer enhanced risk protection. For example, Sina participated in this new campaign by offering loan products guaranteed by insurance companies, micro-lenders, and real estate developers themselves. Different from other types of P2P loans, which typically are for three to six months and carry interest rates of at least 10%, downpayment loans offer lenders a greater sense of security. This is so because those companies offering downpayment loans have to have a trustworthy reputation or a well-established brand. Otherwise there would be no lenders willing to offer long-term funds at such low cost.

For safety, leading platforms have introduced custody systems under which clients' money is deposited in a third-party account to minimise the chance of fund embezzlement. Creditors may rely on debt collection companies for the repayments. Therefore, loans in default are passed to an external collection agency.[44] These safety mechanisms are quite different from those in the US or the UK.

It would be advisable for P2P platforms to establish an independent depository system for clients' funds. This would require P2P platforms to provide clients' funds to independent, third-party custody. P2P platforms would also bear liability to investigate the third parties. Under English law, a third party must be a bank. Chinese regulators may consider adopting similar rules.

4.2.4. *Information monitoring and disclosure system*

Information intermediary is the role a P2P platform is expected to play in the Internet lending business sector. Accordingly, what a P2P platform can do is merely to disseminate information and not assume any credit risk itself. It would therefore be reasonable to expect a minimum level of regulation with a focus on information disclosure. In order to obtain relevant information and also fulfill its regulatory function, a proportionate regime for the risks associated with lending platforms should be devised and accordingly the P2P platforms should file their basic information with the regulators.

Information disclosure is also the regulatory instrument employed by some regulators in other jurisdictions to address the concerns about how to promote the transparency of the novel Internet finance and ensure adequate protection for borrowers and lenders without stifling business innovation. For instance, the UK Consumer Credit Source Book requires P2P platforms to extend to borrowers the key protection they would have had if the credit had been provided under a regulated agreement. Accordingly, a platform must, among others, provide adequate explanations of the key features of the credit agreement to borrowers, assess the creditworthiness of borrowers, provide notices and information sheets to borrowers in arrears or default and a specific risk-warning if the loan is secured against the borrower's home. The chief purpose of these disclosure rules is to allow investors to make informed investment decisions.[45] Similarly, under the New Zealand Financial Markets Conduct Regulations 2014, a disclosure statement for P2P service must contain a description of the nature of the service provided; how investors apply for, and obtain, access to the facility and the eligibility criteria that apply; how issuers apply for, and obtain, access to the facility and the eligibility criteria that apply; how investments are made and financial products are issued under the service; and how much investor money is received and dealt with.[46]

Regular reporting requirements can also help regulators monitor the market. The P2P platforms also need to provide regular reports to the regulatory agencies. These regular reports need to contain such information as the financial position, client money held, and details of loans arranged each quarter. For example, in the UK, the platforms are required to submit a summary report regularly to the regulator and the reported information includes financial statements, customer funds status, complaints, litigation, and detailed information regarding quarterly loan arrangements. In addition, the platform has notification obligations when the total lending amount experiences a fluctuation of 25% or more. The benefits of the reporting requirements need to outweigh the costs, which can be further lowered if the reporting can be conducted via the online reporting system.[47] The diversity of business models across the market may not justify uniform requirements on the form and content of those disclosures. Instead, the regulators or firms should consider multiple factors such as the nature and risks of the investment, and the information needs of their customers.

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

[45] The P2P platforms are likely to be involved in a conflict of interests as they not only need to satisfy consumers but also to guarantee rewards for finding investors. Therefore, information asymmetry may be a key concern arising out of the information disclosure regime. The pure disclosure regime may not work if the information is not scrutinised by a specific regulator.

[46] FMC Regulations reg. 215(1).

[47] UK Financial Conduct Authority, "The FCA's Regulatory Approach to Crowdfunding over the Internet, and the Promotion of Non-readily Realisable Securities by Other Media, Feedback to CP 13/13 and Final Rules" (14 March 2014) p. 33.

In the market, the investors fully rely on the efficacy of the platforms and the value of their internal creditworthiness. Therefore, P2P platforms should vet the borrowers in order to avoid fraudulent transactional information. They should also possess certain technical conditions to ensure the smooth exchange of information and network safety. Due to this requirement, the regulator could even set a minimum capital rule requiring a P2P platform to maintain a minimum level of capital.

Disclosure only makes information available to borrowers and lenders. However, it does not guarantee investors' awareness of risks. As far as retail investors are concerned, the innovative nature of P2P lending tends to be difficult to understand and the high attribution rate of investments therein incomprehensible. Retail investors, in particular, those with learning difficulties, elderly and young investors, are more vulnerable in the sense that they are more susceptible to emotive advertising highlighting headline rates of return compared to lower interest rates on deposit accounts or to social network promotion of platforms. Against this background, the regulatory objective is to ensure fair, clear and non-misleading communications to these vulnerable investors.

P2P platforms should not only disclose information regarding interest, duration, fees and charges but also warn the lenders and investors of potential risks including the credit risk, the borrower's risk of default, and the risk that is covered by the deposit protection scheme. For instance, the New Zealand Financial Markets Conduct Regulations 2014 imposes an obligation on the platform to make a warning statement available. The required boilerplate points out that "investment in these types of businesses is very speculative and carries high risks", and suggests investors "ask questions, read all information given carefully, and seek independent financial advice before committing yourself".[48] This type of hard information is necessary to solve the information asymmetry issue in P2P lending by helping in the prediction of default, and improve the overall investment prospects.

An effective disclosure regime can also achieve the purpose anti-fraud and fair-dealing policies are supposed to achieve. At a minimum, publicly available and readily accessible information about the platform, investors and borrowers may allow the counterparties to check the identities of various transacting parties thereby assessing, rating and screening these parties' creditworthiness. An adequate disclosure system may help ensure a fair, orderly and transparent system for the new lending services.

4.2.5. *Is rating P2P a valid regulatory tool?*

Credit rating agencies, together with lawyers, accountants and other professionals, are viewed as the gatekeepers helping financial regulators monitor the players in the financial market given their expertise and experience in providing rating services to the public investors. They are regarded as reputational intermediaries and third party monitors with the capacity to prevent misconduct by withholding support from wrongdoers.[49] It has been argued that it is the gatekeeper failure in serving as a watchdog for the public that led to an array of financial scandals.[50] Therefore, part of the solutions to cure the financial crisis or corporate failure is to improve the regulatory regime governing gatekeepers and their operational behaviours, which in turn improves corporate governance and financial regulations. Seen from this vein, the importance of rating activities and regulating rating agencies in financial markets is not disputed. The question relevant to the key theme of this article is whether rating agencies can be relied upon to apply their business models to the growing world of P2P loans. Standard & Poor's believes the novelty of this sector, and its wide range of players, present unique challenges in assessing the overall risks in future P2P loan securitisations. In its statement, Standard & Poor's claims that:

> We monitor developments in this nascent sector from a cross-sector vantage point and draw upon out experience in rating various types of consumer, commercial, and structured debt.
>
> P2P lending is evolving, and it is still too early to know what the industry will look like in its more mature state. As with any young and untested market, we believe there are issues that need to be addressed before we can assign ratings. Some of these issues are P2P companies' lack of performance histories through full economic cycles, uncertainty about their long-term commitment to the business, and their financial stability, operational risks, servicing quality, and loan credit performance in a downturn. We also consider the unproven ability and capacity to comply with new and ongoing regulatory and legislative requirements.

P2P is more like a retail version of securitisation. S&P's main concern seems to be that the asset class has not been tested in a full economic cycle yet. Besides, the risk is still evolving and unique even though P2P loans exhibit some similar features like other types of securitised debt. As these loans are

[48] FMC Regulations reg. 196(1) and (2).

[49] Reinier H. Kraakman, "Corporate Liability Strategies and the Costs at Legal Controls" , (1984) 93(5) Yale Law Journal 857–898; Ronald J. Gilson, "Value Creation by Business Lawyers: Legal Skills and Asset Pricing", (1984) 94 Yale Law Journal 239–313; Ronald J. Gilson & Reinier H. Kraakman, "The Mechanism of Market Efficiency", (1984) 70 Virginia Law Review 549–644; Reinier H. Kraakman, "Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy", (1986) 2(1) Journal of Law, Economics & Organization 53–104; Stephen Choi, "Market Lessons for Gatekeepers", (1986) 92(4) Northwest University Law Review 916–966.

[50] John C. Coffee, Jr., "The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting", (2001) (Ctr. for Law & Econ. Studies, Columbia Law Sch., Working Paper No. 191, 2001), available at http://papers.ssrn.com/paper.taf?abstract_id=270944; John C. Coffee, Jr., "Understanding Enron: It's About the Gatekeepers, Stupid", (2002) 57 Business Lawyer 1403–1420; John C. Coffee, Jr., "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reform", (2003) (Ctr. for Law & Econ. Studies, Columbia Law Sch., Working Paper No. 237), available at http://papers.ssrn.com; John C. Coffee, Jr., "The Attorney As Gatekeeper: An Agenda for the SEC", (2003) 103 Columbia Law Review 1293–1316; John C. Coffee Jr., Gatekeepers: The Professions and Corporate Governance (New York: Oxford University Press 2006).

not intermediated by the platforms but rather by users of the platforms themselves, investors do not need a third party's view of the risk. The counter argument may be that there is a need for an intermediary to do the bulk of the work on risk assessment. By declaring the P2P sector rate-able, S&P's is legitimising the P2P lending trend, thereby opening the door to larger institutional flows into the sector. There is another technical difficulty. Credit rating industry in China is still in a preliminary stage, which does not seem sophisticated enough to monitor the financial market by sending to the market reliable rating information.

4.2.6. *Latest online finance rules*

The Chinese government unveiled the *Guidelines Concerning the Promotion of Healthy Development of Online Finance* (the guidelines) to govern the rapidly growing Internet finance sector on 18 July 2015. The guidelines, to a certain extent, legitimise the online finance sector, which has been operated in a vacuum. The chief purpose of the guidelines is to maintain market order and transparency. Although the guidelines indicate that the government's positive attitudes towards the development of the Internet finance sector, they also reflect the government's traditional and long-standing support for incumbent banks.

The guidelines draw a clear line between P2P lending and banking. P2P platforms must clearly disclose to customers that they are intermediaries between borrowers and lenders and are forbidden from taking deposits or providing guarantees. P2P platforms are not allowed to raise funds for their own projects. This restrictive line is drawn up in favor of incumbent financial institutions.

The guidelines oversee a wide range of services, including loans, investments and other financial products offered online. The guidelines support the growth of online financial services such as online payments,[51] P2P lending,[52] crowdfunding equity finance,[53] online asset management,[54] online insurance,[55] online trust[56] and online consumer financing[57] by creating a clear regulatory framework under which they operate.

The guidelines give the priority to risk control. For instance, the so-called custodians would be chosen to oversee the security of assets invested online. Although many third-party payment companies working closely with P2P lending platforms have been in a hope to win the right to serve as custodians for the funds that investors deposit on the platforms, the guidelines only give this privilege to the banks.[58] There are pros and cons for this exclusivity. Giving the banks the exclusive right to act as a custodian obviously does not match the reality of the online lending business. It may be detrimental to the growing sector. On the other hand, reserving fund custody for banks is necessary to protect investors. These measures may help ensure the funds are safe.

In addition, businesses in this sector would be required to fully disclose information about their operations. Further, a system of "qualified institutions" would be set up to ensure high standards of governance in the industry. With more rules in place, the online financing operations will be standardised. Due to the increasing compliance costs, weaker players may feel harder to meet more stringent requirements and the entire market may be more consolidated than before. The increasing operational costs will raise barriers to entry but benefit larger and more dominant players in the market.

5. P2P lending's new trends

The P2P market is not uniform. Rather, it is still evolving and expanding. The alternative finance sector has also been drawing a positive response from institutional investors. Hedge funds, pension funds and other large investment companies are rapidly becoming involved in the sector due to high yields on offer from the loans. Indiegogo, the world's largest crowdfunding platform, announced it had raised US$40 million from investors to fund expansion.[59] Eaglewood Capital, an investment firm, bundled together US$53 million of P2P loans and sold them in tranches to institutional investors.[60]

There has been a tendency that the P2P platforms are falling back into the arms of the formal banking. Notably, some of the largest US P2P platforms have abandoned their retail focus and institutional investors have directly been involved in the lending business. In the US, more than 60% of the P2P loans are now purchased by institutional investors.[61] LendingClub and Prosper are tracking the growing institutional interest. John Mack, the former Mogan Stanley chief executive, has been appointed onto the board of LendingClub.[62] Prosper recruited Stephan Vermut, its chief executive, from Wells Fargo, where he headed the bank's prime brokerage business.[63] The participation of institutional investors into the P2P platforms may eventually change the nature and feature of P2P platforms. Larger investors seek large numbers of loans so as to bundle them into securitised bonds, which can be further sold to more investors. This may drag the P2P sector back into the formal banking system. Institutional investors can purchase best loans much faster than individual investors as they have more sophisticated computer programs to plug directly into the P2P platform. As a consequence, LendingClub has placed limits on the amount of loans investors can purchase and has installed technology that is designed to allow individual investor time to scan the site and give them a chance to compete for loans. Prosper installed speed limits to deter trading firms from buying up its loans by using multiple servers and rapid-fire computer software.

Wells Fargo reversed its internal policy towards the budding alternative lending sector and dropped a ban on its employ-

51 Guidelines, Article 7.
52 Guidelines, Article 8.
53 Guidelines, Article 9.
54 Guidelines, Article 10.
55 Guidelines, Article 11.
56 Guidelines, Article 12.
57 Guidelines, Article 12.
58 Guidelines, Article 14.

59 "Startups Turn To Crowdfunding Sites Kickstarter, Indiegogo for Guinea Pigs", Financial Post, 29 August 2013, available at http://business.financialpost.com/2013/08/29/startups-turn-to-crowdfunding-sites-kickstarter-indiegogo-for-guinea-pigs/?__lsa=adc1-2508.
60 "Wall Street vs 2P", Financial Times, 15 November 2013, p. 8.
61 Tracy Alloway and Arash Massoudi, "P2P Lenders Install 'Speed Bumps'", Financial Times, 11 February 2014, p. 20.
62 Tracy Alloway and Arash Massoudi, "Wells Fargo Reverses P2P Loan Ban", Financial Times, 12 March 2014, p. 15.
63 Ibid.

ees making loans with their own money on P2P platforms. Wells Fargo claimed that, after review of the P2P market, loans made by its staff on the platforms were not "inconsistent with its code of ethics". The U-turn follows the fact that Wells Fargo had deemed making loans on for-profit P2P platforms such as LendingClub and Prosper a "competitive activity that poses a conflict of interest" given the bank's bread-and-butter business of lending.[64] Wells Fargo's changing stance is a sign that the P2P lending sector may become a mainstream competitor to conventional lenders.

The increased participation of institutional versus individual investors may result in a dramatic growth of the P2P sector.[65] The immediate consequence is the stronger interconnectedness of the P2P lending sector with the broader financial sector. However, this may likely increase system wide concerns about the shift of credit risks back from individual lenders to banks and nondepository lenders, thereby exposing other financial sectors to the risk of default inherent in P2P lending. The rapid growth of P2P lending may eventually materialise systemic risk. In addition, the involvement of institutional investors in the P2P lending sector may further worsen market concentration due to the limited number of established players in the market. High concentration is a key feature in the P2P lending sector not only in China but also abroad where most active platforms are in a small size. Regulation can be designed to protect investors from concentration risk, which could be a systemic risk if the market were to become sizeable.

In China, many investors have been showing their great interest and appetite in the P2P lending business since 2007. Many of them enter into the industry including traditional financial institutions such as banks, insurance companies and listed companies. The involvement of these investors has changed the landscape of the P2P lending sector. In 2014, venture capital firms, banks, state-owned companies and listed companies continue to venture into this sector. It appears that banks, state-owned enterprises, venture capital/private equity, and listed companies have shown a great interest in investing in the P2P lending sector in 2014. [66]

Large P2P platforms have been planning IPOs, which may also change the landscape of the P2P sector. The listing of some P2P platforms not only shows a publicised sector but also a return of the technology sector into the spot. The cooperatives of equal customers joined are re-classifying the P2P platform into the two-tier structure of retail and institutional clients. LendingClub's listing on 11 December 2014 in New York with a valuation of US$9 billion already (even though it had just US$160 million in revenues in 2013)[67] paid off for early investors, who include a range of venture capital firms such as Canaan Partners and Morgenthaler Ventures. Its board members include Lawrence Summers, the former US Treasury Secretary, and John Mack, the former Morgan Stanley CEO.[68] This change increases the borrowing costs to retail customers even though smart and cheap technology may also improve returns. For banks and institutional investors, investing in P2P will not harm their brands and bring risks and create additional costs for marketing to individuals. It will be interesting to see if these global changes will also be reflected into the Chinese P2P lending market.

P2P lending, together with equity crowdfunding, has clear securities market implications. Along with some P2P platforms' public listings are the securitisation of P2P unsecured loans, which open not only the market to new investments but also the rest of the financial market to exposure to packaged loans. Some P2P lenders started to securitise loan bundles and sell them to other financial entities or P2P platforms in the form of asset-backed securities. P2P platforms may purchase these loan portfolios at face value less fees and then consolidate and sell them to third parties in different credit tranches.[69] As these packaged loans are predominately unsecured in nature, this securitisation may deepen the financial market and increase systemic risks.

6. P2P's impact on China's banking sector

6.1. *Mixing with social media platforms*

The Internet finance market is destined to arise, in part, as a result of enhancements in digital technology. The substantial growth of crowdfunding and P2P lending is deeply associated with the technological innovation of the so-called Web 2.0 applications on the Internet, which allows users of the Internet to participate in the creation of content hosted on stable websites.[70] The online platform has a social-networking aspect with the capability to involve a large number of users thereby increasing the potential reach of financing opportunities or capital raising facilities.

Internet finance in China is interconnected with social media platforms, i.e., WeChat. WeChat or Weixin in Chinese, similar to WhatsApp, an American messaging service, is known mostly for private chatting and innocuous photo-sharing among small circles of friends. It has become the showcase product for Tencent, China's Internet giant, with more than 272 million active users. Tencent has aggressively promoted WeChat in China and abroad, effectively boosting the number of active monthly users to 355 million at the end of 2013, up 9% from the end of September 2013.[71] WeChat has one of the largest user bases in the world for a messaging app.

[64] Tracy Alloway and Arash Massoudi, "Wells Fargo Reserves P2P Loan Ban", Financial Times, 12 March 2014, p. 15.
[65] US Government Accountability Office, Report to Congressional Committees: Person-to-Person Lending, New Challenges Could Emerge as the Industry Growth (July 2011), Foreword.
[66] China's Internet Lending Business Annual Report 2014.
[67] "Lending Club: Peer Position", Financial Times, 12 December 2014 (online).
[68] Tracy Alloway and Eric Platt, "Investors Bank on Lending Club Success", Financial Times, 15 December 2014 (online).
[69] Tracy Alloway, "P2P Lenders to Turn to Securitisation Deals", Financial Times, 1 October 2013 (online).
[70] Tim O'Rielly, T. "What Is Web 2.0: Design Patterns and Business Models for the Next Generation of Software" (2007), available at: http://mpra.ub.uni-muenchen.de/4578/1/MPRA_paper_4578.pdf (last visited 18 June 2015).
[71] Juro Osawa and Paul Mozur, "Marketing Costs Hit Tencent", Wall Street Journal, 20 March 2014, B7.

Tencent has recently been branching out into ecommerce, payments and gaming.[72] In this sense, it is more diversified than Sina.[73] Recently, WeChat has integrated online-payment functions. Customers can do their banking through WeChat and a wealth-management service has been launched as well. Tencent announced the plan to improve its mobile offerings with the hope of making money by means of fees charged through payment transactions, in which users buy goods with their phones.[74] The downside of the use of social media is that fixed rates of returns may put lenders in a less advantageous position.

Alibaba bought a minority stake in Weibo from Weibo's parent company Sina,[75] valuing Weibo at US$3.3 billion.[76] Alibaba used Sina Weibo, a microblogging service in China, to launch its most recent push into innovative finance, or a form of crowdfunding for Chinese movies, in March 2014. The investment product is called Yu Le Bao in Chinese, or Entertainment Treasure. Investors are offered an opportunity to be involved in the film-making industry by making suggestions regarding what films should be made and who should direct and star in them. Investors can have an expected annual interest rate of 7% for putting up as little as 100 yuan. There will be four projects initially targeting 73 million yuan in total.[77] By offering a 7% return rate, Alibaba's novel online investment projects have amassed a substantial share of China's household savings. The money raised through crowdfunding will be channeled into insurance and wealth management products that were being offered by Guohua Life Insurance, based in Shanghai, and will then be invested in the entertainment industry.

Customers, through a smartphone app., can stash 20,000 yuan in Alibaba's money-market fund, called Yu'E Bao (or "leftover treasure"). The account pays the customer a 4.8% interest rate, compared with the 0.35% from a saving account with a state-owned bank. By early February 2014, around 81 million people, more than the total number of equity investors in China,[78] had signed up for Yu'E Bao, which now has US$40 billion in assets under management and is the largest money market fund in China.[79] Alibaba also plans to sell mutual funds through its Taobao electronic-market platform. Since its launch in June 20113, Yu'E Bao, the deposit-like money market fund, has attracted 400 billion yuan in assets under management, which is already more than the customer deposits held by the five smallest listed mainland banks.[80] Similar online products from Baidu and Tencent contributed to a fall of 1 trillion yuan in bank deposits in January 2014.[81] Baidu Inc. is offering its own money-market-like investment product. The upstart lenders are stepping into areas that Chinese banks traditionally ignored. This constitutes an important sector if China is to sustain growth by empowering consumers and small businesses, and to move away from its dependence on big infrastructure projects funded by state-owned banks.[82]

China's Internet companies and investment firms are a powerful combination given the fact that there are about 600 million Internet users in China, nearly twice the population of the US, according to the China Internet Network Information Centre.[83] Chinese Internet companies have demonstrated astonishing growth. Baidu reported a 43% jump in sales while Tencent posted a 38% rise in revenue in 2013.[84] The funds owe their success to a combination of good timing and failings of China's creaky financial system. Nonetheless, they also have to face a slowing economy, a weakened yuan and declining interest rates.

Crowdfunding is often viewed to have a material impact on promoting overall economic performance.[85] This is also the case in the Chinese context as the capital for innovative enterprises is scarce and the needs of innovative enterprises are not sufficiently met by the conventional funding channels such as banks. Nevertheless, there is a lack of regulatory accommodation. Although it is true that regulation of or legislation on crowdfunding is still new and even some advanced jurisdictions such as Australia have no legislation in place to facilitate crowdfunding,[86] the regulatory vacuum may not only substantially reduce competition in the crowdfunding market but also reduce small and medium sized enterprises' access to credit.

[72] Sarah Mishkin, "Sina Weibo Growth Slows", Financial Times, 26 February 2014, p. 18.

[73] Sina focuses on mobile and social space. Its Twitter-like Sina Weibo has been listed in New York. It made money from advertising and selling data on user behaviour. The number of daily average users grew 4.2% from about 59 million in September to 61.4 million in December 2013. Sarah Mishkin, "Sina Weibo Growth Slows", Financial Times, 26 February 2014, p.18. Since Weibo's launch in 2009, it had grown to 144 million monthly active users as of March 2014. Paul Mozur, Telis Demos and Matt Jarzemsky, "After Slow Start, Weibo Gains 19%", The Wall Street Journal, 18 April 2014, B2. Weibo's IPO in New York received warm welcomes. Shares of Weibo surged 19% in their first day of trading. Michael J. de la Merced, "Shares of Twitter-like Weibo Surge on Opening Day, as China IPOs Mount", New York Times, 18 April 2014, B3.

[74] Juro Osawa and Paul Mozur, "Marketing Costs Hit Tencent", Wall Street Journal, 20 March 2014, B7.

[75] Weibo, as a matter of fact, accounts for the bulk of Sina's market value. Aaron Back, "China's Weibo Sends Message in Tech Selloff", The Wall Street Journal, 8 April 2014, C8. Weibo was listed in the US, fetching 21 times sales. In this sense, Weibo's IPO only gives employees some liquidate gains.

[76] Michael J. de la Merced, "Shares of Twitter-like Weibo Surge on Opening Day, as China IPOs Mount", New York Times, 18 April 2014, B3.

[77] Neil Gough, "Alibaba to Make Movies with Crowdfunding Idea", New York Times, 27 March 2014, B10.

[78] Henny Sender, "Tech Groups Transform How Finance Is Done in China", Financial Times, 16 April 2014, p. 12.

[79] David Barboza, "Web Banks, Offering High Interest Rates, Rise in China", New York Times, 3 March 2014, B1.

[80] "Chinese Banks Call for Cap on Online Interest Rates", South China Morning Post, 28 February 2014 (online).

[81] Ibid.

[82] Paul Mozur and Dinny McMahon, "Alibaba Affiliate Strides Onto Bankers' Turf", The Wall Street Journal, 7 November 2013, C3.

[83] Michael J. de la Merced, "Shares of Twitter-like Weibo Surge on Opening Day, as China IPOs Mount", New York Times, 18 April 2014, B3.

[84] Ibid.

[85] The Corporations and Markets Advisory Committee (in Australia), Crowd Sourced Equity Funding Report (November 2013).

[86] Terence Wong, "Crowd funding: Regulating the new phenomenon" (2013) 2 C. & S.L.J. 89 and Tim Heasley, "Law Changes to Crowdfunding Needed to Kickstart Australian Innovation", 29 October 2014, available at http://www.smh.com.au/it-pro/it-opinion/law-changes-to-crowd-funding-needed-to-kickstart-australian-innovation-20141028-11d4on.html.

Table 1 – Balance sheet of Yu'E Bao (Dec 31, 2013) (Renminbi).

Assets		Debts	
Bank deposit	175,541,071,053.14	Sale of repurchase Financial assets	4,949,996,640.00
Trading financial assets		Remuneration payable to manager	39,100,241.16
Including: bond investment	12,762,005,913.59	Payable trust fee	10,426,730.96
Purchase of resale financial assets	1,580,737,687.37	Payable sales service fee	32,583,343.31
Interest receivable	492,025,474.79	Payable transactional fee	101,301.04
		Payable interest	1,327,955.44
		Total debt	5,033,770,402.91
		Paid-in fund	185,342,015,725.98
Total assets	190,375,786,128.89	Total debts and owner's equities	190,375,786,128.89

6.2. *Break-up of the conventional banking system in China*

Internet finance like P2P is envisioned as a possible vehicle that can eventually break the monopolies of the state-dominated banking system in China, as it disrupts the traditional bank payment systems and takes away the charges and fees the banks have gleaned from such monopolistic services. Alibaba, for example, has dominated the Internet money-fund market. Within its first ten months, it has hauled in more than 400 billion yuan in assets.[87] Tencent Holdings has attracted 50 billion yuan to its Licaitong fund.[88] State-owned banks are used to lending money to the state-owned sector, which, compared to small businesses, is seen to have the necessary financial strength to repay loans. These market players can serve their customers better than most banks as they have a whole ecosystem which facilitates their communications and transactions with e-commerce customers. This intimacy also lowers transaction costs. Lenders can diversify across many borrowers while borrowers get quicker approvals than they would if forced to go through the bank's internal approval process.

Large state-owned banks have moved to cap the amounts depositors can transfer into online products.[89] For instance, China Construction Bank imposed a cap of 5000 yuan per transaction and a total of 50,000 yuan a month for deposits transferred to Alibaba's Yu'E Bao fund. The limit of 10,000 yuan per transfer and 50,000 yuan a month is imposed on Tencent's online product.[90] Chinese banks' restrictions on the depositors' capital transfer again showed their monopolistic positions in the market which harm depositors' interests.

Banks are lobbying regulators to tighten rules governing online products as they felt marginalised due to the 20% capital reserve requirements and other regulatory restrictions, which increase transaction costs. The Chinese Banking Association, a government-backed industry group, is lobbying regulators to cap the yields on online money market funds and reserve requirements as banks have felt a threat from online financial products.[91] If adopted, online money market products would be subject to the same regulatory cap that governs conventional term deposits.

An immediate consequence is the elimination of online products' competitive advantage. Currently, Yu'E Bao and other similar products invest most of their funds in interbank deposits, which are not subject to the cap governing retail deposits. Table 1 is the balance sheets Yu'E Bao publicised at the end of 2014 showing that the major source of income was actually from the interest from commercial lenders. No wonder commercial banks always complained that Yu'E Bao indeed is banks' vampire.

The structural model allows Alibaba to pass on higher interbank yields which, however, hurts bank profits by reducing their supply cost deposits and increasing their reliance on relatively expensive funding from the interbank market. The rates on commercial bank deposits are subject to a cap of 10% above the benchmark set by the PBOC. The current benchmark is 3% for one-year deposits. By contrast, the annualised yield on Yu'E Bao is 6.09%.[92] Convenience is another advantage. Investors in Yu'E Bao and other similar products can withdraw cash at any time without being subject to any penalty. By contrast, premature repayment may trigger monetary penalty on the borrowers in conventional bank loans.

Commercial banks in China are now tackling various challenges and competitive pressure from Internet finance. For instance, ICBC is steadily promoting IT-based banking businesses by exploring ways to apply the big data technology, and expedite the building of a modern information platform meeting transformation and development demand.[93]

7. Conclusions

Internet lending is booming in China while conventional banks cut back on lending to small and medium businesses and

[87] Chao Deng, "China's E-Money Funds Lose Buzz", The Wall Street Journal, 7 March 2014, C2.

[88] Ibid.

[89] Paul Mozur and Grace Zhu, "Beijing to Put Limits on Mobile Spending", The Wall Street Journal, 25 March 2014, C3.

[90] Ibid.

[91] "Chinese Banks Call for Cap on Online Interest Rates", South China Morning Post, 28 February 2014 (online).

[92] It has been reported that the yields were around 7%, double what banks offer. Chao Deng, "China's E-Money Funds Lose Buzz", The Wall Street Journal, 7 March 2014, C2.

[93] Zhang Hong, "ICBC Profit Climbs 10.2 Percent on Fees, High Net Interest Margins", South China Morning Post, 28 March 2014 (online).

individuals. As previously discussed, commercial lenders in China are barred from lending money to these borrowers at interest rates that bankers lend to state-owned enterprises and large players in the market. In practice, banks may be less interested in these customers due to the lack of proven cash flows and collateral. Being part of the shadow banking, P2P lending is filling the vacuum by offering new types of loans. Currently, the P2P lending is only a small portion of all social financing. Nevertheless, it is fair and reasonable to expect a surge of the P2P lending, which is likely to be a bigger part of the financial landscape.

For years, Chinese policy makers tried to liberalise interest rates but made no progress due to lobbying efforts made by Chinese banks and other state-owned financial institutions. P2P indeed brings a new opportunity to interest rate liberalisation as savers can get around the regulation while getting a higher yield on their savings by depositing in P2P platforms. Therefore, P2P can help shake up China's banking and financial sector. Seen from this angle, the government's tolerance of Internet companies' offering a wide range of investment and financial products is an effort to create alternatives to state banks and to loosen interest rate controls.

P2Ps provide great opportunities to grow a powerful lending business in the future. The P2P platforms may have a bright future if the money is channelled into the real economy and regulators gradually loosen its grip over the tightly controlled financial system. The Chinese government's online finance guidelines, unveiled on 18 July 2015, aimed at steering growth of lending and investment over the Internet with the hope of generating more growth and increasing funding and investment in the mainland's "new normal" economy. The PBOC's regulatory move is a strong indicator of the Chinese government's commitment to overhauling state-run enterprises as subjecting protected state-controlled sectors to more direct competition is an effective means of putting China's economy on a healthier footing. These moves are part of the larger "Internet plus" strategy the Chinese government has been deploying to foster new ideas and growth in the economy. P2P lending platforms and other market players offering other Internet based financial products have gone a long way to democratising finance through their online money market funds, online lending and other innovations. Such platforms are destined to play a critical and innovative role in China's transition to a domestic demand driven and consumption oriented economy. The P2P lending sector may help realise some key domestic initiatives including broadening the financial markets, aiding in the long-term financing of the real economy, and promoting wider stability within the financial system.

Although there have been different views as to the appropriate roles of regulators and the effective regulatory instruments that can be employed, the general consensus is that the P2P lending warrants regulation. The Chinese government therefore should put an adequate and facilitative framework in place. There are two options for regulating P2P lending. One option is to rely upon the current financial regulatory system to protect lenders and borrowers. The current regulatory system provides borrowers and lenders with protections consistent with those afforded to conventional bank borrowers and lenders. However, the drawback is that the current system does not have goals and agency responsibilities that are specific to the sector. The latest example is the online finance guidelines which were drawn up and issued by ten central government ministries and regulators including the central bank, CBRC, CSRC and the Ministry of Finance. Although the government's role is identified in this piece of guidelines, the functions of each regulator and ministry involved in drawing up these guidelines are defined in a fragmented manner. The guidelines merely specify which agencies are responsible for regulating which types of Internet financial institutions. The other option is to consolidate legal protections under a single regulator with a sector-wide focus. The downside of this regulatory option is the uncertainties about the efficiency and effectiveness of a new regime. The choice between these two regulatory approaches depends on regulatory flexibility, efficiency and effectiveness. In any event, even in the formative stage, the regulatory system needs to have broad goals – ensuring adequate consumer protections, monitoring the safety and soundness of institutions and overseeing the integrity and fairness of markets. A lack of regulatory accommodation is likely to continue to disadvantage start-ups and small and medium sized enterprises vis-à-vis their counterparts in the state-owned sectors.

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