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INTERNET FINANCE AND ITS POTENTIAL RISKS: THE CASE OF CHINA

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Abstract: *Internet finance is a global phenomenon that further close the digital divide and sidelining of small-medium enterprise (SMEs) equipping for a fourth industrial revolution market. This study reviews the development of Internet finance in China deemed to be the largest Internet finance market in the world. The extant of literature and market reports suggest that this overwhelming performance of China Internet financing is due to factors such as financial market gap, popularity of third-party payment and high returns. However, against the traditional financing operations, investors in this sector suffer substantial degree of risks due to fraud leading to huge losses. We argue that there needs a concerted effort by government and oversight bodies to improve market disciplines to ensure a healthy development of this alternative financing thereby enhancing the economy development of China and elsewhere where Internet financing is operating.*

Keywords: *Internet Finance; Potential Risk; SMEs; China*

Introduction

The development of advanced information technology is changing the financial market today (Han & Greene, 2007). In recent years, Internet lending sites have become new means of mobilising and disseminating small business funds. Individuals who wish to make a profit by investing directly through the Internet are providing credits to small businesses without the need for traditional financial institutions such as banks. Indeed, Internet finance has provided new investment choices for individual investors and solves small-medium enterprise (SME) financing problems in various countries including China.

The objective of this paper is to review the development of Internet financing in China and analyse the potential risk of its operation. This paper is conducted based on review of articles published in academic journals and the press. The remainder of this study proceeds as follows. In the following section, literatures related to Internet finance and the Internet finance development in China are reviewed. The section also highlighted the potential risks of Internet finance currently faced by China. The final section presents the conclusion and further implications brought from this study.

Literature Review

The technologies based on the Internet such as mobile payments, social networks, search engines and cloud computing has led to an evolution in the financial sector (Xie & Zou, 2013). Internet finance, also called peer-to-peer (P2P) lending, usually plays the role of the middleman, acting for those who need money and those who are rich in the financial sector. In addition to financing through commercial banks or the securities market, the third way of conducting financial activities is now through Internet finance platforms.

With the latest financial crisis followed by a slowdown in traditional bank loans within developed economies, the emergence of the Internet lending is a welcoming scenario (Kulkarni & Rigal, 2016). LendingClub and Prosper are the two major platforms in the US projecting the loan volumes. These two sites basically bring people together – those with surplus money and those who need money. These two new P2P loan sites US had increased loan volumes by USD2.4 billion in 2013, up from USD870 million in 2012 (Blackman, 2014). From 2006, LendingClub, for example, has issued USD4 billion in loans, reaching USD2.3 billion by the end of 2013 (Demos, 2014). Further, it has reached USD3.8 billion after completing the acquisition of Springstrone (Moore & Massoudi, 2014). In just a few years, it had moved from a USD1 million start-up company to a USD8.9 billion listed company (Alloway & Platt, 2014). Lending Club is now a giant in the online market place that the total loans issued as of March 2018 amounted to $35,940,013,016 (Bajpai, 2018).

The first Internet finance platform that was established in China started in 2007. Since then, Internet finance has increasingly acquired popularity and market recognition (Xinhua, 2017). Inspired by the Internet lending platforms in the United States, the PPdai became China's first Internet lending site in June 2007. This establishment was soon followed by other Internet finance platforms such as Lufax, Hongling Capital and Renrendai. As a whole, the Internet finance industry has entered the "fast lane". This industry's explosion began in 2013 where a total of about 150 platforms were established (Wei, 2015). The P2P platforms continued to bourgeon from 2014 until mid-2015 where more than 2000 platforms were recorded to be in operation. Figure 1 below shows the number of Internet finance platforms in China, from 2010 to 2017, based on the data taken from China's Internet finance annual report 2017.

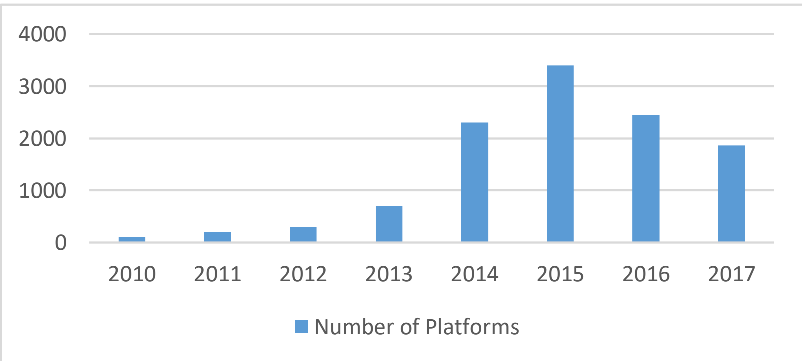

Figure 1: Number of Platforms

Source: China Internet Finance Annual Report 2017

Given that the Internet finance promotes lending through a non-conventional banking system, by 2013, there were about 800 P2P lending platforms that were serving loans to more than 200,000 people with amounts totalled to USD105.8 billion (Wei, 2015). From 2013 to 2014, it was observed that participating investors and borrowers had risen 364% and 320% respectively on a yearly basis (Wei, 2015). In recent years, China's Internet finance business has developed even more rapidly. Based on Table 1 below, the total P2P loan transaction volume had reached 830 billion yuan in 2015, up from almost nothing in 2010 and 97.6 billion yuan in 2013. Since November 2015, the transaction volume has been stable at approximately 130 billion yuan per month (Xu, 2017). There were more than 2,000 online P2P lending platforms in China in 2015 (Williams-Grut, 2015). It was reported that the market was transacting nearly USD150 billion in 2015, more than ten times the size of the US marketplace (Xinhua, 2016).

Table 1: **Growth of China Internet Finance (in RMB)**

	2012	2013	2014	2015
Third-Party Payment (Trillion)	3.66	5.37	8.08	11.90
P2p Loan Platforms	298	814	1544	2595
P2p Volume(Billion)	22.9	97.6	251.5	830.2
Yu'e Bao Balance(Billion)		185.3	578.9	620.7

Source: Xu, 2017.

SME Financing Gap in China

The popularity of the Internet finance among investors in China and their eagerness to invest in online financial products displays the weakness of China's financial system. Unlike western countries, the choices of financial products under the traditional financial operation for investors are lower in China. In China's financial markets, for instance, some large state-owned commercial banks dominate China's financial system. History dictates that these large banks mainly finance large (state owned enterprises) SOEs and government borrowers (Deer, Mi, & Yu, 2015) sidelining SMEs. Hence, without much choices, these SMEs have to raise capital by borrowing from informal channels such as friends, families, and business partners. This has been occurring since the 'reform and opening' policy conducted in 1978.

Although the pattern of financing noted in Chinese commercial banks has changed over the past decade (Lardy, 2014), there is still a large "institutional gap" lurking among small businesses, individuals and households (He, Yan, & Chen, 2013). This institutional situation creates opportunities for the Internet lending with many entering the field of consumer finance. They offer diversified lending services in areas such as consumer credits, car financing, education and training, and mortgage financing in areas where traditional banking finds it too cumbersome (Deer, Mi, & Yu, 2015). It is also worth noting that China's e-commence third-party payment (TPP) approach is thriving. TPP has been the core driving force of e-commerce development (Shim & Shin, 2015), a payment service provider that is independent of merchants and banks. Chinese customers prefer cash payments rather than the credit cards to make online purchases, and this unique situation has created the development of the TPP. Since the payment method under the Internet finance model is based on the TPP, mobile communication equipment and wireless communication technology is applied for transferring the value of money (Shuai, 2011). Alipay and WeChat Pay have become the two dominant TPP approaches in China as they are very convenient and accessible for users to transfer money in the Internet environment.

Meanwhile, Internet finance platforms usually provide high-interest rates than banks and fast loan approvals and this creates a win-win situation for both parties, thereby contributing to the blooming of the Internet finance. The supply of funds for retail investors is the main reason pushing the growth of China's Internet loans. These loans can be three to five times higher than traditional bank deposit rates as has been verified by a survey conducted by the Association of Chartered Certified Accountants (ACCA) . The report indicates that 57% of lenders offer loans at a rate of 12% to 18%. Although the investment rate of the Internet finance platform is different, the average return level is relatively high making this venture very attractive for investors. Figure 2 below shows the average annual production of China's P2P platform. More than 80% of the P2P platform average annual rate of return is between 8% and 18%, which is much higher than those offered by traditional credit financing channels (China Internet Finance Annual Report 2016). The figure reflects the strong demand for borrowers and the difficulty of SME financing from conventional banks.

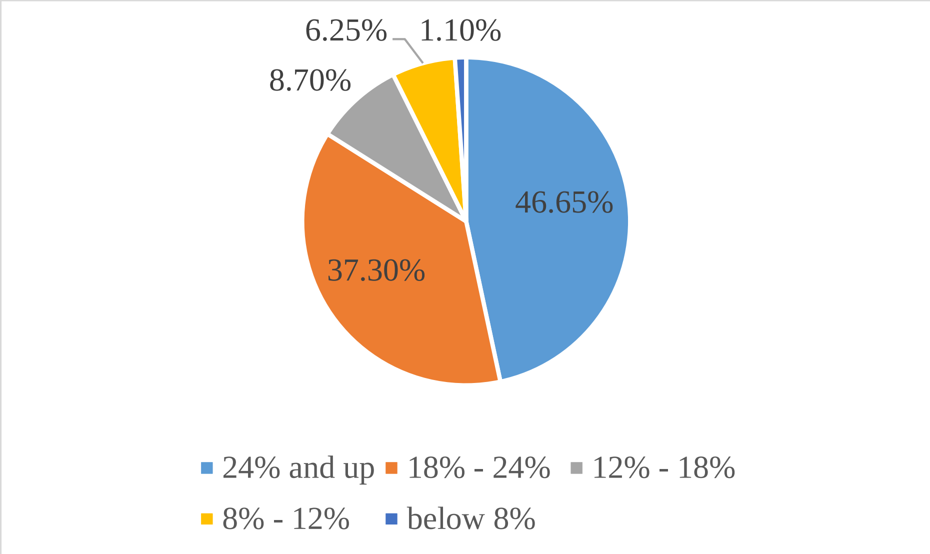

Figure 2: Average Return

Source: China Internet Finance Annual Report 2016

Potential Risks in China's Internet Finance Market

Unlike the financial landscape of the UK and US where the Internet finance market is dominated by large companies such as LendingClub and Prosper, the situation in China is slightly different. To date, China has around 2000 companies which offer Internet finance in the market (Williams-Grut, 2015). These Internet finance companies bring investment choices and financing channels to individual investors and borrowers. However, Internet finance also bring with it other disadvantages such as regulations to monitor the financial transactions which may incur huge sums of money. This can lead to bankruptcies when re-payments cannot be met or fraud and other financial risks (Liu, 2015). The prevalence of the Internet finance has also created other distractions such as disruptions to traditional banking services where certain business territories have become affected negatively (Chen, Li, Wu & Luo, 2017).

It is worth pointing out that the P2P loan platform of China began in 2007. It flourished and became very popular. However, these platforms were not well managed. When borrowers defaulted on the loans, the owner of the platform is involved and is required to compensate the lender. It was reported by the "National Business Daily" (January 21, 2014) that in Hangzhou, Shanghai and Shenzhen, the P2P loan platforms have created scandals of equivalent to 231 million yuan of loans. Owners of those platforms fled their obligations, leaving other investors and borrowers in limbo. In recent years, this occurrence has increased. The surge in the irregularities of Internet finance and loans have sparked fears of social unrest among platform users and borrowers. These fears are expressed through protests because protests is the only way for the lenders to express their anger about the lost investments. From the perspective of attracting attention, it is undeniable that such protests can also attract government attention who can then be motivated to look for resolutions that can address the rescue plans (Wei, 2015).

Meanwhile, the risks faced by Internet lending platforms are "run-away" or "closure" both of which relate to loans given being unpaid or investors having to close shop due to no returns on investment made. Run-away is close to a "bank run" where the owners of the platform run away and make the platforms no longer able to pay off outstanding debts to other investors or they discontinue from serving clients.

On the other hand, fraud refers to the instance where some owners use the platforms to solicit money without having the intention of staying in the lending business. In 2013, 74% of the P2P platforms were reported to be in "operational difficulties, cash squeezes or owners running away" and, it was reported that 1.2 trillion yuan of the money was lost (Jane, 2014). Between January and March 2015, 130 platforms closed and more than 1,250 platforms were regarded to be at risk by local credit rating agencies (Chen, 2015). Figure 3 below illustrates the P2P lending industry of 2016 where rectification, high operation pressure and other reasons had led to a number of the industry being pushed out of business as compared to 2015, resulting in 1741 of these investors being out of business. It appears that the number of closed platforms were comparatively higher than those that were suffering from operation problems, showing that this industry is developing in a positive direction.

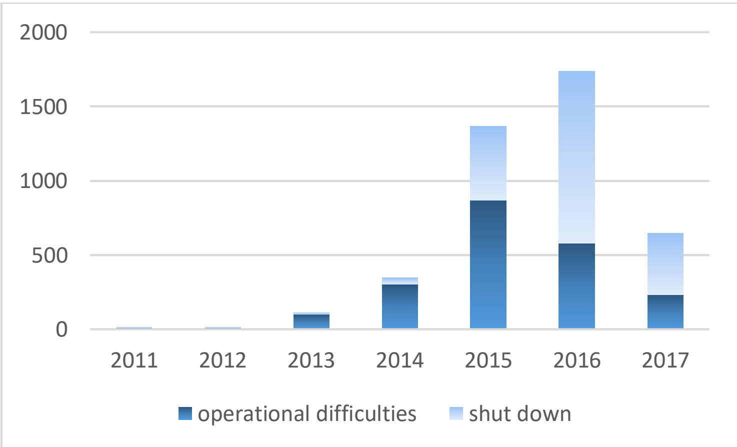

Figure 3: Shut Down And Operational Difficulties Internet Finance Platforms
Source: China Internet Finance Annual Report 2016

From the operational perspective, the risks faced by Internet finance platforms are mainly attributed to technology, operations and law. The technology risks come from the loan issuing methods. This is because Internet finance platforms mainly issue loans based on the concept of data analysis instead of manual investigation. It appears that when the loan market changed, the data of the borrower and lender were not adjusted duly or immediately (Huang, 2013). This caused a mismatch in information which may not be current or true to some extent. Operational risk refers to the risk of direct or indirect loss resulting from incomplete or problematic internal operating processes, personnel, systems, or external events.

Another potential risk arising from China Internet finance platform is due to the fact that China's financial legislation is based on the formulation of traditional financial activities. As a result of this, it can be said that these laws and regulations are not suitable for internet finance platforms. Thus far, there are no such aspects pertaining to the identification of the Internet financial market, the identification of transaction subjects, and the validity of electronic contracts. This situation may result in unclear rights and obligations between trading entities. Internet lending is currently not very strictly regulated in China. They also cannot be easily classified as regular commercial lenders because their primary function is to promote loans by providing credit information rather than the credit itself.

The Chinese government had proposed the first major Internet financial guidance policy in July 2015 after allowing Internet financing and P2P loans to grow rapidly over the years (Deer, Mi & Yu, 2015). This 'guidance' is a loose regulatory policy which encourages the innovation of Internet finance and which supports Internet finance. Even though the regulation on third-party Internet payments became effective on 1 July 2016[1] and the regulation imposed on P2P lending platforms became effective on 17 August 2016[2], the problem on number of Internet finance platforms reduce still continue. In 2018, 88 Internet finance platforms reported as operation problem in June and 220 platforms reported in July (wdzj.com, 2018). The current situation is that the Internet finance platforms lacks adequate regulations and information disclosure; it also involves high-risk lending and occasional fraudulent activities. The fast increasing "in-trouble" platforms reflect the serious situation of the supervision vacuum.

Conclusion and Implication

Internet finance has developed over recent years and this method for financial transaction has received growing acceptance by the public. In China, the economic growth and traditional financial system provide sound environment for the development of Internet finance. The widely used third-party payment such as Alipay and Wechat pay connected people from traditional financial activities to Internet activities and make people access Internet finance easily. However, the fraud Internet finance platforms exposed the potential risks in the development of Internet finance. This situation bring requirement for regulation on the Internet finance market. In the first half year of 2018, based on the financial report Yirendai got 0.7 billion yuan profit while PPdai got 1 billion yuan profit which demonstrate the potential development of Internet finance in China (wdzj.com, 2018). For individual investors, the decision of investment on Internet finance platforms directly related to its potential risks and returns. Hence, in the situation on waiting for more regulation to be enforced on Internet finance market, some technic to help investors decision making should be the focus of future research.

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