



THOUGHT LEADERSHIP BRIEF

Why did the Peer-to-peer Lending Market Fail in China?

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KEY POINTS

- ▶ From 2007 to 2020, China's Peer-to-peer lending market experienced a drastic boom and bust, and ended up with zero surviving platforms.
- ▶ The key reason for the collapse of China's P2P sector was that almost all P2P platforms deviate from the role of information intermediary and became shadow banks offering principal guarantee.
- ▶ As the number of P2P platforms increases, each platform has a greater incentive to offer principal guarantee in responses to fierce competition and the lure of financial fraud under limited regulatory capacity. This hurts the investors' and social welfare.
- ▶ The existence of naïve investors makes offering principal guarantee more attractive to platforms. Promoting information disclosure may not solve the problem.

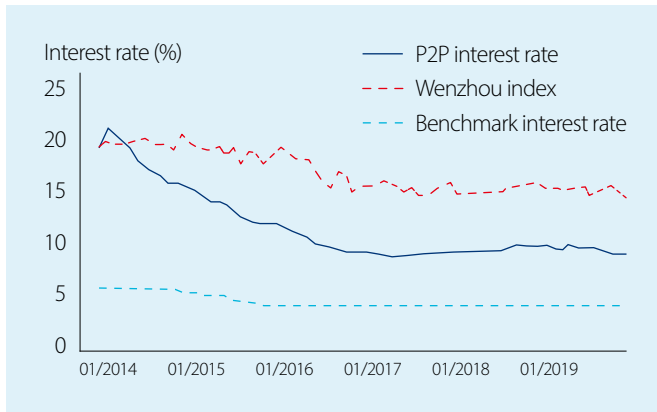
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ISSUE

Peer-to-peer (P2P) lending is an important Fintech innovation in retail banking. P2P platforms use information technology to match lenders and borrowers and facilitate online transactions that enable individuals (or firms) to lend money to other individuals (or firms) without the intermediation of traditional financial institutions. Compared to traditional banks, P2P platforms have a particular advantage in providing small-sized loans and expands financial inclusion.



Figure 1. Interest Rate Comparison in China



Sources: WDZJ (www.wdzj.com), People's Bank of China, and Wenzhou Municipal Government Finance Office. Wenzhou index is the interest rate of private lending estimated by Wenzhou government (www.wzpf.gov.cn)

Figure 1 shows that P2P platforms can provide loans at lower interest rates than private lending without the platforms. For lenders, investing via P2P platforms did not require large amounts of money or a long duration, and the interest rate was much higher than those offered by banks.

The rapid development of information and financial technology and the unmet demand for credit gave rise to a large P2P credit market in China. From 2007 to 2020, China's P2P lending market experienced a drastic boom and bust. The market started to flourish in 2013 and reached its peak transaction volume of CNY 2.8 trillion in 2017. Thousands of P2P platforms connected over 4 million lenders and borrowers and provided billions of loans to individuals and small- and medium-sized enterprises (SMEs). At its peak, the total amount of P2P lending in China was 10 times greater than that in the US. From 2013 to 2018, the P2P trading volume in China was larger than the sum for the rest of the world.

Figure 2. Monthly Number of Active P2P Platforms in China

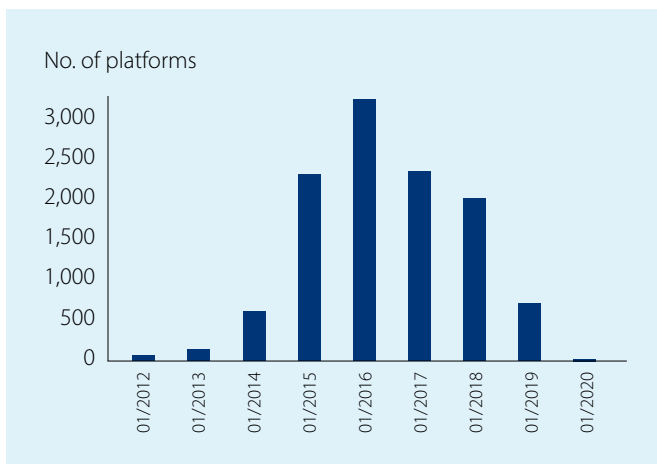


Table 1. Total Amount of P2P Lending (million USD)

Country	2013	2014	2015	2016	2017	2018
China	5520	23,820	97,580	201,310	327,800	207,590
USA	3176	8742	21,282	23,420	17,340	27,420
UK	751	2135	3667	4810	6005	6359
Japan	79	108	326	171	236	873
Germany	48	116	205	227	448	813
France	57	117	181	277	431	494
Australia	2	16	70	165	365	321
New Zealand		14	245	178	242	222

Sources: Cambridge Centre for Alternative Finance.

Despite that the P2P lending market had promoted financial inclusion in China, it was highly risky and volatile. Instances of platform collapse and fraud occurred frequently, causing substantial monetary losses for millions of individual lenders. As investors gradually lost confidence in P2P lending, the market size continued to decline and ultimately collapsed. On November 27, 2020, the China Banking and Insurance Regulatory Commission (CBIRC) announced that the number of P2P platforms had fallen to zero.

However, P2P lending is still an active industry in the US and other developed economies. What are the differences between the Chinese P2P market and those in the developed countries? We develop a theoretical model of the P2P lending market that explains how different market environments can lead to two vastly different outcomes. Why did so many P2P platforms collapse in China, while most platforms in developed countries were able to persist?

ASSESSMENT

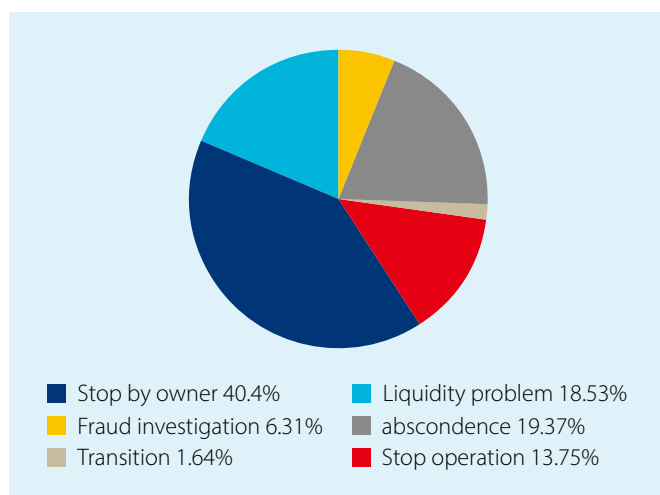
The major reason is that China's P2P platforms deviated from being information intermediaries and started to offer principal guarantee terms. A classical P2P lending platform serves as an information intermediary that provides information about borrowers without taking liability for borrower default. However, the role of P2P platforms in China started to change after 2012 as the competition among platforms became increasingly intense. To compete for funds from lenders, platforms offered principal guarantee to lenders that promised to repay the principal to lenders even if borrowers defaulted. As a result, platforms took on the responsibility for borrower default and exposed themselves to credit risks that were thus shifted away from lenders. By 2016, almost all platforms had become shadow banks.



As shadow banks, platforms formed their own reserve funds by pooling money from lenders to hedge borrower default risks. For example, Ppdai reported to the US Securities and Exchange Commission (SEC) that it had a quality assurance fund and investor reserve funds (www.sec.gov/Archives/edgar/data/1691445/000119312517309953/d285990df1.htm). These reserve funds were similar to the deposit insurance in the traditional banking sector. Lenders are exposed to less risk from borrower default under principal guarantee but face the possibility of platform collapse. If the platform fails, lenders cannot regain their principal. Many P2P platforms lacked professional risk management and sufficiently large reserve funds. Therefore, when there was a shortage of new investors or economic downturns, a small number of borrower default cases could quickly deplete the reserve funds and cause panic among lenders. As lenders lost confidence in the promise of principal guarantee, they started a “platform (bank) run” by withdrawing money from the platform.

In addition, the relatively weak capacity of regulatory authority in China left room for fraud. The intense competition and investor naivety jointly further induce Chinese P2P platforms to choose the risky and unsustainable business model. Having a larger number of platforms also makes monitoring more difficult for the regulatory authority and therefore facilitates fraud. Figure 2 shows different reasons for platform collapse. A large proportion of failed platforms ceased operation for “normal” reasons such as liquidity problems, lack of investors, or failure to earn a profit. However, many platforms failed because of fraud. Among 6,292 events of platform collapse on record, 1,219 (19.37%) were caused by absconding by the owner(s) and 397 (6.31%) were investigated by regulators for possible fraud such as Ponzi schemes and fabricating information about borrowers. Thousands of investors were exploited by these financial frauds.

Figure 3: Reasons for P2P Platform Collapse in China



The existence of naïve investors further increases the incentive of platforms offering principal guarantee. Naïve investors hold the misperception that platforms always have the ability to fulfill the principal guarantee terms. Mandatory information disclosure can mitigate the problem only if the regulation can be successfully implemented to all possible options faced by investors. If mandatory disclosure is selective and cannot cover all platforms, then naïve investors can be attracted to the remaining platforms with perceived low risks.

In contrast, P2P platforms in developed countries (e.g., Zopa, LendingClub, and Prosper) maintained their roles as information intermediaries and never bore liability for borrower default. The P2P lending market in the US and the UK were dominated by a few platforms that do not offer principal guarantee, and institutional investors are more. Therefore, compared with those in China, platforms in these countries face less competition, more sophisticated investors, and more stringent regulation, which led to different outcomes.

Table 2: Platform Collapse with More Than 1 Billion CNY Unpaid Loans:

Platform	Collapse time	Unpaid loan (billion CNY)	No. of lenders
Fanya*	04/2015	33.8	135,000
Ezubao*	12/2015	38	895,000
Kuailu*	04/2016	10	–
Qbao*	12/2017	30	–
Shanlin*	04/2018	2.05	30,000
Tangxiaoseng*	06/2018	5.29	107,000
Lingqianguan*	06/2018	2.2	6,000
Caogen*	07/2018	9.7	130,000
Yindou*	07/2018	4.3	23,000
Jinyinmao*	07/2018	2.23	1,000
Jucaimao*	07/2018	1.14	9,000
Tourongjia*	07/2018	1.68	23,000
Yonglibao*	07/2018	1.64	33,000
Touzhijia*	07/2018	2.9	–
Quark Finance*	08/2018	3.8	24,000
Leaderrcf*	09/2018	1.3	2,000
Yourongwang	01/2019	1.25	–
Koudailic	03/2019	1.03	19,000
Tuandai*	03/2019	14.5	222,000
Xinhehui*	04/2019	2.25	15,000
Wanglibao*	05/2019	3.03	40,000
Credit Harmony*	05/2019	8.4	31,000
Jinxin99*	05/2019	9.7	50,000
Yinhuwang	05/2019	3.37	20,000
Niubangold*	07/2019	4.3	94,000
itouzi*	07/2019	12.9	–
Houbank*	08/2019	1.18	16,000
Laocaibao*	09/2019	5	28,000
Mizlicai*	12/2019	1.32	12,000
Weidai*	07/2020	6	–

Sources: Fintech-Book and various news outlets.

RECOMMENDATION

1. Excessive competition among P2P platforms can jeopardize investors interest and social welfare. It is important to enhance regulatory capacity. For example, to prevent platforms from absconding with investors' money, platforms should establish custody accounts with commercial banks and perform transaction through banks.
2. If the regulator cannot substantially increase its regulatory capacity in the short run, one way to avoid excessive competition is to raise the barriers to entry to control the P2P market at a modest level of competition. For example, the US Securities and Exchange Commission issued detailed rules on how existing laws on securities were to be applied to P2P lending platforms.
3. Providing financial literacy education and informational nudges can improve investors' awareness of the risk of platform collapse and financial fraud. For example, one major regulatory goal of the UK Financial Conduct Authority is to ensure that retail investors are fully aware that lending on P2P platforms is not like bank deposits.
4. In the long run, expanding the credit scoring system can fundamentally reduce the risk in P2P lending markets. In developed countries, individuals and small firms can earn credit records through mature a credit scoring system. As a result, the P2P market is very small relative to the entire credit market in these countries. However, in China, there is no universal credit scoring system for individuals and small firms. P2P platforms attract borrowers with high risk and weak credit records.



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Reference:

Dingwei Gu, Zhengqing Gui, and Yangguang Huang, "Why did the Peer-to-peer Lending Market Fail in China?" *Working Paper* (2021).

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