

## Brief Analysis on Operating Model and Risks of “P2P Lending” in China

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**Abstract:** This paper conducts comparative analysis on operating model of domestic P2P lending platforms, explores advantages and deficiencies of various models, finds out existing problems and puts forward corresponding suggestions. This paper selects two classic P2P lending platforms, and analyzes from company profile, operation process, profit model and risk management. The research shows that P2P lending industry of China is still in preliminary stage of development, and there exist many problems. There are still large space for development by improving credit information system and strengthening the supervision of laws and regulations.

### 1. Research Background and Significance

With the increasing development and expansion of Internet finance, P2P lending industry serving small and micro-sized enterprises has already reached a certain scale, and has brought certain challenges to traditional finance industry in China. At the same time, P2P lending faces many problems and challenges, therefore, there is far-reaching significance to research operating model and development strategy of P2P lending in China.

Hauswald and Agarwal (2008) believe that because small and medium-sized enterprises and individual low-income earners cannot collateralize or offer guarantee, financial institutions like large traditional banks cannot make loans for them, thus, P2P lending provides great convenience for them <sup>[1]</sup>. Most foreign scholars think that risks of online lending mainly come from the lack of guarantee of creditors and borrowers, the asymmetric information and so on. Lee (2012) thinks that there exists “herd behavior” in online lending industry, in other words, most lenders lack the autonomy, and follow the choice of others to determine borrower, which reduces the financing efficiency of online lending platforms. Meanwhile, he also believes that the loan amount of P2P is generally small, and it does not require the guarantee, which will increase the risks of platform <sup>[3]</sup>. Xin Xian (2009) thinks that P2P lending models in foreign countries can be divided into three types, including Kiva non-profit model, Prosper pure mediation model, and Zopa, Lending Club model <sup>[4]</sup>; Jia Shenghua et al (2016) divides P2P business model into debt assignment model, pure information model, guarantee/mortgage model, and asset securitization <sup>[5]</sup>. Huang Zhen (2012) puts forward that there is not requirement for market access, industry standard, or supervision in P2P in China, however, there is a large amount of demand and supply and corresponding intermediary services <sup>[7]</sup>.

### 2. Qualitative Analysis of Operating Mode of P2P in China

#### 2.1 Information publish and broker

Information publish and broker is one of features of online lending platform. Online lending platform, as the intermediary agent, is responsible for the detailed inspection and evaluation on financing status, credit and guarantee, at the same time, recommend high-quality borrowers to lenders with the lending need and accomplish point-to-point capital transaction between lenders and borrowers. There are many types of broker transactions of P2P platform, including lending rate indefinite bidding and so on.

## **2.2 Credit-reporting service**

Compared with relatively mature credit reporting system in foreign countries, credit reporting system in China needs to be improved, therefore, most P2P platforms are required to take measures of credit reporting system to solve the credit problem of borrowers.

## **2.3 Third-party custody**

There are two kinds of P2P fund escrow, including third-party payment platform and bank.

## **2.4 Loan loss provision**

For P2P industry, loan loss provision is that P2P platform builds a capital account, and charges proportional capital according to credit rating of borrowers in each transaction. Meanwhile, the platform also invest a certain proportional capital. When there is bad debt and big systematical risk in platform, loan loss provision will be started to compensate investors and guarantee their interests.

## **2.5 Third-party guarantee**

When investing P2P, investors pay attention to the profitability, mobility and safety of online lending products. Therefore, almost each online lending platform will provide the guarantees in various types, and loan loss provision mentioned before is actually one of guarantees. Third-party guarantee means that some online lending platforms will ask some financing guarantee companies conducting specifically guarantee businesses.

# **3. Case Analysis of Operating Model of P2P Platforms in China**

## **3.1 Categories of operating models of P2P platforms**

### **3.1.1 Pure platform model and debt assignment model**

Pure platform model and debt assignment model are categorized by business process of online lending. In pure platform model, P2P platform only provides information required for lenders and borrowers, not involved in lending transactions. The platform in this model is just a intermediary institution, provides such information of borrowers as capital background, purpose of loan and so on to realize the fund matching of both sides and improve the flow efficiency of funds. However, the platform cannot guarantee the authenticity of information published and the requirement for rational judgment of investors is high.

On the contrary, there is the mediation of intermediary platforms in debt assignment model, and the transaction between lenders and borrowers is no longer the point-to-point transaction, but there is a loan lender. P2P platform selects the borrower first, provides capital to borrower by loan lender, who owns creditor's rights at this time, then the loan lender assigns it to the investor through the platform, and the investor will obtain the interest income. The creditor here is generally the insider closely related to P2P platform.

### **3.1.2 Pure online model and the combination of online and offline model**

Pure online model and the combination of online and offline model are divided by the whole operation process including user registration, credit investigation, transaction done and loan recovery. Pure online model fully depends on online operation, and the application, bidding, risk examination and issuing of loan are conducted online. The combination of online and offline model is the model applied by most P2P platforms. The borrower makes the application online in P2P platform, the platform examines qualification information of borrower offline, issues the bidding in online platform and investor performs the bidding online.

For platform, pure online model always bring higher default risk of loans, therefore, the platform is required to comprehensively evaluate operation risk based on the participation of transaction, the lack of guarantee and pure platform or bond model. The combination of online and offline model can help the platform get more high-quality customers and improve the level of risk management to provide follow-up field management after the loan transaction.

### **3.1.3 Unsecured model and secured model**

The operating model of P2P platform can be divided into unsecured model and secured model according to the guarantee. Secured model can be subdivided into platform guarantee, third-party guarantee and fundraiser mortgage guarantee. In unsecured model, P2P platform does not provide any guarantee for investors, not any mortgage from borrower or third-party guarantee company. In the whole process of loan, the platform does not provide guarantee, and investors shall bear the risks. However, in secured model, the platform is the intermediary agent to provide information of borrowers and lender, and provide a certain guarantee service for investors, thus reducing transaction risk of investors. In secured model, if there is default from the borrower, the guarantee side shall pay principal and interests for investors to guarantee the interests of investors.

### **3.1.4 Asset securitization model**

In recent years, domestic P2P operating models conduct innovations increasingly, and asset securitization product is an emerging model. The asset securitization of P2P generally is launched by small loan company that urgently need funds to lend. The P2P platform or small loan company first packs these credit assets and forms many small asset packages, listed for registration in financial exchanges in various places, and for credit enhancement and ownership affirmation. And then those companies associated with the P2P platform delist and buy back these asset packages and transfer to the P2P platform for investors to issue bidding. Finally, at the expiration date, the small loan company will repurchase the asset package from the investor. If the small loan company defaults, the guarantee company will make the guarantee payment.

## **3.2 Typical case analysis of P2P platforms**

### **(1) Company profile**

The full name of Lufax is "Shanghai Lujiazui International Financial Assets Trading Market Co., Ltd.", a member of Ping An Group, was incorporated in Shanghai in September 2011 with a registered capital of 837 million yuan. It is currently the largest Internet wealth management platform in China. Lufax has three platforms, namely Renmingongshe, Lu.com and Ifex.

### **(2) Operation process**

The operation mode of Lufax P2P platform mainly adopts the debt assignment mode and the online and offline combination mode and third-party guarantee institution mode. Ping An Financing Guarantee (Tianjin) Co., Ltd of Ping An Group provides a full guarantee for the platform products, En-E, including principal and interest and overdue fines. The platform provides the borrower with credit loan, mortgage loan and pledge loan model. The operating projects of Lufax P2P platform are very comprehensive, including various investment products and wealth management products. In addition to the investment sector, the platform also launched fund section, wealth management section, insurance section and debt assignment trading section to increase the liquidity of funds.

### **(3) Profit model**

Based on growing trading volume of Lufax and advantages of Ping An Group, it can be seen that its profit is very promising. At present, there are four types of profit model in Lufax. First of all, in the platform transaction, to create a secondary market for non-standard assets for all institutions and individuals, and create liquidity for such assets, and a transaction fee of 0.5%-5% can be charged in each transaction. Second, in the distribution of products, to create non-standard asset wholesale market for all institutions and individuals, provide platform distribution services for products, and charge 5%-20% of wholesale sales expenses as income, including management fees. Third, in data service, a large number of customer data can be obtained through the platform transaction, and customer needs can be positioned after analysis to publish relevant product information to customers, in order to obtain a certain amount of information advertising revenue. Fourth, in asset underwriting, to provide standardized packaging, pricing, and underwriting services for non-standard assets of customers, and charge an underwriting fee of 5%-200%. At present, the largest source of income for Lufax in the market is the cost of product updating and the handling fee for customers' second-level transfer products. Secondary market transactions of Lufax account for a

large proportion. In the future, with the strategic development of the platform, the third mode and the fourth mode have great development prospects.

#### (4) Risk management

First, Lufax is backed by Ping An Group. The company's majority shareholder is China Ping An Group, a Fortune 500 company. It is the first financial group with financial full-service license in China, with strong strength and lays the foundation for business development of Lufax. The investment services released by the platform are subject to strict professional internal inspection, and at the same time, third-party guarantee companies or core enterprises above AA level provide guarantees. Second, in credit rating, Lufax has established a credit rating department that conducts subject ratings and debt ratings for both borrowers and products. A mapping model is established for standardized products with external ratings and then converted into their own risk ratings. Third, in information disclosure, the information disclosure pursued by Lufax is the differentiated risk warning. Fourth, in post-investment early-warning monitoring, Lufax has established a self-developed early-warning system with financial and non-financial indicators to review all assets for sale at least once every three months. At the same time, for some non-standard assets investment projects, there will also be teams to conduct field inspection. In addition, the risk assessment system and the precise matching of assets and funds are the core tasks of Lufax.

## **4. Risks and Prevention Suggestions of P2P**

### **4.1 Existing risks**

#### **4.1.1 Credit risk**

P2P platform cannot use the credit reporting center of Bank of China, thus China's online lending platforms can only perform credit ratings based on their own standards by uploading document of borrowers, like ID card, so as to examine whether the borrower is qualified to make loans.

#### **4.1.2 Risks of illegal fund-raising**

The supervision and regulatory system of China clearly formulates that P2P platforms are not allowed to build capital pool, so most platforms will choose to establish an intermediate account in third-party payment platform or bank to realize the settlement of transactions of platforms and funds trusteeship. In general, the third-party institution conducts the supervision on intermediate account, however, due to the frequent flow of capital, the small amount of capital and the heavy responsibility, many institutions do not make promises to perform the operation and supervision responsibility.

#### **4.1.3 Risks of liquidity**

For any P2P platform, the liquidity is essential for normal business operation of enterprises. However, there is a certain difference in the matching of the amount of capital between borrowers and lenders, at the same time, platform cannot establish capital pool to absorb deposit, so the risks of liquidity will increase.

#### **4.1.4 Security risks**

With the blowout development of P2P platforms in China with the huge number of platforms, however, most of them are small and medium-sized enterprises, and there is constraint in capital and technology, which directly results in the insufficient attention on network security. When there exist technological loopholes in platforms, information security of borrowers and lenders will be exposed, such as identity and asset information of borrowers and lenders.

#### **4.1.5 Risks of law and supervision**

Since China does not provide a specific legal definition for P2P lending, the access to entry for this industry is extremely low, the loan information is unknown, and the legal supervision is

insufficient. In 2014, the State Council handed over the P2P platform to the CBRC for supervision, but the supervision is far from enough. The platforms can adopt various means to avoid regulations. While evading supervision, they will also face greater financial risks. Besides, some of China's platforms have been involved in the trading of platforms and engaged in financing guarantee business, but due to the lack of supervision, it has not been restricted by law.

## **4.2 Prevention suggestions**

### **4.2.1 To build perfect evaluation system of individual credit rating**

The bad debt rate of P2P platforms in foreign countries can be controlled with a low level mainly because there is more perfect credit rating system. As long as the capacity of credit rating in China is improved, risks of platforms can be effectively controlled. First of all, P2P platforms shall be allowed to use credit reporting system of Central Bank, refer to credit information of borrowers, share platform data with Central Bank and realize a unified credit system. Secondly, P2P platforms shall build perfect inspection mechanism to realize information sharing between platforms. The inquiry of background information of borrowers is important, including such consumption information as ID card, driving license, certificate of non-criminal record, credit card record, certificate of house property ownership and so on, judicial information and registration of real estate. Thirdly, independent third-party credit rating institutions, consulting institutions, guarantee institutions and third-party capital trusteeship institutions shall be constructed to enrich the development of the industry and reduce the operation risks.

### **4.2.2 To strengthen the self-regulation and supervision of the industry**

In the imperfect relevant laws and regulations and supervision, the self-regulation management of P2P industry can be taken to regulate the development of the industry. At present, there is regional self-regulation organizations in P2P industry, which cannot however, be spread around the whole country, and the regulations are only be conducted for legal operation, management of staff and information disclosure, failing to play a substantial regulatory role. Therefore, it is necessary to build a unified industry self-regulation association under the guidance of the nation to strengthen the supervision. First of all, it is necessary to formulate industrial standard and communicate with relevant supervision departments. Secondly, it is recommended that to build a platform for information sharing, refer to successful cases in foreign countries, and put forward regulations on P2P management group and account management to promote the development of the industry.

## **5. Conclusion**

In China, the P2P platform with pure platform model is more suitable for the trend of online lending industry. Different from traditional financing institutions, P2P industry has high freedom with the goal of establishing an open platform to realize the free transaction between borrowers and lenders. If the platform is involved in the transaction, the development of online lending industry will also tends to become traditional financing institutions. In addition, if involved in transactions, the requirements for the capacity of risk management of P2P platforms will be higher to increase the difficulty in the development of the industry. It can be clearly formulated in the system that P2P platforms are intermediary institutions, not allowed to participate in the transaction, which can effectively control investors from randomly using capital and risks of platform escaping.

Compared with pure platform model, P2P platform with traditional debt assignment model have many uncontrollable risks, and certain advantages from some aspects at the same time. In the pure platform mode, the simple one-on-one transaction between borrowers and the lenders has a clear relationship, but not all financing projects can be invested by one investor, which not only increases the risk of investors, but also reduces the success rate of matching. If the debt assignment model is adopted, the borrower's borrowings and the investor's funds are split, and multiple investors investing in the same project or multiple borrowers allocating the same investor's funds can not only reduce the difficulty to match, also reduces the risk of investors. Therefore, under the premise



of maintaining the intermediary nature of online lending platform, the appropriate use of debt assignment mode, while effectively controlling the risk of illegal fund-raising, will make more room for the development of the platform.

The P2P platform with pure online model has a prosperous prospect. Under current situation of China, the online and offline combination mode and third-party guarantee protect the platform and investor in the preliminary stage of development to some extent. This model can better control risks of platform and lenders, whereas seriously limits the development space of P2P industry, almost similar with offline small loan. However, the pure online model is with more potential for the development. With the improving credit reporting system in China, the risks of platform operation gradually decrease, the trading volume breaks through the bottleneck, and the pure online model which is not constrained by regions will be more vital.

Although there are still many problems in P2P industry in China, such as illegal fund-raising, the lack of guarantee for platform capital, credit rating of borrowers, transparency of information disclosure in platform and so on, the supervision departments still hold the attitude to encourage the development and innovation of P2P industry. With the improving laws and regulations and credit reporting system, many unauthorized P2P platforms will be eliminated to keep platforms with scientific development model, perfect management system and risk management and prevention measures, so as to continuously explore the development of P2P industry with more flexible use of capital.

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