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Legal Risks of P2P Lending and Its Prevention

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***Abstract*—In 2015, the State promulgated a series of regulatory policies. However, the chaotic Internet finance and P2P lending lack a national law and regulation to regulate, and the entire industry is still in relatively vague legal supervision. Especially the barbaric rapid development and the frequent phenomena of "escape with money" in recent years have made this economic problem attract enough attention from relevant departments. The gap of law vacuum and the lack of supervision have made the orderly and healthy development of P2P lending platform face an urgent need for legal regulation. Faced with such situation, this paper starts with the relevant theories of P2P lending, analyzes the legal risk of P2P lending, and tries to propose corresponding legal countermeasures.**

Keywords—P2P lending; platform risk control and supervision; information disclosure system

I. Introduction

Internet finance is an emerging field combining the traditional financial industry and the Internet technology, the essence of which is to meet the matching of fund supply and demand with computer technology as a medium, achieve fund accommodation and maximize the use of funds. There are two conditions for such fund flow in different markets: the one is that the right to use the fund and the ownership of the fund are separated, that is, the owners need to transfer the right to use their funds; the second is that the separation has costs, expressed as interest or dividends, etc. There are various types of Internet finance, such as big data finance, third-party payment, P2P lending, crowdfunding, financial portals, which are very common, and the electronization of traditional financial services in financial institutions, the emerging direct banks, online insurance channels and Internet brokers, etc. also belong to the Internet finance in a broad sense. Recently, there are more and more P2P lending platforms being shut down, along with the situations such as loss of communication with CEOs, capital chain rupture, or difficulty in withdrawals. Many central government agencies such as the People's Bank of China and China Banking Regulatory Commission have begun to focus on the governance of P2P.

II. The Relevant Theories of P2P Lending

A. Overview of P2P Lending

P2P (Peer to Peer) was originally a concept in computer networks, which referred to a way of information exchange between Internet peer entities. P2P lending (also translated as Person to Person) refers to the direct lending between individuals through the Internet. Specifically, it means that fund holders who have the funds and have the idea of financial management and investment use credit platforms as a medium to lend funds to other fund demanders who have borrowing needs via credit loans.[1]

B. History of P2P Lending

1) Overview of global development: P2P lending originated in 1976. Muhammad Yunus of Bangladesh founded the Bangladesh Rural Bank (also known as Grameen Bank), offering loans to poor people with no mortgage capacity and help them via small-sum loan. When everyone thought this was just a purely a loan behavior for public benefits, this batch of small-sum loan achieved a high repayment rate of 98.7%, and its economic and social benefits shocked the world. As a result, small-sum loan got recognized throughout the world. Almost at the same time, small-sum loan was integrated with the Internet technology, and P2P online loan platforms began to emerge. With convenient and self-service modes of operation, low rates, win-win interest rates and differentiated pricing mechanisms, foreign P2P financing has achieved great success.

Especially since the financial crisis in 2008, while the traditional financial institutions were in the doldrums, P2P lending platforms ushered in a climax of development. P2P lending companies represented by Zopa in UK, Prosper and Lending Club in USA, and the nonprofit Kiva rapidly rose in Europe and the United States. Up to now, it has covered dozens of countries such as the United Kingdom, the United States, China, South Korea, Australia, Japan, Canada, Spain, Poland, and Germany. According to Zopa, there are about 40 competitive P2P credit platforms around the world. This new type of financial management model has gradually been accepted by the public in the Internet age. Especially after the financial crisis, banks tighten credit to small-scale borrowers, and P2P lending starts to play an increasingly important role.

2) Overview of development of China's P2P lending: The development of P2P lending in China can be roughly divided into four stages:

The first phase is the start-up period from 2007 to 2012. Since the establishment of China's first P2P pure online lending platform in August 2007, domestic P2P lending has sprung up. At this stage, China's P2P platforms were mainly

[1] Tang Jing. Research on the Legal System of China's Non-governmental Online Lending Platform: [Master's Thesis of East China University of Political Science and Law]. Shanghai: School of Economics and Law, East China University of Political Science and Law, 2012, 41.

engaged in credit loans. However, at that time, China's credit information system was not perfect, and the data was not shared between platforms, resulting in a high bad debt rate. Therefore, this business model is not common in China.

The second stage is the rapid development period from 2012 to 2014. At this stage, influenced by the State's regulation and control policies on private lending at that time and the credit crisis, many private capitals turned their offline lending experience to more standardized P2P online platforms. The number of online platforms expanded from more than 50 to 800 in two years, and P2P lending entered a blowout development stage.

The third stage is the adjustment period from 2014 to 2015. After the accumulation in the rapid development period, VCs began to pay attention to the P2P industry. After the venture capital financing at 10-million-yuan level entered the capital market, the number of P2P lending platforms surged, and the public's financing model for P2P lending began to gradually end. At this time, nonstandard online platforms also began to appear, and the phenomena of escape with money and fraud emerged in endlessly. In 2014, there were 275 companies disclosed. At the end of 2015, "Ezubao" was suspected of being involved in fund-raising fraud case, which attracted the attention of the whole society.

The fourth stage is the standardizing period from 2015 to this day. In view of the above situations, national policies were intensively promulgated, and 2015 was defined as the first year of supervision of Internet finance, meaning that the Internet finance entered a period of standardized development.

III. Analysis of the Legal Risks of P2P Lending

A. Analysis of the Lawsuits Related to P2P Lending

The online credit business has brought about changes in business model, paperless transactions, and the connotation of financial risks. It is a financial business with greater operational risks. In view of the characteristics of online credit business such as information sharing through network interconnection, automated batch operation, and full-line operation of financing services, the business has obvious features of "informatization", "virtualization", "centralization" and "batch". As a channel innovation, it must have its own risks while having its advantages.

Both Ezubao case investigated by Economic Crime Investigation Department at the end of 2015 and the case of the Oriental Venture Capital, which was once sensational and the amount of money involved in the case was as high as 120 million yuan, expose the high-risk attributes of P2P lending in the stage of extensive development, lack of supervision and special regulations. According to the data of Wangdaizhijia, as of June 2017, the total number of platforms nationwide totaled 4127, including 1778 platforms with problems. From February 2017 to June, there were 353 platforms having problems, accounting for 43% of the total number of platforms, mainly reflected as to difficulties in cash withdrawal, escape with money, business suspension, and even intervention of economic investigation.

B. Legal Risks in P2P Lending

1) Lack of laws and regulations and unsound self-discipline of the industry: First of all, there is much gap in the supervision of laws and regulations, and the self-discipline of industry has not been well developed: (1) Due to the low barrier and high risk of the industry, the access threshold is low. Legal supervision has not yet proposed an access threshold, failing to effectively control such situations. (2) Due to the importance of data, platform companies may be reluctant to publish or share them, and legal supervision currently fails to explicitly require which types of information to be announced, and has not required mandatory disclosure of important indicators, such as overdue rates and bad debt rates. However, such information is related to the investors' financial security, and the formulation of relevant supporting law and regulations can accelerate China's information construction. (3) There is no special law to give punishment for violation. Since P2P investors are financial consumers, which are a special category of consumers, the protection and punishment of such consumers need to be set up separately. At present, the Commercial Bank Law has not given specific protection or punishment to financial consumers. The securities law, the bill law, the guarantee law, etc. should also be improved and supplemented accordingly. (4) China Internet Finance Association has been approved by the State Council and has been established. However, it has not yet begun to substantively regulate the industry at present, and its website has not yet officially started operations.

Secondly, the current policies and regulations are not detailed, and many regulations are not clear. For example, the Interim Measures for the Management of Business Activities of Online Lending Information Intermediaries (Draft for Comment) clarifies that the main supervisors of online lending are "CBRC (local financial supervision department) + the Ministry of Industry and Information Technology + the Ministry of Public Security + the National Internet Information Management Office)", responsible for "policy guidance, standard guidance and risk disposal", "telecom business supervision", "combating financial crimes" and "financial information services and Internet information content supervision", respectively. However, it stipulates that "local financial supervision departments are responsible for the standard guidance, filing management, risk prevention and disposal of online lending information intermediaries in their respective jurisdictions, and guiding the self-regulatory organizations of the online lending industry in their respective jurisdictions." Which type of regulatory agency does the "local financial supervision departments" mentioned in this article refer to, the Banking Regulatory Commission or the financial services office? The division of hierarchy and powers and responsibilities of local financial supervision departments are not clear.

2) The platform supervision of P2P lending is lacking, and the risk control method is not perfect

a) The platform and mandatory withdrawal mechanism of P2P lending has not been established: At present, all online lending institutions in China should register with the local financial regulatory authorities in the place of registration after receiving the industrial and commercial business license. Most of the lending platforms are registered as investment consulting limited liability companies and E-commerce limited liability companies. Compared with the restrictions on practitioners and registered capital to small-sum loan companies, the supervision on them is much more relaxing. This give opportunity to many people who wish to establish a small-sum loan company but do not have sufficient funds and qualifications, so that they can establish a lending platform with a very low registered capital, and then operate the same business as small-sum loan companies. On the other hand, many people who have the purpose of fraud are also involved in, using the emerging financial carrier of lending platforms to commit fraud. This has caused the unevenness of the online credit industry to a certain extent, and there is an urgent need for an access restriction.

The lack of corresponding exit mechanism has also caused problems of some lending platforms in their operations, or they lack handling mechanism available for reference when their profits are reduced and their operations are difficult. To a certain extent, this is also a reason why many lending platforms escape with money after operational difficulties, because there are no corresponding guidelines and examples for reference, and they do not know how to solve the crisis. Once a lending platform collapses, the lenders and the borrowers will lose the intermediary of communication, the borrowers will not be able to repay the loan, and the lenders will not receive the principal and interest. What's worse, some operators of lending platforms make up borrowers and then tempt the lenders to lend money. Later, they deliberately close the platform, and purchase the creditor's rights at a very low discount. Through the establishment and close-down of lending platform, they gain malicious profits.

b) Imperfect platform risk control, lack of risk warning capability: P2P lending is rapidly developing and has derived many models, such as P2C (Personal to Business), P2G (Personal to Government Project), P2B (Personal to Non-Financial Institution) P2N (Personal to Multi-Institution), with numerous products, different models and different legal risks, and many investors can't distinguish. In addition, with the rapid development of Internet finance, various capitals, industries and enterprises want to seize the opportunity to take a share of financial dividend. Therefore, the phenomena cross-border cooperation and snatching market occur frequently, operators, retail industry, real estate, E-commerce, Internet companies, traditional financial institutions and state-owned enterprises have all begun to be involved in Internet finance. Cross-border Internet investment has made risk control and supervision even more urgent. P2P lending risks are mainly divided into pre-loan management and post-loan management. However, legal risks cannot be completely circumvented, and the platforms usually do not have risk early warning, while the investors themselves bear the investment risk.

C. China's Credit Information System and Information Disclosure System Are Not Perfect

1) The credit information system is not perfect: Online lending platform plays an important intermediary role at both ends of the supply and demand of funds, connecting the underlying assets (capital demander) and customer flow (capital supplier). At present, the imperfection of China's credit information system is the bottleneck restricting P2P lending, and it is also the root cause of many legal risks. From the experience of the British and American industries, a mature personal credit information system plays an important role in the pre-loan risk management of P2P online lending industry, and platforms use it to judge the credit situation and risk-taking ability of investors and borrowers. Big data is essential in the credit information system. The core of big data lies in multi-dimensional data, rather than multi-quantity data. It depicts the comprehensive and real characteristics of users through the comparative analysis of users' different behavior traces. Multi-dimensional data needs to collect data from different industries, such as consumers' online shopping data, home addresses and personal wages. We believe that the free flow of information and information sharing inside and outside the industry will accelerate the construction of big data.

Combined with the current development model of P2P business in China, P2P lending companies can be divided into two categories: pure online mode, online and offline combined mode (O2O mode). First of all, pure online mode: it only involves trading brokerage. The pure online lending model is the most platform-based online lending model, in which P2P online lending platforms exist as a pure online intermediary responsible for formulating trading rules and providing trading platforms. The entire business from user development, credit review, contract signing to loan collection is mainly completed online, platforms do not involve the docking of funds, and the risk is also borne by the investors themselves. Platforms collect account management fees and loan service fees as the source of income. This model is the most common operating mode of most P2P platforms in foreign countries and also the most secure and compliant model. The pure online loan model in foreign countries benefits from the developed credit system in the local area, which still has problems in China. Under the current economic system of China, the default costs of P2P lending are low, and the overdue rates and bad debt rates are high, resulting in a slow development of pure online P2P platforms. In China, the O2O model of attracting flow online and looking for asset offline is more common.

2) Information disclosure is opaque: At present, the domestic online lending platform's disclosure of daily operations is more targeted at advertising and publicity, and the disclosures focus on turnover, loan balance, number of investors, distribution of financiers, distribution of simple product types, and the so-called "bad debt rate", while the risk disclosure is weak, and the risk warning effect is poor. This is quite different from the disclosure of operations by foreign platforms. However, the information disclosure of online lending platforms should focus on the following two aspects, and most of the platforms have not done: Firstly, online lending platforms should disclose the basic situation of their risk management system, including the platform's operating mode (mainly asset source, etc.), risk management (such as risk control system, risk management operation process, qualification of risk control team personnel and whether realizing separation of review and loan, etc.) and technical security level (such as IT system data security, privacy protection, emergency plan, etc.). Secondly, online lending platforms should disclose daily operations, including the specifications, statistics and reporting unified according to the regulatory layer. The disclosed data should cover the balance scale, asset distribution at different risk levels, source and flow of funds, overdue and bad debt levels, etc.

D. Difficulties in Rights Protection in P2P Lending

At present, the difficulties in rights protection in P2P lending are mainly reflected in the following three points:

- The borrowers' personal credit risk is relatively large. At present, each P2P online lending platform evaluates the credit of borrowers mainly based on information provided by the borrower, such as identity certificates, property certificates, payment records, and acquaintance evaluations, when matchmaking trading. On the one hand, such certificate information is extremely easy to be fake, providing a false basis for credit evaluation; on the other hand, even if it is the real proof material is provided, it is one-sided, and is unable to fully understand the borrower's information, and make a correct and objective credit evaluation, and it is also difficult to recover the funds afterwards.
- Some people are engaged in illegal fund raising or illegal fund absorption via P2P online lending platform. Some platforms like look P2P lending platforms, but actually they aim to absorb the funds or use the funds themselves. They use various false information, or control several platforms behind the scenes, borrow new money to pay the old debt, and constantly absorb funds; when the funds are absorbed to a certain extent, the legal purpose has been reached, so they escape with money, making it difficult to protect rights.
- It is difficult to supervise the use of funds after lending. There is no perfect law or regulation stipulating post-loan fund tracking problems, such as how to guarantee that the borrowers use the funds according to the promised use rather than conduct illegal criminal activities after the funds are lent. When the borrower fails to repay the principal and interest on time, the website only acts as the chaser, and the cost of recovery is difficult to make up.

IV. THE PREVENTION COUNTERMEASURES FOR LEGAL RISKS OF P2P LENDING

A. Improving Supervision Policies and Related Laws and Regulations as Soon as Possible

When formulating P2P online lending supervision policy, the supervisory department should not only see the actual demand of P2P lending, fully realize the urgency of online lending supervision, but shall also realize that online lending supervision is a social system project and fully predict the difficulty of online loan supervision. It is necessary to take into account the objective and realistic needs of economic development, and also to proceed from the integration of social supervision resources and coordination of regulatory forces, reach a general consensus on supervision, and concentrate the supervision force of the whole society, so that P2P online loan supervision can avoid detours.

To this end, regulatory authorities should try to reflect the three principles when formulating regulatory policies and related laws and regulations: the first is to embody the principle of urgency. If the "three no" situation of P2P lending, namely no access threshold, no industry standard, and no institutional supervision, continues, it is not only responsible for the security of the people's funds and the healthy development of the economy, but also indulges the emerging financial industry of the Internet. The regulatory authorities should step up research and the introduction of regulatory legal norms on Internet finance.

The second is to embody the principle of coordination. It is necessary to overcome the tendencies such as overly relying on the "enclosed" supervision of government functional departments, resulting in slow response, untimely investigation, and inadequate supervision, it is also necessary to prevent the concentration of regulatory power in a certain department, fully mobilize all forces of social supervision, establish an efficient and sensitive three-dimensional social supervision system, and determines comprehensive supervision mode composed of the People's Bank of China, the China Banking Regulatory Commission, the China Insurance Regulatory Commission, and the China Securities Regulatory Commission based on the mixed characteristics of P2P lending and finance; implement comprehensive supervision on online lending, enhance the transparency and timeliness of online lending supervision, and block regulatory loopholes. Based on the complexity and cross-regional nature of P2P online lending platforms, it is necessary to develop from a single supervisor to multiple supervisors. The People's Bank of China is mainly responsible for formulating of relevant laws and regulations and guiding local governments to play a role in financial supervision, the financial offices, industrial and commercial bureaus, communications and network supervision departments shall work together to standardize the overall operation of online lending platforms.

The third is to embody the principle of practicality. China's financial supervision is not detailed enough. Not only are there many gaps in laws and regulations, but even the existing policies are not clear enough. To this end, it is reasonable to accelerate the introduction and training of Internet finance talents on the basis of fully strengthening the correct guidance of the online lending industry and realizing the self-discipline development of the Internet finance industry, enrich the supervision force and accumulate supervision energy. Then it is necessary to properly absorb the advanced and mature supervision experience of online lending abroad, combine with China's supervision reality, come down to earth, formulate scientific and rational supervision policies, prevent the "high-end, magnificent and classy" policies that are not suitable for China's online lending supervision practice, which delays the effective supervision of Internet finance.

B. Improving the Supervision and Information Disclosure System of P2p Lending Platforms

First of all, the access threshold of P2P online loan platforms should be set as soon as possible to position the industry as an information intermediary. In addition to obtaining the Business License in the Municipal Industry and Commerce Bureau, P2P platforms also need to obtain the P2P Industry Operation License and filing in the Municipal Financial Bureau, and meet the basic requirements of minimum registered capital. In addition, it is necessary to severely punish P2P enterprises that obtain a large amount of working fund to form a “fund pool” for the purpose of issuing loans, and to block the phenomenon of damaging the financial consumer rights are due to the lack of necessary fund supervision and risk control measures.

Secondly, the information disclosure of P2P lending industry should focus on the following three aspects: the first is to achieve the transparency of financial operations, effectively isolate the platform's own funds and lending business funds through third-party fund custody, and prevent platforms from self-financing; the second is to achieve the transparency of P2P business. Under the premise of taking into account the privacy protection of financiers, fully and reasonably disclose the information of financiers and financing projects to investors, and reduce the information asymmetry between investment and financing; the third is to achieve the transparency of online lending platforms, disclose the platform risk management system and core operational information to the supervision level, reduce information asymmetry between the platform and supervisors, and create necessary conditions for the supervision level to carry out financial consumer protection from the perspective of preventing systemic risks.

Finally, P2P lending risk control should be more diversified and systematized (see "Fig. 5"). The information disclosure system should be taken as the core, the platform self-discipline should be strengthened, diligent operation should be performed, and an investor protection committee should be actively set up to timely conduct risk warning. For the security of capital security, an appropriate risk reserve system should be established, and the transaction funds should be entrusted to bank for custody.

C. Establishment of a Risk Rating System for Online Lending Platforms

Relevant departments or research institutions may conduct annual ratings and report on the risks of online lending platforms, and force the platforms to strengthen risk control. For example, Sina Finance conducted effective trials in 2014. The Third Season of the Financial Management Evaluation Room: Evaluation of China’s P2P Enterprises visited the whole country, analyzed from 6 dimensions and 55 subdivision indicators, and tried the risk control rating system on the platforms. P2P enterprises were evaluated from several dimensions such as the company background, technical strength, IT system, risk control, information disclosure and user experience, as well as 55 sub-division indicators. The evaluation score settings are as follows: out of 100 points, basic test occupies 30 points, security test occupies 50 points, experience test occupies 20 points, and an additional part is set, with 15 points plus or minus.

The risk rating of online loan platform is to help users identify platform risks, protect users' investment and financial profits, and avoid investing money in platforms that have problems such as escape with money, difficulty in cash withdrawals, financing fraud, etc. Generally speaking, it is based on user interests and centered on data driving.

V. CONCLUSION

In summary, in the context of China's financial repression, difficulty in financing of small and micro enterprises, and unsmooth investment channels of ordinary people, P2P does provide convenient investment and financing channels for small and micro enterprises and ordinary people, which is why P2P online lending has actually developed so fast in China in recent years. For P2P lending, it is not appropriate to prohibit or rely excessively on criminal means. Rather, legislators and regulators need to find a balance between investor protection and financial convenience, which is difficult. The specific system should be designed according to the nature of the investor, the financial situation, the operating conditions, the family property status, and the investment plan under the framework of a special investment risk law. A risk rating system for online lending platforms shall be established, a risk early warning system shall be implemented, and the supervision and information disclosure system for P2P online lending platforms shall be improved, so that investors have more channels to obtain information and protect themselves against risks. Of course, different investment models require different investor proportions, and the establishment of investor classification system can choose different investors according to different proportions. The most important is to improve the supervision policies and related laws and regulations as soon as possible. The supervisors fill in the blank of supervision, strengthen the system design and the improvement of supervision system, and thus reduce the legal risks of Internet finance as a whole.

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