

Preface

The year 2013 was labeled by many media and industry analysts as “Year One of The Internet Finance Era” in China.¹ The year 2013 has witnessed China’s Internet giants, such as Alibaba,² Tencent,³ and Baidu,⁴ made remarkable moves to enter into the Internet finance market.⁵ Many traditional financial service areas, such as deposit, loan, payment, insurance, and guarantee, have been aggressively “invaded” by these financial market intruders.⁶ However, equally notable was the rise of another Internet-enabled financial service that, as widely covered by media,⁷ has been making groundbreaking impact and encouraging massive general

¹See *China Industry Research Network*: <http://www.chinairm.com/news/20131231/120642562.html>; *Sina Finance*: <http://finance.sina.com.cn/money/bank/hlwjstart/>, for examples.

²The first and largest B2B online trading platform worldwide, whose USD \$25 billion IPO in the New York Stock Exchange on September 19, 2014 was widely considered the largest IPO so far in Wall Street history. Reuters: <http://www.reuters.com/article/2014/09/22/us-alibaba-ipo-value-idUSKCN0HH0A620140922>.

³A leading Chinese IT firm with market cap of about USD \$150 billion and over 600 million users of its most popular app WeChat. Bloomberg: <http://www.bloomberg.com/quote/TCEHY:US>; YODBank: <http://www.yodbank.com/news/view/id-444.shtml>; Anfone Net: <http://www.anfone.com/WXYHL/2014-6/53751.html>.

⁴China’s largest search engine and Google’s formidable competitor in China. *MIT Technology Review*—Aug 2014: <http://www.technologyreview.com/featuredstory/530016/a-chinese-internet-giant-starts-to-dream/>.

⁵Madison Marriage, Tech giants pose threat to fund houses, *Financial Times*: <http://www.ft.com/intl/cms/s/0/0ceee29c-c594-11e3-a7d4-00144feabdc0.html#axzz3HpmiQror>; Sabrina, Alibaba and Tencent Challenging Banks? *China Internet Watch*: <http://www.chinainternetwatch.com/3165/alibaba-tencent-finance/>.

⁶Sophie Song, Alibaba and Baidu Inc. (BIDU) Revolutionize China’s Financial Sector, By Bringing Together Microfinance and The Digital Age: <http://www.ibtimes.com/alibaba-baidu-inc-bidu-revolutionize-chinas-financial-sector-bringing-together-microfinance-digital>; China’s Baidu Adds Financial Services to its Portfolio: <http://www.digitaljungle.com.cn/blogs/china-s-baidu-adds-financial-services-to-its-portfolio>.

⁷<http://online.wsj.com/articles/SB10001424052702304049904579514820323810610>.

public participation long before the influx of large, capital-intensive technology firms into the industry. Recruiting mainly from a relatively lower income segment and targeting smaller monetary transactions, this fast-growing service is online lending.

The primary functionality of online lending is to provide an online platform through which both borrowers and lenders of funds can interface with one another in order to transfer the funds from the hands of the investors/lenders (the surplus economic units) to the hands of borrowers (the deficit economic units) at pre-agreed-upon interest rates. The way of transactions of the online lending enables the demand and supply sides of a lending process to interact directly, cutting out the intermediary function that was previously provided by many traditional financial institutions. As a result, online lending broke the monopoly of many large commercial banks, especially in terms of financing channels, financing targets, and financing sources.

Despite being as a grassroots business by nature, online lending's incredible growth in China since its inception in 2007 has greatly exceeded the expectations of many Chinese business analysts, especially those in the financial service industry. The implications of this higher-than-anticipated growth on China's economic development and its global investment opportunities have the potential to be very profound.

One of the significances lies in online lending's ability to potentially provide China with a new, financially viable method of transitioning from an economy of unsustainable growth to a more sustainable one. After high-speed development for more than three decades, China is now standing at a crossroad. The existing growth model for the Chinese economy is investment and export-driven, characterized by low labor costs but burdened by inefficient use of energy and a heavily polluted environment. It has served China well in the past 30 years, but it has become apparently clear to policy makers and analysts both inside and outside China that this model will no longer be sustainable for the next 30 years and beyond. Going forward, growing China's economy will have to depend more on stimulating domestic consumption and being productive in a more environmentally friendly, energy-conserving manner. The Chinese economy will also have to depend more critically on developing businesses through innovation-based brand competition, instead of relying on inexpensive labor costs as a sole point of competitive advantage. All these factors will be key to the long-term sustainability of China's economic growth.

In a modern economy, however, money is the medium of exchange and it remains, until further notice, the only means of payment for all business activities, so no progress in the economic, technological, or development model can be achieved without adequate financial funding and the necessary financial innovations. This is especially true for a country still in a transition from a centrally planned economy to a fully market-oriented one, such as China. Meanwhile, China's economic goals also

cannot be obtained without the healthy growth and active participation of small and medium enterprises (SMEs), since, in large economies such as the USA and China, over 99 % of all companies, by quantity, are SMEs.⁸

Compared to larger corporations, especially those with monopolistic positions, SMEs not only generate more innovation in a wider spectrum of areas, but also have stronger motivation, by their very nature, to be innovative. By definition, an innovation is a disruption of the existing market status. Since larger firms, especially ones with monopolistic positions, are usually the largest beneficiaries of the status quo, SMEs would be the firms most likely to pursue innovative activities. Large companies often lack the motivation to make market-needed changes, even though the consequence of resistance to that needed change could be detrimental to the firm. The bankruptcy of Kodak, a company that once held monopolistic position in the photoprinting industry, perfectly illustrates the case of a large company unwilling to adopt new digital methods to replace its traditional, once-dominant film technology and ultimately paid the price.⁹

Even though SMEs play an indispensable role in technology innovation, they, like any other business, cannot survive in a modern monetary economy without funding or financing. However, because of their limited scale and, usually, shorter lifetime, SMEs, especially in the developing countries, usually lack the necessary collateral, credit history, standardized financial records, and sufficient disclosure needed to obtain loans from traditional commercial banks. The difficulty for SMEs to get financing has become an almost ubiquitous challenge for SMEs worldwide. But the situation is particularly pronounced in China, since regulatory government restrictions historically prohibit the legal entry of private capital into the financial industry.¹⁰ These restrictions further exacerbate the imbalance of demand and supply in the loanable funds market in China, which, in turn, significantly inhibits the healthy development of SMEs. The combination of these effects then hinders China's transition from an incrementally obsolete economic growth model, one in urgent need of an industry upgrade, to a more sustainable one.

From a consumption perspective, the needed increases in domestic consumption cannot be accomplished if the country's citizens lack adequate purchasing power. In order to achieve a higher domestic consumption percentage in the nation's GDP growth, China will need to increase the actual purchasing power of its residents. Unfortunately, an underdeveloped social security system, skyrocketing real estate prices, and the high cost of basic services such as medical insurance

⁸US Small Business & Entrepreneurship Council, <http://www.sbecouncil.org/about-us/facts-and-data/>. Li Zibin, president of Chinese Small Enterprises Association, Xinhua Net: <http://news.xinhuanet.com/fortune/2010-05>. Ma Jun, China's State Council Development Research Center, Sino Finance: <http://finance.sina.com.cn/hy/20120426>.

⁹Dawn McCarty and Beth Jinks, 2012, Bloomberg, <http://www.bloomberg.com/news/2012-01-19/kodak-photography-pioneer-files-for-bankruptcy-protection-1-.html>.

¹⁰Wang and Yang [1].

and education have all but absorbed the disposable income of many Chinese citizens¹¹; needless to say, this severely slows down the expected growth of China's domestic consumption. As a result, consumer finance could become more and more critical in the push for more domestic consumption. In China, as in any other countries, consumer finance is widely considered a financial innovation that will help link consumers' current consumptions with their future incomes, allowing consumers to plan their consumptions from a timeline perspective of their entire lives. However, smaller monetary-amount consumer financing for lower income consumers appears not to be adequately covered under the traditional financial system in China, which is dominated by large, state-owned commercial banks.

From an investment perspective, small- and medium-sized investors in China typically lack adequate investment opportunities in a financial industry where the stock market has been bearish for years, real estate risk has been rising, and commercial banks' deposit rates have had significant difficulty catching up with rising inflation rates. In this environment, online lending has the potential to provide the massive number of small- and medium-sized investors with an alternative investment opportunity. Online lending can not only satisfy the financing needs of many currently underfinanced borrowers, but can also help the country more effectively utilize the idle funds in the economy, improving the efficiency of capital usage, facilitating the marketization of interest rate determination, and enhancing the basic functionality of the financial market in transferring surplus funds from the holder of the surplus funds to demander of the funds. Essentially, online lending helps improve the efficiency of resource allocation in the economy in general, and in the financial industry in particular.

Therefore, regardless of whether one is looking at the issue from a production, consumption, or domestic investment perspective, China's continued economic growth requires financial innovations such as online lending. These innovations will not only sustain the survival and development needs of SMEs, but also improve the overall living standards of ordinary Chinese citizens, and contribute to sustainable economic growth in China for the coming decades.

Another significance of the fast development of online lending in China is the tremendous opportunities it may bring to the business community worldwide, especially global investors. As the economy with large, and in many occasions the largest, number of cell phone owners, Internet subscribers, online shoppers, online social media participants, underfinanced fund demanders, and over-liquid fund suppliers, Internet-related industries could become one of the pillar industries in China in the next decades, just like the auto industry in the USA in the last century. Some early comers, such as Yahoo from USA and Softbank from Japan, have sweetly tasted the harvested fruit from their venture capital

¹¹2006 Chinese Economy and Society Blue Book, published by Chinese Academy of Social Sciences, http://news.xinhuanet.com/fortune/2005-12/22/content_3953712.htm.

investment in Alibaba,¹² an award for their visions and insights. It can be expected that the online lending that grew from grassroots may trigger a sequence of the shake-up of China's financial industry, accelerate the integration of Internet and finance, and bring in enormous investment opportunity for the business community worldwide.

However, like all other financial tools that facilitate financial transactions, online lending also holds potential default risks that the borrowers may not be able to pay back the principal and interest of the loan in a timely manner, and there also exists a trade-off between risks and returns. Online lending shattered the monopolies of large financial institutions in financing channels, but nonetheless cannot eliminate the information asymmetry and the uncertainties inherent to lending itself. In fact, because of the involvement of many lower end segments of the customers in terms of income level and credit score and use of Internet, and the lack of adequate due diligence as usually conducted by traditional financial institutions, the online lending business model may exacerbate even higher level of asymmetry and, consequently, the higher level of risk. Just as the inappropriate use of financial derivatives, which were originally created to prevent and reduce risks, ended up in the largest financial crisis since World War II, online lending, while it may stimulate financial innovations, may also introduce new risks being an Internet-enabled financing solution.

It is therefore imperative to conduct a comprehensive analysis of this burgeoning industry to explore the value that online lending will provide for borrowers, investors, consumers, and businesses while simultaneously identifying root causes of the potential risks of this financial innovation, and suggest possible solutions for mitigating these risks. From this perspective, this book, *Financing the Underfinanced—Online Lending in China*, could be a timely publication that may satisfy the needs of a wide spectrum of readerships.

This book covers the most important areas and issues in the online lending industry including, but not limited to, the definition of online lending, the history of online lending, the scale of the online lending market, the basic business models and risk analysis of online lending, the characteristics of typical online lending borrowers, the characteristics of typical online lending investors/lenders, the root causes of bankruptcy among failed online lending platforms, payment types, the expansion patterns of online lending, operating procedures, the functionality of platforms, the systematic risks of the industry, a comparative analysis of online lending platforms inside and outside China, the overall ranking of online lending platforms in China, and, finally, the outlook of the online lending industry in the future. In the book, chapters are accompanied by detailed case studies of online

¹²Parmy Olson, 2014, Finding Alibaba: How Jerry Yang Made The Most Lucrative Bet In Silicon Valley History, Forbes, <http://www.forbes.com/sites/parmyolson/2014/09/30/how-jerry-yang-made-the-most-lucrative-bet-in-tech-history/>.

Una Galani, 2014, Valuing SoftBank in Alibaba's Aftermath, The New York Times, http://dealbook.nytimes.com/2014/09/22/valuing-softbank-in-alibabas-aftermath/?_r=0.

lending—the book combines theoretical analysis with conceptual discussions and the best practices in the online lending industry, and could be of interest and value to a variety of readers, including, but not limited to:

1. Existing and potential online borrowers. As online lending is typically associated with small loans with relatively low credit requirements, the participation of borrowers could be massive. According to statistics from YesMyLoan (the largest online lending portal in China, see the content of the book for details), there are already more than 150,000 borrowers on only 90 (out of over 800) online lending platforms in China, as of the year end of 2013. These current borrowers, along with potential ones both inside and outside China, would certainly like to be privy to the most comprehensive and most updated knowledge about this newly developed and fast-growing industry. The publication of this book will definitely help satisfy the needs of these readers.
2. Existing and potential online lenders or loan investors. Just as there are many borrowers as discussed above, there are also a large number of existing and potential lenders in the online lending market place. According to the same data from YesMyLoan, the total number of online lenders already surpassed 200,000, as of the year end of 2013. In particular, given the present market conditions in China, with a stock market being in bearish for years, mounting financial risks in real estate, an indeterminate short-term outlook for the fundamentals of the Chinese economy, inadequate interest rate at commercial banks for depositors to protect themselves against inflation, and lacking choices for other investment options, online lending provides an attractive alternative investment opportunity in China for small- and medium-sized investors. These investors would surely benefit from deeper and more thorough knowledge about this industry, such as is in this book, to help them make better informed decisions.
3. Investors and professionals running online lending platforms. Like any other sectors in the financial industry, online lending not only provides an innovative business opportunity for the people who are engaged, but also exposes online lending platform operators to the risks associated with this particular financial service. The platform investors, both inside and outside China, and professionals operating online lending platforms have an urgent need to supplement their understanding about this industry, especially its risks and potential downfalls, in order to maximize bottom line returns and mitigate risk. This book would unquestionably be an important reference tool for them.
4. Bankers in traditional financial institutions. Online lending can be considered both a formidable challenge and a lucrative opportunity for traditional financial institutions. The integration of finance and Internet has proven to be an indomitable and irresistible trend, and the “anywhere, anytime, any-way customer experience” has become fundamental to all service industries, including finance. Given the popularity of this innovation, the question facing the traditional commercial banking system is no longer whether the banks should incorporate the Internet into their services portfolio, but instead when and how

they should operate online. Internet finance, including online lending, will fundamentally reshape the financial industry, especially on the lending side. As a result, gaining thorough understanding of the online lending industry is the homework that must be completed for traditional commercial bankers and their major domestic and international shareholders so that they can make more intelligent business decisions going forward. This book would provide a great reference and serve that exact purpose.

5. Staff in regulatory government agencies. In China, the online lending industry has been “watched” by regulatory government agencies in the recent years, just instigating their imminent involvement recently.¹³ Even though, the industry in China for now, basically, is still considered in a gray area, and relatively free of “the visible hand,” it can only be expected that, as the risks associated with online lending become increasingly exposed to the general public and more knowledge and understanding about the industry are gained by the government, it is merely a matter of time before government agencies begin to fully regulate. The major dilemma in government regulation is always the extent or degree to which the regulations should be set up and implemented. While over-regulation can unnecessarily hinder financial innovations needed for business development and economic growth, under-regulation may fail to control the risks that will damage the business development and economic growth. As a result, a comprehensive analysis and understanding about the industry is a prerequisite for regulators to help achieve the optimal balance between regulation and market freedom. This book could offer some valuable insights for them.
6. Academics inside and outside China. After over 30-year high-speed growth, the structures of the Chinese economy have fundamentally changed. While many traditional manufacturing industries have gained top producers position worldwide but still with relatively low quality in comparison with these international top brands, some emerging industries such as Internet-related sectors have pretty much leveled starting point even from day one, compared with their global competitors. These Internet-related industries represent the most potential parts of the Chinese economy. As a result, any research about China’s future economic growth without analysis of Internet-related industries, especially these industries’ relationships with financial innovations, would be incomplete, and this book would provide these Chinese business and economy researchers with a valuable reference.

In summary, with the rise of online lending and other Internet finance innovations, we hope the book *Financing the Underfinanced—Online Lending in China* will be a well-timed publication that could help satisfy the needs of a variety of readers, providing some basic knowledge of this newly emerging industry to the general public, and offering updated online lending business

¹³Pan Gongsheng, vice president of People’s Bank of China, on regulations on online lending, http://news.xinhuanet.com/yzyd/finance/20141127/c_1113421169.htm.

models and detailed analyses of the risks and possible returns for existing and potential online lending participants. We also hope this book can act as a valuable reference material for the integration of traditional finance and Internet, presenting some important insights and references to businesses, borrowers, lenders, academics, and government regulation agencies in their study and decision making related to China's online lending industry, in particular, and China's financial industry and economic growth, in general.

Reference

1. Wang JG, Yang J (2014) Who gets funds from China's capital market?—A micro view of China's economy via case studies on listed Chinese SMEs. Springer, Berlin

Financing the Underfinanced

Online Lending in China

Wang, J.G.; Xu, H.; Ma, J. (Eds.)

2015, XVIII, 167 p. 82 illus., 9 illus. in color., Hardcover

ISBN: 978-3-662-46524-0