No.17

Eyes of IIMA Institute for International Monetary Affairs

2017.3.17

China's P2P Lending and Lessons of Sub-prime Loans

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Well-designed Scheme of P2P Lending

P2P lending is a new financial business model that makes full use of information and telecommunication techniques. Its development in China is especially remarkable. Although the outstanding level accounts for less than 1% of total bank lending, the continued growth at the current rate will push the total outstanding to 5% in a few years. The level of 5% of bank lending compares to the US sub-prime loan outstanding at the end of 2006.

P2P lending is a mechanism to connect mainly on the computer networks persons who want to borrow money and those who want to lend money. The matching is made by a computer system, not by institutions like banks and those working there are not human beings but computer programs instead. When a borrower enters necessary information on the system, information on his SNS personal networks and payment records of internet shopping is collected for the analysis of artificial intellect (AI). Thus, his failure probability and corresponding interest rate is calculated instantly. The person who satisfactorily takes the risk and interest rate will lend the money.

Mass information on human networks and payment records thus collected will provide useful materials for credit decisions. AI can process a large volume of information and the failure probability thus calculated will be reliable to a substantial degree. If the interest rate covers the risk thereof, the lending will constitute a sound credited loan.

Since there is no human intermediation, management cost will be restrained. As a result borrowers can get funding at a lower rate than the banks, while the investor can earn a higher yield than bank deposits. The diseconomy brought by numerous small-sized transactions will be limited with the use of IT. If the investors invest in plural borrowers by a small lot, the actual loss, if any, will become closer to the failure probability. In addition, they may feel relieved as they will be able to earn an interest income higher than the failure probability. With combination of high productivity by the use of IT with appropriate risk measurement using AI, and appropriate return that covers the risk, the scheme has proven to be a very well designed financial scheme.

Lessons of sub-prime loans to be remembered

However, let us remember the unfortunate lessons of sub-prime loans. The schemes for sub-prime loans were also well designed. Securitized products with grades from Aaa to Ba were created to sell to the investors. The non-performing loan ratio of the products was considered to be safe even if they rose up to 13-15% for securities with above-A rating, up to 18-21% for securities with above-Aa rating, and up to 26-30% for securities with Aaa rating.

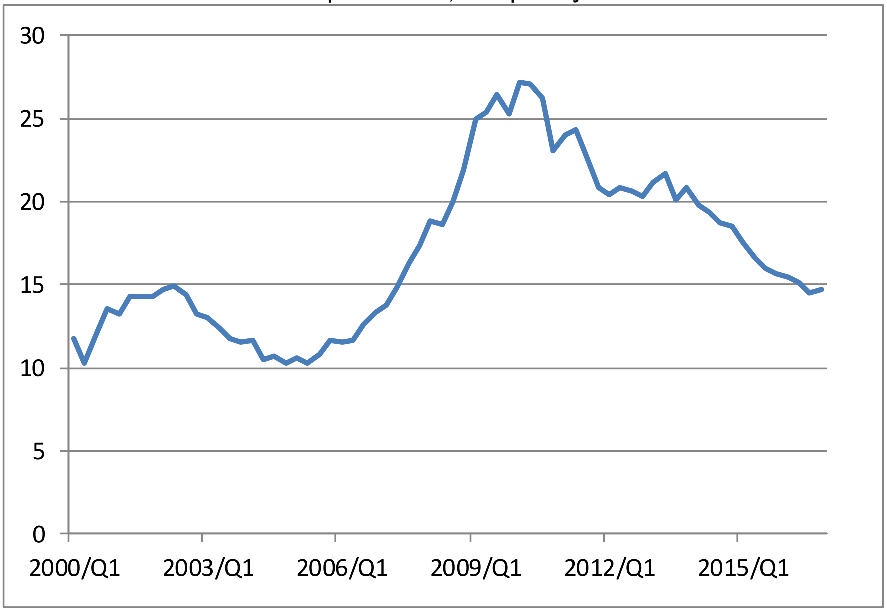
When the crisis occurred in 2007, the non-performing loan ratios of sub-prime loans averaged 17%. If we had thought calmly about this ratio, it was the level that the holders of securities with Aaa rating could have continued to hold them safely. However, many stake-holders lost their cool and rushed to sell the securitized products at a loss. That led to an escalation of self-fulfilling turmoil of the financial market. The rise of non-performing loan ratio to 27%, the worst level, was considered to be largely brought by self-fulfilling negative spiral between finance and real economy. In hindsight, even at 27% it would have been safe enough to continue to hold the portfolios since it was a peak of worsening market.

What the experience of sub-prime loans teaches us is that whether it is for P2P lending or for securitized subprime loans, even the best scheme would not function well without cool and rational behavior of the participants. And as far as we are human beings, we are doomed to lose our cool and a panic will occur.

Importance of monitoring obligation for the use of funds

It may be impossible to prevent a panic from happening, but there will be ways to limit the impact to as small one as possible when a panic should occur. The most expected here is the role of financial regulators. The focal point should be monitoring of borrowed money. It is important to impose someone a duty to report whether the borrowed money would not be directed to speculative investment like properties and stocks. Unless it causes a direct fall of asset prices, disturbance of P2P lending market would end up within the amount of invested money by individual investors. The reporting obligation might be imposed on the intermediators. If it is the case that AI can intermediate the transactions but cannot conduct monitoring, or if assigning of personnel for monitoring would destroy a business model with high cost, it can be said that the P2P lending has had in the first place no feasibility as a business model at all.

米国サブプライムローンの不良債権比率
US Subprime loan, deliquency ratio□



(Source)US Mortgage Bankers Association, Datastream