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The Relationship Between the Development of P2P Platforms and Economic Stability

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Abstract: The rapid development of China's peer-to-peer (P2P) lending platforms has not only injected new vitality into the financial market but also had a profound impact on the traditional banking system. With its efficient information matching and capital circulation mechanism, the P2P platform has solved the traditional loan problem and promoted the financing convenience of small and medium-sized enterprises. However, its rapid development has also brought a series of risks and challenges, such as economic stability problems, potential risk spread, etc. Compared with other countries, especially the United States, we find that the development of P2P platforms in different countries presents different characteristics. To meet these challenges, we need to strengthen supervision, regulate the operation behavior of P2P platforms, ensure the safety of funds, and prevent risks. At the same time, we should also pay attention to its interactive relationship with the traditional banking system, to achieve complementary development, and jointly promote the prosperity and stability of the financial market. To sum up, the development of the P2P platform has brought new opportunities and challenges to China's financial market. We need to deal with it with a prudent attitude and innovative thinking to ensure its healthy and orderly development.

Keywords: P2P, financial market, banking system, loans

1. Introduction

With the rapid development of Internet technology, global financial demand is continuously rising. The forms of financial services have become diversified and intelligent, and the traditional banking system can no longer meet people's basic pursuit of financial services. FinTech, also known as financial technology, is a modern technology that combines financial services and has replaced many traditional financial services. It has revolutionized the way finance and finance research are conducted through the use of technological advancements such as big data, cloud computing, and artificial intelligence. One of the most prominent examples of FinTech in the early 21st century is peer-to-peer (P2P), a small internet lending model that connects borrowers with investors through online platforms. This model provides a wide range of loan and financial services to individuals and businesses, particularly low- to middle-income households. While P2P lending was popular in the Chinese financial market, it also brought about potential risks and challenges. The lack of reliable lenders and secure sources of finance has significantly altered the mainstream of Chinese finance services. As a result, China's financial markets have become increasingly unstable. In response, the Chinese government has implemented policies to regulate and clean up existing P2P platforms in the market. The future of P2P development in China seems to be restricted, and financial scholars are actively exploring the potential prospects and development paths of this FinTech.

Since the introduction of Internet financial technology in China in 2007, P2P has spreading in society based on Internet, by virtue of its unique advantages. Even the total industry loan amount for P2P reached an astonishing $150 billion in 2015, an increase of 258.62% compared to 2014. It is significant to comprehend that the China Banking Service Improvement Report mentioned that the growth rate of loans in China's traditional banking system was only 9.5% in 2015 [1]. Traditional bank loans have become less attractive compared to the popularity of P2P online loans, and more and more people are choosing online loans instead of bank loans. We must explain this issue by mentioning the differences between them. The traditional banking system in China mainly relies on manual review and operation procedures for loans. This type of loan is provided by the bank, and the person in demand of funds needs to apply for the loan according to the application process. According to the authors of Comparison and analysis of online lending and traditional bank lending mechanisms, China’s traditional banking system has a strict review process system, from loan application to repayment of principal and settlement of interest, P2P online loans are mainly conducted online [2]. Investors provide suitable loans to demanders and require them to provide returns including interest. In addition to providing loan contracts and legal texts for both parties, the platform will also charge a certain service fee as a reward throughout the entire lending transaction to maintain the operation of the platform. Some P2P platform investors are even platform operators. After the internet revolution in the 20th century, P2P platforms with big data and cloud computing functions have more convenient and accurate functions. Through algorithm analysis, demanders have been more quickly and accurately recommended for the loans they need on the P2P platform. By comprehensive comparison, the difference between P2P and traditional lending is significant. In terms of loan sources, traditional loans provided by banks are more reliable, while P2P loans are mainly sourced from individuals and enterprises. Compared to the stable interest rates provided by banks, the high-interest rates offered by investors on P2P to avoid default risks have greater uncertainty. However, since P2P platforms provide smaller loan amounts compared to traditional banks, and have shorter, more effective loan application cycles compared to traditional loans, P2P inevitably has sparked a wave of enthusiasm in China's financial market.

Due to the differences between P2P lending and traditional loans, the regular operation of traditional banking systems has been affected. As we mentioned earlier, the introduction of P2P platforms has changed the loan preferences of the Chinese people. The public's preference for P2P priority has made the situation of traditional bank loans awkward. According to literature review, The impact of Internet finance on commercial banks' risk taking: evidence from China, the author found that Internet finance would increase the capital cost and risk bearing of traditional banks [3]. The author of Internet finance development and banking market discipline: Evidence from China used China's fintech index from 2003 to 2014 to evaluate the impact of fintech on banking discipline and found that fintech weakened the relationship between bank deposit growth and capitalization [4]. With the development of FinTech, the relationship between bank risk assets and deposit growth is also gradually deteriorating. Indeed, the P2P platform has brought competitive pressure to traditional loans due to its advantages of short cycle, small amount, and elimination of information asymmetry. The market share of traditional loans is gradually decreasing due to the rapidly developing P2P lending threat. As the preference bias increases, fewer people still looking for bank loans. The decrease in bank interest income has also impacted profits. The author of To Regulate or not to Regulate? A Comparison of Government Responses to Peer-to-Peer Lending Among the United States, China, and Taiwan mentioned that China's P2P lending business models are diverse, and each model also has different types and degrees of risk [4]. Flexible and diversified loan methods and big data push have effectively competed with the traditional banking system in the loan market and robbed many potential users of bank loans, thus affecting the loan deposits of traditional banks.

To aid traditional banks cope with the negative impact and challenges brought about by P2P lending, the country has issued Central Document No. 175 to guide and rectify the Chinese financial market, especially for online lending [5]. The document named opinions on classification and disposal of online lending claims that although online lending, a form of internet finance, plays a decisive role in easing the funds difficulties of micro companies, in recent years, the risk of lending online industry has seriously damaged legitimate rights and interests of investors, having the negative impact on long-lasting development of both traditional banks and economic spheres [5]. This report aims to identify issues of P2P [peer to peer lending] and explains what governments can do to make law if it [5]. In this essay, authors will analyze file 175 from 3 levels: the market, political and economic environment, and the existing mechanism [5]. This report divides online lending institutions into legal (law-based) and illegal ones. It further states that Government still encourages legal online-lending institutions to carry out services, while prohibiting illegal institutions from keeping running. This is because online lending differs from traditional banking system in which it betokens such information collecting capability. Online lending depends on platform's data algorithms to make reasonable predictions for individual users:the promising users or someone which even couldn't afford bills in the future. By examining whether the promising or poor ones, they may have adjusted their interest rate or terms to each borrower. Authors simply name it price discrimination. While price discrimination itself can benefit businesses by increasing revenues, it can also raise concerns about fairness and equity among different consumer groups. Based on political and economic environment of PP2 especially online lending, Government should actively regulate every operation of institutions. Besides, government has responsibility to adopt risk education of P2P for citizens and guide them to make rational investment choices. At the institution levels, government proposes to eliminate the regulatory gap, so that borrowers and lenders can form a virtuous circle of financial relations.

2. Effects on National Economic Growth and Financial Market in Short-run / Long-run

Since the beginning of the 21st century, using per capita GDP as a measure of economic growth; according to World Bank data, China's economic growth has been in a stable and gradual growth state [6]. It is important to mentioning that after the introduction of P2P platforms to China in 2007, China's per capita GDP experienced a shock. The growth rate plummeted from 13.6% to 9.1%. And since 2010, it has been continuously experiencing with decreasing growth. Meanwhile, after the country cleared all P2P platforms by the end of 2020, the growth rate increased from 2% to 8.4% the following year. With its impact of P2P, the country's economic growth will inevitably be affected.

From 2019 to 2021, the emergence of COVID-19 has caused serious economic impact and depression to countries around the world. People have increased their demand for digital financial services, and P2P loan platforms have become the means of livelihood for most people. By the end of 2021, the global debt ratio was still nearly 19% higher than before the pandemic, posing a challenge for policymakers worldwide. The reason for the unusually significant change in debt ratio is due to the post-pandemic economic recovery and the subsequent rapid rise in inflation. Most countries have started to reduce their citizens' debt ratios through policy measures to alleviate economic problems. The decline in debt ratios in emerging markets (excluding China) in 2021 was almost 60% of the increase in debt ratios in 2020. However, there are significant differences in the composition of debt among different countries, and while the debt problems of other countries have been alleviated, China faces unique challenges. Due to the growth of private sector debt, China's total debt ratio will continue to rise in 2021. If the economic outlook continues to deteriorate and borrowing costs further increase, high debt will become increasingly difficult to manage. So far, China has not yet emerged from this vicious trend, so government participation is particularly important at this time. With the COVID-19

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pandemic bringing unprecedented challenges to economies worldwide, online lending has emerged as an essential financial tool for individuals and businesses seeking access to funds. The introduction of the P2P online lending model has indeed affected China's economic growth to a certain extent. This is mainly reflected in the explosive growth of P2P platforms and the subsequent wave of failures, which not only affected the interests of investors and lenders, but also caused short-term instability and market panic in the entire financial market. This panic has led to a decline in the share of traditional bank loans and an imbalance in the financial structure, which has negatively affected the country's financial stability and economic growth.

It's true that in the early days of the COVID-19 outbreak when traditional banking systems in many countries were under pressure, fintech companies and platforms helped relieve some of the pressure by providing online services, contactless payments, and more. The authorities must prudently manage debt and implement fiscal policy. Recent developments in the bond market suggest that investors are more sensitive to deteriorating macroeconomic fundamentals and limited fiscal buffers. Governments should adopt fiscal strategies that help reduce immediate inflationary pressures and medium-term debt vulnerabilities, for example, by curbing spending growth - while providing safeguards in important areas. It also helps the central bank's job, allowing it to achieve its goals by raising interest rates by relatively small amounts. In these turbulent and chaotic times, confidence in long-term stability is a valuable asset.

3. Comparison between China and Other Countries

The P2P financing model originated in the United States and has developed relatively maturely compared to China. However such advantages also provide inspiration for the development of China's unstable P2P platforms. P2P platforms originated in developed countries such as the United States as early as 2005. After 2009, it rapidly developed to meet the loan needs of low - and middle-income families. Nowadays, foreign P2P platforms are more complete compared to domestic ones, with huge borrowing funds, a wide range of participants, and mature risk control measures. Taking the Prosper platform in the United States as an example, the P2P model in the United States has developed rapidly and is divided into two types: for-profit platforms and non-profit platforms. In profitable platforms, Prosper and Lending Club are represented. According to statistics from China National Research Network, the transaction volume of these two companies accounts for approximately 80% of the US market. In 2012, Prosper's new loans increased by 91% year-on-year, while Lending Club's new loans increased by 179% year-on-year. In 2013, the business volume and loan amount of these two platforms continued to increase rapidly. Prosper was founded in 2005 and connects loans between individuals through online platforms, serving as an intermediary between lenders and borrowers. This platform has the following characteristics: Anonymous registration, without using real-name registration, using account names to maintain anonymity between both parties. Having an independent credit score evaluation system, borrowers are required to have a credit score of at least 640 points. Portfolio investments can be made, and lenders can browse and select investment targets, using automated portfolio tools to select lending portfolios.

The severe debt situation of low - and middle-income families has led to the prevalence of this financial technology in China. According to a 2020 Debt Report on the World Bank website, the total net capital flow and trend in East Asia and the Pacific depend on China [7]. In 2018, China accounted for about 80% of the total debt and equity inflows to countries in the region. The extremely high debt ratio of low - and middle-income families means that their disposable income is very low, so they need to take out many small loans to meet their expected living standards. The influx of P2P platforms undoubtedly provides them with easily accessible loan methods, meeting a large number of economic needs. According to statistics from Business model and legal analysis of P2P lending service platform: A case study of Yixin Company. Financial Law Review [8]. Subsequently, P2P showed a rapid

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development speed. Many loan platforms have emerged one after another, among which the platform with the largest business volume is Paipai Loan. Paipai Loan was inspired by the "Prosper" model in the United States, which enables online lending through bidding. Paipai Loan does not directly absorb deposits or provide loans but plays an intermediary role. The borrower publishes loan information on the platform, lists loan needs participates in bidding, and the lowest interest rate earns the loan. Usually, multiple lenders jointly lend funds to a borrower to diversify risk.

The emergence of such platforms undoubtedly brings convenience and economic subsidies to the middle and low-income classes in China, who are constantly worried about economic problems. However, their potential problems are countless. P2P platforms abroad have developed rapidly in the United States, benefiting from a sound social credit system. These platforms utilize social credit management services provided by commercial credit reporting companies, including credit investigation, rating, consulting, etc., to help reduce online lending risks. In contrast, China has not yet established a comprehensive national credit evaluation system, and the credit database of online lending platforms is not connected to banks, which leads to high costs and difficulty in ensuring the authenticity of customer credit information on P2P platforms in China, increasing lending risks. In summary, we will find that Chinese P2P platforms are modeled after loan platforms in t the US, but there is a significant difference in reputation. Domestic P2P platforms mainly imitate foreign models such as diversified investment and margin in terms of risk control mechanisms, which are still insufficient compared to foreign countries. In terms of credit evaluation, there is a lack of third-party social evaluation institutions. Therefore, the Chinese government needs to play a guiding and regulatory role, and develop a more complete social credit system.

To reduce risks in domestic lending platforms, the Chinese government can start by addressing the credit issues of borrowers. Currently, our country's credit system only includes information on individuals with credit from various commercial banks and those with available credit cards. This information mainly covers loans, credit card usage, and guarantees, with significant differences compared to Western countries' credit systems. To improve our credit system, the government should prioritize this effort by integrating resources to establish a nationwide data collection channel, a comprehensive personal credit database, a scientifically sound personal credit evaluation system, and an information disclosure platform. The long-term development of China's P2P platforms cannot solely rely on private and market forces; it requires greater involvement from all levels of government. Firstly, national and local departments should actively introduce policies related to P2P lending to clarify ambiguous issues like platform access, guiding the direction of P2P platform development. Secondly, enhance supervision over P2P micro-lending platforms, and establish standardized systems to increase platform reliability and public confidence. Thirdly, strengthen platform disclosure requirements, ensuring appropriate disclosure of financial information by platforms.

4. Conclusion

In conclusion, the rapid proliferation of peer-to-peer (P2P) lending platforms in China has significantly impacted the country's financial landscape and traditional banking system. The uncontrolled growth of P2P platforms has led to both short- and long-term impacts on traditional banking systems, national economic growth, and financial markets. The study has revealed that the introduction of P2P platforms has altered the loan preferences of the Chinese people, leading to a shift away from traditional bank loans. This has put competitive pressure on traditional banks, affecting their market share and profitability. Additionally, the explosive growth of P2P platforms has caused short-term instability and market panic in the entire financial market, negatively impacting the country's financial stability and economic growth. To address these challenges and ensure the stable development of the financial sector, it is imperative for the Chinese government to implement regulations to curb the unchecked growth of P2P platforms. Firstly, regulations are needed to

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safeguard the stability of the financial system by preventing the diversion of funds away from regulated institutions. Secondly, measures should be taken to prevent unsustainable credit expansion in the short run, which could jeopardize national economic growth. In the long run, regulations are essential to prevent financial instability and promote sustainable economic development. Furthermore, it is crucial to protect the financial interests of low to middle-income families by regulating P2P platforms to prevent predatory lending practices and provide them with the protection afforded by traditional financial institutions.

In addition to regulatory measures, the Chinese government should consider the following specific recommendations to mitigate the potential risks associated with the uncontrolled growth of P2P lending:

1. Establish a comprehensive national credit evaluation system to address credit issues of borrowers and improve the credit system.
2. Introduce policies related to P2P lending to clarify platform access and guide the direction of P2P platform development.
3. Enhance supervision over P2P micro-lending platforms and establish standardized systems to increase platform reliability and public confidence.
4. Strengthen platform disclosure requirements to ensure appropriate disclosure of financial information by platforms.

By enacting laws to regulate P2P platforms and implementing the above recommendations, the Chinese government can safeguard the stability of the financial system, promote sustainable economic growth, and protect the financial interests of vulnerable households. This conclusion and the accompanying recommendations are crucial for addressing the challenges posed by the rapid development of P2P platforms and ensuring the long-term stability and growth of China's financial sector.

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