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Research on Regulation of Internet Finance in China

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ABSTRACT

With the rapid development of modern information technology, the progress of the Internet finance has been accelerated. Internet finance is a new finance mode that mutually integrated traditional finance and the Internet, with the characters of low cost, high efficiency, sufficient information and so on. Along with the development of internet finance, there are potential issues of risks, which directly threatened the subject of finance and even impacted the construction and the improvement of the national financial system. The relevant regulatory authorities should improve the regulatory standards, clear the legal risks of internet finance to establish a better regulatory system for all investors. This essay mainly focused on analyzing China' s current issues of the Internet finance, and also referencing European and American existing cases for comparison and proposed the suggestions of regulating the internet finance and improving financial regulations.

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1 The Boost of the Internet Finance

Internet finance (ITFIN) refers to the traditional financial institutions and the Internet companies using internet technology and communication technology, in order to complete the new financial model which includes financing, payment, investment and information mediation services.

According to the statistical data from the financial regulatory in May 2015, in the field of Internet payment, as of now, there were 269 payment institutions. Among them, there were 117 online payment companies. In 2014, there were total 37.422 billion payment services made in the Internet third-party payment institutions, involving in 24.72 trillion yuan. On year-on-year basis, there was an increase of 93.43% and 137.6% respectively. In the field of network lending businesses, as of late April 2015, the number of P2P online lending platforms that currently operated was 1819, of which there was an increase of 244 new platforms in 2015. In the field of equity crowd funding finance, as of April 2015, the number of equity crowd funding platforms was 62, and the number of equity crowdfunding platforms accumulative financing project was 49,400. In terms of the Internet fund, as of the end of April 2015, Yu' EBao and Wechat financial scale breakthrough 760 billion yuan and the number of active clients exceeded 9,000 million. In the Internet insurance field, at the end of the first quarter of 2015, 86 insurance companies conducted Internet business, and its premium income was 41.111 billion yuan, an increase of 207.5%. In addition, the Internet consumer finance business also began to appear.[2]

ITFIN played an active role in solving the financing needs of small and micro enterprises and the general public. It also promoted the birth of new competition and cooperation. However, the financial risk of the ITFIN continued to accumulate, which challenged the existing financial regulatory system.

2 The Risks and Regulatory Status Revealed During the Development of the ITFIN

2.1 The characteristics of the ITFIN

The reason that the ITFIN was able to rapidly develop, mainly because it has the following characteristics:

2.1.1 Low cost

Under the Internet financial model, both the supply and demand of funds can be done through the online platform for information on their own screening, matching, pricing and trading without the traditional intermediaries and no transaction costs. Financial institutions could set up outlets while avoiding the capital investment and operating costs. Consumers could quickly find their own financial products on an open and transparent platform, which reduced the asymmetric information and more time-saving.

2.1.2 High efficiency

Internet financial services are mainly processed by computers with a fully standardized operational processes. There is no necessary for the customers to wait in line, and business processes are faster which provides a better user experience. For example, Ali small loans relies on the credit database accumulated from the electricity providers. Through data mining and analysis, risk analysis and the credit investigation model, the time range from applying for a loan to be granted, only takes a few seconds to complete. On daily basis, there are near 10000 loans grated.

2.1.3 Civilians

Compared with the traditional bank customers' grading and classification, the Internet did not classify the customer in to consumption population and large enterprise customers. Regardless of their financial status, both the general public and companies could trade on financial operations. The operational procedures are simple and throughout the course of the financial services, the body is no longer a financial institution, but the general public. This is where the traditional financial institutions have significant differences.

2.1.4 Cross-industry and Cross-product

Yu' EBao, for example, which is the platform that attracts cash from customers and with the purpose of depositing the cash into the Liberty Fund, which could increase their benefits. During the whole process of the financial services, the body is no longer the financial institution, but the general public. This is an obvious difference from the traditional financial institution.

2.2 The major risks of ITFIN

2.2.1 Liquid risks

Essentially, Internet financing is financial activities, as there are assets and liabilities in the period and the number of mismatches. Whether the third-party payment or P2P platforms, they are all vulnerable to liquidity risks. This situation is determined by the financial institutions and institutional arrangements itself. And with the progress of Internet technology, the situation will not eliminate the risk. Some Internet finance companies use a high financial leverage during the development, which in turn facing a higher liquidity risk. For example, in 2013, among the nation's major 90 P2P platforms, there are 74 platforms appeared to have cash difficulties. Behind this is the liquidity problem of P2P online lending. It will eventually lead investors to cash difficulties.

2.2.2 Operational risks

The ITFIN services a large number of customer groups which could not be effectively covered by traditional finance. Customer groups are usually with a 'long tail' feature. Relatively, this part of the consumer groups has insufficient knowledge relating to the financial deficiencies, risk identification and affordability. They are also not fully aware of the asymmetry between the financial benefits and the cost of ITFIN. However, the 'free rider' behavior usually occurred in their financial consumption. Some Internet companies' financial irregularities occurred during business operations, or illegally acts as a pool of funds. However, once the risks outbreak, it will cause a wide and a negative social influence.

2.2.3 Technical risks

Internet technology risk is the financial loss that result from the security and reliability of the Internet system. Internet financing highly relies on modern information and communication hardware. It also relies on media such as software, networks and technical software. China's Internet network and information infrastructure are relatively disadvantaged, and the core hardware and software mainly relied on foreign technology. Also, the Internet are more likely to suffer technical financial risks from the external network attacks and information leak.

2.2.4 Credit risk

The access of Internet finance platform is not strict. The user could simply register on the Internet agencies to complete the transactions. Although user' basic information registration is firmly required, there are still false or fake information exist, which makes Internet financial institutions in to a passive situation. Meanwhile, it is hard for institutions to evaluate users' credit. As a result, it is difficult for the ITFIN institutions to ensure a truthfully and completed transaction. Once the borrower accepting the loan while deliberately to disclaim the responsibility of repaying the loan, or failing to repay due to various reasons, the loss should be borne by the Internet financing institution.

2.3 Current situation of the Internet finance regulation

On July 18, 2015, relevant departments of the People's Bank of China released the 'Guiding Opinions on Promoting the healthy development of ITFIN' , which laid the framework for the supervision of the IITFIN institutions. But the classified supervision responsibilities of various departments have not yet introduced. The problems of the current regulatory policy are mainly in the following aspects:

2.3.1 The lack of legislation

The 'Law of People's Bank of China' that released in 2004 had been implemented for 10 years. 'Commercial Bank Law' formulated in

1995, revised in 2003 and had been implemented a longer time. In the meantime, the Internet technology develops and financial innovation comes one after another. Thus, neither the 'Law of People's Bank of China', the 'Commercial Bank Law' nor the 'Insurance Law' referring the Internet financing terms. A number of financial and economic terms are no longer satisfying the development of Internet technology needs.

2.3.2 The uncertainty of industry regulatory

The biggest risk of the Internet financial industry is regulatory uncertainty. Most Internet financial service drifted away from the financial regulators in the form of shadow bank. Its risk control is weak. For instance, some platforms called 'Bao' usually focus on the client-side. They are in the process of fund gathering while they are absorbing deposits in essence. Internet financial operators' main bodies are diversified, including both commercial banks and third-party payment company. Business models are also various. For instance, P2P does not belong to the bank and they are easy to evade the supervisions of the central bank and other government financial departments. In 2013, while P2P industry is being developed, bankrupt came on one after another. At the end of July 2012, more than 70 P2P companies became bankrupt, involving more than 1.2 billion yuan.

2.3.3 Business risks gradually appeared

From the technical services view, INFIN is 'Internet + finance'. It is the Internet that provides financial services to the clients, without relying on physical outlets. Business risks mainly are: the risks referring to the user accounts stolen, fraud and malicious phishing; the risk of money laundering or illegal transfer of funds; the liquidity risk of service agencies, as Internet financing services institution is taken by T + 0 Loaning method, with costs associated with the expansion of unintended risks.

3 The Experience of Managing and Supervision of the Internet Financing of Developed Countries

Europe and other developed countries have a more mature financial system. Compared with other countries, these developed countries' fusion of traditional financial system and the Internet are in the advanced stage which has the following aspects:

3.1 Legislation first

Regarding to the loopholes that may occur after the Internet financing' s appetence, there are means of legislation and other supplements aiming to extension and expansion of the existing regulatory system. For instance, the 'Financial Services Modernization Act' released in 1999 by the United States, states that the third-party payment agencies were defined as non-bank financial institutions. Regarding P2P lending, SEC required that P2P lending is a form of direct financing. According to the provisions of the 'Securities Act 1933' Sections 5, it prohibits any person offer or sale securities without a valid registration or an exemption. In order to strengthen the EU Internet financial supervisions, the EU has promulgated the 'Common framework for electronic signatures Guidelines', the 'Electronic money Guidance', the 'Electronic money institution Guidelines' and other pertinent laws and regulations.

3.2 A clear mechanism

According to the financial characteristics of the Internet, developed countries clarify duties of the Internet financial service attributes based on the traditional finance.

For example, the United States apply state and federal regulatory regime, the Federal Deposit Insurance Corporation (FDIC) in charge of overseeing the third-party payment institutions, which clearly required that state regulatory authorities should not violate state law. Based on this, FDIC public the policy that is related to the practical situation of the state. In July 2010, the United States signed the 'Financial Regulatory Reform Act'. All protection measures of financial consumer should be done by an independent Consumer Financial

Protection Agency (CFPA). Since 2009, French Financial Prudential Regulation Authority (ACPR) started to supervise the payment institutions, and it had the right to control the pay the agency. All institutions that operate the payment business should acquire the license issued by the A CPR in advance. The license permits the company to make credit loan or payment business.

3.3 Functional supervision

The Internet financing is usually included in existing regulatory framework. For instance, third-party payment service of the USA is supervised by the transfer service regulation. The US Congress that established an independent federal government agency of the Federal Deposit Insurance Corporation (FDIC) is responsible for the supervision. The provisions requested that the precipitation funds must be deposited in FDIC' s non-profitable account that issued by the commercial bank. Regarding financial operations, America requests that the network borrowings should be supervised by the securities industry and put emphasis on information disclosure. America passed the 'Innovative Corporate Act' to open the right of raising equity to the public and made detailed provisions. In terms of the supervision of EU equity crowdfunding, the promoters and the use of internet are applied for different regulations. For equity crowdfunding sponsors, they apply to the EU's 'Prospectus Guidelines PD' , while equity crowdfunding platforms apply to the EU 'Markets in Financial Instruments Directive' (MIFID).

3.4 Industry self-discipline

Internet finance is still a financial innovation, and there are many products in the form of constant change. Temporarily, the existing financial regulatory system is unable to comprehensively cover all operations. Thus, it required more self-discipline of enterprises to strictly abbey the relevant laws and moral constraints to operate. British' s top three P2P platforms established the world's first petty loan association. The USA, Britain, France and other countries did promote the establishment of crowdfunding associations, in order to develop self-regulatory rules, and so did some companies. For example, Australia crowdfunding website ASSOB focus on process management that plays a key role in long-term safety operations.

4 Measures to Improve the Internet Financial Supervision System in China

Learning from the experience of developed countries such as Europe and America, and combined with our current regulatory status, we could improve the regulations from the following aspects:

4.1 Accelerate the legislative process of the Internet financing

Alipay exposed several fraudulent events that suggested P2P lending platforms were unable to control the risks. It is urgent for the legal system of the ITFIN to revise the 'People's Bank of China Law' , 'Commercial Bank Law' and 'Insurance Law' to adapt the Internet finance development and the regulatory needs. It is also necessary to establish the Internet finance law framework to cover the trading rules, trading protection and system standards, and clear the customers' rights and obligation during services. Also, should establish 'The electronic transactions Act' , 'Personal information protection law,' 'electronic signature law' to ensure the financial security network.

4.2 Coordinate the implementation of supervision as soon as possible and strengthen supervision

China implemented the "separate operation, separate supervision" where ITFN often involved multiple financial industries, including securities, insurance, banking and so on. It is recommended that People's Bank lead to establish a cooperative supervision system, aiming to a system that division of labor, information sharing, and avoiding regulatory overlap. It is also necessary to improve the financial network access system and implement the on-site inspection and off-site supervision, which in turn are required to regularly submit daily business data and timely submitted data network changes, especially unconventional data. Regarding P2P lending platforms, the access should be connected with central bank credit system, thus to constrain borrowers and control risks.

4.3 The establishment of industry self-regulatory organization

Referring to domestic and foreign financial regulatory experience, and combined with the actual situation of the development of Internet financing in China, the Internet financing industry should establish an industry self-regulatory organization to develop industry rule as soon as possible. Also, the organization members should discuss common problems, consult with each other and assist in regulatory management. At the same time, via the establishment of industry self-regulation by the industry organization, it should build information–sharing mechanism such as P2P industry blacklist database.

4.4 Strengthen the credit system

Internet financing supervision focuses on the risk control. However, the risk control should strictly treat the credit risk as core. Chinese credit system is not well-founded. In this situation, it is necessary to expand the scope of data collection. Based on the People's Bank of China credit system, personal or business credit information, payment records and evaluation records should all be included in the personal database. Moreover, it is suggested to establish a social connotation of personal or business credit system within the industry standards. Also, the establishment of a number of areas including registration and information disclosure of the credit system could further promote the work of the credit collection system, thereby reducing the credit risks of using ITFIN.

4.5 Construction of Internet risk compensation mechanism

At present, Chinese ITFIN has characters of quick development and high risk. In order to better protect the interests of consumers and investors, and to achieve healthy development of the ITFIN, it is important to establish risk compensation mechanism for the financial compensation of the security system. According to the requirements of financial institutions, it is required to develop Internet-related business financial planning, implement deposit policies, and accept the central bank's control and management.

5 Conclusion

In conclusion, the ITFIN in China is still a new thing. There is still a long way to go if we want to achieve a healthy development of the ITFIN. Practitioners, regulators, self-regulatory association should all do their jobs well and cooperate together. With the rapid development of modern information technology in China, the Internet finance will be faced with new opportunities for development, and will fulfill the long-term development of the Internet financial industry.

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