



Paper to be presented at the  
35th DRUID Celebration Conference 2013, Barcelona, Spain, June 17-19

## **Entrepreneurship and Financial Innovation in China- A Case Study of the First P2P Lending Platform in China**

**Shu-Chen Chang**

National Tsing Hua University  
Institute of Technology Management  
shuchenchang@mx.nthu.edu.tw

**Chuan-Kai Lee**

National Tsing Hua University  
Institute of Technology Management  
cklee@mx.nthu.edu.tw

### **Abstract**

This paper studies the rise and growth of the first P2P lending platform in China. Over the past few years, Chinese P2P lending platforms have risen and changed the way of how Chinese people get loans. We analyzed the mechanisms CreditEase adopted to overcome the challenges from a lack of nationwide social credit system and trust in China. Our research shows that unlike P2P lending platforms in Western societies, Chinese P2P lending platforms rely heavily on institution-based trust to ensure the creditworthiness of borrowers.

## Entrepreneurship and Financial Innovation in China- A Case Study of the First P2P Lending Platform in China

### **Abstract:**

This paper studies the rise and growth of the first P2P lending platform in China. Over the past few years, Chinese P2P lending platforms have risen and changed the way of how Chinese people get loans. We analyzed the mechanisms CreditEase used to overcome the challenges from a lack of nationwide social credit system and trust in China. Our research shows that unlike P2P lending platforms in Western societies, Chinese P2P lending platforms rely heavily on institution-based trust to ensure the creditworthiness of borrowers.

Keyword: entrepreneurship, trust, P2P lending platform, CreditEase, case study

## **Introduction**

Entrepreneurship has experienced a rapid growth in China during the past decades (Li, *et al.*, 2012). The P2P lending platform set its foot in China since 2006. The emergence of P2P lending platforms in China is a perfect example of entrepreneurship and financial innovation. The concept of P2P lending was first introduced into China by a foreign-educated Chinese, Tang Ning. Tang Ning went to Bangladesh to study microcredit with Professor Yunus during his study in the University of South. After finishing his studies in the U.S., he went back to China and established the first P2P lending company, CreditEase. He combined the microcredit concept of the Grameen Bank with internet and provided a way for the bottom of the society to get access to credit. Even though there is an increasing interest in the research in the entrepreneurship in China, there is still a short of ideas about the relationship between entrepreneurship and institutional change in this developing country, especially the interaction between entrepreneurship and institutional conditions (Yang, 2007). Also, Frame and White (2004) pointed out the lack of empirical research in financial innovation. Therefore, our study takes steps to fill this gap by exploring how the first P2P lending platform was established and developed in China.

The economist Muhammad Yunus created the microcredit model and established Grameen Bank for poverty alleviation in 1983. In 2006, he and his Grameen Bank won the Nobel Peace Prize in recognition of his efforts to push for the economic and social development from the bottom of the economic pyramid (BoP) (London and Hart, 2011; Prahalad, 2005). By providing small loans from \$50 to \$100 to the rural poor without requiring collateral, the Grameen Bank of Bangladesh helps them get the funds they need to start their own business or to improve their lives. Its operation model is considered to be innovative in a way that it grants loans that need no

collateral check but surprisingly maintains high repayment rates. This unexpected outcome inspired other developing countries to imitate its model and at the same time also led to the emergence of a new business model, the P2P lending.

The first online peer-to-peer lending platform, Zopa was launched in the U.K. in 2005. After the establishment of Zopa, there follows several P2P lending platform such as Lending Club, Prosper and Kiva to name a few and such platforms have grown rapidly in the U.S. and Europe since the global financial crisis. They combined the microcredit concept of the Grameen Bank that grants loans without requiring collateral with internet to create online P2P lending platforms. The online P2P lending platform acts as an intermediary that connects borrowers with investor and profits from service fees (Klafft, 2008). Since this kind of business model requires no collateral check at all, it means that this business model builds entirely on the creditworthiness of the borrowers. Therefore, the screening process used by P2P lending platforms to verify a borrower's creditworthiness plays a crucial role in the development of the platform and the survival of P2P lending companies.

In 2006, P2P lending spread from the West into China. The first P2P lending platform, CreditEase was founded by Tang Ning. However, the first challenge Tang Ning faced when he introduced P2P lending from the West into China is that the social credit system in China is still in need of improvement and is not as mature as its Western counterparts. The Western societies established social credit database long ago before China did. It is until 2006 that China started to run its personal credit information database for the first time. Compared with the personal credit rating systems in Europe or in the U.S., China's credit rating system is at an infant stage. In the second meeting of the Tenth National People's congress held in 2004, the Premier of China, Wen Jiabao also pointed out that "speeding up the construction of social credit system

and improving the supervision and regulation of the financial system are core works for social development in China.” The second challenge Tang Ning faced is that China is considered to be a low-trust society (Fukuyama, 1995; Redding, 1990; Smith, 1894; Weber, 1951). Guiso, Sapienza and Zingales (2004) have mentioned financial contracts are in fact trust-intensive contracts. Besides, if the trust among the people in a society is low, the transaction costs in this society will be higher than those in a high-trust society (Fukuyama, 1995). “Here, when you ask Chinese people if they trust the credit system, 10 out of 10 say no. That is a huge difference [from the US], representing a huge opportunity or – if not done well – representing a huge challenge,” Tang Ning says.<sup>1</sup> All of these led us to question how Chinese P2P lending platforms can develop in a business environment that lacks mature social credit rating system and trust and what the mechanisms they used to evaluate the creditworthiness of the borrowers and built trust between borrowers and lenders.

We used CreditEase, the first and the biggest P2P lending platform in China as our case to illustrate in a low-trust society, how P2P lending platforms build trust between borrowers and lenders and how they evaluate the creditworthiness of borrowers. We conclude with a brief discussion of the mechanisms CreditEase used to overcome the challenges from a lack of nationwide social credit system and trust in China and propose its trust framework.

The emergence of P2P lending platforms is a new phenomenon and is in need of more attention and researches, especially in the case of China. China’s P2P lending platforms are a poorly understood phenomenon. Researches on China’s P2P lending platforms most focus on the role P2P lending platforms play in promoting the

---

<sup>1</sup> Simon Rabinovitch, *The Financial Times*, February 7, 2012, “CreditEase shines in China peer-lending market”.

economic growth and alleviating poverty. There is a lack of researches on P2P lending companies as the unit of analysis. Therefore, our study based on the firm-level of CreditEase can help fill this research gap.

## **Theoretical orientation**

### **Trust**

There are a number of ways to define trust. Trust has different definitions in different disciplines. Trust is an abstract concept and is often interchangeable with credibility, reliability and confidence. Scholars think there is a considerable degree of difficulty in making a clear distinction and definition these terms (Greiner and Wang, 2011). Moreover, trust is a multidimensional concept, encompassing cognitive, emotional and dimensions (Lewis and Weigert, 1985). Although there are many researches on trust from different disciplines, most of them only pay attention to the dimension related to their area, therefore, there is no consistent definition of trust.

In the field of management, the role and the importance of trust in the organization has been widely discussed (Kramer, 1999). Driscoll (1978) studied the role of trust in organizational decision making as a predictor of satisfaction. Trust has also been seen as a mechanism that allows members of an organization to work together more effectively and efficiently (Mayer, Davis and Schoorman, 1995). Trust can also play a role in reducing transaction costs for both inside and outside of an organization (Uzzi, 1997). It's widely believed by management scholars that trust can improve the overall performance of the company (Wang and Emurian, 2005).

There are many studies on trust from different disciplines and each discipline has its own definition of trust. We used the widely accepted definition of trust in this research;

trust is “*the willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party*” (Mayer, Davis, Schoorman, 1995). This definition is well suited for our study on P2P lending platforms because despite the uncertainty and risks involving in the lending transactions, the lender (trustor) is willing to lend their money on the platforms without the ability to monitor the other party ( the borrower) to make sure he/she will repay the loans.

## **Research Method**

We employed the single case study, using CreditEase as our illustrative case to investigate how P2P lending platforms overcome the challenges from a lack of mature social credit scoring system and trust in Chinese society. Yin (1994) pointed out that single case study is suited to confirm, challenge a theory or to represent a unique or extreme case. We chose CreditEase as our illustrative case because it’s the first and now the biggest P2P lending platform in China and it’s playing a leading role in the Chinese P2P lending industry. It well represents a unique case in the P2P lending industry in China.

It’s important for case study to use multiple sources of evidence as a way to ensure the validity and reliability of the research (Vogel and Wetherbe, 1984). We collected our research data from multiple sources, including news articles collected from China Core Newspaper Database (CCND) about CreditEase from 2006 to May 2012 and CreditEase Monthly<sup>2</sup> from September 2010 to March 2012. We used inductive logic to code our data and examined the development of CreditEase in the real world

---

<sup>2</sup> CreditEase Monthly is a monthly magazine published by CreditEase.

context.

## **An illustrative case: CreditEase**

### **P2P lending platforms in China**

Peer-to-peer lending is taking off in China as an innovative method of private lending. CreditEase was established in 2006 and headquartered in Beijing. It is China's first and the biggest P2P lending platform. On this innovative platform, CreditEase connects people with surplus cash with people with the need of cash. The tight bank-credit environment in China from 2007 to 2008 helped push the development of P2P lending businesses. People who can't easily get loans from banks turned to P2P lending platforms for cash. Meanwhile, CreditEase promises 10% to 12% of returns which are much higher than those offered by banks, therefore, it attracts people who have surplus money and want to invest their money to earn higher returns. The P2P lending market in China is considered to be huge. "China has much more P2P potential than the US. You can understand the lack of credit penetration simply by being on the ground here,"<sup>3</sup> says Roger Ying, who founded Pandai.cn, a P2P lending platform in 2011. He thinks P2P lending is filling a void in the financial system in China. His view on the P2P lending in China is the same as the founder of CreditEase, Tang Ning's. "It's because people really need help and are not covered by the traditional banking system,"<sup>4</sup> says Tang Ning. "There are about 60 million micro-entrepreneurs in cities and 200 million rural poor, so it is a huge market opportunity," Mr Tang concluded.<sup>5</sup>

---

<sup>3</sup> Simon Rabinovitch, *The Financial Times*, February 7, 2012, "Peer-to-peer lending takes root in China".

<sup>4</sup> Simon Rabinovitch, *The Financial Times*, February 7, 2012, "Peer-to-peer lending takes root in China".

<sup>5</sup> Simon Rabinovitch, *The Financial Times*, February 7, 2012, "Peer-to-peer lending takes root in

Though P2P lending represents a huge market opportunity in China, it comes with several challenges. On July 21th, 2011, Hahadai, a P2P lending platform established in May 2009 announced that it would shut down its website due to market credit issue in China and a shortage of operating funds. Hahadai claimed itself to be the most rigorous P2P lending site in China and had developed nearly 100 thousands members. Hahadai's announcement caused worries about the risks involved in P2P lending industry and the closure of Hahadai prompted regulators to pay more attention to this industry. A month later after the service closure announcement of Hahadai, in August 2011, China Banking Regulatory Commission (CBRC) issued a notice<sup>6</sup> on its website to warn of risks associated with P2P lending. It warned the society that there is every chance that P2P lending platforms might develop into illegal financial institutions that absorb deposits and grant loans and even conducting illegal fundraising. Those P2P lending companies don't have financial-sector licenses but what they do is not that different from those of commercial banks. CBRC claimed seven risks associated with the booming peer-to-peer (P2P) lending platforms. First, they may affect the effects of macroeconomic regulation and control by Chinese government. As Chinese government took more stringent control over real estate industry and industries with high pollution, high energy consumption and overcapacity, private capital may flow to these restricted industries through P2P lending companies. Second, they may easily evolve into illegal financial institutions. Due to the low entry barrier of P2P lending industry and the lack of strong external supervision, there is a chance that P2P lending companies may break the fundamental rule that loan funds should not put into its own account and become illegal financial institutions that attract deposits, make loans and even illegally raise funds. Third, the business risks of this industry are hard to control.

---

China”.

<sup>6</sup> It's also called Document No. 254 of the General Office of China Banking Regulatory Commission.

The internet-based feature of P2P lending platforms makes them vulnerable to information technology risks. Besides, these P2P lending companies can't log in the credit system to check the credit status of borrowers and carry out effective post-loan management as commercial banks do. Therefore, if serious frauds or illegal activities such as money laundering happen, they will do serious harm to the society. Forth, the ambiguous information provided by P2P lending companies may affect the overall reputation of banks. For example, some banks only provide account service for P2P lending companies but they are advertised by P2P lending companies as their business partners. Fifth, the responsibility for regulating the P2P lending industry is still unclear and the legal status of P2P lending remains mystery. The related legislation on P2P lending activities is not complete in China and is still in development. The nature of P2P lending activities lacks a clear definition in laws and regulation and it's also unclear as to whose responsibility for regulating this industry. Sixth, the evidence of foreign P2P lending practices show the credit risk associated with P2P lending is rather high and loan qualities of P2P lending is much poorer than those of commercial banks. Last of all, some P2P lending companies may be involved in risky second mortgage related business. However, CBRC didn't detail further means to regulate this industry.

There is no government regulator in China that deals with the questions and doubts about the legitimacy and sustainability of P2P lending platforms and there are no laws or regulations about P2P companies. P2P lending industry is neither under the supervision of the central bank of China nor China Banking Regulatory Commission (CBRC). Therefore, the P2P lending industry is actually in a loosely regulated business environment. The unique environment Chinese P2P lending platforms are in led us to consider an important research question: 'How do Chinese P2P lending

platforms overcome the challenge from a lack of mature social credit system and trust in China. To address this question, we draw on the case of CreditEase, the first and the biggest P2P lending platform in China to see how it conquered those challenges.

## **CreditEase**

CreditEase was founded by Tang Ning in 2006. The maximum loan amount an individual can get from CreditEase is around \$5 thousand and the maximum repayment period is up to 48 months. It only takes two working days for CreditEase to complete the screening procedure and grant loans which is way faster than commercial banks do. Therefore, the targeted customers of CreditEase are mainly people who can't get loans easily from banks because they can't provide collateral and those whose needs are not satisfied by the traditional financial system such as micro-entrepreneurs, students and parents, salaried workers and extremely poor rural women. Until 2011, CreditEase has accumulated around 60 thousands borrowers and out of the total borrowers, around 9 hundred is rural poor.<sup>7</sup> The total lending amount of CreditEase is 0.3 billion and out of the total lending amount, 2.6 million is lent to the rural poor.<sup>8</sup> CreditEase promises to pay the principle on a loan if borrowers default. It sets aside the equivalent 2% of total loans from its commission to act as protection funds. If a borrower defaults, CreditEase will pay the lender the principle from protection funds as a means of post-loan management.

When we looked at the development of CreditEase, we identified some important events. Since 2006, it became business partner with several education and training institutions. Tarena, China's largest high-end IT training service provider is the first

---

<sup>7</sup> Guei Ma, *China Economic Times*, September 26, 2011, "The three factors that limit the development of online P2P lending platforms".

<sup>8</sup> Yan-Chi Li, *China Urban-Rural Financial News*, August 10, 2011, "The boom of domestic P2P lending platforms. "

training institution that CreditEase became business partner with. “When we work with educational and training institutions, we know better where the loans went” Tang Ning says.<sup>9</sup> If a student from one of the educational and training institution CreditEase works with applies for student loans, CreditEase will give the loans directly to the educational institution where the student belongs to so that the student can’t use the loans for other purposes but to pay for the tuition, as a result, it decreases the risks of lending.

Since 2009, CreditEase has become business partner with several microfinance institutions in rural areas. It launched China’s first P2P online platform called Yinongdai aimed to help extremely poor rural women in 2009. CreditEase works with the microfinance institutions that with the average default rate lower than 0.5%. This cooperation not only helped CreditEase get access to rural borrowers but also gave it a chance to learn the techniques those microfinance institutions learned from international programs or international aid agencies and use those techniques for its risk management. The way of how these microfinance institutions works with CreditEase is that these microfinance institutions will evaluate the creditworthiness of the rural borrower and once a borrower pass the screening process, the microfinance institution will upload the information of the borrower on Yinongdai and lenders can browse through Yinongdai to select the borrower he/she wants to lend to. As Gang Wang, the director of Xixiang Women’s Development Association which has been business partner with CreditEase since 2009 said “When one applies for loans, our loan officer will visit the applicant to collect his/her credit information and took a photo of the applicant, once the applicant pass our evaluation, we will put the

---

<sup>9</sup> Wen-Ting Zhai, *Entrepreneur*, September, 2010, “P2P microfinance: how far will it go?”.

information and the photo of the application on Yinongdai.”<sup>10</sup>

In 2011, CreditEase reached a strategic cooperation with Fair Isaac Corporation (FICO). FICO would help CreditEase build its own credit scoring and evaluating system. In fact, FICO has entered China in 2007 and has cooperated with more other 10 commercial banks in China. However, the cooperation between FICO and CreditEase is the first time in P2P lending industry. As a result, we concluded that since the establishment, CreditEase is mainly dependent on its own mechanisms to control the risks involved in P2P lending.

## **Conclusion**

The main goal of this paper was to understand the phenomenon of P2P lending in China and how do Chinese P2P lending platforms overcome the challenges from a lack of mature social credit system and trust in China by investigating the case of CreditEase. At the establishment stage of CreditEase, it introduced itself into the educational and training market in China and became the first P2P company that provides education and training loans. The market entry point of CreditEase is actually has something to do with the background of its founder, Tang Ning. Before going to the U.S. to study, Tang Ning worked in New Oriental Education & Technology Group, a provider of private educational services in China as an English teacher. After he finished his study in the U.S., he returned to China and worked as an angel investor and has participated in the investment in China’s largest high-end IT training service provider, Tarena. His previous experiences not only helped him spot a gap in the market which has not been fulfilled by either banks or the traditional financial system but also helped him find a way to control and decrease the risks in

---

<sup>10</sup> Xiao-Hai Li, *China Urban-Rural Financial News*, September 23, 2009, “The practice of P2P lending in Xixiang”.

P2P lending.

After investigating the first P2P lending platform in China, we proposed its trust framework as figure 1 and concluded that unlike P2P lending platforms in Western societies, CreditEase relies heavily on institution-based trust which refers to “*one’s sense of security from guarantee, safety nets, or other impersonal structures inherent in a specific context*” (Shapiro, 1987; Zucker, 1986) to compensate its lack of credit scoring system and trust in China. Even though CreditEase also use individual trust such as economic status and family status to evaluate loan applicant’s creditworthiness but it mainly relies on the educational and training institutions and microfinance institutions it works with as its intermediary to ensure the purposes of the loans and the creditworthiness of loan applicants. In the case of microfinance institutions CreditEase works with, they adopted the method of joint guarantee to ensure the creditworthiness of the loan applicants. For example, if a poor rural woman wants to apply for loans, she needs to find 3 to 4 other women to form a group. If any group member can’t repay loans, the other group members have to repay her loans. The basic concept of joint guarantee is to use one’s social capital or social network to determine the creditworthiness of a loan applicant because if a loan applicant is not creditworthy, he/she will have a hard time finding other people to form a group.

\*\* Figure 1 is inserted here\*\*

This research has provided a starting point for understanding the phenomenon of P2P lending platforms in China and the results of this study help to fulfill the research gap on P2P lending platforms by providing an important case of P2P lending platform in China as well as its trust framework it used to control and decrease the risks.

## Reference

- Barber, B. (1983). *The Logic and Limits of Trust*. Rutgers University Press: New Brunswick, NJ.
- Driscoll, J.W. (1978). Trust and participation in organizational decision making as predictors of satisfaction. *Academy of Management Journal* **21**(1): 44–56.
- Earle, T. C. and Cvetkovich, G. T. (1995). *Social Trust: Towards a Cosmopolitan Society*. Praeger: Westport, Conn.
- Frame, W. S. and White, L. J. (2004). Empirical studies of financial innovation: mostly talk and not much action? *Journal of Economic Literature* **42**: 116-144.
- Fukuyama, F. (1995). *Trust: The Social Virtues and The Creation of Prosperity*. The Free Press: New York.
- Gefen, D., Karahanna, E. and Straub, D. W. (2003). Trust and TAM in online shopping: an integrated model. *MIS Quarterly* **27**(1): 51-90.
- Greiner, M. E. and Wang, Hui (2009). The role of social capital in people-to-people lending marketplaces. *ICIS 2009 Proceedings*. Paper 29.  
<http://aisel.aisnet.org/icis2009/29>
- Guiso, L., Sapienza, P. and Zingales, L. (2004). The role of social capital in financial development. *American Economic Review* **94**(3): 526–556.
- Klafft, M. (2008). Peer to peer lending: auctioning microcredits over the Internet. *Proceedings of the 2008 Int'l Conference on Information Systems, Technology and Management* (pp. 1-8). IMT: Dubai.

- Kramer, R. M. (1999). Trust and distrust in organizations: emerging perspectives, enduring questions. *Annual Review of Psychology* **50**: 569–598.
- Lewis, J. D. and Weigert, A. (1985). Trust as a social reality. *Social Forces* **63**(4): 967–985.
- Li, H., Yang, Z., Yao, X., Zhang, H. and Zhang, J. (2012). Entrepreneurship, private economy and growth: evidence from China. *China Economic Review* **23**(4): 948-961.
- London, T. and Hart, S.L. (2011). Creating a fortune with the base of the pyramid. In *Next Generation Business Strategies for the Base of the Pyramid*, London, T. and Hart, S. L. (eds). FT Press: Upper Saddle River, NJ; 1-18.
- Luhmann, N. (1979). *Trust and Power*. John Wiley & Sons Ltd: Chichester.
- Mayer, R. C., Davis, J. H., and Schoorman, F. C. (1995). An integrative model of organizational trust. *Academy of Management Review* **20**(3): 709–734.
- Prahalad, C.K. (2005). *The Fortune at the Bottom of the Pyramid: Eradicating Poverty Through Profits*. Pearson Education/Wharton School Publishing: New Delhi.
- Redding, G. (1990). *The Spirit of Chinese Capitalism*. De Gruyter: Berlin.
- Shapiro, S.P. (1987). The social control of impersonal trust. *American Journal of Sociology* **93**(3): 623-658.
- Smith, A. H. (1894). *Chinese Characteristics*. Fleming H. Revell: New York.
- Uzzi, B. (1997). Social structure and competition in Interfirm networks: the paradox of embeddedness. *Administration Science Quarterly* **42**(1): 35–67.

- Vogel, D. and Wetherbe, J. (1984). MIS research: a profile of leading journals and universities. *ACM SIGMIS Database* **16**(1): 3-14.
- Wang, Y. D. and Emurian, H. H. (2005). An overview of online trust: concepts, elements and implications. *Computers in Human Behavior* **21**(1): 105-125.
- Weber, M. (1951). *The Religion of China: Confucianism and Taoism*. The Free Press: New York.
- Yang, K. (2007). *Entrepreneurship in China*. Ashgate Publishing: Aldershot, Hampshire.
- Zucker, L.G. (1986). Production of trust: institutional sources of economic structure, 1820-1920, In *Research in Organizational Behavior* Vol 8, Staw, B.M. and Cummings, L.L. (eds.). JAI Press: Greenwich, CT; 53-111.

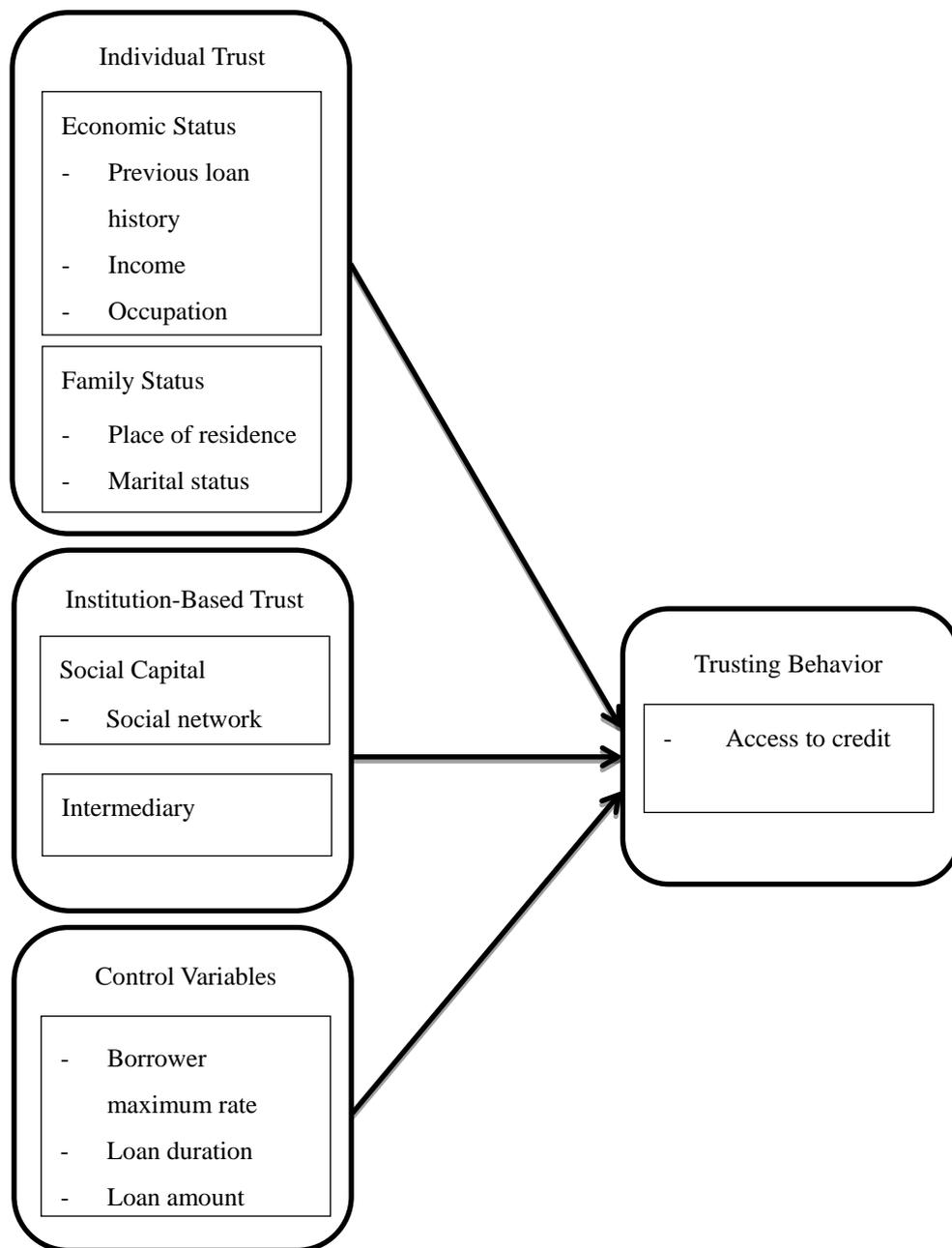


Figure 1. CreditEase's trust framework