

A study on legal improvement on Online P2P financial loan

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Abstract

Along with the recent growth of Fintech industry and low interest rate basis, one of the alternative investment technique for expecting higher investment profit, P2P loan using P2P financial system is greatly increasing.

P2P loan can be referred to as a type of Crowdfunding that the law of Crowdfunding (adopted to revised Capital Market Act) enacted on January 25th 2016 only allows investment type Crowdfunding so that it can be used as a tool of raising fund for startup and venture companies. Also, it is true that Korean government could not make any legislative foundation related to P2P loan. At this moment, those online platform companies mediating P2P loan are not included as financial companies, expected to cause various legal arguments.

Financial Services Commission has released a guideline in February of this year saying that limit of P2P loan is 10 million Korean Won per arbitrating company and 5 million Korean Won per borrower. However, what is more important is to make a law supporting this institutional system. If legislation on P2P loan is implemented without care, it may disturb growth of the field but it may result in the damage of investors if not clearly defined by law. As this is the case, first, "revision of execution regulations for loan business" should take place as soon as possible to intensify inspection of loan companies by registering them to Financial Services Commission. Second, saving customer fund separately in the their organization. Third, making law on protecting investors such as regulating exaggerative advertisement. Fourth, to have transparent and fair public announcement system, standardized agreement and guideline describing clear understanding on autonomous public information publication of P2P loan online platform business and information on the borrower.

▶Keyword: P2P financial loan, Crowdfunding, Fintech industry, The Capital Market and Financial Investment Service Act

I . Introduction

Along with the recent growth of Fintech industry and low interest rate basis, one of the alternative investment technique for expecting higher investment profit, P2P loan using P2P financial system is greatly increasing. This P2P loan means matching capital demander who needs the money and investors who supply the capital in an online

platform. It first began as credit loan where required capital is supplied by several unspecific investors but today, real estate mortgage has become one of the most commonly used type. Followed by this, subjects of investment are becoming more specialized to jewelries, luxury watch and bags, and intangible copyright.

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First of all, principal and interest of invested capital from investors, the capital suppliers are not guaranteed and as a result, no legal protection is made if any loss in invested capital occurs. What is more, this invested capital is operated as loan that even liquidity cannot be guaranteed. This P2P loan which is currently in blind area of financial protection is mainly involved with those people with low income and low credit level, therefore, prompt legal improvement is required.

In this study, it tries to examine types of P2P loan, forms of loan, and its structure. It also looks into legal arguments arising around P2P loan related personals and deals with conflict between legal understanding between financial consumer protection and related laws, afterwards, conclusion is made with the right way of improving legal system.

II. Concept of P2P loan and its advent

1. Concept

P2P loan is one of the Crowdfunding where capital loan is made through online platform with many unspecified participants. This concept combines P2P (Peer-to-Peer) system where each individuals sharing files with other individuals online into the financial transaction. This is also called as Person-to-Person loan where financial deal of direct capital loan is made between the two individuals without going through a financial organization.[1]

The types of Crowdfunding can be divided into the following depending on what kind of reward does investor receives in return; (a) donation type of fund raising where capital investment is made without reward, (b) sponsor type where reward is made in non-financial type such as interest, business profit, etc, (c) loan type where fund is provided to the demander by Crowdfunding method and in

return, receiving interests or principal amount without any interests, and lastly, (d) share investment type where investors are rewarded in the form of stock for their certain profit share as well as dividends.

The current 「The Capital Market and Financial Investment Service Act」 only covers share investment type Crowdfunding and details include announcement regulation required for issuing share such as report and establishment of online small amount investment mediation, investor protection, liability for damages, etc.

Most of online platform business providing P2P loan service plays role of matching fund demander (borrower) and fund provider (investor) without any concern to the number of fund investors. As mediating organization, online platform business applies indirect link to the financial companies for the loan and thus, it can be referred to as loan type Crowdfunding.

From legal perspective, loan Crowdfunding includes loan contract between fund provider and demander. However, it is very rare for P2P loan to have such contract between the two and those online platform business utilizes financial companies based on principal acquirement contract or consigned contract with securities.[2] As this is the case, P2P loan is a type of Crowdfunding and has the same definition with loan type Crowdfunding. Different from the existing loan method operated by financial companies, it connects borrower and investor directly online that its biggest advantage is that it is very quick and convenient, furthermore, one can save a lot of cost required for making a loan.

Different from traditional loan where people sit face to face and review documents along with securities, this P2P utilizes different IT technologies such as personal verification process and providing credit based on information obtained from social network service. Yet, there are no legal basis for this kind of financial transaction. This concept was first introduced around mid of 2000s in North America, the leader of Fintech but in Korea, due to the strong financial system, adoption of this system was delayed. Korean government established plan for nurturing Fintech industry later and within few years, related companies started to appear but we are still at the beginning stage of this industry.[3]

2. Background of appearance

It has been only few years since the first advent of P2P in the world. Starting from England in year 2006,

P2P platform started to appear in America and China in year 2007 and 2009 respectively. The reason for its fast spread in England was because of web 2.0, which is change in technology allowing participation of general individuals in content production and updates of website. Based on this web 2.0 service, online P2P loan service allowed loan demanders to introduce about oneself, profile picture, reasons for loan, and how one going to operate this fund online P2P platform and also, it became a free communication place between investor and borrower. Another reason for this fast growing of P2P loan is year 2008 financial crisis. Due to this global financial crisis, many companies and individuals faced with bankrupt around the world and to solve and prevent such problems, new regulation on capital adequacy called Basel III was introduced. Consequently, activities of credit offering from those financial companies, the body of supplying credit have shrank down rapidly. As banks started to reduce liquidity supply to satisfy the new financial regulations, small to medium business as well as individuals had difficulties of raising required funds. Due to such credit gap, P2P loan became popular soon. Along with this environmental background, the biggest advantage of P2P loan. providing low interest rate to the borrower compare to traditional financial transaction with banks and on the other hand, offering relatively higher profit rate to investors at this low interest rate has become the most attractive point to the users.[4]

III. Status of P2P loan and legal issues

1. Status of P2P loan market

As mentioned above, although present Capital Market Act only allows share investment type Crowdfunding but as various types of P2P loan using Crowdfunding are growing faster, it is used as a financial tool for a new loan alternative.

In 2015, the capacity of P2P loan market in Korea was about 3.5 billion Korean Won, however, by the end of September 2016, total P2P loan amount (accumulated amount) showed a rapid growth, reaching 29.18 billion Won. First started as credit loan, about 16 billion Korean Won of total loan amount is taken by real estate mortgage loan. Recently, real estate project financing type loan is increasing.[5]

The first P2P loan mediating online platform was Money Auction which was established in August 2006 and afterwards, Pop Funding was established in 2007. At the moment, there were 2 companies in Korea but during 2014 when discussion on Crowdfunding was ongoing, the number of companies related to this business showed a rapid growth, it was turned out that total 27 P2P loan companies are operated by July 2016.

Along with the increasing number of companies, business types of P2P loan companies are becoming varied such as credit loan and real estate mortgage loan. Terafunding was released as real estate mortgage loan business from Dongbu Bank. Honest Fund released a financial product which makes portfolio based on spread investment with hundreds of bond. This is done by making a deposit and selecting auto investment mode. Lendit is looking for a business model which operates sharehouse at a cheap price by concluding MOU with social companies. In case of JB Bank and Hanwha Life, they are releasing loan products in cooperation with P2P loan mediating companies.[6]

Likewise, P2P loan is not only focusing on the simple life money lending but targeting niche market to diversify its business models with financial products and social company public interest pursuit products.

2. Problem of protecting interested parties in P2P loan

P2P loan is done when P2P service applier asks for loan on online platform such as website, then, many investors lend money and get interests and profit from this for a certain period of time. Also, they are doing business by relating with financial organizations (saving bank, regional bank, etc). However, as P2P mediating companies are taking the method of cooperating with sister financing companies and financial organizations, there formed no direct legal relationship between borrower and investor.

They only have the right to decide whether to approve the investment or not online. Once loan is made under the approval of investor, legal relationship between borrower and investor is cut and thus, there is a problem of not being able to have any protection for insisting rights. What is more, liquidity issue may occur for investors to collect investment in the middle and there are limits on implementing their rights due to default on obligation. P2P mediating companies have problems of notification explaining legal rights and protecting privacy of borrower.

2.1 Problems of borrower (capital demander) protection

It is expected that protection problem will not be a big issue as P2P loan borrowers are covered by protection regulations such as Loan Act, Credit Reporting Act, Credit Information Act, and Private Information Protection Act.

First of all, interest rate for P2P borrowers is limited to less than 34.9% per year in accordance to Article 15 of Loan Act and Article 9 of execution regulations of the Act. In case, business is run in cooperation with loan companies, the followings are covered under Article 9 of Loan Act; prohibition on excessive loan (Article 7 of Loan Act), important information to be written in hand writing (Article 6-2 of Loan Act), interest rate, calculation of interest rate, method of performance, and overdue interest rate. In contrast, working in cooperation with loan banks, requirement of explanation when selling subordinated bonds is applied to Article 14 of Loan Bank Act.

Other include ban on contacting others related to the borrower for the purpose other than finding one's location in regards to credit collection (Credit Collection Act Article 8-3) and ban on violence, threatening, arresting, imprisonment, night visiting, late night contacting, forcing, and humiliating (Credit Collection Act Article 9). Also, it is inhibited for credit collectors to abuse public rights or legal process in a faulty way (Credit Collection Act Article 11).

When working in cooperation with loan banks, one should have a clear principle for collecting, examining, and processing credit information (Credit Information Act Article 15). Also, it is inhibited to collect or check unclear credit information or one's privacy (Credit Information Act Article 16) and there is a requirement for establishing and implementing security solution for IT system (Credit Information Act Article 19).

For private information protection, information processor cannot collect more than necessary information when providing such information to the third person (Private Information Protection Article 16) and shall receive consent from the subject of information (Private Information Protection Act Article 17). Also, there is responsibility of discarding such information after a certain period of time (Private Information Protection Act Article 21).

However, for security based consigned contract P2P in relation to the banks, as investor is in the position of the actual subject of contract, it is possible to ask for

collection directly. Therefore, illegal collection and too much exposure of personal information may be a problem. Furthermore, borrower may try to provide a lot of information to have loan but in that case, worries of exposing personal information may rise.

For P2P loan borrower, one may have lower credit level or is unqualified for financial trading, therefore, may be exposed to high risk of default. As this is the case, a prompt action on securing legal position and protection of investors is required.

2.2 Problems of investor (capital provider) protection

As P2P capital investors have no any other protections other than regular Civil law related to their contract with online platform operators, there is a problem of having unclear definition on legal position of those P2P loan investors.

2.2.1 Trading of Right to receive original interest P2P loan

If online platform business registers its new loan company as a sister company for loan business, then, provides loan to the borrower as a qualified company, there are no any legal relationship between borrower and investor. In this case, online platform business provides money to the borrower and receives the qualification of having a certain pie of original interest of the loan. Therefore, it can be said that there is a initial contract between investor and online platform investor. however, when the borrower is default on one's loan all the loss belongs to the investor, not the sister loan company of the online platform business. Therefore, this implies that the investor is in fact, in the guarantor position of the borrower.

In case of default, the loan company, borrower can implement its rights to claim charges and force implementation. However, as investor is only a receiver of original interest, one cannot execute any rights related to the law or contract in relation to the loan. Also, he/she cannot claim and directly receive from the borrower.

If creditor, the loan company goes bankrupt, there are many different opinions on whether investor can insist on right of loan ownership based on deputy position or not. In general, deputy participation is composed of trading bond including original interest of the loan, it is considered that investor has the prior right to be the

deputy participant when creditor is bankrupt.

2.2.2 Security providing contract P2P loan

When online platform business provides loan to affiliated financial organization instead of being the subject of loan, in principle, investor is put in the position of actual depositor from the financial organization's perspective. However, looking at this from the legal point, investor carries out all the financial transaction through the virtual account offered by online platform business and no real identification check is made in face to face with financial companies. This implies that investor cannot be the actual depositor. Finally, investor only plays the role of providing fund with one's deposit as security and thus, there are possibilities of legal dispute.

In terms of default by borrower, the creditor, financial company imposes guarantee responsibility to the online platform business of borrower and guarantor. The online platform business can have reimbursement on one's damage by implementing security right. Therefore, financial company and online platform business become exempt from the debt by this security right and finally, investor is left behind with right to indemnify towards the borrower.

2.2.3 Protection on additional risk

P2P loan investor is not only exposed to default of borrower but also to embezzlement, fraud, and bankruptcy of online business platform. This means that investor might have potential risk and in also in the process of credit collecting, as there are no regulations on securing bond right including responsibilities and profit share there are risks of default and liquidity. What is more, this Crowdfunding which is categorized as a high risk product, is exposed to hacking risk related to cyber security such as investment qualification and incomplete transaction.

2.3 Problems on Capital Market act

As P2P business is made in the form of trading right to receive original interest and security provision contract with online platform business, there is no clear right relationship on legal ownership on fund loaned. Therefore, it is difficult to secure legal position of the related parties. However, if P2P loan is identified as a new type of debt security based on loan type Crowdfunding, it can be considered as a transaction of high risk financial products. According to the current law,

there are no related regulations on P2P loan but as it is one type of Crowdfunding, we can consider abiding by law related to share investment type Crowdfunding in Capital Market Act. If we abide by original fund loss, advance notification, and responsibilities for explanation applied to trading high risk financial products in accordance to Capital Market Act, it will be a realistic approach for protection.

IV. Legal regulations on P2P loan

Without any clear regulations on P2P loan, online platform business are carrying on their business based on the law related to loan, online market, and electronic transaction. As size of P2P loan is growing fast, we need institutional basis for making the law. However, some guidelines are made without direct legislation on P2P loan in Korea and this does not mean that the guideline is legally valid. As this is the case, this research looks into the regulations of present law and its limitation, then, suggests ways to make the right institutional system.

4.1 Fund raising without permission

Online platform business collecting fund from many random people for P2P loan is pointed as fund raising without permission from the point that it also provides interests along with the original amount. For this fund raising without permission, financial business approval is required and in case of violation, it is less than 5-year imprisonment and less than 50 million Korean won fine.

To receive investment fund for P2P loan, one should indicate possibilities of losing original fund when concluding a contract and it should also contain information that there are no conditions for preserving original fund when loss occurs. Then, this is not considered as fund raising without permission. However, the recent trend is that the number of illegal private funding is increasing which collects fund from many uncertain people online and offline by guaranteeing high profit (securing original money).

Illegal private funding cases are increasing which reflects strengthening of function of capital market and growth of Fintech. Along with new financial techniques, its methods are becoming more advanced such as P2P financial, Crowdfunding, and virtual money investment as

well as being more intelligent.

Table .1 Number of reports and investigation on fund raising without permission.[7]

Category	2012	2013	2014	2015	End of July 2015	End of July 2016
Report	181	83	133	253	124	348
Investigation	65	108	115	110	42	80

Korean government is preparing for solutions to improve such fund raising without permission and also, is executing to revise law for regulating fund raising without permission to impose fine based on the actual profit along with extending its application boundary.

4.2 Fund mediating by unregistered loan business

Loan business means “doing business with providing financial loan (bill discount, security transfer, etc) or with collecting fund by having transferred loan from loan business companies or credit financial organizations” (Article 2 of Loan Business Act). Those companies not registered or not a credit financial organization but providing loan as a business are illegal and imposed with less than 5 years of imprisonment or less than 50 thousand Korean Won fine. Also, those loan business mediating fund for unregistered loan business companies, they are imposed with less than 3 years of imprisonment and less than 30 million Korean Won fine (Article 19 of Loan Business Act).

Reflecting from the above mentioned Loan Business Act, those many uncertain number of fund suppliers investing in P2P loan products are unregistered companies and there are also opinions saying that online platform mediating their fund is against the Loan Business Act.[8] However, sister company of online platform business is dealing with the loan and investors are only purchasing right to receive original fund and interest from those sister companies. Therefore, it cannot be said that it is illegal to mediate fund of unregistered loan companies. As there are many damage reports on unregistered loan companies to Financial Supervisor Service in relation to unfair guarantee and high interest rate guarantee. As this is the case, a clear regulation for registering P2P loan mediating companies is required. By managing investment fund separately as mentioned in the guideline from Financial Supervisor Service and prompt

legislation of Information Publication we need to protect the market participants.

4.3 Bribery from borrower

As P2P loan online platform business cannot receive bribery from borrower, it is said that P2P loan mediating companies charging commission is against the Loan Business Act.

Commission paid by borrower is payment made to online platform business, not to the loan companies and thus, they are not subject to Loan Business Act by law. However, it is limited to see that sister company of online platform business, loan business as an individual company. According to Article 11-2 of Loan Business Act, loan mediating companies are prohibited from receiving commission from the borrower for mediating service. Those collecting commission are subject to less than 2 years of imprisonment and less than 30 million Korean Won fine (Article 19 of Loan Business Act).

V. Conclusion

Recently, Financial Services Commission has formed a TF and announced legislation for P2P loan guideline as a preliminary solution for protecting investors and growth of P2P loan market. Furthermore, committee around P2P loan online platform business are being made.[9] Through related financial companies, responsible public bodies will check whether they are following guideline or not and if necessary, will ask for modification to the related financial companies. It will also implement revision of related laws (Loan Business Act, etc) to strengthen investigation and inspection on related financial companies.

The way to grow P2P loan market while protecting investors and without any limit of investment from individual investors is to intensify information publication on borrower and develop more detailed techniques on evaluating credit of borrowers. Investment loss in loan business occurs when borrower provides wrong information and investors make investment based on this untrue information. Therefore, institutional system shall focus on making legal foundation not to have such wrong information released. Those borrowers giving wrong information shall be punished and asked for responsibilities for the damage. Also, establishing a

system for accurate credit evaluation could be a way to prevent loss of investors.

What is more, we should have a new perspective on P2P loan regulations. It is necessary to recognize P2P loan product as a new type of financial investment product which could generate loss. Even if loss is made after investing in financial product, one cannot ask responsibilities to the seller and the same approach method shall be applied. From this perspective, it is unnecessary to set investment limit to P2P loan product as there are no limit to financial investment products.

What is more important, it is not the discussion on setting investment limit but making related regulations. What is really needed for nurturing this rapidly growing P2P loan market is not setting administrative instructions but making a strong institutional foundation. As of now, regulations related to P2P loan is not set properly and is exposed to legal instability. There are many legal issues such as investor has loan business or not, loan mediating companies are official under Loan Business Act, or loan bond is loan security under 'laws related to capital market and financial investment.' We need law which can solve those problems. Also, we should have registration system for those loan mediating companies so that they are under inspection from financial organizations. In this way, we can prevent too much flow of not solid loan mediating companies, making the market healthy. To protect fund from investors safe, fund shall be set as trust or deposit in a third organization. There should be a solution to prevent exaggerated advertisement or unfair investment suggestion.

Once such institutional foundation is made P2P loan business, leader of Fintech industry will be able to grow. Therefore, Congress, financial organizations, and professionals should accept various opinions and make law for developing P2P loan business.[10]

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