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The Internet Creates Increased Credit Default Risk for the Financial Industry

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Abstract: The advent of the Internet has changed modern life, creating new opportunities in areas such as work, study and leisure. However, as a result of this new technology, many problems have also emerged at the same time. The purpose of this paper is to examine an important issue related to the Internet within the financial industry and the methods to solve it. This study shows that credit risk is one of the biggest risks of internet finance as the internet is a virtual trading platform. The increased default risk caused by information asymmetry that the Internet brings to the financial industry has two main consequences, namely the inability to recover the borrowed funds and the possible increase in the bankruptcy rate. In response to this risk, the establishment of an internet-based financial credit risk prevention and control system and enhanced dissemination and popularization of internet financial knowledge to the public can appropriately mitigate the higher credit default risk brought by the Internet to the financial industry.

Keywords: *Financial Industry; Internet; Credit Default Risk*

1. Introduction

The Internet, due to the acceleration of technology, gained wide popularity in the financial industry. According to the statistics from China's largest online lending portal YesMyLoan, by the end of 2013, there were more than 800 online loan platforms in China, 90 of which had more than 150,000 borrowers (Wang, Xu, Ma, & SpringerLink, 2015) [1]. However, in the current process of Internet finance development, the Internet not only has a positive impact on the macro-economy, but also it may cause some problems. In view of the fact that there is little literature examining the troubles posed by the Internet to the financial industry, this paper discusses a major problem about it, that is, a substantial increase of the credit default risk, which the borrower may not be able to repay the principal and interest of the loan in time (Wang et al., 2015) [1], this problem could lead to non-recovery of borrowed funds and possibly even a rise in bankruptcies in the financial industry. This essay will first describe the current use or impact of the internet on the risk of credit default, thereafter, some negative consequences will be explored, and finally, two effective solutions will be discussed and evaluated.

2. Impact of the Internet on the Credit Default Risk

In the process of the development and practical application of the internet in the financial industry, lending and borrowing is a gradually common phenomenon. By the end of 2013, China had more than 800 online lending platforms, in particular, some traditional financial institutions, such as PingAn Insurance Group and China Merchants Bank, have started to enter the online lending industry (Wang et al., 2015) [1]. However, as the internet is a virtual trading platform, it cannot be considered as comprehensive as real transactions. Therefore, in the credit transaction process, there is a great risk of default (Lin, Whinston, & Fan, 2015) [2]. Población García & Springer Link (2017, p.201) defined credit default risk as “the possibility of losses arising from the counterparty’s total or partial failure to meet their contractual obligations in terms of the total amount or the due date" [3].

3. Consequences of the Default Risk Brought by the Internet

No matter how virtual and technical the current Internet financial products are, the core of Internet financial products is still finance, rather than Internet technology, so what the Internet financial industry really changes is the way of real finance, not finance itself (Abbasi, Kamran, & Akhtar, 2017) [4].

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Therefore, internet financial transaction is also the pricing of credit risk. Financial Information asymmetry, regulation, financial risk and other factors will not disappear because of the emergence of the Internet, but will be more complex (Abbasi et al., 2017) [4].

Credit risk is the biggest risk of Internet finance. There are two main consequences of the default risk brought by the Internet in the financial industry, namely, failure to recover borrowed funds and a possible increase of bankruptcy rate. First of all, internet finance has increased both rationality and irrationality in the market. Qiao, Chen, & Xia (2018) points out that due to the popularity of Internet technology, many investors have joined the financial industry, so herding behavior is obviously larger than the traditional financial field [5]. As emphasized by Greiner & Wang (2010), non-professional investors can take financial risks at any time and any place [6]. They often imitate the investment behavior of other investors, and ultimately amplify the irrational herd behavior. For instance, a large number of investors rush into the peer-to-peer lending platforms, but there is no symmetrical credit information of borrowers, which leads to greater default risk. This feature makes it easy for internet lending platforms in the financial industry to lend money to enterprises or individuals with unstable incomes or investments in high-risk projects, when they are at risk of default and unable to repay their loans, the relevant risks and losses could not be accounted for, as a result, the borrowed funds could not be recovered (Hou, Gao, & Wang, 2016) [7].

In addition, the credit risk caused by Internet Finance may further increase the bankruptcy rate of the financial industry. Hou et al. (2016) found that in the field of finance with the internet, most Internet financial companies in China do not have access to the credit system of the People’s Bank of China, so they cannot obtain comprehensive credit information of their customers, such as customer property, education background, income, loans, transaction information of financial institutions and so on [7]. When implementing credit risk assessment, internet financial enterprises can only rely on the information provided by customers themselves for verification, which is different from the traditional financial field, traditional financial enterprises can conduct a credit risk assessment with the help of enterprise credit and personal credit data of the people's Bank of China. In addition, in the internet lending mode, the lender cannot fully understand the specific circumstances of the borrower’s use of funds. If the borrower uses venture capital funds, the risk of loan default will increase (Hou et al., 2016) [7]. As a result, this increased risk of default caused by information asymmetry may increase the bankruptcy rate of the financial industry.

4. Solutions to Mitigate the Credit Default Risk Brought by the Internet

There are two strategies to mitigate the higher credit default risk brought by the Internet to the financial industry. First of all, an internet-based financial credit risk prevention and control system should be established. In the aspect of constructing a credit risk prevention and control system, China started late and still has various things to do. Población García & SpringerLink (2017) suggested that the first step is to supplement the credit information data of the People’s Bank of China with the business data of the Internet financial market, optimize the personal credit system with cloud computing technology, and obtain consistent credit standards [3]. Afterwards, the next step is to promote the implementation of this standard to various internet financial credit platforms to ensure the steady development of the internet in the financial industry. This solution ensures that the lender can be might fully informed of the borrower’s circumstances in detail, and in this way, the lender's risk assessment of the borrower may be more transparent, objective and accurate, and address the problem of customer credit information asymmetry. However, this method perhaps is time-consuming and the system may not be created efficiently and completely in a period of a short time.

In addition to the construction of a credit risk prevention and control system, it is also quite necessary to strengthen the dissemination and popularization of financial knowledge on the Internet to the public. First, enable the public to know what Internet finance is, the essence of its business is still investment lending, payment liquidation, which is a new operation mode combined with Internet technology (Población García & SpringerLink, 2017) [3]. At the same time, the public's sense of integrity also should be improved, so as to reduce the occurrence of financial credit risk. This solution can take full advantage of the wide dissemination of the internet, it can give the public a deeper impression of the risks in financial markets at a small cost, so that the public can be more alert to investment or lending and not be blinded by high returns and then ignore the high risks behind them. If these two mentioned solutions from different perspectives can be combined, the default risk brought by the Internet to the financial industry may can be reduced more effectively.

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5. Conclusion

This essay has discussed a significant problem that the Internet brings to the financial industry, that is, a substantial increase of the credit default risk, which may lead to the failure to recover borrowed funds and a possible increase in bankruptcy rate. Current research highlights the importance of establishing an internet-based financial credit risk control system and disseminating financial knowledge on the Internet to the public. However, the generalisability of these results is subject to certain limitations. For instance, this study was only is only within the scope of China, and what is needed more is a cross-national study, considerably more work will require to be done to determine whether the credit default risk is a significant problem caused by the Internet in the financial industry, so that more information from different nations would help to establish a greater degree of accuracy on this matter.

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