lakyara vol.279

China's risk prevention initiatives in Internet finance and FinTech sectors

Takeshi Jingu

13.March.2018

Nomura Research Institute, Ltd.

Executive Summary

The Chinese government is focusing on financial risk prevention again in 2018. Its efforts to regulate and improve Internet finance and FinTech should bear fruit in 2018. Meanwhile, protection of personal information has started to emerge as a new regulatory priority.

Takeshi Jingu
General Manager
Nomura Research Institute (Beijing), Ltd.

Chinese regulation of Internet finance

In 2018, the Chinese government remains committed to financial risk prevention, including in the Internet finance and FinTech sectors.

Chinese regulators' vigilance regarding Internet finance dates back to 2013. It was when the sector was in the midst of a growth boom driven by peer-to-peer (P2P) lending platforms, and many retail investors were being defrauded by unscrupulous P2P platform operators. Despite a public outcry over such fraud, regulators refrained from taking action until 2015. Having long recognized Internet finance's potential to contribute to financial inclusion, Chinese regulators bided their time to develop a better understanding of its benefits and risks.

In July 2015, the People's Bank of China (PBoC) and nine other regulatory entities jointly issued Guidance on Promoting Internet Finance's Healthy Development. In addition to setting forth guidelines for promoting Internet finance's development, the Guidance classified various forms of Internet finance from a functional standpoint and delineated individual regulators' respective jurisdictions within the Internet finance space[1].

Since 2016, China has continued to regulate Internet finance pursuant to the 2015 Guidance. Its basic regulatory stance is articulated in an Action Plan on Thematic Regulation of Internet Finance Risks, released by the State Council in April 2016 and effective from October 2016. The Plan identified issues of regulatory concern in every Internet finance subsector and set a deadline of March 2017 for cracking down on illegalities. Individual regulatory authorities also have released their own detailed action plans. However, the plans have been taking longer to implement on a nationwide basis than initially anticipated, resulting in a mid-2017 extension of the deadline for completion of investigations and corrective action to June 2018[2].

NOTE
1) For example, online payment services are regulated by the PBoC; P2P lending, by the CBRC.

2) The deadlines were extended by a directive issued by the PBoC and 16 other regulatory entities. The directive also addressed additional regulation of Internet finance risks.

Examples of regulatory actions that have ensued include a prohibition against diversion or appropriation of customer funds by online third-party payment services such as Alipay and a requirement that electronic payments that bypass the banking system be routed through the PBoC's settlement system (or another legitimate settlement network)[3].

3) Pursuant to the PBoC et al.'s Action Plan for Regulation of Non-bank Payment Service Risks (released April 2016, effective October 2016).

This requirement is intended to ensure transparent settlement and facilitate real-time monitoring of fund flows by the authorities. In contrast to debit card payments (including China UnionPay Card transactions processed as debit card payments), which are settled via the PBoC's network, payments transmitted by third-party services could previously be routed through the service provider's own bank accounts at multiple commercial banks (to/from customer accounts[4] as shown at the bottom of the diagram in Exhibit 1) without going through the PBoC. This practice was seen as problematic in two respects. First, third-party payment services were essentially functioning as unlicensed settlement networks. Second, transactions settled internally by third-party payment services were evading scrutiny by the PBoC and commercial banks.

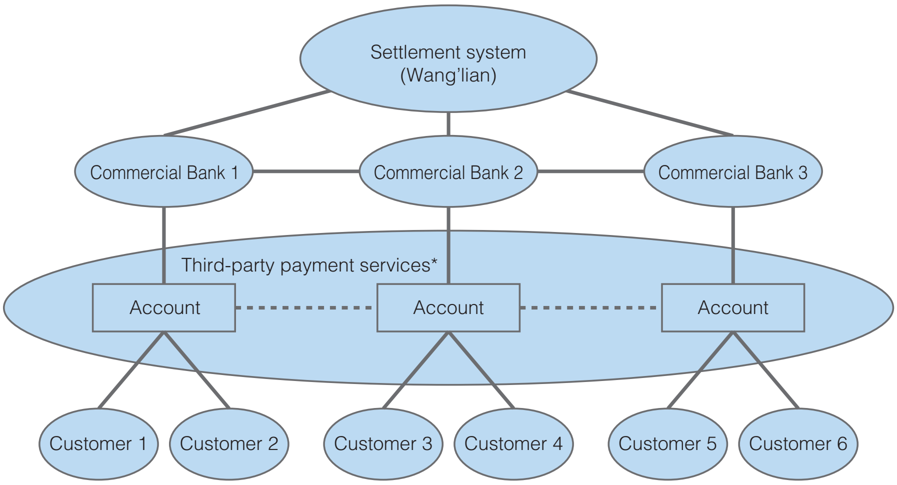
4) See https://www.nri.com/~/media/PDF/global/opinion/lakyara/2016/lkr2016235.pdf. Customers' funds in payment service providers' bank accounts are not covered by deposit insurance. Customers entrust their funds into the payment service provider's custody. Bank accounts in which customer funds are held are titled in the payment service provider's name.

In response, the Wang'lian (Internet Payment Union) settlement system was established with the PBoC's approval in October 2016[5]. All online payments (transfers of funds between bank accounts) transmitted by third-party services must be processed through Wang'lian from mid-2018 onward[6]. Some third-party

5) On July 28, 2017, 45 entities (including PBoC-affiliated institutions and third-party payment service providers) signed an agreement to establish Wang'lian with an initial capitalization of CNY2 billion.

6) Pursuant to an August 2017 PBoC directive.

Exhibit 1: Model for settlement of third-party payments



*Third-party payment services were previously able to settle transactions between customers through their own accounts at commercial banks. From June 30, 2018, they must settle transactions through Wang'lian.

Source: NRI, based largely on China Internet Finance Report 2014 (Lufax et al.)

payment services have been using the Wang'lian system since as early as mid-2017. It is used by 15 banks and nine payment service providers as of September 30, 2017[7]. Wang'lian settles payments routed through third-party services in the same manner as conventional debit card transactions.

7) According to a PBoC report on payment systems' operating status in the third quarter of 2017.

Another area in which regulators have made progress is P2P lending. In April 2016, the China Banking Regulatory Commission (CBRC) issued a separate Action Plan on Regulation of Online P2P Lending Risks. In addition, regulations on online lending information intermediaries' business activities were issued by the CBRC et al. in August 2016.

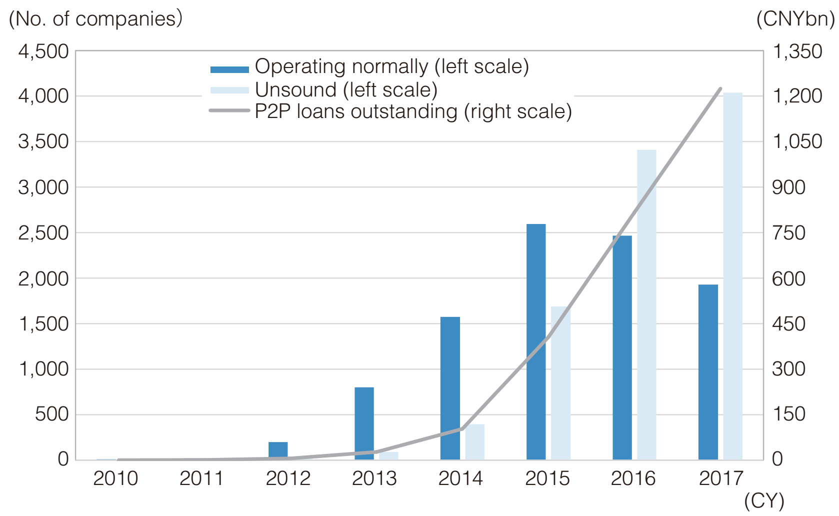
P2P lending platforms are legally deemed financial information intermediaries operating exclusively in the online lending domain. They are prohibited from engaging in de facto banking operations[8] and required to be registered. To register, they must obtain a telecommunications business license and appoint a bank to serve as a custodian of customer funds.

8) De facto banking operations include pooling and lending of funds. PDP platforms are also prohibited from securitizing assets or engaging in similar activities and are subject to a per-borrower limit on loans outstanding.

Registration of P2P platforms has been taking longer than initially planned[9]. The current deadline for completion of registration is April 30, 2018, for major P2P platforms and June 30, 2018, for all others. The P2P lending industry has already undergone a shakeout following its initial rampant growth. Going forward, leading platforms are expected to become even more dominant as P2P lending volumes become increasingly concentrated among top-tier players (Exhibit 2).

9) The initial deadline for registration was August 2017.

Exhibit 2: P2P platforms in China



Source: NRI, based largely on data from Wang Dai Zhi Jia, CEIC and 2013 Chinese Online Lending White Paper

Protection of personal information also on regulators' radar

Another priority is protection of personal information. Privacy protections are particularly important in the FinTech realm, where Big Data analytics are widely used.

Two important developments occurred in June 2017. The first was enactment of a new cybersecurity law. With China yet to enact any laws pertaining solely to protection of personal information, the cybersecurity law is currently the most comprehensive privacy law on its books[10]. The law restricts online businesses from collecting any more personal information than necessary[11] and requires them to disclose the purpose, means and scope of any collected information's use and to obtain users' consent thereto. The second development was that the Supreme People's Court (China's highest court) and Supreme People's Procuratorate (China's highest prosecutorial agency) announced in June 2017 a stricter interpretation of existing legal protections of personal information and heavier penalties for their violation.

China has hitherto had a reputation for being largely unconcerned about protection of personal information, but public consciousness of the issue appears to be steadily rising, as recently evidenced by relatively heavy media coverage of an ethical lapse by Alipay with respect to collecting and using personal information[12].

10) The cybersecurity law's fourth section pertains to protection of personal information.

11) Another intent of the law is to restrict collection of extraneous information through coerced consent (e.g., requiring consent as a condition of app usage). The law also prohibits unlawful acquisition, sale and/or provision of personal information and allows exceptions for anonymized data.

12) Specifically, the disclosure Alipay was using to obtain its users' consent to collection and use of their personal information was displayed in small print on their screens.

about NRI

Founded in 1965, Nomura Research Institute (NRI) is a leading global provider of system solutions and consulting services with annual sales above $3.7 billion. NRI offers clients holistic support of all aspects of operations from back- to front-office, with NRI's research expertise and innovative solutions as well as understanding of operational challenges faced by financial services firms. The clients include broker-dealers, asset managers, banks and insurance providers. NRI has its offices globally including New York, London, Tokyo, Hong Kong and Singapore, and over 12,000 employees.

For more information, visit http://www.nri.com/global/

Inquiries to : Business Planning & Financial IT Marketing Department
Nomura Research Institute, Ltd.
Otemachi Financial City Grand Cube,
1-9-2 Otemachi, Chiyoda-ku, Tokyo 100-0004, Japan
E-mail : kyara@nri.co.jp

http://www.nri.com/global/opinion/lakyara/index