China set to step up regulation of Internet finance from 2016

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Executive Summary

China will step up regulation of Internet finance in 2016. In response, its online financial services industry is expected to undergo a shakeout amid a transition from rapid growth to orderly growth.

China to tighten regulation of online financial services

Internet finance has been growing rapidly in China since 2013 in the wake of the explosive popularity of online financial services such as Yu'E Bao. The Chinese government initially adopted a hands-off approach to Internet finance in the hope that it would improve SMEs' access to financing, even as unregulated growth in the peer-to-peer (P2P) lending market led to widespread losses, with roughly one-third of all P2P platforms insolvent or accused of misappropriating funds.

Last July, the Chinese government finally unveiled a regulatory framework in the form of Guidance on Promoting Internet Finance's Healthy Development. In December, it followed up by issuing draft regulations on P2P lending and regulations on online payment services, the most prominent of which is Alipay. With China embarking upon regulation of Internet finance in 2016, its online financial services industry will likely undergo a shakeout amid a transition from rapid growth to orderly growth.

Two sets of regulations issued in December 2015

First, the draft P2P lending regulations were released by the China Banking Regulatory Commission (CBRC) on December 28, 2015, to solicit public comments. They pertain to the business activities of so-called loan information intermediaries. Although the draft regulations are expected to be revised, they shed light on the Chinese government’s basic regulatory mindset vis-à-vis P2P lending.

The draft regulations define Internet lending as lending directly between parties (natural persons, corporations or other organizations) via online platforms. Internet loan information intermediaries are defined as companies exclusively involved in information intermediation in the online lending market. In other words, Internet loan information intermediaries bring lenders and borrowers together by providing them with information about each other. Additionally, Internet loan information intermediaries
also vet lenders and borrowers’ qualifications, information’s veracity, and projects’ legitimacy and legality.

With P2P lending, the lender assumes the risk of default; the information intermediary assumes no credit risk. The CBRC consequently decided against imposing minimum capital requirements or licensing requirements on P2P platforms. Instead, P2P platforms will be regulated under a registration system.

Meanwhile, P2P platforms will be explicitly prohibited from engaging in problematic acts that have come to light over the past few years. Such acts include related-party transactions (lending to P2P platform companies’ shareholders and other related parties), pooling and lending of funds by P2P platform companies, pledging of collateral, principal guarantees, segmentation of borrowers’ projects by loan maturity, sales of other financial institutions’ financial products3) and providing services to borrowers intending to invest loan proceeds in equity securities.

To prevent risk, P2P platforms will be required to segregate their own funds from lenders and borrowers’ funds. Additionally, lenders and borrowers’ funds must be deposited into the custody of a bank acting as a third-party custodian4). Provincial financial regulatory authorities will assign ratings to registered loan information intermediaries. The CBRC will build a centralized database on the online lending

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3) Including banks’ wealth management products, securities brokers’ asset management plans, investment trust, insurance products, trust products, etc.

4) The custodian (bank) is not responsible for verifying projects or the veracity of transaction-related information.
Next, the People’s Bank of China (PBoC) issued regulations (effective July 1, 2016) on non-bank providers of online payment services on December 28, 2015. The regulations define online payments as fast, low-value payments and online payment service providers as providers of channels for such payments. Additionally, the regulations place priority on authentication of customers’ identity. Depending on the authentication method(s) used, payments per account will be limited to RMB1,000 over the life of the account, RMB100,000 per year or RMB200,000 per year.  

Registered customers will deposit funds into their accounts at their payment service provider. Their account balances will be held in bank accounts in their payment service provider’s name, not in their own names. Funds held in payment accounts will therefore not be covered by deposit insurance.

The regulations prohibit payment service providers from opening accounts for financial institutions or other institutions involved in lending, financing, money management, collateral services, trust services, currency exchange or other financial services. If such institutions were permitted to hold accounts at online payment services providers, transactions between their accounts would be opaque to outside observers, including regulators. Such opacity could pose systemic risk management problems. The prohibition against online payment service providers opening accounts for financial institutions is intended to prevent such problems.

Additionally, payment services providers must develop customer risk screening and management systems/mechanisms and also establish risk reserves and transaction indemnification arrangements.

In terms of regulation, the PBoC will exercise differentiated oversight of payment services providers, giving preferential treatment to highly rated providers. In doing so, it will take into account providers’ resources, risk management controls and other such factors.

Future outlook

First, regulators’ ratings of online financial service providers will likely lead to a shakeout within the industry. Amid expectations of intensification of competition, P2P platforms have been raising capital since last year. Among them, Yirendai floated an
IPO on the US NASDAQ market in December 2015. Other P2P platforms also have disclosed IPO plans. Additionally, several P2P platforms have raised capital from private equity funds in 2016. Such financing activity is expected to continue.

While China is now building a regulatory framework, it will not necessarily be able to eliminate existing regulatory silos. For example, P2P platforms were involved in financing off-exchange margin trades that contributed to last summer’s equity market crash\(^8\). Financial regulatory authorities will increasingly need to efficiently coordinate with each other. As Internet finance continues to develop, China must move forward with long-discussed financial regulatory reforms. In particular, it must expeditiously unify financial regulation along product/service lines.

\(^8\) Proposed regulations would prohibit P2P borrowers from investing loan proceeds in equities. If a new regulatory framework were hypothetically put into place to reduce the risk of equity market crashes like last year’s, the CBRC and China Securities Regulatory Commission would need to closely coordinate with each other.
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