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Online P2P Lending and Regulatory Responses in China: Opportunities and Challenges

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Abstract

As a main form of the Fintech industry, China's online P2P lending market underwent a period of explosive growth in the past few years to become the largest in the world, with online lending platforms having mushroomed across the country. This is a consequence of the simultaneous emergence of three key factors, namely deep penetration of internet, large supply of funds and unmet financial needs. The market exhibits several distinctive features in terms of the size of platforms, the level of market concentration and business models. As online lending gathers moment in China, many problems have come into light.

China has recently established a relatively complete regulatory regime for online lending, introducing a number of significant changes, such as the restriction on the business model that can be adopted by platforms, registration requirement, custodian requirement, information disclosure requirement and lending limits. The new regime will have far-reaching implications, including a reshuffling of the market and more collaboration between online lending platforms and traditional banks. A comparative analysis of the Chinese experience with those in other jurisdictions such as the US, the UK, Hong Kong and Japan is conducted to examine the extent to which the new regime is likely to achieve a proper balance between its two main objectives, namely facilitating the growth of the online lending market and protecting financial consumers. While the new regime is generally sound, its efficacy will depend ultimately on how it is enforced in practice.

Keywords: Fintech, internet finance, online lending, P2P, China

Table of Contents

I. Introduction ... 3
II. The Rise of Online Lending in China: Key Drivers ... 4
A. High Online Penetration Rate ... 5
B. Large Supply of Funds ... 5
C. Unmet Financial Demands ... 6
III. Features of China's Online Lending Market ... 7
A. Highly Dispersed Market with Many Small Platforms ... 8
B. Concentrated in Economically More Developed Regions ... 8
C. Transformation of Business Models ... 9
IV. The 2016 Interim Measures on Online Lending: Main Elements ... 10
A. Business Scope of Online Lending Platform ... 10
B. Registration Requirement of Online Lending Platforms ... 11
C. Lending Limits and Custodian Requirement ... 12
D. Information Disclosure ... 13
V. Implications and Evaluations ... 14
A. The Online Lending Industry Facing Big Reshuffle ... 14
B. More Collaboration Between Online Lending Firms and Banks ... 16
C. The Central-Local Cooperative Regulatory Framework: Innovative but Uncertain 16
D. Appropriateness of The Regulatory Approach: A Comparative Perspective ... 19
1. Law and Development: Regulation or Prohibition? ... 19
2. UK: Special License and Minimum Capital Requirements ... 20
3. US: Burdensome Securities Regulatory Process ... 21
4. Hong Kong: Uncertain and Burdensome Rules under Existing Regulation ... 22
5. A Matter of Balance: The Case of China ... 24
VI. Conclusion ... 26

I. Introduction

With the rapid expansion of the Internet market and the booming of start-ups and small, medium-size enterprises (SME), China has, over the past decade, seen explosive growth of the so-called Internet Finance, a joint product of Internet and the financial sector, which is more commonly referred to as Fintech in other jurisdictions. The term Fintech, a portmanteau word made of `finance' and `technology', is often used to describe the intersection of finance and technology. As the technology is mainly related to the Internet, it has come to be known as Internet Finance in China. In fact, there is no precise and wildly accepted definition of Internet finance or Fintech. While Fintech is basically understood as technologies which are used to change and improve the existing business mode of finance,[1] Internet finance is defined as "a new type of financial mode that integrates the functions of financing, payment and information media via Internet and mobile communications technology"[2].

Although the two terms may have some subtle difference in terms of their focus, they cover essentially the same subject matters, and thus will be used interchangeably in this paper. For instance, as the Hong Kong Steering Group on Financial Technologies (Steering Group) suggested, Fintech "may refer to the application of information and communication technology in the field of financial services"[3], mainly including digital payment and remittance, financial product investment and distribution platforms, peer-to-peer(P2P) financing platforms, cybersecurity and data security technology, big data and data analytics, distributed ledgers.[4]

The above-mentioned P2P financing platform refers to an online platform to match capital providers and capital users, where the operator of the platform manages and facilitates the financing process. Where the financing mode takes the form of loan, it is usually referred to as online P2P lending, also called online or P2P lending.[5] By utilizing modern communication technologies, online lending may reduce certain transaction costs, rendering it economically viable to raise fund through small contributions from a large number of investors. As an attractive alternative to traditional bank financing, online lending has experienced exponential growth around the globe, since zopa.com, the world's first P2P platform, appeared in the UK in 2005. Within a short span of about ten years, the global online lending volume had reached more than USD 100 billion by the end of 2015, and has been projected to surpass USD one trillion by the end of 2025.[6]

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[1] Daniel McAuley, "What is FinTech", 23 October 2015, available at https://medium.com/wharton-fintech/what-is-fintech-77d3d5a3e677#.k5c6aipyy (accessed on 17 March 2017).

[2] Financial Stability Analysis Group of the People's Bank of China, *China Financial Stability Report 2014* (China Financial Publishing House, July 2014), p 171.

[3] Steering Group, *the Report of the Steering Group on Financial Technologies*, 26 February 2016, p 13 available at http://www.fstb.gov.hk/fsb/ppr/report/doc/Fintech_Report_for%20publication_e.pdf (accessed on 17 March 2017).

[4] *Ibid*, p 15-16.

[5] These terms will be used interchangeably in this paper, but as discussed later, the Chinese law adopts online lending as the formal term.

[6] Charles Moldow, "A Trillion Dollar Market by the People, for the People: How Marketplace Lending Will Remake Banking as We Know It," Foundation Capital Submission to White House FinTech Summit (2016).

At the international level, major advancements in Fintech in the past few years have created a race among nations to be the next big Fintech hub. One of the main enablers of success in the development of a successful Fintech ecosystem is regulations. Laws and regulations set the direction for Fintech development. If the regulations are too stringent they may dissuade start-ups, whose lean business model cannot afford to comply with the costly regulations in the traditional manner. But one should not throw caution to the wind, because Fintech is still subject to issues of fraud or loss of investment and extremely relaxed regulations can put participants in Fintech at risk. Hence, there is a great need to strike a proper balance between fostering innovation and protecting consumers.

The objective of this paper is to contribute to the international discourse and debate on the above issue by examining the Chinese experience. On 17 August 2016, a host of Chinese financial regulators and government departments, led by the China Banking Regulatory Commission (CBRC), jointly promulgated the Interim Measures for the Administration of the Business Activities of Online Lending Information Intermediary Institutions (2016 Interim Measures on Online Lending).[7] This is the very first time China has set up a relatively comprehensive and workable regulatory framework specifically for the online lending industry. What mechanisms has this instrument put in place to balance financial innovation and consumer protection? Has the regulatory pendulum swung too far or not far enough? Are there any lessons to be learned from the Chinese experience? This paper attempts to provide a contextual, comparative and critical examination of the Chinese experience, and based on such examination, draw implications for the development of China's online lending market and contribute to the international debate on the regulation of online lending.

II. The Rise of Online Lending in China: Key Drivers

China has seen rapid development of online lending in the past decade. In 2005, Zopa.com, the world's first P2P lending platform was set up in London, and China quickly followed suit with its first P2P lending platform, creditease.cn (Yi Xin), appearing in 2006. This good start has ushered in a period of exponential growth for China's online lending industry, particularly after 2013 when the Chinese government explicitly resorts to internet finance as a general policy tool to stimulate its slowing economy. As of January 2017, there were a total of 2388 P2P platforms in China; the trading volume in 2015 reached USD 67 billion, which was about four times bigger than that in the US and ten times in the UK.[8]

How to account for the rise of online lending in China? In general, an online lending market requires three key factors to thrive, including a large number of providers of funds seeking higher-return investments than bank deposits, wide coverage of internet services, and a great demand for small-volume funds; further, it is important that these

[7] Wangluo Jiedai Xinxi Zhongjie Jigou Yewu Huodong Guanli Zanxing Banfa [Interim Measures for the Administration of the Business Activities of Online Lending Information Intermediary Institutions] (promulgated on 17 August 2016 by the China Banking Regulatory Commission and others).

[8] "Digital Disruption: How FinTech is Forcing Banking to a Tipping Point," 29 March 2016, p54.

three elements must emerge simultaneously.[9] It is submitted that China has had the simultaneous emergence of all the three factors, thus providing a fertile ground for the growth of its online lending market.

A. High Online Penetration Rate

According to the official data released by the China Internet Network Information Centre, as of the end of 2016, China had a total of 730 million internet users, which was more than the US and Europe combined, or was almost equal to the entire population in Europe; the online penetration rate in China reached 53.2%, surpassing the global average rate by 3.1% and the Asian average rate by 7.6%.[10] Given its large number of internet users, it is perhaps not surprising that China's internet economy has grown rapidly, becoming the world's largest retail e-commerce market. By 2013, China had already ranked as global leaders in terms of its contribution to the national gross domestic product (GDP).[11] In 2015, China accounted for 42.8% of global retail e-commerce sales against 22.2% share occupied by the US, and is projected to reach 59.5% in 2020.[12] Emergence of the e-commerce giants, such as Alibaba and JingDong, provides a solid basis for the online lending platforms, many of which are their financial subsidiaries.

B. Large Supply of Funds

Further, due to strict control over the interest rate paid on deposits by traditional banks, Chinese investors are increasingly attracted to online lending which can offer much higher rates of return. In 2004, China started to relax its interest rate control policy by allowing banks to set their loan rates at a discount of 10 per cent of the official base rate issued by the central bank, namely the People's Bank of China (PBOC). This reform process has been accelerated in the ensuing ten years. The government control over the loan rate was further relaxed to allow a discount of 20 per cent in June 2012 and then 30 percent in July 2012, culminating in a complete abolishment of the lower limit on the loan rate in July 2013. A similar reform pattern occurred to the deposit rate. In June 2012, the deposit rate given by commercial banks was allowed for the first time to be higher than the official base rate by up to 10 per cent. This floating-up range was widened successively to 20 per cent in November 2014, 30 percent in March 2015, and 50 percent in May 2015. In August 2015, the cap was removed for the longer-than-one-year term deposit and finally in October 2015, the cap removal policy extended to all bank deposits.

It should be noted however that the formal removal of limits on the interest rate does not necessarily mean its full liberalization or marketization. In practice, the PBOC continues to control or influence the lending businesses of commercial banks, including the setting of interest rates, through informal or soft measures such as the

[9] This analytical framework is inspired by that Professor Gilson develops to explain the development of the venture capital market. Ronald J Gilson, 'Engineering a Venture Capital Market: Lessons from the American Experience' (2003) 55 *Stanford Law Review* 1067, 1076-78.

[10] China Internet Network Information Centre, *Zhongguo Hulianwangluo Fazhan Zhuangkuang Tongji Baogao [The 39th Statistical Report on the Development of the Internet in China]* (issued on 22 January 2017).

[11] Jonathan Woetzel et al, *China's Digital Transformation: the Internet's Impact on Productivity and Growth* (July 2014) McKinsey Global Institute.

[12] Emarketer, 'China Eclipses the US to Become the World's Largest Retail Market', 18 August 2016, available at https://www.emarketer.com

so-called window guidance (chuangkou zhidao). For instance, the PBOC may make a call to or organize a meeting with commercial banks to give them advice on the destination and structure of their loans.[13] Window guidance is an ad-hoc mechanism, which is usually employed in special circumstances. One such example may arise when some commercial banks set grossly exorbitant interest rates with the possible or real effect of disrupting the order of the banking market or harming the interest of consumers. While winder guidance is suasive and non-mandatory in nature, commercial banks will normally respect and follow the advice, given the regulatory role and power of the PBOC.

As such, although there are no formal restrictions on the interest rates commercial banks can set, they cannot deviate too far from the official base rates. In contrast, the interest rate offered by online lending is more marketized. For instance, statistics show that at the end of 2015, the general annualized interest rate of online lending was 12.45% across China, and in some regions such as Shandong province and Hubei province, the rate was even higher than 16%.[14] This compares very favourably with the one-year term deposit base rate which was only 1.5% in 2015. The online lending rate dropped in 2016 but was still around 10%. This has provided strong incentives for China's huge population of netizens to take part in the online lending market.

C. Unmet Financial Demands

Now let's turn to the last key element, namely the demand for a more inclusive financial system in China. After having galloped at an average of nine percent gross domestic product growth rate over the past three decades, the Chinese economy is now at a crossroads. China's three decades of rapid growth were fuelled by capital investment, exports and consumption. With growth falling below 7 percent, China's economy is in dire need of a makeover and consequently, China embarks on a national economic restructuring and upgrading strategy under the rubric of supply-side reform. A key element thereof is the national policy of encouraging entrepreneurship and innovation, which manifests itself largely in the growth of start-ups, small and medium-sized enterprises. However, it has been notoriously difficult for start-ups and MSEs to obtain finance from China's traditional banking system. The inefficiency of the Chinese traditional banking system is mainly due to the long-standing problem of financial repression in China.

To start with, there has long been a general shortage of credit in the Chinese banking system. The Chinese financial system is over-dominated by the banking sector which traditionally intermediates almost 75% of the economy's capital, while the figure is typically less than 20% in developed countries.[15] This means that China depends too heavily upon the banking system for capital allocation with the underdevelopment of other financing methods through the securities markets like bond and equity markets. As the central bank, the PBOC controls the annual and quarterly quota of loans commercial banks can extend by reference to financial metrics such as the ratio of loan balance to deposit balance, the deposit reserve ratio and the total value of loans.

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[13] For certain industries such as the housing market, the PBOC may still issue special rules on the lending activities of commercial banks.

[14] The official website of Wangdai Zhijia (网贷之家), http://www.wdzj.com/

[15] Hui Huang, 'Institutional Structure of Financial Regulation in China: Lessons from the Global Financial Crisis' (2010) 10(1) *The Journal of Corporate Law Studies* 219.

In practice, the quota commercial banks receive is such that they can simply focus on higher-value and less-risky clients without the need to do business with others. The problem becomes more acute after the global financial crisis of 2008 because the Chinese government has tightened its monetary policy in the post-crisis era to control systemic risk and clamp down on a credit room brought about the government's controversial 4-trillion-yuan economic revival measure.[16]

Second, when extending loans, the banks generally have a preference for state-owned enterprises (SOE) or large firms. There are both political and economic reasons behind it. China's banking market has long been dominated by the banks which are majority-owned or otherwise controlled by the state. While government-brokered deals are not as common as in the past, it is still politically safer for those banks to lend to SOEs, even when repayment of the loan may be in doubt. Further, making a big loan to a large, more established firm also makes more business sense than lending to many new, small firms which lack qualified collateral and credit repayment records. Even if SMEs do secure loans from banks, either state-owned or not, the interest rates are significantly higher than that of large firms due to risk concerns.

As a result, SMEs and particularly start-ups are left without easy access to finance from the traditional banking market. The World Bank estimated that only 25% of China's SMEs received bank credits during the period from 2011 to 2013;[17] a more recent report issued by Development Bank of Singapore and Ernst & Young suggested that only 20-25% of bank loans went to SMEs, even though they account for 60% of GDP, 80% of urban employment, and 50% of fiscal and tax revenues in China.[18] Many SMEs are forced to rely upon other sources of financing at exploitative rates. For instance, sometimes SMEs have to pay very high rates, ranging from 36%-60%, to borrow money from SOEs who are able to obtain loans from the banking system.

In sum, there is a great need for a paradigm shift in entrepreneurial finance. This has prompted the Chinese government to resort to non-banking financing sources. For instance, in June 2016, China's securities market watchdog, the China Securities Regulatory Commission (CSRC), set up a unit with the specific task of pushing forward a pilot program to facilitate the issuance of corporate bonds to fund innovative and entrepreneurial activities. In October 2016, the first batch of two such bonds were issued to raise a total of RMB55 million by two high-tech companies. Apart from the development of the traditional financial tools, online lending as a key form of internet finance in China has also emerged to foster a more inclusive financial market in China.

III. Features of China's Online Lending Market

China has made great efforts to ride the international wave of internet finance to sustain its continued economic growth, seeing it as a significant resource for start-ups and middle to lower income citizens alike. Although online lending is a global

[16] Hui Huang, 'China's Legal Responses to the Global Financial Crisis: From Domestic Reform to International Engagement' (2010) 12(2) *Australian Journal of Asian Law* 157.

[17] World Bank, *Enterprise Surveys: China* (2013).

[18] Development Bank of Singapore and Ernst & Young, *The Rise of Fintech in China: Redefining Financial Services* (2016).

phenomenon, the online lending market in China has exhibited its distinctive features, which must be taken into account in designing and evaluating the regulatory regime for it in China.

A. Highly Dispersed Market with Many Small Platforms

As discussed before, China's online lending market has undergone explosive growth in the past few years, producing a large number of online lending platforms. Most of the platforms, however, are operated by small and medium-sized firms. As of middle 2014, the average registered capital of the firms was about RMB 23.7 million, and the registered capital of most platforms was between RMB5m to 20m.[19] As of middle 2015, only 29.7% of platforms had more than RMB 50 million in registered capital. The market thus becomes highly dispersed and competitive, with the biggest 100 platforms as a group only having 1/2 to 2/3 market share. In contrast, the online lending markets in some overseas jurisdictions are far more concentrated. For instance, Lending Club and Prosper together have 98% of the online lending market share in the US;[20] similarly, up to 88.5% of the British online lending market is in the hands of Zopa and Fundingcircle.[21]

Further, according to the identify of their largest shareholder or controller, the platforms could be classified into five groups, namely ordinary private investors, venture capital firms, banks, listed companies and SOEs. As of January 2017, a total of 2007 platforms, or about 84% of all platforms, were owned by ordinary private investors. They were relatively small platforms, and the aggregate of their trading volume accounted for only 20% of the whole market. By contrast, although there were only 15 bank-owned platforms, they were considerably bigger and together had about 18.9% of the total trading volume in the online lending market.[22]

B. Concentrated in Economically More Developed Regions

Table 1 shows the geographical distribution of the platforms as of January 2017. The platforms were clearly concentrated in four economically more developed regions, namely Guangdong, Beijing, Shanghai and Zejiang, which together had 1505 platforms or 63% of all platforms in China. This is in line with the national policy that online lending is to primarily provide an attractive alternative financing vehicle for entrepreneurial users, notably start-ups and SMEs in China. In contrast, the online lending market in the US mainly serves the needs of personal consumption, such as credit card and housing mortgage payments. In the UK, consumer lending also accounted for a greater proportion of the online lending market than business lending in 2012 and 2013.[23]

Locality	Number	Percentage
Guangdong	461	19.3%

[19] Shen Wei, "Internet Lending in China: Status Quo, Potential Risks and Regulatory Options," *Computer Law & Security Review* 31 (2015) 800.

[20] "P2P Lending: Banking without Banks," *The Economist*, March 1, 2014.

[21] CrowdfundingHub, *Current State of Crowdfunding in Europe*, a report based on research conducted by CrowdfundingHub (2016): 63.

[22] The figures were calculated using the data collected from Wang Dai Zhi Jia.

[23] FCA, A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media, February 2015, para 17-18. In 2014, business loans surpassed personal loans in terms of value for the first time.

Beijing	451	18.8%
Shanghai	320	13.4%
Zejiang	273	11.4%
Shandong	113	4.7%
Jiangsu	96	4.0%
Hubei	75	3.1%
Sichuan	47	1.9%
Others	552	23.1%
Total	2388	100%

C. Transformation of Business Models

The International Organization of Securities Commission (IOSCO) defines online lending as 'an online platform that matches lenders with borrowers to provide unsecured loans to individuals or projects'.[24] As it develops at an impressive rate, however, the online lending industry has generated a variety of business models, some of which deviate from the IOSCO's definition of online lending. Below is a survey of several popular business models of online lending.

To begin with, the client segregated account model is a business model that adheres to the IOSCO definition of online lending. Under this model, the platform acts as an information intermediary, disseminating lending information and matching lenders and borrowers. To facilitate transactions, many platforms also provide other value-added services, such as conducting loan rating and borrowers' creditworthiness assessment, offering investment advice and managing repayment. The bottom line is however that lenders and borrowers stand in direct contractual relationship and the platform is not a transacting party. On the platform, lenders can choose any businesses or projects according to their preference and risk appetite. Once the transaction is consummated, the platform will collect service fee from both parties. Importantly, all funds from lenders and borrowers are managed by a segregated account which is separated from the platform's balance sheet. Hence, the funds of lenders and borrowers are not commingled with that of the platform, and will not be affected even if the platform collapses. A good example of this model is Paipaidai （拍拍贷）, which is one of the largest online lending company in China. According to its official website, the matching service provided by the platform does not guarantee the commercial merits of the lending transactions.[25]

Due to information asymmetry, lenders and borrowers naturally lack trust of each other, and thus there is a demand for the platform to provide more than just passive matching services. This has given rise to a number of business models which allow the platform to extend beyond being a purely informational intermediary. The first

[24] Eleanor Kirby and Shane Worner, 'Crowd-funding: An Infant Industry Growing Fast', IOSCO, March 2014.

[25] http://www.ppdai.com/ The so-called notary model is similar to the client segregated account model in which the platform also acts as an intermediary between lenders borrowers. The key different is however that the work of originating loans will rest on a bank instead of the platform itself. After the required money proposed by the borrower is reached, the platform will then issue a note to the lender for his/her contribution to the loan, thus handing over proprietary interest. This note is, in general, a security, and shifts the risk of non-payment of the loan from the bank to the lenders. The notary model is mainly adopted by online lending platform in the US, such as Prosper.

such transformation is the so-called ‘guaranteed return model’. Anxindai（安心贷）offers a useful example to illustrate how this model works. Guarantee companies owned by Anxindai provides guarantee services for online lending transactions made through the platform. Hence, in the event that borrowers default on loans, the guarantee company will be held to joint and several liability. This effectively transfers the credit risk from lenders to the platform or its associated entities. The platform does not only provide credit-related information, but also the service of credit enhancement. As the platform plays a similar role to that of the traditional bank, this type of online lending is said to have ‘bank-like functions’.[26]

The second and more widely practiced transformation is the ‘platform lender model’ or ‘originate-to-distribute model’, which clearly deviates from the IOSCO definition. Under this model, the platform is the one who originates loans to the borrowers. The credit funds of the platform is aggregated by managing a pool of assets on behalf of a group of investors through a collective investment scheme. The platforms commonly do so by repackaging borrowers’ loans and selling them to the investors. This arrangement enables the platform to originate loans to the borrowers proactively without the need for the matches to actually occur. Thus, lenders and borrows do not have a direct contractual relationship, but rather transact with the platform separately. The platforms profit from the spread between the loan’s interest rate and the rate of return promised to the investors. This had been the most popular model in China before the 2006 Interim Measures on Online Lending. Since its nature is different from the traditional P2P definition, it is sometimes called ‘marketplace lending’. Previously, CreditEase（宜信）, one of the largest Chinese P2P lending platform, adopted this model.

IV. The 2016 Interim Measures on Online Lending: Main Elements

The 2016 Interim Measures on Online Lending is China’s first instrument enacted specifically for the online lending market, setting up a regulatory regime in a comprehensive and systematic manner. It has a total of 47 articles which are divided into five parts, covering all important aspects of the online lending industry. Contravention of the 2016 Interim Measures on Online Lending may attract administrative penalty and even criminal penalty.[27]

A. Business Scope of Online Lending Platform

According to Article 2 of 2016 Interim Measures on Online Lending, the term online lending is defined to mean direct lending made among individuals through the Internet platform. Individuals include natural persons, legal persons, and other organizations. Importantly, the role of the internet platform is restricted to be just an online lending information intermediary institution, whose function is to provide information-related services only, such as information search, information release, credit rating, information exchange and credit matching. In other words, the online lending platform cannot act as a financial intermediary.

[26] Tyler Aveni, ‘New Insights into An Evolving P2P Lending Industry: How Shifts in Roles and Risk Are Shaping the Industry’ Microfinance Robustness Program (MRP) (August 2015), 19.

[27] 2016 Interim Measures on Online Lending, art 40.

The transaction between borrowers and lenders is direct lending in that the borrower pays the principal and interest directly to the lender. The online lending platform enters into agreements with the lender and the borrower in relation to the expense standards and payment modes for the information services it provides.[28] Lenders and borrowers that participate in online lending must be real-name registered users verified by the platform.[29] It is the lender who ultimately has power to make the lending decision. Without the lender's authorization, the online lending platform cannot make decisions on behalf of the lender in any form.[30]

As a general principle, the platform cannot provide credit enhancement services, nor should it pool funds in a direct or indirect manner.[31] To assist with compliance, the 2016 Interim Measures on Online Lending enumerates a total of twelve specific activities that the online lending platform is not allowed to carry out, including but not limited to, directly or indirectly raise funds for the platform itself;[32] directly or indirectly accepting or pooling the lenders' funds;[33] providing credit enhancement services by directly or indirectly providing guarantee or promising guaranteed principal and interest to lenders;[34] conducting the asset securitization business or assigning claims in such forms as packaged assets, securitized assets, trust assets and fund shares.[35] Those prohibitions effectively outlaw other business models than the client segregated account model, such as the guaranteed return model and the platform lender model.

B. Registration Requirement of Online Lending Platforms

Under Article 5, setting up an online lending platform needs to go through a three-step procedure: first, get a usual business license from the company registry which is the State Administration of Industry and Commerce and its local branches; second, conduct recordation and registration with the local financial regulatory authority at the place where it is based; third, apply for a relevant telecommunications business permit from the competent communications agency, which is the Ministry of Industry and Information Technology and its local branches. The business license in the first step and the business permit in the third step are general in nature and thus are not very difficult to get. The recordation and registration requirement in the second step is specific to the online lending business. However, it does not involve substantive merit review, nor is there any special requirement in terms of minimum registered capital, paid-up capital or capital reserve.

Hence, it represents a light-touch regulatory approach towards the establishment of online lending platforms. The purpose is to let market forces decide on the fate of online lending platforms. It is made clear that recordation and registration do not constitute the recognition and evaluation of the management capability, regulatory compliance degree and credit status of the online lending platform.[36]

[28] 2016 Interim Measures on Online Lending, art 20.
[29] 2016 Interim Measures on Online Lending, art 11.
[30] 2016 Interim Measures on Online Lending, art 25.
[31] 2016 Interim Measures on Online Lending, art 3.
[32] 2016 Interim Measures on Online Lending, art 10(1).
[33] 2016 Interim Measures on Online Lending, art 10(2).
[34] 2016 Interim Measures on Online Lending, art 10(3).
[35] 2016 Interim Measures on Online Lending, art 10(8).
[36] 2016 Interim Measures on Online Lending, art5(2).

On 28 November 2016, the CBRC, Ministry of Industry and Information Technology, and State Administration of Industry and Commerce, jointly issued the Guideline on the Administration of Recordation and Registration of Online Lending Information Intermediary Institutions (2016 Guideline on Online Lending Registration).[37] It provides detailed information on relevant issues in relation to registration, such as what are the supporting documents, how long is the processing time and how the materials should be processed. As the Chinese regime adopts a registration procedure rather than an approval process, the platform can get registered as long as they provide all relevant supporting materials. Local governments need to issue their own local rules to implement the national law, and local governments have raced to use this legislative power to make rules to promote the online lending industry in their regions.

On 14 February 2017, Guangdong Province firstly issued a consultation paper on the registration matter, providing further details on how the registration matter will be dealt with. Notably, it contains a provision under which the online lending platform is encouraged, albeit not required, to introduce strong legal person shareholders, increase their registered and paid-up capital to RMB50 million and above, and hire persons with rich work experience in financial institutions to be their senior managers.[38] Although this is an aspirational rather than mandatory provision, it clearly shows the intention of Guandong government to make its online lending industry stronger and more professional.

C. Lending Limits and Custodian Requirement

As online lending is inherently risky, it is important that the lenders are suitable for the investment. In principle, the lender that participates in online lending should have investment risk awareness, risk identification capability and experience of investing in non-principal guaranteed financial products, and be familiar with the Internet.[39] The online lending platform should remind lenders in a conspicuous manner of online lending risks and prohibited conduct for confirmation by lenders. And it is the duty of the platform to conduct due diligence assessment of the age, financial status, investment experience, risk appetite, and risk tolerance, among others, of lenders. The online lending platform cannot provide trading services to any lender that has not been subject to risk assessment.[40]

To limit the exposure of investors to the risk of online lending, investment caps are imposed according to the types of investors. This is also consistent with the function of online lending which is to provide small funding to SMEs, start-ups and individual consumers. Specifically, the balance of loans of the same natural person on one online lending platform cannot be more than RMB 200,000 yuan; for a legal person or any

[37] Wangluo Jiedai Xinxi Zhongjie BeiAn Dengji Guanli Zhiyin [Guideline on the Administration of Recordation and Registration of Online Lending Information Intermediary Institutions] (issued by CBRC, Ministry of Industry and Information Technology, and State Administration of Industry and Commerce, 28 November 2016).

[38] Guangdongsheng Wangluo Jiedai Xinxi Zhongjie Jigou BeiAn Dengji Guanli Shishi Xize [Guangdong Province Implementing Rules on the Administration of Recordation and Registration of Online Lending Information Intermediary Institutions] (issued on 14 February 2017).

[39] 2016 Interim Measures on Online Lending, s14.

[40] 2016 Interim Measures on Online Lending, s26.

other organization, the upper limit is set as RMB one million yuan. Further, there are also caps on the total balance of loans obtained by the same person from different online lending platforms: for natural persons, the cap is RMB one million yuan, and for legal persons, it is capped at RMB five million yuan.[41] It should be noted that the above limits for lenders are maximum, and the online lending platform can set stricter lending limits according to the risk assessment results of the specific lender.[42]

Further, in response to the outbreak of scandals where platform owners absconded with funds in the past few years, it is required that the online lending platform separate its own funds and the funds of lenders and borrowers for management, and select a qualified banking financial institution as the custodian of the funds of lenders and borrowers.[43]

On 22 February 2017, the CBRC issued the Guideline on the Custodian Business for Online Lending Funds (2017 Guideline on Custodian Business), providing further details on how the custodian business can be carried out.[44] It clarifies that only commercial banks can provide fund custodian services for online lending businesses.[45] This precludes the possibility of having as custodians other types of banking institutions such as policy banks. The commercial bank should set up special custodian accounts and cannot outsource the relevant work such as account opening, trading information handling and trading password verification.[46] Further, the online lending platform can hire only one custodian.[47] This effectively outlaws the so-called joint custodian model where banks and third-party payment institutions jointly act as custodians. As many banks are concerned about their potential liabilities arising from custodian business, it is made clear that as a general principle, custodians do not provide guarantee for online lending activities and will not be held liable for lending defaults.[48]

D. Information Disclosure

Information disclosure has long been the central plank of financial regulation with the important function of creating an efficient market and preventing fraud and other forms of market misconduct. The 2016 Interim Measures on Online Lending devotes a whole chapter to the issue of information disclosure. The online lending platform should, on its official website, adequately disclose to lenders the borrowers' basic information, basic information on projects needing funding, risk assessment and possible risks, utilization of funds in matched but unexpired projects, and other relevant information.[49] The platform is also required to publish its annual report in a designated section of its official website.[50]

[41] 2016 Interim Measures on Online Lending, s17.
[42] 2016 Interim Measures on Online Lending, s26.
[43] 2016 Interim Measures on Online Lending, s28.
[44] Wangluo Jiedai Zijin Cunguan Yewu Zhiyin [Guideline on the Custodian Business for Online Lending Funds] (issued by China Banking Regulatory Commission on 22 February 2017).
[45] 2017 Guideline on Custodian Business, s5.
[46] 2017 Guideline on Custodian Business, s12.
[47] 2017 Guideline on Custodian Business, s14.
[48] 2017 Guideline on Custodian Business, s2, s22.
[49] 2016 Interim Measures on Online Lending, s30.
[50] 2016 Interim Measures on Online Lending, s31.

Given the importance of information disclosure, there are three mechanisms to ensure the truthfulness, accuracy and completeness of the information disclosed. First, market intermediaries are introduced to act as gatekeepers. The information disclosure must be audited by an accounting firm on a periodic basis; the online lending platform should also introduce a law firm, an information system security assessment or any other third-party institution to assess the regulatory compliance and soundness of information systems of the institution.[51] Second, the online lending platform should submit information disclosure announcements and relevant documents for future inspection to the local financial regulatory authority at the place where it conducts industrial and commercial registration, and place them at the place of domicile of the institution for the reference of the public.[52] Finally, the directors, supervisors and senior executives of the online lending platform should discharge their duties in a faithful and diligent manner, ensuring that the disclosed information is true, accurate, complete, timely and fair and contains no false records, misleading statements or material omissions.[53]

On 28 October 2016, the National Internet Finance Associate of China (NIFAC) issued two implementing rules on information disclosure, namely the Standard on Internet Finance Information Disclosure for Online Lending (2016 Standard on Information Disclosure)[54] and the NIFAC Rule on Self-regulation of Information Disclosure.[55] There are a total of 96 items for disclosure, of which 65 are mandatory and 31 encouraged. They are divided into three categories. The first category is the institutional information about the online lending platform, including the basic information (e.g., the platform's name, registered and paid-up capital), governance information (e.g., directors, supervisors, senior management and actual controller), accounting information and major events such as mergers, divisions and bankruptcy. The second category contains information related to the projects seeking funds, including the basic information of the borrower and the information about the project. The third category of information is statistics about the operation of the online lending platform, such as the total trading value, the total number of transactions, the total number of borrows, the total number of lenders and the total value of loans to be repaid.

V. Implications and Evaluations

A. The Online Lending Industry Facing Big Reshuffle

As discussed earlier, China's online lending market underwent a phase of explosive growth in the past few years, with online lending platforms having mushroomed across the country. In 2015, for example, the number of the platforms grew by almost 40%, but the growth rate slowed down to about 10% in 2016.[56] This is because the

[51] 2016 Interim Measures on Online Lending, s31.

[52] 2016 Interim Measures on Online Lending, s31.

[53] 2016 Interim Measures on Online Lending, s32.

[54] Hulianwang Jinrong Xinxi Pilu Geti Wangluo Jiedai [Standard on Internet Finance Information Disclosure for Online Lending] (issued by the National Internet Finance Associate of China on 28 October 2016).

[55] Zhongguo Hulianwang Jinrong Xiehui Xinxi Pilu Zilv Guanli Guifan [NIFAC Rule on Self-regulation of Information Disclosure] (issued by the National Internet Finance Associate of China on 28 October 2016).

[56] The figures were calculated using the data collected from Wang Dai Zhi Jia.

online lending market suffered from an outbreak of scandals in late 2015 and China started to tighten the regulation of the market from then on. For instance, in December 2015, it was exposed that an online lending platform called Fanya Metal Exchange had illegally raised more than RMB 40 billion; later in the same month, an even bigger scandal came to light involving a Shenzhen-based platform known as Ezu Bao which had reportedly bilked investors for more than RMB50 billion in about one and a half year; and in April 2016, the Shanghai-based Zhongjin group was found to have illegally raised more than RMB30 billion. As of June 2016, there were a total of 1778 problematic platforms, representing 43.1% of all platforms.[57]

It is against this background that the 2016 Interim Measures on Online Lending was promulgated as an effort to clean up the market. Further details are fleshed out by the three important implementing rules, namely the 2016 Guideline on Online Lending Registration, the 2016 Standard on Information Disclosure and the 2017 Guideline on Custodian Business. Together, within a short span of time, they have now set up a relatively complete regulatory regime for online lending in China, putting an end to the previous lawlessness situation which resulted in orderless growth of the underlying market. In general, this represents a positive development and has been welcomed by the market as evidenced by the rebound of trading volume in November 2016.

The newly established legal regime will undoubtedly have far-reaching implications for the online lending market in China. Although it is hard to predict with precision at this early stage, what is certain is that the online lending industry is going to face a storm of reshuffle. In fact, on 13 April 2016, four months before the promulgation of the 2016 Interim Measures on Online Lending, the CBRC had issued a notice to launch a campaign to manage the risks of online lending and crack down on fraudulent P2P lenders.[58] The valuable information and experience obtained from the campaign may have informed the drafting of the 2016 Interim Measures on Online Lending, and now the new regime provides a solid legal basis for continuing to carry out the campaign.

As discussed before, the role of the online lending platform is restricted to be purely informational intermediaries and cannot be financial intermediaries. It is not allowed to provide credit enhancement services, nor can it use securitization techniques. This effectively rules out the legality of other business models than the client segregated account model. It is estimated that more than half of China's online lending platforms will have to change their business models which can be a painful process for many. Coupled with the new requirements in relation to custodian, information disclosure and registration, it is likely that many small and weak platforms with poor internal control mechanisms may be driven out of the market. In principle, this is exactly what is needed, as those platforms are more likely to have problems in practice. From a comparative perspective, there are simply too many online lending platforms in China and the market needs to be more concentrated to allow the emergence of online

[57] See official website of the China Banking Regulatory Commission, http://www.cbrc.gov.cn/index.html

[58] Guanyu Yinfa P2P Wangluo Jiedai Fengxian Zhuanxiang Zhengzhi Gongzuo Shishi Fangan de Tongzhi [Notice on Issuing the Implementing Plan for the Work on Managing Risks of Online P2P Lending] (issued by the China Banking Regulatory Commission on 13 April 2016).

lending giants which will become national champions and even compete on the international level.

B. More Collaboration Between Online Lending Firms and Banks

Another important change brought about by the new regime might be that there will be more collaboration between online lending platforms and traditional banks. As discussed earlier, the online lending platform is required to appoint a custodian which will be commercial banks. In fact, due to the high incidence of problems and scandals, the online lending industry as a whole suffered significant reputational damage. Many platforms thus tried to have collaboration with banks, such as having banks act as custodians, to restore and improve their credibility. However, many banks were very reluctant to do so because they were concerned about the potential liability arising from the provision of custodian services. Before the promulgation of the 2017 Guideline on Custodian Business, only four percent of online lending platforms succeeded in securing custodian services from banks.

Now, the 2017 Guideline on Custodian Business sets out detailed provisions on the role and responsibility of the custodian, thereby alleviating the liability concerns of the banks. It provides that fund custodians shall undertake the responsibilities for the formal examination of real-name account opening, performance of contractual agreements, and overall agreement of lending trade orders, and shall not undertake the substantive examination of the authenticity of information on projects needing funding and lending transactions.[59] Importantly, it is made clear that the custodian will not be held liable for lending defaults.

Hence, banks will be more willing to provide custodian services to online lending platforms. This actually presents a very attractive new business opportunity for banks whose traditional source of revenue, namely the spread between deposit rate and loan rate, has been narrowing significantly in recent years. To be sure, the custodian requirement introduces a new item of cost which will be ultimately transferred to the borrowers. This cost is however well justified as it can effectively prevent fraudulent activities, particularly the so-called runaway issue (pao lu, namely platform owners absconding with funds), which had occurred with a high level of frequency in the past few years. For instance, in 2015 and 2016, there were a total of 3056 cases of problematic platforms, and 32% of them (982 platforms) were in the category of runaway issue.[60] The custodian fee that banks will charge is not regulated, but subject to the negotiation between the platform and its custodian bank. It is hoped that as many banks will likely enter into the custodian services market, competition amongst them will help drive down bank fees and keep them at a reasonable level.

C. The Central-Local Cooperative Regulatory Framework: Innovative but Uncertain

The 2016 Interim Measures on Online Lending sets up a multi-layered regulatory architecture which comprises multiple regulators at both the central and local level. Overall, the CBRC acts as the lead regulator for China's online lending market,

[59] 2016 Interim Measures on Online Lending, art 72(3).
[60] The figure was calculated on the basis of the data obtained from Wang Dai Zhi Jia.

empowered to develop rules for the supervision and administration of the business activities of online lending platforms as well as carry out conduct of business regulation.[61] The current financial regulatory framework in China has the defining feature of being sectors-based, with three sector-specific regulators responsible for banking, securities and insurance respectively, including the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC). [62] Online lending is considered something similar to banking business in China and hence falls within the jurisdiction of the CBRC.

In fact, the idea of assigning online lending to the jurisdiction of the CBRC is not initiated by the 2016 Interim Measures on Online Lending. As early as in 2011, the CBRC already claimed jurisdiction over online lending by issuing a notice on the potential risks of online lending. [63] As online lending operates outside of the traditional banking system, it is seen as part of the shadow banking system in China. In 2014, the Chinese central government, namely the State Council, promulgated an important document with respect to the regulation of shadow banking in China, known as Circular No. 107.[64] This instrument lays the groundwork for the allocation of regulatory responsibilities for shadow banking amongst different regulators, under the principle of 'separate operation, separate regulation'. [65] However, it does not specify who regulates internet finance businesses, largely because back then, the Chinese government was unsure of the proper way of regulating internet finance. Rather, it authorizes the central bank, namely the People's Bank of China (PBOC), to coordinate with other relevant regulators to work out how best to regulate internet finance businesses. One year later, in 2015, the PBOC led a group of ten government agencies, including, inter alia, the CBRC, CSRC and CIRC, issued a rule to divide the regulatory responsibilities for various types of internet finance businesses. [66] For instance, the CSRC is tasked with regulating equity crowdfunding while online lending is assigned to the CBRC. Hence, the 2016 Interim Measures on Online Lending just reaffirms the authority of the CBRC over the online lending market.

Further, as online lending is a form of Fintech involving the application of technology, other governmental agencies also perform important regulatory functions. First, the Ministry of Industry and Information Technology has responsibility for conducting supervision over the telecommunications business involved in the online lending business activities. Second, the Ministry of Public Security has power to conduct supervision over the security of Internet services provided by online lending platforms,

[61] The 2016 Interim Measures on Online Lending, s4.

[62] For a more detailed discussion of the institutional structure of China's financial regulation, see Hui Huang, 'Institutional Structure of Financial Regulation in China: Lessons from the Global Financial Crisis' (2010) 10(1) *The Journal of Corporate Law Studies* 219.

[63] Zhongguo Yinjianhui Bangongting Guanyu Renrendai Youguan Fengxian Tishi de Tongzhi [Notice on Relevant Risks of Peer to Peer Lending by the General Office of China Banking Regulatory Commission] (issued by China Banking Regulatory Commission on 23 August 2011).

[64] Guowuyuan Bangongting Guanyu Jiaqiang Yingzi Yinhang Jianguan Youguan Wenti de Tongzhi [Circular of the General Office of the State Council on Relevant Issues of Strengthening the Regulation of Shadow Banking] (State Council Circular No. 107, 2013) (hereinafter Circular No. 107).

[65] Robin Hui Huang, 'The Regulation of Shadow Banking in China: International and Comparative Perspectives' (2015) 30 *Banking and Finance Law Review* 481.

[66] Guanyu Cujin Hulianwang Jinrong Jiankang Fazhan de Zhidao Yijian [Guiding Opinion on the Promotion of Healthy Development of Internet Finance Businesses] (issued by a group of ten government agencies led by the PBOC, on 18 July 2015).

investigate and punish violations, and crack down on financial crimes involved in online lending businesses. Third, the State Internet Information Office is responsible for conducting supervision over financial information services and Internet information contents.

Importantly, the regulatory framework has a local dimension. Provincial governments are authorized to conduct recordation and registration of online lending platforms within their respective jurisdictions. In practice, this task will be performed by the agency called financial work office (jinrong gongzuo bangongshi) set up by provincial people's governments. Apart from governmental agencies, self-regulatory bodies, notably the National Internet Finance Association of China, are involved in the supervision of the conduct of their members. It should be noted however that self-regulatory bodies in China are usually subject to the regulatory oversight of the relevant governmental regulatory agencies. For instance, the National Internet Finance Association of China is actually under the control of the PBOC.

This central-local cooperative supervisory arrangement is an innovative mechanism with a number of important advantages. The local authority is familiar with and proximate to the market within its jurisdiction. Compared to the central government, the local government should have a closer sense of the development and attendant risks in the market place. It may be privy to local information that the central government does not possess or pay adequate attention to. This is particularly important in a top-down society like China where the central government imposes tight control over the financial market on the basis of the limited information (sometimes false information) it obtains from local governments. For instance, the governor of LiaoNing Province has recently admitted that the province had faked its economic figures for years, dealing a big blow to the national statistics credibility.[67]

Further, the local government should be better able to adapt elements of its supervisory arrangements to meet the needs of the local market and its users through tailor-made rules. The local government has a natural intimacy with the local market and is likely to be more sensitive to the local conditions. They can respond to the local problems more quickly than the central government. On the legislative side, under China's law-making regime, it takes considerably longer time to pass a national law than a local regulation. On the enforcement side, the proximity of the local authorities enables them to better monitor and supervise the market on a real-time basis.

The arrangement is however not without its challenges. Like the long-standing debate on the effect of the competition among American states for corporate charters, there are legitimate concerns over whether the local authorities will race to the top or the bottom in regulating its own online lending markets. The Internet has no boundaries, which renders unimportant the place to set up the online lending platform. It is certainly possible that the local authority may try to attract more platforms to its region by setting more lax registration standards. Further, under the arrangement, the local governments need to bear the cost of regulation.

[67] Frank Tang, 'Chinese Province Admits to Cooking its Books' *South China Morning Post* 18 January 2017.

Hence, the local government may pass the bucks to the central government, particularly because the delineation of responsibility is not clear-cut. This may raise a raft of issues in practice. For instance, if an online lending platform commits misconduct, is it the responsibility for the local government or the central government? Who should come to handle the case, the local authority or the CBRC? The local authority is responsible for the registration process, but interestingly enough, it also has power to impose penalties on misbehaving platforms.[68] Then, how should the CBRC perform its regulatory role? Should the CBRC step in only when the local authority fails to regulate for various reasons such as local protectionism? It will be a challenge to ensure that sophisticated as it is, the central-local cooperation does not create regulatory conflicts, gaps and overlaps.

It is hoped that the above issues might be mitigated by the self-interest of the local government under the pressure of market competition. The law and finance literature has demonstrated strong correlation between efficient financial markets and economic growth. This is because, as a World Bank report shows, efficient financial markets can help overcome barriers to market entry, thereby facilitating economic growth and reducing inequality.[69] Indeed, the local government is the beneficiary of the booming local market. The local regulatory arrangement may thus bestow a commercial incentive on the local government to ensure that it discharges supervisory responsibilities effectively through its vested interest in maintaining reputation and attracting investment.

D. Appropriateness of The Regulatory Approach: A Comparative Perspective

In essence, the significance of the 2016 Interim Measures on Online Lending lies in the legalization of online lending through a system of registration, disclosure, lending limit and obligation that is designed to achieve two main objectives, namely facilitating the growth of the online lending market and protecting financial consumers. The regulatory challenge, always, is to prevent abuses without stifling market development and innovation. Fintech represents not only a shift in digital technology, but more importantly a paradigm change in finance and growth. Around the world, regulators are still getting to grips with the risks and realities of internet finance. This part will thus evaluate the appropriateness of China's regulatory approach from a comparative perspective.

1. Law and Development: Regulation or Prohibition?

At a fundamental level, China's regulatory approach towards online lending is consistent with its gradualist style of economic reform which is carried out on a trial-and-error basis. In the interest of providing ample room for the development of internet finance, China firstly adopted a laissez faire approach towards it. This may seem somewhat strange as China's financial regulation is traditionally characterized by conservatism and repression. To a large extent, before the promulgation of the 2016 Interim Measures on Online Lending, there was effectively a regulatory vacuum for online lending, leading to the 'wild west' quality of the existing online lending market. Nevertheless, it should be recognized that this loose regulatory environment

[68] 2016 Interim Measures on Online Lending, s40.

[69] Stiin Claessens and Enrico Perotti, 'The Links between Finance and Inequality: Channels and Evidence' (2005) World Bank Report.

had been conducive to the Internet Finance players thriving in areas such as online lending and online payments. A report issued by McKinsey Corporate Banking praised China's "open, supportive regulatory environment" in making China the largest P2P lending marketplace in the world.[70] This 'development first and regulation later' approach has long been regarded as a successful experience of China's impressive economic development.

In Japan and Taiwan,[71] online lending is strictly prohibited to avoid its potential risks, but this approach is not an option for China. According to a report issued by Mr Liu Mingkang, the former chairman of the CBRC, despite the serious problems with online lending platforms, there is little need for a blanket prohibition on online lending, as the overall systemic risk currently posed by online lending in China is relatively small.[72] Indeed, regulation rather than prohibition should be a more appropriate approach. To be sure, a defect in the regulatory response to financial market scandals is that it is reactive rather than proactive. The law follows the impugned behaviour of the online lending platforms and changes to repair the things as done. This may come with significant costs, but the law does not seem to have the ability of foresight and cannot prevent the abuse before it occurs. The opportunity cost can be prohibitive if prophylactic rules were put in place to prevent rather than cure, particularly in an emerging area such as Internet Finance where innovation is highly valued. Internet finance such as online lending can be an important tool to facilitate China's transition from financial repression to financial liberalization, and ultimately help realize its goal of 'Public entrepreneurship, innovation' (dazhong chuangye, wanzhong chuangxin).

2. UK: Special License and Minimum Capital Requirements

As noted before, the UK is the birthplace of online lending, with Zopa, the world's first P2P lending platform, founded as early as 2004. Online lending platforms are required to be pure matchmakers, and the client funds must be in the custody of a third party. Hence, online lending platforms in the UK such as Zopa and Lending Circle adopt the client segregated account model for carrying on business.[73] The UK's current P2P regulatory framework came into existence in April of 2014, when the Financial Conduct Authority (FCA) published the Policy Statement 14/4, entitled *The FCA's Regulatory Approach to Crowdfunding over the Internet, and the Promotion of Non-Readily Realisable Securities by Other Media: Feedback to CP13/13 and Final Rules*. This document sets out detailed rules specifically pertaining to loan-based (P2P) and investment-based crowd-funding (equity crowdfunding). It should be noted that separate rules apply to the two different types of crowdfunding platforms since the FCA considers online lending to be less risky than equity crowdfunding.

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[70] Ngai, J. et al., 'Disruption and Connection: cracking the Myths of China Internet Finance Innovation', *McKinsey Greater China FIG Practice*, 2016, http://www.mckinsey.com/~/media/mckinsey/industries/financial%2520services/our%2520insights/whats%2520next%2520for%2520chinas%2520booming%2520fintech%2520sector/disruption-and-connection-cracking-the-myths-of-china-internet-finance-innovation.ashx+&cd=1&hl=en&ct=clnk&gl=hk

[71] Eleanor Kirby and Shane Worner, "Crowd-funding: An Infant Industry Growing Fast," Staff Working Paper of the IOSCO Research Department (2014) 32.

[72] LIU Mingkang, *Internet Finance and Regulation in China*, Fung Global Institute Report (August 2015), 31.

[73] Patrick Jenkins, "US peer-to-peer lending model has parallels with subprime crisis: Credit quality of some loans is triggering concerns," *Financial Times*, May 30 2016.

First, any firm wishing to enter the online lending market after 2014 "must first secure full authorization from the FCA."[74] According to a later document the FCA issued, in deciding whether to grant authorization of crowdfunding businesses, the FCA will look at a range of factors, including planned activities and related risks, budget and resources (human, systems and capital), and a running website to demonstrate user interface.[75] Second, disclosure obligations are imposed on platforms, ensuring that "customers interested in lending…had access to clear information, which would allow them to assess the risk and to understand who will ultimately borrow the money."[76] Third and most notably, a minimum capital requirement is introduced, under which online lending platforms are required to have at least 20,000 BRP in legal capital.[77]

There are some other regulatory requirements, including reporting requirements for firms to send information to the FCA, a plan to ensure existing loans continue to be managed in case the platform crashes, rules the firm must follow when holding clients' money and rules on dispute resolution. The FCA further supervises the platforms through engaging with senior management members, monitoring websites, and reviewing monthly management information. If it notices irregularities, it has power to step in and intervene to "ensure proper protection of consumers."[78] Apart from the regulation of the FCA, online lending platforms in the UK also establish a self-regulatory body called Peer-to-Peer Finance Association.

3. US: Burdensome Securities Regulatory Process

In contrast with the UK, the US does not restrict online lending to any particular business model. Prosper and Lending Club, the two main online lending platforms in the US, both adopt the notary model where the work of originating loans rests on a partner bank instead of the platform itself and based on the loan, the platform issues payment dependant notes to lenders.[79] Hence, unlike their counterparts in the UK, Prosper and Lending Club are not purely informational intermediaries.

Although the US is one of the world's leading jurisdictions for development in the Fintech sector, its regulatory regime for P2P lending is overly complex, including both federal and state requirements. At the state level, each individual state takes different approaches to regulation, ranging from a complete ban, to "allowing platforms to elicit borrowers and sophisticated lenders only," to "allowing activity in accordance to SEC regulatory criteria." [80] The focus of discussion here is on the regulation at the federal level.

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[74] The FCA's Regulatory Approach to Crowdfunding over the Internet, and the Promotion of Non-Readily Realisable Securities by Other Media: Feedback to CP13/13 and Final Rules (March 2014), p.6.

[75] FCA, A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media, February 2015, para 44.

[76] Ibid, p.49.

[77] The FCA's Regulatory Approach to Crowdfunding over the Internet, and the Promotion of Non-Readily Realisable Securities by Other Media: Feedback to CP13/13 and Final Rules (March 2014), para12.3.

[78] Ibid.

[79] United States Government Accountability Office, *Person-to-Person Lending: New Regulatory Challenges Could Emerge as the Industry Grows*, July 2011, 13.

[80] United States Government Accountability Office, *Person-to-Person Lending: New Regulatory Challenges Could Emerge as the Industry Grows*, July 2011, 26-30.

As early as in 2008, the US federal securities regulator, namely the Securities and Exchange Commission (SEC), exercised authority over online lending, by sending Prosper, one of the US's largest P2P lending platforms, a cease and desist letter.[81] The SEC declared that P2P lending platforms such as Prosper must comply with the 1933 Securities Act, on the grounds that the loans/notes being offered by the platforms constitutes as "investment contracts" as defined in *SEC v. W.J. Howey Co.*,[82] and also "notes" as found in *Reves v. Ernst & Young*.[83] Hence, it is necessary to register the loans/notes with the SEC, because it is "unlawful to sell securities without an approved registration statement and prospectus."[84] To become registered, "more than 32 pieces of information" in addition to accounting records of the "last 3 years of the company's business" were required. This is a very burdensome requirement which amounts to carrying out an initial public offer, thereby imposing significant compliance costs on online lending platforms. Most online lending platforms in the US did not have the capital and resources to survive the securities regulatory process and eventually were pushed out of the market. Even the UK's Zopa chose to leave the US altogether to avoid dealing with the stringent regulations.

The 2011 Dodd-Frank Wall Street Reform and Consumer Protection Act suggested an alternative approach in which P2P lending platforms would be regulated entirely through the Consumer Financial Protection Bureau (CFPB), a federal institution created as a result of the global financial crisis of 2008. The CFPB's "broad discretion over financial entities" would allow it to adjust regulatory requirements where necessary, giving start-ups potential to enter into the market, and to effectively monitor these platforms more closely.[85] Unfortunately, a proposal to implement this idea did not pass in the US Congress. Now, with the new President Trump's desire to disempower the CFPB, it seems unlikely that P2P regulation in the US will improve anytime soon.[86]

4. Hong Kong: Uncertain and Burdensome Rules under Existing Regulation

Hong Kong has not set up any specific regulation pertaining to online lending businesses, but rather relies on its existing law to regulate online lending. The actions and services online lending platforms provide could potentially fall under some existing legislations depending on the model that the platform has chosen and how the loan was issued.

On 7 May 2014, the Hong Kong Securities and Futures Commission ("SFC") issued *Notice on Potential Regulations Applicable to, and Risks of, Crowd-funding Activities* (2014 SFC Notice), warning that people who engage in crowdfunding activities may

[81] Paul Slattery. 'Square Pegs in a Round Hole: SEC Regulation of Online Peer-to-Peer Lending and the CFPB Alternative' (2013) 30(1) *Yale Journal on Regulation* 233, 252.

[82] *Securities and Exchange Commission v. W. J. Howey Co*., 328 U.S. §§293, 301 (1946).

[83] *Reves v. Ernst & Young*, 494 US 56 (1990).

[84] Paul Slattery. 'Square Pegs in a Round Hole: SEC Regulation of Online Peer-to-Peer Lending and the CFPB Alternative' (2013) 30(1) *Yale Journal on Regulation* 233, 257.

[85] Ibid, p.261.

[86] Singletary, M., 'Trump's election does not bode well for the Consumer Financial Protection Bureau', *The Washington Post,* 24 November 2016.

be subject to relevant securities laws and regulations.[87] In particular, financial return crowdfunding such as P2P Lending and equity crowdfunding may be subject to the provisions of Securities and Futures Ordinance (Cap. 571) ("SFO") and/or the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) ("C(WUMP)O").[88] It further suggested that other legislation such as the Money Lenders Ordinance Cap. 163 (MLO) and the Anti-Money Laundering and Counter Terrorist Financing (Financial Institutions) Ordinance Cap.615 (AMLO), will apply when necessary.

Under Section 103 of the SFO, "It is an offence under the SFO for a person to issue any advertisement, invitation or document which to his knowledge is or contains an invitation to the public to acquire securities or participate in a collective investment scheme, unless the issue has been authorized by the SFC or an exemption applies." In the 2014 SFC Notice, the SFC specifically uses the term "unsecured loan" to address P2P lending platforms, and it has stated in the past that any "credit linked note" "where the return and redemption are linked to the credit risk of either a single reference entity or a basket of reference entities" would be considered a security.[89] Hence, online lending platforms following the notary model, such as Prosper or Lending Club in the US which issues credit linked notes, need to be licensed with the SFC.

Pursuant to s7 of the MLO, "no person shall carry on business as a money lender without a license" issued by the licensing court unless exemption apply. Under s2 interpretation of the MLO, "money lender means every person whose business (whether or not he carries on any other business) is that of making loans or who advertises or announces himself or hold himself out in any way as carrying on that business." Thus, lenders engage in traditional P2P lending platforms will highly likely fall afoul of the MLO since it is impossible for individual investors to obtain a money lenders license. However, Schedule 1 Part 2 of the MLO provides certain loan exemptions which the lenders may rely on. Under Schedule 1 Part 2, the fifth exemption stated that "A loan made by a company or a firm or individual whose ordinary business does not primarily or mainly involve the lending of money, in the ordinary course of that business" will be excluded from the application of s7 of the MLO[90]. Nevertheless, the applicability of this exemption to P2P lenders remains unclear and probably requires interpretation by the Hong Kong courts. As a result, it is highly risky to operate traditional P2P Lending platforms in Hong Kong due to the uncertain legality of investors to engage in such activities as an unlicensed lender.

Given the uncertainties and burdensome applications under the existing regulatory regime, the operation of P2P Lending business in Hong Kong is highly restricted and has to be carefully devised to work around the regulation. In 2016, a newly

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[87] Hong Kong Securities and Futures Commission, *Notice on Potential Regulations Applicable to, and Risks of, Crowd-funding Activities,* 7 May 2014.

[88] The C(WUMP)O is less relevant to debt crowdfunding (online lending) than equity crowdfunding in that online lending platforms do not usually issue debentures within the meaning of securities. The prospectus requirement for securities offerings is mainly based on relevant disclosure sections in the C(WUMP)O, including s38, s38B, and s38D for companies incorporated in Hong Kong, and s342 and s342C for companies incorporated outside of Hong Kong.

[89] Fong, A. 'Regulation of peer-to-peer lending in Hong Kong: state of play', *Law and Financial Markets Review,* vol.9, no.4, 2015, p. 254.

[90] Sch1, Pt 2, (v) of MLO.

established firm called MoneySQ.com found an innovative way to carry out its online lending business, claiming itself as the first legitimate P2P lending platform in Hong Kong. It essentially adopts the platform lender model: MoneySQ.com has a money lenders license under the MLO, and then partners up with Bridgeway, an assets management company properly licensed by the SFC to manage assets.[91] Through Bridgeway, MoneySQ issues its investment invitations to "professional investors" to raise fund, which is exempted from the authorization and prospectus requirement. MoneySQ.com then uses the fund to originate micro-loans to borrowers with interest rates ranging from 6% to 15%, and the professional investors participating in the collective investment scheme expect to receive a fix rate of return about 5% or 5.5%. Sophisticated as it is, this arrangement is not totally free of legality concerns, particularly in relation to the promising of 'a fix rate of return' by the platform.[92] Anyway, the SFC seems to acquiesce in the MoneySQ arrangement. Since the platform was established in March 2016, the SFC has not expressed any objection to its legality.

5. A Matter of Balance: The Case of China

As noted earlier, China's new regulatory regime is intended to encourage the healthy development of the online lending industry to provide an alternative source of finance for entrepreneurship and innovation, while at the same time protect investors from predatory and fraudulent activities. This is a matter of balance which needs to be handled with care according to the local conditions in China.

To start with, the Chinese law requires that online lending platforms perform the role of purely informational intermediaries and appoint third-party custodians to keep client funds. This means that China's online lending platforms can only adopt the client segregated account model. From a comparative perspective, it follows the UK approach, and differs from the US practice. Is this a right choice? The answer is in the positive. While the restriction on the business model may impede the development of the market, it is necessary to achieve the goal of protecting investors and controlling financial systemic risks. In the US where the notary model is used, several recent high-profile scandals in the online lending market have attracted widespread attention. For instance, Renaud Laplanche, the former CEO of Lending Club, forced to resign due to his mismanagement of investor's assets.[93] Patrick Jenkins, a financial journalist of Financial Times, further describes the current P2P Lending bubble in the US is parallels with the subprime mortgage crisis in 2008.[94] This has prompted the US Treasury to recommend a tighter regulations for P2P Lending business in their recent report.[95]

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[91] Official website of MoneySQ, https://www.moneysq.com/

[92] The promise may be misleading to the extent that investment made to a collective investment scheme is never risk-free. It thus may constitute an offense of fraudulently or recklessly inducing people to invest money pursuant to s107 of the SFO which may attract criminal or civil liabilities

[93] Hutchinson, Wall Street Daily, May 2016, also see U.S. Department of the Treasury, "Opportunities and Challenges in Online Marketplace Lending", May 2016, https://www.treasury.gov/connect/blog/Documents/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf

[94] Patrick Jenkins, "US peer-to-peer lending model has parallels with subprime crisis", Financial Times, May 2016, https://www.ft.com/content/84f696ec-2436-11e6-9d4d-c11776a5124d

[95] US Department of the Treasury, "Opportunities and Challenges in Online Marketplace Lending", May 2016,

If the US has difficulty handling the above problem, it can be only worse in China whose regulatory capacity is more limited. In fact, the high proportion of problematic platforms in China shows that the risks of online lending have already manifested under the transformation of business model. At the very least, it is sensible for China to impose the restriction at this stage of market development. It should be noted that in recognition of the acute problem of lack of trust between borrowers and lenders, online lending platforms are still allowed to invite third parties such as guarantee companies and insurance companies to provide guarantee for lending transactions. This is a pragmatic comprise which facilitates the growth of the market while controlling the risk exposure of platforms.

The lending limit is the key regulatory tool introduced under the 2016 Interim Measures on Online Lending, which gives technical effect to the regulatory objectives. Conceptually, imposing lending limits is not surprising given that online lending is seen as a form of inclusive financial innovation which is meant to provide small-value finance to start-ups, SMEs and individual consumers. Nevertheless, it has generated a heated debate over its appropriateness, with many complaints from the industry that it may unduly restrict the amount of credit to be provided and ultimately stifle the contribution of the online lending market to economic growth.

The author recognizes the difficulty in achieving a workable balance between market growth and investor protection, but believes that the lending limit is well justified under China's local conditions. First, the lending limit clearly helps control the risks of online lending, particularly default risk and systemic risk. This is important in China where there is generally a lack of big data of credit history. Even worse, due to its relatively brief track record of operation, China's online lending market has yet to accumulate the depth of data and experience on which traditional lenders rely. China's central bank, namely the PBOC, has established a national credit reference centre since March 2006, but online lending platforms are not yet covered in the system at the time of writing.[96] It is important for China to move without delay to build a credit reference system for internet finance, or include internet finance within the PBOC's existing system.

Second, the lending limit is closely related to the existing law on illegal fundraising, namely *Interpretation of the Supreme People's Court of Several Issues on the Specific Application of Law in the Handling of Criminal Cases about Illegal Fund-raising* (SPC Interpretation on Illegal Fundraising).[97] Under s3(1) of this instrument, criminal liability may arise if an individual absorbs public savings of not less than 200,000 yuan illegally or in disguised form, or an entity absorbs public savings of not less than 1 million yuan illegally or in disguised form. The lending limits mesh well with the criteria for criminal sanctions against illegal fundraising. This can prevent traditional

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https://www.treasury.gov/connect/blog/Documents/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf

[96] See official website of the Credit Reference Centre of the PBOC, http://www.PBOCcrc.org.cn/zxzx/index.shtml

[97] Zuigao Renmin Fayuan Guanyu Shenli Feifa Jizi Xingshi Anjian Juti Yingyong Falv Ruogan Wenti de Jieshi [Interpretation of the Supreme People's Court of Several Issues on the Specific Application of Law in the Handling of Criminal Cases about Illegal Fund-raising] (issued by the Supreme People's Court of the PRC on 13 December 2010, effective 04 January 2011).

offline illegal fundraising activities from migrating online under the cloak of online lending and financial innovation. Indeed, many online lending platforms previously adopted the so-called 'offline plus online' model to consummate transactions: the transactions were marketed offline and then executed online. For instance, CreditEase reportedly employed more than 30,000 salespersons to advertise its services and find suitable borrowers.[98] This strategy is useful because face-to-face marketing is more acceptable for Chinese people, particularly those in economically less developed regions. But this may allow illegal private lending in the disguise of online lending, and thus is now prohibited.[99]

Third, although there is no such rule in the UK and the US, the Chinese online lending regulation does not have relevant requirements adopted in those jurisdictions. As discussed before, the Chinese online lending platforms only need to register themselves with the local authorities, and there are no substantive requirements such as minimum capital requirements. Online lending platforms are not required to have special financial services licenses, apart from a general telecommunication license which can be easily obtained. In contrast, the UK regime contains license and minimum capital requirements. The lending limit may perform similar functions as those requirements in protecting investors and controlling financial systemic risks.

Finally, as a matter of commercial reality, the loans made through online lending platforms are generally small in value even in jurisdictions that do not impose lending limits. For instance, in the UK, the average loan amount borrowed by personal consumers via online lending platforms in 2014 was GBP5,471; the average loan amount borrowed for business purposes in 2014 was GBP73222.[100]

Hence, the lending limit is theoretically sound and fits well into the exiting legal regime in China. Its practical effect may not be unduly restrictive to the point of stifling the development of the market at the present time. It is also flexible in the sense that the numerical limits can be adjusted to stay aligned with market developments in the future. Based on the above analysis, it is suggested that in addition to the lending limits, there should also be limits on investments in online lending so as to better protect investors by limiting their risk exposure.

VI. Conclusion

Internet finance such as online lending has been promoted as an important vehicle to foster a more inclusive financial system in China under its national strategy of supply side reform (gongjice gaige). The arguably overzealous encouragement of the Chinese government, coupled with the fact that there was effectively a regulatory vacuum before 2016, helped China's online lending market grow rapidly over the past few years, but also gave rise to many gaping problems therein.

The promulgation of the 2016 Interim Measures on Online Lending marks a watershed in the history of China's online lending regulation. This has been followed

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[98] Tyler Aveni, "New Insights Into An Evolving P2P Lending Industry: How Shifts in Roles and Risk Are Shaping the Industry" Microfinance Robustness Program (MRP), 23.

[99] The 2016 Interim Measures on Online Lending, s10(4).

[100] FCA, A review of the regulatory regime for crowdfunding and the promotion of non-readily realisable securities by other media, February 2015, para 20, 26.

by three implementation rules which were issued in quick succession to flesh out more details. Together, they have now made up a relatively complete regulatory regime for online lending, which will have far reaching implications. It will usher in a new era for the development of China's online lending market, with platforms facing a period of reshuffling. It will also provide opportunities for more collaboration between online platforms and traditional banks.

In essence, the significance of the new regulatory regime lies in the legalization of online lending through a system of registration, disclosure, lending limit and obligation that is designed to achieve two main objectives, namely facilitating the growth of the online lending market and protecting financial consumers. These two objectives may be consistent in some instances, while in other situations they may be diametrically opposed. Hence, the challenge of finding the best possible way to regulate online lending consists of nothing more than trying to strike a balance between the two regulatory objectives. Importantly, the balance is a delicate one and needs to be adjusted according to the local conditions.

The Chinese experience contributes to the international debate on the way in which online lending should be regulated to maintain the right balance. While the laissez-faire policy taken by the Chinese government before 2016 generated significant costs as evidenced by the high proportion of problematic platforms, it provided ample room for the online lending market to grow. A total prohibition on online lending is simply not a viable option for China. Further, the objectives are illustrated in some significant regulatory elements, particularly the lending limit. Based on a comparative analysis of the Chinese experience with those in other jurisdictions such as the US, the UK and Hong Kong, it is submitted that the Chinese regime is generally sound and less onerous. The central-local cooperative supervisory arrangement is innovative, but not without concerns. It remains to be seen whether the regulatory regime will function as efficiently as expected in practice.