



## Status quo of China's P2P lending regulation

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### ABSTRACT

This research illustrates the status quo of China's P2P regulation by corresponding the current laws and rules with the business models and risks analyzed above. In this paper, China's current P2P lending regulation is presented in terms of the existing laws, department rules, industry associations, and the adjudication situation of problem platforms. Through the research, it can be seen that the existing laws have blank and gray spaces for P2P lending industry. New department rules are expected to make up those legal gaps but have relatively low legal force. Regarding the industry self-regulation, the national industry association has just been established and has low coverage rate, while the local associations seldom have substantial effects. Besides, the adjudication situation of problem platforms is not ideal.

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## Introduction

This research illustrates the status quo of China's P2P regulation by corresponding the current laws and rules with the business models and risks analyzed above. In this paper, China's current P2P lending regulation is presented in terms of the existing laws, department rules, industry associations, and the adjudication situation of problem platforms. Through the research, it can be seen that the existing laws have blank and gray spaces for P2P lending industry. New department rules are expected to make up those legal gaps but have relatively low legal force. Regarding the industry self-regulation, the national industry association has just been established and has low coverage rate, while the local associations seldom have substantial effects. Besides, the adjudication situation of problem platforms is not ideal.

## Existing laws

In China, peer-to-peer lending is classified as the category of private lending and is interpreted by the existing laws like the General Principles of the Civil Law, the Contract Law, other laws and related judicial interpretations published by the Supreme People's Court (CBRC, 2015). However, there are no formal specific laws to specially regulate P2P lending industry.

## Legal relationships in P2P lending

### Lending relationship

The lending relationship between borrowers and lenders is the most basic relationship in peer-to-peer lending. The 12<sup>th</sup> chapter of the Contract Law provides an important basis for private lending's legitimacy. The Private Lending Judicial Interpretations released by the Supreme People's Court in 2015 explain the online lending relationship further.

### Intermediary relationship

Peer-to-peer lending platforms establish a convenient and efficient platform for borrowers and lenders, providing intermediary services for both sides. Platforms are responsible for reviewing and publishing borrowing information, making contacts for borrowers and lenders, collecting

and allocating repayments, and receive service fees in return. The 426<sup>th</sup> rule of the Contract Law says that clients should pay intermediaries in promoting the establishment of contacts (NPC, 1999). This shows that P2P lending platform's role as an intermediary is approved by the laws. However in practice, many platforms are not pure information intermediaries, but credit intermediaries that have a capital pool. In this situation, there are no clear laws to regulate. Although these platforms play a role that banks do, they are not banks and are not regulated by bank regulations in China.

### Principal-agent relationship

The relationship between P2P lending platforms and custodian banks or third-party payment companies is a principal-agent relationship. Based on the demand of fund security, lending capital should be isolated from P2P platforms' own capital. Therefore, P2P platforms are supposed to entrust qualified banks to manage and monitor the lending capital. Additionally, many platforms have not realized the cooperation with banks but entrust to third-party payment companies to achieve the same goal. The 21<sup>st</sup> chapter of the Contract Law elaborates principal-agent relationship. In practice, there are essential differences among platforms' custodian institutions. Some custodian banks are responsible for monitoring and managing the funds, but most third-party payment companies only provide payment channels and deposit accounts (Lingyi, 2015).

### Guarantee relationship

The guarantee relationship refers to the relationship between borrowers and guarantors. Most P2P platforms in China introduce guarantee mechanism into operations to protect investors' benefits and increase competitiveness. This is an important business process for platforms to attract lenders, as most investors in China consider guarantee as a crucial requirement on investment decision-making. The Guaranty Law explains related behaviors in detail. However, it does not clear the illegal nature of P2P platforms' self-guarantee by using the own capital to compensate default loans.

### Debt assignment relationship

Table 1 China's P2P lending relevant laws and regulations

Content	Laws & Regulations	Ministry & Time
Illegal fund-raising	Measures for the Banning of Illegal Financial Institutions and Illegal Financial Business Operations	The State Council, 1998
	Illegal Fund-Raising Judicial Interpretations	The Supreme People's Court, 2011
Internet information security	Decisions on Maintaining Internet Security	The National People's Congress, 2000
Privacy protection	Decision on Strengthening the Protection of Online Information	The National People's Congress, 2012
Anti-money laundering	Anti-money Laundering Law	The National People's Congress, 2006
Telecommunication	Administrative Measures on Internet Information Services	The State Council, 2000

Table 2. The Draft Measures' requirements

	Risks	Requirements
Asset side	Moral hazard	No investing in stock market
	Asset diversification risk	No selling other institutions' financial products No crowdfunding
Platform side	Moral hazard	No self-financing No collecting funds
	Credit review risk	Industry central database
	Information disclosure risk	No exaggerating profitability Information disclosure requirements
	Liquidity risk	No offering loans No dividing maturities
	IT risk	Internet information security laws
	Credit risk	No self-guarantee
Liability side	Lack of financial knowledge	No advertising to non-real-name registered users

There are several modes of debt assignment in P2P lending. Platforms' own or purchased creditor rights, institutional investors' P2P funds, and secondary market for P2P projects all refer to the transfer of debt. The Contract Law allows creditors to assign their rights under an agreement to a third party, providing that the debtors are notified (NPC, 1999). However in practice, platforms or institutional investors make borrowers have very little information about real lenders to make the transfer more smooth (Lingyi, 2015). There has not been any interpretation about this practical contradiction yet.

### **Relevant laws and regulations**

China's P2P lending relevant laws and regulations in Table 1

#### **Illegal fund-raising**

Illegal fund-raising is the most serious problem in China's P2P lending market, damaging investors' benefits badly and decreasing investors' confidence in the whole industry.

#### **Internet information security**

All money transfer activities in P2P lending are operated through the Internet. Weak Internet information security will definitely bring great damage to both platforms and investors.

#### **Privacy protection**

P2P lending refers to large amounts of both borrowers' and investors' personal information. Privacy protection is an important part of the lending process for P2P platforms' continuing operation.

#### **Anti-money laundering**

Laundering money through online trading is a trend for the crime of money laundering in such an Internet era. P2P market provides an opportunity to people who want to launder money, as those people may release fake borrowing projects first and then invest by the dirty money.

#### **Telecommunication**

P2P lending belongs to value-added telecommunication service in China, which is supervised by related regulations.

### **Department rules: the Draft Measures**

The CBRC together with the Industry and Information Technology (MIIT), the Minister of Public Security (MPS), and the National Internet Information Office (IIO) jointly published a discussion draft of the Interim Administrative Measures for the Business Activities of Online Lending Information Intermediary Institutions (the Draft Measures) on December 28, 2015 for public review and comments within an 18-month transitional period. This marks that China's regulation of P2P lending industry has taken a substantial step forward. The Draft Measures release implementing rules mainly on P2P lending's basic principles, record management, business requirements, consumer protection and legal responsibilities.

#### **Crystalize the regulatory authorities**

Central and local financial supervision departments jointly regulate P2P lending service industry. The CBRC is the main regulator for P2P lending, which is responsible for making unified policies and regulations. The MIIT and IIO are in charge of supervising the field of telecommunication and Internet information respectively. In addition, the MPS is responsible for the crackdown on financial crimes in P2P lending. Local governments are responsible for compliance guidance, record management, and risk treatment within respective jurisdictions.

#### **Improve the rules on legal relationships**

For the intermediary relationship, the Draft Measures reasserts the P2P lending platforms' role as information intermediaries and requires platforms to include Online Lending Information Intermediary in their names. As for the principal-agent relationship, the rules require platforms to use custody accounts with qualified banks to hold client money. Regarding with the guarantee relationship, the Draft Measures explicitly put forward that platforms cannot provide self-guarantee. But for the debt assignment relationship, the rules remain unclear about transfers of creditor rights in P2P lending.

#### **Basic principles and business requirements**

The basic principles of Draft Measures include no credit enhancement services, no capital pool,

and no illegal fund-raising. In addition, there are 12 detailed forbidden behaviors listed on the Draft Measures. As the nature of regulation is to control risks, this research will present the requirements of the Draft Measures with corresponding risks analyzed before (Table 2).

### Industry association

The China Internet Finance Association (CIFA) was formally established in March 2016. It has the same administrative level with the Payment & Clearing Association of China (PCAC), which was established in May 2011 and also directed by the PBC. There are 437 members on the first name list of the association, which includes 39 P2P lending platforms (CIFA, 2016).

The CIFA is a national Internet finance self-regulatory organization, implementing the State Council's decisions and arrangements on standardizing and developing Internet finance. Under the direction of the PBC, the CIFA performs duties of industry self-discipline and plays a positive role in both industry standardization and legal rights protection. The CIFA is mainly responsible for making rules for different business types in Internet finance, which includes the P2P lending industry; specifying penalty mechanism to improve the industry's constraining force, and building a positive image and creating a favorable atmosphere for the whole industry.

Actually, before the establishment of CIFA, there have been dozens of local P2P lending industry associations. However, these associations are mixed with both good and bad. On the one hand, high-quality associations are keeping progress. On the other hand, low-quality associations gradually become specific platforms' back stages. Some associations are established by the local governments, such as Beijing and Shanghai P2P lending industry association. But most other associations are founded by independent corporate organizations. These associations do not have enough constraining force and thus cannot play a good role in industry self-regulation.

### Problem platform adjudication situation

According to the MPS, there have been more than 500 problem platforms be submitted to investigations until May 2016 (MPS, 2015). And

there are only 13 cases have been pronounced judgment until July 2016 (The Paper, 2016), constituting only 3% of total cases. In these 13 judicial cases, 6 cases are sentenced as the crime of fund-raising fraud, other 6 cases are the crime of illegally absorbing public deposits, and 1 case is the crime of contract fraud. 11 platforms' inquisition time is more than 12 months, especially Youyi Lending, with 38 months' inquisition time. Besides, Dongfangchuangtou has the shortest inquisition time with 9 months, as the actual controller surrendered himself to the law. In terms of the compensation situation, one platform has the compensation ratio of 60%, 4 other platforms have the ratio of 40%, another one platform has the ratio of only 3%, other platforms have not published their compensation ratios.

To sum up, the adjudication situation of problem platforms is not ideal, as too many cases have not been disposed of. It can be seen that such cases are difficult to investigate and obtain evidence since investors are scattered across the whole country.

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