Asia Alert

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China Fintech – the Beginning of a New Regulatory Era?

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This alert outlines the recent potentially seismic shifts in the Fintech regulatory landscape affecting the regulation and commercial business model of China's online micro-lending company ("**MLC**") sector – a part of the Mainland economy that has become systemically important, with large, internationally well-known players such as Tencent, ANT Group, Ping An and Lufax playing a highly visible role.

These recent draft regulations and guidelines published by the Chinese banking and anti-trust regulators show the new regulatory approach which is proposed to be taken:

- the November 2, joint consultation paper published by the People's Bank of China (PBOC) and the China Banking and Insurance Regulatory Commission (CBIRC) on the regulation of online MLCs (the "**MLC regulations**"); and
- the November 10, draft anti-monopoly guidelines issued by the State Administration for Market Regulation Commission (SAMR) (the "**Anti-monopoly Guidelines**").

The MLC Regulations

The commercial setting

China's regulators have been concerned for some time about the systemic risks to the Chinese economy posed by online MLCs and the enormous amount of leverage made easily available by those lenders and their partners – a number of the consumer loan Fintech players put up only 1 percent of the loan amount, whilst collecting substantial loan referral fees from the bank lenders who make most of the loan amounts available. The regulatory spotlight on the sector is evident in the PBOC's November 6, China Financial Stability Report (2020), for example, which includes discussion about proper regulation of the online lending sector and related activities.

What happens next?

The key intended regulations are described in more detail below and include (i) no cross-provincial online lending except with prior regulatory approval; (ii) a 30 percent minimum contribution requirement for MLCs making loans; and (iii) more stringent capital and leverage requirements.

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It is difficult at this point to predict precisely the impact of the proposed MLC Regulations (some parts of which are still unclear/open to interpretation), but it is expected that the proposed regulations would likely impact the growth and size of MLCs (especially small to medium-sized MLCs).

All of this may result in online MLCs relying more on establishing or maintaining partnerships with banks in order to sustain or grow their businesses, in particular because of the capital adequacy aspects of the proposed new regulations. However, at this point, it remains to be seen precisely how the MLC industry will react.

More detail

The consultation period for the proposed MLC Regulations closed recently (December 2, 2020) and the regulations are expected to be implemented shortly (the exact timing is unknown at this point).

Currently, MLCs are not regulated by the Chinese banking regulators – the CBIRC and PBOC – but are regulated instead by the local financial regulation offices which review and enforce different laws and regulations relating to the financial sector in each province or region. These local offices deal with a range of matters and so are not particularly well configured to effectively regulate MLCs. The purpose of the proposed regulations is therefore to tighten the regulation of MLCs, and to make them subject to certain requirements and restrictions which typically apply to properly capitalized banks.

Some believe that the proposed regulations are long overdue – there has been increasing pressure on regulators to take a proactive stance with respect to the regulation of MLCs, especially given that a number of MLCs have undergone significant growth and their local regulators are not equipped to adequately deal with what have become (in some cases) systemically-important enterprises.

Key provisions – the draft MLC Regulations

The key provisions in the Fintech regulations which are likely to materially impact the businesses of MLCs are as follows:

1. Each MLC is required to obtain a license from the banking regulator and to renew that license every three years.
2. There were already restrictions on the geographic scope of MLC business licenses, but MLCs were using the online space to circumvent this restriction, acting in the "grey zone". Under the regulations, online lending to borrowers in provinces other than the province in which the MLC is based/licensed will not be permitted except with prior regulatory approval.
3. For joint loans (with banks), MLCs will be required to contribute no less than 30 percent of the total loan amount. Historically, some Fintech operations have contributed as little as 1 percent to jointly made consumer loans.
4. More stringent capital and leverage requirements: for example, the registered capital (equivalent to paid-in share capital) amount of certain MLCs must not be less than RMB5 billion, leverage (debt/net equity) caps are fixed at 1x and 4x for non-standardized funding (such as bank and shareholder loans) and standardized funding (such as bond and ABS financing), respectively.

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The introduction of the proposed regulations did not come as a particular surprise to the market because some Fintech players have been viewed in some quarters as effectively conducting a very large banking business without being subject to proper regulation (since they are categorized as "Fintech" enterprises, rather than as banks or financial institutions).

Impact on MLCs

MLCs currently work very closely with banks with respect to MLC core businesses, which are (i) providing customer referral and other related services to banks ("**referral services**") on a fee basis; and (ii) lending to customers via their online platforms (independently or jointly with banks) ("**customer lending**").

There is an expectation that the proposed regulations, once effective, would have a moderating effect on the size and growth of MLCs as they adjust their existing business models.

This is because the proposed regulations will place more restrictions on the customer lending activities of MLCs (in the form of, among other things, the geographic restriction, the 30 percent minimum contribution-to-joint-loans requirement and capital requirements). MLCs may respond by skewing their business models more in favor of referral services, or investing in/teaming up with banks in other ways, in which case MLCs may therefore be more inclined to enter into more/closer partnerships (whether on a referral or equity basis) with banks.

Larger MLCs will likely be able to weather the effects of the regulations better, given their stronger market and financial position as well as their links with the regulators.

Other aspects of Fintech regulation - the draft Anti-monopoly Guidelines

Another noteworthy regulatory development in the Fintech space is the draft Anti-monopoly Guidelines published by SAMR on November 10 – they are aimed at strengthening the regulation of internet/platform economy businesses in China. The period for public comments expired on November 30, but it is not clear when SAMR will formally promulgate the guidelines. Key intended changes flagged in the draft guidelines include:

- Adjusting key definitions/concepts (such as monopoly agreements and abuse of market dominance) under the anti-monopoly law to take into account the specific characteristics of internet/platform economy businesses – to enable more effective regulation of anti-competitive behavior in the sector.
- Explicitly providing SAMR's power to investigate, among other things, the use of algorithms and most favored nation clauses in anti-competitive conduct situations.
- Clarifying that VIE structures (which are commonly used by internet/new economy businesses to navigate sectoral foreign ownership restrictions) do fall within merger control review. This flags SAMR's express authority and intention to review proposed mergers between tech platforms that previously could have escaped review, since the treatment of VIEs fell into the "grey zone".

Again, the precise impact of these proposed guidelines on the Fintech sector is a little uncertain at this point. Much will depend on how aggressively the guidelines are policed by SAMR, but many expect there to be a meaningful level of impact on key

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players in the sector, especially since existing commercial practices designed to gain or consolidate market power are intended to become subject to closer regulatory scrutiny.

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