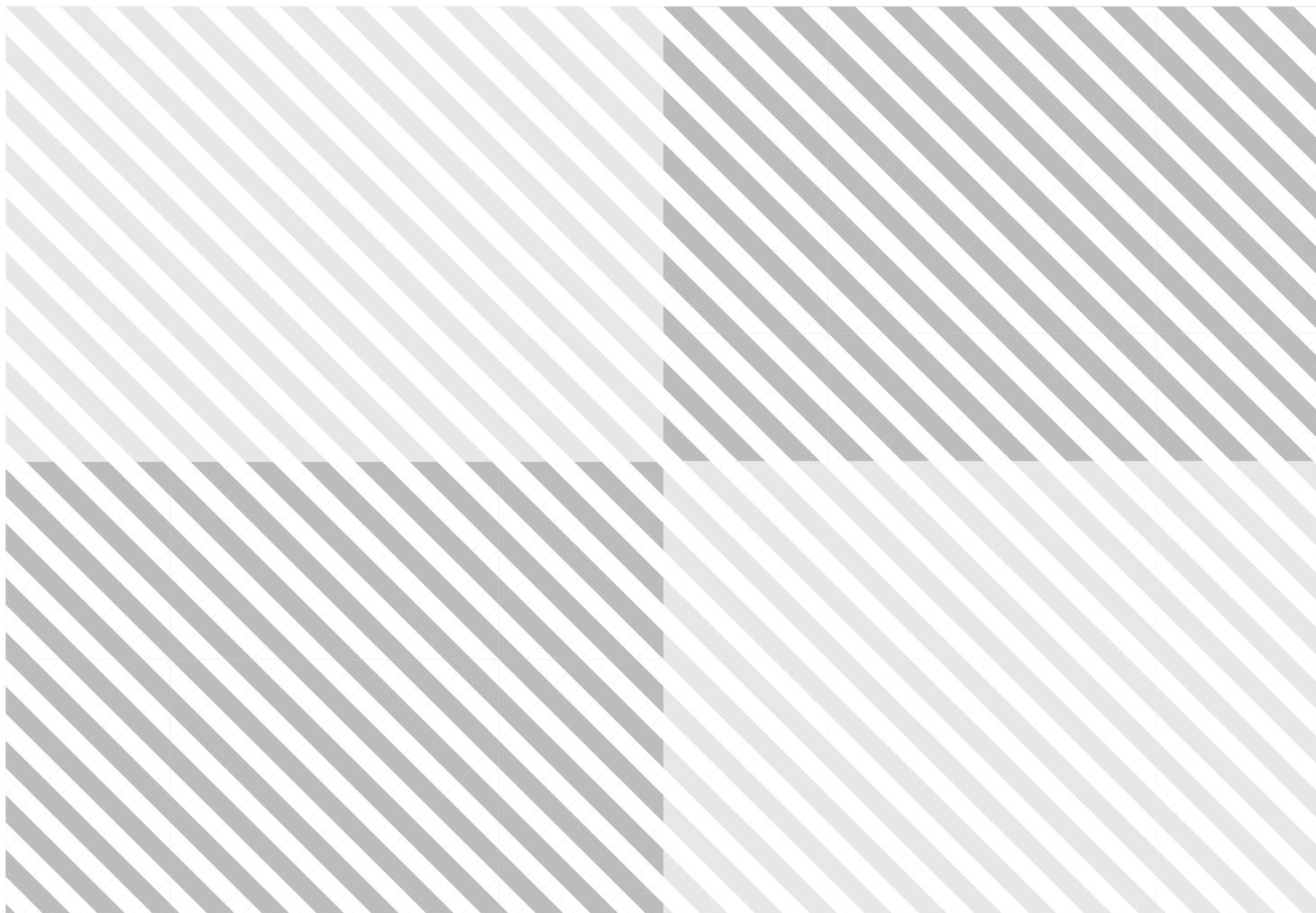


White Paper

# The Complex Regulatory Landscape for FinTech

## An Uncertain Future for Small and Medium-Sized Enterprise Lending

August 2016



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# Foreword



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Traditional banking-sector participants are witnessing an emergence of marketplace lenders (MPLs) that is profoundly changing the way individuals and businesses within the financial community interact. An estimated \$4.7 trillion in financial services revenue is at risk of being displaced by FinTech. This has made regulators increasingly aware that appropriate reform is needed, given MPLs' positioning in the financial services market, as well as their evolving business models and increasing institutional support.

Policy-makers are attempting to develop a regulatory framework for MPLs that encourages growth and innovation, while balancing the need for addressing systemic risk and safeguarding consumers. The applicability of current regulations, and the language of those forthcoming, need to be clear and transparent so FinTech firms can appropriately navigate their industry's ever-changing environment. Failure to do so will have a dramatic impact on MPLs' potential to improve the world economy as a whole. Furthermore, the regulatory architecture must remain dynamic to handle the innovation coming from MPLs and the fast pace at which they move and evolve.



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This publication highlights the major differences in the current regulatory frameworks between China, the UK and the US with respect to MPLs. In particular, it focuses on the differences regarding investor protection and securities laws; clearing, settlement and segregation of client money; risk retention and capital requirements; secondary servicer requirements; tax incentives; promotion of SME lending; credit analysis and underwriting; data protection; regulatory reporting; registration and licensing; debt collection; and interest rate regulation. It then examines and assesses the concerns that these differences raise for MPLs. We hope policy-makers will work together to create a standardized and accommodative framework for FinTech's growth and innovation.

# Acknowledgements

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**Figure 1: Interviews Conducted**

## 1) Regulatory Bodies



## 2) FinTech Companies



## 3) Other



# List of Abbreviations

|         |   |
|---------|---|
| ACH     | Automated Clearing House  |
| ADIC    | Administrative Department of Industry and Commerce  |
| AMBA    | Administrative Measures of Business Activities of Internet Lending Information Intermediary Institution |
| AML     | Anti-money laundering   |
| API     | Application programming interface   |
| APR     | Annual percentage rate  |
| B2B     | Business-to-business  |
| B2P     | Business-to-peer  |
| BBOR    | Borrowers' Bill of Rights   |
| B/S     | Balance sheet   |
| BSA     | Bank Secrecy Act  |
| CASS 7  | Client Assets sourcebook  |
| CBRC    | China Banking Regulatory Commission   |
| CFPB    | Consumer Financial Protection Bureau  |
| CIRC    | Chinese Insurance Regulatory Commission   |
| CLIC    | China Life Insurance Company Ltd  |
| CONC    | Consumer Credit (sourcebook)  |
| CRA     | Credit reference agency   |
| CRC     | Credit reference centre   |
| ECOA    | Equal Credit Opportunity Act  |
| EFTA    | Electronic Funds Transfer Act   |
| FCA     | Financial Conduct Authority   |
| FDIC    | Federal Deposit Insurance Corporation   |
| FICO    | Fair Isaac Corporation  |
| FSCS    | Financial Services Compensation Scheme  |
| GDB     | Guangdong Development Bank  |
| GLBA    | Gramm-Leach-Bliley Act  |
| GOPHD   | Guiding Opinions on Promoting the Healthy Development of Internet Finance                               |
| HCSTC   | High-cost short-term credit   |
| ICP     | Internet content provider   |
| IOFSSM  | Implementation Opinion on Financial Support for Small and Micro Enterprises Development                 |
| IPO     | Initial public offering   |
| IRS     | Internal Revenue Service  |
| ISA     | Individual savings account  |
| JOBS    | Jumpstart Our Business Startups (Act)   |
| MPL     | Marketplace lenders   |
| NIFA    | National Internet Finance Association   |
| NYSE    | New York Stock Exchange   |
| P2B     | Peer-to-business  |
| P2P     | Peer-to-peer  |
| P2PFA   | Peer-to-Peer Finance Association  |
| PBOC    | People's Bank of China  |
| PS      | Policy Statement  |
| RFI     | Request for Information   |
| RMB     | Chinese renminbi  |
| SBA     | Small Business Administration   |
| SEC     | Securities and Exchange Commission  |
| SFIA    | Shanghai Financial Information Association  |
| SLB 1.0 | Guiding Options of the Pilot Small Loan Business  |
| SLB 2.0 | Draft Rules of Non-Deposit Lending Institutions   |
| SME(s)  | Small and medium-sized enterprise(s)  |
| WDZJ    | Wangdaizhijia   |

# Executive Summary

This White Paper is the second in a series produced by the World Economic Forum's Global Agenda Council on the Future of Financing & Capital. The first publication, written in conjunction with Oxford University's Saïd Business School, examined the financial technology (FinTech) industry's contribution to small and medium-sized enterprise (SME) financing issues otherwise not addressed by traditional financial institutions.<sup>1</sup> The scope of this second publication delves deeper to examine the regulatory hurdles that marketplace lenders (MPLs) face as banking and securities regulators attempt to encourage financial innovation while protecting investors and consumers. The aim is to extract lessons learned and make broad recommendations for rule-makers as they move forward, namely through a comparison of competing regulatory regimes and methods, first-person interviews with private-sector managers and investors, and an in-depth case study of CreditEase, one of the largest industry participants.

While the world economy is still rebounding from the 2008 financial crisis, the funding gap for SMEs continues to grow. Since 2008, banks have been reluctant to lend for either of two reasons: their balance sheets are too fragile, or regulatory restrictions have increased following the crisis. FinTech has filled this void and has the potential to reshape the financial services industry, since many believe FinTech companies can cut costs more adeptly and assess risk, as well as offer an alternative to traditional lending markets.<sup>2</sup> The trend of the alternative banking sector is on the rise. As *The Financial Times* noted, "[t]he number of asset managers lending directly to companies in the US and Europe has more than doubled in the past two years, underlining fears about the rapid development of these financial intermediaries known as shadow banks".<sup>3</sup>

The nomenclature used to define FinTech companies in the market differs vastly depending on where the company operates and what type of business model is used. For this publication, the term MPL is used, defined as any non-depository institution that lends money to individuals or businesses through online activities. The current regulatory regimes of three representative markets – China, the UK and the US – are examined, as these markets are the largest in their respective regions and represent three different approaches to regulating the MPL market.

Competing regulatory methods are then compared and contrasted across a range of common concerns, including:

- *Investor protection and securities laws:* This is the key focus of regulators because MPLs provide investors with direct access to new and potentially riskier forms of investment.
- *Clearing, settlement and segregation:* Reliance on the traditional banking sector for clearing and settlement, combined with strong rules regarding the handling of client money, will strengthen confidence in the burgeoning industry.
- *Risk retention and capital requirements:* Advocates argue that risk retention and capital requirements will help ensure that MPLs operate prudently in managing financial risks and align their interests with investors.
- *Secondary servicer agreements:* Such agreements can reduce counterparty risk and provide additional investor protection against exposures to potential bankruptcies or operational failures.
- *Tax incentives:* If implemented appropriately, they can help promote the development of MPLs as a significant source of funding for SMEs.
- *Promotion of SME lending:* Policy-makers are including MPLs in their response to the SME funding gap.
- *Credit analysis and underwriting:* Technology and alternative data can help fill the credit information gap, but traditional data sources need to be expanded.
- *Data protection:* Requirements strengthen the controls on technology risk and improve investors' and borrowers' confidence in MPL.
- *Regulatory reporting:* Regulatory reporting requirements will help regulators understand the risks and benefits of the MPL model.
- *Registrations and licensing:* MPLs benefit from a single licensing agency, which allows for a more defined business and regulatory scope.
- *Debt collection:* As the MPL market develops, regulators will need to more clearly define roles and responsibilities of MPLs in the debt collection process.
- *Interest rate regulation:* Such regulation must balance the interest of borrowers and the profitability of the MPL industry.

As described later in more detail, each market has had a different approach to MPL regulation. For example, the US has taken a reactive approach, relying on existing rules and regulations to govern MPL. The UK, and to some extent, China, have been proactive, developing MPL-specific regulatory structures. To better understand the implications of these different approaches, industry commentary has been reviewed, and MPLs, regulators and other market participants have been interviewed, to identify the primary regulatory pain points. Their concerns are centred on three distinct buckets:

- *Regulatory uncertainty:* MPLs seek clarity and the certitude that comes from a transparent and coherent rule-making process. Ambiguous and/or shifting regulatory burdens can hinder financial innovation more than any other apprehension.
- *Transparency, fraud and self-regulation:* Self-regulatory bodies have proliferated globally to rein in cases of fraud and abuse. Regulators have even consulted with self-regulatory bodies when developing their response to MPL, recognizing that industry leaders may be best equipped to understand and respond to changing trends.
- *Standardization and data:* As these businesses grow beyond national borders, concerns develop on how to lawfully handle data, given piecemeal global privacy laws. The use of alternative data in making credit decisions also raises questions about potential unintended consequences that come with digitalization, such as discriminatory correlations, financial exclusion or penalization of borrowers with little or no digital footprint.

Although MPLs are the focus of this discussion, these challenges are not limited to them, and lessons can be learned that are applicable to the overall FinTech industry.

# Global FinTech Snapshot

## Introduction

The FinTech sector has grown dramatically in the past few years, and is on track to expand even further. According to Silicon Valley Bank, a US-based high-tech commercial bank, global FinTech investments are averaging \$50 million, with over 68% of deal activity at the Seed or Series A stage of the business's life cycle.<sup>4</sup> In fact, Goldman Sachs recently estimated that \$4.7 trillion in financial services revenues is at risk of being displaced by FinTech.<sup>5</sup>

Prior to the 2008 financial crisis, the traditional banking sector had considerable unmet demand, particularly in developed markets, and the vast majority of small and medium-sized enterprises (SMEs) in emerging markets went underserved. The crisis exacerbated this issue and threatened the collapse of the world's largest financial institutions. The post-crisis regulatory reform has been far-reaching for traditional banking-sector participants. Many regulators have been concerned with re-establishing stability in the financial system, whether through better recovery and resolution plans for banks or by implementing higher capital requirements. The latter has altered the economic viability of traditional banking-sector participants to originate loans, translating into a contraction of the credit supply for individuals and SMEs.

In response, financial markets and services were flooded with technology-driven innovation, whereby new non-depository institutions – referred to as peer-to-peer financing by Chinese regulators, loan-based crowdfunding platforms by UK regulators and marketplace lenders (collectively, MPLs) by US regulators – provided loans of various types and duration to end users through online and mobile channels. Some of these companies lend from their own balance sheets, commonly referred to as “balance sheet lenders”, and some serve as brokers between investors and borrowers, commonly referred to as “platform lenders”. This is a distinction relevant to regulators and will be discussed further.

MPLs are willing to provide many products and services to borrowers that traditional banking-sector participants avoided following the 2008 financial crisis. Traditional banking-sector participants have preferred to lend to large enterprises in light of the associated higher transaction costs, information asymmetry, personal guarantees and operational risks associated with SMEs. MPLs have the potential to directly benefit SMEs by extending the availability of credit and accelerating the loan process. Estimates from Goldman Sachs support this, noting that all of the \$177 billion in small business loans currently in the traditional banking system is at risk from non-bank disintermediation.<sup>6</sup>

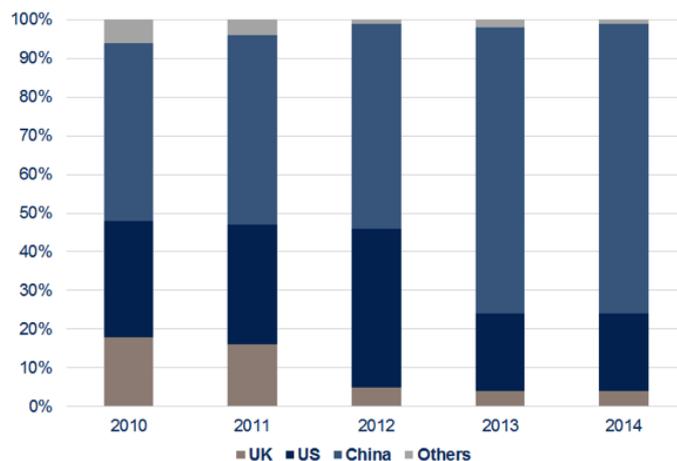
## FinTech Conundrum

At their best, MPLs are more agile and better able to fill gaps that traditional banks cannot, or are unwilling to, address. The latter are hindered by their legacy processes, older systems and branch-focused culture. As highlighted by the World Economic Forum, the factors contributing to MPLs' flexibility are their ability to provide unsecured lending, source funds from investors with higher risk appetites, apply innovative credit scoring models and operate with a lean set-up.<sup>7</sup> More importantly, much of the growth in MPLs is due to many not being regulated in the same way as traditional banking-sector participants. Regulators are becoming increasingly aware of this and recognize that appropriate reform is needed. In considering what type of reform to implement, regulators are balancing the need for a regulatory framework that ensures MPLs' activities do not create future supervisory issues, with the benefits of encouraging innovations that will provide borrowers with the necessary liquidity and financing.

## Major FinTech Markets

Three representative markets – China, the UK and the US – provide the scope for this White Paper. Each country is the regulatory leader within its respective region, but each has taken a different approach to MPL supervision. Chinese MPLs have grown rapidly (Figure 2) because of the limited financing channels currently available to borrowers, while UK and US MPLs have leveraged existing credit systems and more mature financial markets.<sup>8</sup> In addition, the specific issues faced by each market vary according to their particular market and regulatory structure.

**Figure 2: Market Share of MPLs by Loan Amount, \$ billion**



Source: HJCO Capital Partners. *When Finance Meets Internet: The Marketplace Lending Industry*. January 2016

China's FinTech market is expanding at an astonishing rate. By the end of 2015, China had become the biggest online financing market in the world, with total transactions exceeding \$150 billion.<sup>9</sup> Despite this rapid growth, a lack of clear regulatory guidance brought serious risks and issues of fraud to the public's attention. The latest infamous example is the Ezubao scandal, in which over 900,000 investors lost \$7.6 billion. To keep pace with the rapid growth, the Chinese government is now focused on providing greater regulatory guidance by establishing a suitable regulatory structure and feasible industry standards. This includes, but is not limited to, origination standards and capital requirements for MPLs.

Within developed markets, the UK government has been a leader in encouraging growth within its FinTech industry, providing the potential to drive innovation. In 2014, the UK FinTech market accounted for 80% of new European MPL-originated loans, according to estimates by Morgan Stanley,<sup>10</sup> while overall revenue volume was \$30 billion, according to estimates by EY.<sup>11</sup> The UK provides a unique market opportunity considering London has the highest concentration of financial institutions in the world.<sup>12</sup> MPLs prefer the country's regulatory approach to FinTech and its financial services infrastructure.<sup>13</sup> The UK's 2016 "Brexit" vote to leave the European Union may impact the country's MPL sector, as the current "passport" regulation rules allowing British firms to operate across Europe without greater regulatory hurdles may expire. However, at the time of writing, no major firms have left London, nor have any announced plans to do so. Finally, and according to a recent survey from Silicon Valley Bank, 39% of UK MPLs cited Europe as the greatest opportunity for growth, compared with 22% targeting the US and 15% Asia.<sup>14</sup>

The US has also seen rapid growth within FinTech, and traditional banking-sector participants are beginning to step into the ring. Goldman Sachs is currently launching its own MPL platform, while JPMorgan and Citi are developing relationships with OnDeck and Lending Club, respectively. US MPLs have also been successful in raising funds from venture capital firms and financial institutions. For example, in October 2015, Kabbage raised \$135 million in funding, led by Reverence Capital Partners and other investors including ING, Santander InnoVentures and Scotiabank.<sup>15</sup> Goldman Sachs estimated that lending grew 65-fold – from \$26 million to \$1.7 billion between 2009 and 2014 – on the two largest US platforms, Lending Club and Prosper.<sup>16</sup> However, as noted in this White Paper's "Private-Sector Outlook and Concerns" section, many US MPL participants believe that growth could have been greater if regulators harmonized the regulatory landscape and set out a clear vision for MPL supervision.

## Market Disparities

As FinTech firms in China, the UK and the US compete in the global marketplace, they must also navigate major differences in interest rate environments, credit infrastructures, government support for financial innovation, and the relative strengths within their technology sectors.

The differing interest rate environments between China, the UK and the US have led to disparities in how MPLs can provide financing to SMEs. Within China, where interest rates are not fully marketable and credit risk experience is limited, commercial banks are inclined to provide financing only to large companies offering MPLs a significant opportunity to step in and lend to the underserved SME market. In comparison, the UK and the US interest rate environments are more formalized and transparent, allowing MPLs to more effectively price and underwrite their loans. In addition, information on borrowers' credit history is readily available to UK and US MPLs, and credit agencies regularly report aggregated data on borrowers. However, traditional sources of credit information for SMEs still need to be strengthened.

The Chinese and UK governments have recognized the benefits of MPLs and released policies to support their activities, enabling such firms to better compete with US MPLs. In particular, the Chinese government has implemented the "Opinions of the general office of the State Council on the implementation of financial support for the development of small and micro enterprises" and the "Guiding opinions on promoting the healthy development of internet finance" that has addressed the importance of further developing online financing sources like MPL. Likewise, within the UK, the Financial Conduct Authority (FCA) has launched Project Innovate, a programme whereby "new and established businesses – both regulated and non-regulated – can introduce innovative financial products and services to the market".<sup>17</sup> While the US has lagged behind in implementing similar programmes, the Office of the Comptroller of the Currency recently released a White Paper setting forth its "vision for responsible innovation in the federal banking system", which specifically addresses FinTech.<sup>18</sup>

FinTech's basic technology infrastructure includes the use of alternative data, cloud computing, mobile internet and vertical search engine services. It took leading Chinese technology companies, such as Alibaba, Tencent and Baidu, three years to catch up with companies in the UK, the US and other developed markets.<sup>19</sup> Today, however, China is leading the way in the innovation of third-party payment platforms, such as Alipay and WeChat Payment. This rapid growth of technological innovations supports FinTech's development in China. Likewise, the UK and the US have focused on improving their technology sectors by providing support for innovation and growth. In December 2015, for example, the UK government announced it would increase investment in the technology sector, pledging £800 million over the next decade.<sup>20</sup>

# SME Environment

## Financing Issues

Despite their economic importance, SMEs have struggled to secure adequate financing. Over 200 million SMEs worldwide have no access to formal financial services, creating an over \$2 trillion gap in funding for capital investments and working capital that is crucial to increasing their growth prospects.<sup>21</sup> Traditional banking-sector participants perceive SME lending to be riskier, as it is harder to gauge borrowers' creditworthiness in light of limited information and history. The loans are also much more sensitive to macroeconomic shifts, and SMEs typically have fewer fixed assets for securing loans.<sup>22</sup>

## Global SME Lending

Major differences exist globally in the level and growth of SME lending. In June 2014, the China Banking Regulatory Commission (CBRC), the agency responsible for supervising and regulating the country's banking organizations, opened up financing channels for Chinese SMEs by adjusting how banks calculate the loan-to-deposit ratios on SME loans in order to encourage banks to lend to that sector.<sup>23</sup> Additionally, the CBRC reported that loans to micro and small businesses climbed to RMB 21.41 trillion (Chinese renminbi) in the first quarter of 2015.<sup>24</sup> According to estimates from the British Banking Association, net lending to SMEs in the UK amounted to £2 billion in 2015 despite applications for loans and overdrafts being lower than those in 2014.<sup>25</sup> Likewise, according to estimates by Goldman Sachs, the total addressable US small business lending market is \$186 billion, which accounts for only 1% of the total loan market at risk of disintermediation.<sup>26</sup>

## Job Creation

SMEs are considered the backbone of many world economies. Regulators need to be concerned about how current and forthcoming regulations will affect funding sources, such as MPLs. Within China, the government has taken many steps to promote job growth within the start-up industry. In April 2015, the State Council announced that it would increase certain tax breaks and subsidies to support job creation and entrepreneurship.<sup>27</sup> Such measures included giving guaranteed loans of as much as RMB 100,000 for small companies and providing social security subsidies to those that hire university graduates.<sup>28</sup> Within the UK, high-growth SMEs created 68% of all new jobs in 2012-2013, according to estimates calculated by Octopus Investments, a UK technology-focused venture capital firm.<sup>29</sup> In the US, the December 2015 Jobs Report noted that American businesses added back 252,000 jobs, with SMEs driving this improvement, creating nearly 2 million of the roughly 3 million private-sector jobs generated in 2014.<sup>30</sup> Furthermore, a stated objective of the Jumpstart Our Business Startups (JOBS) Act was to promote entrepreneurship that favours (self-)employment. This was achieved partly by promoting the emergence of alternative finance platforms, for example, equity crowdfunding.<sup>31</sup>

# Regulatory Environment

The regulatory regimes for MPLs within China, the UK and the US are still under development (Table 1). However, each market's regulatory response has largely depended on its experiences with MPL, its regulatory environment and the structure of its financial markets. As they develop further regulations, and to avoid dampening MPL development and growth, policy-makers within the three countries must remain aware of current trends and issues faced by MPLs, which are an important source of SME financing.

**Table 1: MPL Regulatory Overview**

|   |                   |               |                 |
|---|--|---|--|
| <b>Regulatory Approach to MPL</b>                             | Rule and principle based   | Principle based   | Rule based   |
| <b>Funding Source</b>   | Platform lender, as broker, and B/S lender   | MPL regulation limited to platform lending  | A hybrid of several different funding models   |
| <b>Securitization</b>   | Yes, but only sponsored by third parties   | No securitizations to date  | Yes, can be sponsored by both MPLs and third parties   |
| <b>Capital Requirement</b>                                    | No for platform lender; yes for B/S lender   | Yes for platform lender; no for B/S lender  | No   |
| <b>Risk Retention</b>   | No   | No  | No, but under consideration  |
| <b>Deposit Insurance</b>                                      | Yes  | No  | Yes  |
| <b>Client Funding Segregation</b>                             | Yes  | Yes   | No specific regulatory requirement, but applies in market practice                                 |
| <b>Disclosure to Investors</b>                                | Yes  | Yes   | Yes, when filing securities  |
| <b>Secondary Servicer Agreements</b>                          | No   | Yes   | No specific requirement, but institutional investors require MPLs to arrange substitute servicers  |
| <b>Tax Promotion</b>  | Yes, but only for early-stage FinTech firms  | Yes   | No   |
| <b>Promotion of SME Lending</b>                               | Yes  | Yes   | No   |
| <b>Data Protection</b>  | Yes  | Yes   | Yes  |
| <b>Anti-Money Launderers (AMLs)/Reporting/Info Disclosure</b> | Yes  | AML rules exist, but they are not yet extended to MPL   | May apply, depending on structure of MPL; bank partners must comply                                |
| <b>Disclosure to Borrowers</b>                                | Yes, in the SLB 1.0 for B/S lender; no specific requirement in the draft AMBA for platform lenders | Yes   | Yes, but fewer protections for SME borrowers   |
| <b>Registration Requirement</b>                               | Yes  | Yes   | Some state lending licensing laws  |
| <b>Credit Underwriting/ Credit Information</b>                | Existing CRC system that needs further development for SME lending                                 | Requirements for platform lenders; UK government promoting greater access to credit information | Requirements such as the ECOA apply; market participants calling for greater access to credit data |
| <b>Interest Rate</b>  | Requirement on interest rate cap   | Limited interest rate caps  | MPLs partnering with banks to utilize favourable usury laws  |
| <b>Clearing/Settlement</b>                                    | Two major settlement and clearing models with banks  | Partnering with banks   | Partnering with banks  |

Note: B/S = balance sheet; SLB 1.0 = Guiding Options of the Pilot Small Loan Business; AMBA = Administrative Measures of Business Activities of Internet Lending Information Intermediary Institution; CRC = credit reference centre; ECOA = Equal Credit Opportunity Act.

Source: Authors

## Business Models

MPLs operate two basic business models: balance sheet lending and platform lending. Balance sheet lenders utilize funding from the MPLs' own balance sheets to finance loans, thereby carrying the underlying credit risk of the loan.<sup>32</sup> Platform lenders, however, act merely as brokers, facilitating connections between lenders and borrowers, and do not take on credit risk.<sup>33</sup> The regulation of platform lending will often depend on who is borrowing or lending, and their level of sophistication. This White Paper refers to four basic categories of arrangements (Table 2): peer-to-peer (P2P) loans, which are consumer loans made by retail investors; peer-to-business (P2B) loans, which involve retail investors but are made for a business purpose; business-to-peer (B2P) loans, which are consumer loans made by institutional or "accredited investors"; and business-to-business (B2B) loans, which are business loans made by institutional or "accredited investors".

**Table 2: Platform Lending Arrangements**

| Type of Entity       | Type of Loan | Type of Investor              |
|----------------------|--------------|-------------------------------|
| Peer-to-Peer         | Consumer     | Retail or individual          |
| Peer-to-Business     | Business     | Retail or individual          |
| Business-to-Peer     | Consumer     | Institutional or "accredited" |
| Business-to-Business | Business     | Institutional or "accredited" |

Source: Authors

Platform lending also varies across the markets. For example, in the UK and China, loans are made through direct contracts between the investor and borrower, whereas in the US, platform lenders will often stand between the investor and the borrower. Some MPLs, however, have attempted to manage their risk exposure by using a hybrid of both balance sheet and platform lending. Each model raises particular regulatory challenges and prudential concerns that will be discussed further.

## Regulatory and Market Overview

Funding sources have largely defined the regulatory response to MPLs because MPLs provide investors direct access to a new and potentially riskier form of investment. MPLs that focus on small retail investors, for example, are likely to be scrutinized differently than those focusing on sophisticated institutional and/or accredited investors, or those that fund loans through their own balance sheets.

Regulators have also focused on prudential concerns related to funding sources, such as aligning the interests of platform lenders with their investors through risk retention rules or capital requirements. Further, there is concern that MPLs have not been exhaustively tested in differing interest rate and funding environments, and that investors may be vulnerable if MPLs have difficulty maintaining operations during funding shortfalls.

Platform lenders, which provide retail investors with direct access to this new market, raise significant issues about the need for proper investor protection and suitability requirements. Instances of funding mismanagement, as well as fraud and criminality within funding markets, have also drawn strong reactions from regulators, particularly in China.

### China

China's underdeveloped capital markets and reliance on bank financing have driven many investors and borrowers to "shadow banking" participants such as MPLs.<sup>34</sup> Prior to 2015, however, a legal and regulatory vacuum regarding MPL prevailed in China. Funding mismanagement and liquidity problems drew much public attention when the media published accounts of misappropriation, material misrepresentations and selling of inappropriate products to small investors by Ezubao, the platform lender. As of 2015, there were 896 problem platforms,<sup>35</sup> a 326% increase from 2014.<sup>36</sup>

In light of these issues, the People's Bank of China (PBOC), the country's central bank and primary banking supervisor, released in consultation with other Chinese central regulators the Guiding Opinions on Promoting the Healthy Development of Internet Finance (GOPHD), which provided the first detailed regulation of "internet finance."<sup>37</sup> The GOPHD outlines China's regulatory approach to MPL, as well as online payment platforms, equity crowdfunding, online portfolio sales, online insurance services and online consumer finance.<sup>38</sup>

The Chinese MPL industry includes both platform and balance sheet lenders, with many operating under hybrid funding models in which they provide intermediation between investors and borrowers, as well as fund loans from their own balance sheets. However, the CBRC issued the draft Administrative Measures of Business Activities of Internet Lending Information Intermediary Institution (AMBA) in December 2015, which sets out rules for platform lenders that offer P2P and P2B loans.<sup>39</sup> The draft AMBA stated that these lenders may not (i) fund loans from their own balance sheets, (ii) issue securities to investors, (iii) provide pooled investment funds or (iv) receive public deposits. Since at least 60% of Chinese platform lenders are already operating within the new regulations' guidelines, the draft AMBA provides an 18-month grace period for the remaining platform lenders to become compliant.<sup>40</sup>

No explicit regulation for B2B platform lending exists and, according to a senior CBRC officer, the CBRC is likely to continue focusing on implementing regulations for P2P and P2B lending, as current problems are more severe in this market.<sup>41</sup> Regulators are, however, exploring a suitable regulatory structure for balance sheet lenders, who currently are generally governed by the rules for "non-deposit lending institution". In August 2015, the State Council released the Draft Rules of Non-Deposit Lending Institutions (SLB 2.0), which specifically forbid balance sheet lenders from accepting public deposits. However,

SLB 2.0 expanded the fundraising channels available to balance sheet lenders, which previously included only issuing equity, accepting capital donations and obtaining institutional funding from no more than two banks within the respective province. Now, it also includes bond issuances and asset securitization.

SLB 2.0 is a supplement to the Guiding Options of the Pilot Small Loan Business (SLB 1.0).<sup>42</sup> The stated purpose of both SLB 1.0 and SLB 2.0 is to promote small business lending in China. While the SLB 2.0 provides more specific rules than SLB 1.0, the definition of a small business loan is ambiguous, as is the applicability of these rules to certain non-depository lending institutions. SLB 2.0 does, however, exclude certain financial institutions, such as securities and commodities firms, as well as consumer finance and automobile finance companies.

Heavy debate has ensued about whether MPL regulation within China is best characterized as principle based or rule based. While the GOPHD provides general guiding principles for promoting healthy development of the MPL market, the draft AMBA and SLB 2.0 provide some greater detail. Unlike much of the regulation for traditional financial institutions, these regulations follow a principle of “lists of forbidden activities”, many of which identify the strictly prohibited activities and provide very few minimum standards of compliance. This approach, however, leaves more freedom for innovation and development of this new market.<sup>43</sup>

The Chinese MPL market will likely undergo dramatic changes in 2016, as MPLs that cannot meet the requirements of the draft AMBA and SLB 2.0 will either exit the market or be acquired by larger MPLs. Compliance, risk management and the implementation of the draft AMBA and SLB 2.0 will also be key topics for the Chinese MPL market in 2016, and may result in further regulation that more clearly defines acceptable practices.

## UK

In the UK, the FCA acts as the primary regulator for MPL and must authorize all MPL platforms performing regulated activity.<sup>44</sup> Regulated activity in this context means any loan facilitated by a platform lender in which the lender is an individual.<sup>45</sup> Regulated activity also includes any loan made through a platform lender in which the borrower is an individual and the loan amount is less than £25,000 or is not for a business purpose.<sup>46</sup> As such, regulated activity is limited to all P2P and P2B loans and some B2P loans, and does not cover balance sheet lending. UK businesses that only offer credit to other businesses do not need to be authorized by the FCA.<sup>47</sup> Moreover, the FCA has stated that it will not regulate B2B loans.<sup>48</sup> This reflects a priority for protecting retail investors in this new market.

While B2B or “direct lending” is largely unregulated in the UK, institutional investors may be subject to certain regulatory oversight if they themselves are a regulated entity. For example, insurers face certain regulatory requirements under the FCA’s Policy Statement (PS) 15/8

Solvency II directive, and trustees of pension funds are limited when investing funds held for certain pension plans.<sup>49</sup>

Some market participants are concerned about the FCA’s principles-based approach, which they claim fails to prescribe certain minimum standards.<sup>50</sup> The FCA has responded to these concerns by emphasizing that its approach seeks to provide “adequate investor protection” while also allowing “sufficient flexibility for firms to operate and arrange finance for small and medium enterprise”.<sup>51</sup> The FCA also made it clear that it is not foreclosing the option of future rule-making, as already seen this year with the addition of new rules regarding individual savings accounts and advising investors in making regulated loans.<sup>52</sup>

## US

While some large US MPLs use a hybrid of several different funding models, as previously noted, the regulatory concerns are largely defined by who maintains the credit risk once the loans are made and, to a large extent, the method of passing such credit on to investors. Platform lenders often pass credit risk on to investors by selling whole loans, securitizing pools of loans or selling certificates backed by pools of loans.

Another common mechanism used in the US MPL market is the borrower payment dependent note (Note), which qualifies as a security under US law.<sup>53</sup> Under this arrangement, platform lenders offer Notes backed by loans, rather than selling whole loans to investors or merely matching investors and borrowers. The regulation applying to each transaction may turn on the type of investor involved in each transaction. Transactions involving institutional or “accredited” investors may be subject to less stringent reporting or registration requirements than those involving retail or individual investors.<sup>54</sup> This is covered in further detail in the “Investor Protection and Securities Laws” subsection.

Regulated US institutional investors may also be subject to more general regulation or guidance that could affect their ability to invest in MPL-originated loans. For example, according to guidance issued by the US Securities and Exchange Commission (SEC), the agency responsible for regulating the country’s securities industry, 85% of investments held by mutual funds should be liquid assets.<sup>55</sup> Some whole loans purchased by asset management may not meet this requirement.<sup>56</sup>

The US regulatory regime has done little to directly address the MPL market head-on, opting instead to enforce existing rules. Some have criticized this approach as allowing the upstart industry to position itself advantageously within the fragmented US regulatory system, in what amounts to “regulatory arbitrage” by avoiding costly regulations like capital requirements.<sup>57</sup> However, in response to the US Department of the Treasury’s September 2015 Request for Information (RFI), major US MPLs, such as OnDeck, have called for harmonizing the legal and regulatory landscape

“in order to promote the efficient and responsible development of this space”.<sup>58</sup> They argue that “the existing landscape was created at a time that did not contemplate our modern Internet economy, and therefore includes a number of archaic inefficiencies”.<sup>59</sup>

As the activities of US MPLs become more complex and as institutional investors become a greater source of funding (thereby spreading the risk to the broader market), regulators have shown signs that they may become more involved. MPLs’ reliance on traditional banking-sector participants for funding and transactional support has piqued the interest of federal and state banking regulators. The SEC has already taken action to require registration of securities issued by some US platform lenders. In addition, the Consumer Financial Protection Bureau (CFPB), which has authority over US consumer protection regulation, may decide to expand its reach to small business lending or the MPL market more broadly. The US Treasury RFI may itself also suggest that more direct regulation is forthcoming.

## Investor Protection and Securities Laws

### China

MPL’s relatively recent development, combined with instances of fraud and mismanagement within the market, have created a need to develop investor confidence. The focus of the draft AMBA is largely on investor protection. The draft AMBA clearly states that the borrower is obliged to ensure the validity, authority and completeness of information provided to investors; however, the draft AMBA also places the onus on platform lenders by requiring that they perform due diligence and assess this information.

Funds lent through a platform lender must be used for legal purposes and only for the purpose listed in the loan agreement. The draft AMBA also sets certain minimum criteria for “qualified investors”, including familiarity with the internet, investment experience in non-guaranteed financial products, and an understanding of the potential credit risks and their own risk tolerance. However, these criteria are very broad and provide little guidance on how they should be assessed.

The draft AMBA also places emphasis on public reporting, information disclosures, due diligence and risk control requirements in order to strengthen investor protection.<sup>60</sup> Platform lenders are required to clearly inform investors of the associated risks and prohibited activities. Furthermore, platform lenders must assess the proper risk tolerance levels of investors. Lastly, in order to strengthen the risk control of platform lenders, the draft AMBA states that transactions involving such lenders should be limited to certain smaller amounts based on the risk control capabilities of the platform lender, avoiding concentration risk associated with a single borrower.<sup>61</sup> However, the draft AMBA provides little guidance regarding minimum standards in carrying out each of these activities.

The Chinese regime does not allow platform lenders to offer performance guarantees, to sell securities or to sponsor securitizations. The draft AMBA does recommend, however, that these lenders cooperate with qualified independent third parties, such as banks and insurance companies, to provide securitizations, guarantees and other insurance products. Providing insurance products requires close cooperation and more information-sharing between MPLs and insurance companies. Because cooperation is complex and the risks in platform lending are currently high, most insurance companies are still being conservative in cooperating. By the end of January 2016, 80 platform lenders had signed cooperation contracts with insurance companies in China.<sup>62</sup>

The Chinese Insurance Regulatory Commission (CIRC), the agency responsible for regulating the Chinese insurance industry, released guidance in January 2016 for insurance companies doing business with platform lenders in order to strengthen credit underwriting and information disclosures.<sup>63</sup> The CIRC noted that insurance companies should pay particular attention to the platform lenders’ due diligence and credit underwriting standards, business performance and technology capabilities. In the future, stricter controls and further regulation clarifying the roles and responsibilities between such lenders and insurance companies could increase cooperation.

### UK

The FCA has described its approach to investor protection as “primarily a disclosure-based regime” designed to ensure “that investors have the information they need to be able to make informed investment decisions and that all communications are fair, clear and not misleading”.<sup>64</sup> The FCA described the types of investor disclosures it expects from platform lenders, including “default rates, investment security mechanisms, comparative information and periodic reporting to clients”.<sup>65</sup> However, it stopped short of prescribing specific disclosure requirements, opting instead for “high-level rules” that place the onus on the platform lenders “to provide appropriate, useful information and not to over-burden consumers with too much detail”.<sup>66</sup> MPLs will, however, be subject to the FCA’s conduct of business rules, which set out principles for communications with clients, including financial promotions. The FCA has identified communications and promotion issues that may run afoul of these principles; of particular concern are promotions suggesting that investing through platform lenders is equivalent to depositing money in the bank.<sup>67</sup>

Loans originated through platform lenders involve direct contracts between the investor and the borrower and, therefore, do not involve the issuance of Notes or other instruments that could be considered securities.<sup>68</sup> While securitizations have not taken place within the UK market, participants within it have advocated that the market serve as a significant funding source for SME loans.<sup>69</sup> Jonathan Kramer, director of sales for Zopa, the UK’s largest platform lender, stated that “securitisation is coming to Europe, and that’s a good and healthy thing”.<sup>70</sup> Commentators have noted that the MPL model has a short

track record and has not been tested through different parts of the credit cycle. Advocates of securitization, however, point out that UK platform lenders such as Zopa and Funding Circle are “highly transparent,” publishing loan performance metrics on their websites that conform with the principles of the UK’s leading MPL trade association, the Peer-to-Peer Finance Association (P2PFA).<sup>71</sup>

Investment trusts, such as P2P Global Investments or the Funding Circle SME Income Fund, offer MPLs yet another investment vehicle. Investors can buy and sell shares of the trust, which are listed on the London Stock Exchange. The trust then manages loans made through MPLs across multiple markets, including the US and the UK.<sup>72</sup>

Under the FCA’s regime, platform lenders will also have the authority to conduct the new regulated activity of advising investors in making regulated loans, because they allow outside investors to make loans through their online platform.<sup>73</sup> As of 6 April 2016, the FCA began to regulate such advising activities “in broadly the same way as other regulated investment advice” by including rules regarding suitability and the supervision of advisers, and by providing investors who receive advice access to ombudsman service and the Financial Services Compensation Scheme (FSCS).<sup>74</sup> In assessing suitability, advisers are required to establish “the risk a customer is willing and able to take and making a suitable investment selection”.<sup>75</sup> Some market participants have argued, however, that in many cases it would not be possible to conduct the due diligence necessary to establish suitability.<sup>76</sup>

## US

Rather than selling whole loans to investors, many platform lenders in the US issue Notes backed by loans selected and funded by those investors. While the loans remain with the platform lender, the credit risk is passed on to the investor because the Notes entitle the investor to payment only when borrowers make payments on the loans.<sup>77</sup> In 2008, the SEC determined that Notes issued by certain platform lenders, including Lending Club and Prosper, represented investment contracts offered to the general public and, therefore, must be registered as securities under the Securities Act and other state laws.<sup>78</sup> These platform lenders are also subject to significant SEC reporting requirements.<sup>79</sup>

US platform lenders generally do not guarantee the performance of individual loans.<sup>80</sup> However, issuers of Notes may be responsible for any material misstatements or inaccuracies in their registration documents.<sup>81</sup> While these registration requirements do provide investor protection, they also impose significant cost to the platform lenders.<sup>82</sup>

Notes sold only to accredited investors in private placements may not be subject to the same registration requirements.<sup>83</sup> “Accredited investors” are generally defined as institutional investors or high-net-worth individuals.<sup>84</sup> As interest from institutional investors has increased, however, whole loan sales have become an increasingly significant

investment mechanism. In addition, the sale of whole loans to accredited investors may not represent a sale of securities that would require registration.<sup>85</sup>

Each US state may also have independent suitability requirements that determine an investor’s ability to invest in Notes. For example, Lending Club and Prosper require investors in many US states in which they operate to have an annual gross income and a net worth of at least \$70,000; or, alternatively, to have a net worth of at least \$250,000.<sup>86</sup> The US Small Business Administration (SBA), the agency that provides support to entrepreneurs and small businesses, has noted that these requirements are well above the median income and net worth in the US and effectively exclude a large source of responsible investors. The SBA has also indicated that these requirements are more stringent than the SEC’s “crowdfunding exemption” adopted in October 2015, which allows investors with an annual income or net worth of less than \$100,000 to invest \$2,000, or 5% of the lesser of their annual income or net worth, during a 12-month period.<sup>87</sup>

Platform lenders may also establish an independent trust that holds a pool of loans and issues certificates to institutional investors seeking a more passive investment. To the extent that platform lenders are engaged in advising investors to purchase trust certificates, these MPLs may also be required to register as an investment adviser under federal or US state law.<sup>88</sup> Lending Club, for example, has established LC Advisors, LLC, a registered investment adviser that sources investors for trust certificates. As of 31 December 2015, certificates issued by an independent trust were Lending Club’s second-largest source of investment.<sup>89</sup>

Securitization has also become a large source of loan funding for platform lenders and, notably, for firms traditionally categorized as balance sheet lenders. While consumer loans and student loans have made up the majority of the securitizations to date, securitizations of SME loans originated by balance sheet lenders Kabbage, CAN Capital and OnDeck have also taken place.<sup>90</sup>

## Clearing, Settlement and Segregation of Client Money

### China

To better protect client funds, the draft AMBA requires that all funds held in relation to P2P and P2B loans remain segregated from a platform lender’s proprietary funds. Platform lenders are required to open escrow accounts with regulated financial institutions (normally banks), which then verify the requirements of the loan agreement and process and settle payments. The funding segregation has promoted partnerships between platform lenders and banks, and strengthens the controls on post-monitoring and use of funding.

Currently, two main settlement and clearing models exist between platform lenders and banks under this funding management model:

1. Direct connections with banks – This model requires all platform-lender customer accounts be opened directly in banks that will settle the transactions after verification. Although less risky and more efficient, it requires better system connections between the platform lender and the bank, which are currently under development in China. Lufax has been very successful under this model; however, replicating its success has been difficult since it was founded by the Ping An Group, which operates its own banks under the same umbrella, removing many of the complexities that may arise from unaffiliated platform lenders and banks.
2. Direct funding management by banks – Under this model, platform lenders will open a consolidated escrow account and have customer accounts opened as sub-accounts. The biggest difference with this model is that it requires customers to manually process transactions, which normally involves a “reload” and “withdraw”. Currently, this model is applied by most Chinese platform lenders.<sup>91</sup> However, some domestic banks, such as Agricultural Bank of China and China Construction Bank, froze the reloading business because of the increasing credit risk concerns caused by recent financial crimes in MPL. These changes have cast uncertainty on this model, and both counterparties are waiting for further clarification from AMBA’s final release.

Closer cooperation between MPL platforms and banks will likely strengthen funding controls, improve risk controls and transparency, and better protect investors’ interests. However, because of current regulatory uncertainties and lack of standardized market practices, much needs to be done to identify the most efficient and reliable cooperation model.

## UK

Regulated UK platform lenders generally service loans by processing transactions and loan repayments and are, therefore, subject to the FCA’s Client Assets sourcebook (CASS 7) client money rules.<sup>92</sup> The rules previously required that investor funds held in relation to regulated loans be segregated, usually in a client bank account, from the platform lenders’ funds and any funds held in relation to unregulated loans. Platform lenders complained, however, that it was burdensome to keep funds held in relation to regulated loans (e.g. P2B loans) segregated from funds held in relation to unregulated loans (e.g. B2B loans). The FCA altered its rules in March 2016 to allow platform lenders to hold client funds from regulated and unregulated loans together under CASS 7. Under this arrangement, all client funds would still need to be segregated from the platform lenders’ funds.<sup>93</sup>

The FCA chose not to include loans made via platform lenders within the FSCS, which generally protects customers when authorized financial services firms default on their obligations.<sup>94</sup> In announcing its decision, the FCA found that both the amounts that might be lost and the amounts that would be covered by the FSCS if a platform lender failed did not justify including platform lending within the FSCS.<sup>95</sup> Some platform lenders do provide contingency funds to cover investor losses in the event that the borrower defaults. The FCA has warned, however, that these lenders should not overstate the protection provided by the contingency fund and should provide information on the size of the fund relative to the amount of outstanding loans.<sup>96</sup>

## US

US MPLs also rely on banks to hold investor funds and process payments. Transactions with borrowers and investors, including the funding of loans and collection of payments, are generally conducted through the Automated Clearing House (ACH), a nationwide network through which banks can transfer funds electronically.<sup>97</sup> As such, MPLs must rely on an unaffiliated bank to process transactions over the ACH network. These arrangements can provide significant protection to investor and borrower funds, including Federal Deposit Insurance Corporation (FDIC) insurance.<sup>98</sup>

Some MPLs seek to use automatic bank withdrawals to obtain payment from borrowers on a weekly, and sometimes daily, basis, which can help smooth the borrowers’ cash flow.<sup>99</sup> While automatic electronic payments are permitted, the Electronic Funds Transfer Act (EFTA), which governs the rights of consumers during transfers of electronic funds, prohibits any lender from requiring or coercing a borrower to authorize electronic payment. However, the EFTA only applies to consumer borrowers and does not protect businesses.<sup>100</sup> Consumer advocates have warned that this type of payment could lead to abusive withdrawal practices.<sup>101</sup> Commentators also warn that direct access to borrower accounts could lead to an erosion of underwriting standards because of less concern that borrowers will make loan payments ahead of other expenses.<sup>102</sup>

## Risk Retention and Capital Requirements

### China

The draft AMBA does not impose capital requirements on platform lenders; however, SLB 2.0 requires that balance sheet lenders maintain capital not lower than RMB 5 million for limited liability companies and RMB 10 million for corporations.<sup>103</sup> The Chinese regime does not impose any risk retention requirements.

## UK

Regulated platform lenders in the UK are subject to minimum capital requirements to ensure that they operate “prudently in monitoring and managing business and financial risks”.<sup>104</sup> The capital requirements will include a fixed minimum of £20,000, which will be increased to £50,000 on 1 April 2017, and a volume-based amount calculated from the total value of loaned funds outstanding.<sup>105</sup> The UK regime does not impose any risk retention requirements.

## US

While MPLs in the US are not subject to capital requirements, they should be aware that the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) created new rules that require securitizers to maintain risk retention interest in the loans they securitize. However, these risk retention rules will not be fully implemented until the end of 2016.<sup>106</sup>

The subject of risk retention has also been raised in the non-securitization context. The US Treasury RFI asked for comments on the application of risk retention rules for MPLs. The basic concern that the US Treasury expressed was whether platform lenders should be required to have “skin in the game” in order to align their origination and underwriting operations with investors’ interests. Stakeholders within the industry that are opposed to such rules note that risk retention would favour balance sheet lenders over platform lenders.<sup>107</sup> The latter lenders also argue that risk retention is not necessary because they maintain a direct economic interest in the loans they originate. A significant portion of their revenue comes from servicing fees that are only paid if and when borrowers make payments on their loans, and/or from management fees that are not paid if the loans are charged off. These platform lenders also claim to have a reputational interest in ensuring they originate loans with diligent and credible underwriting standards.<sup>108</sup>

## Secondary Servicer Agreements

### China

The Chinese regime does not specifically require MPLs to arrange for a secondary service provider during operational failures or bankruptcy. However, the draft AMBA does include liquidation procedures upon bankruptcy, which require platform lenders to segregate investor funds from bankruptcy proceedings.

## UK

The FCA requires regulated platform lenders to make arrangements that ensure loan servicing will continue if the firm goes out of business or cannot otherwise administer the loan agreements. The FCA stopped short of prescribing the substance of these arrangements and merely required platform lenders to take reasonable steps “to design systems and controls that are appropriate to the needs of their business model and consumers”.<sup>109</sup>

## US

No such requirement exists in the US, but platform lenders, such as Lending Club, have made arrangements with secondary, or backup, servicers.<sup>110</sup> Additionally, in response to counterparty risk, institutional investors may require platform lenders to arrange for a substitute servicer in case of bankruptcy or other operational failure. Institutional investors may also require platform lenders to create a wholly owned subsidiary that will issue Notes and retain the underlying loans so that investors may have some protection should the platform lender file bankruptcy proceedings.<sup>111</sup>

## Tax Incentives

### China

The GOPHD also seeks to promote MPL through the tax system. For example, MPL firms in the early stages of their business life cycle, as well as companies devoting research and development expenses to “new technologies”, may be entitled to “preferential taxation policies”.<sup>112</sup> However, these deductions may not apply to mature firms or products.<sup>113</sup>

## UK

The UK government also used the tax code to encourage platform lending, and created a new investment vehicle known as the Innovative Finance Individual Savings Account (Innovative Finance ISA), effective 6 April 2016. It entitles investors to beneficial tax treatment on interest and gains from loans arranged through platform lenders up to a certain amount.<sup>114</sup> HM Revenue & Customs noted that the policy’s objective was to “encourage the growth of peer to peer lending and improve competition in the banking sector by diversifying the available sources of finance.”<sup>115</sup>

## US

The US has not instituted any tax policies designed to encourage MPLs or their investors. However, platform lenders, such as Lending Club, have advocated that “investors who provide capital in defined underserved areas and to low- to moderate-income small business borrowers be taxed at the capital gains tax rate, rather than the current marginal income tax rate, if the loan is held for over 12 months”.<sup>116</sup> Lending Club also proposes that the US follow the UK model and allow investors to “offset losses

directly against interest income and gains and have returns on the first \$5,000 of investments made tax-free”.<sup>117</sup>

## Promotion of SME Lending

### *China*

In order to further promote the development of SMEs, the Chinese government released a variety of supportive policies. The State Council issued the Implementation Opinion on Financial Support for Small and Micro Enterprises Development (IOFSSM) in 2013, which set two growth targets for small business lending in China: (1) the growth rate of small business loans must keep pace with other loan categories; and (2) the year-over-year growth must be positive.<sup>118</sup> Furthermore, the IOFSSM states that local governments should support establishing and improving the security and guarantee scheme of SMEs, and establishing a credit risk compensation fund to help lower SME credit risk. Last but not least, the IOFSSM confirmed the importance of MPL as an alternative source of funding for small businesses.<sup>119</sup> The rules supporting small business lending will help to lower the credit risk concerns of SME lenders, and will help to improve the efficiency of MPLs. However, without constructing a complete credit management system for SMEs, the key challenge for SME lending remains.

### *UK*

The UK government has introduced the Small and Medium Sized Business (Finance Platforms) Regulations 2015 (Finance Platforms Regulations). The Finance Platforms Regulations require designated banks to provide specified information to earmarked “online finance platforms” on SME customers that have been denied a loan.<sup>120</sup> These platforms will then provide that information to alternative finance providers, such as MPLs. According to the British Business Bank, a state-owned economic development bank that is conducting the due diligence of potential designees, “[t]hese platforms will help match the SME with [an] alternative finance provider that could provide them with the finance they need to grow and expand.”<sup>121</sup>

### *US*

US MPLs focused on SME lending, such as OnDeck, have called on US policy-makers to support the development of a referral system similar to the Finance Platforms Regulations in the UK. OnDeck has also called upon the US government to support MPL-bank partnerships through policy-making or supportive statements.<sup>122</sup>

Despite the current lack of support from policy-makers, MPL-bank partnerships are already occurring. In December 2015, OnDeck and JPMorgan announced that they would be partnering to make small business loans. Under the agreement, JPMorgan will provide the capital to make the loans, and the products will carry

JPMorgan branding. OnDeck will receive fees to originate and service the loans. Citi announced a similar deal with Lending Club in April 2015, whereby Varadero Capital, an alternative management firm focused on specialized credit investments, would purchase loans through a credit facility provided by Citi. Partnerships such as these will provide additional capital to small business borrowers and will lend legitimacy to MPL.

In November 2015, however, the FDIC released guidance regarding effective risk management practices for banks when purchasing loans from third parties.<sup>123</sup> The guidance instructs banks to independently review and validate third-party underwriting standards and proprietary credit models, establish concentration levels, perform profit analyses and incorporate loan purchase programmes into the bank’s audit programme.<sup>124</sup> While the guidance does not mention MPLs, commentators have noted the added cost this will impose upon a large source of funding for MPLs.<sup>125</sup> However, despite these additional costs, it may be more cost-effective for banks to continue partnering with MPLs than to develop their own online lending platforms.

## Credit Analysis and Underwriting

### *China*

Within China, SMEs are struggling to secure financing, since many of them do not have the credit history required by traditional banking-sector participants. The PBOC maintains a credit reference centre (CRC) that provides credit records for many Chinese companies. The credit information on SMEs is limited, however, because the system mostly registers information on traditional bank loans, mortgages and liens, which are not applicable to most SMEs, especially entrepreneurs.

The GOPHD notes that the Chinese government is currently adapting the CRC to better capture credit information for SMEs and individuals. Furthermore, the GOPHD encourages MPLs to leverage new technologies, such as big data and cloud computing, to analyse alternative credit information, such as online-shopping histories and utility payments.<sup>126</sup> These alternative approaches could assist the Chinese government in constructing a comprehensive credit system that better serves SMEs and individuals. The GOPHD also encourages MPLs to establish their own credit information-sharing platforms and to collaborate with banks in reporting credit information. The draft AMBA also states that regulators will continue developing and improving the platform lending infrastructure by establishing a centralized database that could help to improve the availability of credit information for SME lending and thus strengthen the controls of credit risk.

Compared with the US and the UK, China has a long way to go to establish a complete credit information system for SMEs and individuals. To achieve this goal, regulators, traditional banking-sector participants and MPLs need to work together to establish suitable credit models for SMEs,

and to explore technological solutions to better capture and analyse other alternative credit information.

The draft AMBA does not provide any specific requirements for platform lenders regarding disclosures to borrowers. However, the Draft Rules of Non-Deposit Lending Institutions lists several disclosure requirements for balance sheet lenders, including loan amount, annual percentage rate (APR), payment schedule, debt collection provisions, and security or lien provisions.

## UK

Platform lenders in the UK are required to perform an assessment of prospective borrowers' creditworthiness before a regulated credit agreement is made. This assessment must be based on sufficient information provided by the borrower and credit reference agencies. The firm must also consider the borrower's ability to make repayments and what, if any, adverse impact the agreement may have on the borrower's financial situation.<sup>127</sup> Platform lenders are also required to ensure that any loan agreements the firm provides contain certain contractual rights, including the right of the borrower to withdraw from the agreement within 14 days.<sup>128</sup>

The FCA also adopted rules regarding disclosures to borrowers. Before a regulated loan is made, the platform is required to provide the borrower with explanations on the credit agreement's important features. The information provided should allow the borrower to make a reasonable assessment of the key risks associated with the loan – in particular, the borrower's ability to repay it.<sup>129</sup> These provisions, however, will apply to only a small fraction of SME loans.<sup>130</sup>

The UK government has also established the Small and Medium Sized Business (Credit Information) Regulations 2015 (Credit Information Regulations), which will require designated banks to submit SME credit information to designated credit reference agencies (CRAs). These agencies must then provide that information to finance providers. The CRAs must also provide the information to the UK central bank (Bank of England) upon request. The goal of this provision is to allow banks and alternative finance providers to make better and more informed decisions when offering credit to SMEs.<sup>131</sup>

## US

Loans made for business purposes in the US (i.e. commercial loans) are exempt from many consumer-lending laws, such as the Truth in Lending Act, which requires lenders to provide borrowers with information on the terms and cost of credit. Industry commentators have called for a more level playing field between consumers and small businesses regarding legal protections, and for further transparency within the small business lending market, particularly with regard to pricing metrics.<sup>132</sup> In his remarks at the Information Management Network Conference on Marketplace Lenders in October 2015, Antonio Weiss, Counselor to the Secretary of the US

Treasury, noted that many respondents to the US Treasury RFI supported the application of additional consumer protection laws to small businesses.<sup>133</sup>

The use of data to improve decisions on credit could also become the target of regulatory scrutiny. SME lenders are subject to the Equal Credit Opportunity Act (ECOA), which makes it unlawful for all creditors to discriminate against credit applicants on the basis of race, colour, religion, national origin, sex, marital status, age or receipt of public assistance. Weiss noted, however, that some have raised concerns that the use of algorithms and non-traditional data when making credit decisions could create "unintended correlations that lead to discriminatory lending or penalize customers without a large digital footprint".<sup>134</sup>

In an effort to facilitate greater enforcement, the Dodd-Frank Act amended the ECOA to require financial institutions to report to the CFPB data collected on small business, along with data on lending to women-owned and minority-owned businesses.<sup>135</sup> Karen Gordon Mills, Administrator of the US Small Business Administration (2009-2013), noted that a lack of data has hindered a true assessment of the current SME funding gap, but that this data, when collected, will be "a seminal data set on small business credit conditions".<sup>136</sup>

## Data Protection

### China

Most Chinese MPLs outsource their website development and maintenance operations to third-party information technology firms. This dependency on third-party relationships has exposed many Chinese MPLs to higher risks of cyberattack and data leakage. Hackers have targeted Chinese platform lenders because of the latter's high transaction volumes and large databases of user information.<sup>137</sup>

To better mitigate these risks and to protect customer data, the GOPHD requires any organization or individual intending to create an online financial services company to implement record-filing procedures and coordinate with Chinese telecommunications authorities before launching its website.<sup>138</sup> The GOPHD also addresses the importance for MPLs to intensify their technical security levels in response to increased cybersecurity requirements within China. Likewise, the draft AMBA clearly states the responsibilities of MPLs in collecting and maintaining customer data in order to conserve its integrity and security.<sup>139</sup>

### UK

MPLs in the UK are subject to relevant data protection laws, including the UK's Data Protection Act of 1998. As data controllers, MPLs will be required to register with the UK's Information Commissioner's Office, maintain appropriate security measures and inform lenders and borrowers of their data collection and privacy policies.<sup>140</sup>

## US

The collection and use of borrower and investor data in the US also raises significant privacy concerns. The Gramm-Leach-Bliley Act's (GLBA) Privacy Rule provides borrowers with privacy rights (including notice of data collection practices), places requirements on financial institutions to establish data security regimes, and restricts financial institutions' ability to share non-public data with unaffiliated third parties.<sup>141</sup> However, the GLBA Privacy Rule does not apply to commercial transactions, such as SME loans.<sup>142</sup>

## Regulatory Reporting

### China

Licensed platform lenders and balance sheet lenders are subject to reporting requirements similar to those in the traditional banking sector. The SLB 2.0 and the draft AMBA require MPLs to periodically provide regulators with relevant lending information, including total transaction amounts and volumes, current balances and concentrations (including the largest exposure and a listing of the top 10 exposures), and default rates. MPLs are also responsible for reporting suspicious anti-money laundering (AML) transactions and ensuring that appropriate standards are in place to identify high-risk accounts and transactions.<sup>143</sup>

Both balance sheet lenders and platform lenders are required to periodically report on their operations and financial performance. The draft AMBA also encourages platform lenders to hire certified public accounting firms to audit their financial reports and conduct internal control assessments. Platform lenders should also report such audits and assessments at least annually. Furthermore, the draft AMBA encourages platform lenders to develop self-regulatory organizations that will release timely industrial performance reports that provide default rates and report exposures to any potential financial crimes.<sup>144</sup>

### UK

Regulated platform lenders are also subject to FCA reporting requirements. Firms must submit financial position reports on a quarterly basis that cover the firm's balance sheet, profit and loss, and capital position. Platform lenders must also submit reports on client money holdings, complaints and loans.<sup>145</sup> Policy-makers have not extended *The Money Laundering Regulations 2007* to apply to platform lenders.<sup>146</sup> The FCA has warned, however, that platform lenders should have "controls in place to mitigate the risk of their sites being used for money laundering."<sup>147</sup>

## US

US financial institutions are subject to stringent AML reporting and monitoring requirements under the Bank Secrecy Act (BSA). The term "financial institution" has not formally been interpreted to include MPLs; however, those MPLs structured as regulated entities, such as a securities broker-dealer, will have to comply. Additionally, many loans from US MPLs are originally issued by a chartered bank, which will be required to comply with the BSA.<sup>148</sup>

## Registration and Licensing

### China

The draft AMBA requires platform lenders to register and file with local CBRC branches after they have received business licences from the State Council's Administrative Department of Industry and Commerce (ADIC), the authority responsible for advancing legislation on administering and applying for a business licence. Furthermore, as mentioned in this White Paper's Data Protection subsection, platform lenders need to register with telecommunications authorities; they also must obtain an internet content provider (ICP) licence before launching their websites. Lastly, since the draft AMBA defines platform lenders as "intermediations", all such lenders need to name their business with the exact terms of "online lending information intermediary institution".<sup>149</sup> Currently, many platform lenders face huge challenges to complete licence applications within the 18-month grace period.<sup>150</sup>

The SLB 2.0 requires balance sheet lenders to acquire pre-approval from the ADIC and apply for approval regarding their lending business from local CBRC branches; they then only apply for a business licence after receiving both approvals. Similar to the requirements of platform lenders, the State Council's Draft Rules of Non-Deposit Lending Institutions also require balance sheet lenders to name their company with the specific term of "lending" or "financing".<sup>151</sup>

### UK

The FCA must authorize all UK platform lenders performing regulated activity. Platforms in operation prior to 1 April 2014 were able to apply for interim permission to continue operations pending full authorization by the FCA.<sup>152</sup>

### US

While commercial lending in the US is less regulated than consumer lending, MPLs are still subject to independent state licensing laws. Rather than obtaining state licences that would allow them to lend directly to borrowers, many MPLs partner with banks. OnDeck, for example, has noted that it lends directly to SMEs in all but 12 US states that require commercial lending licences or do not honour their choice-of-law provisions.<sup>153</sup> In those states, however, OnDeck relies on a bank to issue the loan to the SME. OnDeck can then purchase the loans from the bank to retain on its balance sheet or sell to investors.

## Debt Collection

### *China*

Although the draft AMBA attempts to provide a foundation that protects investors' legal rights, it leaves several issues for further implementation, such as the procedures for debt collection. The draft AMBA provides no guidance regarding the appropriate role of platform lenders in the debt collection process. The collection issues faced by investors impacted by the Ezubao scandal highlight the need for clear guidance on proper insolvency and collateral regimes.

### *UK*

The FCA's Consumer Credit sourcebook (CONC) sets guidelines for UK platform lenders when dealing with borrowers that fail to make payments. The rules provide that platform lenders are required to notify borrowers when they are in arrears. The rules also prescribe the form and content of notices of arrears, including the requirement that the firm direct the borrower to a source of impartial debt advice.<sup>154</sup>

The FCA does not require platform lenders to actively pursue borrowers who are in default.<sup>155</sup> The FCA does state, however, that firms should clearly inform investors of the process they follow when loans enter default, and what role the firm will play in collections and in arranging for debt collection agencies.<sup>156</sup>

### *US*

While most platform lenders issue unsecured loans, some small business lenders, such as Funding Circle, secure loans with a general lien on the collateral of the business, and require the business's proprietor to provide a personal guarantee. MPLs argue that using a general lien is more appropriate than employing specific collateral because, unlike a bank, their credit analysis focuses on the business's fundamentals and not on the value of its assets.<sup>157</sup> If the loan goes into default, however, the lender can take the assets to satisfy the loan. Notably, the Fair Debt Collection Practices Act, which defines the right of debtors during the collection process, does not cover commercial debt, and many SMEs will not have the benefits of its protection.<sup>158</sup>

## Interest Rate Regulation

### *China*

Under the GOPHD, MPLs will also be subject to judicial interpretations of the Supreme People's Court.<sup>159</sup> Recently, the Provisions of the Supreme People's Court on Certain Issues concerning Application of Law in Trial of Cases involving Private Lending (Private Lending Provisions) set maximum interest for "private lending" markets.<sup>160</sup> Under the Private Lending Provisions, any interest rate above 24% is unenforceable by the courts, and any above 36% is illegal. These new rules provide more flexibility to MPLs than the former requirements, which set the maximum interest rate at no higher than four times the rate charged on similar bank loans.<sup>161</sup>

### *UK*

Interest rates are largely unregulated within the UK market; however, in January 2015, the FCA introduced an initial cost cap of 0.8% of the outstanding principal per day and a 100% total cost cap on interest rates charged on pay-day lending or "high-cost short-term credit" (HCSTC). In doing so, the FCA chose to leave platform lending within the HCSTC definition.<sup>162</sup> This cap would likely not apply to most SME loans.

### *US*

Some US states have usury laws to limit interest rates on consumer loans and, to a lesser extent, on commercial loans. However, federal law supersedes US state usury laws and allows nationally chartered banks and FDIC-insured US state chartered banks to "export" the usury laws of their domicile state when making loans across state borders. MPLs have partnered with banks in US states that have limited usury laws so that they can lend to borrowers across the country without having to comply with usury laws on a state-by-state basis.<sup>163</sup>

In May 2015, however, the United States Court of Appeals for the Second Circuit ruled that non-bank purchasers of loans issued by banks may not rely on the federal pre-emption. The case has since been appealed to the US Supreme Court, the nation's highest federal court. Many industry stakeholders have downplayed the ruling, arguing that loan purchasers may still rely on choice-of-law provisions contained within the loan agreements. While the ruling is sure to cause uncertainty throughout the MPL industry, it will cause less uncertainty in the SME lending segment.

# Private-Sector Outlook and Concerns

As regulators and policy-makers develop their understanding of MPL and attempt to implement appropriate regulation, market participants continue to wrestle with concerns regarding regulatory uncertainty; transparency, fraud and self-regulation; and standardization and data. The following section underscores the concerns of MPLs within China, the UK and the US for each of these categories.

## Regulatory Uncertainty

While operating in an uncertain environment regarding the applicability of current and forthcoming regulations, MPLs balance the strategic benefits of implementing transformative operational innovations. As already discussed in detail, regulators differ in their approach: they either provide incremental responses that cover portions of the industry as they develop (i.e. the US), or codify the rules proactively to encourage development and address specific issues (i.e. the UK and, to a certain extent, China). Whichever the case, MPLs are seeking the clarity and certitude that come from a transparent and coherent rule-making process and the ability to plan ahead.

### China

Before 2015, Chinese MPLs were primarily concerned about the fragmented regulatory framework and the forthcoming regulations positioned to favour traditional banking-sector participants. The release of the GOPHD, the draft AMBA and the SLB 2.0 addressed many of these concerns, as they served to legitimize the industry and provided meaningful guidance in many areas of concern. With the business scope broadly defined, MPLs are now facing huge challenges in how to restructure their businesses in order to comply with these new regulations. However, ambiguity still remains a concern because many areas, such as capital requirements, funding controls and suitability requirements, remain ripe for further regulation.

The current draft AMBA and the SLB 2.0 will improve risk controls while developing a more robust risk management administration, and will improve MPLs' competitive positioning in the traditional capital markets. Dawei Liu, senior vice-president of CreditEase, recently noted, however, that establishing a complete risk management process system is difficult in the current environment replete with uncertainty.<sup>164</sup> To secure capital to cushion the effects of these uncertainties, Chinese MPLs are going public and listing abroad. For example, Yirendai, a subsidiary of CreditEase, listed on the New York Stock Exchange (NYSE) in December 2015, making it the first Chinese MPL to do so in the US.<sup>165</sup> This set a precedent for other Chinese MPLs to proactively address regulatory uncertainties by providing assurances to investors through transparent financial disclosures.

However, Chinese regulators clearly will be changing their approach. Premier Li Keqiang recently delivered a clear message that the Chinese government is now switching its focus to standardizing and strengthening controls instead of simply promoting the development of online financing platforms such as MPL.<sup>166</sup>

### UK

The UK system displays the flexibility and responsiveness that can be achieved with a single regulatory portal. However, regulatory uncertainty still abounds, primarily around issues of rule clarity and agency communication. One of the most common complaints voiced by UK MPLs is the lack of support in navigating regulations implemented by the FCA. Many UK MPLs are small and have limited experience with regulatory compliance. The P2PFA, founded in 2011 by prominent UK MPLs including Zopa, Funding Circle and RateSetter, has publicly stated that the primary way the FCA could better help nascent firms is by clearly outlining the specific regulations that apply to the respective lending platforms.<sup>167</sup>

Another challenge articulated by UK MPLs is the FCA's lack of communication. P2PFA specifically requested a clearer contact method with the FCA for UK MPLs to inquire about the authorization process.<sup>168</sup> Clearer communication will eliminate confusion and inconsistencies. By recognizing MPLs' heightened sensitivity to regulations and their interest in improving communications, regulators can broaden bank and lender involvement in bringing financial innovations to market.

Given the ever-evolving nature of a technologically based industry, the regulations inevitably need to continue adapting as well. While the FCA has proactively adjusted rules and standards, these small changes have significant impact on small business borrowers. Again, while the FCA is responsible for addressing these issues, it is perceived, like any government agency, as moving slowly. The P2PFA specifically named "faster resolution of unforeseen consequences of regulation" as one of the most significant improvements that regulators could make to better support the industry.<sup>169</sup>

### US

The most common regulatory struggle in the US does not concern a specific regulation or regulator, but rather the extremely complex process of navigating multiple regulatory portals. While the regulatory landscape for traditional banking-sector participants is well established, it is less clear which federal and state agencies, statutes and laws govern US MPL activity. Similarly, as discussed in detail earlier, the specific compliance requirements under particular statutes and laws are not clear. In support of regulatory harmonization, an industry leader at OnDeck

recently articulated the issues faced when navigating this complex regulatory landscape, and even suggested that cross-agency working groups be established to promote specific compliance guidelines for the FinTech industry.<sup>170</sup>

The US MPL industry largely began after the 2008 financial crisis and, thus, was not subject to the post-crisis regulatory deluge. The crux of MPLs' competitive advantage is the current lack of capital rules and regulatory restrictions that encumber traditional banking-sector participants. US MPLs hope for regulatory clarity and do not want to be stifled by burdensome regulations that would limit their ability to operate more cost-effectively.<sup>171</sup> As the US MPL industry matures and its importance in the financial services sector grows, heightened regulatory scrutiny may diminish its cost advantage.<sup>172</sup> In its response to the US Treasury's RFI, Lending Club claimed this as its number one concern: "[W]e believe that any mandated capital-based risk retention requirements for marketplaces would be misguided and detrimental to both borrowers and investors."<sup>173</sup>

## Transparency, Fraud and Self-Regulation

The allure of the FinTech industry and MPL is reflected by the potential for transaction transparency and inclusion not offered by the traditional banking system. However, abuses in this transparency and the consequences of individual "bad actors"<sup>174</sup> are of upmost concern, as such actions diminish the industry's reputation and invite regulators' scrutiny. Self-regulatory bodies have proliferated globally to rein in cases of fraud and abuse, and to provide a standard code of conduct. These bodies often stand in for official regulatory regimes and are preferred by MPLs.

### China

In response to the GOPHD and draft AMBA, which promoted the development of self-regulation, the Shanghai Financial Information Association (SFIA) was founded in July 2015 as the first self-regulatory FinTech industrial association in China.<sup>175</sup> Over 200 MPLs have become members of the SFIA and other similar self-regulatory FinTech industrial associations established in the cities of Shenzhen, Zhejiang and Jiangsu.<sup>176</sup>

Such self-regulatory bodies helped to form a baseline of market entrance requirements for MPLs and improve the development of market standards. In 2013, the Shanghai Internet Finance Services Enterprise Alliance issued the first market entrance standard for Chinese MPLs; it covered basic requirements for business scope, management team structures and capital requirements, and acted as a market standard before the release of SLB 2.0 and the draft AMBA.<sup>177</sup> In 2015, the SFIA issued the first sample loan agreement in China that applied the regulatory requirements, and provided a standardized sample for real business practice that other Chinese MPLs could possibly replicate.<sup>178</sup> In response to GOPHD and the draft AMBA, the National Internet Finance Association (NIFA) was established on 25 March 2016 as the first national MPL industry association.<sup>179</sup>

Establishing information-sharing platforms and credit information systems for SMEs will be critical to improving transparency and accelerating the standardization of credit underwriting by Chinese MPLs. In recent years, creating information-sharing platforms, such as Wangdaizhijia (WDZJ), has provided investors with increased access to updated reports that outline MPLs' financial performance. WDZJ collaborates with third-party credit rating agencies and publishes monthly rankings of MPLs on a matrix that covers various metrics, including default rate and information transparency.<sup>180</sup> This information assists investors with executing investment decisions while strengthening the environment of self-regulation. However, since most of the current information-sharing platforms are still under development, much needs to be done to build an independent and credible information disclosure agency in China.

### UK

Self-regulation is robust in the UK, with over 90% of digital lending firms voluntarily joining the self-regulatory body, P2PFA.<sup>181</sup> The P2PFA's purpose is "to promote high standards of conduct and consumer protection".<sup>182</sup> Last year, it released a set of operating principles for members, which require member platforms to develop and publish a standardized methodology for default disclosure, ensure the transparency of loan books to provide customers the necessary tools for comparing data, and ensure retail investors are on a level playing field with institutional investors.<sup>183</sup> In addition, members are required to commit to non-discriminatory practices between retail and wholesale institutional investors.<sup>184</sup> UK MPLs can implement these requirements in several ways; for example, Zopa requires all lenders, whether they service retail or institutional customers, to receive a randomly allocated basket of loans to fund.

The P2PFA's success in strengthening standards of transparency, risk management and governance in the UK FinTech industry serves as an example for other regulatory agencies by creating a system with limited government involvement.<sup>185</sup> In fact, when drafting the existing regulatory structure, the UK government called on P2PFA's existing framework as a model. However, while self-regulation does a fine job of ensuring the majority of MPLs "play by the rules", other issues with respect to transparency and risk are top of mind for UK MPLs, particularly those related to AML. Under the current regulatory regime, existing AML and anti-fraud measures only cover traditional banking-sector participants.<sup>186</sup>

### US

In response to reputational concerns, US MPLs are interested in controlling risk levels and predatory practices. The Responsible Business Lending Coalition unveiled the Small Business Borrowers' Bill of Rights (BBOR), a widely cited document that spells out six principles for transparency and accountability: the right to transparent pricing and terms, non-abusive products, responsible underwriting, fair treatment from brokers, inclusive and non-discriminatory credit access, and fair collection practices.<sup>187</sup>

This concern for small business borrower protection is not unwarranted and is often cited as one of the leading industry tensions.<sup>188</sup> According to Fundera, the US venture capital-backed loan site, “a lot of the practices we have been seeing on the part of small-business loan brokers have been very similar to what we saw with sub-prime mortgages.”<sup>189</sup> Further, Eric Weaver, chief executive officer of the Opportunity Fund, recently stated that “there are some very troubling practices in the online small business credit market that we need to contain without stifling innovation.”<sup>190</sup>

With respect to transparency in pricing, fees and broker practices, a fierce debate is occurring on whether annualized interest rates or alternative approaches, such as factor rates, are most beneficial to SMEs, and whether the industry should mandate a standardized method of calculating rates. One of the BBOR’s goals is to apply APR or annualized interest rate requirements to lines of credit, MPL loans, merchant cash advances and other products that may not meet the strict definition of a loan.<sup>191</sup> Critics of factor rates argue that they are deceptive and do not allow easy comparison to other loan options that are often expressed as an APR. Factor rates can also be mistaken for an APR, making them appear far less expensive. Advocates of annualized rates argue that they allow SMEs to more effectively compare loan offers with other loan options and manage their cash flows, as APRs take into account the rate of repayment required by the loan.<sup>192</sup> As the Responsible Business Lending Coalition has noted, “[f]aster repayment corresponds to a higher annualized interest rate, reflecting higher monthly repayments owed by the borrower.”<sup>193</sup>

Currently, OnDeck is the largest player that still offers short-term rates as “cents on dollar” (essentially a factor rate), while still keeping longer-term loans on an annualized rate basis.<sup>194</sup> OnDeck argues that its “customers understand pricing on a ‘dollars in, dollars out’ basis and are primarily focused on total payback cost.”<sup>195</sup> However, even it admits that uniformity is an issue, and is “exploring ways to increase standardization of pricing and comparison terms in our industry in order to help small business customers assess their credit options.”<sup>196</sup> OnDeck appears to be considering whether to provide historical APR data as supplemental information to its customers. Regardless of which method is most beneficial to the SME customer, greater transparency is clearly necessary.

As terror threats continue to increase, an expected need has developed for transparency and compliance in order to cut off financing channels for these nefarious acts. Any MPL processing large payment volumes will be required to identify the parties of any transaction in order to comply with AML laws.<sup>197</sup> The existing legal framework for addressing AML and terrorism financing is insufficient. Rooted in reporting and record-keeping requirements imposed by the BSA, the current text was derived well before the advent of the internet, and does not address MPL activities.

## Standardization and Data

While MPLs rely on vast amounts of digital data, one of the foremost concerns is how to best and lawfully collect, aggregate and exploit this data. Privacy laws are piecemeal across the world, and no standardized method for collecting, storing and processing data exists.<sup>198</sup> Additionally, while this data has been at the heart of MPL’s innovation, it can also create unintended consequences, such as discriminatory lending, financial exclusion or penalties for potential customers with little or no digital footprint. Another concern is that credit models used by MPLs are “black holes” that leave little opportunity for borrowers to identify misuses of their data.<sup>199</sup>

### China

The development of market standards in China is not keeping up with fast growth of the country’s MPLs. Recent instances of fraud and mismanagement, such as the Ezubao scandal, have highlighted the need for stronger oversight. Although the GOPHD and draft AMBA provide guidance and rules on the regulatory controls of MPLs, concrete market practices and standards need to be established to further implement the regulations. Currently, Chinese MPLs need to work on standardizing market practices to include proper entrance, products and service standards, as well as information disclosure and customer information-sharing platforms.<sup>200</sup>

China has many MPL products because of a lack of standardized product development processes; moreover, most of the products are highly leveraged with elevated credit risks.<sup>201</sup> To avoid situations like the Ezubao scandal, Chinese MPLs must work together to address the current inadequate products and service standards, and to ensure products remain within controllable risk levels. To better protect investors, Chinese MPLs should also collaborate with regulators to implement standards on product development that incorporate proper risk control models and state requirements for profits, fees and investment management models. In doing so, Chinese MPLs and regulators need to remain aware of the potential risks and suitable investor types. To further implement the information disclosure requirements in the draft AMBA and SLB 2.0, the Chinese MPL industry must establish practical standards for information disclosures and customer service arrangements in order to further improve the service quality of MPLs and better protect the legal rights of investors and borrowers.

In China, a firm’s ability to harness the power of big data is met with both positive and negative reviews. On the one hand, less restrictive rules on the use of certain types of data have allowed Chinese MPLs to embrace the use of alternative sources of data to facilitate credit analysis of SMEs. Unlike big corporates, most SMEs do not have credit histories or records captured by the PBOC’s Banking Credit Information Systems. Therefore, many MPLs have explored alternative data sources, which include telecommunications, e-commerce, search and social media. The Chinese government has granted credit bureau

licences to leading e-commerce finance companies such as Baidu, Alibaba and Tencent, which have had the most access to SME credit information.<sup>202</sup> However, because of China's unique market environment, the private sector and the government are working together to search for more feasible alternatives.

Nevertheless, this embrace of using data is limited within the country. Most of the e-commerce giants and big platforms that maintain SME customer databases are unwilling to share their data with other market players because they view such databases as their source of competitive advantage.<sup>203</sup> Without a self-owned customer database, most Chinese MPLs have limited access to reliable credit information because they are not currently recognized as regular financial institutions and do not have access to the PBOC's CRC database. This positions most Chinese MPLs at a disadvantage to traditional banking-sector participants. Chinese MPLs hope to gain access to the national credit system, enabling them to better manage their risk exposures. Meanwhile, China is looking to build a centralized database for MPLs that will capture credit information for SMEs. Regulators such as PBOC and CBRC also need to intervene to motivate better market collaboration and sharing of customer transaction data.

## UK

The two major data concerns in the UK are access and burdensome reporting requirements. MPLs are experiencing issues with accessing the UK's payment system infrastructure, making it burdensome for them and forcing them to rely on relationships with banks. Currently, 400 smaller firms pay 10 large players for access to the system.<sup>204</sup> Giving UK MPLs access to this payment infrastructure database will lower transaction costs and give them the autonomy to better compete with traditional banking-sector participants. As previously noted, the UK government has taken steps to address this through the Credit Information Regulations by requiring designated CRAs to supply that information to finance providers.

With respect to UK MPLs' use of self-generated customer data, current regulatory reporting laws have notoriously cumbersome obligations. Even the UK government has noted that financial regulation and requests for increasing amounts of data may be hindering the capacity of financial institutions to operate and, more importantly, innovate.<sup>205</sup> In a 2015 report, the UK government's chief scientific adviser stated: "Regulations and data requirements could benefit from being redesigned, simplified and automated. Harmonizing financial regulation across multiple jurisdictions and creating new automated reporting and analytics standards could improve the financial services industry's efficiency, potentially reducing systemic risk and delivering economic benefits."<sup>206</sup>

## US

The most common concern of US MPLs is the standardization of available data points and less restrictive rules on using data. Under current US privacy and fair lending laws, US MPLs cannot leverage the same demographic data as their international peers, hampering their ability to access information needed for the underwriting process.<sup>207</sup>

Beyond loosening the regulations around obtaining and releasing customer information, several leading US MPLs have specifically requested that the US government be more open to enhancing access to its own customer and small business data. In their responses to the US Treasury RFI, both the Lending Club and OnDeck provided specific suggestions for sharing government-held data that could enable lenders to offer lower-cost, faster, easier and safer access to credit. Suggested ideas include digitizing the Internal Revenue Service's (IRS) 4506r tax-return transcript process to allow lenders instant access to available data; increasing access to customer bank data already collected by the IRS and SBA; and, more broadly, establishing rules for adequate and verifiable reporting of information to financial investors concerning borrower characteristics.<sup>208</sup>

Finally, a handful of US banks are opening their software and data to outside applications, but at not nearly the same level as in the UK and Europe. The push for more open bank application programming interfaces (APIs), which facilitate access to data, could transform the way consumers interact with their banks and increase competition among providers.<sup>209</sup> Commentators have noted that requiring banks to open up their APIs could encourage innovation by giving alternative finance providers access to a large pool of transaction data.<sup>210</sup> A more open standard API would also provide borrowers with greater transparency on how their data is used.<sup>211</sup>

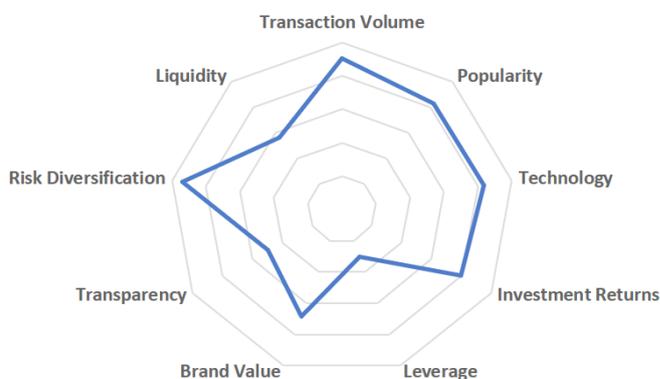
# Case Study: CreditEase

As China's FinTech market develops, MPLs will have to navigate a new and evolving regulatory landscape. This case study examines how a leading internet finance company, CreditEase, and its platform lender subsidiary, Yirendai, are adapting to this complex regulatory environment.

## Background and Performance

Ning Tang, the current executive chairman, founded CreditEase in 2006. In December 2015, Yirendai, a subsidiary of CreditEase, became the first Chinese MPL to be listed on the NYSE, raising \$75 million in the process.<sup>212</sup> As one of the biggest and most influential internet finance companies in China, CreditEase and Yirendai have a significant competitive advantage. According to analysis from WDZJ (Figure 3), Yirendai excels in risk diversification, investment returns and average transaction volumes compared to all other registered Chinese MPLs.<sup>213</sup>

Figure 3: Business Performance Analysis of Yirendai (March 2016)



|                  | Transaction Volume | Popularity | Technology | Investment Returns | Leverage | Brand Value | Transparency | Risk Diversification | Liquidity |
|------------------|--------------------|------------|------------|--------------------|----------|-------------|--------------|----------------------|-----------|
| Score out of 100 | 90.5               | 82.7       | 83.4       | 79.5               | 30.3     | 68.3        | 49.3         | 94                   | 56.4      |
| Industry Ranking | 3                  | 4          | 4          | 2                  | 63       | 6           | 16           | 1                    | 79        |

Source: WDZJ.com

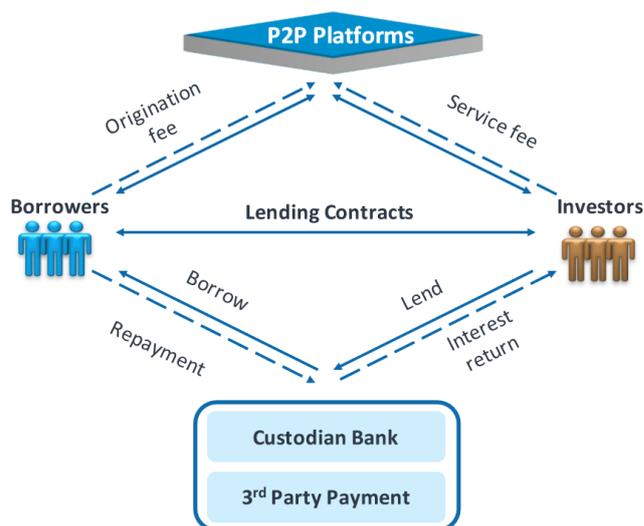
## Regulatory Response

With increasing regulatory pressures in China, CreditEase is striving not only to meet regulatory requirements, but also to proactively set higher standards among Chinese MPLs.

## Business Model

Yirendai operates as a platform lender, matching lenders and borrowers and collecting origination and servicing fees (Figure 4). It made the choice not to fund loans from its own balance sheet even before the release of the draft AMBA, which prohibited platform lenders from also operating a hybrid business model.<sup>214</sup> By clearly defining its business model, Yirendai was able to avoid the upheaval and disruption caused by the draft AMBA, and will be well ahead of its competitors if and when they become compliant.

Figure 4: Yirendai's Business Model



Source: Fang, Yihan. "Online Lending in China". Yirendai. 2016

In April 2015, Yirendai also obtained an ICP licence from the Chinese telecommunications authorities as an internet information provider, anticipating that the draft AMBA would require platform lenders to do so.<sup>215</sup> Again, Yirendai's anticipation of regulation gave it an advantage versus competitors, who will have to scramble to become compliant.

### Investor Protection

Following recent instances of fraud and mismanagement, the Chinese platform lending market has placed a high premium on investor protection and underwriting standards. CreditEase has gained a competitive advantage with its end-to-end risk control systems.<sup>216</sup> To better protect customers' interest, the company introduced the "whole process risk management scheme", which includes detailed controls during the client due-diligence phase of the pre-transaction process, the credit analysis phase of the credit underwriting process, and the close monitoring phase of the post-transaction process. CreditEase also fully leverages big data and other alternative information in its credit assessments, and has developed anti-fraud models to prevent risks of fraud.<sup>217</sup> These measures have helped Yirendai to maintain a bad debt ratio of under 2% in recent years.<sup>218</sup>

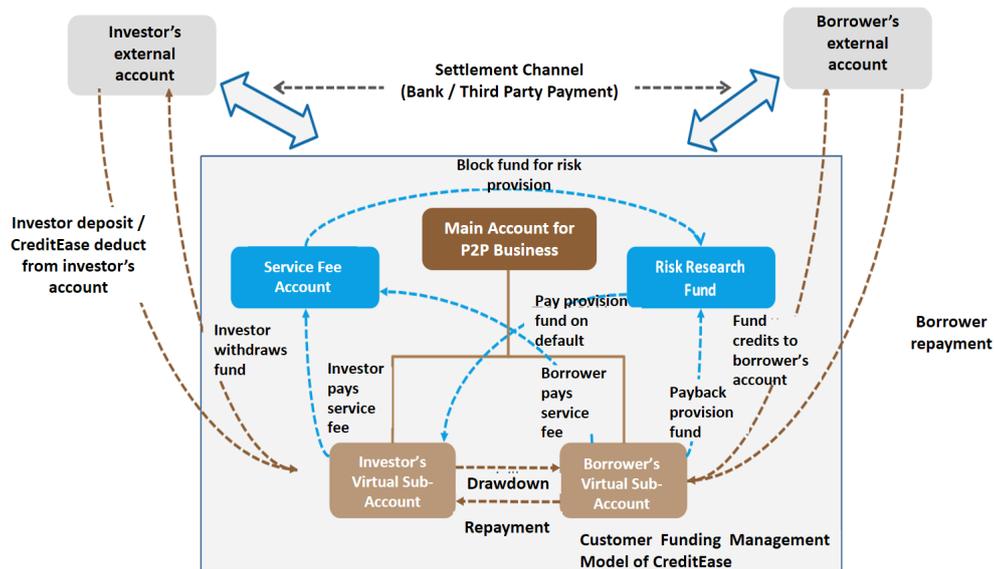
Yirendai's initial public offering (IPO) not only provided CreditEase and Yirendai with sufficient capital for future development, but also placed Yirendai under the SEC's scrutiny. As a public company, Yirendai has significant disclosure requirements, which have strengthened risk controls and improved transparency. Accordingly, investors are better protected with sufficient equity and more transparent business practices.

In response to the draft AMBA, which prohibits platform lenders from providing performance guarantees, CreditEase partnered with China Life Insurance Company Ltd's (CLIC) Beijing branch and AVIC Capital Co. Ltd's AVIC Trust Co. Ltd (AVIC Trust). Under the current collaboration agreement, AVIC Trust will issue trusts to investors that fund loans through CreditEase, and CLIC will provide credit insurance for loan losses to AVIC Trust. This arrangement provides certain guarantees to these investors.

### Clearing, Settlement and Segregation of Client Money

To remain compliant with the funding segregation requirements of the draft AMBA, CreditEase has partnered with China CITIC Bank International (CITIC) and Guangdong Development Bank (GDB) for its funding management and loan settlement activities.<sup>219</sup> CreditEase generally utilizes secondary settlements and clearing, as detailed in Figure 5.

Figure 5: Yirendai's Funding Management Model



Source: Fang, Yihan. "Online Lending in China". Yirendai. 2016

The recent collaboration between Yirendai and the GDB has further improved the efficiency and segregation of funding. Funds from investors and borrowers will be directly settled from their bank accounts. The GDB fully monitors the movement of funds and ensures appropriate segregation between client money and Yirendai's own funds. This refined model is achieved by improving the system's integration between Yirendai and the GDB.<sup>220</sup>

## Credit Underwriting

With limited credit history on SMEs, CreditEase, through its subsidiary CreditEase Shangtongdai, established its own big data team to develop credit assessment models based on data from past transactions. In 2015, CreditEase Shangtongdai won the Best Big Data Application Innovation Award in the China Finovating Creative List Awards.<sup>221</sup> According to Lei Peng, deputy general manager of CreditEase's Big Data Innovation Center, CreditEase Shangtongdai "utilizes big data technologies to provide credit and lending services to small and micro-enterprises".<sup>222</sup> He went on to say: "[I]f the borrower's information is complete, Shangtongdai can authorize credit in just one minute. After comprehensively evaluating the borrower's operational and credit data, the platform provides credit quotas based on risk pricing. CreditEase obtains all possible public information and risk-related data from the Internet, using big data technology during and after the loan, thereby ensuring asset quality."<sup>223</sup>

Apart from this internal innovation, CreditEase has also partnered with the Fair Isaac Corporation (FICO) as the first customer of the FICO Alternative Lending Platform. An analytic and decision-making software platform, it is designed to address the fact that "[l]oan and lease amounts in the P2P and micro-loan industry are often too small for creditors to justify a traditional origination process".<sup>224</sup> CreditEase believes that this relationship will significantly improve its underwriting and risk control processes.<sup>225</sup>

Lastly, as discussed earlier, the core problems of Chinese MPLs are the absence of a centralized data platform and poor collaboration in sharing data. CreditEase is taking initiatives to build the necessary foundation for a centralized data platform. Zhicheng Credit, CreditEase's credit rating company, is sharing data on past lending history and also providing a public version of a "risky customer" list to encourage other Chinese MPLs to do the same.<sup>226</sup> The goal is to create a data-sharing scheme within China that will improve underwriting throughout the industry and combat instances of fraud and misuse by customers, particularly those that borrow heavily from multiple platform lenders.<sup>227</sup>

## Promoting Industrial and Global Collaboration

CreditEase plays an important role in promoting industrial collaboration and self-discipline; its founder, Ning Tang, serves as chairman of Beijing's P2P Association and deputy director unit of the Zhejiang Association of Internet Finance.<sup>228</sup> CreditEase was also elected to serve as an executive director unit of the PBOC's NIFA.<sup>229</sup> NIFA President Li Dongrong has stated that the association will "serve as a bridge between government and industry".<sup>230</sup> NIFA will formulate rules and generally work to strengthen the industry,<sup>231</sup> marking a significant collaboration between regulators and private industry.

CreditEase is also working to expand beyond China's borders by developing partnerships with global firms and exporting its technology to foreign markets.<sup>232</sup> Yirendai's IPO provided CreditEase with significant public awareness in the global MPL industry. CreditEase is actively involved in global MPL conferences such as LendIt, providing vast exposure for CreditEase to learn from other leading platforms and improve the broader industry's understanding of the Chinese MPL market.

## Future Development Plans and Ongoing Concerns

Following the Ezubao scandal and other instances of fraud and mismanagement, market confidence is a major concern for CreditEase and the rest of the Chinese MPL market. To re-establish confidence, the company, as one of the market leaders, should further promote collaboration among platforms to break information barriers by building information-sharing systems that would mitigate credit risks. Meanwhile, CreditEase plans to work closely with regulators in forming future MPL regulations and to explore suitable governance approaches that better promote the Chinese MPL market's healthy development.<sup>233</sup>

With Yirendai's successful IPO, CreditEase is now exploring opportunities to access capital markets both domestically and globally. More IPOs will be expected for other CreditEase subsidiaries, which will further strengthen their internal controls and increase the global awareness of the company.<sup>234</sup>

CreditEase is also going beyond financing to work with SMEs in China to improve their businesses. In 2012, the company launched the Credit Wings Plan, which provides SME clients with professional training and development.<sup>235</sup> CreditEase hopes that by improving their business fundamentals, SMEs will be seen as better credit risks and, therefore, will be able to secure financing more easily.<sup>236</sup>

In conclusion, to strengthen the controls and promote the healthy development of the Chinese MPL market, leaders such as CreditEase must be more proactive in setting higher standards for risk controls and striving to promote technological innovations. MPLs must work more cooperatively in forming market standards and sharing information to mitigate risks. Lastly, market leaders need to work with regulators to find the most suitable approach for regulations on MPL, particularly in a way that does not impact SME lending.

# Conclusion

As discussed in detail, regulators differ in their approach: they either provide reactive regulations that cover portions of the industry, or codify the rules proactively to encourage FinTech's development. This creates a complex regulatory environment for MPLs to navigate, and provides an uncertain future for SME lending. In examining the differences across China, the UK and the US, the regulatory approaches to MPLs can be broadly applied across the FinTech industry, and can serve as a case study for changing the way governments operate in the 21st century. Three recommendations follow:

- **Increase coordination and collaboration between regulators:** How a government sets up its regulatory structure for the financial market can broadly impact innovation. The ongoing debate over the relative strengths and weaknesses of principles-based and rules-based systems of regulation shows no end in sight. Regardless of which model regulators deem most appropriate, the most important objective for policy-makers should be to increase the coordination among regulatory institutions – not just domestically, but also, if possible, internationally.
- **Apply lessons learned across the FinTech industry:** While MPLs face certain regulatory burdens not borne by other FinTech activities, the concerns outlined in this White Paper can serve as a roadmap for policy-makers as they attempt to rein in other types of financial innovation. In broad terms, technology-led financial innovations provide services more closely aligned with how people actually deal with their money, thus blurring business lines. As activities converge, regulators will have to adjust to meet these new business models. Specifically, the principles of investor protection, capital requirements and data protection are three areas where lessons of MPL regulation can be broadly applied to these new, amorphous models.
- **Apply FinTech principles to regulatory capacity:** As the world becomes increasingly digitized, regulatory capacity needs to increase in tandem. This is already occurring, as firms develop solutions to automate compliance tasks and reduce operational risk. Governments cannot remain static or be delayed, but must respond. Similar to FinTech's disruption of financial markets, the next trend of "RegTech" will make regulation highly data acquisitive, and will involve the use of real-time information and the incorporation of algorithms and analytics.

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IMPROVING THE STATE  
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The World Economic Forum, committed to improving the state of the world, is the International Organization for Public-Private Cooperation.

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