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Banking & Finance Law

New Cash Loan Rules Issued, a Deathblow to the Industry?

Financial Asset Management Department

Rumors have circulated for some time of tightening regulations in the cash loan industry in China, and some large platforms have already embraced regulation by lowering interest rates. However, few expected the regulator, the Leading Group Office for Thematic Regulation of Internet Finance Risk Work and the Leading Group Office for Thematic Regulation of P2P Lending Risk Work (“**P2P Leading Group**”), to formally promulgate on December 1, 2017 the *Circular on Regulating and Rectifying Cash Loan Services* (“**Circular**”). The Circular strikes a heavy blow against predatory practices and has caused a relative chill in the cash loan industry.

What are cash loans?

Although the concept of cash loans has appeared in Internet finance regulatory documents several times, no government document or legislation has provided an official definition or classification standard (implied and by extension). The P2P Leading Group on April 18, 2017 issued *Supplementary Notes Concerning Carrying Out the Cash Loan Business Clean-up and Rectification Work*, which does not precisely define the concept, but summarizes four main characteristics of the cash loan industry:

- a. Excessively high interest rates;
- b. Loan amounts actually extended are inconsistent with those stipulated in the loan contracts;
- c. No collateral, short terms;
- d. Relying on exorbitant interest rates to cover risks, debt collections by force.

While the Circular also fails to clearly define cash loans, it describes four major characteristics of cash loans, which are “no use scenario,” “no specified purpose,” “no defined customer limitations,” and “no collateral.” Based upon this, we can assume that most of the products currently in the market that feature small sums or no usage scenarios that allow borrowers to instantly withdraw credit to their bank accounts would be classified as cash loans.

Based upon the descriptions above, among the products currently provided by the loan facilitation platforms, those that have the following features may be exempted from being categorized as cash loans:

- a. “Consumer installment loans” that have a definite use scenario and which adopt entrusted payments as the payment method, including purchase loans, education loans, cosmetic loans, car purchase loans; and business operating loans for enterprises or merchants;
- b. Mortgage or pledge loans, such as loans secured with real estate or vehicles.

However, there still exists uncertainty as to whether “credit card repayment loans” are classified as cash loans in accordance with the Circular. Although credit card repayment loans have a specified purpose (i.e., to repay credit card bills), the loan funds will be paid to the borrower's personal bank account, rather than to the credit card bank (i.e., not an entrusted payment). Thus, the loan funds can be used freely by the borrower, causing the regulator to potentially classify these credit card repayment loans as cash loans on the grounds that they have no definite use scenario and no specified purpose.

Core principles for the cash loan industry clean-up

The following are the core principles emphasized to clean up the cash loan industry:

- a. **Mandatory licensing:** Platforms must be licensed in order to engage in the cash loans business, and no organization or individual may operate to extend loans without a license. This directly renders the “super individual lender” and “advance payment” methods illegal.
- b. **Financing costs calculated by integrating interest and expenses:** The overall financing costs are to be calculated within the interest limitation set out by the Supreme People's Court with respect to extension of private loans. In addition, the Circular requires an integrated calculation of loan interest and expenses and the result of this calculation is to be annualized. This directly challenges the profit-making logic of most cash loan platforms by covering high risks with high profits. In practice, loan cost annualization should help borrowers to clearly see the total cost of financing. As the Circular stipulates that the scope of expenses subject to the integrated interest-expense calculation is now expanded to “all kinds of expenses,” this will prevent loan platforms from charging additional expenses in disguised form when extending loans, such as tie-in sales of insurance.

- c. **KYC**: Loan platforms may not induce borrowers to excessively borrow loans and may not extend loans to borrowers without sources of income. The maximum principal and interest for a single loan payable by the borrower must be clearly prescribed, and loans generally may not be extended for more than twice. These provisions are intended to restrain the circumstances by which some cash loan platforms induce borrowers to repay loans by borrowing additional funds or by borrowing funds from multiple platforms which cause borrowers to become heavily indebted.
- d. **Operating in a prudent manner**: Loan platforms are to strengthen internal risk control and carefully use “data-driven” risk control models. Platforms may not conceal non-performing assets in any manner. Clearly, the regulator has proposed these requirements because it is aware of problems associated with so-called “big data” risk control methods that are employed by many cash loan platforms and of the actual circumstances in which many cash loan platforms use their extremely low non-performing asset ratios as promotion highlights.
- e. **Prohibiting debt collection by force**. This is a principle that is consistently upheld by regulators.
- f. **Information protection**: Cash loan platforms must strengthen the protection of customer information, shall not abuse customers’ information privacy, and shall not illegally sell or disclose customers’ information. Strengthening information protection is a requirement that is constantly emphasized by the regulators, and aims to suppress the acts of many cash loan platforms to illegally sell customers’ information to other platforms for profit. The Circular will further regulate the conduct of cash loan platforms with respect to the obtaining, sharing and use of customer-authorized personal credit ratings data.

Four major weapons to clean up the cash loan industry

In our opinion, in addition to the core integrated loan interest and expense calculation requirement, which is tantamount to the “nuclear weapon” for many cash loan platforms, the Circular also reveals the following four major weapons in order to bring order to the cash loan industry:

a. Prohibit micro-lending

i. Control licenses

- License application examinations have been suspended for establishing new online (Internet) micro-loan companies, and also applications for conducting micro-lending across provinces (regions, municipalities). Those online (Internet) micro-loan companies that have already been approved for establishment are also subject to a suspension on approvals to operate.

- Where the application for establishment is granted by an authority that is inconsistent with the requirements stipulated by State Council documents, the company's qualifications for conducting the relevant business will be re-examined. This means that the approval for establishment of an online (Internet) micro-loan company may become invalid if the approval is granted by a department which is not competent to render such an approval. However, it is still unclear which State Council documents should be referenced when determining whether an approval department is competent to grant an approval. It is very likely that relevant regulatory departments may introduce unified and high-threshold standards for examining micro-loan company establishment applications.

ii. Control assets

- Online (Internet) micro-loan companies will be required to suspend the issuance of “cash loans” and expressly forbidden to engage in activities such as “repaying loans with borrowings” and “loans from multiple platforms.” Micro-lenders are also prohibited from issuing “campus loans” and “down-payment loans,” and from issuing loans for making speculative investments, such as the purchase of stocks and futures.

iii. Control funds

- Online (Internet) micro-loan companies are prohibited from selling, transferring or transferring in disguised form a company's credit assets through Internet platforms or local exchanges. This will put an end to the practice of many online (Internet) micro-loan companies transferring their assets for the purposes of raising capital, and will also help to eliminate the practice of transferring the right to benefit from debt claims. Moreover, as interpreted literally, these provisions target acts of micro-loan companies themselves, rather than the “cash loan” assets.
- Fundraising is prohibited through online peer-to-peer lending information intermediaries (“**P2P Platforms**”). This provision is expected to have limited effect, especially in the case that P2P Platforms that are currently subject to maximum financing limits, which will make it difficult for micro-loan companies to raise funds through P2P Platforms.
- Capital raised by credit asset transfers and asset securitization, etc. are to be combined with on-balance sheet financings, and the ratio of this combined amount to net capital will temporarily be the ratio currently implemented by local authorities. This leverage constraint will effectively put an end to the business method of having many online (Internet) micro-loan companies freeing up capital through asset securitization on exchanges.

The central financial regulatory departments are expected to formulate and issue an

“Implementation Plan on Thematic Regulation of Micro-Lending,” and will further refine the relevant regulatory requirements.

b. Regulate banks

- i. Financial institutions subject to relevant prohibitions include most financial institutions transacting with cash loan platforms, including banks, trust companies and consumer finance companies.
- ii. It is reiterated that banking financial institutions are required to comply with the *Interim Measures for the Management of Personal Loans*.
- iii. Banking financial institutions may not provide funds in any form to institutions to extend loans that are not qualified to do so, and may not extend loans jointly with institutions that are not qualified to do so.
- iv. Banking financial institutions may not outsource their core businesses such as credit examination and risk control services when cooperating with third-party institutions to engage in lending. This means that even if the cash loan platforms provide credit examination and risk control services, the banking financial institutions must still independently fulfill their credit examination and risk control obligations. In practice, most banking financial institutions will conduct a second credit review, but there are also some banking financial institutions that essentially rely on cash loan platforms to conduct credit reviews. Under the Circular, those banking financial institutions must adjust their business models.
- v. Loan facilitation services are to be simplified and return to their origins, and banking financial institutions may not accept credit enhancement services or credit enhancement services in disguised form provided by unlicensed entities. Under the loan facilitation business model, it is quite usual that the platforms are required to provide lenders with security, guarantees or credit enhancements. Since the Circular expressly prohibits banking financial institutions from accepting any guarantees or credit enhancements provided by unqualified agencies, there is a great possibility that banking financial institutions will be discouraged from continuing to carry out the relevant business or they will try to seek other means of achieving risk-sharing. However, there are no existing laws or regulations that clearly prohibit cash loan platforms from indirectly providing credit enhancement or joint and several liability guarantees. In the future, it may be an option that financing guarantee companies and insurance companies provide credit enhancement to banking financial institutions and then to have cash loan platforms provide counter-guarantees.
- vi. Banking financial institutions will require and assure that cooperating third-party institutions not charge borrowers any fees or interest. This provision has a

game-changing effect which puts an end to the industry practice of cash loan platforms directly charging borrowers service fees, and of banking financial institutions charging interest. If cash loan platforms stop charging fees on borrowers but make settlements with the banking financial institutions, the current business model of banking financial institutions will be challenged at an unprecedented level. While there is uncertainty as to whether banking financial institutions are willing to charge borrowers the maximum financing costs as permitted under the laws and regulations, banking financial institutions may also have to make significant adjustments to cash loan-related business management and risk control systems.

- vii. Banking financial institutions and asset management products issued and managed by banking financial institutions may not subscribe directly or subscribe in disguised form to any (quasi) ABS products, the underlying assets of which are cash loans, campus loans, or down-payment loans for the purchase of real estate.
- viii. In addition, although the Circular targets the regulation of cash loans in general, several provisions under this chapter set forth requirements by expressly referring to the loan facilitation business as a subject of regulation (instead of to the cash loan business only). Therefore, we are uncertain whether this document will also be applicable to banking financial institutions that engage in loan facilitation services in the future. From the legislative intent, we tend to believe that the same standards will apply to loan facilitation services equally.

c. Controlling P2P

- i. Taken literally, cash loan businesses are not the only target of regulation in connection with P2P Platforms.
- ii. The Circular provides several prohibitions for P2P Platforms, especially in the following aspects:
 - P2P Platforms may not facilitate or facilitate in disguised form the loans that violate interest rate requirements provided for by law.
 - P2P Platforms may not withhold interest, procedural fees, management fees or deposits from the principal and may not set excessively high overdue interest, late fees and penalties, which means P2P Platforms must abandon the common practice of withholding relevant fees.
 - P2P Platforms may not outsource core services such as customer information collection and screening, credit evaluation and account opening. This renders impossible the service outsourcing model adopted by some P2P Platforms. P2P Platforms still have to fulfill the relevant responsibilities on their own even when they cooperate with some third-party customer acquisition platforms.

- P2P Platforms may not provide loan facilitation services to students, individuals with no sources of repayment or individuals with no repayment capacity.
- P2P Platforms may not provide loan facilitation services for real estate purchase loans, such as “down-payment loans” or “real estate-related financing” and may not provide loan facilitation services for loans without designated uses.

d. Severe punishment

- Punishments include suspension of business, rectification orders, circulating notices of criticism, refusal of filings and cancellation of business qualifications. Serious violations may result in industry bans, or even administrative penalties.
- Regulatory departments will suspend the business of websites and platforms that assist various agencies in conducting business in violation of laws and regulations and pursue liability against those websites and platforms in accordance with the law.
- For organizations or individuals that engage in extending loans without licenses:
 - Those who are suspected of engaging in illegal business will be reported to relevant departments for investigation;
 - Financial institutions and non-bank payment agencies must cease to provide financial services. The communication administrations will punish Internet finance websites and mobile applications in accordance with law.
 - Those that engage in illegal activities such as illegal fund-raising and illegal securities activities will be investigated and punished in accordance with the corresponding rules, such as illegal fund-raising rules, rules related to cracking down on illegal securities activities and rules related to cleaning up and rectifying various exchanges.
- In case of institutions that are in serious violation of the laws and regulations such as being suspected of committing illegal fraud and collecting debts through force, relevant evidence should be timely reported to the public security organs.

Prospects for the cash loan industry

Although the Circular provides a series of stringent requirements, it also leaves some room for interpretation in terms of the implementation of certain provisions. Thus, there remains uncertainty as to what extent certain provisions be implemented in practice. In particular, P2P reform has not yet been completed and remains a daunting task. With respect to the management of cash loans, participating institutions referenced in the Circular are subject to supervision by the local financial supervisory departments, although we are not certain as to what kind of supervision strategies will be adopted by the local departments and to what extent

they will implement the Circular. One certainty, however, is that this is a bad time for new cash loan platforms to enter the capital markets, because the Circular clarifies some ambiguities under the previous cash loan regulatory policies, and investors will tend to adopt a cautious attitude when assessing the future profitability and development of cash loan platforms, and valuation models will also need to be adjusted accordingly. However, every coin has two sides. After the inadequate cash loan platforms are removed, those that survive will be those platforms that have substantial risk control ability and sound profitability. In this respect, the promulgation of the Circular presents an opportunity for “good money to drive out bad money” and bring the industry to an era of winner takes all.

● **Important Announcement**

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