China regulates online payment business of non-bank players

China's online payment market is growing at break-neck speed. In the first three quarters of 2015, the total volume of online transactions processed by payment institutions exceeded RMB 56 billion, and the monetary value of transactions reached close to RMB 3.3 trillion.

But these impressive figures have come with significant "growing pains" in the industry, as the quality of some of the industry participants has not consistently matched the quantity. The collapse earlier this year of peer-to-peer lender Ezubau – an apparent Ponzi scheme that has reportedly cost 900,000 lenders over USD 7 billion – has made the case that tighter regulation is needed in order to curb the excesses of China's payments revolution.

Against this background, on 28 December 2015, the People's Bank of China (**PBOC**) issued the Measures for the Administration of Online Payment Business of Non-bank Payment Institutions (**Measures**), which will become effective on July 1, 2016.

Non-bank payment institutions in China

Online payments via non-bank payment institutions are now widely seen all over China. The payments are not just being used for retail purchases, but also in increasingly innovative ways to support all manner of payments, investments, loans and money transfers – whether on a business to consumer basis – between consumers or between businesses. The rapid evolution of payment services models in China has led to a number of problems and risks faced by the online payment industry and its regulators, including the following:

- inadequate customer due diligence procedures that result in increased risk of fraudulent payments, money laundering and tax avoidance
- inadequate financial controls enabling the embezzlement or misdirection of funds and creating risks to liquidity
- lapses in system security that allow funds or customer data to be misused or misappropriated, and
- the use of payment technologies to bypass authorities' traditional controls on "hot money" and liquidity across different financial markets.

The PBOC has issued the Measures in response to these and other issues.

Basics of the Measures

The Measures apply to all "non-bank payment institutions" (**Payment Institutions**), which are defined to be institutions that are not banks but which – with a payment business permit – are authorized to provide online payment services, including through the Internet and mobile devices, landlines and interactive digital television.

According to the Measures, a Payment Institution's role is limited, among other things, to "offering the public with fast and convenient payment services in small- and micro-amounts." The PBOC's intention is clear: Payment Institutions should not be vehicles for large-scale payment transfers.

KYC and client management

The Measures require Payment Institutions to establish a real-name management system, achieved through following "know your client" (**KYC**) rules, registering clients and verifying their identity documentation, creating a client identification number, and applying continuing client identification measures over the course of the client relationship. These requirements are meant to ensure the effective verification of clients' real identities and so prevent the opening of anonymous or pseudonymous accounts, as well as prevent individuals from bypassing the KYC payment thresholds discussed below by operating multiple accounts in concert.

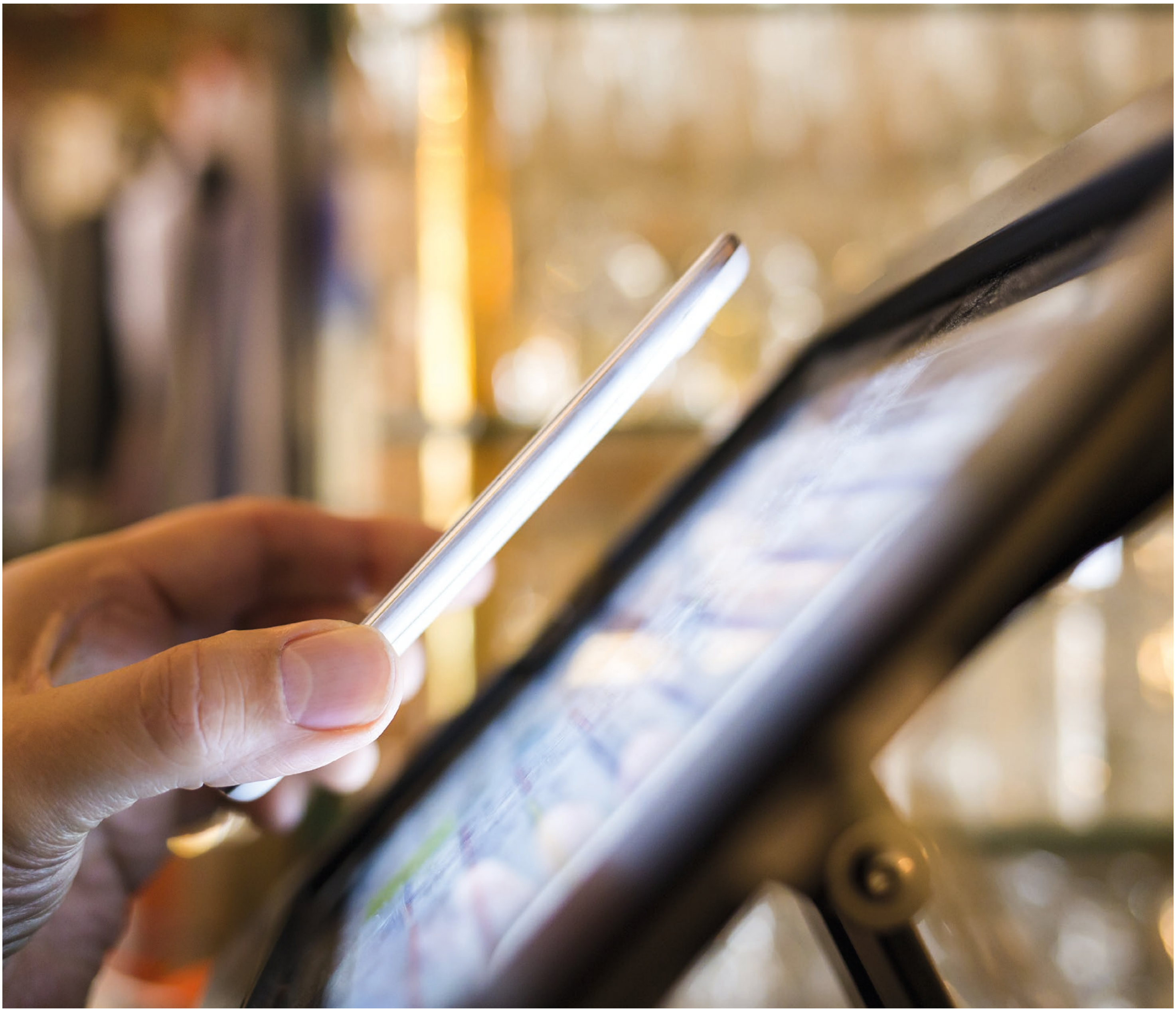
To protect users of online payments, the Measures clearly separate payment accounts and bank accounts. Money in payment accounts are not treated as deposits attracting the full weight of banking regulation.

The Measures prohibit Payment Institutions from opening payment accounts for financial institutions or other organizations providing financial services such as loans, financing and other forms of credit, asset management, guarantees, trust services, foreign exchange services, or cash deposits and withdrawals, effectively ring-fencing Payment Institutions from the traditional banking system.

Payment Institutions are required to carry out KYC on a three-tiered basis, with payment account limits structured in a manner that corresponds to the approach to customer identification and the function of the funds or fund transfer:

Type	Means of customer identification	Function of payment	Amount limit
I	Non face-to-face verification with at least one legal and secured external channel for basic identity information verification	Consumption and transfer	RMB 1,000 cumulatively since account opening
II	Face-to-face verification or non face-to-face verification with at least 3 legal and secured external channels for cross- basic identity information verification	Consumption and transfer	RMB 100,000 cumulatively per year
III	Face-to-face verification or non-face-to-face verification with at least 5 legal and secured external channels for cross- basic identity information verification	Consumption, transfer and investment	RMB 100,000 cumulatively per year

Payment Institutions are required to keep client records for at least five years.



Risk management and client rights protection

Based on client type, method of identity verification, transaction behavioral characteristics, and credit-worthiness, the Measures require Payment Institutions to establish a client risk rating system and dynamically adjust a client's risk rating and relevant risk control measures to changing circumstances.

Payment Institutions are obliged to investigate and verify transactions that are suspected to be fraudulent or made in support of money laundering, terrorism or other illegal activity. They are also required to delay settlement and terminate client service as appropriate.

In addition, Payment Institutions are under an obligation to establish a thorough risk management system, and to have mechanisms in place to remedy unauthorized transactions. They are also required to compensate clients who have suffered monetary loss not proven to be the client's own fault.

In terms of client data collection, usage, storage, and transfer, Payment Institutions need to follow "data minimization" principles that seek to reduce volumes of customer data to that which is strictly necessary in order to minimize the risk of loss or unauthorized access and use. The specific purpose and scope of data usage must be notified to clients. Payment Institutions must not disclose clients' information to other organizations or individuals unless otherwise stipulated by law, or confirmed and authorized in each instance by the customer.

There is also an important element of data localization in the Measures. Payment Institutions are required to have secure processing systems and backup systems based within China and operating in accordance with regulatory standards. Transactions within China must be completed and settled using processing systems located in the country.

A Payment Institution may not induce or force clients to use its payment services, nor may it interfere with its client's using other organizations' payment services.

Conclusions

The Measures are an important development towards the maturing of China's rapidly expanding and highly innovative market for non-bank payment services. Chinese consumers and businesses are clearly enthusiastic about having alternatives to the traditional banking system, but it is clear from Ezubao and other recent examples that improvements are needed to the regulatory environment and the culture of compliance.

While users will likely find that the implementation of the Measures makes some forms of online payments less user-friendly, this is a balancing act – with benefits for users of these services in the form of better security for money and data. Whether the Measures will succeed in striking the right balance will be largely determined by the way they will be applied by business and the authorities after their entry into force on 1 July 2016.

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