# The Role of Public Policy in Regulating, Promoting Financial Innovation

Yue Yin

University College London, London, WC1E 6BT, The UK
zcfbyin@ucl.ac.uk

**Abstract.** This paper investigates Chinese public policy effects on financial innovation development by evaluating its dual regulatory and promotional functions. The research investigates policy implementations that were established to limit financial risks and protect market fairness. This analysis includes two significant studies: the sudden growth and destruction of the peer-to-peer (P2P) lending sector and the halted Ant Group IPO. The two examples demonstrate that inconsistent oversight results in marketplace disorder coupled with unbalanced conditions. The paper evaluates promotional policies through examination of financial tools, including R&D tax credits and subsidies, which increased company investment in innovation. Public financial infrastructure projects that focus on payment systems and Central Bank Digital Currencies (CBDCs) allowed the government to establish conditions for new financial services development. The investigation demonstrates how appropriate risk control measures should exist together with innovative strategies. Public policy in China demonstrates its ability to steer financial innovation through its implementation, while showing certain obstacles in the process. The current level of progress comes with ongoing restrictions in long-term effective policy implementation due to regulatory capacity inadequacies and policy division. A better, consistent policy strategy designed for future financial development needs to be established for sustainable growth.

**Keywords:** Financial Innovation, Public Policy, and Risk Control.

## 1 Introduction

Geographical markets use financial innovation as their main economic driver to conduct necessary changes while ensuring sustainable development. The combination of green finance alongside fintech operating as essential subareas emerges from technological improvements, yet essential environmental and social requirements [1, 2]. The rapid market growth of green financial products, including ESG funds and green bonds, continues to expand throughout both international market sectors. China leads the global investment in these products [3]. The innovation wave has operated within the framework of public policy tools, such as tax incentives and regulatory sandboxes, through regulation mechanisms, together with market design adjustments and fiscal incentives. New financial technology faces regulatory oversight in public policy, while


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the same policies take active steps to enhance innovation through removing obstacles and developing supporting frameworks and network systems.

Green finance appears to respond to worldwide environmental issues, while capital needs to be reallocated to low-carbon sustainable initiatives [4]. Regulatory bodies, combined with governments, have issued mandatory guidelines, disclosure requirements, and taxonomies that drive fundamental changes to ESG investing [5]. The Chinese government assumed a vital role in guiding funds toward green investments through green credit policies and ESG reporting obligations, along with digital payment platforms [6].

The MSCI China Select ESG Rating Trend Leaders Index presented increasing cumulative performance data between mid-2024 and early 2025, as shown in Figure 1. The index displayed minimal alteration in performance statistics from April to August 2024. Still, it underwent significant growth in September 2024, which led to moderate price corrections before resuming an upward trajectory toward March 2025. The trend reflects increasing investor belief and market adoption of ESG-compliant companies because of better regulatory rules and rising sustainability fund investment.


**Fig.1.** Trend of MSCI China Select ESG Rating Trend Leaders Index (Data Source: MSCI )

The green finance market and ESG market sector of China have shown significant development throughout recent years. GSIA reports that ESG fund assets in China reached RMB 2.6 trillion during 2024, while total passive and active product growth remained swift [3]. The China Securities Regulatory Commission (CSRC) experiences increasing ESG disclosure from listed firms because of combined international and domestic regulatory changes [7].

The study explores the twofold work of public policy as it applies to financial innovation regulation and promotion. It focuses on policy mechanisms that reduce market risks and stability threats by focusing on market failure stabilization and digital infrastructure development, because researchers seek to determine proper levels of government intervention versus support for innovation. The paper focuses on Chinese green finance and ESG development as exemplary examples of contemporary policy-innovation relationships.

## 2 Public Policy as a Stabilizer and Equalizer in Financial Innovation

### 2.1 Market Stability and Risk Containment: The Case of Peer-to-Peer Lending

Financial market stability depends heavily on regulatory oversight because of China's rapid P2P lending sector growth, followed by its sudden demise. At their launch, P2P platforms were meant to bring democratization to financing, but they enabled users to avoid financial institutions to create direct credit deals. China reached its P2P lending sector peak in 2015 through the operation of more than 5,000 P2P platforms that distributed more than RMB 1 trillion in cumulative loans [8]. The P2P industry faced destruction by 2020 because of fraudulence, combined with platform failures and insufficient governmental oversight.

The regulatory authorities showed late but strong resistance in their response to the phenomenon. The early Chinese government policy toward P2P involved minimal oversight and strong support, aligning with the broader strategic goals of Internet Finance [9]. Around 2013, Internet Finance was officially framed as a key instrument for promoting financial innovation and facilitating economic restructuring. As a result, the government adopted an approach characterized by ‘encouragement first, regulation later’ in its treatment of the P2P sector. This tolerance from the government enabled platform multiplication despite their lack of financial capital standards, clear disclosure, and investor defense measures. Many platforms conducted risky or fraudulent practices by offering guaranteed returns and stealing funds from clients, which triggered severe losses for investors and public discord.

A major policy shift emerged following the inception of a thorough rectification campaign in 2016. This campaign marked a fundamental transformation of the regulatory framework through the introduction of mandatory bank custody of funds, risk-based classification management, and a formal filing system for platforms. The regulatory collaboration between central organizations (CBRC and PBOC) with local governments performed platform closures for non-compliances and established enhanced licensing procedures. Different scholars have presented the central and local co-regulatory model as having two sides because local authorities could more easily monitor market participants yet still showed weak enforcement capacity and prioritized local economic growth instead [8]. The uneven pace of enforcement efforts, together with their late response, produced minimal prevention for both platform breakdowns and investor financial loss.

Research data shows that later interventions prove to be effective mechanisms for achieving their results. The research by He and Li indicates that politically connected platforms, together with platforms operating in jurisdictions with strong financial governance, showed fewer failures [9]. Platform failure events grouped themselves at times that carried political significance, which indicated that regulators made their moves under political influence. Major financial operations, Ezubao and Tuandai, collapsed, showing the huge dangers that arise from unregulated fintech growth. The market collapse forced investors to protest against regulatory deficiencies, which had failed to protect retail investors in novel financial sectors.

The governance of financial risks requires public policy to take a central position when innovation occurs in the financial sector. Unlike countries such as the UK that adopt a more experimental and prudential approach through regulatory sandboxes, China has implemented a more centralized and conservative risk control strategy in the aftermath of the P2P lending crisis, further underscoring the central role of public policy in managing financial innovation. The World Bank (2022) has documented how digital environments enhance the risk factors that include cyber threats, along with fraud and systemic instability [10]. New technologies become risk-magnifying instruments instead of decreasing risks when supervision is insufficient and licensing rules are unclear. The Chinese authorities' late regulatory response produced two negative effects: greater financial market turbulence, along with reduced confidence in innovative products from the general public.

### 2.2 Ensuring Fair Competition: The Ant Group IPO Suspension

Another key role of public policy in the context of financial innovation is to ensure equal market access and prevent regulatory arbitrage by establishing a level playing field. The regulatory decision to stop Ant Group's $34.5 billion initial public offering (IPO) in November 2020 illustrated public policy's requirement to remain active. Ant's initial plans for becoming the biggest IPO failed just before the debut as its founder, Jack Ma, condemned Chinese financial authorities who restricted innovative methods [11].

The regulatory suspension originated from efforts to develop system-wide risk identification and address regulatory gaps, particularly as systemic risks emerged—such as Ant Group's use of asset securitization to shift loan risk onto the banking system, potentially triggering a chain reaction. Although these measures were technically motivated, political influences also shaped their timing and public visibility. Ant offered a wide range of financial services—including payments, micro-loans, and asset management—delivered primarily through digital platforms. The organizational structure enabled the company to escape many regulatory requirements that traditional banking institutions must operate under. The consumer lending division of Ant securitized loans before transferring credit risks to other banks, which created doubts about their hidden financial practices.

After suspending the IPO, Chinese regulators declared Ant Financial a financial holding company and imposed new capital and governance regulations based on the Financial Holding Company Law. The procedure sparked criticism for being unclear, yet experts viewed this event as indicating improved general regulatory handling of Big Tech companies working in financial sectors.

Regulators now understand that fintech giants, which present as technology businesses, must receive equivalent regulatory oversight since they execute financial core operations. OECD (2020) and the World Bank (2022) present evidence showing how regulators can manipulate the financial landscape because of unequal bank-Big Tech rules, which both enhance regulatory arbitrage and increase market concentration while generating risks that remain difficult to track. These entities can leverage their data sophistication, together with their size, to pursue market control by avoiding standard prudential protection measures.

The intervention in Ant Group's IPO highlights the necessity of applying uniform regulatory standards to all financial entities, regardless of their technological facade. The continued relaxed regulatory environment for Ant Group compared to traditional banks could have bestowed it an unbalanced advantage. The payment system lost stability as other financial institutions could have suffered from this decision. The regulators chose to suspend Ant Group's initiation because their approach prioritizes fair competition across the market alongside innovation opportunities.

The P2P lending industry, together with Ant Group, demonstrates that proper financial regulations serve to stabilize financial markets and establish fair competitive conditions. Political factors, together with policy resistance, slow down regulatory actions, but both examples demonstrate the damage caused by inadequate monitoring of developing markets. The growing fintech industry demands the creation of predictive regulatory systems that intertwine innovative capabilities with market stability.

## 3 Public Policy as a Driver of Financial Innovation

The government, through public policy, advances financial innovation by using both monetary support and developing essential infrastructure. Public authorities provide monetary support and tax incentives to R&D companies to reduce innovation-related costs and risks, including uncertain market prospects, technological failure, and financing constraints. At the same time, public investment in digital financial infrastructure, such as digital payment platforms and central bank digital currencies (CBDCs), creates foundational conditions that foster experimentation and new financial models.

### 3.1 Fiscal and Tax Incentives for Innovation

Research and development activities within the financial sector experience underinvestment because of the intangible nature, along with high risks and long development timelines of R&D. Therefore, firms generally use self-generated funds and remain hesitant about external capital sources. The government can reduce these obstacles by using direct financial support mechanisms and tax benefit programs as public policy measures. R&D tax credits reduce the cost of capital for innovation, thereby making marginal projects financially viable [13]. The depreciation allowance works most effectively together with depreciation provisions that account for technological knowledge obsolescence.

Research conducted in OECD countries indicates that stepwise R&D tax credits effectively motivate private enterprises to increase their innovative activities. Established companies of any size utilize tax-advantaged internal funds before alternative funding sources to align their investment behaviors to fiscal policies. According to Aghion et al. (2013), innovation productivity rises when institutions provide support through governance systems and public venture capital, which decreases managerial career risks and support long-term R&D strategies [12].

China has experienced innovation within the fintech sector driven by specific funding mechanisms, particularly in scenarios such as digital lending, robot-advisory services, and API-based finance. State-supported venture capital funding combined with benefits from technology-focused tax programs has resulted in the quick development of digital payment solutions, rob-advisory services, and AI-operated lending solutions [1]. The intervention methods concurrently decreased capital expenses for initial innovators while showing official backing to develop faith among investors toward fledgling business projects.

### 3.2 Infrastructure-Led Innovation: Digital Payments and CBDCs

Digital infrastructure development initiatives from public authorities structure the financial innovation pathway by creating operational frameworks to support innovative business processes. Foundational payment systems such as real-time retail payments and CBDCs generate an open business framework for the financial sector to foster innovation, according to the Bank for International Settlements.

The digital payment systems launched by India through Unified Payments Interface (UPI) with China through Interbank Payment System have proven to deliver low-cost operations alongside better accessibility and broader acceptance of customers in digital financial services. Fintech companies thrive through public goods, which include standardization and interoperability, and trust, because they enable companies to create innovations without duplicating basic infrastructure. The Chinese government established mobile and QR-based payment foundations, which created the environment for Alipay and WeChat Pay to thrive and change retail finance patterns and consumer payment habits [1].

Financial infrastructure changed when central bank digital currencies started to be implemented. As noted by BIS (2021), CBDCs serve as public alternatives to private digital payment systems, offering universal access along with robust privacy protections and integrity safeguards. Small fintech entities gain easier market entry through CBDCs because they minimize reliance on dominant platform companies while stopping the separation of financial resources. The usage of cross-border CBDC systems between countries enables payment system optimization and diminishes compliance expenses while creating opportunities for development in both remittances and trade finance operations.

CBDCs possess the ability to offset market concentration. The digital yuan launched by China partially targets the dominance of two major technological firms by securing a public role in monetary systems. The policy-driven development of infrastructure proves to be more than supportive because it creates profound transformations.

Public policy enables financial innovation through the combined effects of incentive schemes and the advancement of infrastructure. Fiscal tools decrease the private R&D research expense to encourage risky innovation and long-term development. Payment systems that include CBDCs form the digital foundation that supports the operation of secure and scalable financial services that also include inclusivity features. By implementing these comprehensive strategies, governments achieve two key results, including innovation catalysis and the direction of innovation toward improved public outcomes.

## 4 Conclusion

Policy measures both regulate and promote financial innovation in China's domain, as explained in this paper. Market stabilizing efforts and unfair practice remedies by regulators show their involvement in regulatory functions. The management of the P2P lending collapse, together with the Ant Group IPO suspension, exhibits policy tools to tackle new dangers while reshaping business operations. Financial innovation tends to create significant challenges unless regulators implement suitable measures that bring back order while ensuring fairness.

Policy works extensively to promote innovation in addition to managing its other essential functions. The combination of tax benefits, research and development spending, and digital financial platform investments from the public sector motivated private companies to establish innovative technologies and operational formats. The establishment of centralized digital currencies together with national payment systems provides basic conditions for financial system improvement and enhanced financial market competition.

The implemented developments encounter various continuing boundaries that need resolution. Policy enforcement often follows rather than prevents issues, and multiple governmental bodies struggle to maintain coordination with one another. Because of these issues, innovation slows down, and inconsistencies exist. The development of future policies should implement better integration while remaining flexible enough to adapt to quick changes in financial technology.

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