Internet Finance and China

WILL BANKING INNOVATION PROMOTE GROWTH AND REFORM?

By Leonora Walet

After blazing a trail in e-commerce, Alibaba Group Holding Limited and Tencent Holdings are breaking new ground in banking by parlaying their successful businesses into a launch of what could become formidable competitors to China's state-owned financial firms.

The staid world of banking may seem an unlikely expansion target for these two technology firms, but their scrappy start-up spirit may be just the thing for competition. Already, the companies are winning deposits away from state banks with money market–like funds that pay higher rates on renminbi deposits than are available in traditional accounts. Alibaba's popular Chinese money market fund Yu 'e bao—Chinese for leftover treasure—attracted ¥574 billion ($94 billion) within a year after its launch in June 2013.

KEY POINTS

E-commerce firms with large customer bases are being allowed to compete in China's banking sector.

Experts disagree about the potential of internet finance to disrupt traditional banking and financial services.

The technology titans are also branching into offering online transfers, making loans to small businesses, and developing new investment products. In addition, they obtained licenses in 2014 to open China's first private banks.

"The surge in online and mobile payments in China gives tech companies the customer base that should allow them to compete in the banking sector, especially with the popularity of their internet-based fund products. Chinese regulators are keeping a largely positive outlook toward competition in the financial services industry," says Will Tao, analysis director at internet consulting firm iResearch.

Almost all banks in China are state controlled, but Beijing wanted to inject some competition and innovation into the sector with the aim of getting credit flowing to small firms that still struggle to access bank loans. Small and medium-sized businesses account for 60% of China's economy and about 75% of jobs, economists say. If China is to sustain economic growth, it needs to empower small businesses. Beijing hopes this new crop of privately owned lenders can boost access to funds for small-scale borrowers.

ONLINE-ONLY BANK

China's Premier, Li Keqiang, is a big supporter of reforms in the banking industry.

When internet conglomerate Tencent launched WeBank—China's first internet-based bank—in January, Li was in attendance to celebrate the event.

Li visited WeBank's headquarters in the southern city of Shenzhen, where Tencent is also based, to give the launch his stamp of approval. A keystroke on a computer keyboard by the Chinese premier signaled the first approved loan by the online bank—a ¥35,000 ($5,700) loan to a truck driver named Xu Jun.

"I could say that this is a small step for WeBank, but it's a big step for financial reforms," Li was quoted as saying. He then encouraged WeBank to "break a path in the field of internet banking"—for example, by helping to reduce transaction costs for small clients and in doing so, compel traditional financial firms to be quicker on reforms.

Tencent set up WeBank in the Qianhai special economic zone after receiving regulatory approval in July 2014. It owns 30% of the online bank, which has ¥3 billion (HK$3.75 billion) in registered capital. Two other stakeholders are Shenzhen Baiyeyuan Investment and Shenzhen Liye, with 20% each. The remaining 30% will be split among seven additional shareholders. Without physical branches to attract depositors, Tencent will have to rely on its secret weapon: The WeChat mobile messaging service, whose active users now total more than 400 million.

WeChat dominates all messaging platforms in China, and activities around it have expanded over the years to include taxi booking and online purchases. Users have linked their bank cards to the application to seamlessly transfer funds to Tencent's version of Yu 'e bao, known as Licaitong, which reached ¥100 billion in assets in less than a year since its inception in January 2014. Offering banking services over the same platform is a natural extension of Tencent's foray into financial services, analysts say. These new avenues for consumers to manage their finances will in the long run drive innovations in services in the broader market.

IS THE MARKET READY?

Just how disruptive can internet finance be to traditional banking? China's financial services sector is immature compared with developed markets, and it lacks the variety of products or services found in such markets as the United States or European Union. China's banks are tightly regulated, with deposit interest rates controlled by the authorities and currently set at low levels. Although the industry has made strides over the past 30 years, the investment choices for individual savers and investors have remained limited.

Although there is little evidence to suggest that internet-based finance is making a serious dent in the operations of traditional banks, what is apparent is that businesses like Alibaba and Tencent are injecting life into the sluggish world of Chinese finance and aiding in the industry's transformation in the process, analysts say.

"Some investors are concerned about the challenges to traditional financial institutions posed by internet players, but we see internet-based financial services complementing the existing services provided by banks, especially in areas previously neglected. The new internet products will be used to differentiate the services offered by traditional financial institutions," says Leon Qi, CFA, director of China financial research at Daiwa Capital Market.

Third-party payment service is an area in which internet companies are making serious inroads. Third-party payments have seen strong growth in China in recent years, with the value of transactions rising at a yearly compounded rate of 62% in the 2009–12 period, according to iResearch data. In 2012, ¥12.9 trillion of funds were paid through third parties. The contribution of online third-party payments to total online payments rose from 17% in 2009 to 28% in 2012.

Alibaba's offerings are some examples of how new services for consumers to manage their finances are driving innovations in the broader market. Chairman Jack Ma has been using the company's own version of PayPal—the payments processing service called Alipay—as a springboard to aggressively offer financial products.

In the past, the Chinese were using Alipay simply to shop on Alibaba's Taobao, a virtual store in which vendors sell consumer goods like iPhones or shoes. Today, the payment platform is so much ingrained in China that its millions of users rely on the platform to pay for nearly all household bills or to purchase products online. They also use its mobile version, the Alipay Wallet app, on their smartphones to quickly transfer funds to and from their bank accounts and to those of friends or relatives.

Taking innovation one step further, Alipay introduced users to Yu 'e bao, the money market fund. Users can invest as little as ¥1, and move their funds in or out anytime. The funds, which are invested in such low-risk securities as government bonds and interbank loans, offer a return of about 4.5%–6%, which is higher than what savers get on one-year bank deposits.

Analysts say the convenience of moving funds in Yu 'e bao is what appeals to the market, and Alipay has combined this offering with insurance products as well as lending to companies that set up virtual storefronts on its websites.

Ma, who controls Alipay, recently rebranded the company as Ant Financial Services Group as it deepens its efforts to gain a strong footing in the $27 trillion banking industry. The new Ant Financial will oversee six financial services entities that are affiliated with Alibaba. Apart from Alipay, Ant Financial will have in its portfolio the Alipay Wallet app with its 190 million active users; the money market fund Yu'e Bao; Zhao Cai Bao, the finance arm that aims to create a marketplace for ¥1 trillion of loans for small and medium-sized enterprises in two years; the micro online loan provider Ant Credit; and finally, its own private bank, MYBank.

The success of Yu 'e bao has also spawned similar offerings from e-commerce firms. Tencent's Licaitong offered its own version of Yu 'e bao within six months of the latter's launch. Web services company Baidu and e-commerce companies 360Buy, Jing Dong, and Suning also offered similar products months later.

Some of the smaller Chinese banks have launched money market fund products similar to Yu 'e bao. Yet, there were concerns raised in the industry that the funds, which offer higher interest rates than regular bank deposit accounts, are not well regulated and pose a long-term threat to the deposits of state-run banks.

"Over the long term, the competition from more convenient and high-yield internet-finance products will mostly affect banks' funding costs and the composition of funding, rather than the amount of funding," says Qi. "More retail funds shifting into money market funds will also force banks to offer higher rates than the regulated deposit rates through wealth management products, which will effectively accelerate the pace of interest rate deregulation in China."

MOVING FORWARD

Although traditional banks retain a clear lead, it is becoming apparent that China's financial sector needs change to keep up with the tech upstarts.

One emerging challenge is coming up with regulations that could protect the users of these online services.

"Despite the potentially wider business scope that internet companies might be able to enjoy, these financial products will be operating under a bank license and are subject to all the regulations governing banks. This means the internet players will be closely monitored by the financial regulators," says Richard Cao, an analyst at Guotai Junan Securities.

For now, internet companies are proponents of third-party payment services and peer-to-peer lending. That may not sit well with those averse to risk.

"From that perspective, of all the commercial institutions in China, the banks offer the strongest credit protection. Hence, it is difficult for other players, including the pure online payment companies, to challenge the banks' position in the payment industry," Qi says.

But these online firms are part of China's longer march to a liberalized financial sector.

"Internet-based firms are emerging in China's finance services because the immature nature of China's banking industry is giving rise to opportunities for non-banking entities to thrive," says Cao. "It is only unique to China because of the inefficiency of the system. Efficiency of the banking sector will increase through a market-oriented pricing mechanism. The liberalization of China's interest rates is a critical step in China's reforms in the banking sector."

Leonora Walet is a financial writer based in Hong Kong.

KEEP GOING

"Where to Invest in China: Four Powerful Trends Long-Term Investors Can't Ignore," *Enterprising Investor* (26 November 2014) [blogs.cfainstitute.org/investor]

"A Start of Something Big," *CFA Institute Magazine* (November/December 2014) [www.cfapubs.org]

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