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Yao Lei

Policy discussion of internet finance in China

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Policy discussion of internet finance in China

Abstract

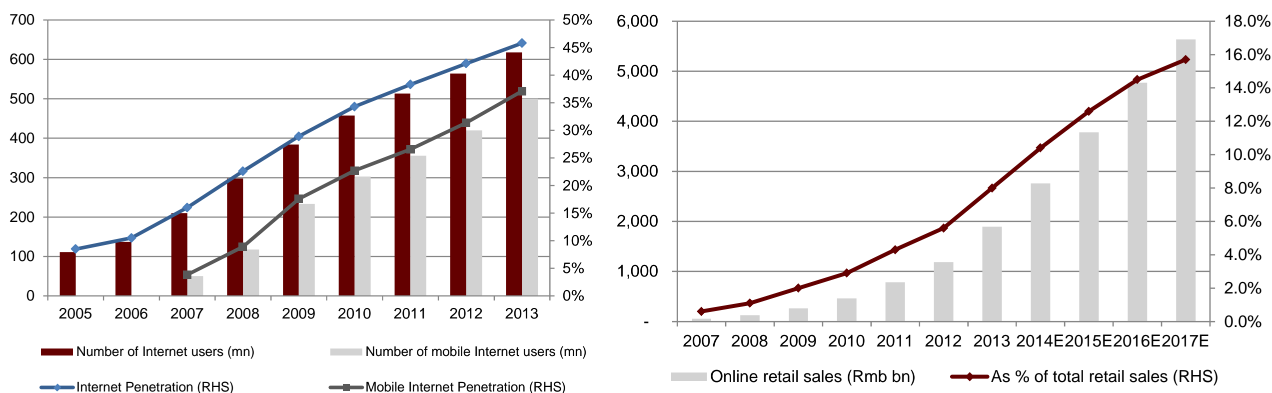
Internet finance has recently gained increasing attention in China. Many are concerned about whether it will reshape the financial service industry and significantly threaten the existing players. We think the boom in Internet finance in China is attributable not only to the mega transformation trend to mobile Internet, but also to the inefficiencies of the current financial system. Therefore, we see a need to accelerate the market-oriented financial reforms and strengthen function-based regulation to foster the healthy development of Internet finance and the overall financial system.

1. Four typical products of Internet finance in China

In this section I describe four typical Internet finance products offered in China. The first Internet finance products/services were provided by traditional financial institutions and quasi-financial institutions via Internet. China Merchants Bank established the first open Internet banking system in 1997. With Internet technology constantly permeating the financial sector, the convergence between Internet and finance has become an irresistible trend. At present, different types of Internet finances – such as third-party online payment, online wealth management distribution, P2P lending and crowdfunding are developing rapidly.

The rapid penetration of Internet and mobile Internet laid the foundation for Internet finance in China. Among developing countries, China stands out for its deployment of Internet and mobile Internet, with penetration ratios of 45.8% and 37.1%, respectively, in 2013. This created a favorable environment for E-commerce, especially via mobile devices. In 2013, E-commerce reached Rmb1.9trn, to represent 8.0% of total retail sales. Moreover, large Internet companies have accumulated substantial customer bases, such as 438mn monthly active users for Tencent's Wechat and 231mn active buyers for Alibaba's Taobao, compared to the 449mn retail customers of ICBC, the largest retail bank in China.

Figure 1. Internet penetration and online retail sales

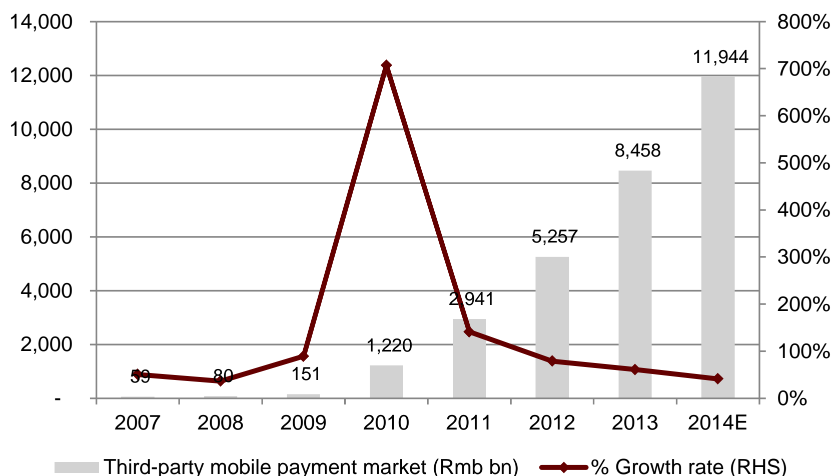


Source: CNNIC 2014 Statistical Report on Internet Development in China (left); iResearch (right)

1.1 Third-party online payment

Third-party Internet payment facilitates the development of E-commerce. Originally third-party online payment was seen to provide convenient ways of facilitating the payment process or to form a supplementary part of the payment system. However, with the increasingly large customer base and customer migration to Internet, third-party online payment is playing an increasingly important role. By the end of June 2014, online payment users had increased to 292mn, of which about 200mn were making mobile payments. According to People's Bank of China (PBoC, the central bank), the market size of third-party payment had increased by 60% YoY in 2013 to Rmb16trn, and mobile Internet payment has of late been the major driver of the growth.

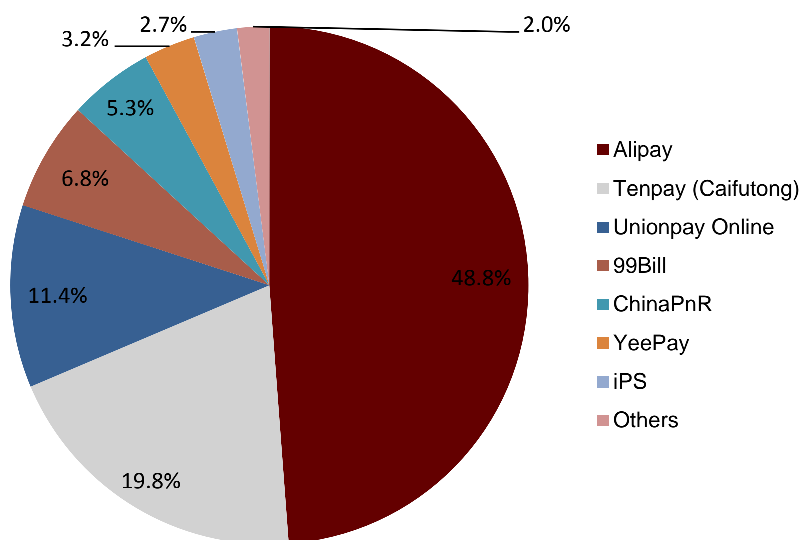
Figure 2. Third-party Mobile Internet Payments



Source: iResearch

Third-party online payment is a highly concentrated market. As of Feb 2014, there was a total of 269 licensed third-party payment institutions, 90 of which support online payment. Alipay and Tenpay took dominating market shares of 48.8% and 19.8%, respectively (Source: iResearch), in the first half of 2014. At the same time, some smaller third-party payment companies are struggling as they have been continually operating at a loss.

Figure 3. Market shares in third-party online payments, Q214

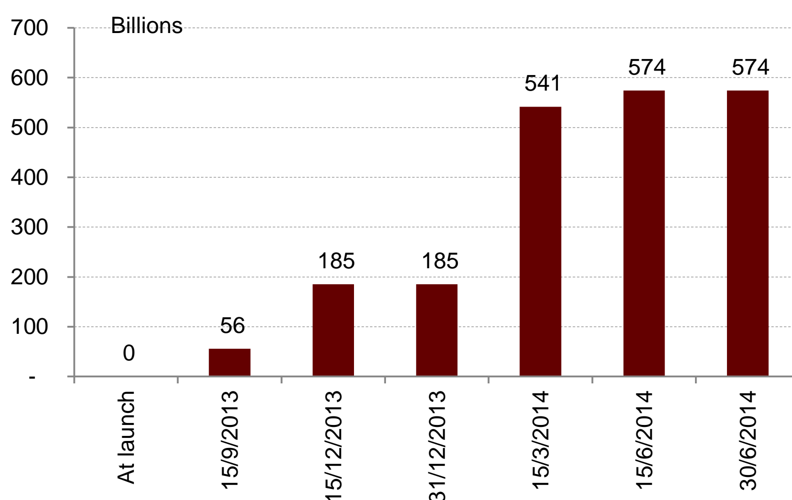


Source: iResearch

1.2 Online wealth management product distribution

Some Internet giants leverage their customer base to distribute financial products, especially standard products such as money market funds (MMF). E-commerce website users typically hold some money in their online accounts (such as Alibaba's Alipay) that earns no interest. Therefore, when a product is launched to provide interest on such idle cash, it is natural for the users to transfer the cash into such products, and online technology makes this very easy. Moreover, when the product has been proven to provide higher-than-deposit-rate returns, some online users will even invest more by transferring money from their bank accounts. Yu'E Bao is a money market fund distributed via Alipay. By the end of June 2014, the balance of Yu'E Bao had reached Rmb574.2bn, about 1% of total household deposits in China. Even though fund growth has slowed down during the first half of 2014 as money market rates have declined, Yu'E Bao continues to attract attention.

Figure 4. The success of Yu'E Bao, MMF fund by Alipay



Source: Hexun.com

In view of the success of Yu'E Bao, other e-commerce companies have joined the competition and started to collaborate with traditional fund companies to launch their own money market fund products. The rationale for Internet companies to sell financial products is likely to be: 1) to leverage existing user traffic on their portals as online distribution channels for financial products and provide value-added services that attract users to remain on their online portals; 2) to nurture the usage of their own online payment mechanisms and capture more user logins; and 3) to become a cheaper and more efficient distribution channel for financial products that could eventually drive additional revenue.

Table 1. Other Internet players also engaged in the wealth management product distribution

Product	Internet Company	Cooperating Fund
Baidu Baizhuan	Baidu	China Asset Management Co
Wexin Licaitong (Huitianfu)	Tencent	China Universal Asset Management
Suning Lingqianbao (Guangfa)	Suning	Guangfa Fund
Weixin Licaiton (Guangfa)	Tencent	Guangfa Fund
Weixin Licaiton (Efund)	Tencent	Efund
Weixin Licaitong (Huaxia)	Tencent	China Asset Management Co
Baizhuan Ligunli	Baidu	Harvest Fund
Wangyi Xianjinbao	Wangyi	China Universal Asset Management
Suning Lingqianbao (Huitianfu)	Suning	China Universal Asset Management
Sina Weicaifu (Cunqianguan)	Sina	China Universal Asset Management
JD Xiaojinku (Jiashi)	JD	Harvest Fund
Yu E Bao	Alibaba	Tianhong Fund
JD Xiaojinku (Penghua)	JD	Penghua Fund

Source: www.Bankrate.com.cn

Banks are forced to compete with Internet companies in the distribution of their own MMFs. At first, they were reluctant to actively promote MMFs, as cooperating with fund companies – even their subsidiaries – will accelerate the conversion from deposits to MMFs and increase their funding costs. Since they realized that this is the inevitable trend amid interest rate liberalization, some banks have launched so-called‘bank-version’MMFs and some are using a direct banking model. As a result, assets under management in MMFs have skyrocketed to a a total of Rmb883bn at end-2013, equivalent to 0.85% of total bank deposits in China.

The fast growth of MMFs and other products offered via Internet channels has raised concerns that bank deposits could eventually be eroded, leading to higher funding costs for banks as depositors move their funds from demand and short-term deposits into other products. MMFs are allowed to invest in short-term financial assets, such as bonds, bank deposits, repos, etc. Even though the deposits remain in the banking system, the MMFs raise banks' funding costs substantially. Demand and short-term deposit rates are usually 0.4%-0.8%, while rates for Internet-based products are much higher (5%-7% in 2H13).

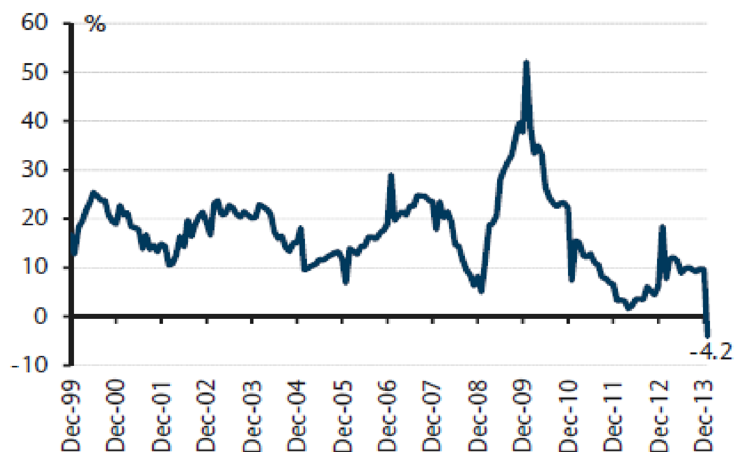
Table 2. Banks are forced to launch their direct banking

Bank	Product	Launched in
Bank of Beijing	Online and office branch providing various products and services	2013-09
China Minsheng Bank	Mainly wealth management products	2014-02
Industrial Bank	Mainly wealth management products	2014-03
Ping An Bank	Mainly wealth management products	2014-08
Bank of Shanghai	Mainly wealth management products	2014-05
Baoshang Bank	Provides P2P financing products	2014-06
Bank of Nanjing	Mainly wealth management products	2014-07
China Resources Bank of Zhuhai	Mainly wealth management products	2014-03
Bank of Chongqing	Mainly wealth management products	2014-07
Bank of Jiangsu	Mainly wealth management products	2014-08
Guangdong Nanyue Bank	Cooperates with e-commerce company to offer loans	2014-09
Bank of Ningbo	Mainly wealth management products	2014-08
ICBC	NA	Expected to launch in 2014

Source: Banks' official websites

Internet finance has accelerated the process of shifting from bank deposits to MMFs and other wealth management products, thus introducing new challenges for monetary policy. For instance, M1 growth slowed to 1.2% in January 2014, the lowest level since data became available in 1997. Demand deposits saw negative year-on-year growth at -4.2%, which had never happened before.

Figure 5. Shift out of deposits



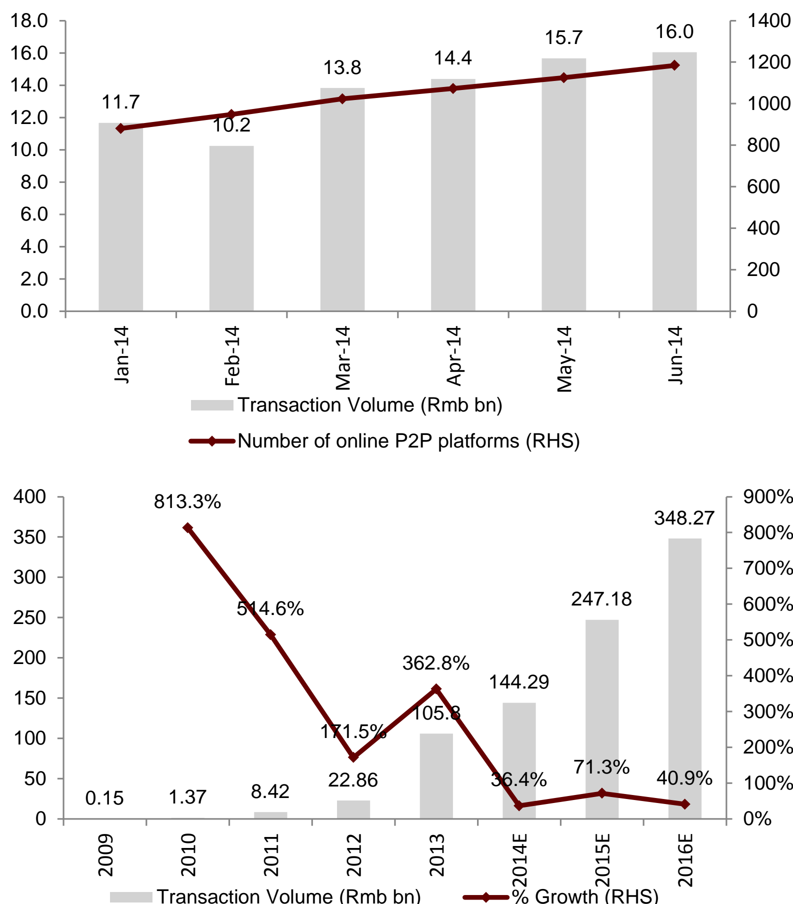
Source: PBoC

1.3 P2P and crowd funding

Peer to peer (P2P) lending originated from Zopa in UK and gained more publicity via the Lending Club in the United States, and it has flourished since 2013 in China. By the end of August 2014, there were some 1357 active P2P lending platforms in China with an outstanding loans amounting to more than Rmb58.1bn. For the first 8 months in 2014, the total transaction volume totaled Rmb125.3bn. However, since the rapid growth of P2P industry, the risks have multiplied, as some P2P platforms lacked risk control capability and suffered huge losses leading to bankruptcy. Most likely P2P industry in China is entering a consolidation stage (Table). There are three types of P2P companies in China:

- Start-ups such as YiXin and RenRendai.
- P2P platforms established by existing financial companies, such as Lufax in PingAn Group.
- P2P platforms based on e-commerce platforms, such as HuiCong and Haier.

Figure 6. Rapid growth of P2P in China



Source: Wangdaizhijia.com, iResearch

Table 3. Major P2P platforms in China

Company	Transaction Volume in past 3 months (Rmb mn)	Operating time
Hongling Capital	3,640	5 years 6 months
Lufax	3,158	2 years 8 months
wzdai.com	2,475	2 years 7 months
Xinhehui	2,029	9 months
srong.com	1,416	3years 11 months
Weidai	1,241	3 years 2 months
iTouzi	1,049	1 years 6 months
Renrendai	953	3 years 11 months
Jimubox	891	1 years 1 months
Yooli.com	882	1 years 7months

Source: Wangdaizhijia.com, iResearch

Besides debt-type P2P platforms, the equity-type crowdfunding is also gradually gaining ground in China. AngelCrunch, a crowdfunding platform, has attracted 8,000 start-up programs since its establishment. More than 1,000 of these programs have been verified as feasible, and the total number of start-up entrepreneurs is more than 20,000; the number of verified investors has reached 840. It has attracted a total of 80 financing programs with a total financing of more than RMB 280 million.

2. Challenges of Internet finance to financial regulation

In China Internet finance has had a very large effect on the financial system, for two reasons:

1) The inefficiency of incumbent financial services has made substantial room for Internet finance.

- Third-party payment companies have provided tailored solutions to certain industries and significantly enhanced the convenience of shopping and payment for the public.
- As to P2P, it has fulfilled the borrowing demands of consumers with incomplete credit information and of small enterprises, which have not been fully serviced by traditional financial institutions.
- The slower pace of interest rate liberalization also favored the rapid development of Internet-based MMF and P2P, as depositors are keen to seek high-yield products, especially when the market rate is much higher than the regulated deposit rate. The average return for MMFs in 2013 was 4.1%, beating the 3.3% regulated 1-year time deposit ceiling and, of course, the 0.4% demand deposit rate.

2) The regulator has had an accommodative attitude towards Internet finance. As Internet finance has to some extent helped enhance financial intermediation, regulators have been more accommodative to its development. However, this raises concerns about “regulatory arbitrage”, or how to maintain regulatory consistency between Internet finance companies and existing financial institutions.

- Regulators have set strict money laundering rules as applies to banks, such as the requirement on opening bank accounts. However, third-party payment companies have less strict control on account opening in order to enhance customers’ usage experience and convenience. Though the regulator is attempting to introduce caps for every kind of payment, such proposals are meeting with much resistance from third-party payment players.
- As to wealth management distribution, regulators have been strict as regards investor suitability, in order to protect consumers’ rights. For instance, the investment threshold is RMB1,000 for mutual funds, RMB50,000 for bank-made wealth management products and RMB1mn for trusts. However, Internet players do not comply with such requirements, especially in connection with certain high-return products with corresponding high risks.
- With the growing size of Yu'E Bao, intensive debate has ensued as to whether PBoC should impose a required reserve rate on interbank deposits related to MMFs. To attract more investors, MMFs have provided same-day redemption (so-called T+0 redemption) since late 2012. This enables investors to redeem MMFs in real time, subject to a daily limit ranging from RMB50,000 to RMB5mn. As of end-2013, 33 fund companies had launched their own T+0 MMFs. Yu'E Bao has invested around 90% of its assets in interbank deposits of banks,

which could increase the volatility and liquidity risks of the banking system, if MMF units are redeemed in large amounts.

- P2P is an innovative approach to raising funds, but it also introduces many legal concerns. In the offline world, if a company raises funds with guaranteed returns from the public, it violates the law.

3. Discussion of policy problems

China has not completed its market-oriented reform of the financial system. The financial markets are still segmented, which means that Internet finance can be used for arbitrage purposes. This raises the question of the regulation of Internet finance in China? Can Internet finance abet the reform process and promote more inclusive finance? These are questions of policy.

There are three major risks associated with Internet finance that need to be controlled in any future regulatory framework:

1) Ambiguous legal status and business boundaries. For instance, P2P lending platforms are engaging in a type of business that is difficult to define in the legislation or to effectively regulate. This often causes business activities of Internet finance enterprises to go beyond regulatory boundaries and enter into a gray zone of law, sometimes all the way into illegal activities. Internet financial regulation in China is lagging behind.

2) A perception of "implicit guarantee". For instance, MMFs have had no reported losses for investors in China, giving investors a sense of security. In fact, investing in MMFs is not without risk. MMFs do not provide a guarantee of principal or return. Current MMF investors may largely be ignoring the risk of losses; they could be confused by promotional language emanating from some fund companies offering "ultra-low risk". Traditionally, funds redeemed from MMFs were available on the third day (T+2). Investors with high liquidity requirements may not be able to afford a two-day delay and would therefore stick to demand deposits, despite the lower return. The T+0 feature proved to be very attractive for investors, but it also introduces additional risk to the finance market.

3) Insufficient risk control may lead to operational risks. Some Internet finance enterprises have adopted a controversial high-risk transaction model for the sole purpose of expanding their business and increasing profitability. These enterprises fail to establish such mechanisms as customer identification, transaction record keeping and analysis, and reporting of suspicious transactions, which may encourage use of the platform for money laundering and other illegitimate activities. There are also some Internet enterprises that fail to practice sound internal management or to provide adequate protection of information security, which entails potential risks of customer information leakage.

To encourage financial innovation and control risks, the PBoC should take take the following steps in the future:

- Accelerate market-oriented reforms such as interest rate liberalization and gradually relax the entry-approval mechanism. As the boom of Internet finance is partly the result of the half-way reform of the financial system, market-oriented reforms could provide a level field for traditional financial institutions and Internet finance companies by bringing the Internet finance companies into the comprehensive regulatory framework. At the same time,

regulators should push forward the building of a credit system for small and micro businesses and for rural areas, which could help to reduce the credit risks of P2P companies.

- Strike a deliberate balance between encouraging innovation and preventing systematic risks. Internet finance increases customer convenience and improves the efficiency of the financial system. Regulators should be more accommodative to technological changes in the financial services industry, but they also need be alert to potential systematic risks, such as contagion risks between banks and Internet finance companies, especially the liquidity risks of the rapidly growing MMFs that allow T+0 availability. Such risks are marked by "low probability but huge potential loss" and could have a significant impact on the stability of the financial system. In practice, regulators should strike the correct balance between principle-based supervision and rule-based supervision in respect of Internet finance and thus enable efficient market dynamics while at the same time controlling the risks.
- Ensure the consistency of financial regulation and prevent regulatory arbitrage. The payment and credit underwriting services provided by Internet finance companies function much like traditional financial institutions. If the regulators apply different standards to financial services or products with similar functions, this could encourage regulatory arbitrage. Some Internet finance companies have, without approval, engaged in the businesses which are under strict license control in the offline world. Therefore, regulators need to ensure the consistency of their rules: if they engage in similar business, traditional financial institutions and Internet finance companies should be subject to the same rules.
- Encourage mandatory information disclosure and promote consumer education and protection. Consumer protection is key to Internet financial regulation, especially in light of the fact that some wealth management products distributed via Internet have been sold with misleading information, and some third-party payment companies have failed to prevent the leakage of customer information. Mandatory information disclosure could impose greater market discipline on Internet finance companies.

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