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Internet finance growing rapidly in China

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Executive Summary

Internet finance is a hot topic in China. In particular, the advent of Alibaba's Yu'E Bao in 2013 was a watershed event in terms of financial innovation. However, new regulations are needed to protect investors.

Internet finance made its advent in China in 2013

While Japanese media coverage of Chinese finance is predominately focused on shadow banking, Internet finance is a hot topic in China.

Broadly speaking, two trends are driving growth in Internet finance in China. First, e-commerce and other Internet companies are branching into the financial sector. Second, traditional financial services are migrating to the Internet (e.g., online banking, online broking). In some cases, companies are both competing and cooperating with each other as noted below. In terms of financial functions, Chinese Internet finance mainly encompasses (1) payment and settlement services, (2) lending (microcredit, supply chain financing, peer-to-peer (P2P) lending), and (3) sales of investment products (e.g., funds, insurance)[1]. Additionally, data amassed by e-commerce companies are being utilized to assess customers' credit.

Against such a backdrop, Alibaba, China's biggest e-commerce company, launched Yu'E Bao in June 2013. Yu'E Bao has had a huge impact on China's financial sector. Yu'E Bao allows customers of Alipay[2], Alibaba's online payment service, to invest their idle Alipay account balances in a money market fund. Alipay account holders can buy into the money market fund with a minimum investment of one yuan and redeem their fund holdings at any time to pay for online purchases.

Yu'E Bao customers' money is invested in the Zenglibao Money Market Fund managed by Tian Hong Asset Management. Customers can check their returns online daily. According to Tian Hong, the Zenglibao fund had assets of over 250 billion yuan in January 2014, making it China's largest fund[3].

In response to Yu'E Bao's success, Internet companies have been partnering with fund management companies to roll out similar products in rapid succession. Such

NOTE

1) See "Alibaba Microfinance's asset securitizations" (October 2013), http://www.nri.com/~/media/PDF/global/opinion/lakyara/2013/lkr2013179.pdf .

2) Alipay is a third-party payment platform established in 2004 to settle transactions for Alibaba's Taobao C2C site. It provides online escrow services for Taobao merchants and consumers.

3) At year-end 2013, Tian Hong Asset Management was ranked second by AUM behind China Asset Management, but it ascended to the top spot in January 2014

Examples of Internet finance in China

Company	Product/service	Brand name	Description
Alibaba	Payments, settlement, remittances	Alipay	Established in 2004 as a third-party payment platform to resolve Alibaba's Taobao C2C site's payment difficulties. Can be used to pay utility and credit card bills and transfer funds to participating banks. Has also started to extend credit to consumers based on their repayment histories.
	Lending	Ali Microfinance	Microfinance company that extends credit to merchants of Alibaba B2B site, Taobao C2C site and Tmall B2C site. Also securitizes loans to microenterprises.
	Fund management	Yu'E Bao	See main text
		Taobao wealth management	First online third-party fund sales platform (November 2013). Provides sales support to fund distributors.
Alibaba, China Ping An Insurance & Tencent	Insurance sales	Zhong An Online Property Insurance	Sells insurance and settles insurance claims online without bricks-and-mortar branches (November 2013).
Tencent	Payments	Tenpay	Payment service similar to Alipay
	Fund management	WeChat	WeChat is a messaging app like Line. WeChat wealth management products were launched in January 2014 (see main text).
Renrendai	P2P lending		Established in May 2010
Demohour	Crowd funding		Established in May 2011
China Construction Bank	E-commerce, financial services	Shanrong	B2B and B2C e-commerce platform (June 2012). Industrial and Commercial Bank of China's Rong-e-Gou (B2C) platform went live in January 2014. Bank of China, Bank of Communications, et al. also have similar platforms.

Source: NRI, based on company disclosures and media reports

products include Baifa, launched in December 2013 by Baidu, China's top search engine, and Harvest Fund Management; wealth management products launched in December 2013 by Tiantian Fund Sales in partnership with three fund management companies (E Fund Management, Penghua Fund Management and Xincheng Fund Management); and WeChat[4] wealth management products launched in January 2014 by Tencent Holdings and four fund managers (China Asset Management, Huitianfu Fund Management, E Fund Management and Guangfa Fund Management).

4) WeChat is a messaging app like Line.

Such new product launches are significant in two respects. First, they have contributed to market-driven financial liberalization. These new online products can be likened to US financial innovations in the early 1980s in that they have made demand deposit accounts that pay de facto market interest rates available to Chinese consumers.

Second, the new products have unleashed wave of innovation in the publicly offered fund space. Previously, publicly offered funds' minimum investment was typically 1,000 yuan. By lowering the minimum investment to one yuan, the new online products have made money market funds more accessible to the masses. Meanwhile, the fund-investor class has broadened to include younger generations, reflecting that Chinese Internet users are predominantly young. The new products have also diversified sales channels for publicly offered funds, which were previously sold mainly at banks.

From banks' standpoint, the new online products could lead to an outflux of retail deposits and decreased fund sales. Banks are consequently compelled to develop online businesses and wealth management products to compete against the new online products. Together with shadow banking, the pairing of the Internet and financial services is driving market-based financial innovation (interest rate liberalization, liberalization of business models, and cross-sectoral market entry).

Risk prevention and stricter regulation

Financial regulation has failed to keep up with Internet finance's rapid growth. Among financial regulators, the People's Bank of China (PBoC) looks approvingly upon Internet finance. The PBoC has called Internet finance a beneficial complement to the existing financial system and said it improves financial efficiency through different channels than traditional finance[5)]. Additionally, the PBoC noted that in comparison to traditional finance, risks posed by Internet finance are more concentrated in consumer information security and risk control. To promote Internet finance's sound development, the PBoC plans to study its characteristics and impacts, clarify regulatory authority over Internet finance, and strengthen financial education and protections for consumers.

While China looks likely to build a regulatory regime for Internet finance, incipient risks are already emerging. Namely, some of the aforementioned online fund products launched after Yu'E Bao's success were offering rates of return in the 8-10% range at the time of their inception (December 2013)[6)]. These very high returns are seen as a concern. The problem is that online money market fund sponsors are not only providing a fund sales platform but also boosting their funds' apparent rates of return by paying bonus interest funded from sources other than their funds' investment returns[7)]. Some of them are alleged to have engaged in unlawful fund sales[8)].

The China Securities Regulatory Commission (CSRC) warned in November 2013 that it will crack down on illegalities in online fund sales. In 2014, the CSRC announced a crackdown on illegalities related to sales of certain funds offering high returns (e.g., overemphasis on returns without adequate risk disclosure, advertising funds' returns inclusive of bonus interest intended to promote sales)[9)]. The CSRC has already ordered some companies to rectify such practices.

Regulators are thus finally starting to pursue consumer (investor) protection in the Internet finance sector. In addition to being a new business, Internet finance is a

5) China Monetary Policy Report Quarter Two, 2013. The report noted a number of advantages of Internet finance, including greater transparency, broader participation, lower intermediation costs, and faster payment processing.

6) By comparison, one- and three-month repo rates were generally in the 6-7% range in Nov-Dec 2013.

7) These high returns are intended to attract customers. The funds pay the bonus interest to new customers for a limited time (e.g., one month).

8) Companies not licensed to sell funds are involved in online fund sales as fund sales platform providers. Because they are beyond the purview of the Securities Investment Fund Sales Control Law, such platform providers sometimes pay bonus interest in the form of additional fund shares separate from their funds' investment returns.

9) CSRC Chairman press conferences (November 2013, January 2014).

sector populated by not only financial institutions but also nonfinancial companies, most notably e-commerce and other Internet companies. Chinese authorities are therefore likely to take action to close existing regulatory gaps, including revision of China's regulatory silos.

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