



REPORT

Chinese Fintech

The Path to Regulation

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Chinese Fintech - the Path to Regulation

Within the span of weeks, Ant's anticipated IPO – marked as the most valuable filing in history – came crashing down. Ostensibly for a series of controversial remarks made by CEO Jack Ma that criticized China's regulators, the bigger question is whether China is trending towards an era of regulating its financial industry and how this government oversight will impact the future of behemoth platforms such as Alipay and WeChat Pay.

In a US-China Series virtual forum, I spoke again with Martin Chorzempa, a research fellow at the Peterson Institute for International Economics, to discuss the fallout of Ant's suspended IPO and the future of the payments system in China.

Martin and I discuss the inevitability of regulation of fintech upstarts and whether or not Jack Ma's speech critical of regulators was nothing more than a convenient excuse. Martin provides us with an excellent historical context and frames an argument where these companies will face ever increasing scrutiny, not solely because of their actions but because of the banking system's strategic importance. This was less about the politics of Jack Ma flying to close to the sun and more about the Party maintaining control.

In the Ant Group report we published in late October, we discussed nationalization risk, and frankly, I think it is underestimated over the medium term. These companies are now too big to fail, which in Chinese parlance, means they are too big not to comply. The banking system is one of three segments of any society that can derail the prevailing order. The other two being the military and healthcare. Putting it in these terms, Beijing's response to the dominance of Alibaba and Tencent specifically is hardly surprising.

With the necessity of the Chinese Communist Party to control every facet of daily life in China, why would they hand over dominance of a systemically important sector of the economy, i.e., the banking system, to two technology companies that are only tangentially controlled by the Party? It is incredible in this context that it took this long for a clampdown to be initiated.

Background on Fintech Development

Martin Chorzempa: The events of the last few weeks represent a watershed moment for fintech in China. Just weeks prior, the political economy of fintech seemed relatively stable. To understand how we reached this point, it's important to look back on recent developments:

- For nearly a decade between 2004 and 2013, fintech was scarcely on the radar of the People's Bank of China (PBOC). Both Alipay and Tencent Pay — now both behemoths — were relatively small players.
- Threats to the traditional financial system emerged when Yu'e Bao was launched in 2013, allowing users to invest "leftover" money sitting in e-commerce accounts. This platform took away hundreds of billions of RMB that otherwise would have been free deposits for banks.
- Around the same time, the popularity of Q.R. codes as a payment option threatened state-owned UnionPay.
- For some time, Jack Ma won sympathy by arguing that state-backed monopolies on payments were against the interests of everyday people.
- In 2016, a gradual reassertion from the authorities created an equilibrium: startups would not challenge the traditional banking system, and instead, their digital systems — in the form of data, algorithms, and users — helped banks deploy capital effectively. By getting money to consumers and small businesses, this was in line with the Party's objectives.
- Regulatory attempts at reining in companies like Ant were ineffective, as startups had much political support.

The Fallout of the IPO's Suspension

Martin Chorzempa: When Ant's IPO ballooned from \$250 billion and reached a valuation that was on par with some of the largest, most successful financial companies globally, regulators in China were concerned about these sky-high valuations.

Jack Ma's speech on October 24th at a summit, in which he criticized the malaise present in China's financial system and regulators' tendency to focus more on risk than on innovation, set off alarms. Ma's objections directly clashed with Chinese Vice President Wang Qishan, who had begun the same conference advocating for risk control. This was seen as contradicting essentially a member of the Politburo Standing Committee (though Wang is not). It was a demonstration from Ma that unnerved the government.

Three things happened: first, in an era in which China demands loyalty from its entrepreneurs, Ma and other Ant Group executives were dressed down for taking such a public position. Second, new microlending regulations essentially obliterated the funding model for Ant's 2.1 trillion RMB lending portfolio. If these rules are implemented — its implementation is unclear — Ant may be

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required to hold around 15 times as much capital than its current holdings to maintain its loan portfolio. In other words, Ant would be required to have 30% capital for a balance sheet that contains 2% of outstanding loans.

This may leave it impossible for them to profitably fund their lending business. It is an extraordinary shift and break in the development from "techfin" to a much more regulated financial company.

I believe that these rules would have come out at a much later date, posing as a lesser problem for Ant and the sector in general, had Ma not made that speech. Politico authorities may have come down on regulators, pressing for the need to cut down this company's risk.

Risk Control: Inevitable?

It's unprecedented for two upstart companies in any major segment of the Chinese economy to dominate a sector as strategically important as financial services. Is what we've seen with Ant — and Jack Ma's speech — simply the fast-tracking of the inevitable?

Martin Chorzempa: We're seeing a trend towards control and the reduction of risk. However, this may have come at a later point, where Ant would have been much larger. Keep in mind, it would have been much more difficult for the government to act if the IPO had been done already, and many Chinese investors bought shares in the company. It would result in a significant decline in valuation and stock price. People would blame the government for their losses.

Aside from political considerations, describe the positive interactions between the Party's objectives and Alipay and WeChat Pay's contributions. Where do these two parties' interests, diverge?

Martin Chorzempa: To some extent, both companies have been successful precisely because they benefit the government's manifold objectives. They've served as critical foundations for the development of China's consumer tech sector; provided a virtually free, very fast, and efficient payment system upon which startups are built; and the access to nearly a billion users through these super-apps, which no other startup could do.

For instance, Alipay and WeChat Pay have helped the government increase consumption through easier access to loans at a time when credit cards are still rare in China. Their data operations help launch small businesses, which help local governments and ministries improve governance — and by the way, increase and automate surveillance. At the beginning of his tenure, Xi Jinping recognized the utility of data in policymaking.

Where they diverge, to give one example, was in the consumer creditor sector, where the problem of a lack of consumer credit had become the overextension of credit. The level of over-

indebtedness and reckless investments increased the risk exposure to banks due to the lack of an equity cushion.

This unease in consumer credit has very much contributed to a shift, especially in a world where Alipay and WeChat Pay have become essential financial infrastructure. The economic impact of an outage in Alipay, for instance, would be much greater in 2020 compared to 10 years ago. This has led to an understanding of the need to nationalize these systems. We see it in PBOC Governor Zhou Xiaochuan, who was once a proponent of fintech, recently coming out and advocate for regulation.

What influence does the digital RMB have in this process, especially given tensions in data control and privacy — which, in WeChat's case, the app claims it does not disclose data to third parties?

Martin Chorzempa: It's hard to know the level of access to data that the government has from these platforms. The PBOC has been frustrated for a while in platforms' resistance to data requests. While I don't think Beijing has the capabilities to monitor transactions and payments directly, it may have access under certain conditions.

The digital RMB changes that. The former head of the Digital Currency Research Institute at the Central Bank has suggested that the digital RMB promises anonymity for users' interactions in transactions, including the tech company that provides the wallet. Yet no anonymity exists in the eyes of the Central Bank; the PBOC would have access to real-time payment data.

How this relates to Alipay and WeChat Pay is unclear, but Mu Changchun, currently the head of the Digital Currency Research Institute, has pointed out — at the same summit that Jack Ma spoke recently — that digital currency does not compete with Alipay or WeChat Pay. Instead, it functions as one payment option, along with virtual credit cards, direct bank transfers, or Alipay balances. Yet if such an integration exists, it's a big question who has access to which data. It's clear, however, that the PBOC wants more control.

As the traditional state-owned banking system has morphed from a very inefficient retail model to a slightly more efficient wholesale model functioning as the funding arm of Alibaba and Tencent, is this an effort in any way to protect the traditional business models of state-owned banks?

Martin Chorzempa: It's an effort that protects banks and even protect them from themselves. For small- and medium-sized banks, the ease of deploying capital through Yu'e Bao comes at the expense of building opportunities for the bank to cross-sell to the consumer and gain data on consumer behavior. In the short term, the benefits to the bank puts them in a passive position, where capital is allocated according to the marketplace conditions of Alibaba or Ant, or Tencent. Perhaps regulators hope that their measures would force banks to develop their own consumer lending capability.

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Tencent and Regulation

With all eyes turned to Jack Ma and Alibaba lately, what's Tencent's status in this regulatory transition?

Martin Chorzempa: Tencent has been much more careful than Ant so far. One reason is that, as a separate financial company with its own KPIs and shareholders, its business is integrated throughout the rest of its operations; there's concern that blowback from its actions would affect Tencent in a more significant way, compared to Ant's effect on Alibaba's business. We see a pattern where Ant is willing to take risks where Tencent is less willing to. One example is the individual credit scoring system. Yet, the reaction that is provoked by Ant extends to Tencent and other fintech companies.

In the aftermath of Jack Ma's speech, senior Tencent people talked about how they appreciated regulators and their desire for regulation that would tamper down risk. Yet regulations will still affect them. No matter how quiet Pony Ma is, the pace at which regulations are levied upon these companies will be clear.

At this point, is regulation warranted given the actual or potential systemic risks posed by Alibaba and Tencent? Or is it Jack Ma's speech that triggered regulations that may or may not be justified?

Martin Chorzempa: My controversial view is that the risks are a bit overstated. A product like Yu'e Bao has generally been very well-received, and default rates have been very low, even during the height of the pandemic in China. Those rates were on par or below that of banks. Bear in mind that Ant does not originate asset-backed securities. I don't think Ant necessarily needs to hold all of this capital if the risk is not on their balance sheet.

Regulation should occur at the bank level, where reasonable valuations could be done, and risks could be assessed. The main focus area should be financial holding company regulation, where one regulator could oversee a whole group of aspects — be it payments, investment, insurance, and so on — and make sure there aren't too many problematic transactions at risk. I think this is a more important area for regulation than the specific capital side.

A Push for Internationalization?

Will these regulations, if they restrict domestic growth, lead to a greater push into overseas markets? For instance, despite Ant proclaiming incredible international opportunities in its prospectus, are those opportunities limited?

Martin Chorzempa: Overseas opportunities are very much beset by geopolitical risk. We see that with WeChat, where its identity as a Chinese company rouses concerns in the U.S. (along with TikTok) as well as in India. Instead of promoting the use of their specific Alipay app, Ant and

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Alibaba have built a network of investees that implement a model driven by Chinese technology in expertise in other markets. Some are successful, but attempts at internationalization are met by suspicion: financial data is some of the most sensitive data.

We saw that happen when Ant was blocked in its purchase of MoneyGram in the U.S., which is used by servicemen to send money home. Though they ended up buying a smaller British company, it shows the headwinds in international expansion and the challenges of using it as an alternative strategy for expanding in the domestic market.

Nationalization Risks

Let's get to the elephant in the room: what's the risk of the nationalization of these payment platforms? What are some less extreme risks for these business models?

Martin Chorzempa: Jack Ma has famously said that he'd be willing to give Alipay to the government if the government asked for it. In reality, he expected the government would never actually ask for that, but he has to say it to indicate loyalty. Many elements of these systems have already been nationalized. So, the interbank element of payments where Ant and Tencent had accounts at every major bank, and then they moved money between banks themselves based on their own network, that part has been nationalized already

Instead of nationalization, what we'll see is increased favoring of state-backed alternatives. So, the digital currency is a great example of that. Of course, they're offering less privacy overall but just privacy from the private sector. And so I don't think there'll be a strict nationalization, although there have been some calls for it, but more of like a regulation regulating them into a potentially disadvantaged position against state-controlled alternatives.

Conclusion

Alibaba and Tencent will face the sort of regulations that any other strategically important sector would face, including interference by the Party on how they run their businesses. The private sector plays no role in the military and a minor role in healthcare that was sideswiped by the government response to COVID-19. The banking system, including the extraordinary innovation that has vaulted China to pre-eminence in digital payments, will also face much stricter scrutiny. The result will be share prices that will struggle to outperform in 2021 and beyond, even with a remarkably constructive framework for emerging market equities and risky assets as a whole.

Be careful when comparing regulation in China with that of the US and Europe. China doesn't have lobbyists. China won't go through years of congressional hearings to get to where they need to be, if at all. Jack Ma won't be publicly placed in front of partisan hearings to defend his actions. It doesn't work that way. The Party will make a decision and implement it. Stringent regulation is coming and coming quickly.

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Several weeks ago I wrote that the Ant Group ban should not, by itself, to have been taken as a bearish sign or an indication that the valuation gap between the US and Chinese equities won't converge in the years ahead. However, it is not a free lunch for Chinese tech companies. They may have an environment where they can grow without the fear of foreign competition, but as Jack Ma well knows, the CCP will have the final say.

Regulation threats in China should be taken much more seriously and a sign that the days of unfettered growth are coming to an end. There is only one organization that can dominate the banking system, and that is the Party. Investors will have to come to grips with this and value the firms accordingly.

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By Paul Krake

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