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REPORT
Ant Group
China Fintech Update

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China Fintech Update

Our on-going focus on Ant Group and Fintech regulation more broadly continued with *Martin Chorzempa — Senior Fellow at the Peterson Institute for International Economics,* returning to continue our conversation on the true drivers and consequences of the clampdown on Ant Group.

As we have stated since the IPO's suspension in Q4, this is so much greater than Ant Group and Alibaba founder Jack Ma, overstepping his bounds. This is about regulating a strategically important segment of the Chinese economy that had been transformed in recent years via a fintech revolution led by Alibaba and Tencent. Their dominance had fallen outside the regulatory framework, led by the PBOC, and recent actions have seen the Chinese regulators take back control.

Martin and I discuss the latest state of play that culminated over the weekend with the announcement that Ant Group and other online consumer lenders would be required to put aside 30% of capital for all new loans in conjunction with their bank partners. When combined with the bank holding company structure, Ant Group's future profitability has been dramatically curtailed and will dramatically decrease the IPO valuation when it comes to market, most likely at some stage in Q4. The IPO will go ahead because Ant Group needs the capital to cover the regulatory burden.

We explore China's New Regulatory Environment and the growing dominance of the PBOC. Regulatory turf-wars are common in China, and the PBOC appears to have taken a dominant position in the country's financial and economic direction.

No fintech conversations are complete without a continuation of our dialogue regarding the Digital RMB. We look a whether the time is right to allow foreign payment firms such as Paypal, American Express and Square to participate in a meaningful way. Given the strength of the incumbents, some foreign competition is healthy but hardly threatens the positions of local actors.

We finish off with Bitcoin, where we chat about the prospect of the Party banning Bitcoin as it goes against pretty much everything the Communist Party stands for. For those of you who think Bitcoin cant be regulated, think again.

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Ant Group: The Latest

Martin Chorzempa: Regulators have been forcing Ant Group to put it back to its payment roots through a difficult restructuring process. Several key points:

- Jack Ma and his companies' political influence were holding back regulation for a long time despite the anti-monopoly threats the company had posed in terms of consumer privacy, protection, and financial stability. Since the IPO, it is now known that they were only funding 2 percent of a 2.1 trillion RMB portfolio. In October, Ma's speech in which he famously criticized regulators saw political support wane, thus giving way to a flood of new regulations.
- There was hope that the company would be divided into pieces: a regulated financial holding company would hold payment licenses, consumer lending, and securities, but the tech side of the company would be left with a much higher valuation. Yet Ant Group's size has meant that the government did not have full oversight over the company's different businesses: securities, payments, and banking subsidiaries.
- The PBOC, frustrated by their inability to access data on these elements, is now rectifying the problems and using regulatory initiatives to place Ant Group under an overall financial holding company structure.

The PBOC is aiming for a financial holding company structure for Ant Group, much like in the US, where the Federal Reserve can look at a company's structure and impose regulations on its multiple financial subsidiaries. It remains unknown how Ant's financial holding structure will be formed, but certainly, there will be much more risk aversion. It is fair to say that the disruptive era of China fintech is probably over, though the company will likely remain very innovative and essential.

China's New Regulatory Environment

What does the holding company regulation of Ant Group say about the regulatory environment in China, given that for years, different regulators had been reorganizing their jurisdictions?

Martin Chorzempa: The last significant reshuffle in 2018 witnessed the PBOC gaining many of the powers that had previously been held by the banking regulator. In short, the PBOC became responsible for the whole system. On the data side, the PBOC is now able to oversee aspects such as data privacy and security in finance, as well as consumer protection.

The PBOC has also been able to designate companies such as Tencent and Alipay as monopolists in the payment space. Whereas the State Administration would usually handle that designation for Market Regulation, the PBOC took the lead in this definition. The regulator's digital currency initiative will also grant new surveillance and control tools over the financial system, which may leave other, now less powerful bureaucracies searching for a response.

Does the PBOC's oversight of holding company structures in tech allow it to have jurisdiction over other sectors and its regulators – for instance, over insurance?

Martin Chorzempa: It could be argued that the PBOC has achieved a super-regulator status. The reorganization in 2018, for instance, resulted in the banking regulator losing policymaking control to the PBOC, and the former now implements the directives of the latter. Whereas the insurance regulator would have direct supervisory authority over an insurance subsidiary, the PBOC can now observe the space as a whole, along with other sectors in tandem.

There are also overlapping appointments: for instance, the party secretary of the PBOC is also occupied by the head of the banking regulator, Guo Shuqing. In essence, the government has created layers overlapping the same companies so that instances where large companies have virtually no oversight can be avoided.

Discuss the financial stability elements of this regulation within the context of the PBOC being a super-regulator.

Martin Chorzempa: The main concern surrounding Ant was credit risk allocation in Ant's loan portfolio. Some key points:

- That the company was only retaining 2 percent of the capital for its loan portfolio was a warning sign for regulators, even though as a tech company, Ant has been managing financial risk while also selling risk management to the banks. Tech companies tend to be thinly capitalized, and banks, in theory, should be able to manage the capital and absorb risk.
- Concerns arose that Ant could pump out the maximum amount of credit possible to spur sales on its e-commerce platforms while offloading risk onto banks. Any defaults on its loan portfolio go directly onto the balance sheets of banks, and regulators were worried about the misalignment of incentives.
- Chinese consumers are awash in credit, where only a few years ago it was challenging for individuals to obtain credit: Ant changed that. The government is especially sensitive to students who borrow money on their parents' credit line.
- NetsUnion had nationalized the financial infrastructure created by Ant and Tencent, and the PBOC continues to extend its reach in making sure that companies like Ant do not offload risk to the rest of the financial system.

Ant will continue to facilitate large volumes of credit but with less control over lending. It is imaginable that whereas consumers now take Huabei loans that are designed by Ant, there may be an alternative in which banks can compete on the Alipay platform to issue differentiated products based on Ant's data and risk management. The impact of this regulatory overhaul is not clear, principally because of the unresolved issues of capital charges involved in the holding company structure.

Is there a larger plan of deleveraging and forcing the economy to be less reliant on credit by implementing regulations and limiting consumer credit?

Martin Chorzempa: This has been observed in the fintech space since 2015 when credit access drastically increased. There is a trend towards stabilizing the macro leverage ratio and even deleveraging. The recent economic global shock that hit China has not resulted in the flooding liquidity, and the PBOC has reiterated that they will not inject liquidity instead of asking companies to avoid layoffs. The lesson was learned from the last generation of stimulus that made access to credit too easily, resulting in high debt loads, zombie firms, and wasted projects. As of right now, the current success has shown the economy can perform well without significant credit increases.

Were these regulations inevitable, given the Communist Party could not allow financial services to be dominated by two tech companies becoming too big?

Martin Chorzempa: That is a pattern being played out across all new sectors of the economy, whereby the government allows new initiatives to operate in a gray zone; once they become significant enough, regulations are gradually implemented to take control over these sectors. It is a consistent pattern across all areas of fintech, as well as e-commerce. In the case of Ant Group, there are two sets of beneficiaries:

- First, state-owned banks will gain more control over their relationships with clients and will no longer be beholden to tech platforms to reach consumers. This is a crucial long-term strategy for the party in making sure that banks do not become irrelevant.
- Second, newer tech-startups less focused on financial services could help banks better utilize their data in risk management. These startups can better compete with Alibaba and Tencent, whose dominant positions have restricted others from thriving.

Regulation and Digital Currencies

Is the regulation towards Ant Group linked to the digital RMB and access to Alipay and WeChat Pay infrastructure?

Martin Chorzempa: The digital RMB is a real threat to Alipay and WeChat as a public option in electronic payments to private entities. Several key points:

- Data that would have ended up with tech companies instead are handed over to the government, allowing the latter to control profit engines. If Ant was able to preserve their business and stave off the threat of digital currency in the past, that is unlikely now, given the decline of Jack Ma's political influence.
- The digital RMB will not replace Alipay and Tencent. One can imagine a future in which transactions made through Alipay and Tencent are conducted by moving digital RMB, and in such a scenario, the PBOC will have much more control over the data. There may

be caps on fees, and the PBOC could provide public digital wallets available at lower fees for merchants.

- It is not a complete nationalization. Ant remains independent, operating within a set of boundaries that define public financial infrastructure.

I generally think that these regulations are justified because the risks are difficult to identify without fully understanding these companies under financial holding structures. After all, the interconnections between Ant Group subsidiaries are complex and filled with incentives.

Ultimately, regulators wish to preserve the benefits — the innovation and efficiency — of a private company. Alibaba and Tencent were able to transform China's payment systems from cash to digital payments in a short period, thereby making China a leader in fintech. It is a feat that state-owned UnionPay could not accomplish.

Could banks also become more consumer-friendly and adopt fintech infrastructure developed by Alibaba and Tencent?

Martin Chorzempa: Banks have been attempting to do so for the past few years. Ant demonstrated that consumer lending could be profitable, and Huabei loans significantly disrupted the banks' business, forcing them to raise interest rates to increase profit margins.

However, Ant Group and Tencent's restrictions could decrease the incentive for banks to be competitive. Regardless, these state-owned banks will find difficulty integrating new technology by incorporating startup-minded talent and culture. I have heard that there is some success so far: China Construction Bank, for instance, is reducing the cost of underwriting and making it easy for small businesses to get credit.

As Chinese authorities try to balance financial development and prevent financial risk, what can they consider besides implementing stricter regulation? What is being done by the United States in this space to mirror and tailor this?

Martin Chorzempa: China and the US have generally taken opposite approaches to fintech. Whereas China has allowed enterprises to thrive before creating financial rules later, the same companies would have to be monitored under financial holding company regulations in the US. In short, the US needs more adaptation and flexibility in its regulatory framework, which it has been trying to do with the OCC fintech charter. China is trying to find the right balance to achieve oversight without stifling innovation. China will not so easily tighten because small companies and individuals need credit, which is integral to its dual circulation model.

This is the direction they want, and despite the hostile receptions of Jack Ma's speech, I think the PBOC is taking a tightening approach while attempting to address circulation issues in China.

Will we finally see penetration by global fintech firms?

What role do foreign players such as PayPal, Mastercard, and SWIFT play in the payments space, given the regulations against big Chinese payment players?

Martin Chorzempa: These American payment companies do stand to benefit. China believes that it can afford to allow foreign companies to enter the country since domestic players are so dominant and efficient, making it difficult for Western payment companies to gain significant market share.

The greatest benefit lies in better connectivity between China and the rest of the world regarding cross-border e-commerce and payments; foreign payment companies can service Chinese merchants, especially considering domestic companies such as Tencent have not been successful in their international expansion.

In the case of SWIFT, despite analysis suggesting that China wishes to create its alternative to SWIFT and bypass US sanctions, the PBOC may find it more efficient to internationalize the RMB if it does not operate on the SWIFT payments system. Instead of doing away with SWIFT, an interesting scenario would involve better interactions between the digital RMB with SWIFT, thereby elevating the RMB's use as an internationally traded currency. This could also help China plan out necessary steps such as more liquidity markets, hedging instruments, and the development of onshore financial markets.

With China's national security laws around data, can foreign companies like JP Morgan adapt to regulations surrounding offshore data?

Martin Chorzempa: It is a challenging environment to operate in for foreign payment companies, but China is not the only country pursuing a nationalization of data. The US is wary of Chinese companies entering the country and gaining access to sensitive data, as well as India and the EU. It remains to be seen how these data protection regimes will interact, and indeed, they will act as trade barriers.

The State of Bitcoin in China

What is the prevailing mindset of Chinese authorities towards bitcoin?

Martin Chorzempa: While the general populace is receptive to bitcoin, the government sees it as a considerable threat. While individuals are not banned from holding bitcoin, it is nearly impossible for them to access it, as exchanges that allowed people to buy and sell bitcoin with RMB have been forced out of the country.

The authorities are viewing the technology with interest, but they are very wary of speculation that could cause financial instability, and most of all, for bitcoin to be a conduit for capital flight.

The same form of suspicion is held towards blockchain, as little benefit is seen in the decentralization of currency. This may impede the digital RMB from gaining an advantage by interacting well with digital currency systems and blockchain.

What would be a tipping point in terms of further regulation of bitcoin?

Martin Chorzempa: The tipping point took place around 2015 or 2016 when China made the initial decision to allow exchanges to operate under regulations against money laundering. Yet worries over the value of the RMB and capital flight propelled the government in stifling bitcoin's rise. Interestingly, miners are allowed to exist, and perhaps so because it contributes to rural economies that otherwise would have few income streams. Authorities do have control over mining capabilities, and blockchain is public so that it can be regulated.

The Return of Ant's IPO?

Is the IPO now inevitable, as the holding company needs to raise capital for the loans it generates?

Martin Chorzempa: More capital will be needed, and regulators' statements have pointed out that the IPO can go ahead once the regulatory process has been completed.

From the regulators' perspective, it was important that Ant did not go through with the IPO at the original valuation since any implementation of rules post-IPO would hurt the valuation. That would have been particularly detrimental to international investors who were under the impression that the fintech regulatory system was ready for the IPO and that Ant's business was well-understood. Many state and retail investors were also ready to buy shares in the company.

Ultimately, it was less embarrassing to cancel the IPO and implement the regulatory framework instead of allowing IPO whose valuation would have tanked under fears of regulatory oversight. Regulators are aware of the need to maintain innovation and access to credit for small businesses and consumers while avoiding risks associated with high debt.

Over the next six months or so, what can we expect with the Ant Group IPO? Will there be a significant decline in consumer credit?

Martin Chorzempa: It appears that Ant has come to a restructuring agreement with the PBOC, and my guess is that it will take six months to a year to achieve. Questions such as the specifics of capital charges remain undecided. The exact timeline will depend on the health of the Chinese economy, and if there is any upcoming uncertainty, then the IPO will likely be delayed.

As for consumer credit, there is an increase in pernicious consumer credit being made available by banks and consumer finance companies, and Ant will probably try to restructure as quickly as possible. I think the PBOC will want Alipay to continue to thrive: it will be interesting to look at the new prospectus and what will be said about regulations. That will be when we learn about how much the loan book has shrunk or if it is just growing at a slower rate.

Conclusion

Over the weekend, many of the feared “reforms” to consumer lending and Ant Group were confirmed: According to the Financial Times:

Under the rule changes announced over the weekend by the China Banking and Insurance Regulatory Commission, online lending platforms will have to contribute 30 per cent of the funding for loans they offer in partnership with banks.

The CBIRC will also cap how much capital commercial banks can commit to online lending in co-operation with tech platforms. The new rules will come into force next year.

I will leave the last word to strategist Bruce Pang, also from the Financial Times

Bruce Pang, head of macro and strategy research at China Renaissance Securities, said the new rules meant banks would be required to cap the joint lending business they carry out with these fintech companies. Some of the fintechs would also need to seek new licenses.

“Online lending platforms could face more valuation pressure with dampened growth prospects, considering that they would have to raise more capital to fund [themselves] in joint loans with banks,” Pang said.

Ant Group is being regulated like a utility. While investors, especially the pre-IPO investors who were days away from a payday that would have valued the company at $300bn, recent moves have probably more than halved the valuation. The technology component also being forced into the bank holding company is another drag on value. That said, the IPO will occur because Ant Group needs the regulatory capital. While the multiple that will be paid for the company as a public entity will be well below previous expectations, Ant Group will adapt and remain dominant within a more stringent regulatory framework.

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