WHY FINTECH “MADE IN CHINA” DOES NOT HAVE TO BE DISRUPTIVE TO CONQUER

by Patrick Lecomte , **09.02.17**

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Dr. Patrick Lecomte, Deputy-Director Centers of Excellence ESSEC Asia-Pacific, explores the exponential rise of the Chinese Fintechs and their ambition to rival with the West’s tech giants.

When Jamie Dimon, CEO of JPMorgan, announced to his shareholders in April 2015 that ‘Silicon Valley is coming to finance,’ he probably did not foresee that hardly two years later, instead of Silicon Valley, it would be the Chinese internet giants which would dominate global Fintech.

Fintech is everywhere, in the United States, in Europe, and in the financial centers of Asia (Hong Kong, Singapore). But it is in China that it has literally exploded. Between July 2015 and June 2016, investments in Chinese Fintech reached USD 8.8bn, above that of both the United States and Europe. Chinese Fintech, which developed autonomously and without links to the exterior, benefits from the blooming environment of internet in China.

Home-grown heavyweight potential

With 730 million internet users, China is indeed the world’s largest digital economy and the one growing most rapidly. Although the Americans, Germans, and Japanese spend more on line than anyone else, an ever-increasing percentage of Chinese buy, sell, and transfer funds via the internet more than anywhere else in the world. To give an idea, in 2016, sales on Alibaba reached USD 502bn – that is, more than twice those of Amazon.com. E-commerce in China now represents nearly 47% of the world total. The younger generations, Gen-Y and milennials, play a driving role in the growth of the digital economy. Among the middle classes, these consumers represent nearly 45% of the total consumption of goods and services. More than half of those born after 1990 consume online and manage their finances via Fintech applications on their smartphones.

The giants of the Chinese internet that are Alibaba, Baidu and Tencent have understood the message by positioning their platforms to cover the complete range of needs, both financial and non-financial, of the emerging Chinese middle class. In 2016, Tencent’s messenging application WeChat, for example, enabled 32 billion red envelopes (*hong bao)* – traditionally associated with the giving of gifts during the 6-day Chinese New Year holiday – to be sent: that is, 6 times the number of transactions recorded by Paypal over the whole of 2015!

Other than the unique scale of the domestic market, which moreover plays a major role in the capacity of Fintechs to quickly reach a large size (*scalability*), other key factors have a determining influence on the success of digital finance in China.

Trust – Chinese style – makes it easier

Another related element is the very high level of consumer adoption of Fintech services – a reflection of the trust that Chinese internet users give to market newcomers. A study carried out by the Singaporean bank DBS showed that in 2016, nearly 40% of Chinese people were using new means of payment developed by Fintech companies against only 4% in Singapore, nevertheless one of the most innovative hubs in the world for Fintech. The same year, 35% of Chinese people also bought insurance products from Fintech companies against only 1% to 2% in the rest of Asia.

Have the banks missed the boat?

Admittedly supported by a very favorable technological environment, the strong adoption rate of Fintechs fundamentally reflects the shortcomings in the Chinese banking sector which has failed to satisfy the needs of large areas of the economy.

Traditionally, banks have concentrated on companies linked to the central government (SOEs) and large corporations to the detriment of small-to-medium firms and private individuals. This has led them to ignore enormous segments of the market that newcomers from Fintech have scurried to target. Consequently, for nearly half of Chinese private individuals, Fintechs represent their main account from which to borrow money, save, and buy insurance or investment products. In terms of volume, Fintechs have already overtaken traditional banks. Nevertheless, in terms of value, the banks still control 90% of transactions, the Fintechs mainly managing a multitude of small-sum transactions. In a near future, the danger for Chinese banks is not so much in terms of volume but customer relations and information, whereas online transactions feed the ever-richer databases of the Fintechs specialized, for example, in online payment.

The fact is that Chinese banks suffer from a strong deficit in trust among the population. A survey by EY (*Global Consumer Banking Survey 2016*) explains that traditional banks have become far from relevant for Chinese consumers. The most visionary financial institutions have well understood that their interest is to ally themselves with Fintechs rather than opposing them. This is the case with Ping An, a giant Chinese insurance company which helped finance Lufax. In just a few years, Lufax has become the largest Peer-to-Peer lending platform in the world.

However, all is not love and honey between banks and Fintech, in particular when it comes to Chinese finance’s new frontier – the gigantic market represented by Chinese people excluded from the banking system. This population of 234 million people, 71% of whom live in the countryside and 54% of whom belong to the country’s poorest, is a priority for the Central Government seeking to encourage financial inclusion. The competition between banks classically based in rural areas where these populations live – such as the Postal Savings Bank of China (PSBC) – and Fintechs is ferocious.

Clean soil, good seeds, and a tutor

Up until last year, Chinese Fintechs benefited from a very favorable regulatory environment, in particular in Peer-to-Peer lending and asset management. Several scandals, including a Ponzi pyramid on a P2P platform managing 7.6 billion dollars for 900,000 users, led the Chinese central bank, PBOC, to adopt a stricter attitude and improve the monitoring of Fintech activities. Nonetheless, Chinese rules are still clearly softer than those adopted, for example, by Singapore or the United Kingdom.

Another non-negligible factor which may explain the very rapid growth of Fintechs in China results from the sheer volume of funding available for the sector, from both companies supported by the government and the central government itself which manages more than 750 funds financing innovative start-ups throughout the country (representing an aggregate seed funding total of USD 231bn in 2015). To feed their strong growth, Fintechs also need talent. They are particularly fond of Chinese talents trained in the best foreign universities and with professional experience within leaders such as Google and Facebook. Faced with opportunities offered in China, these profiles are increasingly more in number to return to the country after a stay abroad, women playing a sizeable role in the creation of Fintechs and their management.

Geographically, the Fintech sector spreads out from three main locations: Beijing where the headquarters of JD.com and Baidu can be found; Shanghai as a financial center and close to Hangzhou where Alibaba’s headquarters is based; and Shenzen province near Hong Kong where the technology giants Huawei and Tencent have their home.

after Chinese regulators expressed their concern regarding foreign participation in the sector. In these conditions, what will the capacity of Chinese Fintechs be to deploy abroad? In the short term, Asia is in their sights: Hong Kong, but also the ASEAN region and the Indian sub-continent. Through Ant Financial, Alibaba has already massively invested in Thailand, Singapore, Vietnam and India.

Regarding development in Europe or the United States, their approach has consisted in following the waves of Chinese tourists to London, Paris or New York by providing them access to the same means of payment abroad as in China. Since October, Alipay has been available in New York and in California. Likewise, WeChat payment will soon be up and running in the major American cities. From here until 2020, Chinese tourists travelling abroad should reach the level of 500m a year.

McKinsey & Co. reckons that a first stage for Chinese Fintech going global will consist in getting themselves onto the US stock market. They might also look for stakes in companies that are already well established in the West such as Paypal. Case in point: Ant Financial has just announced its intention to buy US-based MoneyGram for USD 880mln. The takeover will require regulatory approval from the US Committee on Foreign Investments, which will be an interesting case to follow and might set the tone for the industry in the coming years. Beyond this particular case, it makes no doubt that given the current environment, Chinese Fintech's path from local Chinese leaders to global giants remains uncertain.

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