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KPMG Global China Practice

China 360

Internet-based funds: the dramatic rise of 'industry disruptors'

June 2014

China's financial services sector has long been dominated by its State-owned banks, and although Chinese consumers are among the world's most diligent savers, historically they have had limited investment options. Many retail investors keep their savings in bank accounts yielding less than 1 percent annual interest. Last year, however, China's financial services landscape abruptly changed.

In June 2013, China's largest technology and internet companies entered the financial services market, via internet-based investment platforms. These platforms provided consumers with flexibility, convenience, and a return on capital not previously available in the market. Retail investors have embraced the concept, and have transferred billions[1] of Renminbi into the investment funds offered on these internet platforms. The entrance of the tech giants into the financial services market has the potential to further disrupt the industry, as Chinese consumers get comfortable with new alternatives to traditional bank accounts.

This month's China 360 dives into the emergence of these internet-based funds, by explaining how they work and how they compare to more traditional investment products. What are the potential next steps by regulators, or by the banks – should they compete with the tech giants, or partner with them? And when the dust settles, who will be the real winner?

1. http://finance.people.com.cn/fund/n/2014/0418/c201329-24914986.html

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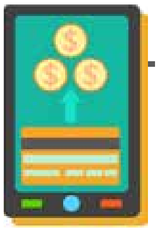
What is an internet-based investment fund?

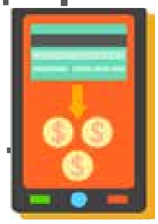
China's internet-based funds burst onto the scene in the second quarter of 2013. The first internet-based fund to launch was named Yu'E Bao (余额宝, meaning 'leftover treasure'), which is an internet investment product offered through the Chinese e-commerce giant Alibaba Group Holding's third-party payment affiliate, Alipay.com.

Following quickly on the heels of Yu'E Bao came a number of similar investment products from other leading companies in China's technology and e-commerce arena: more details on these competing products are provided below. These internet-based investment products came to market with a few common advantages:

- Convenience: a completely virtual/mobile environment with same day bank transferability, no transaction fees, the ability to view daily interest earned, and importantly the ability to invest any small amount of money – 'spare change' increments of RMB1 (USD0.17).[2]
- Competitive rates of return: annual percentage rates (APR) started out at around 7 percent. While rates have cooled somewhat, as of mid-May 2014, many products provided APRs just below 5 percent, still well above standard bank savings and deposit rates.[3]
- Professional money managers: funds are managed by professional fund management companies. For example, Yu'E Bao's funds are managed by Tianhong Asset Management Company.[4]
- Safety: underlying investments are in low risk, short-duration investments. Approximately 90 percent of Yu'E Bao's consumer funds are invested at China's interbank deposit rate (which has ranged from 2 to 11 percent in the past year), at 29 of China's largest and safest banks.[5]
- Additional functionality and linkages: these savings products are directly linked to or packaged with other services provided by these technology companies, such as leading payment or e-commerce platforms, providing new value and convenience to the Chinese consumer.



Since launching in China, consumers have been racing to deposit funds into Yu'E Bao at a rate of RMB 3 million per minute.[6]



Yu'E Bao's competitors quick to counter

Alipay not only enabled consumers to realize competitive returns on their 'spare change', but also linked the massive Alibaba customer base and the Alipay on-line payment function to Yu'E Bao, streamlining the user experience of earning interest on deposited funds, and also purchasing goods and services online or through their handheld device. This savings model quickly proved extremely popular.

2. http://news.xinhuanet.com/english/china/2014-01/15/c_133047510.htm
3. http://topic.chinadaily.com.cn/index/cache/collection/cbsweb/source/chinadaily.com.cn/title/Why+Yu%27ebao+returns+decline%3F?aid=17501842
4. http://www.ibtimes.com/alibabas-online-money-market-fund-yue-bao-8-things-you-need-know-1560601
5. http://www.ibtimes.com/alibabas-online-money-market-fund-yue-bao-8-things-you-need-know-1560601
6. http://www.businessspectator.com.au/article/2014/3/6/china/alibabas-yuebao-gives-chinas-banks-rude-awakening
7. http://finance.people.com.cn/fund/n/2014/0418/c201329-24914986.html

By February 2014, Yu'E Bao had attracted more retail investors (81million) than the Shenzhen and Shanghai stock exchanges combined (67 million).[8] Since Yu'E Bao's initial success, a number of other companies have launched similar offerings. It remains to be seen whether any of them can overcome Yu'E Bao's first mover advantage; all are seeking to build on consumer strengths and networks of their own.

Other leading internet-based funds [9]

Tencent's Li Cai Tong (理财通)

Tencent owns China's WeChat social networking and communication application. There are over 300 million[10] active WeChat users, who are increasingly using the WeChat platform for activities like taxi booking or online purchases. WeChat users who have already linked their bank cards to the application can seamlessly transfer funds to the Li Cai Tong fund product.

Baidu's LiCai (理财)

Baidu also entered the online fund market in late 2013. Baidu is a web services giant that provides a wide range of on-line content and services, and operates China's most popular search engine. Baidu's offering is not linked to an online payment platform like Tencent or Alibaba. Instead, it offers a variety of internet-based funds, enabling depositors to make their choice, based on investment performance.

360Buy Jing Dong / Suning

360Buy Jingdong and Suning are two well-known consumer product e-commerce companies in China. They both entered the internet funds market in early 2014: 360Buy Jing Dong launched Xiao Jinku (小金库), while Suning introduced Ling Qian Bao (零钱宝). Both companies offer two online funds each, with an online payment/purchasing function that links to their respective e-commerce websites.

8. www.21cbh.com/2014/2-28/4MMDA4NTJfMTA4MDY4Mg.html
9. Unless otherwise noted, information is drawn from: http://www.atelier.net/en/blog/2013/12/20/alibaba-vs-world_426075
10. http://technode.com/2013/01/16/tencent-weixin-reaches-300-million-users/

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Financial services comparisons in China

China's financial services sector is still developing and does not yet offer the variety of products or services found in most developed markets. Although the industry has made gigantic strides over the past 30 years, the investment choices for individual savers and investors have been limited, and interest rates for bank deposits have been set at a low level.

Below is a comparison of the key features of internet-based investment fund products and other more traditional products available to individual investors in China:

China's newest internet-based money market funds have some important selling points. As shown in the table below, they offer a relatively higher risk-adjusted rate of return than the returns of an average wealth management product (which may range from principal protected, liquid products to higher risk corporate bonds and trusts). Internet-based funds also offer higher returns than a bank demand deposit or a time deposit, with similar risk characteristics and greater flexibility with regard to fund transfers and accessibility.

Common consumer financial products in China, 2014 [11]

	Lock-up period	Typical return	Risk	Restrictions
Internet-based funds [12]	Instant withdrawal	4.5 to 7 percent*	Backed by financial stability of the 29 borrowing banks	No fees. RMB1 million maximum deposit [13]
Certificates of Deposit [14]	1 Year	3.4 percent	Backed by bank	Minimum deposit of RMB100,000
Wealth Mgmt Products	Typically 30 days to 2 years	3.76 – 5.5 percent**	Variable; from principle protected, to trusts and corporate bonds	Cannot withdraw without a notification period
2-yr Time Deposits	2 years***	3 percent	Backed by bank	No early withdrawal
Bank (Demand) Deposits [15]	Instant withdrawal	0.35 percent	Backed by bank	Accounts may have daily withdrawal limits

* Based on APRs publicized by leading products from June 2013-May 2014

** Returns can be variable, above figures represent the indicative principal fund return for low to high risk funds, through eight months in 2013 [16]

*** Indicative time deposit, length of deposit can be longer or shorter, with higher or lower APR

11. Information on financial products primarily sourced from websites of major Chinese banks available in May 2014
12. http://www.cnbc.com/id/101712108
13. http://www.askci.com/news/201401/28/281031471740.shtml
14. Pilot program to launch as early as Q2'2014 involves more than 10 banks; http://online.wsj.com/news/articles/SB10001424052702303749904579579351919863912
15. http://www.businessspectator.com.au/article/2014/2/26/china/alibaba-and-chinese-banking-thieves
16. http://www.chinairn.com/news/20130413/093801511.html; http://www.chinairn.com/news/20130824/090054978.html

Consumer-centric approach to regulation

Predictably, the surge in online and mobile payments in China has the potential to pit the banks against the tech companies, especially with the popularity of the new internet-based fund products. For the most part, regulators have kept a largely positive outlook toward competition, but also stress that policies should ensure consumer safety and market stability.

> **Financial products, such as Yu'E Bao, will not be banned… strict regulatory policies did not exist in the past; some policies will be optimized in the future.[17]**
>
> **– Zhou Xiaochuan,**
> Governor of the People's Bank of China

In April 2014, the People's Bank of China (China's central bank), and the China Banking Regulatory Commission stated by June 30, 2014 all banks must be prepared to implement transaction limits and establish a means of verifying consumers' identities as they link their bank accounts to third-party payment platforms, such as Alipay.[18] Transaction limits would put a cap on the daily or monthly amount that could be transferred to a third-party internet company.

One major bank has already responded by limiting Alipay transfers to RMB50,000 (USD8,065) per month, although some local media outlets had variously suggested that bank policies would limit individual transfers to RMB5,000 daily, or RMB 10,000 monthly.[19]

On the whole, government policy and regulators appear to be broadly receptive to these innovative and popular financial services. New rules appear primarily focused on protecting the safety of commercial bank clients' funds and information, and on the rights and protections of consumers.

> **At the moment the authorities should encourage this newly born industry to develop and innovate, but the authorities… should introduce regulations against potential harm.[20]**
>
> **– Zhou Xuedong,**
> Deputy to China's National People's Congress and Head of the Nanjing branch of the People's Bank

17. http://huxiu.me/post/78542224297/yuebao-will-not-be-proscribed-says-zhou-xiaochuan
18. http://www.scmp.com/business/banking-finance/article/1487614/beijing-set-limits-online-payments-security-push
19. http://www.scmp.com/business/banking-finance/article/1487614/beijing-set-limits-online-payments-security-push
20. http://huxiu.me/post/78542224297/yuebao-will-not-be-proscribed-says-zhou-xiaochuan

Banks getting competitive

In light of the popularity of online-based funds with consumers, some banks have already started to launch their own online-based platforms and savings products. It is interesting to note that thus far, these competitive counter measures are not from China's biggest banks: it is the smaller banks that are taking the lead in developing these on-line products.

The big banks shouldn't be too far behind though; it is likely that they are choosing to first accumulate data about the industry and position themselves to obtain maximum benefits. Because of their vast size, the large banks need to sort out risk and operational issues before they introduce a new service. If and when the larger banks decide to enter this market, they will likely seek to capitalize on their ability to cross sell other (financial) products and services.

> **"It is likely that within the next 6 to 12 months, one should start expecting competitive practices and tangible results from the larger banks, as these banks transition from successful corporate service models, and focus more on retail market servicing models."**
>
> **– Kevin Liu,**
> Partner, Management Consulting,
> KPMG Advisory (China) Limited

On the other hand, the banks need to recognize that their particular internet-based funds may not be as flexible as the internet fund offerings such as Yu'E Bao or Li Cai Tong. For example, to participate in a bank's internet-based fund, a consumer must have an existing bank account at the participating bank, and also expect some short-term liquidity and transfer restrictions.

In contrast Alipay's Yu'E Bao is a platform that accepts funds from any Chinese bank, and provides instantaneous fund deposit and withdrawal.

A final challenge for the banks is that they are now competing with companies whose 'bread and butter' services are internet-based goods, services and applications, and who also have a deep understanding of how to successfully satisfy the demands of China's on-line consumers.

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Partnerships are critical to unlocking greater opportunities

Internet-based fund products are innovating ways that consumers can manage their savings and expenditures in China. The tech companies have a nimble business model, opportunities to capture 'big data' on how consumers manage their money, and undisputed strengths in extracting synergies (and revenue) from an on-line customer base.

And while the banks and other traditional financial services providers may lack some of the tech companies' advantages, what the banks do have is a gigantic client base with financial assets: the largest five banks in China manage about 70 percent of China's RMB64 trillion in deposits.[21] Partnering with one of these banks (or even smaller banks) would unlock a very significant and liquid customer base.

> **"Some of the most innovative banks in China are asking 'how can we partner with these tech companies.' And the banks that aren't asking the questions will shortly discover they are left in the technological dust of China's constantly transforming tech sector."**
>
> **– Egidio Zarrella,**
> Partner, Head of Data and Analytics, KPMG China

For this reason, we expect that China's savviest financial institutions will continue to explore linkages with tech companies, potentially through alliances or joint ventures, to create more flexible and user-friendly applications that enhance the customer's overall usage of 'on-line' banking and financial services.

The big winner is… the customer

Internet funds such as Yu'E Bao and Li Cai Tong are clearly tapping into a strong customer need. Chinese consumers are flocking to these innovative internet-based platforms that are allowing them to conveniently manage their money.

While some may dismiss these products as an internet fad, it is much more likely that the emergence of internet-based investment fund products heralds a new and dynamic phase in the development of China's financial services market. KPMG professionals expect to see even more innovations in both the financial services and tech sectors, as financial technology (or 'fintech') continues to improve the customer's 'total banking and loyalty experience.'

These 'industry disrupting' innovations represent market-driven competitiveness: a healthy mechanism that accelerates product-specialization and improved consumer services. Provided regulatory controls are in place to ensure healthy market development and robust consumer protection, it is the individual investor who will emerge as the undisputed winner.

21. http://www.stats.gov.cn/tjsj/ndsj/; http://wenku.baidu.com/link?url=UdOJWGF0ZaT8BUlFk4IAPNxKOg_EoihvOgfJHO6AdMzY4jHlDo0oocqcnAgE8U3FNdHZQFficOeQOC_EVOj8BDB5tPOcvXFEHt5RmKclw4K

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