Orient Capital Research

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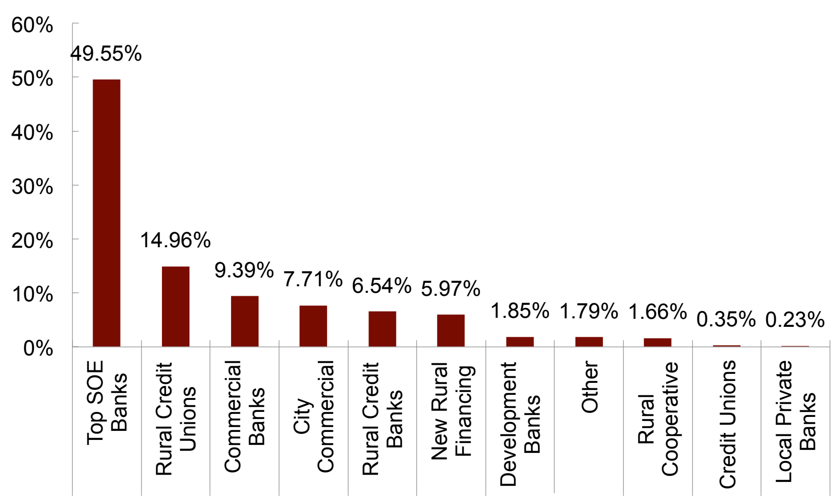
P2P in China

Will State Banks Maintain Control?

We presented data on P2P at a June 6 conference in Beijing on inclusive finance, P2P, and crowd funding sponsored by the Central University of Finance and Economics (CUFE). The conference was "internal" to China – two western academics and I were the only foreign presenters. Other participants included the Director of the Consumer Protection Bureau of the PBOC, researchers from the country's two main planning boards, the NDRC and CASS, academics, and executives from the leading online companies.

There are now more than 1,700 P2P online lending companies in China with a volume of $42 billion in 2014 to 630,000 cumulative borrowers. Although the loan balance is small compared with the total consumer loans of $3.8 trillion and business loans of $9.6 trillion at the end of 2014, it is growing at 3x to 4x per year. ***The real question is how far are the regulators going to allow private companies to take market share from the state banks?***

China's Banking Assets Market Share



Source: Orient Capital Research; CUFE Conference, Nanning 2014

Competition for Shadow Banking Fees

The state banks were aggressive in 2009 in taking back market share from the Trusts. They were losing both depositors and fee income. In response, the banks began selling Wealth Management Products (WMPs). We calculated that in 1H 2013 the four state banks earned Rmb 50.4 billion from shadow banking fees, or 25% of total fee income.

State Bank Fee Income from Shadow Banking (1H 2013)

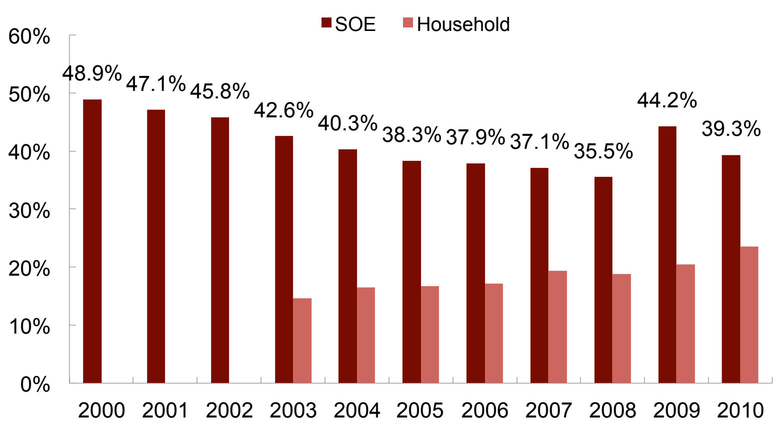
China Big Four Banks - Trust and Wealth Management Income
(RMB Mln)

	On and Off BS WMP Funds Raised	Fees from All Agency, Trust and WMP Activity	Trust, Agency and WMP Fees as % of Total Fee Income
ICBC	2,811,200	15,243	21.0%
China Construction Bank	3,199,200	11,809	30.6%
Bank of China	2,946,486	10,902	22.5%
Agricultural Bank	2,680,676	12,502	26.3%
	11,637,562	50,456	25.1%
Off BS Funds Raised	**7,564,415**		

Source: Bank Statements, Orient Capital Research

Judging by the conference, clearly are under orders from the leadership to improve access to credit among small businesses. They also are encouraged to increase credit access to the rural sector. But these policies are in contradiction with maintaining the state banks' 50% plus share of total lending – plus the focus on SOE lending. How is this going to work?

Breakdown of Loans to State Firms and Households in China



While attendees didn't address this question directly, from the conference, we noted that:

1) **Competition.** The biggest issue for online finance will be competition between state banks and online startups. Alibaba's Yuebao unit posted very fast growth, threatening the deposits of existing state banks, who quickly fought back with their own online units and rules intended to support their operations. Currently, state banks have been slow to take back market share from startups. Eventually, new companies will see growth curtailed but will be allowed to grow to a "certain" size (hard to determine) as a foil to the banks.

2) **Pro Small Business.** The tone of the conference was surprising anti "big industry." The title inclusive finance was used to protect Chinese versions of distribution of income.

3) **Top Down Policies.** There was a contradiction between "top down" economic leadership from State Council/Banks/SOEs in Beijing and more pro-rural factions among academics and research institutes. "China capital is a reverse pyramid, how can we turn it around?," said a PBOC official.

4) **SME Policy.** SME lending is policy that is heavily pushed by the leadership. But there was some question at the conference at how effective it has been. Some suggested the state banks are quietly ignoring pro-SME lending in favor of traditional state firms, whose debt is guaranteed by Beijing or local governments.

5) **New Form of Shadow Banking.** Shadow banking through Trusts and bank lending (Wealth Management Products) will gradually be replaced by other institutions, including online finance.

6) **Rural finance.** There is a huge market opportunity but total loans likely to remain small as a percentage of the total due to the lack of growth compared with industry and consumer firms in the urban areas.

China's Financial Access by Type

Bank Branches	216,000
Insurance Branches	22,000
ATMs	1,247,000
Points of Sale	15,900,000

Source: PBOC Consumer Protection Bureau

Shifting Policy May Stifle the Growth of P2P

"Inclusive" Finance

The leadership has made "inclusive finance" a priority – making capital available to small business and individuals. This is due to concern about lack of access to capital among small businesses, which is stifling GDP growth. It also reflects a bureaucratic wish to rebalance the economy toward consumers without changing the structure of state ownership of firms.

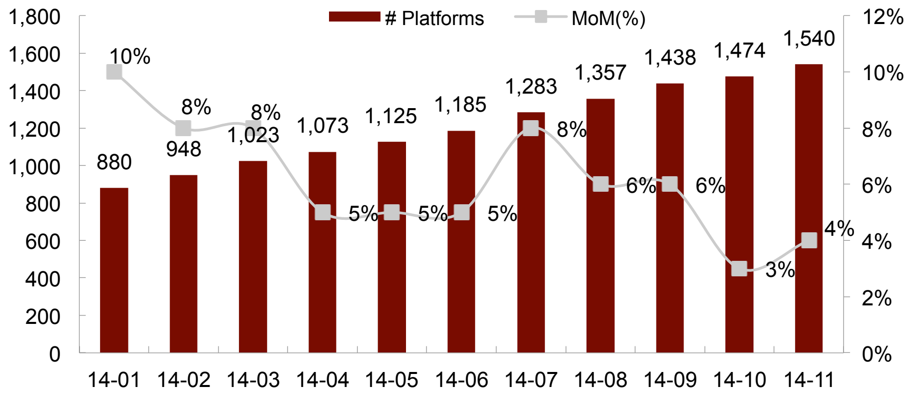
Internet finance looks like an easy way to do this – but there are problems. For example, the PBOC's 63-page Q4 2014 monetary report mentions internet financing just twice. The Third Party Plenum in 2013 made inclusive finance part of its platform. This includes loans to small business, crowd funding, P2P and other areas of internet financing. They have put in place favorable tax treatment, local government funding, and some relaxation of interest rates. Banks have also been told to increase lending to small business. Premier Li Keqiang, during a visit to state bank ICB, said the bank should do more SME lending, a clear sign of senior level support.

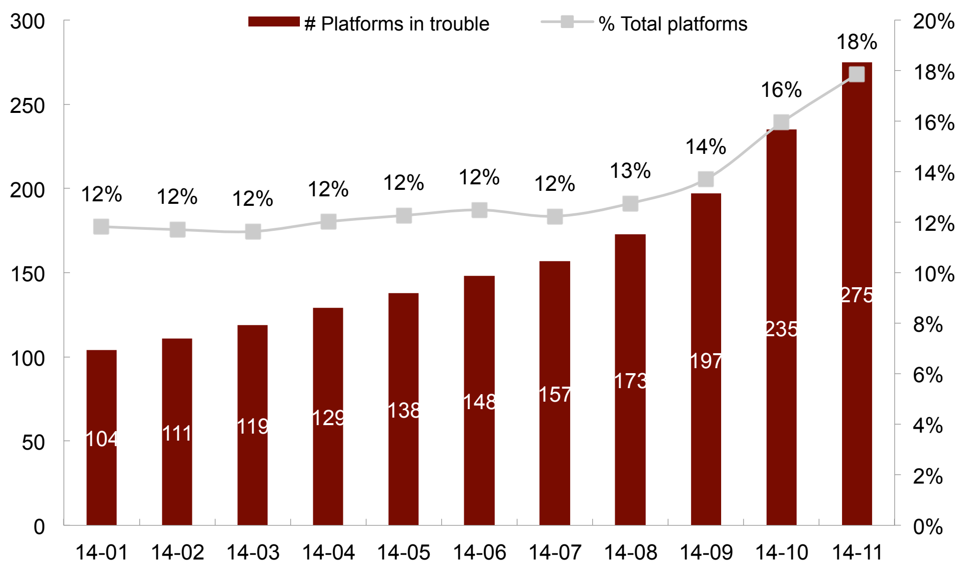
Regulators Step In

However, regulators are aware of lack of progress in developing non-bank lending to individuals and small business. Jiao Jinpu, Director of the Financial Consumer Protection Bureau, People's Bank of China, admitted that the sector has problems. "Chinese capital is a reverse pyramid. How can we turn it around? How can we expand coverage? We must get more complete access to SMEs and people who have no access to traditional finance."

He noted the growth of inclusive finance industry. Guaranteed loans cover 89 million people, but there are 120 million rural households that need additional capital they aren't receiving. There are an average of 0.4 mobile payments accounts per person, 3.3 mobile transactions per person, and 45.9 non-cash transactions.

Growth and Problems with P2P in China





Significant Challenges

1) Development is uneven. Financial resources are flowing to the prosperous regions.
2) Sustainable commercial model is insignificant. Yield is low for inclusive finance.
3) Incomplete laws and regulations. Lack of protection laws for stakeholders.

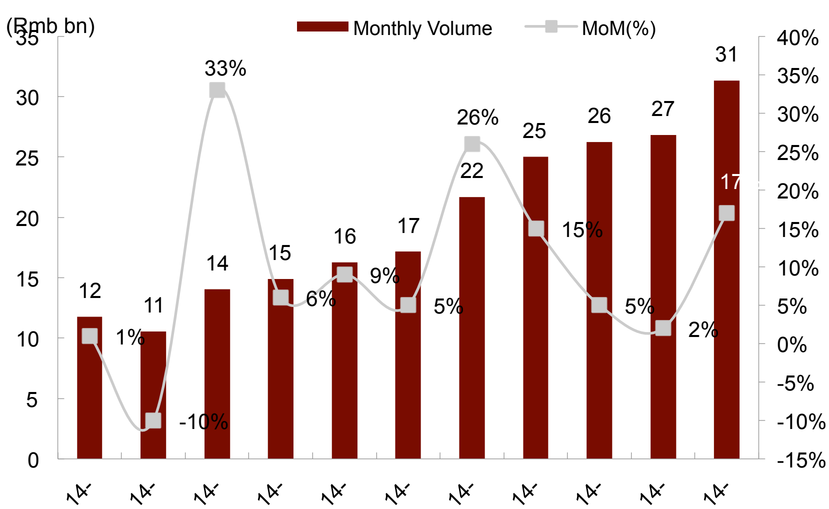
Zeng Gang, Director of Research on Small and Medium Commercial Banks at the Chinese Academy of Social Sciences, a research institute that advises the State Council, argues that there should be greater access to non-standard forms of lending, including P2P and crowd funding; and additional private capital should be permitted. Last, the government has to strike a balance between "risk control" and efficiency. CASS has recently started a research program on these issues.

The businesses who spoke at the conference clearly view crowd funding and P2P as a huge opportunity. But there are an excessive number of participants, little regulation, and rising fraud.

Eloancn

Wang Sicong, Chairman of one of the larger lenders, Eloancn, said online lending "has not yet been recognized by the authorities." Founded in 2007 as one of the earliest P2P platforms in China, eLoancn is a Wenzhou-based online lending platform where members can borrow and lend money among themselves at better interest rates than a bank typically offers. eLoancn differentiates itself from peers due to its focus on agriculture, farming and rural areas. Its main business comes from farmers' personal loans, which are mainly used for agricultural reproduction and breeding. The company has set up more than 1,000 operation centers across over 100 cities in China. According to the site, it recorded a turnover of RMB300 million in 2013 and RMB1.72 billion this year as of October.

P2P Volume in 2014



Eloancn has reportedly received $150 million in private capital from Legend Holdings, the private equity arm of Lenovo, according to press reports. Online finance is also an important part of the company's long-term development program. Legend Holdings's current financial units include offline payment company Lakala, Zhengqi Financial, a financial company targeting SMEs, commercial bank Hankou Bank, and insurance company UIB.

Chairman Wang said Eloancn has branches in 50% of China's counties and is growing at 3% to 5% per month at an average monthly interest rate of 1.5%. They expect to reach 17 billion Rmb in loans in 2015 and 20 billion Rmb by 2016. They have launched a mobile phone system with video that tracks usage by each user. "Our borrowers are not interest rate sensitive as they need the money urgently," he said.

He implied that Eloancn is the largest in the market. Alibaba relies on customers from its database of businesses while most banks have yet to enter the P2P market.

Alipay was separated from Alibaba in 2011 and established as a Ant Financial controlled by Jack Ma and other Alibaba executives. Since its inception in 2004, Alipay has shown strong growth, aided by the transaction volume from Alibaba, Tabao and Tmall. However, as noted above, it relies on its database of commercial borrowers from its online transactions arm so functions in a different category from the normal P2P operators.

Conclusion: The state banks will have to give up a degree of market share. Either a) the regulators will curtail private activity in the online market or b) the state banks will establish large P2P units, and with their large branch network, take share that way. Either way, there will be a ceiling on P2P activity – we just don't know yet how high.

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