

The Internet Finance in China: The Living Space and the Regulations

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Abstract

This paper focus on the internet finance in China. A recent new trend in financial area shows that a high-interest Web banking on the rise in China. When everyone is pleased, Chinese regulators say they are considering new rules to govern the sector. This paper discusses that if it needs the supervision for the Web banking and the internet company who has a foot into financial field? If needed, How and what rules it needed? Paper pay attention to the characters of Public Finance and Shortage make-up by the internet companies using the historical data and comparative analytical method. This paper bring forward the rules from the space for survival and development of internet companies according to their targeting segment that national banks don't look at.

Keywords: Internet Finance, Regulations, Web Banking

1. The Problems

In the era of information technology, new things are constantly coming to the fore. With the help of Internet, mobile terminals, big data, cloud computing, social networking and other next-generation communication technologies, Internet is changing traditional financial model and strongly penetrating into financial fields in china from 2013-2014. Since the second half of last year, the internet giants, Alibaba (the largest online and mobile commerce company in the world), Baidu, Tencent, 360 and the other Internet giants in China have rush for internet financial markets and push out so many financial investment products represented by Yu'E Bao which translates as 'leftover treasure' in the financial market, triggering a booming of internet finance in domestic financial markets, followed by a large number of people who are pouring into the field for money. Other big Chinese internet companies have followed the suit, promising even higher returns than Yu'E Bao. Not everyone is pleased to the case of Yu'E Bao. Recently, critics have referred to the online products as 'vampires sucking blood

out of banks' and warned that investor may not be aware of the risks. Following this, a series of problems have caused by this rapid development of Internet finance. One is the result of higher return offers by internet giants which is an assault on one of crucial instruments the Chinese government uses to manage the economy; the other is the cases the credit card cash. It was at the beginning of 2014, tens of billions of dollars credit card cash out case erupted. All these cases exposure primarily between Banks and third party payment services providers on the Internet financial means of cooperation, thus the Central Bank introduced a number of restrictions for the third-party payment platform, including the suspension of the QR payment and virtual credit cards and issued a set of online payment limit on draft. Following this, the regulators and financial decision-makers pay more attention to the internet company who had a hand in financial field. Facing these problems and the sudden flourishing of new creations which brought about a lot of problems, the demands for regulation to such new creations rose in China. One of the view for regulation was expressed that 'no need to take a new regulation to the Internet giants who

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has a hand in financial field; two main reasons for supporting the idea, one is that if you give rules to this new creations early than expect, the rules might stifle financial innovation on the Internet and the visible hand of regulation fully came into being in the invisible hand of the market after the collision will affect the development of Internet finance. The others believe that, Internet finance has not changed the nature of financial; it offers the service including payment, financial products, and traditional finance areas such as sales, financing, and investment, so the internet company's activity is in the financial business, and it needs supervision as banks. Chinese regulators said recently that they are considering new rules to govern the sector. Overview of the current points about the regulation on Internet finance, it can be simply divided into two basic types: one is that the internet finance might saves transaction costs in financial activities; might offer convenience for the public; and promotion of market-oriented interest rate; shack up the country's banking and financial service sectors. 'The financial industry needs spoilers to make a revolution', said jack Ma, CEO of Alibaba, during a speech last year. The other point questioned that the internet companies push up interest rates and assault on the crucial instrument the Chinese government use to manage economy: the interest rate and questioned whether it is technically safety. But all of these points are short of the basic theoretical foundation and the prudent regulatory principles for the regulation and the necessity of regulation. This author believes that should the Internet financial companies need regulation? If needed, where is the margin of regulation? How to give supervision it can proportion the development of internet finance on the premise of innovation? All these questions must be answered based on the understanding of the essence of the Internet finance; knowing the space of internet finance for their survival and development in Chinese special financial environment. Therefore, this paper intends firstly to make it clear about the economics logic basis of internet finance, through understanding of the essence of the financial Internet; and the space for its survival and development, secondly to explore the ideas about how to supervision Internet financial companies.

2. The Rapid Development of Internet Finance in China

Innovation in technologies has brought many good

things to our well being. One of the most important evolutions in technology is no doubt the development of the Internet finance. The number of internet companies that offer financial services over the Internet is increasing rapidly in the China by using 'transactional websites', customers can buy online investment products, apply for loans, and perform a variety of other financial transactions without leaving their home or place of business. All these depend on the explosive growth of the internet user. In China, as the change of time, more and more person likes to use internet, the following (Figure 1.) shows the trend.

As the Figure 1 shows, the internet users in China keep increasing, in Q1 of 2014. The number of Internet users reached 671 million.

Based on this On-line services exist in china now and an increasingly broader range will become available over the next few years. Computer-literate people will become the predominant retail investor in China. They will have high requirements for convenience and control over their finances. Many will be active investors, intensive users of information and interested in a wide range of securities, composites, and derivatives. 80 per cent or more of China retail investors will be potential users of on-line services by 2015, according to the expectations. What are the Chinese internet financial giants does offer on-line trading or on-line financial service for people in China?

2.1 Third Party Payment

Third party payment is an effective way to solve troubles in payment (third party is a generic legal term for any individual who does not have a direct connection with a legal transaction but who might be affected by it). It can guarantee the goods quality and reliable exchange, and the exchange of a purchase. It will monitor the processes of trade to ensure the both buyer and seller is honest. The third party payment offers necessary support for ensuring a successful business in e-commerce. The first third party payment company, the Alipay, was found in china in 2004, when the CEO (Mr. Jack Ma) was awarded that the third party payment is a good idea for solving the credibility problems between buyer and seller in E-commerce. In international trade, third party payment is more important too. Alipay Cross-Border E-Payment Service is a payment solution that allows buyers to pay for goods sold on international partner merchant websites using Renminbi (RMB) from 2014. Alipay will then remit the sum in a foreign currency to the international merchant in settlement.

The following (Figure 2.) shows the market scale and market structure of the third party payment in China in recently.

and credit checking tools. The following (Figure 4.) shows the numbers of the P2P platform in China from 2009.

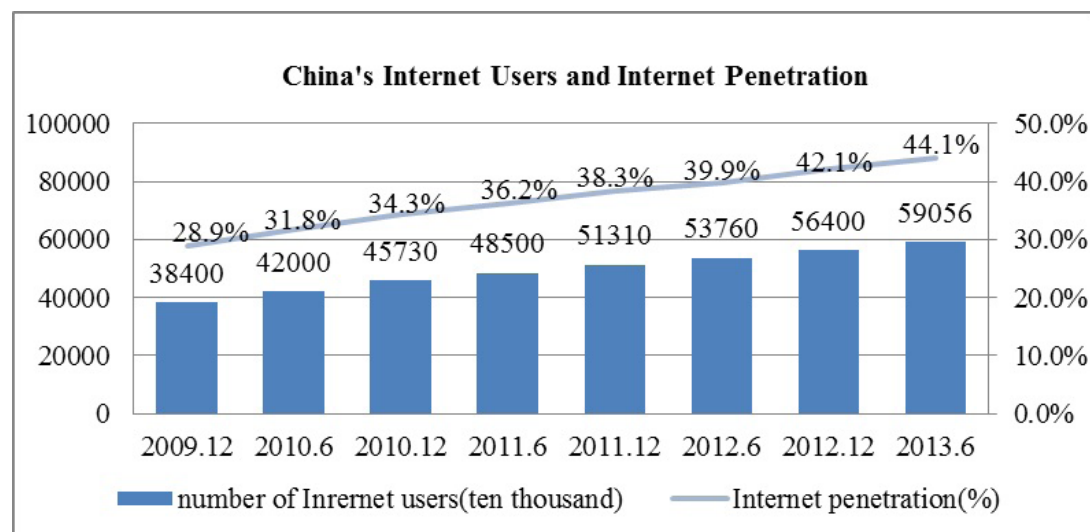


Figure 1. Numbers of internet user in China from 2009-2013.

Sources: <http://www.stats.gov.cn/>

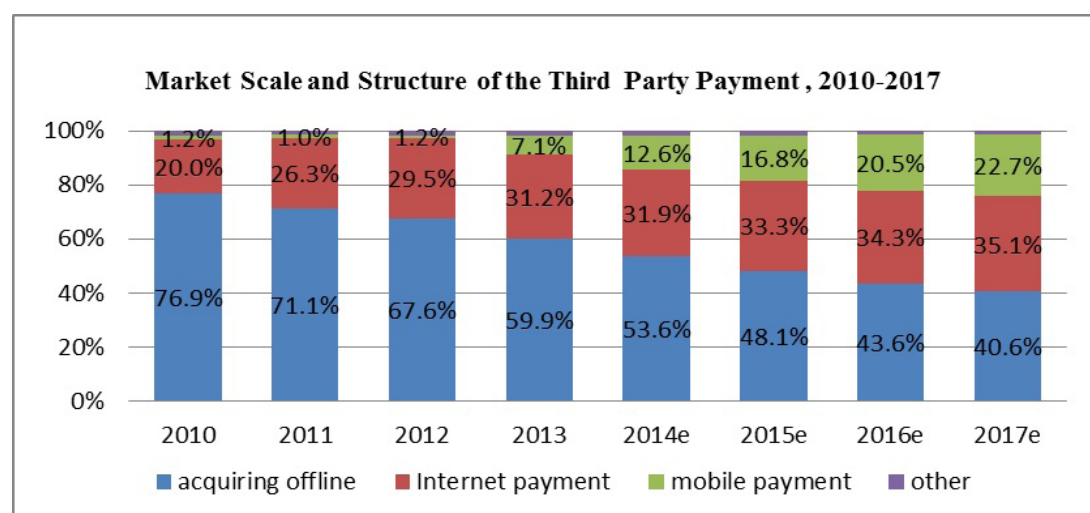


Figure 2. The market scale and market structure of the third party payment in China..

Sources: <http://www.stats.gov.cn/>

2.2 Peer-to-Peer Lending

Peer-to-peer lending (also known as person-to-person lending, peer-to-peer investing, and social lending; abbreviated frequently as P2P lending) is the practice of lending money to unrelated individuals or 'peers,' without going through a traditional financial intermediary such as a bank or other traditional financial institution. This lending takes place online on peer-to-peer lending companies' websites using various different lending platforms

2.3 Crowd Funding

Crowd funding is the practice of funding a project or venture by raising monetary contributions from a large number of people, typically via the Internet. It describes the collective cooperation, attention and trust by people who network and pool their money via the Internet to support efforts initiated by other people or organizations. Crowdfunding occurs for any variety of purposes, from disaster relief to citizen journalism to artists seeking sup

port from fans, to political campaigns, to funding a startup company, movie or small business or creating free software.

product provided by Alibaba Group allows users to directly invest in the private Tianhong funding

The following Figure 3 shows the transaction size by Third Party Payment Company from 2010.

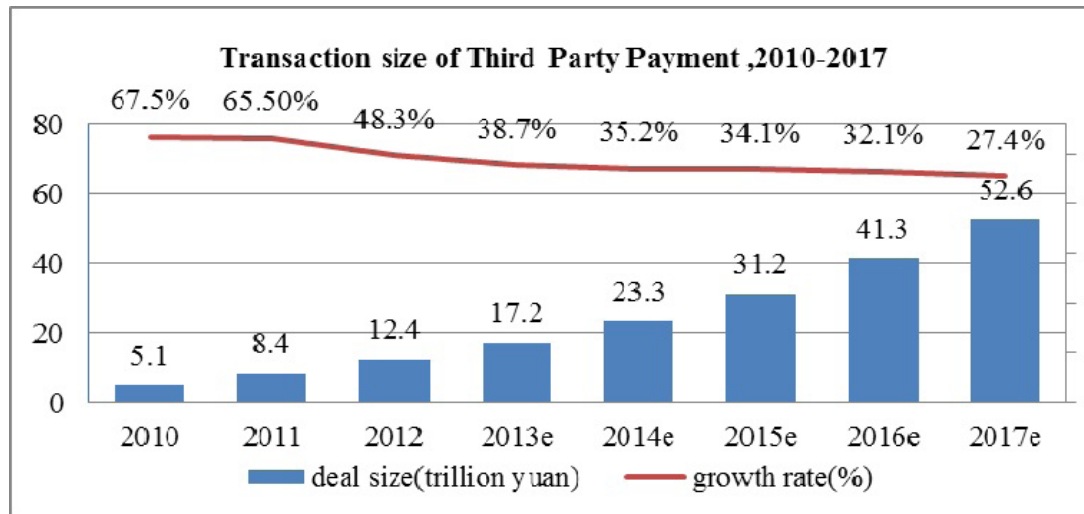


Figure 3. Transaction size of Third Party Payment, 2010-2017.

Sources: <http://www.stats.gov.cn/>

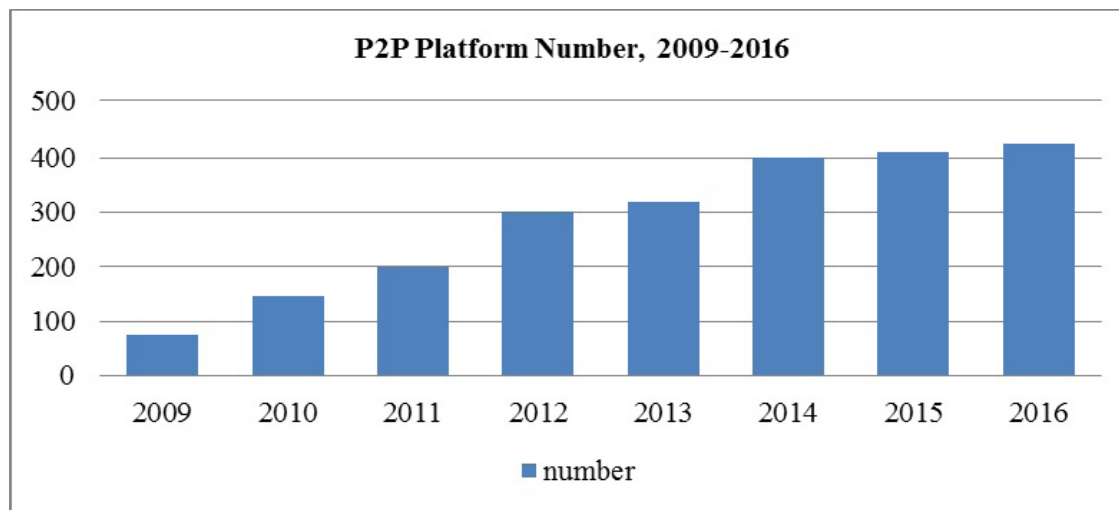


Figure 4. P2P platform number, 2009-2016.

Sources: <http://www.stats.gov.cn/>

There are four models of crowdfunding in china, the most commonly-used model is Project crowding, the other is Equity Crowding; Creditor crowd funding and Returns the raised.

2.4 Online Wealth Investment Products (or Internet-Based Investment Product)

In china, the investors are turning to online investment products. The high rates offered by product like Yu'E Bao, The financial product

company using spare cash from Alipay accounts. In China, 70 percent of respondents showed interest in online financing products, with most having a preference for Yu'E Bao . Initially pitched by the Chinese ecommerce group as a platform for its users to manage excess funds in their online payment accounts, Yu'E Bao is becoming something far more powerful: a straight-up substitute for traditional bank deposits. Other Chinese tech companies are getting in on the act.

Following (Table 1.) shows the development of project crowdfunding in china by June of 2014.

Table 1. Development of crowd founding in China

Project Number of Crowd Funding	Raised Capital (10 Thousand Yuan)	Number of Participants	Expected Amount Raised (Ten Thousand Yuan)
1432	18791.07	109174	206276.38

Sources: Data collected from National Bureau of Statistics

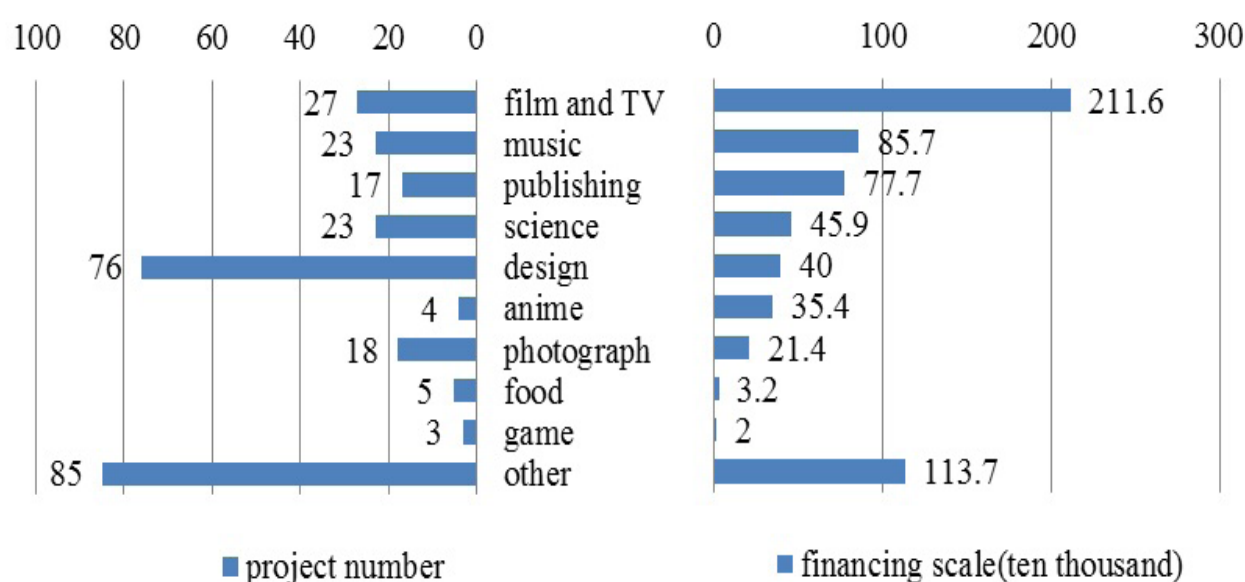


Figure 5. Successful financing projects number and scale by July 2013.

Sources: <http://www.stats.gov.cn/>

Tencent, developer of the hugely popular messaging app WeChat, is said to be designing a fund platform similar to Yu'E Bao. Baidu, the search engine company, began marketing investment products. Major Chinese internet companies are now disrupting the Central Bank's controls by offering enticing yields aimed at ordinary savers with spare cash. So, internet finance is here to stay in China. All the internet companies are targeting a segment that banks do not look at.

3. The Essential Characteristics of Internet Financial and Economic Logic

Understanding the essential characteristics of the financial Internet is not merely an academic question, but rather a question how to supervise and by what means to supervise. This is a regulatory policy issue. On the essential characteristics of Internet finance, Mr. Xie Ping, the first person who proposed the concept of internet finance said, the internet finance is a new emerging finance which based on the internet tools, for example, Cloud Payment, Cloud Computing, Social Network and Search Engine, the field which internet finance entered, the financing, payment and information intermediary, is the combination between traditional financial industry and Internet companies; but someone

point out that the Internet finance is completely different with the traditional finance, it is an emerging industry. Someone said on the Baidu Encyclopedia, 'The internet finance is nothing but finance, it use the internet for financial service or using the internet spirit for financial service'. Others argue that internet finance is just the macro crowd funding, namely, internet financial service can attract all the grass-roots who never have access to banking before by the portability and maneuverability of the Internet financial service. CBRC (China Banking Regulatory Commission) believes that the function of the internet finance is providing financial service including financing, Fund Remittance, and Guarantees and Credit rating to the grass-roots, based on the electronic commerce, internet, and information technology, from a financial and economic point of view. CBRC should abide by three principles for give rules to internet financial companies according to the logic line of supervision to Internet financial innovation. The first, it is a core to protect consumers' legal rights and interests against infringement; the second, take precaution to against and reduce the financial risks, this is the bottom line of CBRC; the third is, the rules put forward should result in more product innovation for the Internet financial companies. April of 2014, the People's Bank of China issued the China Financial Stability Report. In this report, the Central Bank gives a definition about internet finance including broad sense and narrow sense. In broadly, the internet finance means not only the internet technology enterprises engaged in financial business, but also the financial institutes which provided service based on the internet. In narrowly, internet finance just means the internet company who engaged in financial business. These descriptions for the characteristics of internet finance by Central Bank concentrate on two of crucial points on the Internet finance: one of meaning is that the internet finance means the financial activities (services); the second of meaning is the financial activities (services) provided by the non-financial internet technology companies which engaged in E-commerce. Here is where the problems or points lie. If we just take the internet finance as the Internet technology companies entered in the financial field, or broadly, take it also including the financial institutions provide financial services via the Internet, then the thread of argument will be confined into the financial sector, maybe the authority would use the same rules for the financial industry to regulate the Internet firms who involved in the financial sector.

Therefore, the Central Bank has a very positive view of the Internet finance, but issued a report in June 2014, the People's Bank of China, 2013, in this report, the central bank warning people about the risk of internet finance, and said the Bank would work out a plan for promoting a sustained, rapid and sound development of the Internet financial industry. At the same day, the Head of the China Banking Regulatory Commission also stated the opinion on how to supervise P2P, and the four bottom lines for regulation. That is why there is a statement about whose children who take him home by CBRC. We'd better to discuss the characteristics the internet finance from the points of view: the behavior of enterprises and the logic of economics. We know that Economics pay attention to maximization of enterprise profits, how to achieve utility maximization based on the best allocation of resources under the resources constraint condition are the subjects of Economics. The maximization of economics of so-called is the comparative analysis of 'costs' and 'benefits'. It means when the cost given, people will pursue as much of the proceeds, when revenue given, people will pursue cost as little as possible. We call this in Economics as 'rational behavior'. The person who does business according to this behavior we call him 'Economic Man' or 'Rational People'. The behaviors of Internet Enterprises entered into the financial sector are following this economic logic. According to the economics text the finance itself specifically refer to connect savers (who has money) and borrowers (who needs money) – providing 'intermediation services', so the finance is win-win for everyone involved. Internet finance has not changed the characteristics of finance; it does the business the same with banks based on the internet, and thus it just replace the functions of banks. If we take a look of Internet finance from the financial perspective, it is no difference between the financial service providing by internet technology enterprises and the service providing by financial institutions doing financial service based on the internet. But think it over, you can find, the difference including in degree and scope between the internet enterprises who providing financial service and the financial institutions who providing financial service. First of all, take it from the supply side (the Internet Financial Company). All the high profits the internet enterprise that entered into financial field providing services or products to the grass roots made, is depended on the big data within the existing resources (policy) constraints. Such as the case of Yu'E Bao, for last decade, the government monopoly has

aided state-run banks by placing a ceiling on the savings deposit rate and a floor on bank lending rates. The wide spread between the two, known as the net interest spread, has helped state-run banks pocket fat profits. Savers, on the other hand, have seen the value of their cash deposit deteriorate, since the rate of inflation has usually been higher than the government – controlled deposit rate. Under this condition, the interbank rates have soared in China in 2013 because banks, particularly smaller banks, are desperate for cash. Major Chinese internet companies disrupted those controls by offering enticing yields aimed at ordinary savers (the grass-roots) with spare cash, the internet finance emerged. In short, all the internet companies that entered into financial fields have the same reason. So, we can say that the internet players are targeting a segment that banks don't look at; it means the internet players are only able to have made good omissions and deficiencies. In fact, the backstage technical support platform for banks and other traditional financial institutions have all been computerized and networked, these banking businesses based on the network operation is for the giant firms for their large amounts of funds. Let's compare the business between state-run banks and the internet finance companies. In 2013, the electronic payment amount of state-run banks totaled RMB 332 trillion Yuan; the electronic payment amount of internet financial companies totaled RMB 1.5 trillion Yuan. The number of transactions by state banks went beyond 13 billion Yuan; the number of transactions by internet financial companies went beyond 1.7 billion Yuan. According to these results, the banking service provided by internet finance is for small- and micro-sized enterprises which the state-run bank does not look at, as Chinese banks prefer to lend to larger companies, especially state-owned enterprises. For example, P2P (person-to-person lending) and crowdfunding (all loans for individual projects). It is the behavior of different enterprises between the financial services provided by internet companies and the financial institutions such as banks based on the internet. Therefore we believe that the essence of Internet finance is capital financing, especially inclusive financial system provided by the internet enterprises with internet technologies based on the difference between scale and scope of the service. 'The users that our platforms are serving may not necessarily overlap with those that are being served by the traditional banking and financial services industry', says Alipay, Alibaba's online payment system.

4. The Living Space and Development for Internet Finance

If the Chinese government has to intensify oversight of the Internet finance, they have to know not only the essential characteristics of Internet finance, but also to understand the space of survival and development for the Internet financial firms. More clear the target or the supervision objective is, more abundant their rules choose. Like Irving Fisher said in his famous work 'the theory of interest' for the definition of interest, the emergence of the Internet finance in China is the result of a series of events. Internet finance in China has presented in 2003, but showing the flourishing development takes as financial innovation by all persons is a series of events that from 2013 onwards. In June 2013, interbank overnight pledge repo rate rose to 30%; overnight SHIBOR rates rose to 13.44%, so called the Time Point of Money Shortage suddenly appeared on the Chinese monetary market. The weeks spike in Chinese interbank rates reflects the growing competition for deposits. Money shortage in financial markets in China showed some companies facing temporary difficulties at a certain moment, but this incident has given the Internet financial companies an opportunity. Alibaba seized the opportunity, at this time when an ordinary demand deposit in savings accounts at major banks offers an interest rate of just 0.35 percent a year, and Yu'E Bao offers an annual interest rate of about 6 percent and still allows depositors to withdraw their money at any time. From this time, for every RMB 12 that companies and individuals have deposited in Chinese banks since June, they placed roughly RMB 1 in their Yu'E Bao accounts. While it remains tiny compared with total deposits in the Chinese banking system, this migration of cash from banks to the Alibaba platform is only speeding up. More than 30m people in China have signed up to Yu'E Bao, or 'Leftover Treasure', only six months since its launch. So the Interest Rate Spread between state-banks and the internet finance created a living space for internet companies. The living space for internet financial companies is actually based on the Big Data, which depends on the data processing ability of the internet technique and the cloud computing. Data is the core of the information age, and also the core capital in internet finance age. After years of development, Chinese Internet companies' aggregate quality and algorithm have reached the stage of creating new business models. And that, the data-processing systems

made by Internet companies is exactly the features of internet finance: it means that the big data set aggregate vast amounts of small data which is a congregation of many small and medium-enterprises. For example, Ali financial company who held the transaction data both buyer and seller on Taobao based on the collection and algorithms in hand, and used the results for their new business model. That is the power of the Big Data. But we can see from the current situation in China, the internet financial giant such as Amazon, Taobao, Jingdong, only held the data of B2C and C2C online shopping, the data of B2B, the giant firm or state enterprise's data has always been in the hands of state run banks and other state financial institutions. Furthermore, we can see the P2P. Almost all the P2P are the small businesses just like shops from a booth to spread the composition, size of the market size. According to the annual report on the P2P by Wangdaizhijia (the home of internet credit), the turnover of P2P is at 105.8 billion in 2013, and will be 300.0 billion in 2014. And the Central Bank's statistics showed that in 2013 the new local currency loans came in at 8.89 trillion by state banks and state financial institutions. Of course, there is no comparison between the two. Therefore, on a macro scale, the living space of Internet finance is the space or a field the state run banks don't look at. It makes good omissions and deficiencies for the financial products and service by state run banks and state financial institutions, and provide financial service for the grass-roots and minor enterprise which the state banks no willing to serve them. What makes Yu'E Bao attractive is the small size, the investors don't need to invest much, and small is the killer app. So, although China's regulation are suffocating smaller investors and average customers, the phenomenal growth of internet finance is intensifying competition for deposits and putting pressure on china's state-run banks, while the money involved is relatively small – about \$50 billion in a \$9 trillion economy.

5. The Conclusions and Ideas

If we take the Internet finance as the direct financing or indirect financing by the internet companies entered into the financial field, then the supervising in the authority should be first that: does the Government allow a technical business such as Internet companies across the border of industries into the banking business? If not, then let all the internet companies out of the financial field, all the financial business now in the hand of Internet financial

company taken over by state run banks or state financial institutions. In fact, all state run banks now have constructed their backstage technical support platform for business through Internet and interworking in with the world. For example, the Industrial and Commercial Bank of China Limited (ICBC) has built up the database management system based on the Data Warehouse which make it true to centralized management for customers information, account information, product information, transaction information. If the Government do allows the internet technical enterprise engaged in financial business, then the supervision in the authority should be that: where are the business boundary lines the government likes to draw for the internet companies who entered in the financial field? In other words, how much the government would allow the internet technical enterprise engaged in the financial activities? How wide is the work range? This is why many people proposed the Negative List. At present, there are agreeing on the necessity of supervision to the Internet finance both of the policy makers and regulators. Central banker believes that the Internet finance involves three major risks: the internet financial status has been lack of clarity in the law or maybe goes beyond the limit of the law; the third party payment company has been lack of the Escrow System of Client Transactional Capital; the inner-controlling financial system has its system defects. According to central banker, all these will bring the financial risks to Chinese economy. As a consequence, an important supervision principle has been laid down by the government: in principle, it just hangs on the in Separate Supervision System, means 'whose children who take him home'. So, The China's Securities Regulatory Commission, China Banking Regulatory Commission and the China Insurance Regulatory Commission (Commonly known as three commission) have a different vital role to play in the internet financial field. the Central banker will formulate a policy, the General Rules, for the Internet finance companies. The problem here is: most of Internet financial products involved in the other industries, such as banks, brokers, funds, insurance and so on, the internet financial industry is a diversified business industry, for instance, the famous mixed business operation model, the financial accounting APP and APP Card Cattle based on the SMS (Short Message Service) or Email. Moreover, the Internet finance clouded not only the boundaries of industries, but also deliberately use the strategy crossover

between industries in the creative design and business development, and was willfully create some mixed financial products get around the regulation. Therefore, how the separated regulations will be put into force? Whether there will be effects? How to avoid dead space? If we can't solve these problems well, the supervision to the Internet financial companies will be faulty in internet finance, which can also be the bursting point of Internet financial risks. In fact, the internet finance is highly regulated early, from the perspective of macro-, although many people think the regulation is not yet in place. For example, the third party payment have been supervised by the Central Bank; electric commercial small and micro loan was watched by the Local financial Office; Zhong'an online property insurance company was centralized by Circ (China Insurance Regulatory Commission); the financing product like Yu'E Bao and the other 'treasure' were in the hand in SFC (the China Insurance Regulatory Commission); P2P and crowd founding relate not only to Record-filing management by NDRC (The national development and Reform Commission), but also supervised under the other authority just like Department of Commerce, CSRC, China Banking Regulatory Commission and CIRC. Therefore, we believe that, if we recognized the Internet finance is the Internet technology enterprises engaged in financial business, the Regulatory Framework for the existing financial institutions is enough for the internet financial companies, no need to change the fundamental principles of financial regulation. However, if we recognized the Internet financial investment is designed specially to the Mid-and-small Investors who are the weak, in order to protection of small investors and institutional investors' interests, the authority has to take precautions against and reduce the financial risks. The first thing for financial authority is to establish a regulatory system for protecting the interests of middle and small invested who invested in some financial products via internet finance. The micro regulation of the internet finance maybe need a flexible management at some aspects according to the logic of the internet finance. For instance in the payable settlement, according to the provisions of the Central Bank, 'the Monetary fund transfer between payment institutions must entrust to the banks financial institutions, no permission for payment institutions to deposit funds between or entrust the funds to other payment institutions'. But in the real activities manipulation, the way of doing by most of the third party payment companies are not in accordance with this

regulation, some specific ways doing by them have not get special permission from the authority. In fact, if the existing rules for financial business have no revised, the ways of doing by some internet financial companies should be banned. In financing business by internet finance, for example, we first pay no attention to some activities for example, take deposits from people illegally or in disguised form; we have no intention to discuss these illegal activities here. In fact, Many loans business doing by some internet companies are 'three-no' (with no market threshold, no industry standard, no supervision). For example, for financial institutions, it is necessary for them to improve their capital adequacy ratio requirement according to The Basel Capital Accord, but some of internet financial companies such as P2P, who were deliberately, ignored the financial risk involved, without any obligation or no provisioning coverage ratios requirement. Once some accident occurred (it was occurred), it certainly leads to grave consequences. All of these must be taken into consideration when we work out the new rules for internet financial institutions which is intensifying competition for deposits and putting pressure on China's dominant state-run banks.

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Appendix Overleaf.....

Appendix

- i Which is high yield financial management software by the E-commerce giant Alibaba who had an offer to hundreds of millions of its users: 'give us your cash, and we will pay you more than the banks will pays'.
- ii www.people.com.cn, 2014.
- iii See www.baidu.com.cn
- iv All the data come from <http://www.stats.gov.cn/>
- v www.people.com.cn, 2013
- vi www.wangdaizhijia.com
- vii <http://www.pbc.gov.cn/>.
- viii www.people.com.cn, june of 2014.