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China's payments market moving in right direction

A massive shift in China's payment market is taking place. The government issued a set of new regulations in November aimed at defining a legal framework and allowing further liberalization and growth while emphasizing consumer protection, stimulating competition and regulating digital third-party payment providers.

China's payment market is unique in its bipolar nature, with the bank card segment controlled by state-backed China UnionPay International and the digital payment segment having innovative services like those offered by Alibaba's Alipay and Tencent's TenPay. © Reuters

China's financial services market has come a long way. In particular, non-cash payments have surged, driven by the growing middle class and thriving digital economy. There were less than 1 million bank cards in circulation in China in 1993. There are now 4.9 billion. In 2014, the total value of credit and debit card transactions in China reached $73 trillion while digital payments reached $1.25 trillion.

China's payment market is unique in its bipolar nature. At one end of the spectrum, the bank card segment is controlled by state-backed China UnionPay International. On the other, the digital payment segment has leapfrogged many foreign markets with innovative products and services such as those offered by Alibaba Group Holding's Alipay and Tencent Holdings' TenPay.

Today, 48% of Chinese retail purchases are paid through UnionPay bank cards compared with just 4.7% in 2002. China's only domestic bank card association and interbank network, UnionPay has grown from a solely domestic network to a global powerhouse. Its transaction volume reached $1.9 trillion in the first quarter, surpassing Visa's $1.75 trillion.

Although UnionPay dominates at physical points of sale, it has been relegated to a distant third by private enterprises in the digital sphere. Alipay is the leading company in digital payments, with a 49.5% share of the market. It is followed by Tenpay's 19.5% while UnionPay only has a 11% slice.

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Alibaba's offerings, consolidated into a separate group now called Ant Financial Services Group, have been so successful that Ant has been valued at an estimated $45 billion. With services ranging from money market funds to consumer credit ratings, Alibaba and its digital peers are taking significant business away from traditional players.

Foreign players like Visa and MasterCard are no strangers to China's payment market, but their previous attempts at entering the country, including a partnership between Visa and UnionPay, proved unsuccessful. Although foreign card players were officially permitted to launch operations in China in 2014, rumors of restrictive requirements made the companies' executives hesitant.

Those fears proved to be unfounded. In early November, China's central bank said that foreign card companies would not be required to set up joint ventures with local companies or use UnionPay's network. Visa and its foreign peers had been concerned that such requirements would limit operational independence in China and cut into their profits. The rumored launch of Apple Pay in China early next year could be yet another sign of China's willingness to open its market to foreign players.

Enhancing stability

Despite the growth of the sector, regulations had been lagging behind. Regulators are now playing catch-up to innovations that have proceeded apace.

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One key new regulation targeting the payment market focuses on promoting fairness and competition. It stipulates that e-commerce operators need to offer a variety of payment systems. For example, Alibaba's Taobao platform, China's dominant e-retailer, would be required to allow users to pay via a UnionPay or TenPay account instead of forcing them to use Alipay. This will lead to more competition of payment providers on the various platforms, which will ultimately benefit users.

The new regulations are also aimed at protecting consumers from fraud when using third-party payment systems. Previously, Chinese consumers only needed a phone number and an identity card number to pay online, leaving both individuals and retailers vulnerable to online fraud.

The new regulations limit potential loss by capping the amount that can be spent per day on third-party platforms based on the level of security these platforms offer. When a purchaser surpasses the cap, the remaining balance is directly deducted from a bank account linked to the user's profile.

For example, if Alipay requires only two types of identification verification without any additional digital security certificates, a user can spend just 5,000 yuan a day from this account. If the user wants to spend more than that, the first 5,000 yuan will be deducted from the Alipay account, and the remainder from the bank card linked to the consumer's Alibaba account.

This system creates three positive outcomes: the user cannot lose more than 5,000 yuan to fraudulent activity, the vendor is guaranteed payment, and digital payment platforms are forced to take online security more seriously.

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Financial products offered by online companies have gained tremendous popularity in China. But these operators are offering credit products without being subject to any regulation. This would expose consumers to uncalculated risks.

The new regulations will ensure that digital players receive the same level of scrutiny as traditional operators, ensuring organizations have the correct systems, expertise, and licenses in place. Affiliates of companies including Alibaba and Tencent have already obtained banking licenses, enabling them to continue their business under these new regulations.

Another new rule concerns chip cards, which will now need to conform to a homegrown standard. This new technical standard enables cards to be used for contactless payment, with money and encrypted data stored directly on the card. The regulation also addresses the unique needs of the China market, such as support for dual currency transactions with Hong Kong and Macau.

The new China standard is incompatible with the widely adopted EMV standard, backed by Europay, MasterCard and Visa, which will create a parallel environment and duplication for foreign card companies. One could argue that this may deter foreign companies from entering China, but a closer look shows that the new local standard should suit China better. Ultimately, Visa and MasterCard need to decide if they want to follow local regulations or risk missing out on China's $73 trillion market.

Greater innovation

The impact of these regulations will reverberate across China's financial system. Innovation by Chinese internet companies will continue to alter the landscape of the domestic financial services industry. Ant Financial already offers a slew of innovative financial products and services. Now as a result of the new regulations, companies will be creating technology solutions for issues that were previously not on their radar.

These companies could be leading the way in new compliance innovations or antifraud technologies. China's traditional financial institutions will now have to compete with internet players that are not only faster and more agile, but have direct access to hundreds of millions of end-consumers who are already loyal customers on their various platforms. Their use of data analytics to unearth trends across platforms to develop products in close coordination with end-users will challenge traditional banks and financial institutions.

Overall, we see the new regulations as a positive sign in a maturing economy. China's five-year plan for 2016-2020 advocates the continued liberalization of China's financial system. As always, regulators could go a bit too far or stop short when formulating new regulations. It is critical that there be a continuous dialogue between regulators, companies and consumers to fine tune and adjust proposed rules.

Overly detailed scrutiny of such regulations is not useful as long as the direction is right. In general, China has been heading toward more deregulation, providing more opportunities for both domestic and foreign companies, while enhancing consumer protection. A little bit of back-and-forth along the way is expected and should not be a concern.

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