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What's next for China's booming fintech sector?

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The fast and furious growth of the country's Internet finance industry will inevitably slow. Companies need to begin positioning themselves for sustainable success.

China's Internet finance industry has boomed in recent years. The country leads the world when it comes to total users and market size; financial-technology (or fintech) start-ups are mushrooming, as are company valuations; capital markets are aggressively pursuing the Internet finance industry; and consumer behavior is altering dramatically. By the end of 2015, the market size of the country's Internet finance sector was more than 12 trillion renminbi (\$1.8 trillion), dominated by the payments sector (exhibit).

Four factors are driving this rapid growth. First, China has an open, supportive regulatory environment. In fact, in 2013 the People's Bank of China explicitly expressed support for tech companies to promote Internet finance. Second, the country has a highly developed e-commerce sector, with more than 30 percent of the Chinese population already using Internet payment systems. Third, there is enormous latent demand for inclusive finance. Due to historical protection and strict regulation, traditional players are moving slowly to meet underserved customer segments, opening the door to disruptors. And finally, the strong profitability of traditional banks has underwritten a strong trial-and-effort culture, facilitating aggressive investments in innovative digital services.

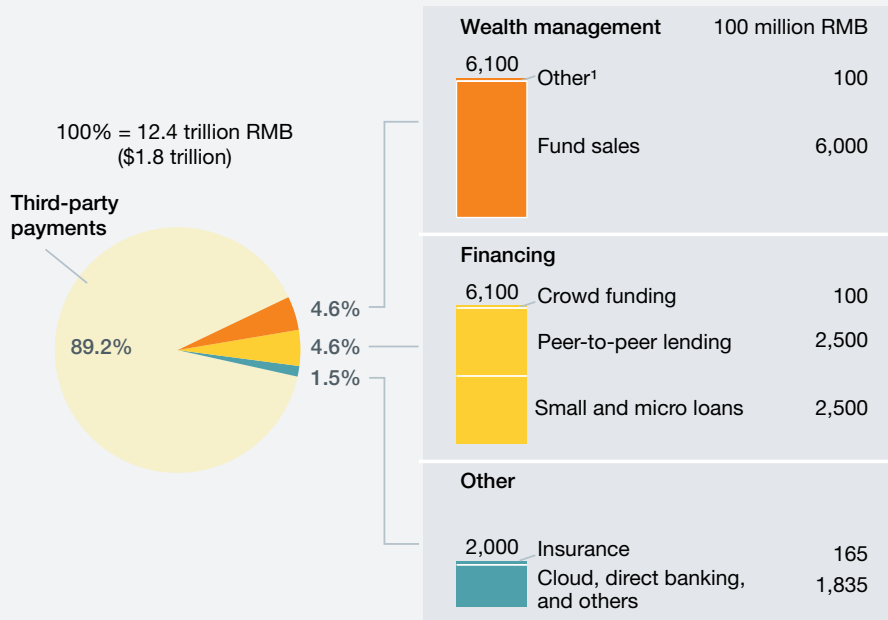
The Internet finance sector's torrid growth will inevitably slow. This will present challenges and opportunities for companies, especially as more mature regulations are imposed and a degree of consolidation takes place. As outlined in our new report *Disruption and connection: Cracking the myths of China Internet finance innovation*, surviving and thriving in this changing environment requires companies to take steps now. That means understanding not just the trends likely to shape the sector but also the kind of companies that have evolved in recent years.

China's three types of fintech players

Numerous players from various industries have rushed to stake a claim to China's Internet finance sector. We've identified three distinct types of companies that are taking the lead, each with distinctive value propositions:

Exhibit

By the end of 2015, the market size of China's Internet finance sector exceeded 12 trillion renminbi.



¹Other wealth management products—eg, trusts and private equity.

McKinsey&Company | Source: CNNIC; iResearch; McKinsey analysis

- Internet attackers, or 'barbarians from the outside.'** China has a uniquely competitive landscape dominated by a few digital companies that have established comprehensive multilicensed financial ecosystems. They differ from each other by core businesses or target groups. As one of the largest e-commerce companies globally, for example, Alibaba used its e-commerce business as a foundation of its financial empire, first entering into the payments sector before expanding into financing and wealth management, with an emphasis on hundreds of millions of individual and small- to medium-enterprise (SME) customers. Tencent took another route, expanding beyond the powerful social nature of its WeChat platform to build a consumer-oriented financial network that taps into its huge user base. These entrepreneurial attackers form the largest group and the most prolifically and wildly innovative, offering local products and expanding aggressively by taking full advantage of the customer insights at their disposal.
- Traditional financial institutions.** Incumbent financial institutions are accelerating their push into the Internet finance sector. They don't want to just witness this wave—they want to ride it. Yet strict regulations and relatively conservative mind-sets mean they are typically followers rather than leaders, at least compared with Internet attackers. That said, institutions such as Ping An Insurance Group are strategically entering the sector through subsidiaries including Lufax, Pinganfang, and Ping An Puhui. In addition, large commercial banks are acting: for example, China Construction Bank and Industrial and Commercial Bank of China are now building their own e-commerce platforms. Others will inevitably follow. Traditional players also have several strengths that should not be underestimated: a legacy of strategic partnerships, comprehensive product offerings, professional risk-management expertise, and physical branches.

- **Nonfinance companies.** Although small in number, companies with no experience in either finance or the Internet are joining the sector. Examples include retail companies Gome and Suning, and real-estate group Wanda Group, which are marrying extensive offline resources such as customer leads with data mining to design new financial products. In doing so, they threaten to undermine banks' control over key business customers.

Six emerging fintech trends

In the near future, we believe China's Internet finance players will enter a "warring stage" that results in consolidation. Regulations will be updated to account for new companies and products, and growth will become more orderly. In next five years, we see the enormous potential of six developing trends being gradually unleashed. Players should act quickly and firmly, strengthening skills and capabilities to take advantage.

Mobile payment and wealth management

Payment is the most mature sector in Internet finance, but its growth is far from slowing. Consumer engagement and affinity are increasing, and online-to-offline mobile payment via smartphones has become a new battlefield where companies are already starting to compete fiercely for market share. Traditional financial institutions, in cooperation with mobile-hardware manufacturers, are also starting to adopt near-field communication payment. At the same time, China's capital market is opening up. As they accumulate more wealth, Chinese consumers are hunting for higher investment returns—meaning that all investment products, except savings, are expected to maintain rapid growth. That provides opportunities for Internet-based wealth-management businesses.

Online consumer and SME finance

As China's economy seeks to evolve from investment led to consumer led, demand for financial services among Chinese households will only increase. Younger Chinese consumers are early adopters and keen drivers of innovation, more open to online personal-finance products, and have both a higher propensity to spend and a higher tolerance for financial risk. Indeed, as more advanced application of data enables quick and remote decision making, the full range of conventional consumer-financing products—such as credit cards and consumer loans—can be offered online, further broadening the industry's potential scope. In addition, there remains a large gap between the needs of SMEs and traditional banking products. SMEs in China contribute a significant share of GDP and employment (nearly 80 percent and 60 percent respectively), yet their development has been beset by a shortage of funds. As the country's economy slows, banks are becoming more reluctant to address this issue—presenting a huge opportunity for the highly efficient, low-cost fintech sector.

B2B Internet finance

In the next five years, companies will still contribute the majority of banking revenue in China—and the long business-to-business value chain will generate both opportunities and innovation. Chinese companies are shifting from simply borrowing to having more complicated

needs, such as transaction banking and asset management. In transaction banking, Internet finance can provide time-effective supply-chain financing solutions and digitized cash-management systems to support high-quality management of corporate finance and capital for large companies. In asset management, Internet finance can better address increasingly complex customer needs by providing quick, customized, and differentiated product matching, especially when high-quality assets are difficult to find. Internet channels are also well suited to marketing and customer expansion.

Financial cloud and infrastructure

Unlike the traditional model, where financial institutions operate their own data and IT centers, cloud-based services allow customers to be served remotely based on demand, paying for that usage. Cost effectiveness is a major advantage, with the cloud allowing customers to easily access information with minimal up-front and overhead spending. It also allows customers to retain flexible infrastructure that can be quickly scaled up or down. That's especially important for small players who need to rapidly build IT capabilities to serve explosively growing user bases and fluctuating volumes. Many IT companies such as Alibaba, Huawei, and IBM are already providing cloud solutions and platforms. We believe cloud-enabled innovation in the Internet finance sector will only increase.

Big data application

Big data allows financial institutions to collect and analyze customer data, providing more tailored products and services through a personalized marketing experience. In risk management, big data allows players to use advanced statistical models to better understand the correlation between factors and risks, based on both internal and external data. Combining this with cloud services facilitates real-time credit investigation and decision making at a low cost. Financial institutions that master these data-driven advantages will enjoy increased operational efficiency and business performance. It's perhaps no wonder that there's a huge unmet need for big data analytics—and more and more companies are emerging to serve financial institutions unable build this capability in-house.

Disruptive technology

Blockchain and related disruptive technologies have drawn close attention in the financial industry. Blockchain, the technological base of Bitcoin, is characterized as being safe, transparent, and unmodifiable—however, it has much greater potential than digital currency alone. It enables point-to-point transactions without a clearing intermediary, substantially reducing transaction time and cost. Further, if combined with smart contracts, blockchain makes it possible to automatically issue digital securities and trade financial derivatives. More broadly, the insurance sector will also provide new opportunities for the application of blockchain.



All of this isn't to suggest there aren't nonexposed risks, uncertainties, and challenges associated with China's booming Internet finance industry. These include consumer irrationality, product defects, and even fraudulent activity, and require careful maneuvering. Players also should cautiously deal with the implicit credit risk and liquidity risk, and be aware that regulators are determined to strengthen the management of Internet finance.

Yet we believe China's fintech sector will inevitably embrace fiercer competition and further industry integration, with true winners emerging through selection and elimination as they navigate the developing trends we have identified. No matter which element of the Internet finance industry they are in, and whatever their business models are, players must keep evolving to survive and realize a sustainable stake in the sector's future growth. [□](#)

[Download the full report on which this article is based, *Disruption and connection: Cracking the myths of China Internet finance innovation*, on McKinsey.com.](#)

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