**HOT TOPICS**

**WHAT RECENT CHANGES TO THIRD-PARTY MOBILE PAYMENTS IN CHINA MEAN FOR BUSINESS**

China’s third-party mobile payments market has seen vibrant growth in the last few years and has transformed the way payments are made. Within the industry, Alipay and WeChat Pay have dominated the market, claiming 92% market share. As Chinese consumers grow accustomed to these payment methods, there are growing implications for foreign companies looking to sell to them. For many, the payment methods are unfamiliar in their home countries.

WeChat and Alipay have become indispensable in the consumer-to-business (C2B) and peer-to-peer (P2P) payments ecosystem in China, especially in urban areas.

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**FIGURE 1:**

**MOBILE PAYMENT TRANSACTION AMOUNT**

<table>
<thead>
<tr>
<th>Year</th>
<th>Mobile Payment Transaction Amount in Trillion RMB</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011-2019</td>
<td></td>
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</table>

Source: iResearch, 2017 China’s Third-Party Mobile Payment Report

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1. China Foreign Exchange Trade System (CFETS); central parity exchange rate set by the PBOC
2. State Administration of Foreign Exchange: The time-series data of China’s Foreign Exchange Reserves
3. iResearch, 2017 China’s Third-Party Mobile Payment Report
With the ability to make payments instantly through scanning Quick Response (QR) codes or through chat messages, WeChat Pay and Alipay have gained wide adoption and have quickly become the preferred method of payment for many. The ability to pay another individual instantly and make purchases at e-commerce sites, supermarkets, malls, taxi cabs, roadside stalls, restaurants, etc., are some examples of day-to-day usage.

Embracing the digital wallet nature of Alipay/WeChat, many consumers have even “ditched” their wallets and carry little to no cash or card, and merchants at the point of sale ask customers if they would like to pay via WeChat or Alipay while they usually do not mention cash or card.

For foreign companies selling to consumers in China, familiarity with the mobile payment channels is critical as urban consumers overwhelmingly prefer these methods. Therefore, building an effective local payments strategy that is well-integrated with the customer’s sales experience is not only prudent, it is expected.

While WeChat and Alipay are largely used for domestic transactions in China, they are also gaining ground outside of China, supporting cross-border transactions for Chinese tourists travelling abroad. In fact, despite the recent trade tension between the U.S. and China, Tencent is looking for opportunities in the U.S. market later this year.

Regulations have had to play catch-up with the rapid growth of the industry. Some early “growing pains” have included the lack of real-name verification on the mobile payment accounts, and lack of security on the static QR codes for C2B payments. Most recently, a new payment system was implemented to regulate the payments clearing for these transactions.

**REAL NAME VERIFICATION:**

During the initial rollout of WeChat Pay and Alipay, the user authentication requirement was not in place, leaving open the risk of money laundering and scams through these channels. The People’s Bank of China (PBOC), in response, created stricter rules and regulations on user authentication. The regulations went into effect on July 1, 2016. Now that the rules are implemented, user authentication is required in order for WeChat and Alipay users to leverage the payments feature, and the users’ transaction limits are adjusted based on the level of information provided for authentication:

**Type I:** One authentication method is used (typically linking to a bank card), and the payment limit is RMB 1,000 total.

**Type II:** In-person ID verification or three external authentication methods, such as ID, bank card, water and electric bills, etc., are required and RMB 100,000 in transactions are allowed per year. Only purchases and P2P transfers are allowed, while wealth management products are not. Transfers to the user’s own bank accounts do not apply towards the limit.

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4 CNBC: Chinese tech giant Tencent plans to expand its US payments footprint — despite ongoing trade war
Type III: In-person ID verification or five external authentication methods are required from the types listed above, allowing for an RMB 10,000 daily limit and RMB 200,000 in transactions per year. This type accommodates purchases and P2P transfers, as well as the purchase of wealth management products offered on a third-party platform. Transfers to the user’s own bank accounts do not apply towards the limit.

QR CODE SECURITY:

QR code security at the point of sale was scrutinized recently by the PBOC due to the inherent lack of security of static QR codes. Many QR codes that merchants present to customers for payment would be home-printed on a piece of paper and displayed on a desk in public areas. Perpetrators would exploit them by replacing the QR code with their own and, instead of pulling up the merchant’s payment account, the compromised QR code would point to a webpage with harmful content, such as a virus or Trojan horse, or pull up the perpetrator’s account, causing payments to be routed to the perpetrator instead of the merchant.

The PBOC released regulation on QR codes at the end of 2017, which was implemented in April 2018. The regulation limits the transaction amount depending on whether the payment is made using a static QR code that customers scan to make payments or an active QR code that changes periodically on the phone or payment terminal.

The risk mitigation levels are separated from A to D. Active QR codes are classified from Level A to Level C depending on the level of customer authentication available, and static QR codes are Level D regardless of authentication.

The implication is that the less authentication required — or if a static QR code is used for payment — the more restrictions are placed on the amount that consumers can transact.

For example, for Level A, defined as using at least two types of authentication methods with digital certificates or electronic signatures, there’s no set limitation on transaction amounts. On the other end, for Level D, the daily transaction limit is RMB 500 for the consumer. Merchants that had relied on a static QR code at the point of sale may need to upgrade to dynamic QR codes through a payment terminal, especially for higher transaction amounts.

CLEARING MODEL AND RESERVE FUND

The most recent regulatory changes have a significant impact on how mobile payments are cleared, as well as on the profitability model for third-party payment companies such as Alipay and WeChat Pay.

As of July 1, 2018, third-party payments that ultimately involve bank accounts, such as mobile payments, are required to be processed through the non-bank payment institution payments and clearing platform system called Nets Union Clearing Corporation (NUCC). NUCC is owned and operated by a consortium of companies, including entities backed by the Chinese central bank and third-party payment companies, including Alibaba and Tencent.

One of the reasons for this change is anti-money laundering (AML) concerns. Prior to this change, the payments were cleared through a closed network within the third-party payment company’s own network and ecosystem, into which the central bank did not have visibility. Centralizing the routing through a clearinghouse provides the visibility the central bank needs to monitor the transactions, including for AML purposes.

This is a significant departure from the prior operating model, whereby each payment company set up their own banking relationships to facilitate the settlement of the funds ultimately due to the account holders’ banks. The new requirements essentially sever the ties between the payment companies and banks, moving the payments traffic onto the NUCC platform.
In addition to introducing the payment system, the PBOC requires that these payment companies deposit 100% of their prepayment reserve funds with a centralized custodian by January 2019. Prepayment reserve funds are payments from online shoppers held temporarily by payment companies prior to being paid to the merchants. The payment companies earn interest or investment income on the withheld funds. The reserve ratio was 20% when the policy was initially announced. It was raised to 50% as of April 2018, and it is being incrementally increased to the 100% target as January 2019 approaches.

While it doesn’t appear as a major change, investment income from prepayment reserve funds has been a significant revenue source for some third-party payment processors. Alipay and WeChat Pay are estimated to hold nearly 1 trillion yuan ($151 billion) of customers’ funds combined, about 90% of the total reserve funds, according to Caixin. As a result, Financial Times estimates that Alibaba and Tencent could stand to lose around $1 billion in revenue due to the new payment rules.

What this means for companies
While the recent changes will be mostly invisible for companies from an operational standpoint, they could lead to higher costs down the road for the following reasons:

1. While the payments clearing changes to the NUCC platform should have minimal impact to the end users’ experience, the clearing costs for transactions for payment companies may increase as the payment processors now have to connect to the centralized platform, increasing operational costs.

2. The prepayment reserve fund requirement would impact the payment processors’ profitability model as it is one of the ways that these payment companies generate revenue. Without this source of income, they would need to look for other ways to make up the lost revenue, such as raising the service costs for merchants or introducing higher fees when settling the funds from within the digital wallet to the actual bank accounts.

CONCLUSION
For foreign companies looking to sell to consumers in China, understanding the market’s payment practices and payment market changes is important when developing a company’s payment strategy, especially when the payments experience is an integral part of the sales process. As the mobile payment industry as a whole continues to evolve and mature, you can expect more regulations that address certain gaps and issues in the future.

China’s recent import policy changes and what they mean
With the trade imbalance being one of the contentious points between the U.S. administration and the Chinese government, China has been introducing policies to encourage imports, including from the United States. The reduction of import taxes on certain goods as well as plans for the first International Import Expo can be perceived as a way for China to address the trade imbalance.

It can be argued that these policies go beyond solely addressing trade imbalances. Chinese consumers have shown interest in purchasing foreign goods, especially as the Chinese middle class gains wealth and sophistication in discerning their purchases. There is also the perception that foreign products in certain areas, such as infant, health supplements, cosmetics, etc., are of a higher quality than similar domestic products. However, many of these foreign products have had import duties assessed, a complaint shared by many foreign companies as the import duty makes their products comparatively more expensive and reduces sales. Not deterred, many Chinese consumers take overseas shopping trips to countries and regions where the cost of these foreign goods is comparatively cheaper than purchasing them within China.

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5 Caixin: PBOC to Raise Reserve-Funds Ratio for Third-Party Payment Firms to 100%
6 FT: Tencent and Alipay set to lose $1bn in revenue from payment rules
China's first international import fair will be held in Shanghai

To boost options for consumers, the Chinese government published a list in June 2018 containing a list of nearly 1,500 consumer products that would have their import tariffs reduced or removed to spur demand. Some of the goods include apparel, cosmetics, home appliances and drugs. This is also in line with the pledge of opening up the economy.

To further encourage imports, China's Commerce Minister Zhong Shan announced in November 2017 that the inaugural China International Import Exposition (CIIE) will take place in Shanghai between November 5 and 10 this year. As the first-ever import fair in China, it provides a platform for foreign companies looking to sell into the burgeoning and increasingly sophisticated Chinese consumer market. The reception for the CIIE appears to be positive thus far. The exhibition has already been overbooked by 20%. 120 countries are planning to participate as of March 2018, and about 150,000 buyers are expected to visit the fair. The CIIE therefore provides an opportunity for foreign companies to showcase their products and services for the Chinese market.

China’s push for imports comes during a critical time as trade tension creates uncertainty for companies doing businesses with both the United States and China. Some tariffs were already in place between the two countries as of July 6.

While China has demonstrated willingness to encourage imports into the market to offset some of the concerns about trade imbalance, uncertainty will continue for some time.

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7 SCMP: China to halve import tariffs on 1,500 consumer products from July 1
8 SCMP: Why China is betting on Shanghai trade expo for global goodwill
9 SCMP: China’s first global import fair signals shift to consumer-based growth