WILL PAYPAL THRIVE IN CHINA? - CHINA'S NEW REGULATION OF THIRD PARTY PAYMENT SERVICES

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On June 21, 2010, the central bank of China issued the administrative rules governing payment services by non financial institutions (the "Rules"). The Rules are the first set of regulatory measures China has adopted towards non-bank third-party payment processors like PayPal. As such, the Rules is expected to fundamentally impact China's third party payment service, an important feature and integral link of e-commerce. Eventually not only third party payment service providers will be affected, but e-commerce itself.

The fast growth of third-party payment service is in response to the boom of e-commerce in China. According to statistics in June, 2010, China has about 420 million internet users. (http://www.internetworldstats.com/top20.htm). Currently about 25% of them purchase commodities online. In 2009, the volume of transactions through third party payment processors amounted to 580.84 billion RMB (about USD 85.42 billion). It is estimated that in 2012, annual transactional volume will grow to 1200 billion RMB (about USD 176.4 billion). Currently there are more than three hundred (300) third party payment service providers in China, the largest ones being Alipay, Tenpay, and China

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Unionpay. (PayPal, though having established itself in China, lags behind AliPay, TenPay and China Unionpay in terms of transactional volume).

Compared with traditional payment methods and credit card payment, TPP has its obvious advantages: convenience, cost saving (TTP processors typically charge low processing fees), added security features (TTP processor essentially acted as escrow by holding funds in its account pending the payer's instruction to forward payment), and accessibility (e.g., Alipay's TTP transfer can be effected by using a pre-purchased stored value card rechargeable online or by phone, and therefore conveniences those who are not qualified to receive a credit card). Certain unique features of China's e-commerce environment have further contributed to the popularity of e-commerce in China. Threshold for applying for credit cards from a bank is high in China. As a result, many people, especially students and migrant laborers, cannot obtain credit cards. Even for those who have credit cards, many are wary of using them for online purchases for fear of leakage of personal information. Banks have also imposed stringent maximum transaction limits on on-line transactions effected through credit cards. Third party payment services have alleviated most of these problems and thus have contributed significantly to the growth of e-commerce in China.

There are, however, problems associated with TPP services. A serious concern is TTP being used as a money laundering tool. For example, a recent case in Suzhou involves a massive illegal gaming scheme operated by overseas online gaming companies. The perpetrators used TPP services to transmit 3.6 billion RMB (about US$ 0.52 billion) in furtherance of the scheme. One of the masterminds behind the scheme, Keith Mei, was a senior managing personnel of 99Bill, one of the leading TPP service providers in China. 99Bill was reported to have reaped 17 million RMB (about US$ 2.5 million) in illegal profits from the scheme.

Viewed in this background, the Rules were promulgated at a good time. They set standards for the booming third party payment service market and were designed to address its problems. Several features of the Rules are worthy of special attention:

1. The licensure system: By setting up a licensure system, the state finally recognized third party payment services as a legal alternative money transmittal system supplemental to traditional banking systems. The state has included within its regulatory ambit online payment services (including money transmittal effected through internet, cell phone, residential phone, and digital TV), the related currency conversion service, issuance and servicing of pre-paid purchase cards (called "value stored cards"), and other payment services conducted by non financial institutions. Providers for these services must now apply for and obtain a "Payment Service License," a new type of license specifically issued to qualifying third party payment processors.

2. Market entry threshold: The Rules set the threshold credentials for entities qualified to provide third party payment services. In short, a qualifying entity must be a corporation established in China, have 100 million RMB in registered capital (30 million if doing business within a specific province rather than nationwide), be staffed with five or more senior managers with expertise in payment services, establish an anti money-laundering compliance system, and maintain a well-designed governance structure and risk prevention system. In addition, the Rules also set credentials for entities controlling licensed TPP companies (called "major contributors"). A "major contributor" is any entity controlling a TPP company or owning more than 10% of its shares. Such a "major contributor" must be a corporate entity, must have more than two years of experience providing information support to financial institutions or to e-commerce activities, must have operated at a profit for two consecutive years up to the date of application, and must have not been penalized or sanctioned

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for illegal activities within three years up to the time of application. It is estimated that about half of the 300 plus TPP companies currently operating in China will be eventually disqualified by these standards.

3. The Rules prescribed operational standards for TPP companies. These measures include requirements that transmittal of funds must be through banking institutions (rather than through agency arrangements or debiting/crediting between TPP providers), that a mandatory AML compliance system must be in place, that the customers' funds be kept separate from the TPP's general funds in a trust account with a commercial bank, that a mandatory threshold ratio of 10% be maintained between the company's registered capital and the daily balance of customers' trust funds at all times, and that the money transmittal records include mandatory information such as the identity of the payer and the recipient and information regarding their respective banks, etc. These standards address various concerns typically associated with TPP services: security of customers' funds, anti money-laundering concerns, and circumvention of the better-regulated banking system.

4. Foreign Invested TPP – The Rules indicated that the central bank would issue a separate set of rules governing foreign-invested TPP entities.

Many players in the TPP market view the promulgation of the Rules as a positive move by the government to regularize the third party payment market. The President of Alipay, for example, indicated that such regulations are much needed, and that his company is ready to apply for the operation license. For foreign TPP service providers like PayPal, however, it is not clear whether they can immediately apply for the license under the Rules, because the Rules indicated that there should be a separate set of regulations governing foreign invested TPP providers. In any event, the Rules provided for a grace period up to September 1, 2011 for all TPP companies to obtain licenses. So PayPal still have some time.

Overall, imposition of standards on China's TPP industry will work to PayPal's advantage by providing a more leveled regulatory ground for it to compete in the Chinese market. Before the Rules were promulgated, PayPal was competing with domestic TPP companies with no heed for rules or regulations, while PayPal as a U.S. company had to carefully comply with U.S. laws and regulations, especially those relating to anti money laundering. Compliance costs indeed drove up PayPal's overall operational costs and restricted its activities within China. Now, Chinese competitors are likewise subjected to domestic regulations and, as a result, will incur compliance costs. Let's hope that PayPal will fare better in a more regulated Chinese TPP market.

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