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Why China Stopped The Ant Group’s IPO (Part 2): Ant’s Dangerous Business Model

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- ***“… Ant’s businesses are very complex. It isn’t easy to understand them. You can’t get a full picture from either a financial or a technological perspective…”*** – a Sanford Bernstein Analyst (quoted in *The Wall Street Journal*)

HANGZHOU, CHINA - OCTOBER 26, 2020 - A pedestrian passes the ant group logo at the Hangzhou ... [+] BARCROFT MEDIA VIA GETTY IMAGES

Various concerns and provocations contributed to the cancellation of the Ant Group’s public offering – “the biggest IPO in history” – but **the root cause** is the perception of **a dangerous accumulation of systemic financial risk** spewing out from Ant’s business model. It exposes the broader Chinese financial system to potential instability, even crisis. It is a familiar scenario. As the cliché goes – “We have seen this movie before.”

In a sentence – **Ant is creating the conditions for a repeat of the same sort of “sub-prime” credit crisis that triggered the 2008 financial debacle in the U.S.**

Inside its complex and opaque portfolio, there is a volcano oozing toxic debt out into the Chinese financial system. Correcting that problem will severely reduce Ant’s projected

What is Ant, Exactly?

This is a question more Americans may be asking now. Well, the word "exactly" doesn't really apply. Ant is so many different things, perhaps too many. We have nothing like it here in the U.S., and we never will. (American anti-trust regulators would block it.)

The Ant Group – which until this summer was called Ant Financial Services – has quite suddenly come to dominate China's huge potential market for consumer finance. Ant today processes more financial payments than any other company in the world. It runs the largest mobile payment platform. It runs the largest money market fund in the world. It is the largest Fintech company in the world. It is worth far more that any of China's Big Four state-owned banks – or it would have been, had the IPO gone forward. Indeed, estimates of Ant's pre-offering valuation set it above JP Morgan Chase (the world's most valuable actual bank). The list of Ant's superlatives is described in **my previous column**.

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Ant has created in China a parallel ecosystem of financial services targeted to ordinary Chinese consumers, the billion-plus "little people" who, until Ant stepped in, had been largely left out of the official financial system. For payments, credit, health insurance, investments – Ant has created products to serve the underserved masses. The company provides investment products (like Fidelity, say), property and casualty insurance (like Geico), life insurance (like Prudential), credit scoring (like Fico), health insurance (like Blue Cross), crowdfunding, online banking, financial data and software…

They do it all with the most advanced technologies of the digital era, brilliantly packaged for the ordinary consumer.

- “Imagine if main-street banks, Wall Street’s brokers, Boston’s asset managers and Connecticut’s insurers were all shrunk to fit into a single app designed in Silicon Valley that almost everyone used.”
- “Ant has fundamentally changed the way hundreds of millions of Chinese citizens spend, save, invest and borrow money.”

All this was achieved at warp-speed. Ant turned six years old last month. Amazing. Frightening.

In this context, Ant’s offering is/was(will be?) a milestone in China’s Rise. The *Financial Times* summarizes its larger significance:

- “Ant’s debut was due to mark the crowning glory of a homegrown financial technology — or fintech — champion. It was also expected to shore up confidence in Hong Kong after Beijing’s imposition of a new security regime this year. Its listing in Shanghai and Hong Kong was intended to show that China no longer needs US capital markets to finance its world-class corporations. Ant’s significance was also set to be geopolitical. The company’s IPO reinforced a broader narrative of China as a technological superpower seizing the global initiative from the US.”

So what went wrong, really?

Extreme Innovation

Innovation. We are told, endlessly, that it is a most wonderful thing. Innovation creates opportunity. But innovation also creates risk.

Ant is furiously innovative. It seems to do everything on the fly.

The move into health insurance is a good example. In October 2018, Ant launched its own health-insurance-for-the-masses product, called Xiang Hu Bao (“mutual protection”). The company signed up 100 million customers in its first year. (Obamacare has enrolled 8.3 million Americans in its six years.) Ant uses blockchain for medical claims, payments and records, advanced analytics, artificial intelligence. (Obamacare has a website.)

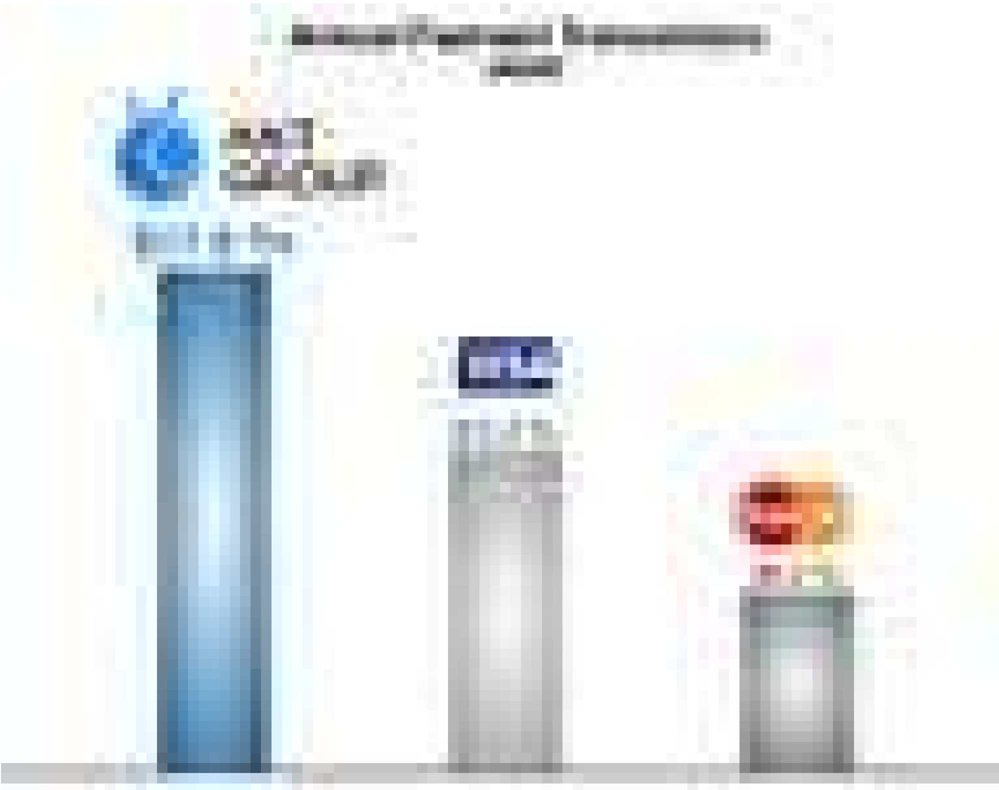
Another example is Ant’s money market fund. Ant stumbled into this business, as an outgrowth of its payments processing business:

- “Almost accidentally, by holding its users’ money in escrow until its online merchants had delivered their orders, Alibaba created Yu’e Bao, [which became] the world’s biggest money market fund ….”

To borrow a topical phrase (from the world of vaccine development), Ant embodies a commerce platform run by Alibaba (Ant's parent, often called a Chinese version of Amazon). It was another opportunistic innovation.

Alipay is 16 years old. Mastercard is 54 years old and Visa is 62 years old.

Alipay is now larger than Visa and Mastercard put together.

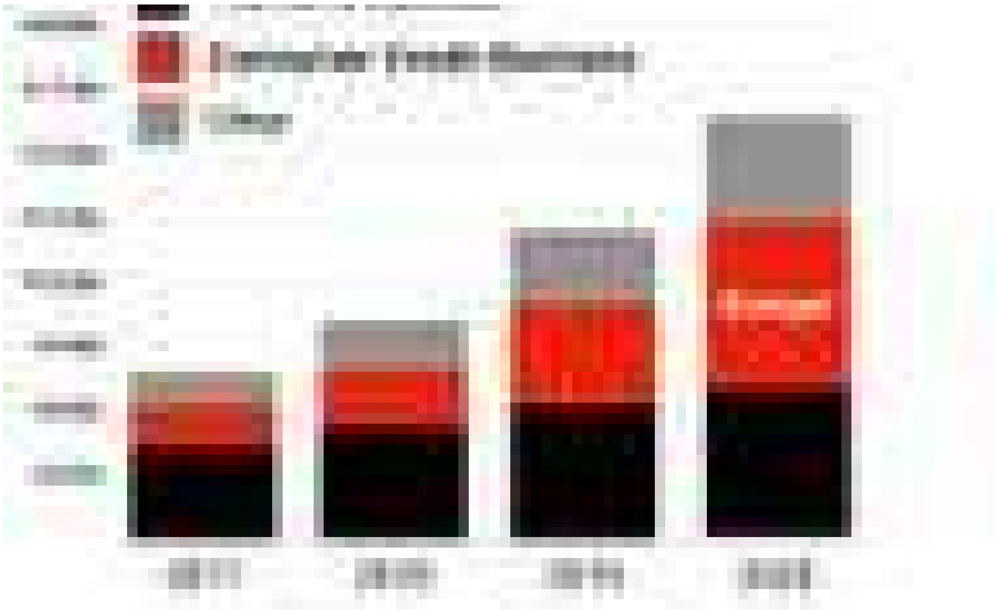


Ant, Visa, Mastercard, Annual Payment Transactions CHART BY AUTHOR

The second pillar is the dangerous one: Ant has become (more or less overnight) a major suppler of credit – loans – to consumers and small businesses – that is, to the lower strata of the credit market. Including what we used to call "subprime" customers – those who could not get credit from the traditional banking sector.

These loans are unsecured. Ant can offer them (supposedly) because it has wonderful analytics tools that can quickly assess an applicant's credit-worthiness. Except that Ant doesn't actually supply the credit, or make the loans. They qualify the borrowers, *originate* the loans, and then hand them off to banks which actually carry the liability. Ant collects a service fee. The banks own the risk.

It's a successful line of business: 62% growth in 2018, 92% in 2019. Another 80% year-over-year in the 12 months ending in June 2020. Consumer credit is now Ant's largest operating unit – 40% of the company's revenue generated in the first half of 2020. The outstanding balance of Ant-originated loans to the "little people" of China (the name "Ant" was chosen to identify with this vast, underserved market segment) **increased by 333% in 30 months**. In a brief span, Ant has captured 15% share of this market. The company is said to have over 500 million customers – almost all of them "ants" themselves (Chinese consumers).



Growth of Consumer Credit as Proportion of Ant's Revenues CHART BY AUTHOR

The Danger

It bears repeating. These loans are not held by Ant.

- "Banks underwrite the debt, take the credit risk and collect interest payments, while Ant collects fees for facilitating the transactions."

The risk that borrowers might default is not Ant's risk. Those loans and that risk are now sitting on the balance sheets of about 100 Chinese banks. Those banks didn't perform the "due diligence" on those loans. They never met the borrowers. They are just buying a stream of payments. They rely on Ant's technological magic (which is perhaps less than fully transparent to them) to quantify and control the credit risk, i.e., the risk that some of the "ants" may not pay them back.

It is a great business for Ant. The company deploys hardly any of its own capital in the process.

- "Outstanding loans made via Ant's platforms stood at $312 billion at the end of June, of which 80% were to individuals. **Just 2% were funded with Ant's own money and the rest were funded by banks or asset-backed securities.**"

This makes it a very profitable business. Ant's operating profit margin on all its businesses is 34%. (Apple's operating margin is 24%. Amazon's is about 6%.)

Remember the Sub-Prime Crisis?

Now, to put this in the perspective required to understand the cancellation of Ant's offering...

This consumer credit business is based on the **originate-to-distribute model** that was at the heart of the sub-prime mortgage crisis in the United States. In brief – the mortgage originators who fueled the subprime crisis did for mortgages exactly what Ant does with Chinese consumer credit. They worked with customers (home-buyers) to secure a

The originate-to-distribute model is saturated with what the economists like to call "moral hazard." The originator is incentivized to generate loans, and has no direct incentive to make sure they are good loans. The buyers of the loans are unprepared to assess accurately the risk associated with them. A Federal Reserve study summarized:

- "The credit crisis that began in 2007 was a direct result of a decline in lending standards fostered by moral hazard inherent in the originate-to-distribute securitization model."

We know how it ended in 2008. (Remember Countrywide?) Over time, standards for the origination of mortgages became very lax, because the originators were not exposed to any of the risk that the mortgages might go bad. That risk had been sold off to the outside investors.

In 2014, one of the SEC Commissioners commented as follows:

- "As we painfully learned, this "originate-to distribute" model often resulted in a decline in loan quality. Simply stated, since the lenders were not going to suffer if the loans were not repaid, they no longer had the incentive of ensuring that the loans would be of appropriate quality. The evidence is clear that, in the years leading up to the financial crisis, mortgage lenders increasingly loosened their underwriting standards, and often disregarded a borrower's ability to pay. This resulted in lenders originating loans with higher risk characteristics, such as loans with low-or-no down payments or interest-only provisions. At the same time, banks and lenders increasingly relied on the "originate-to-distribute" model to sell these riskier loans, including subprime mortgages, into the securitization chain. Ultimately, the result was a widespread deterioration in loan credit quality, which resulted in billions of dollars [in losses]."

Is Ant a super-spreader of "sub-prime" risk?

Is Ant recreating the same sort of bubble? The company's marketing has something of the same flavor. Ant's two consumer credit businesses are known as *Huabei* and *Jiebei* – which translate (I am told) as "Just Spend" and "Just Borrow." All very casual. The loans are in any case unsecured. The head of consumer protection at China's banking regulator decries these offerings as "debt traps" for "low-income and young people." **Sub-primes**.

Does this create systemic risk? Risk that extends beyond Ant itself?

Of course it does. Let's go back to those banks that "buy" the sub-prime consumer risk that Ant manufactures:

- "As of June 30, Ant was working with about 100 banks, including all policy banks, large national state-owned banks, all national joint-stock banks, leading city and rural commercial banks, international banks that operate in China, as well as trust companies."

This is a pathway for contagion. The banks aren't doing due diligence on these loans. Is Ant doing *its* due diligence? Well, sort of – except that there are no humans involved. "Judgment" is too slow and old-fashioned. Ant's credit qualifications are all done by

- **"Ant's platform takes just 3 minutes to process a loan and 1 second to disburse the loan, with zero human intervention."**

They are not the only ones doing this. But they are the biggest. The scale of their credit creation is scary, if we contemplate the possibility that something might some day go awry with their algorithms.

Ant Has No Skin in the Game

The regulatory solution adopted in the aftermath of the 2008 crisis in the U.S. was to require originators to keep some of the risk on their balance sheets.

- "The Dodd-Frank Act requires securitizers to retain at least 5% of the credit risk associated with the mortgages underlying residential [the securitization instruments]."

This retained interest (and risk) is known as "skin in the game." The rationale is straightforward. And it is valid. A Federal Reserve Study, following the 2008 crisis, found that even a seemingly low 5% retained interest significantly reduced the rate of bad loans.

Does Ant have *any* skin out the game at all? Ant charges a service fee on each transaction, equal to 2.08% of the value of the loan. This offsets, it would seem, the 2% of capital that Ant purportedly contributes. The Net is… zero? If so, **Ant carries essentially none of the risk.**

Of course in the long run, an originator of bad loans will find it hard to persuade the banks to keep buying this "toxic" debt. But history shows that this prospect is too remote in time to discipline the process, and it does not prevent a lot of these buyers from getting into serious financial difficulty.

The Chinese regulators have been alert to this problem, in a general way. They made rule changes in September – which Ant fought of course – to require originators to fund and retain 30% (!) of the loans they originate. They were in effect forcing Ant *to become a bank*, at least as far as their consumer credit business is concerned. And it would be a very highly-capitalized bank. (Western bank capital ratios are in the 8-12% range. As noted, the Dodd-Frank requirement is just 5%.)

Requiring Ant to have "skin in the game" effectively reclassifies the company – as a bank. And banks are worth a lot less than Tech companies, dollar for dollar of earnings-per-share.

I think the regulators only belatedly realized the impact this would have on Ant's valuation. The shift from a Tech company valuation to a Bank valuation could cost Ant as much as half its market capitalization. (I'll quantify this in **the next column.**) The authorities panicked when they saw that this re-valuation of the company was not understood by the market, by the millions of small investors in particular. The frenzy was setting the stage for a huge replay of the recent SMIC bubble and collapse (described **in the previous column**). Such an outcome could drive deep losses for millions of investors, and further shake the foundations of the Chinese financial system. *That* – more

The Ant Group's spoiled public offering is the latest Chinese fiasco. The regulators arguably did the right thing, but they waited too long and acted with excessive violence. It will prove to be a watershed in the evolution of the country's financial system.

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George Calhoun's new book is *Price & Value: A Guide to Equity Market Valuation Metrics* (Springer 2020). Prof. Calhoun can be contacted at gcalhoun@stevens.edu

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My first career: I spent 25 years in the high-tech segment of the wireless technology industry, involved in the early... **Read More**