

Banking on China

Successful Strategies for Foreign Entrants



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Preface

China has sustained explosive economic expansion for so long that the extraordinary nature of its growth is sometimes overlooked or forgotten. But the facts are self-evident: over the 25-year period from 1979 to 2004, China's economy grew at an average annual rate of 9.6 percent.¹

China's unrelenting growth will continue to create personal wealth, fuel economic development, and attract multinational corporations, which in turn will lead to greater demand for financial services. In fact, for the period between 2004 and 2010, China is expected to generate approximately \$130 billion—or more than one-quarter of the increase in annual global banking revenues.

Foreign institutions have long recognized this opportunity, but their participation has been heavily restricted. When China joined the World Trade Organization at the end of 2001, however, the government began encouraging foreign banks to invest in local financial institutions while gradually expanding the range of products and services that foreign-owned branches could offer. Foreign companies have embraced this liberalization. Between 2001 and 2005, they invested or committed to invest about \$20.9 billion in Chinese financial institutions, with \$17.6 billion invested in 2005 alone.²

Faced with seductive circumstances—continuing growth in the market, fading restrictions, and surging foreign investment—potential entrants might be tempted to proceed immediately. But many challenges and uncertainties lie behind China's allure.

Although banks face an uphill battle when they establish operations in any foreign market, the terrain in China is even more daunting. For example, it is not entirely certain how the government regulations that shape the entry approaches and in-country operations of foreign institutions will evolve—or how they will be applied in the coming years. In addition, the relative immaturity of the Chinese market makes disruptive change a major possibility.

As a result, many foreign entrants feel forced to essentially gamble on the options that market conditions and regulations will ultimately favor. In truth, however, strategy, not luck, will determine the winners in China. Although many factors in China are beyond the control of entrants, just as many skills and capabilities can be leveraged to create advantage.

In such an environment, explicit plans for establishing a winning position are critical to achieving competitive advantage. To this end, we have defined the actions that can help foreign institutions set a course for long-term success. We also explore the rationale for participating in this market, the approaches foreign institutions have used to enter China, and the challenges they have faced. In identifying the emerging best practices that underpin our recommendations, we have drawn on the experiences of foreign banks in China and on our own critical perspective of this unique sector.

Ultimately, we have been struck by the close resemblance that entering the financial sector in China bears to playing the ancient Chinese game of Weiqi (pronounced "WAY-chee")—a game of skill and strategy, not of chance. The layout of the Weiqi board game is a simple grid, and the object is straightforward: to capture more territory than one's opponent. Therefore, in illustrating the options for foreign banks seeking to capture valuable territory and unleash significant value in China, we've used the Weiqi grid in many of our exhibits.

In China, as in Weiqi, a strategic outlook is essential. Players in both realms must know their desired position and must plan a sequence of moves leading to it while maintaining sufficient flexibility to respond to moves by adversaries and changes in the environment. Finally, the opening move in Weiqi is critical: players must secure a small parcel of territory as a platform for growth. Likewise, entrants into China's financial-services sector will find it useful to secure a manageable position before establishing a broader presence.

1. This rate reflects real growth in gross domestic product (GDP) as updated in December 2005 by the National Bureau of Statistics of China.

2. These figures reflect bank-related investments only; they exclude \$2.8 billion that foreign nonbank financial institutions have invested in Chinese nonbank financial institutions.

Summary of Key Findings

Since the end of 2001, when the Chinese government began encouraging foreign companies to invest in local banks, more than 30 foreign players have invested in the country's financial institutions.

- Foreign institutions invested or committed to invest approximately \$20.9 billion in Chinese financial institutions from 2001 to 2005, with the lion's share of that amount—\$17.6 billion—invested in 2005 alone.
- The top five investors account for about 70 percent of the total foreign investment in the industry. The largest single investments hover near \$3 billion, but many companies have invested less than \$100 million.

In this liberalizing environment, foreign institutions are drawn to China for its spectacular growth, its concentrated areas of value, and the opportunity it presents to deploy competitive advantages.

- For the period between 2004 and 2010, China is expected to generate approximately \$130 billion—or more than one-quarter of the increase in annual global banking revenues.
- Although China is a vast and populous country, banking opportunities and revenues are—and are expected to remain—highly concentrated. For example, the wealthiest 0.4 percent of households in China own more than 60 percent of the country's total personal wealth. Furthermore, over the next five years, more than half of the banking revenue in China is expected to be generated in 6 of the country's 31 provinces, and more than 80 percent will be generated by four lines of business that will open to full foreign participation in December 2006.
- Chinese banks currently offer a limited range of undifferentiated products and services. Foreign players will be able to leverage new and best practices, especially in winning attractive customers.

Foreign banks face government restrictions that affect their entry through both alliances and organic growth.

- To address alliances, the Chinese government limits a foreign institution to holding a maximum 20 percent stake in a local bank (as of this report's publication date). While local banks can have more than one foreign investor, the total level of foreign investment cannot exceed 25 percent.
- To address organic growth, the Chinese government has set high capital and asset thresholds for foreign-owned banking operations and has allowed foreign-owned branches to offer products and services in the Chinese currency, renminbi (RMB), only after the branches have met minimum operating and performance requirements.

Although the opportunities are enticing, unknowns in the market make success in China uncertain.

- Even after December 2006, substantial regulatory barriers are likely to remain. Some industry observers believe that the pace of deregulation will be linked to the competitiveness of local institutions.
- Because it is a unique and relatively immature market, China will require foreign banks to invest time and money to learn about Chinese customers and the products and services that will appeal to them.
- The relative immaturity of this market also paves the way for sweeping change. The landscape could be radically altered as emerging megatrends—for example, a shift from product silos to customer-based competition—redefine the sources of value and the challenges associated with competing for them.

To win in the long term, foreign entrants must first define a clear strategy that spells out how they will use their existing capabilities and what type of player they will become in China.

- To help mitigate the risk and uncertainty inherent in this market, a sound strategy should include more than one pathway toward achieving the desired position.

- Entrants should look to other industries—such as automotive—for insight into the types of strategies that have succeeded and failed in China.
- Among other operational challenges, most entry strategies must grapple with the scarcity of well-trained banking employees who are literate in Chinese and familiar with the culture. As soon as they define a strategy, therefore, entrants must focus on recruiting, training, and retaining valuable employees in China.

Next, players must *position their institution for success* by carefully managing stakeholders both within and beyond their organizations.

- A company's senior leaders must understand how and why an investment in China will differ from investments in more developed markets—and must commit to a long-term strategy.

- Companies must dedicate significant resources to establishing lines of communication with all relevant government and regulatory bodies in China.

Finally, entrants must *manage for China* by excelling at building alliances and growing organically. The former includes both joint ventures and equity investments in existing institutions.

- In forging alliances, entrants must choose partners that will embrace change, taking care to build trust on the basis of common motivations and concerns, and to use quantitative measures to track performance.
- Those seeking to enter China by building a business from the ground up must position outstanding leaders and managers on the ground—people who excel at building not only enterprises but also relationships.

Responding to the Lure of an Opening, Expanding Market

China's financial-services industry is undergoing substantial liberalization on two fronts. Since the end of 2001, the Chinese government has encouraged foreign institutions to invest in local banks. During the same period, restrictions on foreign-owned branches have gradually eased. Five years ago, foreign-owned branches could offer only a limited range of products—and only to foreign customers in selected cities. Beginning in December 2006, they will be permitted to deliver products in the local currency, renminbi (RMB), to all retail and corporate customers across the nation. In conjunction with China's relentless economic growth, these reforms represent an unprecedented opportunity for banks around the world.

Foreign Activity Is Intensifying

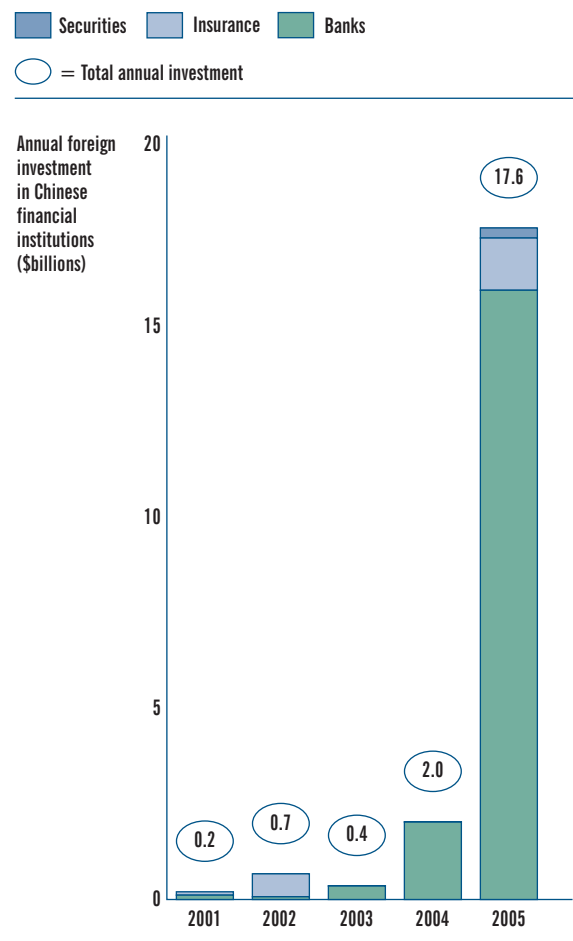
In October 2005, Liu Mingkang, chairman of the China Banking Regulatory Commission (CBRC), endorsed foreign banks as “an indispensable component” of China's banking industry. Indeed, regulators have even gone so far as to mandate foreign participation as a prerequisite for new banking ventures, with Liu saying in late 2004, “With respect to new entrants in the banking sector, such as Bohai Bank in Tianjin, the presence of a qualified foreign strategic investor is considered an essential criterion for approval. In addition, we at the CBRC also welcome foreign participation in the existing and newly licensed finance companies, the restructuring of trust and investment companies, and the establishment of securities investment funds sponsored by banks in China.”

Consequently, the foreign presence in the Chinese financial-services sector is significant and growing. Between 2001 and 2005, foreign investments in Chinese financial institutions soared. (See Exhibit 1.) Securities and insurance companies have attracted some interest, but foreign investors have homed in primarily on local banks. In fact, foreign investors have channeled more than three-quarters of their total investment into four of the largest

Chinese banks, with two of those institutions—Industrial and Commercial Bank of China and Bank of China—together capturing more than half of the investments. (See Exhibit 2 and the sidebar “The Local Landscape.”)

In China's financial-services sector, foreign investment not only focuses on a handful of targets but also is generated by a handful of investors. Although more than 30 foreign institutions have invested in Chinese financial institutions, a mere

EXHIBIT 1
FOREIGN INVESTMENT IN CHINESE FINANCIAL INSTITUTIONS SURGED IN 2005



SOURCES: Literature research; BCG analysis.

NOTE: These figures reflect bank-related investments only; they exclude \$2.8 billion that foreign nonbank financial institutions invested in Chinese nonbank financial institutions.

THE LOCAL LANDSCAPE

There are five types of domestic banks in China, the largest being the so-called Big Four state-owned institutions: Agricultural Bank of China, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China. There are also 12 national shareholding banks. Bank of Communications, the largest of these, is the only shareholding bank with a truly national branch network.

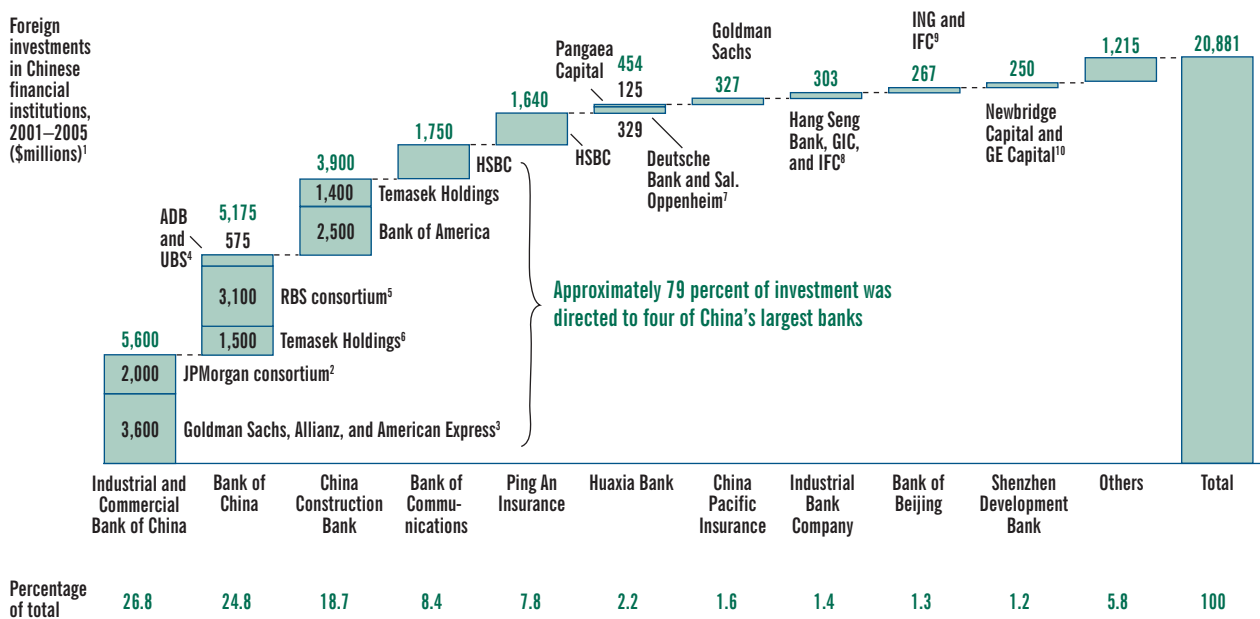
In addition, there are more than 100 city commercial banks, tens of thousands of urban and rural credit unions, and three so-called policy banks: China Development Bank, the Export-Import Bank of China, and Agricultural Development Bank of China.

5—including one consortium—account for about 70 percent of the total foreign investment. (See Exhibit 3, page 12.) While individual investments by these five major investors are approximately \$3 billion, many more institutions have invested less than \$100 million. Furthermore, most investors have sought a stake in only one or two local players.

Some foreign institutions are also establishing their own branches and representative offices in China. After Nanyang Commercial Bank, based in Hong Kong, opened the first foreign-owned branch in the Shenzhen Special Economic Zone in 1982, 69 banks from 20 countries established 232 operational entities in China through September 2005.

EXHIBIT 2

FOUR OF CHINA'S LARGEST BANKS GARNERED ABOUT 79 PERCENT OF FOREIGN INVESTMENT



SOURCES: Literature research; BCG analysis.

NOTE: Figures are based on December 2005 data and exchange rates.

¹These figures reflect bank-related investments only; they exclude \$2.8 billion that foreign nonbank financial institutions invested in Chinese nonbank financial institutions.

²The deal has not yet closed. JPMorgan is investing \$1 billion, and Abu Dhabi Investment Authority and Kuwait Investment Authority together are investing \$1 billion.

³Goldman Sachs is investing \$2.1 billion, Allianz is investing \$1.2 billion, and American Express is investing \$0.3 billion.

⁴UBS is investing \$500 million, and Asian Development Bank is investing \$75 million.

⁵The consortium consists of The Royal Bank of Scotland, investing \$1.6 billion; Li Ka Shing Foundation, investing \$0.75 billion; and Merrill Lynch, investing \$0.75 billion.

⁶Central Huijin Investment Company has not yet approved the deal.

⁷Deutsche Bank is investing \$232.65 million, and Sal. Oppenheim is investing \$96.35 million.

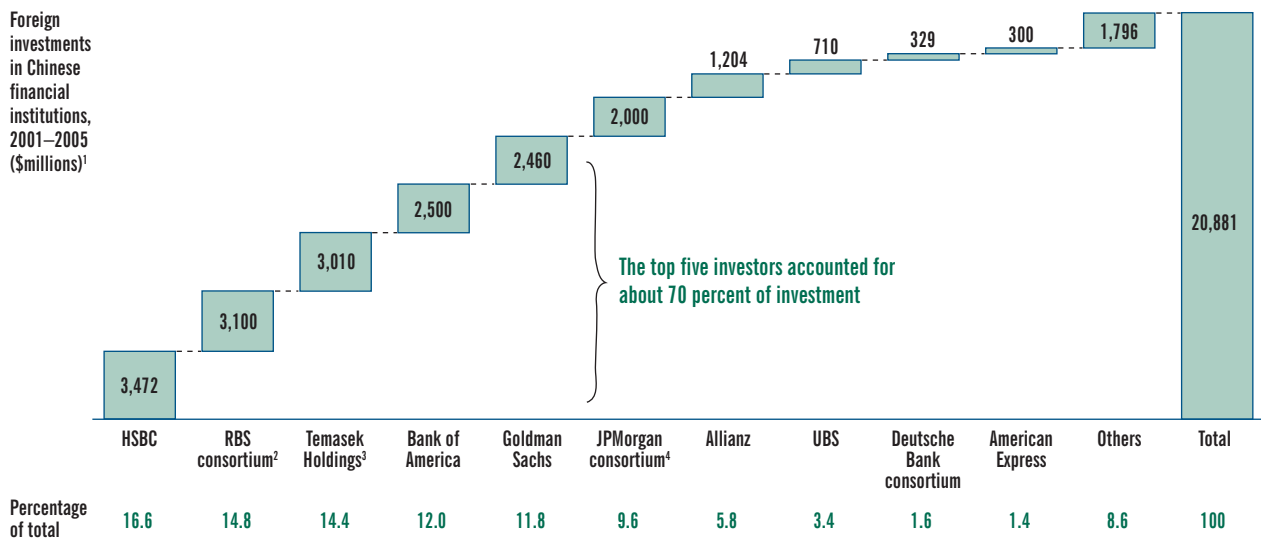
⁸Hang Seng Bank is investing \$209 million, the Government of Singapore Investment Corporation (GIC) \$52 million, and the International Finance Corporation \$42 million.

⁹ING is investing \$215 million, and the International Finance Corporation is investing \$52 million.

¹⁰Newbridge Capital is investing \$150 million, and GE Capital is investing \$100 million.

EXHIBIT 3

FIVE INVESTORS GENERATED MORE THAN TWO-THIRDS OF THE TOTAL FOREIGN INVESTMENT IN CHINA'S FINANCIAL-SERVICES SECTOR



Sources: Literature research; BCG analysis.

NOTE: Figures are based on December 2005 data and exchange rates.

¹These figures reflect bank-related investments only; they exclude \$2.8 billion that foreign nonbank financial institutions invested in Chinese nonbank financial institutions.

²The consortium consists of The Royal Bank of Scotland, investing \$1.6 billion; Li Ka Shing Foundation, investing \$0.75 billion; and Merrill Lynch, investing \$0.75 billion.

³The figure includes the not-yet-approved deal to purchase a stake of Bank of Communications at \$1.5 billion.

⁴The deal has not yet closed. JPMorgan is investing \$1 billion, and Abu Dhabi Investment Authority and Kuwait Investment Authority together are investing \$1 billion.

New Entrants Must Size Up an Irresistible Opportunity

Clearly, deregulation has been the greatest impetus for foreign activity in China's financial-services market. But foreign institutions are also drawn by the market's much-touted growth, the promise of unleashing significant value while focusing on just a few areas, and the potential to outperform local competitors with superior products and services. Growth is the most obvious of these draws—both because the banking industry in China today is so profoundly undersized when compared with other major markets and because multinational banks seek a new avenue to boost their bottom lines.

To understand China's potential, consider that while the United States and the combination of the top five European countries (France, Germany, Italy, Spain, and the United Kingdom) accounted for 32 percent and 22 percent, respectively, of global banking revenues in 2004, China represented a meager 6 percent. (See Exhibit 4.) By the end of this decade, however, China is expected to see its share of global banking revenues rise to 10 percent while the United States, the top five

European countries, and Japan will see their share fall. For the period between 2004 and 2010, China is expected to generate 28 percent of the increase in annual global banking revenues, the equivalent of approximately \$130 billion—and more than either the United States or the combined top five European countries.

Fortunately for many global financial institutions, the market in China is opening just as their cost-reduction initiatives are winding down. Although such initiatives have brought measurable benefits over the past decade, further cost cutting may start to weaken sales capabilities at many institutions and thus jeopardize market share. Looking ahead, only those financial institutions that can generate high and sustainable growth will be poised to lead the global market. Yet growth will be difficult to achieve in most mature markets, where the consolidation of the financial services industry, together with increasing competition and commoditization, offer limited local opportunities for expansion.³

3. This topic is explored further in the BCG report *Striving for Organic Growth in Retail Banking*, December 2005.

Furthermore, global players are drawn not just to the pace but also to the pattern of growth in China. In a country of 1.3 billion people and more than 9 million square kilometers, the greatest potential value in financial services is highly concentrated in particular regions, customer segments, and lines of business. Institutions seeking to establish a presence in China can reasonably pursue their goals by focusing on a few key targets:

- In combination, 6 of China's 31 provinces are expected to generate more than half of the coun-

try's banking revenues over the next five years.⁴ Individually, each one of those provinces boasts banking assets equivalent in volume to the assets held in entire countries—such as Australia, Brazil, and Sweden. (See Exhibit 5, page 14.)

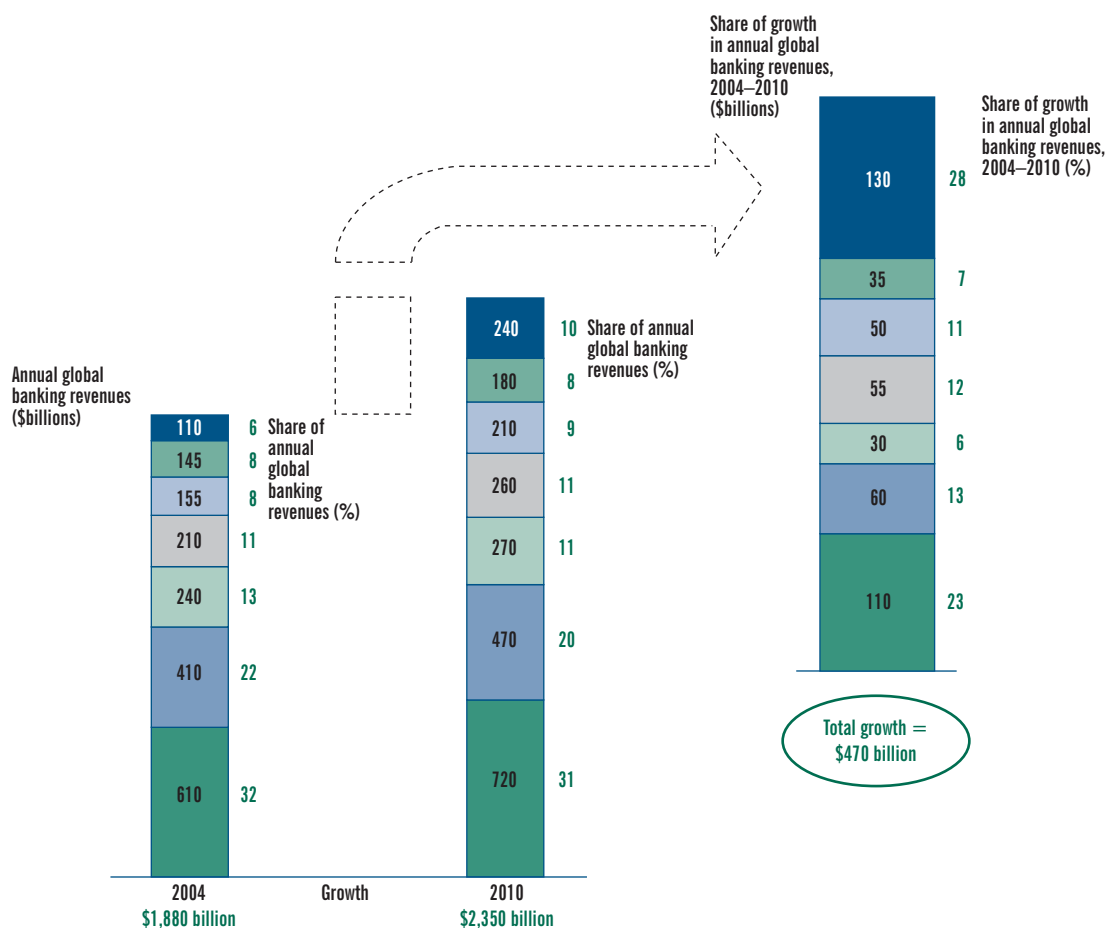
- The wealthiest 0.4 percent of Chinese households own more than 60 percent of the country's total personal wealth. Despite the concentration of

4. The six provinces are Beijing, Guangdong, Jiangsu, Shandong, Shanghai, and Zhejiang. (This report does not cover Taiwan or the two special administrative regions, Hong Kong and Macao.)

EXHIBIT 4

CHINA'S SHARE OF ANNUAL GLOBAL BANKING REVENUES IS PROJECTED TO RISE—AND THAT GROWTH WILL DRIVE THE LARGEST INCREASE IN ANNUAL REVENUES THROUGH 2010

■ China ■ The Americas (excluding the United States) ■ Asia-Pacific (excluding China) ■ Europe (excluding the top five countries), the Middle East, and Africa
 ■ Japan ■ Europe's top five countries¹ ■ United States



SOURCE: BCG analysis and estimates.

NOTE: Percentages are based on rounded revenue figures.

¹France, Germany, Italy, Spain, and the United Kingdom are the top five markets for banking revenues in Europe.

wealth in such a tiny percentage of households, China's vast population makes it the second-largest market for wealth management in Asia, excluding Japan, with about 1.6 million households in the country today owning approximately \$820 billion in assets.

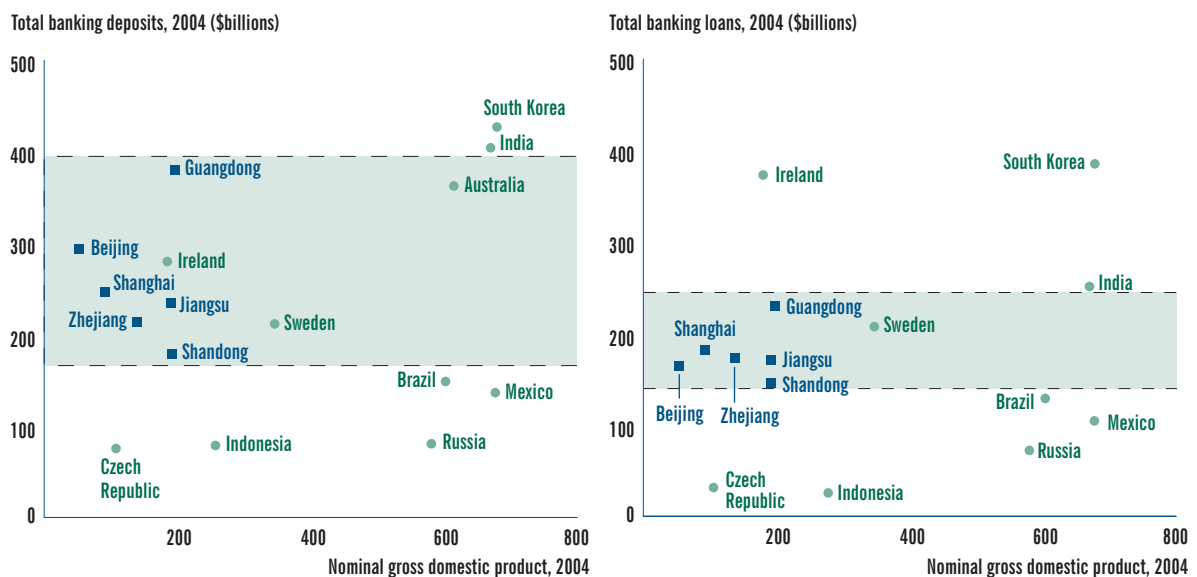
- Value is also concentrated in retail and corporate loans and deposits in renminbi—an area that we estimate will generate 80 percent of banking revenues by 2008.

Finally, financial institutions have been attracted to China because they believe they can easily best Chinese banking products and sales channels, which remain largely undifferentiated, particularly in retail banking. Once the December 2006 reform expands the competitive scope for foreign banks, they will have a clear opportunity to build competitive advantage by offering a more sophisticated range of products and services, either in partnership with local banks or through their own branches.

EXHIBIT 5

CHINA'S LARGEST PROVINCES BOAST BANKING ACTIVITY ON A PAR WITH THAT OF SOME NATIONS

China's top six provinces by gross domestic product



SOURCES: Almanac of China's Finance and Banking, 2005; The Economist Intelligence Unit; China Statistical Yearbook 2005.

Making the Opening Move

Foreign companies seeking to compete in China's financial-services sector must navigate a reform policy that sometimes promotes conflicting interests. On the one hand, China recognizes that foreign players can help strengthen local institutions by introducing best practices, providing valuable recapitalization, raising the level of competition, and improving governance. On the other, a rapid increase in competition could catch some local institutions off-guard.

Foreign Banks Must Weigh the Pros and Cons of Two Entry Approaches

To balance these competing interests, the government has imposed restrictions on the two broad types of entry available to foreign players: buying into an existing business through an alliance with a Chinese bank and building an organic presence from the ground up. These restrictions, which will remain in place after product offerings are liberalized in December 2006, are intended to enable foreign banks to participate in, but not dominate, the market.

Minority Stakes in Alliances. Foreign participation is welcome in China, but foreign control over banking operations is still viewed with skepticism. Therefore, even though established banks in China are encouraged to take on strategic investors from abroad, current regulations limit a foreign institution to holding a 20 percent stake in a local bank. While local banks may have more than one foreign investor, the total level of foreign investment may not exceed 25 percent.

Thresholds for Organic Growth. The government has set high thresholds for entry that effectively require foreign banks to invest for five years or more before they can establish a branch that offers a competitive range of products and services. Only banks with total assets of at least \$20 billion may establish a branch that can conduct business in renminbi and serve local nonretail customers. The bank must also hold at least RMB 300 million (about \$37 million) in working capital, must have operated a representative office in China for at least two years before establishing an operational

branch, and must have run the operational branch for at least three years and earned profits for two consecutive years. Playing in the local retail sector is not possible until December 2006—and then the ante will be higher than in the corporate sector. In addition to meeting all the above requirements, foreign banks will need to hold RMB 400 million (roughly \$50 million) in working capital to offer retail lines.

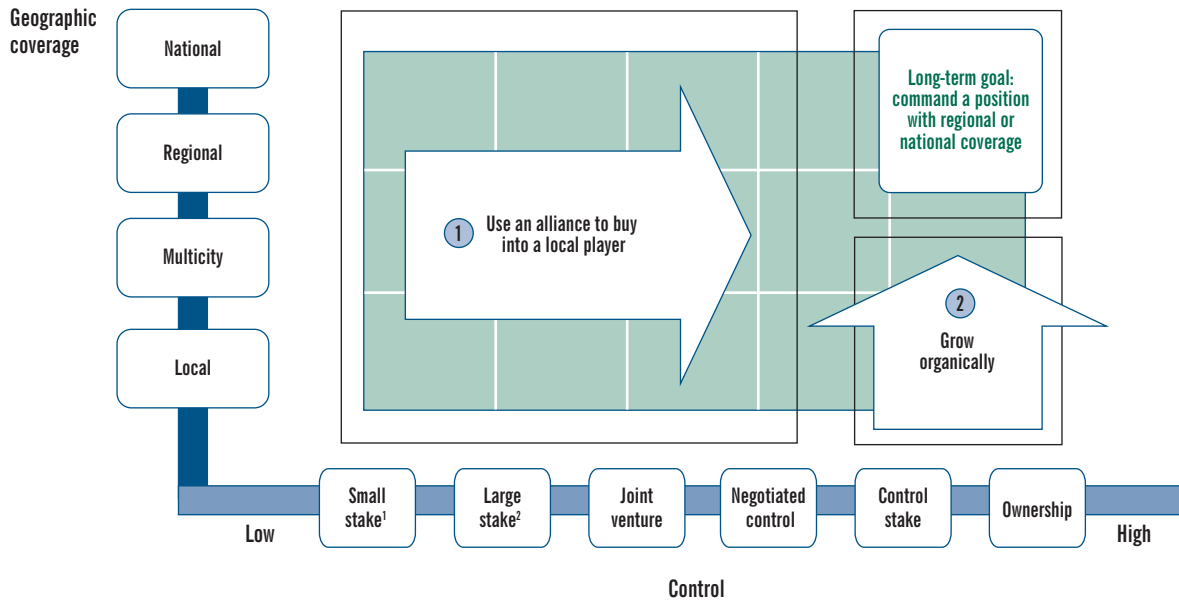
In seeking to establish the strongest presence in China as quickly as possible, foreign institutions must weigh the advantages and disadvantages of these two approaches and strike a balance that best exploits their capabilities. Given all the possible environmental changes and competitors' potential moves, the game of Weiqi serves as a valuable lens for assessing strategies in China. In applying the Weiqi framework, we view the two approaches explored above—alliances and organic growth—as possible opening moves for entry into the market. Furthermore, we view the ultimate goal for foreign investors as commanding a position that provides regional or national coverage in China. (See Exhibit 6, page 16.)

By embracing the first approach—forging an alliance with a Chinese bank—a foreign investor can tap into local knowledge as well as an existing network of branches, an established customer base, and a recognized brand. When entrants buy into the market this way, the geographic coverage they gain can range from local to national, but their degree of control can range only from minor to no more than moderate—depending on which company they invest in and how much they invest.

Along with the benefits they acquire through an alliance, however, entrants also sacrifice control and assume risks—specifically, the risks embedded in the existing bank's loan and customer portfolio, operational processes, culture, and organization. The lack of operational control may make it difficult for companies to drive the changes necessary to improve performance, manage the loan portfolio, and develop differentiated offerings. Certainly, local management could opt to ignore the practices

EXHIBIT 6

IN MAKING THEIR OPENING MOVE IN CHINA, FOREIGN ENTRANTS HAVE TWO BROAD APPROACHES



SOURCE: BCG analysis.

¹A small stake is less than 10 percent.

²A large stake is between 10 and 20 percent.

suggested by a foreign partner, leaving the potential for competitive advantage unrealized.

Even when foreign investors can assume management control while holding a minority share, they may find effecting change tremendously difficult. That’s because other factors unique to the Chinese environment affect control as well. For example, because the Communist Party of China maintains an active presence within companies, it has an impact on management decisions. As a result, achieving change in China’s financial institutions will require a much more gradual and careful approach than many investors would prefer.

The second approach, building a presence organically, presents opposing advantages and disadvantages. Foreign financial institutions that “grow their own” forgo an existing base of customers and branches, as well as local know-how. As a result, they risk being stymied by the complexities of government regulations and cultural differences. However, they gain control of their destiny—at least to the extent that Chinese regulations will enable foreign entrants to expand branch networks and businesses.

Although foreign players have been permitted to establish branches in China for more than 20 years, none of those efforts have yet evolved into a substantial presence. Major restrictions limiting foreign-led organic growth are set to expire in December 2006, but some regulations and administrative processes will remain. These will continue to affect the speed and depth of entry of foreign players. For example, while a foreign bank will be able to obtain licenses to conduct business everywhere in China and across all permitted renminbi-denominated products, the opening of each new branch and the launch of each new product will still require government approval.

A Variety of Options Exist Within the Two Approaches

In practice, many foreign players pursue both alliances and organic growth, resulting in a broad range of activity in the market. (See Exhibit 7.) The most common organic-growth strategies—embraced by more than 60 players—have been based on small branch networks, which comprise fewer than five branches and provide only local coverage. Only a handful of entrants have pursued more aggressive organic growth by

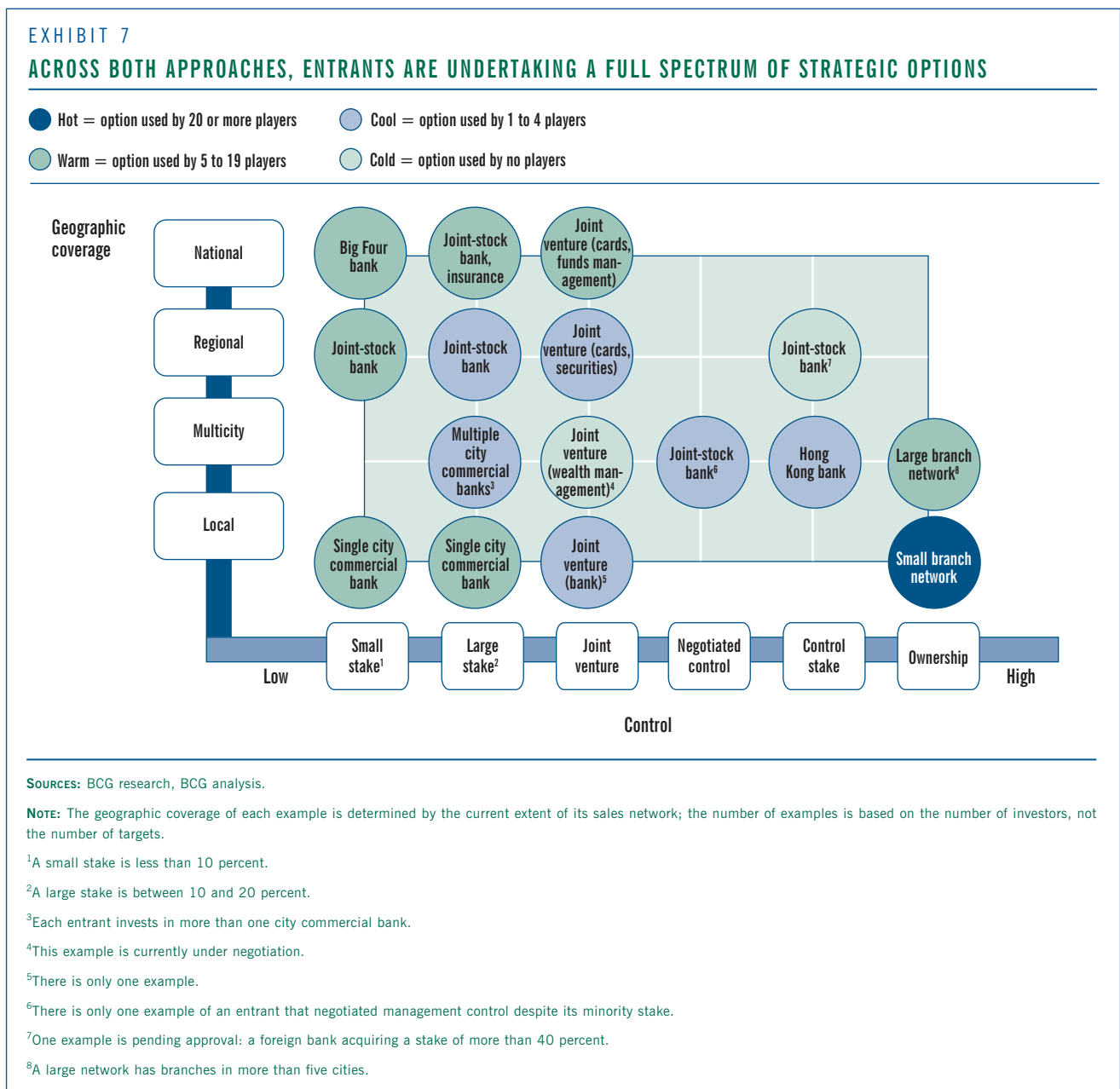
building a larger branch network covering multiple cities.

Many foreign players dissatisfied with the progress of organic growth added alliances to the mix after the government began allowing them. Each type of potential partner brings distinct advantages and challenges to an alliance.

- **“Big Four” Bank.** These state-owned targets offer foreign investors an opportunity to access a nationwide sales network and broad customer base, but they leave investors with little control over local management. These banks have already attracted significant investment, and three of the four—China Construction Bank,

Bank of China, and Industrial and Commercial Bank of China—already have investors.

- **Joint-Stock Bank.** This option provides investors with a national banking license and a better chance to exert influence on local management. Since 1986, 12 joint-stock banks have been established. Because they were established more recently than the Big Four banks, they tend to carry less historical baggage and could be more agile and responsive to the market. The coverage of joint-stock banks is typically regional. Like the Big Four, most joint-stock banks have already accepted a foreign investor. The most prominent example is Bank of Communications, which sold a 19.9 percent stake to HSBC.



- *City Commercial Bank.* By partnering with one of these banks, an investor would have a greater chance of influencing management and would also gain access to a citywide sales network and customer base. Geographic scope, however, would be limited to the municipality, and many of the top ten targets are already spoken for. Prominent examples include ING's acquisition of 19.9 percent of Bank of Beijing, BNP Paribas's acquisition of 19.2 percent of Nanjing City Commercial Bank, and Australia and New Zealand Banking Group's acquisition of 19.9 percent of Tianjin City Commercial Bank. With more than 100 city commercial banks in existence, however, many second-tier targets remain available. Their attractiveness may get a boost if regulations ease, allowing expansion beyond home territories.
- *Hong Kong–Based Bank.* By partnering with or gaining control of one of these banks, an entrant could leverage the preferential terms of the Closer Economic Partnership Agreement (CEPA), which lowers the capital requirements and waives the requirement that foreign investors establish a representative office prior to opening a branch. CEPA also makes it easier for banks to demonstrate branch profitability. In addition to these benefits, a bank based in Hong Kong would provide access to a large pool of employees who are literate in Chinese and experienced in this market.
- *Securities Firm.* These firms could offer a foreign entrant not only an existing customer base and sales network but also access to a comprehensive national license that covers brokerage, underwriting, proprietary trading, and asset management—but not banking. Securities firms therefore serve as an attractive platform for entering segment-focused businesses such as wealth management. Unfortunately, with stock market reforms still pending in China, few securities firms are performing well. Yet underperforming players are often eager to strike alliances—thus affording entrants a strong negotiating position. Recently, UBS acquired 20 percent of Beijing Securities, and Goldman Sachs took a 33 percent share in a joint venture with Gao Hua Securities—the maximum share that foreign companies can hold in a joint venture with a securities firm.
- *Fund Manager.* Through an alliance with this type of partner, an entrant could tap into China's growing fund-management industry while leveraging existing distribution channels and an established customer base. In addition, a foreign player could develop its own investment products to complement existing offerings. Institutions that have chosen this path include ING Investment Management, Deutsche Asset Management, and Fortis Investment Management. Again, pending stock-market reforms in China limit the current attractiveness of this option.
- *Joint-Venture Bank.* By establishing a joint-venture bank with a local partner, an entrant could build from scratch the organization, operations, and processes necessary to win in this market while still drawing on the strengths of its partner. Joint-venture banks in China, however, are subject to the same restrictions as any foreign bank or bank branch. Bohai Bank is the only example of a joint-venture bank that is treated as a local bank, but many industry observers expect that the Chinese government will not allow another deal of this kind in the near future. Therefore, the true benefit of this kind of play is the strength of the local partner and its offering. An example of this approach is HSBC's investment in Ping An Bank, a joint venture with Ping An Insurance.
- *Product Joint Venture.* Under this approach, an entrant cherry picks profitable product segments. For example, some investors have already taken strategic stakes in a Big Four or a joint-stock bank and have deployed them as a base for launching a product joint venture while securing a broad sales network. The approach is a good starting point, but most commercial banks will want to go beyond a single-product strategy to capitalize further on customer relationships.
- *Insurer.* The insurance business in China is attractive in its own right, but it can also provide complementary products for an integrated financial-services player. Some banks are already active in this sector. The most notable example is HSBC, with its 19.9 percent stake in Ping An Insurance.

Whereas most entrants assess these options with an eye toward establishing a sustainable presence in the Chinese market, some also seek attractive capital gains. But the prospect of realizing a capital gain should not be the only reason for making a large investment in a Chinese bank.

Moving Ahead, with Caution

Many foreign banks recognize the unparalleled opportunity that has been created by the opening of China's financial-services sector, but they are uncertain about how or when their investments in the market will grow to become sustainable, successful operations. If they proceed with caution, however, they can move ahead in China, armed with lessons from foreign investors that have already made moves in other portions of China's opening economy.

Understanding That Uncertainty and Change Abound

Perhaps the clearest evidence of the uncertainty pervading China's financial-services market can be found in the entry strategies of the foreign institutions themselves. Many have placed more than one bet—in fact, some have made as many as seven different investments—largely because it is so hard to predict how the opportunities in this market will unfold.

Their caution owes, in part, to lingering questions about future competitiveness in the Chinese banking industry. It is difficult to forecast how local players will evolve or what will happen if their improvements do not proceed far enough, fast enough. Some industry observers believe that the pace of deregulation will be linked to the competitiveness of the local industry.

Furthermore, while December 2006 will signal an important new phase of reform, it will by no means end government involvement in this sector. In interviews we conducted for this report, several CEOs expressed concern about just how much regulation will remain and how predictably it will be applied. “The key unknown is the speed of deregulation of the market,” remarked one participant. Others noted the lack of transparency in the regulators' decision-making processes or were staggered by the number of official bodies involved. “There is always another layer of decision makers,” one interviewee contended. Although the government is working diligently to improve the regulatory environment, most of these complexities are likely to persist for some time.

Additional uncertainty surrounds the development of China's financial-services sector as a whole. In such a relatively immature market, foreign institutions—despite their wealth of experience—will need to invest time and money to fully understand their potential customers and the products and services that will appeal to them.

For example, Chinese consumers have a culturally unique outlook on credit. “The typical credit-card customer segment in today's China is still difficult to penetrate, as they [consumers] do not spend more than they have,” remarked one executive. Because of these differences, strategies that have proved successful in mature markets may be of little value in China. Banks will need to discover new ways to win.

The relative immaturity of this market also provides a basis for sweeping change. The experience of more developed markets suggests that China's financial-services sector could evolve in any of several ways—for example, by shifting from product silos to customer-focused competition. Coupled with the catalysts of government reform and foreign investment, the dual opportunity and threat of a nascent market makes for a dynamic environment. Although many expect the Chinese market to change for the better—by gaining an improved infrastructure and realizing an increase in fee-based income as a proportion of revenue—they also grapple with the uncertainty that arises whenever competitive evolution is compressed into a short time frame.

In assessing the situation in China, we have observed ten megatrends that, over the next five years, will redefine the sources of value in this market and the challenges associated with competing for them. (See the sidebar “Ten Megatrends Will Transform Banking in China,” page 20.) Ultimately, foreign institutions will benefit from most of these changes, but they will also have to work hard to remain competitive in a rapidly changing environment. Many institutions will need to revisit their processes, operations, and strategies to ensure compatibility with the evolving marketplace. The potential for radical change adds another dimension of complexity to an already complicated market.

TEN MEGATRENDS WILL TRANSFORM BANKING IN CHINA

1. Banks will shift from product silos to customer-based competition.

- Foreign banks will lead the trend
- Chinese banks are already planning customer-centric systems

2. Fee-based income will increase as a proportion of total banking revenues.

- Current fee levels are low compared with international standards
- Chinese banks have already begun to introduce fees

3. The walls dividing banking, securities, and insurance will collapse.

- Local financial holding companies (FHCs) are emerging
- New regulations for FHCs are expected

4. Joint-stock banks will challenge the market position of the Big Four banks.

- Joint-stock banks are growing faster and have higher-quality assets than their Big Four counterparts
- Typically, these banks also boast better product innovation and service, as well as more modern systems

5. Foreign banks will cherry pick the most attractive customer, product, and geographic segments.

- New entrants can focus on the most profitable products
- Proven expertise and an established brand will give new entrants a strong position

6. The gap will widen between China's developed East and its underdeveloped West.

- The government is providing incentives to encourage investment in the West
- The business environment in the West, however, remains more challenging

7. Sophisticated players will spur growth in financing in small-to-medium-sized enterprises (SMEs).

- The SME segment is underserved, in part because serving it requires sophistication
- Some foreign institutions are already operating profitable SME-financing businesses in China

8. The infrastructure supporting credit, information, and payments will improve dramatically.

- Substantial investment is already flowing into IT systems
- Payment and credit information platforms are being established

9. The market will shift from primarily bank-credit financing to financing from the capital markets.

- The regulatory environment will improve
- In an enhanced environment, a broader range of companies will be able to access debt and equity through capital-market finance

10. Overcoming the scarcity of talent will become an increasingly important, and challenging, factor for success.

- The demand for qualified staff is projected to outpace the supply
- Employee poaching has already been observed

One of the most significant trends, and perhaps one of the greatest challenges, is the growing scarcity of talent. With an increasing number of foreign banks converging on this market, the demand for local professionals—people who are familiar with the culture, the language, and the overall landscape and who can communicate with senior managers from foreign banks—is quickly outpacing the supply. Some players are already poaching talent from competitors. Most foreign banks are also having difficulty finding enough of their own managers who are willing to work in China and can flourish in this environment. As competition in China increases, human resources are only going to become more scarce.

Learning from Other Industries

Foreign investors in the financial services market aren't the first to race one another into China's opening economy. Competitors in other industries have entered China with much the same hopes of tapping into the country's spectacular growth and exploiting their own competitive advantages in a burgeoning marketplace. And the challenges that the other new entrants have faced provide a sobering reminder that winning is not a foregone conclusion—even when a market is growing at breathtaking speed and on a grand scale. In fact, the high growth rate in China may be confounding success.

The automotive industry provides an illustrative example. Foreign manufacturers began investing in this rapidly growing market in 1985, and as their investment surged, capacity quickly outstripped sales. (See Exhibit 8.) As prices plummeted, margins eroded. Of the roughly 20 foreign manufacturers that entered this market, only 4 have managed to gain market share above 5 percent, and only 3 are growing at above-average rates.

With the pace of foreign investment not likely to wane, China's banking industry could become just as overcrowded as the car industry. Moreover, the concentrations of value in the financial services sector—by region, customer segment, and line of business—mean that competition could intensify particularly quickly in specific areas.

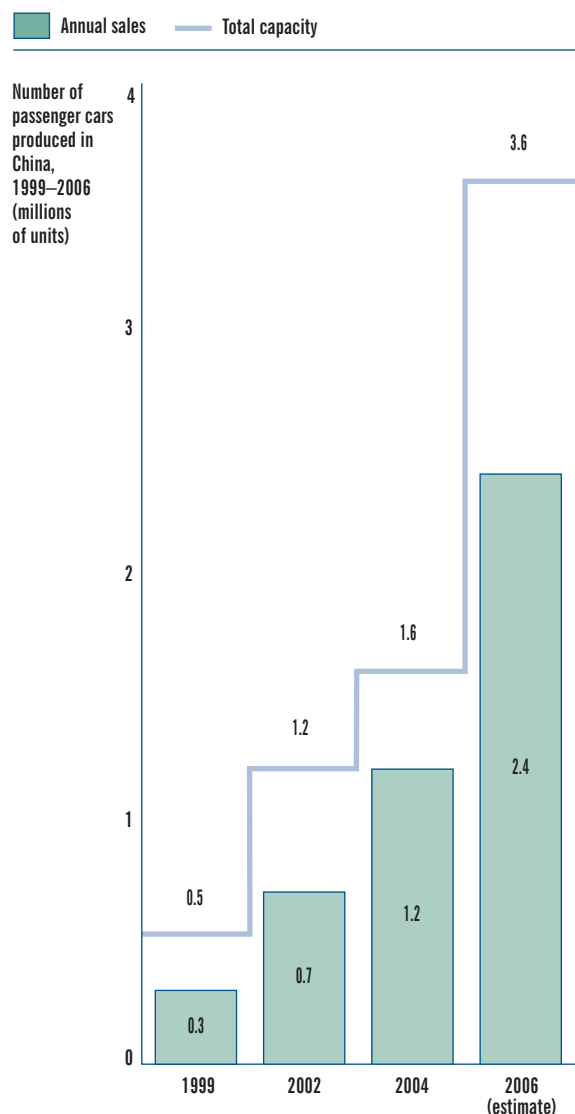
“Expect tough competition from local banks, especially the better ones,” one executive predicted.

Another said, “Once the floor on interest rates is removed, Chinese banks will compete heavily on price without even knowing when they get themselves into trouble, because they do not have the necessary interest-rate risk-management capabilities yet.

Drawing Insight from Winners

Fortunately, not every lesson from other liberalized industries in China is grim. A handful of foreign

EXHIBIT 8 SURGING FOREIGN INVESTMENT FUELED OVERCAPACITY IN CHINA'S AUTO INDUSTRY



The industry averaged a utilization rate of 65 percent between 1999 and 2006.

SOURCES: Credit Suisse First Boston; China Automotive Technology & Research Center (CATARC); literature research; BCG analysis.

entrants in the automotive industry, as noted above, were able to gain market share above 5 percent, and several achieved growth rates in excess of the market average—in some cases, far above it. Their successes highlight the value of clearly defined strategies that take a long-term view, as well as the importance of focusing on the elements of in-country operations that are critical to success, such as the performance of alliances.

One exemplary tale to consider is the story of a North American automaker that entered the Chinese market in the late 1990s. Together with its joint-venture partner, the company developed long-term strategies for its product portfolios and brand positioning, and it built an effective sales and distribution network. In the end, the close collaboration and long-term vision paid off, and the automaker was able to avoid a problem common among partners in joint ventures: “sleeping in the same bed but having different dreams.” The automaker quickly emerged as a leader in China’s passenger-car market, and China in turn has become a bright spot in this player’s global portfolio.

Another positive lesson can be drawn from a Japanese automaker that designed its joint venture for balanced power-sharing with its local partner. The venture clearly delineated responsibilities, with the Japanese automaker focused on produc-

tion and marketing and the local partner focused on financials and government relationships. In six years, the joint venture became the most profitable manufacturer of automotive equipment in China, in part because the foreign player recognized that its success hinged entirely on the success of its partner.

Three broad lessons can be derived from the experiences of foreign companies in China’s automotive industry. First, foreign entrants can succeed in China—but only if they learn how to serve local markets and local tastes, how to cope with regulatory restrictions, and how to manage their alliances. Second, not all players that are successful in Europe and the United States will enjoy the same success in China. Conversely, some players that lag in other markets have won leadership positions in China by leveraging the unique capabilities that are essential in this market. And third, the only certainty in China is change.

With these lessons in mind, financial institutions should be careful not to underestimate the challenges of this rapidly developing economy. But these realities shouldn’t deter them from entering and moving ahead in this space. Financial services investors should emulate their peers in other industries that have found ways to thrive amid uncertainty, change, and restrictive regulations.

Playing to Win

The Chinese market presents a seductive set of circumstances: continuing impressive growth, fading restrictions, and surging foreign investment. So seductive, in fact, that entrants might be tempted to proceed with immediate speculation.

In an environment as challenging and uncertain as China, however, competitive advantage cannot be achieved unless an entrant makes explicit plans for establishing a winning position from the outset. To this end, we propose three sets of actions that can help foreign institutions set a course for long-term success. (See Exhibit 9.)

First, to mitigate some of the risk associated with uncertainty, a financial institution should *define a clear strategy* that is explicitly linked to relevant capabilities, focused on a specific target aspiration, and diversified—that is, charts more than one pathway to the desired goal. Second, the entrant should *position its institution for success* by fostering relationships with key stakeholders at corporate headquarters and in the government. Third, it should *manage for China* by recognizing

the challenges and factors for success specific to the two broad types of entry approach: alliances and organic growth.

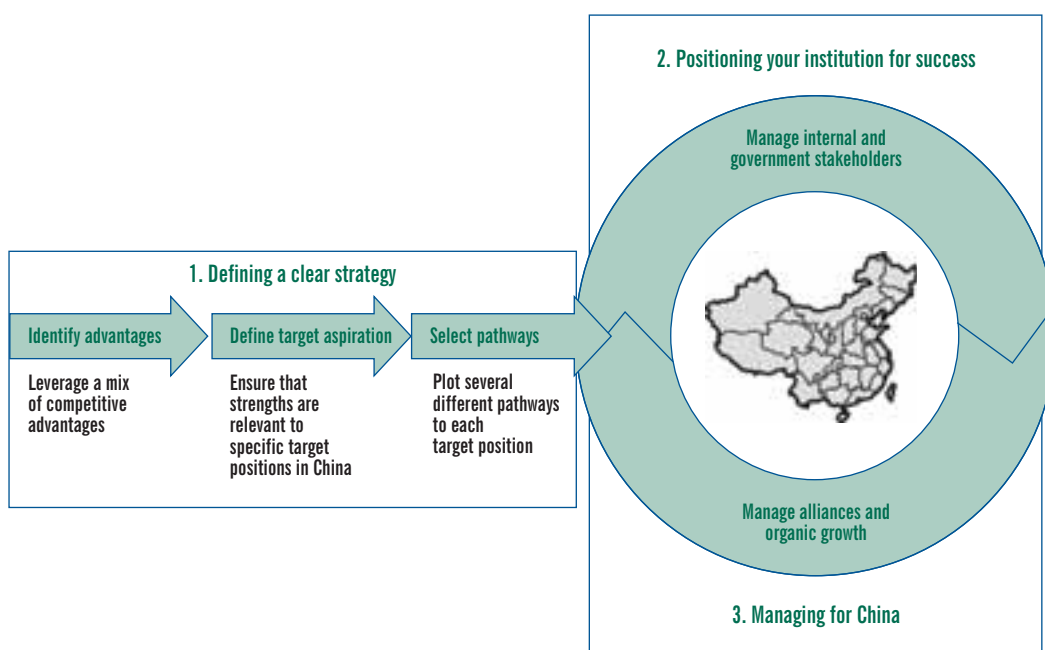
Defining a Clear Strategy

Fending off increasingly fierce competition and capturing a growing share of China’s financial-services sector will require leading-edge skills. Through interviews and research, we have identified seven sources of competitive advantage in this market. (See Exhibit 10, page 24.) In defining a successful strategy, a company should begin by assessing its strategic advantages in these areas. If it has none, it must think hard about how to compete in China in the long run.

The next step is to identify a target aspiration. We have defined six possible target aspirations in China’s financial-services market. (See Exhibit 11, page 24.) An entrant should identify the aspirations that are within its grasp, understanding that different capabilities and combinations of capabil-

EXHIBIT 9

ESTABLISHING A WINNING POSITION IN CHINA REQUIRES THREE KEY STEPS



SOURCE: BCG analysis.

EXHIBIT 10

SUCCESS IN CHINA DEMANDS COMPETITIVE ADVANTAGES

Competitive advantage	Example of player
① Leading global position	A banking titan with ample financial and human resources
② Proximity to China	An institution with a home market close to China or the ability to draw on management's understanding of China and employees who speak Chinese
③ Customer segment expertise	An institution with a winning customer-service model for specific customer segments
④ Product expertise	An institution with leading capabilities in designing and managing specific product lines
⑤ Processing expertise	An institution with best-in-class, highly efficient product-processing capabilities
⑥ Emerging-market expertise	An institution with ample experience in building successful banking operations in a similar environment
⑦ Existing corporate-customer base	An institution that can leverage the customer base to generate revenue early in the entry process

Source: BCG analysis.

EXHIBIT 11

INSTITUTIONS SEEKING TO WIN IN CHINA CAN PURSUE MANY TARGET ASPIRATIONS

Target aspiration	Role
Leading national bank	Serving all customer segments across all banking products with a national branch network that ranks among the top banks in China
Corporate bank	Capturing profitable corporate-customer relationships with a focus in high-growth regions
Regionally focused retail bank	Offering full commercial-banking services to personal and commercial retail customers in attractive geographic areas
Wealth management specialist	Providing superior service to affluent and high-net-worth customers with a focused network and full product and service portfolio
Product specialist	Offering single product lines with attractive economics
Industry utility provider	Leveraging strong processing and technical capabilities to provide national outsourcing services to Chinese banking players

Source: BCG analysis.

ities are suited to different target aspirations. (See Exhibit 12.) The most ambitious aspirations require the most—and most sophisticated—capabilities.

The third step is to identify a pathway to achieving the target aspiration. The Weiqi board can be used to illustrate the range of potential pathways associated with the six target aspirations. (See Exhibit 13.)

- Playing the role of a *leading national bank*, which targets integrated banking operations on a national basis, requires an attack on all fronts. Some examples are investing in a joint-stock bank to secure a national banking license, building profitable product franchises through joint ventures, and growing a foreign-owned branch network organically.
- To establish a *corporate bank* with a regional presence, an entrant must capitalize on existing corporate-banking relationships with multinational clients while building a local wholesale business. Control is crucial when playing this role because the high levels of nonperforming loans in China will pose inherent risks as the risk management infrastructure remains under

EXHIBIT 12

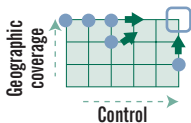
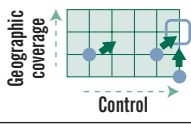
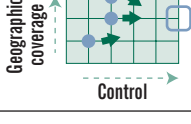
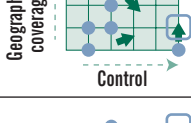
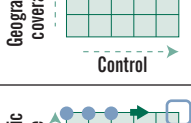
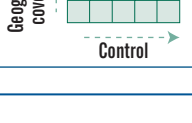
IMPERATIVES FOR INSTITUTIONS VARY BY TARGET ASPIRATION

Target aspirations	Competitive advantages						
	① Leading global position	② Proximity to China	③ Customer segment expertise	④ Product expertise	⑤ Processing expertise	⑥ Emerging-market expertise	⑦ Existing corporate-customer base
Leading national bank	●	●	●	●	●	●	●
Corporate bank		●	●				●
Regionally focused retail bank		●	●				
Wealth management specialist			●			●	
Product specialist				●		●	
Industry utility provider					●	●	

SOURCE: BCG analysis.

EXHIBIT 13

GIVEN THEIR TARGET ASPIRATIONS, ENTRANTS CAN CHART POTENTIAL PATHWAYS

		Geographic focus	Alliance options	Organic growth options
Leading national bank		National	<ul style="list-style-type: none"> • Big Four bank • Joint-stock bank • Product joint ventures 	✓
Corporate bank		Regional	<ul style="list-style-type: none"> • Hong Kong bank • City commercial bank 	✓
Regionally focused retail bank		Regional	<ul style="list-style-type: none"> • City commercial bank • Product joint ventures 	Not applicable
Wealth management specialist		Multicity	<ul style="list-style-type: none"> • City commercial bank • Securities firm • Product joint ventures 	✓
Product specialist		National	<ul style="list-style-type: none"> • Product joint ventures 	Not applicable
Industry utility provider		National	<ul style="list-style-type: none"> • Big Four bank • Joint-stock bank • Joint-venture bank 	Not applicable

SOURCE: BCG analysis.

NOTE: In each target position, an entrant will aim to achieve full control of banking operations in a specific geography or market.

development. As a result, the organic branch network can play a vital role. At the same time, acquiring a Hong Kong–based bank can add knowledgeable staff, a customer base, the advantages of CEPA, and perhaps an existing branch network in mainland China. City commercial banks in attractive cities could further complement these pathways.

- An entrant looking to build a *regionally focused retail bank* needs to leverage local partners rather than rely on organic growth. A city commercial bank can provide a strong platform for building this business, offering a focused network and the potential for launching attractive product joint ventures, such as mortgages or credit cards. This approach suits foreign banks that have limited corporate business but strong retail expertise and close proximity to China.
- A *wealth management specialist* will focus on municipalities that have high concentrations of wealth. In order to win in this segment, an entrant must focus on the quality of sales channels and customer service, as well as the attractiveness of products. In these respects, both city commercial banks and securities firms can serve as platforms for establishing a strong position. A foreign-owned branch network is also a feasible option, but it may be difficult to secure a good return on equity in the absence of a strong corporate loan book. Product joint ventures for fund management or mortgages could also complement the service offering. Finally, although a joint venture with a large bank would allow the entrant to tap into an existing client base, no such arrangement has yet been negotiated successfully.
- As a *product specialist*, an entrant seeks national coverage for specific products. The pathways to this target aspiration can involve narrowly defined joint ventures, in which the foreign investor could leverage the valuable assets of a Chinese partner without having to assume the risks embedded in the local organization. The foreign investor will contribute product expertise, while the Chinese partner will provide important industry and government relationships, sales channels, and access to an existing customer base.

- An *industry utility provider* will strive for national coverage, providing outsourcing opportunities across China for activities such as payments or retail loan processing. While a foreign entrant needs to bring outstanding processing expertise to the table, a Chinese partner will be required for its national presence and business portfolio. Joint ventures would be a possible pathway, supported by a stake in a joint-stock bank or a Big Four bank.

A portfolio approach, which relies on more than one pathway, can help mitigate some of the risk associated with this market. In charting their pathways, entrants should also recognize that China is far too large to capture at once. Even if a bank wants to establish a broad national presence in China, it must begin with a more manageable focus. Initially, banks should concentrate on specific customer segments, regions, and lines of business.

Banks that are planning to form an alliance must recognize that the number of potential partners is dwindling, owing to the surge of foreign investment. But they should also keep in perspective the size and number of options that remain. Many of the top city commercial banks had not yet formed an alliance as of December 2005. (See Exhibit 14.) Some of the available options are located in cities that boast GDP levels comparable to the national economies of Vietnam or Slovakia.

In addition to the three steps described above, foreign banks that are planning to enter the Chinese market must observe some guiding principles as they develop their target aspirations and pathways: a balance between long- and short-term goals, a balance between analysis and action, and a focus on human resources.

The first guiding principle is critical because although a sound China strategy requires a long-term horizon for success, banks must also enter this market with a plan to score wins in the short term. Even if corporate headquarters is willing to wait for profitability, an alliance partner may not be as accommodating. In addition, while investing in China is seemingly obligatory for many financial institutions today, popular sentiment among both shareholders and leadership could change, espe-

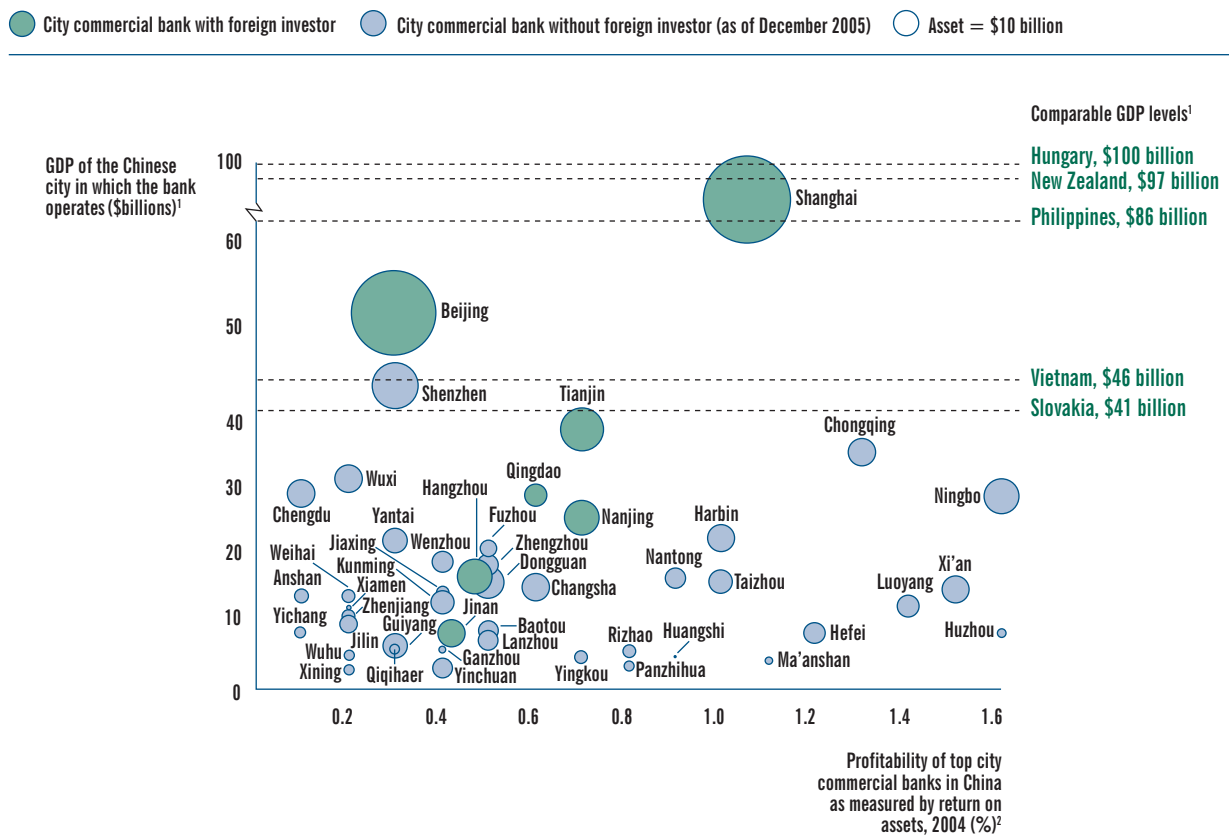
cially if returns on investment fail to materialize. By demonstrating success early, entrants will stand a greater chance of maintaining the momentum necessary to drive these investments toward long-term goals. An entrant should therefore plan to leverage its advantages—for example, international best practices in risk management, IT, product design, and customer service—as soon as possible.

The second principle implies that a “fast follower” approach can make more sense than rushing into this market simply to secure banking real estate, particularly if a bank spends its time deliberating on the best target aspiration and pathways, and developing essential capabilities to react quickly when the right opportunity arises. For example, a company would be well served by taking time to understand the dynamics of the Chinese banking market, build relationships with

regulators, and gather a team of people who are ready to hit the ground running. But a bank should not postpone its plans for China indefinitely in the hopes that the uncertainty will be resolved, regulations will be streamlined, or a rapidly changing environment will suddenly become stable and predictable. China’s banking market will remain dynamic and challenging for the foreseeable future.

Although China boasts the largest population in the world, the third principle—focusing on human resources—is critical because well-trained banking employees who speak Chinese and know the culture are scarce. Foreign entrants are already scrambling for the few eligible employees in the market. As soon as they define a strategy, therefore, entrants must plan for recruitment, training, and retention.

EXHIBIT 14
SIZABLE INVESTMENT OPPORTUNITIES REMAIN



SOURCES: BCG's proprietary database on city commercial banks; city commercial bank annual reports; *China Statistical Yearbook 2005*; city-level statistical yearbooks, 2005.

NOTE: Jinan City Commercial Bank and Hangzhou City Commercial Bank have both received foreign investments, but the return on assets for them is unknown.

¹The GDP is nominal, reflecting current prices.

²Return on assets is calculated by dividing profit before tax by year-end assets.

Positioning Your Institution for Success

As they prepare to launch operations in China, either with a partner or on their own, foreign institutions will need to manage relationships with corporate headquarters and with government officials—two imperatives commonly associated with building enterprises in developing markets.

Managing the Relationship with Corporate Headquarters. To manage this relationship carefully, entrants should focus on three important elements: engaged leadership, defined performance measures, and communication.

In the report *Organizing for Global Advantage in China, India, and Other Rapidly Developing Economies* (March 2006), BCG determined that success in rapidly developing economies (RDEs) such as China is characterized by high levels of engagement from senior leaders. Successful companies rely on these executives to set bold top-down goals for growth; provide clear indications of sustained commitment (for example, through public announcements of increased investments); orchestrate the global allocation of resources to support operations in the RDE; and overcome barriers, including any internal bias toward directing resources to mature markets, in which short-term results are generally larger and more certain.

As a next step, a bank should define clear performance measures for its in-country operations, taking care to reflect the top-down goals articulated by senior leaders. In doing so, it should be careful not to impose measures used in mature markets, because they could place unreasonable demands on managers to focus purely on short-term, bottom-line results.

And finally, regular, comprehensive communication should update senior leaders frequently on basic facts, figures, and issues. Local leadership should also make an effort to manage expectations at corporate headquarters so that senior leaders understand how and why an investment in China will unfold differently from investments in mature markets. In parallel, entrants should develop a communication plan for reaching other key audiences, with a special focus on investors, including the board of directors, analysts, and shareholders.

Managing the Relationship with Government. In China, government is not a monolith but a multi-layered collection of interests—municipal, provincial, and national—that sometimes pursue conflicting agendas. To ensure that they reach all relevant parties, entrants should map the government approval process for the pathways they have chosen, identifying all decision-making parties. If appropriate, they should share this map with the potential partner. An articulated and shared plan will clarify the network of contacts that must be built and maintained. Furthermore, the plan should be reviewed regularly, with contacts prioritized and a budget specified. Dedicating resources in this manner will ensure a smooth communication process. Separately, entrants should pursue goodwill programs that demonstrate a strong commitment to China. Being a good citizen can be just as valued as complying with licensing requirements.

The consequences of neglecting these relationships can be severe. Without government ties, plans for partnering with local institutions, opening new branches, or even launching new products might be stifled. “Some products, while waiting to be approved, might get copied and then launched by competitors,” cautioned one leader.

Managing for China

The imperatives for managing internal and government relationships apply to both organic growth and alliances, but each entry approach demands its own unique set of management priorities.

Management Priorities in Organic Growth. As financial institutions pursue plans for organic growth in China, they should recognize three imperatives: employing talent on the ground, adapting operating models to local conditions, and tapping global resources.

When it comes to employing talent, sending outstanding leaders and managers to China not only improves the competitiveness of local operations but also sends a strong signal about the company’s commitment to its investment. These people must thrive in a dynamic environment and should be as skilled in building relationships as they are in building enterprises. They also must spend a significant

DEDICATED EXPATRIATES

BCG recently explored the preferred practices of multinational consumer companies that are taking steps to ensure that their investments in China succeed. Particularly critical is sending not just stars to China but also people who are prepared to dig in. An excerpt from “In Harm’s Way: Getting It Right in China” (BCG Opportunities for Action in Consumer Markets, October 2005) explores this imperative:

Companies that are serious about their China strategy will have to send entire families, and lots of them. Furthermore, those families will have to stay longer than just a couple of years—probably four or five. So persuading them to go will be much harder.

The South Koreans, and some Europeans, seem to know what it takes. Americans and Canadians, however, typically go for two-year tours of duty timed to coincide with the academic schedules of their children. They are overburdened with ceremonial chores—such as accompanying far too many visitors from headquarters who seek an introduction to this important market. On the personal side, they tend to retain a Western lifestyle, and they are often insulated from the local community and dependent on a bilingual staff. It is difficult for them to finish anything they start or start anything they have to finish.

amount of time in the country. (See the sidebar “Dedicated Expatriates.”) In addition, financial institutions should encourage their managers in China to identify high-potential local employees, and actively coach and develop them for top management positions.

When they arrive in China, senior leaders must be prepared to tailor their business models to local realities and continual changes. In Europe, for example, where mortgage markets are often low-growth and low-margin sectors, players focus on managing the same volume with fewer people. In China the situation is vastly different, as are the requisite skills.

On average, the mortgage market in China is expected to double in size every year during the first decade of this century. As a result, players need the flexibility and capabilities to grow their organizations, train and hire people, and cope with massive change on a number of fronts, including government regulations, customer needs, and local and foreign competition. This fact has two implications for how they operate:

- Operations in China should be structured to allow for quick and decisive moves. To permit fast responses to environmental changes, the right level of local decision-making authority is required. Product design, for example, should be handled locally, so that products remain in line with market demand and regulations.

- Entrants should build a strong local work force as soon as possible, recruiting and training even before local operations begin. Once the operation is up and running, institutions should ensure that clearly defined career paths and relevant people-development tools are in place for local staff.

Entrants also require the right processes, tools, and policies to ensure global collaboration.⁵ While local conditions should play a major role in shaping these operating models, entrants should leverage common global processes—for example, for financial and strategic planning—to allow greater continuity and collaboration with global operations.

Management Priorities in Alliances. Although institutions pursuing alliances will also require excellent talent, flexibility, and global collaboration, three additional priorities will prove more pivotal to their success: supporting change, building trust, and monitoring performance.

For foreign investors, the first and nonnegotiable priority is supporting change at the alliance partner. Although foreign institutions, as minority investors, are likely to secure one or two seats on a Chinese organization’s board of directors, the board will likely have limited influence at best,

5. BCG examines these processes in detail in the report *Organizing for Global Advantage in China, India, and Other Rapidly Developing Economies*, March 2006.

and change will need to be driven through other channels. That's because boards are a novel concept to Chinese banks—leaving the role of the board unclear and management and decision-making processes poorly defined. Against this backdrop, three factors are crucial to supporting change:

- When choosing a target, evaluating the partner's management team is arguably the most important element of the foreign investor's due diligence. The partner must be able to embrace and execute change. Among other things, the partner's management should welcome the investor's advice.
- Entrants should begin by enabling technical changes, since these will be far easier for the partner to accept and execute than changes to the corporate culture. Technical changes often focus on middle- and back-office functions such as risk management and IT rather than product development and innovation, sales, or client relationship management. When they begin to focus on changing the corporate culture, foreign investors will need to demonstrate both persistence and sensitivity—supporting change rather than forcing it.
- Because local partners can opt to ignore advice from minority stakeholders, entrants must bring focused and relevant expertise that is appropriately tailored and delivered. Likewise, their experts must possess communication and change-management skills to help the local partner adopt best practices. Because few experts have operated in an environment like the one taking shape in China, they'll need to learn much about the country and adapt their recommendations to fit its unique conditions. Interestingly, one of the banking leaders we interviewed told us that his company had dispatched several retired senior managers to its alliance partner. These experts had experienced market deregulation before, which gave them an informed perspective on the challenges emerging in China. As a result, their background was highly valued by the Chinese partner.

As a financial institution forges an alliance with a bank in China, its second priority is building trust.

This requires understanding and meeting the goals of its potential partner and committing to help the partner succeed. Often, Chinese financial institutions seek foreign partners as a way to enhance their own management skills in corporate governance, risk management, IT, and internal controls. They might also be looking to launch new businesses or increase the capital adequacy ratio—the ratio of capital to total risk-weighted credit exposures—to meet the standards set by regulators. At the same time, however, they remain wary of increased competition in the market and the prospect of ceding management control to a foreign company.

To assuage any fears and build confidence in their commitment, foreign investors can work to understand the key performance indicators of the decision makers within the partner bank. These officials often have strict management metrics they need to meet every year, and some of those metrics may differ radically from the entrant's priorities—for example, by emphasizing the importance of maintaining (rather than reducing) head count. By identifying and addressing these potential conflicts, the entrant can ensure that it works with rather than against its partner.

As a third priority, foreign investors must measure how well the alliance performs. In negotiations, players must specify how the strategic and financial performance of the alliance will be measured. And once operations begin, they must remain vigilant by monitoring the partnership's effectiveness, determining, for example, whether any changes in the competitive environment challenge the strategic logic of the alliance. Whether or not measured performance meets expectations, the metrics will indicate when an institution should execute its planned exit strategy—either to realize the payoff of its investment or to cut its losses.

Taking the Next Critical Step

Foreign entrants will need to find ways to succeed in an increasingly competitive, rapidly changing environment. Given that China is beset by regulatory pressures and pervasive uncertainty, more than one observer has characterized its financial-services sector as a gamble. Just as the jackpot in China promises to be big, so are the risks.

As they develop or refine a strategic plan for this market, therefore, both potential entrants and existing players must recognize that timing is critical. For companies that have not yet entered China, now is the time to examine the opportunity and decide whether and how to approach this market. They must understand that a fully competitive branch will take at least five years to build and that the establishment of an alliance must allow for screening options, selecting partners, and negotiating deals. In the meantime, potential alliance partners are disappearing and the competitive landscape is growing more crowded.

For companies with an established presence in China, now is the time to ensure that they are optimizing all the factors within their control. They must confirm that their aspirations are consistent with their capabilities, that their activities are geared toward flexibility and high growth, that their operations are set up to manage relationships with headquarters as well as with local government and regulatory authorities, and that they have the right leadership in place. The competition will only intensify as uncertainty and change abound and the stakes rise for playing to win in China.

The Boston Consulting Group publishes other reports and articles that may be of interest to senior financial executives who are exploring, or are already active in, the financial services sector in China.

Recent examples include:

Organizing for Global Advantage in China, India, and Other Rapidly Developing Economies

A report by The Boston Consulting Group, March 2006

Striving for Organic Growth in Retail Banking

A report by The Boston Consulting Group, December 2005

The Role of Alliances in Corporate Strategy

A report by The Boston Consulting Group, November 2005

“In Harm’s Way: Getting It Right in China”

Opportunities for Action in Consumer Markets, October 2005

“Banking on China: Where to Place the Chips?”

Opportunities for Action in Financial Services, July 2005

Succeeding with Growth: Creating Value in Banking 2005

A report by The Boston Consulting Group, May 2005

Overcoming the Challenges in China Operations

A report by The Boston Consulting Group and Knowledge@Wharton, April 2005

Building Professionalism: The Next Step for Life Insurance in China

A report by The Boston Consulting Group, March 2004

China Crossroads: Competitive Priorities for Chinese Banks

A report by The Boston Consulting Group, September 2002

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