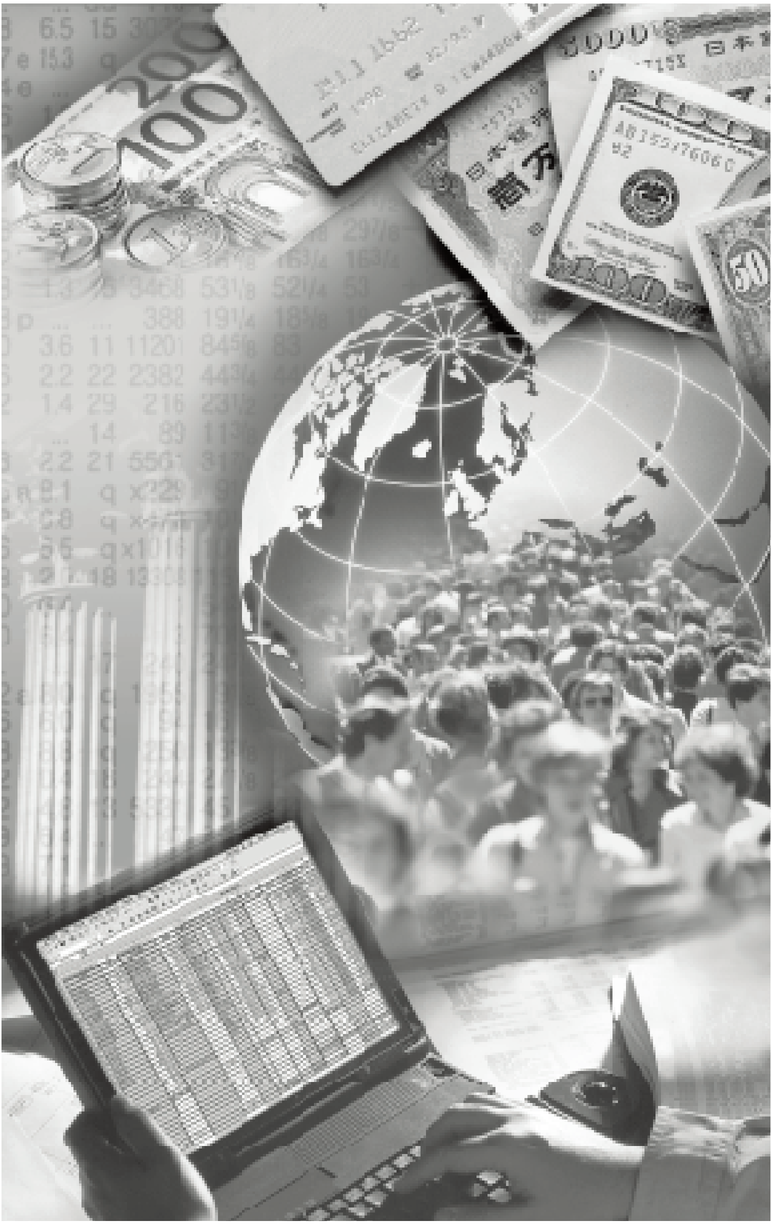
Opportunities for Action in Financial Services

Banking on China: Where to Place the Chips?

THE BOSTON CONSULTING GROUP



Banking on China: Where to Place the Chips?

For international financial-services institutions, seeking a foothold in an explosive emerging market is a bit like entering a casino: everyone is searching for the jackpot. But succeeding in such a market may be even more difficult than winning in a real casino, because the rules of the game are not always straightforward. You're playing against skilled competitors, not just against the house. What's more, the house—the state authorities—can change the rules, and therefore the odds, at any time.

China's banking market has been likened to a casino. Legions of foreign banks, having gained incremental access to the market since China's admission to the World Trade Organization, are placing their bets by buying minority stakes in Chinese banks (and other Chinese financial institutions) and by trying to expand their currently modest branch networks in the country. These banks are wagering both that China's remarkable economic story—evidenced by average compound annual growth in GDP of nearly 10 percent for the past 25 years—will continue, and that further deregulation expected by the end of 2006 will lead to new sources of profit by allowing the banks to compete in products and regions that have previously been off-limits.

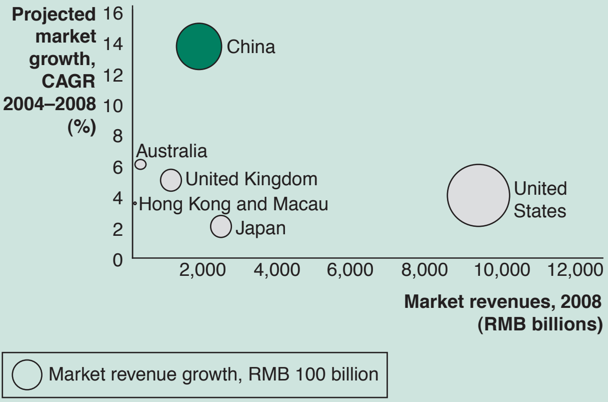
On the one hand, this would seem to be a pretty sensible bet. China's growing ranks of middle-class households need sophisticated products and are just beginning to demand higher levels of service. The increasing presence of multinational corporations in China is creating a demand for world-class corporate financial expertise. Indeed, roughly 30 percent of new bank deposits created globally over the next five years will likely flow into China's banking market, helping it expand far more rapidly than most other major markets. (See Exhibit 1.) In the long term, China is widely expected to evolve into a premier banking center as the size of its economy grows and possibly surpasses that of the United States by 2040.

On the other hand, any market as vast and complex as China is fraught with risks—just like a casino. There are cultural barriers and strong customer loyalties to local institutions that must be overcome. Competition is intensifying in parallel with awareness of China's potential. And regulatory constraints will continue to exist in 2007 and beyond.

Where does all this leave foreign banks looking for new sources of growth? In our view, those that have

Exhibit 1. China Is a Large and Fast-Growing Commercial-Banking Market

Market Size and Growth: China and Selected Major Overseas Markets (2004–2008)



SOURCES: Central banks; analyst reports; BCG analysis.

NOTE: At press time, U.S.$1 equaled RMB 8.2865.

international aspirations would be both wise and prudent to explore what the China opportunity could mean for their institutions. Because one thing is certain: the rush is on. Banks that do not investigate ways of tapping into China's enormous potential can be fairly sure that their competitors will. And the long-term winners in China, by virtue of sheer scale, will be able to build leading global positions.

How can financial services companies forge a potential strategy for navigating China? The first step is to gain a richer understanding of how the country's banking landscape is structured.

Assessing the Odds

The Chinese banking landscape is diverse, to say the least. There are five basic types of domestic banks, the largest being the so-called Big Four state-owned institutions: Bank of China (BOC), China Construction Bank (CCB), Industrial and Commercial Bank of China (ICBC), and Agricultural Bank of China (ABC). There are also ten national shareholding banks, more than 100 city commercial banks, and tens of thousands of urban and rural credit unions. In addition, there are a number of important state development banks.

But the landscape is rocky. Chinese banks have had severe problems with nonperforming loans and have required huge capital injections from the government. BOC and CCB each received $22.5 billion from the state in 2003, and ICBC is benefiting from a $15 billion injection this year.

Unfortunately, some Chinese banks still lack modern credit-risk management techniques, so they may continue to offer loans to questionable borrowers, which could potentially lead to new rounds of defaults in the future. Moreover, on a systemic level, other aspects of doing business—such as management processes, decision making, internal operational controls, corporate governance, organizational design, IT functions, and general leadership—need improvement. Several scandals have hurt consumer confidence.

All that said, it is equally important to acknowledge that many Chinese banks have come a long way over the past five years toward meeting international standards. Chinese banks will likely also benefit from their collaboration with foreign banks—although the latter will need to learn what type of guidance to offer their Chinese partners and find ways to help them increase transparency, develop stronger commercial practices, and target the right customer and product segments. Such issues should be part of foreign banks' overall strategic thinking about China.

Foreign banks will also have to navigate cultural differences. For example, although close relationships are important to doing business anywhere, they are perhaps more so in China, where business takes place only after trust and a degree of respect have been established—not the other way around, as can happen in Western business culture. Establishing and maintaining good *guanxi* (or relationships)—not only with customers and business partners but also to some extent with local and national financial authorities—should be as much of a priority for foreign banks as differentiating their products and services to various market segments.

Where segments are concerned, corporate banking (which has historically served state-owned enterprises) will remain the largest banking segment in China—with market revenues projected to grow to about RMB 846 billion ($102 billion) by 2008. Retail-banking revenues should climb to about RMB 493 billion ($59 billion) by 2008. Within these segments, large corporate customers and affluent retail customers will likely have the highest profit potential.

A key for foreign banks will be the upcoming removal of restrictions on RMB-denominated products. Since the end of 2001, foreign banks have been able to offer foreign-currency products to Chinese companies and individuals, but RMB-based loans and deposits have been restricted. By the end of 2006, however, foreign banks will be permitted to deal in RMB products with all Chinese retail and corporate customers in all regions. (See Exhibit 2.) Moreover, six specific provinces will likely be the most attractive in terms of size, income per household, and economic growth rate: Beijing, Guangdong, Jiangsu, Shandong, Shanghai, and Zhejiang.

One noteworthy difference between the banking business model in China and that in many other parts of the world is the relatively low percentage of fee-based income among Chinese banks. As recently as 2003, noninterest income represented about 11 percent of total revenue for the Chinese banking market, compared with roughly 48 percent for the global banking market. Although fee-based income is expected to rise somewhat in China, foreign institutions will have to work hard to find ways to make fees—not a traditional part of domestic-banking charges in China—more palatable to Chinese customers in both the corporate and the retail segments.

Exhibit 2. Restrictions in the Chinese Banking Market Will Ease Further by December 2006

		December 2001	December 2002	December 2003	December 2004	December 2005	December 2006
Foreign-currency business	Geography	All of China					
	Customers	All individuals and enterprises					
Local RMB business	Geography	Dalian Shanghai Shenzhen Tianjin	Guangzhou Nanjing Qingdao Wuhan Zhuhai	Chengdu Chongqing Fuzhou Jinan	Beijing Kunming Xiamen	Ningbo Shantou Shenyang Xi'an	All of China
	Customers	All foreign individuals and enterprises		All Chinese enterprises			All Chinese individuals

Sources: The World Trade Organization; People's Bank of China.

Eyeing the Tables

Numerous global banks have already established a sizable footprint in China. HSBC, for example, has acquired stakes in Bank of Communications, Bank of Shanghai, and Ping An Insurance—and has the largest branch network of all foreign players. Citibank, whose initial presence in China was established more than 100 years ago, has acquired stakes in Shanghai Pudong Development Bank and China Life Insurance. Commonwealth Bank of Australia has a stake in Jinan City Commercial Bank and is adding an interest in Hangzhou City Commercial Bank. The list goes on and on. Moreover, when limitations on foreign ownership stakes (currently capped at 20 percent for any single foreign institution) are further relaxed, the presence of international banks will intensify.

Having a presence doesn't necessarily mean being profitable, but foreign institutions that have taken the time to understand the Chinese market, develop close relationships, and follow through with effective execution will benefit handsomely. That's why so many other foreign banks are seeking to get into the game. All of China's Big Four banks have suitors, and virtually all joint-stock banks and city commercial banks located in high-growth areas are currently entertaining troops of foreign banking executives.

Of course, each of the many ways in which foreign banks can establish potential long-term positions in China has its own market and organizational challenges. For example, building organically branch by branch may maximize control and independence, but it also presents tall hurdles in scale, geographic coverage, brand building, and navigating cultural differences. Buying a sizable stake in either a Big Four bank or a smaller institution may provide entry through an established entity, but it requires a considerable upfront investment for relatively little management control. Starting a joint-venture bank may well be a viable way of sharing initial investments and management influence, but such projects are extremely difficult to pull off.

Deciding which of these potential paths might be best suited to your bank requires a thorough assessment of your own institution's international aspirations, cultural and organizational capabilities, appetite for risk, and time horizon for a possible initial investment.

Foreign banks should also note that competition both in mainstream product areas and in the largest cities will become increasingly intense in the short and medium terms. They should therefore consider whether they might fare better by placing their bets on products or regions in which they can achieve greater scale and face less competition. Options include focusing on higher-growth and less contested locales (such as smaller coastal and large inland cities), products such as credit cards and mortgages, and value-chain processing services to mainstream banks. In addition, a certain degree of business model innovation may be necessary in order to successfully pursue small-to-medium-size enterprises, large state-owned enterprises, mass-market consumers, and wealthy individuals—especially considering the fact that fee-based services are not yet fully accepted in China.

Foreign banks should also study, as much as they can, the experiences of all early movers into China, not only in financial services but also in industries that have been open to foreign companies for a longer period—such as consumer goods, engineering, and chemicals. The goal is to identify best practices in navigating partnerships, organizing effectively, dealing with employee displacement issues, and managing headquarters' aspirations and expectations.

Placing Your Chips

Thinking through growth strategies is a difficult exercise for any financial institution. Should expansion be organic or should it occur through partnerships or acquisitions? Should the product line be expanded or streamlined? Should a previously targeted segment be dropped and a different one pursued? Banks face these dilemmas constantly.

Another common question applies to the China opportunity: should growth be sought domestically or across borders? China is something of a special case, however, because of its vast geography, its upwardly mobile population of 1.3 billion, and its enormous potential for banking services.

Getting established in China is an arduous, long-term endeavor. And China is the type of market in which there will always be a strong element of the unknown. Despite the risks, however, the simple fact is that opportunities for foreign banks in China are very significant, and relatively few have a strategy in place to ensure that they can take maximum advantage of the additional degrees of freedom they will soon have.

Ultimately, there are five basic imperatives that foreign financial institutions considering entry into China should address now:

- Invest the time and effort to learn about the Chinese market

- Build "China capabilities" institutionally and culturally

- Develop a full set of strategic options

- Explore the growing importance of linkages between banking and other financial services, such as insurance

- Think through a path to profitability in China, considering various market scenarios

China is a country that few banks with international aspirations can afford to ignore. Institutions that take too long to size up the game and decide how to approach it may find themselves without even a small share of a potential jackpot of growth and profitability—while their competitors hit it big.

Giles Brennand
Tjun Tang
Douglas Beal

Giles Brennand, Tjun Tang, and Douglas Beal are vice presidents and directors in the Hong Kong office of The Boston Consulting Group.

You may contact the authors by email at:
brennand.giles@bcg.com
tang.tjun@bcg.com
beal.douglas@bcg.com

To receive future publications in electronic form about this topic or others, please visit our subscription Web site at www.bcg.com/subscribe.

© The Boston Consulting Group, Inc. 2005. All rights reserved.

THE BOSTON CONSULTING GROUP

Amsterdam
Athens
Atlanta
Auckland
Bangkok
Barcelona
Beijing
Berlin
Boston
Brussels
Budapest
Buenos Aires
Chicago
Cologne
Copenhagen
Dallas
Düsseldorf
Frankfurt
Hamburg
Helsinki
Hong Kong
Houston
Jakarta
Kuala Lumpur
Lisbon
London
Los Angeles
Madrid
Melbourne
Mexico City
Miami
Milan
Monterrey
Moscow
Mumbai
Munich
Nagoya
New Delhi
New York
Oslo
Paris
Prague
Rome
San Francisco
Santiago
São Paulo
Seoul
Shanghai
Singapore
Stockholm
Stuttgart
Sydney
Taipei
Tokyo
Toronto
Vienna
Warsaw
Washington
Zürich

BCG

www.bcg.com

7/05