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The Path to Profit In China's Financial Sector

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The Path To Profit In China's Financial Sector

China's financial sector is on the move. Historically it has lagged behind sectors such as mobile phones and automobiles, in which deregulation and infusions of foreign investment came sooner, but China's banking, insurance, and securities industries are now claiming their share of world attention. In 2005, overseas financial institutions invested US\$14.2 billion in the Chinese banking sector (see Exhibit 1). By the end of 2005, many of the world's largest banks had chosen a partner—or, in some cases, more than one partner—for their entry into the growing Chinese banking market. These moves in the banking sector come alongside continuing investment in insurance, asset management, and securities.

Forecasts for the industry's growth potential abound: According to Booz Allen Hamilton estimates, China is set to become Asia's third-largest life insurance market by 2010 and the world's third-largest financial market overall by 2015, behind Japan and the United States.

While impressive, such estimates for the midterm should not be surprising, given China's recent emergence as the world's fourth-largest economy and its potential to overtake even the Japanese economy by 2015 to become the world's second-largest, behind the United States.¹ After all, financial services are the lifeblood of any economy, ensuring that payments can be made between buyer and seller and matching those who have capital with those who need capital.

Although the potential is large, the market will see fierce contests among global competitors, working through joint ventures, minority stakes, and wholly owned subsidiaries, and much larger and increasingly ambitious and confident Chinese institutions. Within such a diverse, large, and fast-changing market, the winners will be those who seek out the most attractive opportunities for themselves as institutions. Winners will need to go behind the headlines on growth markets to identify those distinct opportunities where they can earn an attractive return. This in turn will require a deep understanding of the underlying drivers of market

opportunity and the path to earning a profit, based on a sober assessment of market conditions and companies' own capabilities.

Exhibit 1

Foreign Strategic Investment In Chinese Banks Announced In 2005

	Price Paid (US\$ Million)	Strategic Investors
Bank of China	\$1,600	Royal Bank of Scotland
	\$1,500	Merrill Lynch and Li Ka Shing Foundation
	\$1,500	Temasek ⁽¹⁾
	\$500	UBS
	\$75	Asian Development Bank
	\$5,175	
China Construction Bank	\$2,500	Bank of America
	\$1,500	Temasek
	\$4,000	
Industrial and Commercial Bank	\$2,580	Goldman Sachs ⁽²⁾
	\$1,000	Allianz
	\$200	American Express
	\$3,780	
Huaxia Bank	\$225	Deutsche Bank
	\$104	Sal Oppenheim
	\$329	
Bank of Beijing	\$215	ING
	\$59	IFC
	\$274	
Bohai Commercial Bank	\$123	Standard Chartered
Tianjin City Commercial Bank	\$120	ANZ
China Minsheng Bank	\$106	Asia Financial Holdings ⁽³⁾
Shenzhen Development Bank	\$100	GE Consumer Finance ⁽⁴⁾
Nanjing City Commercial Bank	\$87	BNP Paribas
Hangzhou City Commercial Bank	\$78	Commonwealth Bank of Australia
Total Investment	\$14,172	

Notes: 1) Original agreement to purchase 10% of BOC in Aug. 2005 limited to 5% by Central Bank. 2) Cooperation memorandum announced Aug. 2005 and definitive agreement reached Feb. 2006. 3) Wholly owned by Temasek. 4) Transaction is subject to approval by Chinese regulatory authorities and SDB's shareholders.

Sources: China Economic Net; China Daily; The Banker; People's Daily; China Economic Review; Business Week; International Herald Tribune; Taipei Times; The Guardian; company Websites; press releases; Booz Allen Hamilton analysis.

1 National Bureau of Statistics of China

I. The Underlying Drivers of Market Opportunity

Distinct Challenges and a Clear Overall Direction

China's challenge is to develop a financial sector of the right size and—more important—the appropriate diversity and capability to match and support the growth of the broader economy and society. Today, bank financing provides 85 percent of corporate funding, and domestic capital markets are underdeveloped. This limits the ways in which corporate customers can raise financing, and it means that institutions and individuals alike have a narrow choice of investment vehicles in terms of risk profile, time horizon, and liquidity. Consumer credit, too, remains relatively underdeveloped, accounting for less than 10 percent of total lending in 2004. This is despite the rapid growth that has brought consumer credit to five times the level it was in 2000. Indeed, many consumer credit markets, such as credit cards, will remain smaller than those of countries such as Korea and Taiwan over a five-year time horizon, despite the high growth rates that are likely. The reason for this is that Chinese banks have traditionally operated by channeling consumer deposits into corporate lending to state-owned enterprises.

A more diverse and capable financial system is needed to address the unmet needs of hundreds of millions of consumers and tens of millions of companies. The overall product opportunities are well-known to many, especially in consumer banking, where the risk-assessment challenges are more manageable than for small and medium-size businesses. For example, regulatory change is enabling growth in consumer credit markets such as mortgages, credit cards, and auto loans. At the same time, consumers' expectations are rising and consumers are asking more of their financial institutions. Emerging middle-class consumers are demanding higher service levels and more customized offerings, such as wealth management, financial planning, and the convenience of phone and Internet banking. There are many opportunities for ambitious, innovative financial institutions to meet these demands and build strong businesses over the midterm.

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Such business growth, however, cannot be considered in isolation from the governmental and regulatory context. In every major economy, the government plays an important regulatory and shaping role in the financial sector. While the extent and nature of this role varies between countries, it is always present. In China, even more than in other countries, the financial system is at the heart of supporting a strong economy and maintaining stability and confidence. The government needs to ensure that confidence in the financial system is maintained. It also needs to ensure that both the system's capabilities and its infrastructure are growing rapidly enough to meet the needs of the economy and then to take action where this is not happening. This can include the need to develop deeper and broader capital markets and a more effective financial infrastructure, as well as the need to enable the development of capabilities in individual institutions.

As a result, the financial institutions that succeed in China will combine insight into specific unmet customer needs with an understanding of how the broader economic and social context will shape priorities in the development of the financial sector. They will then find practical implementation solutions based on current market conditions, while building more sophisticated capabilities in the medium term. ICBC Jiangsu represents one example of this approach. Small and medium-sized business (SME) lending is well acknowledged as a significant unmet need. Increased financing opportunities for these companies will be an important enabler of further economic growth. However, poor accounting data and the absence of credit history makes good credit assessment difficult. ICBC is now making credit assessments based on the information in its SME customers' bank accounts, such as utility usage, tax payment, export and import volume, and cash flow. This allows lending with reduced risk, providing both profitable business for the bank and enabling more-rapid SME growth.

Capitalizing on the Underlying Dynamics

At an overall level, many of the market opportunities in the Chinese financial sector are well-known: individual life insurance, group life and pensions, credit cards, and wealth management, to name a few. Success, however, requires going beyond the obvious to understand the underlying market and policy dynamics that are driving the opportunity; the specific nature of unmet customer needs; the constraints on customer choice; the challenges in delivering an effective solu-

tion; and how a differentiated approach could create a sustainable advantage and a profitable business. Digging down to the fundamentals may also lead to the discovery of latent opportunities that others may miss in the rush to capitalize on the headline market opportunity. Discussion often centers on serving China's emerging middle class in the more affluent cities such as Shanghai and Beijing. These consumers do offer sizeable opportunities—though many competitors are vying for their business. The examples that follow shift the focus elsewhere and are not for everyone, but they serve to illustrate the wide diversity of opportunities that a country with the scale of China can offer.

Banking For Everyone: Amid all the talk of credit cards and wealth-management offerings, it is important to remember that income levels vary widely across China. While Shanghai enjoys per-capita GDP levels of more than US\$6,000, levels in the poorest provinces, such as Anhui and Guizhou, are nearly one-tenth of this number. In urban areas, the average income of the poorest 20 percent is less than one-twentieth of the average income of the richest 20 percent. In this environment, meeting customers' banking needs means very different propositions for different segments. Additionally, an increasingly important government priority is to ensure that the benefits of economic development are spread more evenly, within urban centers and between urban and rural areas. Access to banking services is typically seen as a basic necessity, even as a right, in countries around the world. Whatever the economics of serving the poorest customers, the government will support measures that ensure access to banking services to lower-income groups, even as many banks focus on wealthier clients. Institutions that can develop cost structures and propositions that fit these needs will have a chance to prosper.

One way to achieve this objective may be to harness the technology already in the hands of many of the less-wealthy Chinese consumers: mobile phones. There were 390 million mobile phones in use in China as of December 2005. These provide platforms for information, communication (via phone banking), and potentially even payment transfer between phone account balances. Many of the poorest people also have access to the Internet and thus to Internet banking through the use of shared access in village kiosks.

Financial institutions' focus on profitability and profitability management is increasing.

Another approach may be to further develop the initiatives that China has already undertaken in micro-finance. Micro-finance banks, such as Bank Rakyat Indonesia (BRI), have built profitable businesses making loans of US\$50 to US\$100 in Indonesia. BRI, which listed successfully in 2003, has nearly 4,000 low-cost branches across the Indonesian archipelago that are often little more than huts. In India, ICICI Bank, one of that country's most successful private-sector banks is building a business enabling other institutions that are focused on micro-finance to implement a similar approach. ICICI currently has assets of US\$265 million and 1.5 million customers in this line of business.

Addressing The Needs Of An Aging Population: China's population is aging rapidly, yet there is no comprehensive pension system in China. According to one forecast, the number of people under 40 may already have peaked at 800 million and will decline by one-third, or 250 million, over the next 20 years. By contrast, those over 40 will grow in number by 270 million—by more than half—over the same period, with those 60 and older growing the fastest. Similarly, China's health and welfare systems are in crisis. Nearly 80 percent of the rural population and nearly half of the urban population have no health-insurance coverage. The old "iron rice bowl" welfare model, under which a state-owned enterprise provided cradle-to-grave care to its workforce and their families, is neither sustainable nor fit for the needs of an ever-wealthier population.

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Individual consumers, of course, are all too aware of the problems with welfare and pension provision. The lack of a social safety net is a significant factor in encouraging high household savings (currently at around 30 percent of GDP) and keeping consumption levels relatively low, despite government attempts to encourage greater consumption. Historically, this tendency to save has been reflected in high levels of savings through bank deposits. Now, however, prod-

uct innovation and deregulation are starting to drive demand in new areas. For example, 83 million people took out private health insurance in 2003 and the market is growing at 30 percent annually. Life insurance premiums more than doubled between 2001 and 2003, though growth has slowed substantially since. Much of the growth was driven by the availability of simple offerings called participating investment products, which provide a close substitute to bank deposits with a more attractive return, given their profit-linked nature.

The scale of the welfare and pension challenge means, however, that these changes in individual behavior are not sufficient on their own; nor can the government alone meet the challenge through a tax-funded system. The Chinese government is therefore pursuing a three-pillar approach that will combine the financial contributions of individuals, the government, and companies to put in place provisions for retirement and insurance against ill health. Such changes may in turn stimulate consumption, as consumers are more reassured about prospects for old age and save less. This will then make consumer credit more attractive to individual consumers.

Implementation requires a detailed set of policy choices on, for example, regulatory boundaries, investment portfolio guidelines for asset managers and life insurance companies, tax treatments, and the scope of competition. The result will be growth in both the individual and institutional pensions market, as well as the likely emergence of more active institutional investors in China and, as a result of the latter, the potential to diversify the sources of financing for many of China's corporations. One example of this is the recent move to allow insurers to invest up to 15 percent of their assets in infrastructure projects such as ports, highways, and railways. This change both allows insurers to earn higher returns on their portfolio, thus encouraging life insurance purchases and making long-term saving more attractive, and provides a new and diversified form of financing for important infrastructure projects that support continued economic growth. It also provides a demand for increasingly sophisticated asset-management capabilities that many overseas firms are well-placed to provide.

II. The Path to Profit

It is generally not the size of the market opportunity that stirs debate when assessing the potential of the China market; it is the prospects for profit. In any market, the ability to earn a profit rests on certain

preconditions. First, profit needs to be an important, motivating objective for the bulk of the players in that market. Second, these firms need the capabilities to manage for profit; finally, they need to enjoy a sustainable competitive advantage in delivering something that customer's value.

Focus on Profit and Profit-Management Capabilities

Historically, most Chinese financial institutions have not emphasized profit. State-owned enterprises have had—and in many cases continue to have—access to large amounts of low-cost capital from their banks. Interest rates and insurance premiums have been highly regulated, so individual banks and insurers have not had reason to develop pricing and profit-management capabilities. Customers have had limited choice, so there has been limited focus on customer value.

This situation has started to change. Financial institutions' focus on profitability and profitability management is increasing. Overseas stock market listings of minority stakes (for example, in Ping An Insurance and China Construction Bank), government policy announcements, and regulator initiatives to improve accounting and capital provisioning are starting to affect the behavior of individual Chinese banks and insurers. The purchase of stakes by foreign banks and insurers and the injection of overseas management capabilities will reinforce this trend.

At the same time, customers have more choices and competitive intensity is increasing, depressing profit margins. How this balance between profit focus and profit pressure plays out in individual sectors will determine what profit levels can be achieved. Particularly important will be how successful individual institutions are at building distinctive capabilities—often together with overseas partners—and translating these capabilities into a distinctive proposition that is relevant to specific customer segments.

Chinese regulators will remain keen to ensure that financial sector growth does not bring with it excessive bad loans.

In consumer banking, for example, there is a clear alignment around profit as an objective. Foreign banks ultimately need to earn a return on their investment. Regulators, too, see consumer banking as an oppor-

tunity for state banks to develop more profitable lines of business alongside corporate lending. The very intensity of competition, especially for more affluent customers in the wealthiest cities, will depress margins. Some banks will undoubtedly prefer short-term volume gain to profits. The surest route to profit will be a careful selection of customers and development of products based on a good understanding of risk, behavior, and pricing.

Most Chinese institutions today continue to lack these pricing and risk-selection capabilities that underpin profitability management. The information needed for customer and product line profitability is typically not readily available. Risk-based pricing, credit-risk assessment, and insurance-underwriting capabilities are also in the early stages of development. While this increases the risk of volume-driven strategies, it also offers substantial opportunities for competitive advantage and enhanced profitability to those who move quickly to build these capabilities, often with foreign partners. Speed of execution will be the key: The benefit will go to those who out-execute competitors in building these new capabilities.

In corporate lending, profit pressures will overall continue to be even greater. This is the legacy of large-volume lending to state-owned enterprises at interest rates that do not reflect a risk-adjusted cost of capital. While China has definitely embarked on the difficult process of restructuring unprofitable enterprises, governments—at the national, provincial, and municipal levels—will want to continue to manage this process carefully. For many state-owned enterprises, withdrawing bank credit too quickly or seeking to price in line with risks could tip the business into liquidation. This would bring with it further job losses and unemployment. These constraints will continue to weigh on bank actions and thus on business profitability.

Increasingly Supportive Regulatory Environment and Infrastructure

Profitability is also influenced by the development of supporting market infrastructure, such as credit bureaus, that can provide the information base for profit-based decision-making. In this arena, initiatives are underway at both the local and national levels. In 1999, Shanghai established a credit bureau that now has 2.5 million credit reports. PBOC, the central bank, is developing a nationwide bureau after starting in seven pilot cities. Data quality, however, remains an

issue by the standards of many developed markets. This means that individual banks will be able to gain advantage from additional in-house capability.

Chinese regulators will also remain keen to ensure that financial sector growth does not bring with it excessive bad loans, as banks compete to develop consumer credit businesses. The specter of Korea's credit card crisis in 2003 remains ever-present: Rapid expansion of credit card usage, as a result of aggressive competition between card issuers supported by government tax incentives and without shared use of consumer credit information, led to consumer default rates in excess of 15 percent. China experienced its own lesson in this area as well: When default rates in the Chinese auto-finance market soared to levels that may have reached 20 percent or higher in 2003, regulators strongly encouraged Chinese banks to slow lending growth. Another example is auto insurance: CIRC initially focused on licensing new entrants such as Da Di and Tian An in order to increase competition. When this resulted in aggressive price discounting that was not justified by the underlying risks, CIRC modified its approach and is now giving greater emphasis to appropriate provisioning of individual insurers and ensuring new products are appropriately priced to allow a profit.

III. Each Institution Needs to Find Its Own Path to Profit

The growth and diversity of China offers many distinct opportunities: opportunities to address the unmet needs of increasingly demanding consumers and companies; opportunities to build on deep-seated changes in industry boundaries and capital market structure; opportunities to innovate and manage for profit ahead of competitors. And the competitors are themselves increasingly diverse: local institutions, often with government shareholders, an overseas listing, and a foreign partner; and overseas institutions, many times with their own business and a stake in one or more Chinese partners.

Each financial institution is uniquely positioned and each will need to find its own path to profit. Success will require getting beyond the headlines of China's growth story to identify specific business propositions that meet market needs and build on distinctive capabilities. Success will then require out-executing competitors to ensure a competitive advantage that endures.

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