

Olympic Growth Retail Banking in China

Over the years, China has leveraged its liberalization policies and trade reforms to grow into one of the largest economies in the world. An average Gross Domestic Product (GDP) growth of around 9%, dynamic trade, high foreign direct investment inflows, and skilled manpower, have all played a crucial role in making China's economy prosperous.

The roaring economy has infused growth in various sectors, including banking. China's banking sector assets rose to 52.6 trillion yuan (\$7.32 trillion) in 2007 from 43.9 trillion yuan in 2006, the China Banking Regulatory Commission (CBRC) reported.

With the impending shift from corporate to retail banking, it is estimated that 30% of future growth and profitability will come from retail, small business lending and fee-based lending.

Domestic players and foreign banks are fighting tooth and nail to dominate the Chinese retail banking industry. While new banking avenues are boosting their morale, the fear of an overheated economy lingers.

This article examines the booming banking sector in China and takes a look at the players, products and prospects.

Supervising the Banking Sector

- ▶ China Banking Regulatory Commission (CBRC) - All Chinese banks are directly or indirectly overseen by CBRC. CBRC formulates regulations, assesses risks, protects the depositor interests, and curbs crimes in the sector
- ▶ People's bank of China (PoC) – China's central bank, responsible for the creation, maintenance, and implementation of monetary policies, foreign exchange, and gold reserves
- ▶ Policy Banks - Finance economic and trade development and state-invested projects. They are:
 - ▶ Agricultural Development Bank of China (ADBC)
 - ▶ China Development Bank (CDB)
 - ▶ Export-Import Bank of China (Chexim)

The Retail Space: Players

Chinese banks have been run by either the central or state governments. Until a few years ago, the banking sector had remained conservative in its approach.

Today's zooming economic growth coupled with wide-scale liberalization policies have thrown open numerous financial service options to the Chinese. As a result, the retail banking sector is witnessing a historical 25% increase in customers and accounts per annum.

The state-owned commercial banks control 53.2% of the country's total banking assets. In addition, China has numerous government-owned, second-tier commercial banks. The assets of twelve joint-stock commercial banks account to 13.8%, while city commercial banks have a 6.4% stake in the country's banking assets.

Post economic reforms and the World Trade Organization (WTO) agreement (December 2006), foreign private banks have been allowed to operate in China. The entry of foreign banks has had a positive effect on the competitive aspect of China's banking industry.

Experts feel that to reap early profits, foreign banks will need to enter into partnerships with local banks. This will reduce the time required to understand the market, provide an existing base of customers, and ensure quick insights into customer requirements.

Most major players have invested in domestic banks and simultaneously built their own franchises. Over 20 foreign banks are now setting up operations in China.

Demand for Retail Banking Products: A Snapshot

There is no better way to explain the potential of retail banking in China than to study the growth in retail banking products.

- ▶ **Bank Cards** – The Chinese people had accumulated 1.5 billion bankcards by the end of 2007 (a growth of 32.6% for the same period of the previous year, according to the People's Bank of China).
- ▶ **Deposits** – The emerging middle-class is making use of banking products like never

before. As a result, the renminbi deposits among the country's financial institutions reached 40.49 trillion yuan (5.70 trillion U.S. dollars) in February 2008.

- ▶ **Loans** – The opening up of the Chinese economy has enabled its people to gain easy access to loans. The People's Bank of China reported that the value of renminbi loans in financial institutions accounted for 27.22 trillion yuan, up 15.73% (in February 2008) compared with the same period last year.
- ▶ **Mutual Funds** – The mutual funds sector plays a significant role in the Chinese retail banking sector. It is estimated that the 350-plus funds control more than \$450 billion in assets.
- ▶ **ATMs** – Local banks have a decisive advantage over foreign lenders in the location and number of ATMs. To meet the country's growing demand for effective banking services, Chinese banking institutions have increased the withdrawal limit from ATMs to RMB 20,000 from RMB 5,000, after approval from the Mainland Banking Regulator.

What's Next in Chinese Retail Banking?

The domestic banking sector is now under tremendous pressure to come up to international banking standards due to stiff competition from foreign banks. Towards this, domestic banks are sharpening their acumen in every aspect of banking – from customer relationship management to banking technology. However, Chinese banks also need to attract the vast population of unbanked customers, provide innovative products for different sections of people, and incorporate efficient risk management processes. What follows here are some key future trends in the retail banking scenario in China.

An Emerging New Breed: The Middle-Class

With an increase in private banking services for the highly affluent Chinese population, the banking sector also needs to brace itself for the emerging high net worth individuals in the middle-class.

Effective products and exceptional customer service are key to retaining this emerging sector. The significance of this population for the banking sector is reinforced by the fact that the Chinese economy is creating a huge number of the young and affluent.

Reduction in Non-performing Loans

Slow pace of reforms in the sector, transition to a market-oriented economy, and absence of internal management processes have resulted in a large build-up of non-performing loans (NPLs) in domestic banks. Recently, dedicated reforms by the government have brought down the non-performing loan ratio from 23.6% five years ago to 6.7%.

To reduce NPLs, the government has set up four Asset Management Corporations (AMCs). Banks can set up joint ventures with these AMCs and buy out NPLs. As a result, investors can gain entry into the Chinese banking sector while reviving bad assets, and bringing in cutting-edge technology and effective managerial skills. Some of the largest international financial services groups Morgan Stanley, Citibank, and Merrill Lynch have taken this route.

Rural Banking Services

As in the case of most developing countries, China faces the challenge of a rising gap in the incomes and living standards between its rural and urban populace. In a bid to uplift its rural sector, China is promoting investments in its rural sector and has allowed foreign investors to set up banks in rural sectors toward this objective.

Financial inclusion and rural banking could present the next big opportunities for banks in China. One of the key challenges in extending access to financial services in under-served rural markets has been the high 'cost to serve'. This includes the costs associated with origination; supervision and continuous monitoring that are incurred in these markets. Increasingly, technology is being viewed as key to a low-cost banking strategy for the rural market. Creative technology solutions can be tailored to the unique and often challenging needs of remote markets.

The two key business challenges that must be overcome to extend banking to the rural and poor population are elimination/ reduction of cash handling expenses and low cost delivery channels. A sound technology initiative built into the overall business strategy can help banks address both the challenges and not only contribute to the economy by bringing these individuals into the financial umbrella but also create a profitable parallel target segment. To take banking to the unbanked, banks must adopt business process change and implementation of new technology in tandem.

Growth in E-Banking

As retail banks compete for the maximum number of customers, it becomes vital to provide customers with multiple options for payment. China's major commercial banks signed up 75 million online banking customers by the end of 2006. In 2007, the number of online banking users was estimated at 117 million, as the Chinese electronic payment transaction value exceeded \$13.3 billion for the first time.

Some factors that drive the online banking industry are:

- ▶ China's booming stock market
- ▶ Ever-expanding demand for easy-to-use banking and online payment services
- ▶ Substantial wealth that translates to higher banking transactions
- ▶ Increasing number of internet and mobile phone users

While technology has played a major role in enabling online banking, further investments should enable customers to take effective advantage of IT – interact seamlessly with support staff, provide a single dashboard through which they can view different products and services and provide high security and increased speed. All this will be possible even as the cost for banks is reduced.

In addition, banks need to address issues of technological incompatibility, slow transaction processing, internet crimes, and poor accessibility to boost online banking services in future.

Mobile Banking

One of the countries with the best penetration of mobile phones among the population, China's increasing wealth and need for better personal banking has triggered a growth in mobile banking services. With consumers increasingly accessing the Internet through third generation mobile phones, Chinese banks need to leverage this opportunity to increase revenues, reduce operational costs, and attract new customers.

To improve the penetration of mobile banking services, Chinese banks can look into:

- ▶ Introducing reasonable service charges
- ▶ Providing exceptional user interfaces and customer support
- ▶ Increasing security measures
- ▶ Complying with international financial regulations
- ▶ Spreading awareness: For instance, by using PDAs or mobile applications, bank executives can provide services to unbanked customers who lack access to computers and self-service channels

In the current scenario gaining access to mobile phones is easier than accessing computers and broadband services. As a result, the mobile banking channel has great potential to become a major service channel for banks in the near future.

Enhancing Back-office Operations

To withstand stiff competition and leverage new market avenues, Chinese banks require state-of-the-art back office processes. Automation and consolidation of back-end and front-end processes will enable banks to provide customers personalized services.

Factors such as globalization and technological advancements are changing the way customers operate their financial accounts. A bank needs to provide multi-entity, multi-currency and multi-language functionality across time-zones. Customers should be able to make transactions and view their account information across any bank branch.

Rapid core system transformation is crucial for domestic banks to compete with foreign players. These core systems should be implemented in short durations and should provide the complete range of banking products – deposits, loans, delivery channels, point-of-sale (POS) networks, etc.

The Roadmap for Foreign Banks

For foreign banks to grow in China, they need to prioritize their operations and utilize their world-class customer management services and risk-management practices effectively.

Foreign banks could look into the following strategies as they enter the Chinese banking market:

- ▶ Targeting affluent customers – A fifth of Asia-Pacific's millionaires live in China. However, Chinese banks have not been able to provide effective wealth management services to their affluent class. Foreign banks thus find this sector highly profitable, as they account for over 50% of retail banking profits.
- ▶ Selling Credit Cards – Estimates reveal that the number of debit cards exceeds credit cards by a large margin: In 2007, the Chinese had 1.41 billion debit cards as against 90.26 million credit cards. As the Chinese are still not comfortable with the idea of credit, foreign banks can effectively market their credit card products.
- ▶ Mortgage – Liberal policies and increasing incomes are driving Chinese to own real estate. However, Chinese banks have not been able to provide best-of-breed mortgage fund options. Foreign banks are thus certain that this sector will grow to be their main source of revenue in China.
- ▶ Reaching out to the rural sector – In a bid to reduce the gap in income between the rural and urban Chinese, the government is encouraging the establishment of bank branches in rural China. HSBC has recently opened a new branch in rural China. Over the years, this could be a sector of great potential for foreign banks.

Domestic Players: Banking on Technology

Facing competition from foreign banks, needing to streamline post-M&A operations, and a growing customer-base make it essential that domestic banks focus on technology.

State-owned banks are paying attention on data consolidation across various branches. As a result, IT is likely to play a more effective role in Chinese banking in channel integration, risk management systems, management and accounting systems, and implementing data analysis and data mining. Heavy investments in technologies like WiMAX, 4G and IPv6 are providing Chinese banks top-end processes and systems that could give stiff competition to their European and American counterparts.

However, it is necessary to understand the challenges involved in using cutting-edge technology. IT infrastructure in Chinese banks has been unable to match the growth in bank cards. The systems also face safety concerns. With worries of a breakdown in IT banking infrastructure during the Olympics, the Chinese government is ensuring that banks upgrade their IT systems to match increased bank card usage and online transactions.

Conclusion

With the world's largest populated country reviving its conservative banking system, it is safe to assume that the opportunities and challenges for banks – domestic and foreign – are numerous.

Huge foreign investments, enthusiastic domestic and international banking players, and implementation of cutting-edge technology are some of the factors that will push the Chinese banking sector to the top. A combination of skilled manpower, top-end IT infrastructure, reduced government intervention, and a large array of banking products will make the Chinese banking sector a high revenue generator.

It is equally important that the government and banks analyze the dangers of an overheated economy and develop processes to fight unpredicted economic crisis.

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