# PREFACE

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China’s accession to the World Trade Organization (WTO) marked a new era in the global economy. For the first time after more than forty years in a controlled market, China took the step towards fully opening its doors to foreign trade partners. Step by step, these partners will establish their bases in China, enjoying equal access to one of the biggest and fastest growing economies in the world.

This is both good and bad news for the Chinese banks. On the one hand, this market stimulus will intensify economic growth, opening more opportunities for them. On the other hand, the Chinese banking industry has limited internal capabilities and is still heavily burdened by massive non-performing loans. Foreign competition is hardly welcomed.

With the market transforming, fierce competition looming, and significant opportunities ahead, China’s banking industry is at a crossroads of change. Standing still is not an option as institutions confront both the onslaught of new competitors and the equally daunting challenge of finding the right direction for themselves.

This paper discusses the uncertainties facing the Chinese banking industry and identifies some strategic priorities that banks must address. Although the paper’s primary audience is the senior management of Chinese banks, the insights may be equally enlightening to foreign banking executives who contemplate entering the Chinese market. Drawing on experience from other markets that have undergone sweeping banking reforms, the paper will also explore five plausible competitive scenarios in China. Banking players are urged to monitor regulatory directions and market forces closely to gain early insight into the changing landscape and to set their priorities.

The paper is based on The Boston Consulting Group’s (BCG) broad experience in advising banking clients in China and globally, supplemented by publicly available information. Special thanks go to the project team, led by Sean Jiam, and to many BCG colleagues who developed much of the thinking in this report. They include Min Cao, Jie Feng, Joseph Kwok, Sin Beng Ong, Connie Yu, Simon Yuen, and Vivian Zheng. We would also like to thank the BCG officers who contributed their insights: Thomas Achhorner, David Gilmour, Jim Hemerling, David Michael, Roman Scott, Peter Wetenhall, and John Wong.

“China Crossroads: Competitive Priorities for Chinese Banks” provides an in-depth look at the Chinese banking industry at a momentous time in its evolution. We welcome your feedback and encourage you to contact us.
Executive Summary

Far-reaching reforms have rippled through the competitive landscape of China’s banking industry. The country’s entry into the WTO will likely catalyze further change. Chinese banks need to re-evaluate their business models, set clear strategic agendas for the future, and strengthen their internal capabilities in order to survive in a new competitive order.

Set against this context, the goal of this paper is to set out plausible scenarios for future competition, and to define the keys to success. The paper also seeks to provide a prescriptive strategic agenda for senior Chinese banking executives so that they might better identify and develop the capabilities they will need. Obviously, the prescription must be tailored to the specific aspirations, heritage and condition of each institution.

China’s financial regulators, over the past two decades, have set in motion a series of market-oriented reforms that have edged the banks closer to true competition. The country’s entry into the WTO will further lower barriers into its banking markets. Foreign institutions are already poised to enter, attracted by strong growth possibilities. Some Chinese banks are also raising the competitive bar, having learned from international practices and the disciplines of free markets.

What remains unclear is the timing and pace of reforms, which makes it difficult to forecast the future shape of the financial services industry with any certainty. However, based on developments in other markets around the world, several scenarios can be identified for how the competitive landscape might evolve.

Five Scenarios For Future Competition

Banking markets can be described along two dimensions: product scope and geographic reach. Within these dimensions exist five competitive structures that warrant analysis for a better understanding of China’s future banking landscape.

- **Specialists Rule**: Market specialization across products
- **Era of the Warlords**: Geographic fragmentation
- **Blossom of a Hundred Flowers**: Market specialization and geographic fragmentation
- **Any Model That Works**: Selective market specialization and fragmentation
- **War of the Giants**: National universal banking

Clearly, it will take several years for the new landscape to form and stabilize. In the meantime, Chinese banks must arm themselves with the capabilities to compete regardless of how it actually takes shape.

Key Priorities for Chinese Banks

BCG recommends that Chinese banks focus on five priorities to strengthen their competitive capabilities:

- **Priority #1**: Strengthen organization and corporate governance
- **Priority #2**: Develop a segmented service capability
- **Priority #3**: Build a strong risk management framework and culture
- **Priority #4**: Maximize operational efficiency
- **Priority #5**: Use partnerships for competitive advantage

Key Success Factors For Implementation

BCG suggests six principal factors for successful implementation of these initiatives:

A. Develop a compelling vision for action
B. Have visible, committed leadership willing to tackle tough issues
C. Use rigorous project management techniques
D. Actively obtain the support of key stakeholders
E. Fill gaps in capabilities and culture
F. Put in place the right support infrastructure

Preparing For The Road Ahead

Over the past few years, Chinese banks have successfully navigated a difficult environment. However, the roadblocks will now be larger and the stakes higher. There are three practical steps that the banks can take to prepare for the future:

1. Make sure the entire senior management team realizes the imminent challenges ahead, and feels the urgency to acquire the capabilities needed to deal with them

2. Develop a realistic plan to move beyond the crossroads

3. Pursue implementation of the plan with appropriate vigor and flexibility
China today is one of the largest banking markets in the world. Total bank assets amounted to US$1.9 trillion in 2001, comparable to advanced markets such as the United Kingdom, Germany, and France. Assets have been growing at an annual compounded rate of some 15% for the past five years. The level of bank assets relative to gross domestic product (GDP), at over 160%, is also among the highest in the world. Sustained growth and the long-term potential of the Chinese market, set against a stagnant global economy, is attracting many foreign banks.

The rapid growth of the Chinese banking sector over the last decade has been assisted by a relatively stable macroeconomic environment and Chinese households’ high propensity to save. The high degree of bank intermediation also reflects the relative underdevelopment of Non-Bank Financial Institutions (NBFIs) and the securities market in China. While large, China’s banking system suffers from a large overhang of non-performing assets, conservatively estimated at 25% or more of total loans. Still, despite mounting internal problems, the Chinese banking industry is expected to grow in global importance.

Exhibit 1.0.1
China’s Banking Market — Sizeable and Growing Fast

<table>
<thead>
<tr>
<th>Bank Assets Growth Rate (CAGR 1997-2002)</th>
<th>GDP USD Bn</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%</td>
<td>300%</td>
</tr>
<tr>
<td>15%</td>
<td>250%</td>
</tr>
<tr>
<td>10%</td>
<td>200%</td>
</tr>
<tr>
<td>5%</td>
<td>150%</td>
</tr>
<tr>
<td>0%</td>
<td>100%</td>
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<tr>
<td>-5%</td>
<td>50%</td>
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<td>-10%</td>
<td>0%</td>
</tr>
<tr>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

1.1 Reforms underway: shift occurring to market-driven environment

The transformation of China’s financial sector began in earnest around two decades ago, commencing with regulatory reform and culminating with market deregulation. There are five key stages:

Pre-1991: Building of the banking infrastructure
In 1984, People’s Bank of China (PBOC) relegated the lending business to the newly established state banks, marking the creation of the modern financial system. Over the following decade, the PBOC built on this foundation, gradually introducing legal structures and encouraging interbank transactions.

1991 to 1995: Acting as cashiers to economic transformation
To preserve control over capital allocation during the transformation of the economy, the state banks maintained their traditional role as state treasurers, directing capital from households to both State-Owned Enterprises (SOEs) and emerging shareholder enterprises. Only toward the end of this period did the banks themselves recognize the need to become more profit-driven. Subsequently, they applied more rigorous risk management measures.

1996 to 2000: Embracing market reforms
During this period, through a series of reforms, policy-mandated lending gave way to a more market-driven form of lending. Economic reformers recognized that effective commercial credit disciplines were crucial to appropriate allocation of capital among newly restructured enterprises in all sectors of the economy. At the same time, interest rate deregulation and limited entry of foreign institutions catalyzed competition. These changes prompted the introduction of increasingly diverse products, such as consumer financing.

2001 to 2005: Preparing for free market competition
In late 2001, China entered the WTO. This momentous step is expected to create a more level playing field for both domestic and foreign banks. Under its WTO commitments, China agreed to liberalize its commercial banking sector in a phased approach. In anticipation of competition, the authorities continued to implement aggressive plans to enhance the strength of domestic players. Accordingly, the authorities are expected to float ownership of the state banks within 5 years, leading them toward full independence.

Exhibit 1.1.1
Transitioning Toward Market-Oriented Environment

<table>
<thead>
<tr>
<th>Stage 1: Building of the banking infrastructure</th>
<th>Stage 2: Acting as cashiers to economic transformation</th>
<th>Stage 3: Embracing of market reforms</th>
<th>Stage 4: Preparing for free market competitions</th>
<th>Stage 5: Free market competition</th>
</tr>
</thead>
<tbody>
<tr>
<td>PBOC relegated its lending business to the newly established state banks</td>
<td>Establish national interbank market</td>
<td>Consumer lending promoted</td>
<td>Lending rate further deregulation?</td>
<td>Full operations of foreign banks will be allowed</td>
</tr>
</tbody>
</table>

Source: Literature search; BCG analysis
2006 and onwards: Free market competition

Beyond 2006, product and geographical limitations on foreign banks will be completely phased out. The Chinese banking industry will for the first time follow the rules of true open markets.

*                         *                         *

1.2 Market is large but still in a nascent and emerging phase

Despite its size, the Chinese banking industry remains at an embryonic stage of development. Its key characteristics are laid out below:

- **The Chinese banking market is significant and evolving**
  - Large market, dominated by corporate banking
  - Healthy growth expected in retail banking
  - Market is more geographically fragmented than in Europe

- **Players are heterogeneous, but all have profitability problems**
  - Top four state-owned banks dominate overall market
  - Significant opportunity for profitability

**Exhibit 1.2.1**

**Solid Industry Growth Likely To Continue In Medium Term**

<table>
<thead>
<tr>
<th>Year</th>
<th>RMB Tr</th>
<th>Policy driven</th>
<th>Historical trend</th>
<th>Global comparison</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td></td>
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<td></td>
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<td>1998</td>
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<td>2005</td>
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</tbody>
</table>

- **Market conditions are primitive and immature**
  - Simple, basic products are the norm
  - Corporate governance still insufficient
  - Inadequate capabilities and weak core infrastructure
  - Regulatory environment still developing

**The Chinese banking market is significant and evolving**

- **Large market, dominated by corporate banking**
  The legacy of state-directed lending created within the state-banks a large stock of corporate loans worth some US$760 billion, making up around 91% of their total loan portfolios. However, recent moves toward market reform have slowed growth in corporate lending. Consumer loans are now driving growth in the state banks’ loan portfolios.

- **Healthy growth expected in retail banking**
  In contrast to weak growth in corporate lending, consumer credit has grown by around 114% per year over the last three years. (Exhibit 1.2.2) Despite strong growth, retail lending represents only about 9% of the state banks’ loan portfolios, a small share compared to developed markets such as the U.S., where retail lending often occupies nearly half of banks’ credit portfolios. Strong growth in consumer lending is forecast to continue, fueled by the following factors:

  - **Government policies**: To maintain the growth momentum of the economy, the government has adopted supply side “pull” macroeconomic policies by stimulating private consumption and encouraging consumer lending. Accordingly, consumer demand is anticipated to rise from its current low level. (Exhibit 1.2.3)

  - **Expansion of customer base**: Broad-based economic development is expected to create a growing contingent of urban middle and upper classes with strong purchasing power and sophisticated needs. According to the Economist Intelligence Unit (EIU), only 6% of Chinese households had disposable incomes of over US$3,000 in 2000. By 2006, this figure is expected to increase more than six times to 40%.
As this happens, the emerging rich will likely demand a wide range of banking products such as mortgages, automotive loans and other credit facilities, thereby driving the overall growth of consumer credit.

Lower risk profile: In general, consumer loans are more transparent than corporate loans and default rates are lower. As consumer credit information develops, and as banks are mandated to improve their asset quality, they will likely continue to diversify into the lower-risk consumer loans business.

Market is more geographically fragmented than in Europe
China contains many regional markets. Economic development has run at different rates, and the high variance in incomes across cities reflects this uneven growth. Income in the coastal regions, for example, is markedly higher than in inland areas. (Exhibit 1.2.4) Further, the nature of industry also tends to differ by region. Banks, particularly foreign entrants, need to be aware of differing customer needs and different banking economics in each area, and adapt their business models appropriately.

Players are heterogeneous, but all have profitability problems
- Top four state-owned banks dominate overall market
In terms of market share, the four state banks dominate, collectively controlling more than 85% of bank assets. The remaining market is highly fragmented with regional joint-stock and foreign banks making up some 15% of the market. (Exhibit 1.2.5) The industry has three major groups of commercial banks with different characteristics:

- **Major state banks**: These institutions, with their extensive branch and distribution networks, represent a major force in mass-market retail banking. Their geographic dispersion has created significant decentralization. Head offices often have limited knowledge and low operational control over activities of provincial branches.

- **Regional joint-stock banks**: These banks focus on large urban centers and coastal regions, with an emphasis on corporate banking. They generally practice stricter controls over risk and are more cautious in extending their balance sheets. Strong local networks and organizational flexibility are their key advantages.

- **Foreign banks**: Existing restrictions currently limit their business scope. Relatively more active in project financing.

**Significant Opportunity for Profitability Improvement**

As a whole, Chinese banks lag behind their foreign counterparts along performance measures such as return on capital and return on assets. (Exhibit 1.2.6) State banks, handicapped by years of mandated lending, perform the worst.

Clearly, Chinese banks must bridge significant capability gaps if they are to compete successfully against foreign institutions.

**Market conditions are primitive and immature**

The Chinese banking market is still evolving with the following characteristics:

- **Simple, basic products are the norm**
  Product innovation has historically been curtailed by stringent regulatory restrictions. The market has also been sheltered from competition. Key customer profiles have been homogenous (state-owned enterprises) and their needs basic, with little impetus for sophisticated products.
Consequently, over 90% of the four major banks’ revenue is derived from interest-related income, which generally yields lower risk-adjusted returns than fee-based products. Fee-based services account for less than 5% of revenue. This ratio is considerably lower than in developed markets such as the U.S. and Japan, where fee- or commission-based services make up a much higher percentage of revenue. (Exhibit 1.2.7)

Further, regulators often obstruct product development. For example, to introduce a new credit card, new product specifications such as terms, rates and features have to be submitted for approval. These specifications can be disclosed to other players, and the new products are often copied even before they are rolled out into the market. This significantly diminishes the strategic advantage of product innovation, and lowers the incentive to invest in this capability.

- Corporate governance still insufficient

Historically, policy-driven environment and state-controlled ownership have limited development of corporate governance in China’s banking industry.
Management decisions have been driven by policy mandates, and initiatives to promote accountability have been rare. Gaps in corporate governance remain widespread: unclear roles and responsibilities, ineffective performance evaluation and poor incentives are common practice.

As more joint-stock banks seek public listing and as state banks undergo “commercialization,” responsible corporate governance is becoming an imperative.

- **Inadequate capabilities and weak core infrastructure**
  Most Chinese banks have not yet developed capabilities that are commonly found in more developed countries. Concepts such as customer segmentation and customer relationship management are only starting to gain recognition. Fundamental infrastructures, such as information and risk management systems, are sorely inadequate.

- **Regulatory environment still developing**
  Regulations often focus too much on basic input or compliance issues, rather than on more complex process issues or outcomes.

  Important questions such as “Are there appropriate information, skills or tools to achieve compliance?” or “What level of capital adequacy, return of capital or non-performing loans has the bank achieved?” are rarely addressed in the current environment. This incomplete framework often reduces the effectiveness and impact of regulations.

  Moreover, unclear, inconsistent, and sometimes seemingly random interpretation of regulations adds to the uncertainty, reinforcing the view of many foreign players that they should tread carefully.

- **Reforms are creating a market-driven environment**

- **Customers will be more demanding as the Chinese economy progresses**

- **Threats loom from foreign players, post-WTO**

### Reforms are creating a market-driven environment

- **Intensifying competition from capital markets**
  One of the side effects of reform has been the increasing volume of capital raised through equity and bond issues. This has threatened the commercial banks, since credit borrowing is no longer the only avenue to raise funds. Financial disintermediation poses a real threat to them in retaining and developing their corporate client base.

  Banks face similar challenges in securing their supply of capital. Households previously had almost no choice but to place their money into saving accounts. But current options include stocks, unit trusts, and insurance vehicles. These alternatives often offer more attractive terms and flexibility, and are competing directly with the banks for capital.

- **Path towards commercialization demands fundamental changes at state banks**
  The state banks started as institutions whose purpose was to supply credit to state-owned enterprises. But they now need to tackle unique problems associated with their pasts. The authorities have begun the process of “commercializing” these banks, hoping to reduce and eventually eliminate their dependence on the government.

  This commercialization has included removal of mandatory quotas for disbursing loans, which has created incentive systems that make banks accountable for their loan decisions and for extending their customer bases.

  While these developments are positive, state banks are still burdened with massive non-performing loans (NPLs), which in turn inhibit full commercialization. The government began to address this problem in 1999, transferring RMB 1.4 trillion of bad loans from balance sheets of the four state banks to four newly created Asset Management Corporations (AMCs).

### 1.3 Three key challenges facing the industry

Major structural changes are reshaping the Chinese banking landscape today, posing three challenges to all players.
Despite these measures, non-performing loans of the big four state banks still totaled RMB 1.8 trillion, or a staggering 26.6% of their loan portfolios, as of September 2001.

- **Interest rate deregulation**

The first stage of interest rate liberalization started in 1996, when restrictions on the interbank lending rate were relaxed. Gradual deregulation in other areas followed, such as in bond repurchase rates, treasury-bidding practices, and foreign currency rates. China’s accession to the WTO is expected to introduce another round of deregulation. The ceiling for loan rates should be liberalized in two to three years, while deposit rates will be fully deregulated in five to ten years.

Since more than 90% of revenue is generated from interest income, ongoing deregulation is likely to have a profound impact on the way banks think about their businesses. They will experience significant downward pressure on interest margins, forcing them to explore new revenue lines. Similar interest rate deregulation in Hong Kong several years ago intensified competition in the mass affluent and credit card markets for new revenue sources.

At the same time, interest rate deregulation will likely bring more volatility to the money markets. Banks will have to introduce more effective risk management practices.

**Customers will be more demanding as the Chinese economy progresses**

The rapidly improving economy is changing the needs of banks’ customers on two fronts. On the corporate side, increasingly multilateral and global trading relationships will generate more complex financing needs, such as trade guarantees, foreign exchange, and subsidiary capital management. On the consumer front, increasingly affluent and demanding customers will force change in both products and distribution channels.

- **Fee-based services are necessary to remain competitive**

Expansion into fee-based services has been a natural evolution in banking industries around the world. In China, the competitive environment in the banking market has engendered the need for these services. For example, the Bank of Communications recently developed a personal financial services program, which provides customers with customized financial plans for a fee of between RMB 200 and 1,000.

**Exhibit 1.3.1**

**Chinese NPLs Significantly Higher Than International Levels**

![Exhibit 1.3.1 Chinese NPLs Significantly Higher Than International Levels](chart)

(1) Data as of year ended 2000

Source: “Top 1000 World Banks 2001” report by The Banker; Almanac of China’s Finance and Banking 2001; EIU; BCG analysis
Customers want “Universal Banks”

Closely related to the strategy of developing more diverse revenue streams is a trend toward “Universal Banking,” which provides one-stop shopping for customers and meets their various needs with a broad portfolio of products.

In China, customer demand is paving the way for universal banking. Emerging consumer segments are already providing opportunities for cross-selling financial products. The rapid growth in mortgages, for example, provides an opportunity to bundle other products such as insurance and wealth management services. Direct spending through bankcards reached RMB 128 billion by 2001, and is expected to grow as banks standardize their cards. Banks can also leverage opportunities from existing bankcard distribution and introduce additional services.

While customers are demanding that banks provide a wider range of products, regulations prevent banks from venturing too far into other offerings such as insurance and securities. These restrictions reflect a broader concern that regulators may not have the ability to monitor such diverse institutions. However, major banks are bypassing these obstacles through alliances that enable them to offer cross-sector products and services. (Exhibit 1.3.2.)

Apart from the demand for more product variety, technological advances have also created demand for more convenient channels with broader coverage. Online banking and ATMs are examples of these emerging channels.

Threats loom from foreign players, post-WTO

Foreign banking institutions are currently restricted in terms of product offerings and geographical scope in China. However, under its commitment to the WTO, China has agreed to phase in liberalization. This approach will give foreign banks limited access to the Chinese domestic market in the near-term, and complete access in the longer term. In anticipation of this, foreign banks have already begun to aggressively establish representative offices and branches in China.

Experience suggests that new entrants try to “cherry-pick” attractive segments, such as high net worth customers...
Exhibit 1.3.3
Foreign Competition Already Waiting Round the Corner

Foreign Bank Presence in Major Cities

<table>
<thead>
<tr>
<th>City</th>
<th>Branch</th>
<th>Rep. office</th>
<th>JV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td>47</td>
<td>7</td>
<td>17</td>
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<td>Beijing</td>
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<td>Tianjin</td>
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</tr>
<tr>
<td>Xiamen</td>
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<td>2</td>
<td>10</td>
</tr>
<tr>
<td>Dalian</td>
<td>10</td>
<td>7</td>
<td>0</td>
</tr>
<tr>
<td>Others</td>
<td>31</td>
<td>31</td>
<td>15</td>
</tr>
</tbody>
</table>

Source: Almanac of China’s Finance and Banking 2001

Exhibit 1.3.4
Many Foreign Banks Already Have RMB Licenses

Shanghai (21)
- ABN AMRO
- ANZ
- Bank of America
- Bank of East Asia
- Bank of Tokyo-Mitsubishi
- Citibank
- Commerzbank
- Credit Agricole Indosuez
- Credit Lyonnais
- Credit Suisse First Boston
- DBS
- Dresdner Bank
- HSBC
- Korea Development Bank
- Mizuho Bank
- OCBC Bank
- Shanghai-Paris Int'l Bank
- Standard Chartered Bank
- Sumitomo-Mitsu Bank
- UFJ Bank
- Woori Bank

Shenzhen (10)
- Bank of Tokyo-Mitsubishi
- Bank of East Asia
- Citibank
- Mizuho Bank
- HSBC
- Nanyang Commercial Bank
- UFJ Bank
- Standard Chartered Bank
- United Overseas Bank
- Wing Hang Bank

Dalian (5)
- Bank of East Asia
- Korea Exchange Bank
- Chohung Bank
- Industrial Bank of Korea
- Shinhan Bank

Tianjin (4)
- Korea Exchange Bank
- Chohung Bank
- Industrial Bank of Korea
- Shinhan Bank

Note: Data as of June 2002
Source: Almanac of China’s Finance and Banking; literature search
and corporations with complex financial needs. Indeed, few will have the appetite for small-to medium-size businesses where local knowledge and large branch networks are important. Moreover, valuable multinational clients are widely expected to defect to banks that are better able to serve them, which will almost invariably be the foreign banks. The recent transfer of the telecommunications company Ericsson’s account from Minsheng Bank to Citibank illustrates this.

As foreign banks move into local markets, incumbents face a real threat of losing share in certain key segments:

- **State banks: Mass affluent households and foreign exchange market at risk**

  For state banks, the most vulnerable segments are their mass affluent retail customers and their foreign currency business. Foreign players offer a compelling value proposition to the mass affluent, including their vast experience from other markets in delivering cross-sector financial services, their service capability, and their strong brands.

  With China’s accession to the WTO, foreign players are now allowed to conduct foreign exchange business with individuals and enterprises in all of the country’s major cities. Foreign players had already captured more than 20% of the foreign exchange market before the WTO move, despite holding only some 2% of total assets.

  Moreover, foreign banks are also moving into renminbi lending including project financing, which historically is the stronghold of the state and development banks. For example, DBS Bank recently secured a mandate to arrange a RMB 1.2 billion loan for a joint venture project.

- **Regional joint-stock banks: Corporate clients and urban markets at risk**

  Joint-stock banks will face direct competition in the large corporate segment and also in urban markets. Foreign banks can leverage their strengths in lower foreign currency funding costs, more sophisticated product offerings and extensive worldwide networks. These attributes are increasingly important to corporate customers as their scope and scale expands.

  At the same time, as state-owned banks become increasingly commercialized, they will gradually reallocate more of their resources back to the more profitable urban markets, competing in the same segment as the joint-stock banks. Joint-stock banks thus face being squeezed from two fronts – by foreign banks, with their strong brand equity, and by state banks, with their strong branch networks.

1.4 Banking industry is at a major crossroads today

All players in the Chinese banking sector share a common set of challenges, from changes in regulation and shifts in customer demand to pressures from post-WTO competition. Different groups of banks face unique uncertainties, stemming from differences in ownership structure, role in the industry, and the size and diversity of their businesses.

Each bank must therefore decide on which direction to take and how to shape its own strategic path. Uncertainties may abound, but neither time nor competition will stand still. Now is the moment to make those tough decisions and take the next step forward.
2. What Competitive Scenarios Are Likely To Play Out?

With market reforms underway, it is worthwhile to explore how different competitive scenarios might play out. In this context, the past experience of other countries can help us envision the possible future of China’s banking industry.

This chapter presents hypotheses for market evolution.

2.1 Landscapes - defined by geography and product

Historically, the banking landscape in international markets has evolved along two major dimensions:

- **Geographic diversity: from fragmented market to national dominance**
  This refers to whether market leaders are regional (fragmented) or national players. The key factors driving this dimension are government policy and economic and geographic variances.

- **Product scope: from specialized market leadership to universal banking dominance**
  Markets can also be defined along products lines, ranging from those dominated by universal banks that engage in cross-sector services, to specialized markets with few products. Specialization can be sector-based (e.g., commercial banking, investment banking, securities brokerage, and insurance); or product-based (e.g., credit cards, mortgages, custodian services). New channel-based pure-plays for e-banking and e-payments have also emerged, though their long-term success is uncertain. The key drivers here are regulatory policies and market forces.

2.2 Five possible competitive scenarios

The evolution of banking in other markets suggests that China could evolve into one of the following competitive scenarios:

- **Specialists Rule**: Market specialization
- **Era of the Warlords**: Geographic fragmentation
- **Blossom of a Hundred Flowers**: Market specialization and geographic fragmentation
- **Any Model That Works**: Selective market specialization and fragmentation
- **War of the Giants**: National universal banking

**Specialists Rule**

In “Specialists Rule”, a limited number of players in each financial sector or product segment dominate the national market. Since sector/product boundaries are distinct, alliances and joint ventures are common to extend product distribution channels.
In developing markets, sector specialization is driven mainly by regulatory restrictions, as banks are prohibited from engaging in other sector services. In more mature markets, product specialization usually develops to “cherry pick” lucrative segments such as credit cards and mortgages.

National market dominance often exists in tightly controlled, developing markets, where market leaders may be state-owned and supported national banks. In open markets, leading players can also leverage network and scale advantages to dominate national markets.

China’s market today can be viewed as a classic example of “Specialists Rule,” with some specialists in banking, securities, and insurance sectors and the four major state banks dominating national banking. In this early stage, typical product specialists such as credit card monolines or mortgage providers have not yet developed. It is interesting to note that banks are currently locked out of the automotive financing market by regulation, indirectly nurturing a major specialist opportunity in China today.

**Era of the Warlords**

In the “Era of the Warlords” scenario, geographic boundaries are the dividing lines. Typically, the banking industry is fragmented and regionalized, largely due to vast differences in geographic markets or to regulations prohibiting cross-region business.

Consequently, competitors in each region have developed internal capabilities to offer comprehensive services, and their homogeneity leads to intense competition across product lines. Since most competitors offer universal services, alliances are less common.

Due to the heterogeneity across markets (e.g. regional
industry focus), local knowledge and network effects present significant barriers for new entrants. Strong incumbents may resist pressure to consolidate, so the market remains fragmented.

The Italian retail banking industry, especially prior to 1990’s, resembled the “Era of the Warlords,” with markets dominated by regional, universal (retail) banking players. Bank of Italy had limited branch openings before 1990, causing the markets to remain concentrated and limiting banking system evolution. By 1997, eight of the sixteen larger provinces were dominated by provincial players. Each player occupied more than a third of its market, and six of them had market shares of over 70%. Such concentration prevented consolidation or national banking. Inefficiency was common.

**Blossom of a Hundred Flowers**

“Blossom of a Hundred Flowers” reflects a landscape that is highly fragmented across both product and geographical dimensions. This is often the result of both market specialization and regulatory constraints. A number of dominant local and regional specialists emerge. Alliances with other market specialists are common.

This situation is possible in very immature markets where small regional players focus on specific sectors/product segments, partly as a result of regulatory demarcations. Generally speaking, “Blossom of a Hundred Flowers” is a transitional state. In the long run, scale and focus advantages will induce cross-product or cross-region consolidations. Hence, this scenario is not observed in advanced markets.

**Any Model That Works**

“Any Model That Works” is characterized by truly free market competition. When faced with potential competition, incumbents defend selectively in profitable and strategic markets, allowing new competitors to take over other segments. In this model, universal banks exist but are not usually dominant, and some market specialists expand nationally. Alliances across markets are common. The United States is a good example of this scenario.

The U.S. banking sector until the 1990’s was highly influenced by regulatory factors. The Glass-Steagall Act (1933 and 1935) barred commercial banks from investment banking activities. Interstate banking was largely prohibited by the McFadden Act of 1926.

But key regulatory changes in the late 1990’s dismantled the sector barriers from the Glass-Steagall Act and allowed interstate banking. This triggered mass cross-sector consolidation. Notable examples included mergers involving Citibank (retail and commercial banking), Salomon Smith Barney (investment banking), and Travelers’ Group (credit cards and insurance); JP Morgan (investment banking), Chase Manhattan Bank (retail and commercial banking), and Hambrecht & Quist (investment banking). These mega-mergers created giant banks across major sectors. So far, however, they have not yet achieved complete dominance, and significant regional players and sector specialists remain.

At the same time, maturing customer needs and new channels have led to new specialists in the United States. Successful examples include MBNA and Capital One in credit cards, and StateStreet Bank in custodian services. In particular, MBNA, a pure-play credit card issuer, was second to Citigroup in 2001 in terms of outstanding credit balance. New online channels have also given rise to pure e-banking players such as Juniper and the e-payments leader Paypal, which was recently acquired by the online auctioneer EBay.

**War of the Giants**

In “War of the Giants,” a few national players with broad product offerings dominate the market. This scenario has often begun with universal banks evolving through a process of cross-sector and cross-region consolidation into large national banks. Well-established product markets by major universal banks forestall further opportunities for specialization by niche players.

The Australian banking market currently resembles the “War of the Giants.” The big four banks – National Australia Bank, ANZ Banking Group, Commonwealth Bank of Australia and Westpac Bank – dominate almost every region and offer a very broad product range. They
participate extensively across sectors such as investment banking, retail banking, and combined banking, insurance and securities services.

*                       *                       *

2.3 Inferences for China and the banks

So what do all of these scenarios truly mean for China? Can banks influence the outcome of this transformation?

This section discusses how China could evolve against these five scenarios in the coming five to ten years, and what the state and joint-stock banks should do to proactively shape the landscape. Since regulatory policy is the biggest driver of market evolution, one can gain early insights into future scenarios by examining policy trends. Chinese banks should be wary of foreign competition in all cases, although the degree of the threats will vary with each scenario.

Scenario I: Staying as Specialists – Life Almost as Usual

This scenario is likely if the Chinese government largely maintains its current policy bias, which:

- Restricts the banking industry from non-bank financial services
- Supports state banks’ dominance, or allows a few major regional banks to expand nationally

In this scenario, both major state and joint-stock banks should focus on:

- Defending existing businesses from further specialization and disintermediation
- Extending products by striking alliances with other financial services players

This means aggressively growing key product markets and strengthening needed capabilities, such as customer relationship management, to discourage the rise of specialists such as credit card monolines and mortgage agencies. Banks can also proactively partner with other financial services players to expand their product scope by serving as distribution channels.

Scenario II: Blossoming of a Hundred Flowers – Weakening of the State Banks?

This scenario can happen if the government purposely downsizes the state banks’ network and influence, and if regional banks dominate the market. This is not impossible, as branches of state banks are being closed and commercialization plans signal less reliance on the government.

State banks should gear up for market competition ahead of this vulnerable transition period. All other players, foreign banks included, are urged to look for geographic expansion or market specialization opportunities during this unstable time.

In other markets, such as Indonesia, changes in the governmental stance on state banks have been known to reverse the balance of power among competitive players. (Exhibit 2.3.1)

Banking sector deregulation from 1988 to 1990 in Indonesia promoted fair competition among banks, reduced state banks’ reliance on the government, and abolished the guideline that had previously forced state enterprises to deal specifically with state banks.

Exhibit 2.3.1
Changes in Market Dominance Due to Banking Reforms in Indonesia

![Exhibit Image](Image)
Using “Share of Loans” as a proxy, the private banks’ market shares rose steadily following the deregulation, surpassing the state banks’ lead by late 1994 and continuing through 1997 until the Asian financial crisis struck. Since then, the strengthening of state banks and the entry of foreign banks, both largely orchestrated by the Indonesian government, have changed the competitive landscape yet again.

### Scenario III: Emergence of the Giants – Dawn of Universal Banking

This scenario is similar to Scenario I (Life Almost as Usual) with minimal changes in regulations, except that the Chinese government would eventually allow banks to offer cross-sector services such as investment banking, securities brokerage, and/or insurance. This is not unlikely, as even advanced markets such as the United States are allowing more crossovers of businesses.

But this landscape would require a new set of competencies. “Building scale and capabilities fast” would be the motto, leaving mergers and acquisitions a likely strategic option. Banks that might wish to be among the giants in this race could start by aligning themselves with other financial services partners now, while exploring closer affiliations later. Smaller banks could position themselves for acquisition by local or foreign players.

### Scenario IV: Entering the Era of the Warlords – Everything Changes

This scenario is a combination of Scenarios II (Weakening of the State Banks) and III (Dawn of Universal Banking), resulting in regional market dominance and cross-sector banking services. This is less likely to be a near-term scenario.

The Chinese government, cognizant of the shock that major changes may bring, will be unlikely to introduce drastic regulatory reforms in the near term, at least until the NPL issue is resolved. Moreover, unless artificial barriers are imposed to prevent national expansion, this scenario will not be sustainable since full-service universal banks will likely extend their scale and networks nationally. Under this scenario, Chinese banks should position for similar strategies highlighted in the two previous scenarios.

### Scenario V: Any Model that Works – Free Market Reigns

This scenario is similar to Scenario IV (Everything Changes) above, which involves transitioning to regional market focus and cross-sector services. The key difference here is that regulatory changes actually promote free market competition, allowing many players to compete in different dimensions simultaneously in a heated economy.

In this scenario, without dominant “universal” players, domestic and foreign players alike will have the most opportunities to shape the landscape. Major Chinese banks need to be selective in their market focus, as it will be difficult to defend from all fronts. Alliances will be needed to fill the capability gaps. Smaller banks are advised to direct their energy to selected regions or specialized markets where they have the strongest advantage. Strategic leadership to guide the bank’s direction and organizational flexibility will be particularly important in this scenario.

* * *

### 2.4 What should the banks do now?

**Competition is coming to China – both domestic and foreign**

In addition to post-WTO regulatory changes, the astounding growth of China has convinced many foreign banks to place the Chinese market at the top of their priorities. A case in point is HSBC, which became the first foreign bank to take a strategic stake in a Chinese bank, buying 8% of Bank of Shanghai in early 2002. HSBC already has roughly twelve branches and representative offices in China, in addition to major back-office processing centers in Shanghai and Guangzhou. It also plans to expand across sectors from retail banking and corporate finance into insurance, asset management and domestic investment banking over the next few years.

Universal banking may be surfacing as well. There are early signs that the government might eventually remove the regulatory barriers that separate banking, insurance,
and securities brokerage. One signal has been the approval for CITIC, a state-owned trust and investment company, to set up a holding company to unite its banking, securities, insurance and fund management operations. The prospect of “financial supermarkets” promises to draw heated competition from all financial services players.

**Banks need to work out how to get ahead in this new competitive order**

As increasingly sophisticated domestic and foreign players elevate the rules of competition, Chinese banks need to reassess their strategies and upgrade their capabilities. There is still time for them to decide on their roles. The key is to close capability gaps by first developing the basics, then by progressively enhancing capabilities and improving long-term vision. (Exhibit 2.4.1) The following chapter discusses priorities for building the capabilities to compete.

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**Exhibit 2.4.1**

“First Get Out of the Swamp, Then Make for Paradise”

- Get started first by developing the basics
- Work on progressive capability building
- Improve view of what vision looks like over time
- Long-term vision is still highly uncertain

<table>
<thead>
<tr>
<th>BCG’s view on how to get started</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market today is highly immature and rapidly changing — no sense in spending too much time on the vision</td>
</tr>
<tr>
<td>Significant capability gaps exist — better to focus on these given resource constraints</td>
</tr>
<tr>
<td>Practical and economic approach</td>
</tr>
<tr>
<td>● Get some sort of basic vision together</td>
</tr>
<tr>
<td>● Develop capabilities progressively</td>
</tr>
<tr>
<td>● Revisit vision annually as more clarity on what it looks like is gained over time</td>
</tr>
</tbody>
</table>
3. What Are The Priorities For Chinese Banks To Compete?

Two key traits are needed to win in the new competitive landscape: the initiative to foresee potential changes, and the ability to act and respond to those changes. Understanding scenarios on how the market might develop is just a first step. It is also vital to strategically build internal capabilities in order to seize opportunities quickly, and to respond to challenges brought about by market developments.

BCG believes that all Chinese banks will need to build and strengthen capabilities in five specific areas. Clearly, the degree and emphasis will differ by institution.

### Priority #1: Strengthen organization and corporate governance

**BCG Insight:** Status quo is no longer an option. Strong, committed leadership and clear corporate objectives are needed to set the right direction for change. Implementing any strategy requires a flexible, engaged and market-oriented organization.

Management of top state banks has been constrained by state policies, with limited leeway to exercise conventional business management and organizational leadership. This situation also exists, though less acutely, in joint-stock banks, which are partly under state control.

With the recent push for commercialization from central government, Chinese banks have limited time to enhance their competitiveness against increasing domestic and foreign competition. Strong leadership and clear corporate objectives are required. Chinese banks need to:

- Establish world-class corporate governance
- Effectively manage human resources and capabilities

#### Establish world-class corporate governance

The recent collapse of several major corporations has brought the issues of corporate governance and accountability to the world’s attention. These issues are even more pressing for the Chinese banking industry with its historical lack of governance, trends towards market-driven competition, and a desire to attract capital investments. World-class corporate governance involves two key components: active management oversight by the Board of Directors, and strong organizational leadership with a clear role-of-center.

- **Active management oversight by the Board of Directors**
  Many Chinese companies, including state banks, do not have formalized or independent Boards of Directors due to state control or traditional family ownerships. Typically, in large organizations, the Board of Directors is needed for three roles: (i) to provide vision and strategic direction; (ii) to oversee company performance including strategy and

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Priority #2: Develop a segmented service capability
Priority #3: Build a strong risk management framework and culture
Priority #4: Maximize operational efficiency
Priority #5: Use partnerships for competitive advantage
Based on client work, BCG has identified four basic drivers of good performance. An effective Board of Directors:

1) Defines clear roles for its members, makes the necessary time commitments, and understands its mission

2) Selects capable and committed directors who have relevant experience and the intellectual capacity to represent all stakeholders fairly

3) Establishes procedures that enable it to understand the company’s business issues

4) Promotes constructive behavior during discussions and debates, and defines efficient protocols to interact with company management

**Strong organizational leadership with clear role-of-center**

Major Chinese banks, particularly the state-owned institutions, have enjoyed considerable autonomy at the provincial level. They often operate like a federation of independent businesses that share the same name, rather than as part of a regional or national company.

This leads to two types of problems. Firstly, provincial decisions at state banks can be heavily influenced by provincial government policy, rather than by business economics. Secondly, significant differences can exist in financial performance, service quality, product offerings, and pricing across regions, considerably weakening the overall brand.

To prepare for market competition, banks need to strengthen the “role-of-center” and establish corporate leadership. The key is to ensure that the organization works toward common strategic objectives and agreed business plans. The corporate headquarters should:

- Clearly define and communicate its vision, values, and strategy
- Establish an effective framework to ensure close monitoring of accounting practices and performance of branches and business units
- Reform human resources policy (including performance evaluation and incentives) to attract talent and motivate its workforce

Branches and business units should participate actively in planning, and be empowered to execute strategic directives with sufficient autonomy. Effective communications are critical to ensure dissemination of corporate directives and feedback of branch issues.
Effectively manage human resources and capabilities

In BCG’s experience, human resources (HR) management is one of the least adopted management practices among Chinese banks.

Employee morale, loyalty, and effectiveness are often hampered by:

- Compensation and career advancement systems based on tenure (and other non-transparent factors) rather than merit
- Inadequate performance management (e.g., performance tracking, incentives, and clear objectives and targets for staff)
- Missing links between the five important areas to HR: business planning, requirement definition, recruiting, performance management and employee development

Chinese banks should adopt a comprehensive HR management strategy to attract, motivate, and retain an effective workforce. The BCG Human Resource Wheel provides a framework for this process.

As a crucial first step, banks need to translate their corporate business plan into a needs analysis. This should outline how improvements in HR can help the company achieve its corporate objectives. This analysis enables firms to optimize their investments in people practices and to make truly strategic, rather than merely tactical, changes. Corporate and business strategy must drive HR strategy.
BCG’s Human Resource Wheel specifies four ways to improve HR effectiveness:

1) **Clearly define human resource requirements.**
   Each institution should create a human resource plan with specifications on employee numbers and skills, both for today and for the future. The plan should be based on the needs analysis described above, and be fully aligned with corporate strategy. It will include elements such as job definitions, capability definitions and competency sets. In some cases, the plan will include contingencies for staff retraining or retrenchment.

2) **Strengthen sourcing and placement.** A war for talent for good banking personnel has already started in China. Competition for quality staff will increase as more foreign banks enter the fray. In addition to their international reputations and world-class training programs, foreign banks also offer considerably higher salaries, as well as incentive programs such as employee stock ownership. In one example, the annual salary of a foreign bank’s local business unit manager in Shanghai was RMB 150,000, whereas that of a general manager in a state bank was only RMB 40,000. Chinese banks need to strengthen recruitment and retention strategies to build and compete for human capital. This can only be done through understanding and satisfying the long-term needs of their employees, which is not an easy task. In parallel, banks must look at alternatives such as temporary recruitment or outsourcing.

3) **Institute performance management.** To align employee behavior with corporate strategy and objectives, Chinese banks must establish effective performance management. This means creating meaningful metrics, setting appropriate targets and incentives, and instituting robust feedback systems. Targets need to reflect a cascading of corporate plans down the organization as set out in Exhibit 3.1.3. They also need to be fair and based on what the individual can actually control. Performance indicators should encourage out-performance, rather than just the meeting of minimum goals.

4) **Promote employee development.** Career development and training is another motivating force for employees, and is crucial in ensuring that they improve their skills in line with changes in internal and external demands. Employee development is linked to performance management in translating feedback into actionable, effective training and career management steps.

* * *

**3.2 Priority #2: Develop a segmented service capability**

*BCG Insight:* A segmented service capability is a key sustainable advantage. This starts with understanding customers in detail and working out how to best serve them through targeted product development, maximized impact from pricing, and effective distribution.

Recent trends toward “universal banking” and retail banking have created demand for new products and services. Product innovation is a prerequisite to win market share, but does not create sustainable advantage since it can be easily copied. However, it is not easy to replicate the segmented service capabilities that are required to effectively innovate, develop and deliver these products. This can presently be a source of true competitive advantage in China.

Developing requisite segmented service capabilities requires Chinese banks to:

- Understand the customer
- Utilize pricing strategy
- Ensure effective use of distribution channels

**Understand the customer**

International benchmarks show that around 80% of a bank’s income is typically derived from the top 20% of its customers.

In China, the top 10% of premium customers reportedly contribute about 60% of profitability. At the other end of the spectrum, the bottom 10% of the country’s bank accounts — possibly more, many with balances of less
than RMB 100 — are loss-making. These accounts create a heavy cost for the banks and also draw resources away from servicing high value customers.

Clearly, state banks have a community service to fulfill that might prevent them from eliminating these unprofitable segments. However, BCG has seen many ways in which understanding the value of the customer can help banks re-direct unprofitable business to more cost-effective channels or services. Exhibit 3.2.1 illustrates how a bank might tailor customer strategy by combining product usage information with segment profitability.

### Exhibit 3.2.1
**Tailor Customer Strategy Based On Segment Profitability**

It is imperative to develop a good understanding of customers’ profitability, and segment them accordingly. The overall objective is to develop better and more profitable products and services. This can be achieved through the following segmentation and customer relationship management strategies:

- **Segmentation**
  
  Customer segmentation allows banks to tailor their products and focus their resources to better serve more profitable segments. It also enables banks to develop more cost-effective ways to serve segments that are unprofitable today (e.g., shifting low value customers to electronic channels).

  Segmentation criteria should reflect current client portfolio and target client characteristics, such as:

  - Client data: industry, region, size
  - Buying behavior: number of bank relationships, financial sophistication
  - Client relationship: number of products sold, length of relationship
  - Value creation: gross income, net profit, return on equity, capital employed

  Segmentation allows banks to:

  1) **Maximize return through targeted products and services.** Banks can prioritize and develop specific value propositions for each segment, and restructure their product portfolios to increase segment profitability. Targeting products begins with analyzing and identifying unmet customer needs, and then addressing those needs through new product development or enhancing existing offerings.

  2) **Channel customer segments to different service venues.** The goal is to service customers at a level commensurate with their revenue potential. In many advanced countries, banks are replacing their general service branches with lower-cost, 24-hour self-service ATM centers to serve the simple transaction needs of its less valuable customers. At the same time, they are staffing upscale centers with knowledgeable account managers to better meet the needs of their premium clients.

  3) **Minimize low-value customers through account fees.** Despite the unpopularity of banking fees in China, foreign players such as Citibank and HSBC have initiated minimum account fees to discourage customers with low balances, and to offset the cost of serving them. The Chinese Banking Association has reportedly also submitted an application to government authorities to allow Chinese banks to charge account fees on balances below RMB 100.

- **Customer Relationship Management (CRM)**

  Currently Chinese banks do not fully understand the needs of its customers. To better understand customer preferences, Chinese banks need to improve their Customer Relationship Management practices to collect integrated customer information.
Effective client relationship management will provide the foundation for Chinese banks to:

- improve segment profitability through product portfolio optimization
- expand product usage through effective cross-selling across channels
- enhance sales effectiveness through systematic organization cooperation
- selectively retain high-value clients

Exhibit 3.2.2 outlines how banks can realize significant value creation by knowing what customers are looking for and translating this into a clear understanding of the economics of serving them.

### Utilize pricing strategies

BCG’s global client work on bank pricing strategies reveals significant untapped revenue potential. However, most banks overlook pricing as a lever to boost value. Moreover, the simple product mix in China fosters a perception that there are limited pricing opportunities. In reality, a multitude of pricing opportunities exists. Exhibit 3.2.3 shows that price can have the highest impact on banking returns for Chinese banks.

BCG’s Pricing Framework offers a number of innovative strategies to capture value and strengthen product/service offerings along multiple dimensions. Banks need to:

1) **Align pricing strategy with business strategy**
   For example, bundling correctly priced products together can assist banks in expanding into the wealth management market.

2) **Price to customer value**
   Pricing structure can be changed to influence price perception and to help locate the “sweet spots” of customer value. One example is Washington Mutual (WAMU) in the United States. By focusing charges on “acceptable” penalties such as bounced check charges, and by pricing to remove transaction, minimum balance and monthly fees, WAMU was able to offer free checking accounts. It managed to increase its annual fee income by 30%, and added 514,000 new checking accounts in 2000.

3) **Use pricing to create efficiencies and manage risk**
   Risk characteristics can be used to further differentiate pricing, and encourage low-cost channel use.
4) **Optimize the price-volume tradeoff**

   By understanding how price changes will impact demand, prices can be raised without affecting demand. For instance, one BCG global banking client was able to reap a 10% increase in fee income by increasing prices for payment products with minimal impact on volume.

5) **Improve price realization**

   Price realization consists of two levers: compliance and performance. Compliance refers to the degree that specified prices are being realized (e.g., whether price schedules set centrally are being violated, and whether fees are enforced). Performance refers to the extent the sales force is maximizing profits in the way they charge customers. BCG client work reveals that banks regularly discount or waive charges, particularly in wholesale and private banking products. What’s more, such discounts are often not known to the customers.

6) **Organize for better pricing**

   Banks need open price communication and coordination across different business units to ensure that pricing decisions are maximizing profitability. Organizations often operate in business unit “silos,” and random or uncoordinated pricing occurs. Typically, there is no account manager or department that manages pricing and profitability across all products and services that any single customer is buying.
Ensure effective use of distribution channels

A bank’s distribution channels are the primary interface between the institution and its customers. The effectiveness of these channels directly impacts customer satisfaction and future value potential. Existing banking networks also present the most formidable weapon against foreign competitors, which have limited local presence.

BCG case experience has identified several factors that influence channel effectiveness:

- **Optimizing channels to enhance customer service and reduce cost**
  This involves redesigning service channels to better align customer preferences and bank objectives; reconfiguring branch networks and layouts to increase sales and minimize manual transactions; and enhancing customer reach through multiple channels such as call centers and e-banking.

- **Promoting cross-selling across business units and channels**
  Many customers hold multiple accounts and utilize diverse services across different banks. But banks can considerably increase their share of the customer relationship through effective cross-selling among different contact points. The key is to identify cross-selling opportunities, provide training about different products and cross-selling techniques, and offer the right incentives to motivate cross-selling practices across the organization.

- **Creating new revenue opportunities from cross-selling third-party products**
  Banking involves frequent interactions and is among the most trusted of all business relationships. Hence, third-party products can be efficiently cross-sold in this sector. While cross-selling investment products such as unit trusts and insurance are already common practices in advanced countries, Chinese banks are just beginning to explore these revenue opportunities. For example, a recent push for the open-end fund “Peng Hua” included Industrial and Commercial Bank of China as a distributor. The bank’s involvement increased daily fund inflows from several million RMB to over a hundred million RMB. In the end, ICBC reportedly
contributed to approximately 80% of fund subscriptions.

* * *

3.3 Priority #3: Build a strong risk management framework and culture

BCG Insight: Integrated risk management is one of the most pressing issues for Chinese banks. A phased and pragmatic approach is needed. A strong risk management culture will be crucial for sustainable profitability.

Risk management is among the most critical issues for Chinese banks, especially in view of significant bad loan portfolios, increasing regulatory pressure, and recent fraud issues. As such, BCG has identified three imperatives that can help Chinese banks remedy the situation:

- Manage existing book of non-performing loans
- Create an integrated risk management system
- Nurture a risk-return employee culture

Manage existing book of non-performing loans

One of the biggest challenges facing Chinese banks today is how to deal with the staggering levels of non-performing loans on their balance sheets. Even with AMCs handling a large portion of the NPLs for the top state-owned banks, all are still left with a sizable amount of post-1995 bad loans. Joint-stock banks do not fare much better with NPLs, and they do not have the benefit of government support.

Stricter loan loss provisioning and capital adequacy requirements are expected to tighten pressure on banks to clean up their balance sheets. State banks also need to strengthen their balance sheets to prepare for future privatization.

In general, there are three options for dealing with NPLs:

- **Write-off:** Demands financial strength, as this incurs “major” accounting losses; not a preferred option
- **External workout group:** Sell off loan (often at discount) to an external financing bank or government-related entity; frees balance sheet of NPLs and creates a “healthy” bank
- **Balance sheet restructuring:** Delay payment schedules, issue subordinated bonds or hybrid securities, or securitize loan portfolio to strengthen the balance sheet

The ultimate success of the effort depends on strong management support to push the process, clear communication to all participants to generate enthusiasm, and a good tracking system (e.g., key performance indicator reports) to pinpoint laggards. There is also a need for valuation, negotiation and asset management skills.

Create an integrated risk management system

Sound integrated risk management systems are built on three building blocks: methodology and tools; organization and process; and systems and infrastructure.
Such a framework allows banks to address three categories of risk:

**Market risk.** Most Chinese banks do not properly manage market risk, due to the absence of well-defined processes, centralized technology infrastructure, appropriately set-up organizations, and timely capital-market data. Moreover, they are often unknowingly exposed to market risk in the form of asset-liability mismatches and unmanaged proprietary trading in marked-to-market risks. While market risks today might be small in comparison to credit risks, they could grow substantially if appropriate efforts are not made.

BCG has observed the following market risk management gaps with Chinese clients:

- Minimal or untimely monitoring of asset-liability and trading marked-to-market risks
- No consistent measure for comparing and aggregating risk
- Subjective control mechanisms and conflicting roles between investment and control
- No risk optimization to maximize risk-adjusted returns

**Credit risk.** BCG’s global risk management survey reveals that credit risk is viewed by the majority of the banks as the most important risk category. While China is in the process of developing a credit culture, it has yet to deeply penetrate Chinese banks. Many have neither the institutional history nor the tools and methods necessary to evaluate credit risk in a systematic fashion. Common pitfalls include:

- **Fragmented roles and responsibilities:** oversized and ineffective loan committees
- **Limited and inconsistent account manager involvement:** limited cooperation between credit and account departments to enforce customer risk management
- **Overlapping and duplicated processes:** wasted resources in overlapping roles, duplicated activities and multiple sign-offs throughout the loan approval process
- **Limited financial, commercial skills:** staff are often technical engineers rather than credit, financial and business analysts with the skills to manage customer risk
- **Major gaps in credit risk management system:** absence of integrated systems on both the customer and management information level

Indeed, Chinese banks are handicapped by a lack of systematic consumer and industry credit history information, and by inadequate data for collateral evaluation. Industry and governmental efforts have been initiated to address the credit history issue, and it is time to start planning for integration with these data resources. Meanwhile, close cooperation between credit and account management is vital to provide separate risk and policy/customer perspectives.

**Operational risk.** This is a significant problem for most banks globally. Issues range from unclear definition of the risks involved to difficulties in quantifying them. Most banks recognize operational risk as specific-event risk and strategic business risk, including inappropriate behavior, defective processes or technologies, external events, and the risk of failure to produce returns. Inadequate operational controls have contributed to hundreds of millions of U.S. dollars in hidden trading
losses by rogue traders at Allied Irish Bank and Barings, costing not only the jobs of some banking officials, but also the demise of the banks themselves. Significant efforts continue to be made to address these risks globally.

Chinese banks also face problems in managing operational risk. Indeed, some observers might argue that this is one of their most vulnerable areas, given the limited focus on it to date and the organizational challenges that doing business in China presents. The key to early-stage operational risk management is to focus on pragmatic approaches. This requires:

- **Clear definition of operational risk** within the bank, measured as a bank-specific combination of specific-event risk and strategic business risk
- **Creating an internal loss database.** Specific processes and business units are analyzed for risk; possible effects are estimated and capital is reserved for potential losses
- **Implementation of clear functional control and procedures to limit risk exposure**

Building an integrated risk management system is not an easy task. It is not something that can be accomplished overnight, but rather takes shape through a multi-stage process. Chinese banks need to implement such a framework, gradually adding to their systems and capabilities. Having a rules-based business will not be enough, however. It is also paramount to nurture a risk-return employee culture.

**Nurture a risk-return employee culture**

The key is to create a corporate culture in which the principles of avoiding risk and generating returns are not diametrically opposed. Employees must be trained with the simultaneous consideration of risk and return, and empowered with tools to make risk-adjusted return decisions, which need to be reinforced by management and by incentive policies. Getting there takes time.

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**3.4 Priority #4: Maximize operational efficiency**

*BCG Insight: Chinese banks should not overlook day-to-day operations amid long-term strategic initiatives. There are many opportunities to improve operational efficiency, which can bring direct and immediate profit impact through cost savings.*

Operations are very complex, yet fundamental to the daily functioning of a bank. Operational expenses are sometimes equivalent to over half a bank’s revenue. Any savings here can significantly reduce costs. BCG believes it is crucial for Chinese banks to:

- Develop cost management and budgeting controls
- Align IT initiatives with business priorities
- Optimize branch network efficiency
- Reengineer people and processes
- Reduce cost through strategic sourcing

**Develop cost management and budgeting controls**

Cost control management is vastly inadequate in China. Recent surveys of Chinese banking executives conducted by BCG reveal a general lack of oversight and accountability, plus an absence of well-defined expense approval processes. These executives also expressed concern over the effort needed to capture cost information, the difficulties in selecting an appropriate IT solution, and the lack of benchmarks for target setting.

More fundamentally, there is limited awareness of what cost control management entails. In Chinese banks, it is often handled haphazardly rather than through an orderly process, such as laid out below, of integrated planning, approval, reporting and monitoring.

1) **Budget Planning.** Capital budget planning is a prime driver of the cost control process. It is derived from the annual business and operational plan that defines revenues, costs, and capital expenditures for the period. Headquarters and business units need to work closely in setting strategic priorities and appropriate budgets.
2) **Expense Authorization.** Expense authorization is not just a simple process of assigning signature authority against expenses. The system needs to balance the need for adequate fiscal governance with the need to avoid excessive bureaucracy. Setting expense limits also depends on other factors such as the company’s risk appetite, management’s trust of budget holders, and the size of the organization.

3) **Management Reporting.** Conventional management reporting processes often focus too narrowly on business and financial governance, overlooking cost control issues. Cost control should be closely integrated into the management reporting process to track key value drivers, thus providing early indicators to cost issues and aiding in decision-making.

4) **Monitoring.** Monitoring consists of performance measurement and internal auditing. Performance measurement requires alignment of metrics with strategic requirements, the setting of appropriate targets, and a closely linked incentives system. Regular internal auditing is also imperative to minimize operational risks. The goal is to ensure budget compliance.

The benefits of a comprehensive cost management and budget control framework are not limited to budget compliance and avoidance of operational risk. Such a framework also helps uncover structural cost misalignments, highlights opportunities for shared services and scale-related savings, and identifies internal cost cutting opportunities through internal or external benchmarking.

### Aligning IT initiatives with business priorities

Both the Chinese government and the banking industry place strong emphasis on improving the country’s technology infrastructure, as demonstrated by the Golden Card project and significant IT investments by Chinese banks. Recent initiatives to replace legacy systems, to centralize data systems, and to acquire risk management, customer relationship and e-banking systems continue this trend.

Several studies by BCG reveal that IT issues such as project failures, cost blow-outs, and time overruns stem...
from management rather than technical shortcomings. Therefore, attempts to address these complications through additional IT resources are doomed to fail. The key to IT success rests with proper management, not with increasing expenditure. BCG has identified six major disciplines to make sure IT investments provide sustainable and tangible business value:

- **Business and IT Strategy Alignment.** IT begins with business objectives, not systems, and the best solutions emerge only when business needs drive technology decisions. Thus, it is critical that companies should first ask “What is IT for and how can we use IT to create business value?” rather than “How much IT do we need?” Moreover, successful companies systematically focus their IT resources on helping the business create advantage (for example, in supporting customer service excellence or low-cost processing).

- **IT Architecture.** Successful companies gain competitive advantage through transforming information into insight, not by blindly acquiring technology’s newest bells and whistles. They selectively choose new technologies and aggressively simplify and standardize their architectures. Chinese banks should create a blueprint and standard for their IT systems and enforce them in order to break away from incompatible, decentralized and fragmented legacy systems. In the long term, this will bring them significant cost savings combined with unprecedented flexibility.

- **IT Investment and Renewal.** Not only do successful banks know how much they are spending on each and every IT project – and why – but they also employ a disciplined process for setting project priorities and spending targets. Banks should consider IT projects as financial investments with clear, achievable return goals. Therefore, every project must have a strong business case, where costs, benefits and risks are clearly articulated, discussed and approved by senior executives.

- **IT Skills and Sourcing.** Success in any area depends as much on what a company chooses not to do as on what it actually does. This fact has proved especially true in IT because new technologies are continually emerging and demanding new, initially scarce, and
often expensive skills and experience. Many Chinese banks have also tried to “economize” by developing complete applications themselves, when they would have been better off leveraging off-the-shelf products, which are more stable, mature, and more quickly deployable. Successful companies rigorously define which IT functions their employees should perform and which should be performed externally. They also recognize that outsourcing does not necessarily eliminate a problem, but rather exchanges one set of issues for another.

- **IT Development, Delivery, and Support.** IT failure rates rise sharply with project size. Often, the cost of a failed project goes beyond just lost dollars to include lost time and missed opportunities – huge penalties in today’s marketplace. Smart companies think big but start small. They avoid mega-projects and costly system failures by planning and executing in short, intense phases. Three-month cycles for delivering project results with business value are rapidly becoming common practice.

- **IT Leadership and Governance.** Winning companies succeed only when they translate their vision into results on an ongoing basis. To accomplish this goal, they foster deep collaboration and joint decision making among business and IT managers. Broad, strategic IT steering committees and lean project review groups are efficient means, among others, to ensure effective decision making and accountable solution delivery. BCG often assists clients in developing powerful governance mechanisms and management processes to turn governance and IT leadership concepts into practice.

### Optimize branch network efficiency

Branch offices are expensive. Branch rationalization offers an effective means of reducing costs and improving operating efficiency. Following PBOC’s directives, between 10% and 30% of state bank branches have been closed down since 1997. However, there is still substantial room to improve both branch efficiency and customer service.

The considerations for closing or merging branches have focused mainly on standalone branch efficiency and asset base. But in fact, effective branch rationalization involves multiple considerations:

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**Exhibit 3.4.3**

**Benefits of IT Projects Must be Evaluated and Prioritized**
• **Teller efficiency**: By re-allocating staff throughout different locations, a client achieved a 10%-50% reduction of headcount.

• **Network optimization**: Banks need to decide on how branch network and format design can strike an optimal balance between coverage and cost.

• **Multi-channel management**: Segmentation, delivery preferences, channel cost and usage, and new channel formats need to be carefully considered to help channels deliver the most efficiency.

The goal is to optimize both branch efficiency and customer experience of the overall network.

**Reengineer people and processes**

In the early 1990s, process reengineering was implemented extensively in the United States. To remain competitive, many methodologies were developed to cut costs and enhance efficiency through redesigning and restructuring processes. As a result, many U.S. institutions have highly efficient operations. In order to close gaps in operational efficiency with foreign banks, Chinese banks will also need to take a closer look at their people and process practices.

A variety of tools can be used to identify, measure and evaluate potential areas for efficiency enhancement. The approach should be systematic: first, map the key business process/decision flows, including all people, information and document activities. Second, analyze the breakdowns of business processes against indicative criteria such as unit cost and turnaround time. Third, identify potential improvement opportunities (e.g. bottleneck, duplication, unnecessary procedures) through benchmarking or gap analysis. Finally, redesign processes and implement changes.

Exhibit 3.4.4 illustrates a BCG client sample unit-cost analysis. By comparing against industry benchmarks (e.g. in absolute dollar terms or percentage composition), areas of potential cost savings and service quality improvement can be identified.

Another useful tool is process flow analysis. As seen from Exhibit 3.4.5, the average length of time taken from the start to finish along each major process is tracked. Each “white-space” represents process wait time along

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**Exhibit 3.4.4**

**Unit Cost Analysis and Benchmarked Savings**

<table>
<thead>
<tr>
<th>Case Example: Credit Origination-To-Disbursement Unit Cost Benchmarking</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Actual Unit Cost</strong></td>
</tr>
<tr>
<td><strong>Unit Cost from Benchmarking</strong></td>
</tr>
<tr>
<td><strong>Screening and applying</strong></td>
</tr>
<tr>
<td><strong>Pre-evaluation</strong></td>
</tr>
<tr>
<td><strong>Credit analysis</strong></td>
</tr>
<tr>
<td><strong>Credit approval</strong></td>
</tr>
<tr>
<td><strong>Offer</strong></td>
</tr>
<tr>
<td><strong>Offer to customer acceptance</strong></td>
</tr>
<tr>
<td><strong>Documentation</strong></td>
</tr>
<tr>
<td><strong>Disbursement</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

*Source: BCG case example*
the process. Excessive “white-space” suggests potential inefficiency that could be eliminated through reengineering.

**Reduce cost through strategic sourcing**

Strategic sourcing has recently been a popular cost-saving initiative. New technology platforms have even been created to support these efforts. However, this topic is largely overlooked in the Chinese banking sector for a couple of reasons:

- Except for technology platforms, purchasing costs are believed to be relatively low due to cheap materials and servicing costs. Chinese banks are also thought to incur fewer purchasing expenses relative to those in advanced markets (e.g. fewer direct-marketing mailings, less general business outsourcing).

- Potential conflicts of interests and various forms of “buyer kick-back” practices to stakeholders are still pervasive in China. This reduces the incentive and makes it more difficult for stakeholders to raise sensitive procurement opportunities and explore competitive supplier pricing.

Even though purchasing costs in China may not be huge, the cost savings may still be substantial relative to net income since they directly impact the bottom line. In fact, using estimates from typical BCG client procurement projects where average savings of 20% of addressable baselines are possible, strategic sourcing can result in approximately 10% to 15% increases in profit margins for state and listed Chinese banks.

Significant savings can be achieved by:

- **Leveraging volume discount**: Consolidate buying power across business units or regions, rationalize centralized vs. decentralized procurement

- **Negotiating better terms**: Screen for preferred vendors, renegotiate contracts to demand best pricing available, review branch leasing and maintenance programs

- **Challenging specifications**: Understand cost/performance tradeoffs and avoid unnecessary over-specifications. Managing demand can be one of the biggest levers of savings.

- **Enhancing purchasing management**: Control...
maverick spending, promote system rationalization and standardization, encourage buyers to challenge specifications and costs, and avoid conflicts of interests

- Improving cost control and budgeting: Monitor savings and benchmark market pricing, incentivise cost-saving behavior, and create a cost-conscious culture

3.5 Priority #5: Use partnerships for competitive advantage

**BCG Insight:** Chinese banks should leverage alliance capabilities to benefit from the competitive advantages of their partners. Whatever the situation of the bank, partners can usually bring something valuable to the table, as long as the partnership is selected appropriately and the process defined properly.

As China’s growing economy leads to diverging customer needs, many banks will seek to expand their product and service capabilities through allying with other firms. While current partnerships mainly focus on distribution, the scope of alliance cooperation will likely be increasing in complexity. Banks are urged to start building up partnership capabilities as follows:

- Leverage alliance capabilities to expand services and revenue
- Select and manage alliance relationships carefully
- Design an appropriate variety of alliances

**Leverage alliance capabilities to expand services and revenue**

The most common form of alliance relationship in the Chinese banking industry today is the distribution alliance. Partners include insurance companies, securities brokerages, fund management firms, mobile operators, and other banks. The scope of cooperation ranges widely, and includes product development, sales and distribution, and services. Examples include:

- **Expanding product capabilities**
  Instead of trying to develop new products in-house, which may not be feasible due to internal or external limitations, banks can turn to their partners for help with developing new products or services, allowing for a shorter time to market.

- **Capturing revenues through sales and distribution of third-party products**
  With their extensive reach and established customer base, Chinese banks can capitalize on relationships with customers by serving as distribution channels for third-party products and services.

- **Offering new intermediary services**
  Chinese banks are expanding their revenue base by offering new intermediary services to their alliance partners.

Foreign banks are not always competitors. Indeed, Chinese banks can benefit from allying with them in pooling syndicated loans. They can also offer RMB interbank loans to foreign banks, which exceeded RMB 21 billion at the end of 2001. If these cooperative relationships continue, Chinese banks might extend their services overseas through their foreign partners, or be considered as merger candidates when regulations relax.

**Select and manage alliance relationships carefully**

- **Be very focused in sourcing partnerships**
  Allying with the right partner is critical to success. Banks need to carefully examine their own capability and resource gaps against their strategic goals, and identify partnership candidates that complement them. Expectation and cultural fit are other important considerations. Banks that are new to forming alliance relationships are advised to start with simple and common arrangements, and to learn the skills to develop successful partnerships over time.

- **Manage partnerships against commitments and metrics that are clearly defined at the outset**
  Clear initial structuring of alliance relationships in terms of time, skills, resource commitments and management metrics is necessary to avoid unpleasant
surprises down the road. This is even more crucial when foreign partners are involved, since cultural misunderstanding and expectation differences can arise. Partnership management is an on-going and dynamic process. Banks need to monitor the management metrics and refine them if necessary. Open communication is vital.

**Design an appropriate variety of alliances**

The alliance mechanism selected has to reflect the long-term interests of both parties. In particular, many accords with foreign parties are set up with little thought regarding how the alliance will evolve as:

- the Chinese partner acquires technical expertise
- the foreign partner acquires knowledge of the Chinese market

Successful alliances are built on a long-term symbiosis between complementary businesses.

Chinese banks can get world-class know-how from consultants and from third-party advisors who have:

- knowledge bases from many institutions
- skills at introducing different practices into banks
- practical experience in China

Alternatively Chinese banks can acquire technical know-how through allying with foreign parties. However, for existing shareholders, selling an equity stake may prove to be a very expensive method for acquiring intellectual capital even though no immediate cash outlay is required. Strategic alliances should be built on a sounder, mutually beneficial advantage.

* * *
4. How Should Banks Begin To Create Winning Game Plans?

4.1 The importance of strategic planning

The five key strategies set out in Chapter 3 can greatly enhance the capabilities of any bank, if properly designed and executed. Banks need to work out in a strategic plan how to prioritize their capability-building initiatives, how to integrate the inevitable dependencies, and most importantly, how to develop capabilities to support the overall set of business objectives.

Such a strategic plan gives clear direction on what objectives the organization is working toward and what targets it is trying to meet over specific time frames. It represents the bank’s vision for the kinds of customers it will serve, the types of products it will offer, and how it will deliver them. Clearly, all this needs to be developed in the context of a dynamic market, an evolving competitive situation, and a realistic perspective on internal capabilities.

Without such a plan, banks can expend significant resources without accomplishing anything. This is because every initiative is uncoordinated, purely tactical projects emerge just to plug gaps, and any strategic impact that might have been achieved is lost. The small window of opportunity to close competitive gaps before foreign banks enter in force can be squandered.

A typical strategic planning process is set out below.

Exhibit 4.1.1
Strategic Planning Process

<table>
<thead>
<tr>
<th>Phase</th>
<th>I. Understand Current Position</th>
<th>I. Develop Strategic Direction</th>
<th>III. Define Corporate Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Where are we today and how will the market evolve?</td>
<td>Where do we want to go? How do we get there?</td>
<td>What outcome do we expect? What initiatives/actions do we need?</td>
</tr>
</tbody>
</table>
| 1.    | Market profiling (size, segmentation etc..) | Define and decide strategic direction
- Target segmentation
- Enablers
- Infrastructure refinement | 5-year financial projections |
| 2.    | Competitive analysis against local and foreign players | Evaluate merger/alliance opportunities | Development of the 5-year Corporate Plan |
| 3.    | Review of financial performance | New Long-term Strategic Plan | Quick win initiatives |

Exhibit 4.1.1 | Strategic Planning Process |
The process needs to be tailored to a bank’s specific situation.

The next section discusses some of the key challenges of strategic planning in China.

4.2 Key strategic planning challenges in China

Three challenges faced by both Chinese and foreign banks

Banks face a unique set of circumstances that are peculiar to China. The strategic planning process has to take these into account.

- **Uncertain Market Landscape**
  It is unclear what further steps the regulatory authorities will take to catalyze reform. This, in turn, makes it difficult to chart the reform process with any degree of accuracy or certainty. Under these conditions, it is important to craft flexible strategies. Banks should anticipate the unfolding of different scenarios and develop the ability to bend with each one. For instance, changes in regulations have and will create new markets overnight. Banks should prepare to capitalize on new opportunities and respond to challenges as they arise.

- **Heavy Market Fragmentation**
  Banks operating in China should bear in mind that it is a vast country, and that its regions have developed differently. This geographical and economic fragmentation has given rise to a series of different financial sub-systems that have dissimilar economic characteristics. Strategies should be adapted for regional differences and for their specific business practices.

  Further, China’s recent transition from a centrally planned to a market-oriented economy has created a plethora of different corporations and consumers, each with their own distinct financial needs. This broad cross-section of customers necessitates a strategy that incorporates each segment’s requirements.

Exhibit 4.1.2
Tailored Strategic Planning Approach

Bank X’s approach to strategic planning needs to balance
- Building coherent joint strategy in turbulent environment
- Development of effective monitoring mechanisms

<table>
<thead>
<tr>
<th>Bank X’s characteristics</th>
<th>Design for Strategic Planning dominated by business line relatedness, turbulent environment and poor financial track record</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highly related Business lines</td>
<td>Dominant dimensions:</td>
</tr>
<tr>
<td>Corporate center</td>
<td>- Highly related business lines need coherent joint strategy</td>
</tr>
<tr>
<td>Turbulent</td>
<td>- However, strategic capabilities are in the business lines not the center</td>
</tr>
<tr>
<td>Command and control</td>
<td>- Turbulent environment needs close monitoring despite CEO’s relatively hands-off style</td>
</tr>
<tr>
<td>Poor performer</td>
<td>- Past financial performance limits degrees of freedom</td>
</tr>
<tr>
<td>Unitary</td>
<td>Implication for Strategic Planning process</td>
</tr>
<tr>
<td>Relatedness of business lines</td>
<td>- Need joint strategy team with strong representation from each business</td>
</tr>
<tr>
<td>Location of strategic capabilities</td>
<td>- Quarterly targets need to be agreed for key performance indicators</td>
</tr>
<tr>
<td>External environment</td>
<td>- Resources need to be focused on initiatives to strengthen the core business</td>
</tr>
<tr>
<td>CEO style</td>
<td>- ....</td>
</tr>
<tr>
<td>BU autonomy and ownership</td>
<td></td>
</tr>
<tr>
<td>Financial track record</td>
<td></td>
</tr>
<tr>
<td>Ownership</td>
<td></td>
</tr>
<tr>
<td>Top performer</td>
<td></td>
</tr>
<tr>
<td>Diverse</td>
<td></td>
</tr>
<tr>
<td>Bank X’s strategy team with strong representation from each business</td>
<td></td>
</tr>
</tbody>
</table>
• **Poor Data Availability**

It is often difficult to obtain accurate and timely primary data. Changes in methodology and environment have also created discontinuous data sets. Besides, definitions are not always accurate and must be carefully analyzed for consistency and reliability. Other data, apart from official sources, also exist, and a certain degree of local knowledge is required to obtain these data.

It is thus important to know where to find reliable data and to understand how they should be interpreted for them to be useful. A similar, even more fundamental data challenge is the shortness of relevant time series, given the many structural, step changes in the recent past.

• **No history of commercial planning**

Chinese banks have little experience in commercial planning because the central government has traditionally taken care of it. This means that management today often has no real concept of what is practically achievable. Objectives can often be unrealistic and unattainable. Further, the industry as a whole has exhibited few long-term trends, making it difficult to leverage past experience into realistic forecasts. This has made the work of the corporate strategist tricky.

Strong financial performance is often underpinned by good strategic planning. China’s banks need to realize this in order to deliver successfully in the future.

• **Weak execution**

This lack of both planning and achieving corporate objectives has engendered a weak operational culture. Often, even if plans have been well thought out and constructed, they have not been effectively implemented at lower levels of the organization. Planners need to take this into account and communicate with line managers so that targets can be realistic and achievable. This often means scaling down the complexity of the plans to deliver simple and succinct objectives that can be easily controlled and monitored.

Decentralization at provincial levels and below often complicates execution. Planners must realize that sub-offices and branches often have their own procedures and systems.

Plans should also not be too ambitious in the short-term. As the internal infrastructure evolves, so will its ability to reach more complex objectives. But this will take time.

* * * *
5. What Are The Key Implications For Management?

“Recognize the urgency, impart a culture of change, plan, and take action”

Just as the strategic plan is the crucial first step to set future direction for the bank, strategy implementation is the actual journey that takes the bank to its destination. Efforts to navigate a path ahead are futile if the organization is not motivated to get started, not prepared to overcome the obstacles along the way, exhausts its energy to continue, or just gets lost.

Chinese banks face some unique strategy implementation issues. These include:

- **Strong resistance and limited motivation to change.** A highly risk-averse culture and a lack of performance incentives to encourage improvements and innovation are among the biggest roadblocks. Top management often discourages change, and managers below fear attempting innovation and failing. In addition, the geographic scale and diversity of branch networks compounds the inability to force through change.

- **Complex stakeholder objectives.** For example, meeting conflicting social and economic development objectives as well as profit objectives.

- **Distraction of near- to medium-term public listings.** With many banks seeking public listings, management focus can turn toward packaging the institution for investors rather than making serious change. Since implementation of major initiatives often incurs disruptions and risks, it can be difficult to drive change.

- **Gaps in key skills to manage change.** Competition, increasingly sophisticated customer needs, and change management demand new skills beyond those required for core banking operations. Most banks do not have these skills in-house and can be significantly challenged in managing through evolutionary stages.

- **Incomplete control over all the levers of competition.** For example, regulators still limit the flexibility over areas such as product development and pricing. Established internal procedures such as human resource policies, particularly when they need to be coordinated with government input, may also impede the speed and scope of changes.

However, Chinese banks can take several practical steps to begin the journey forward successfully:

1. **Make sure the entire senior management team**
realizes the imminent challenges ahead, and feels the urgency to acquire the capabilities needed to deal with them

This step is critical. The management team needs to have a shared understanding of the tasks ahead and the need for change. Executives also must have a realistic view of the capability gaps, and ask themselves: "How much better do we need to be, and in what areas?"

In order to be useful, these views need to be based on facts and analysis, not just on opinions. They also need to be shared by the whole management team, not just by a few individuals. Otherwise, the organization will be unable to make the necessary changes to meet new objectives. Most importantly, the gaps need to be prioritized. An organization cannot expect to improve in all areas all at once.

2. Develop a realistic plan to move beyond the crossroads

The road ahead is a long one and fraught with uncertainties. A bank cannot expect to navigate through the complexities without a well-crafted plan. Starting with the priorities established in the first step, this second step addresses how to achieve those priorities: what needs to be done by whom, in what sequence. The plan needs to balance carefully between what can be done versus what must be done. It must involve evaluating various competitive scenarios, and determining the best course of action in each one. It also involves setting tough priorities about what is most important to success, and what is less so. Consequently, third party experts are sometimes involved to bring in state-of-the-art competitive planning techniques.

3. Pursue implementation of the plan with appropriate vigor and flexibility

This step is clearly the most difficult, and requires commitment over a long period of time. In a complex organization, it also requires a willingness to tackle many obstacles and to lead the process of change on a large scale. Implementing company-wide strategic changes requires the involvement of many people across the company, and requires them to do many new and unfamiliar tasks.

It is essential to distill such a complicated implementation into several basic success factors, and be sure to focus adequately on each of these. When each success factor receives the right amount of attention, implementation on any scale can succeed. If these factors are not properly addressed and balanced, however, implementation will certainly fail.

The six key success factors for successful implementation in a Chinese company are:

A. Develop a compelling vision for action

Formulate a compelling case for change, which includes a clear and detailed vision of the desired level of future performance. This is especially important when there is little recognition of the need for change, and where there is a strong belief in preserving the status quo. These conditions often exist in state-owned enterprises that have not been exposed to significant competition in the past.

B. Have visible, committed leadership willing to tackle tough issues

Ensure that there are visible and united senior leaders who are committed to leading the organization through the difficult changes, and that these leaders clearly expect all managers to support change. This is especially important when the organization has little experience at major change projects, and when people are not sure whether the senior team is fully committed. In state-owned enterprises, middle management is reluctant to act without clear endorsement from the top.

C. Use rigorous project management techniques

Utilize structured project management methodologies and clear accountabilities to ensure full delivery of project benefits on time. This is especially critical when the complexity of change is high, when there is a previous lack of discipline, or when the company has weak project management skills. In a state-owned enterprise, some managers may be very comfortable with the techniques, but other managers
may have no experience at all.

D. Actively obtain the support of key stakeholders
Understand and address the issues of the different stakeholder groups/individuals to build support and facilitate smooth implementation. This especially matters when stakeholders have conflicting agendas or priorities, when there is low acceptance of proposed change, when the impact on the workforce is likely to be high, or when the change will impact a broad range of stakeholders. In a state-owned enterprise, there is typically a very complicated set of stakeholders, and each of them can be critical to successful change.

E. Fill gaps in capabilities and culture
Systematically assess and develop the human resources and organizational behaviors needed to deliver the proposed changes. Remember that roles and responsibilities for a significant proportion of workforce may change. Many new employee capabilities may be needed, and cultural and behavioral change is essential to success. When a state-owned enterprise prepares for tougher competition, it is inevitable that there will be important gaps in capabilities that need to be addressed.

F. Put in place the right support infrastructure
Ensure that the key elements of corporate infrastructure are adjusted to support the new performance requirements. For example, budget processes and performance metrics, HR policies and processes, and IT architecture and systems all may need to be revised in order for change to be successful. In a state-owned enterprise, these infrastructure issues are often critical elements of successful change.

* * *
6. Conclusions

The Chinese banking industry is at a crossroads today. Rapid transformation is taking place in the external environment: this includes market-oriented reforms, increasingly demanding customer needs, and intensifying competition from foreign entrants. Meanwhile, critical internal issues are compounding the pressure for change: high non-performing loans, the imperative for strengthening risk management, and desperately needed infrastructure upgrades. Chinese banks cannot afford to stand still.

However, this is also not the time for banks to go in all directions, lest they flounder and end up going nowhere. Banking executives need to make carefully considered decisions about the future of their institutions. As seen in Chapter 1, the challenges facing each bank are very different, and each player has to decide on which direction to take and how to shape its own strategic path. Many uncertainties exist and the competitive scenarios set out in Chapter 2 have yet to be played out. But competition does not stop—banks can still choose which role they want to play in this unfolding landscape.

The priorities set out in Chapter 3 can equip Chinese banks with strengthened capabilities to win in any new landscape — regardless of what shape it takes. Indeed, strategically building these internal capabilities is not just an option, but a prerequisite for success in any competitive market. These capabilities need to be built with a common purpose in mind. In Chapter 4, the importance of developing a strategic plan to give clear direction and priorities to the organization is highlighted. However, strategic planning is difficult in China, because of both the nature of the market and the inherent characteristics of Chinese banks.

Fortunately, as set out in Chapter 5, there are some practical steps that senior management can take to begin moving ahead successfully, and there are six key success factors that are extremely useful for superior implementation in Chinese companies.

The market is changing. Competition is imminent. But there is a path that leads through the uncertainties. Now is the time to make the tough decisions and take the next step forward.
The Boston Consulting Group is a general management consulting firm that is a global leader in business strategy. BCG has helped companies in every major industry and market achieve a competitive advantage by developing and implementing unique strategies. Founded in 1963, the firm now operates 54 offices in 34 countries.