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BANKING

Retail banking in China: New frontiers

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Welcome to our inaugural report on the retail banking sector in China. The growth of the sector since the late 1990s has been phenomenal. With the recent opening up of the sector to foreign banks, we view the timing of this report as particularly opportune. We hope it will serve as a roadmap to both domestic and foreign banks seeking to better understand the retail banking sector and the challenges and opportunities presented by it.

The retail banking sector in China is still underdeveloped by international standards, but in light of the sheer scale of savings in China, the future potential of the sector is immense, making it one of the most attractive prospects in the world for banks. Gaining access to this sector is one of the major drivers behind the rapidly growing number of foreign banks setting up operations in China and making strategic investments in Chinese banks. At the time of writing this publication, nine foreign banks have applied to incorporate locally in China (a requirement to fully access the retail banking sector). However, we expect that by the end of 2007, this number will be higher, benefiting the sector as a whole.

While the retail banking market in China will continue to be dominated by domestic banks, there will be many areas, including credit card issuance, mortgage lending and wealth management, where foreign banks can make their presence felt. The expected long-term growth in the market will allow successful players to develop significant businesses and compete in one of the most exciting markets in the world.

I would like to thank Reuters for their efforts in conducting such extensive interviews and research for this report.

Simon Gleave
Partner in charge
Financial Services
KPMG in China and Hong Kong SAR

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China's banking sector is at a historical turning point. Late last year, new rules guiding foreign bank retail operations in mainland China were formally published by Beijing, based on China's obligations to the World Trade Organisation. Within months, the first competitive effects of this highly anticipated opening will start to flow through the country's vast but still maturing retail banking network.

I am therefore exceptionally pleased to be able to offer this new Reuters-KPMG study to you at this critical time.

Foreign lenders will soon be able to provide credit cards, mortgages and wealth management services to the country's growing affluent population, making retail banking the next frontier for China's financial services industry.

Chinese banks are concerned at the potential competition that is heading their way. Yet foreign competitors themselves are only beginning to understand this potentially vast market, where credit cards are a relatively new phenomenon and personal investment products remain limited.

This latest joint study, written by Reuters Asian Financial Services Correspondent Brian Kelleher, supported by KPMG Financial Services partners in Beijing, Shanghai and Hong Kong, explores these challenges and opportunities in depth. We are confident that this report will help inform the decisions which all sides will have to make in what is seen as the number one growth market in the world.

Eric Hall
Editor for North Asia
Reuters

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Introduction

China is undergoing an historic economic and cultural transformation as it emerges as one of the largest consumer markets in the world. The government in Beijing has assembled the necessary ingredients for this change to happen, and providers of retail banking services are now starting to benefit.

The findings detailed in this report are based on interviews with executives from many of the leading domestic and international financial institutions active in China. The report focuses on three areas with particularly encouraging growth prospects, namely credit cards, mortgages and wealth management services. The use of these services among customers remains extremely low relative to the conventional withdrawal, deposit and transfer functions offered by banks.

China's size and rapidly growing middle class make it an obvious target market for foreign banks. Between them, the country's 1.3 billion citizens hold nearly USD 2 trillion in personal savings.[1]

1 People's Bank of China: China Monetary Policy Report, Q2 2006

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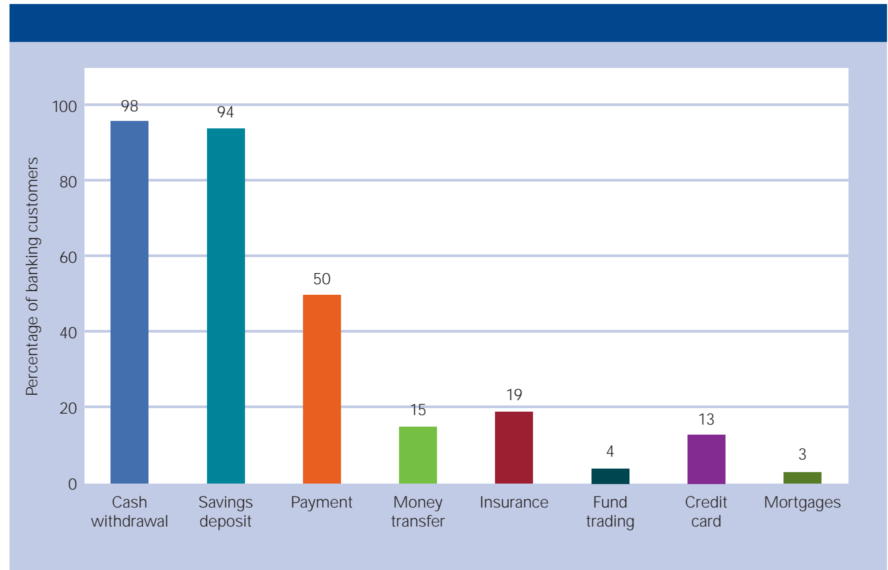

Source: TNS China Banking Service Marketing Forum 2007

Yet while the opportunities for growth in retail banking services are tremendous, they also carry caveats including the requirement to incorporate locally for those banks that wish to fully access the retail banking market. China is in some respects a typical emerging market, with developing capital markets and a consumer base that is only just starting to understand and embrace credit. Competition is intensifying among domestic Chinese banks, while overseas players are clamouring for a foothold. These factors combine to create an extremely challenging market.

One of the most interesting developments for foreign players is the newfound ability to offer local currency services and to incorporate locally. These developments will allow international banks to operate more like conventional retail banks, offering a full suite of services to domestic customers.

The wave of listings by Chinese banks is also encouraging. The well-received USD 21.9 billion dual listing of Industrial and Commercial Bank of China (ICBC) in October 2006, following successful initial public offerings from China Construction Bank (CCB) and Bank of China (BOC), served notice that international investors believed that domestic banks are improving their standards of governance and corporate reporting. These capital markets transactions coincided with a flurry of investments from international banks such as Bank of America, RBS, Deutsche Bank and ING, which view the Chinese market as one of the world's top growth opportunities. The following pages outline the status of the retail banking sector from the perspectives of both domestic and foreign banking institutions.

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Market overview

The local heavyweights

The retail banking market is dominated by China's state lenders, namely Agricultural Bank of China (ABC), BOC, CCB and ICBC. These four institutions control more than half of the country's total banking assets, according to official figures for the first three quarters of 2006.[2] Between them, ICBC, BOC and CCB held RMB 7.78 trillion in personal deposits as of 30 June 2006.[3]

The state-run banks operate from a highly advantageous position. They have more than 75,000 branches throughout the country and enjoy close links to China's largest companies, including state-owned and formerly state-owned enterprises.[4]

China's accession to the World Trade Organisation (WTO) has provided the impetus for bank reform. BOC, CCB and ICBC have received a combined USD 60 billion in new capital as well as other purchases of non-performing loans, to help clear up their balance sheets. Non-performing loans have fallen from more than 20 percent to less than 5 percent of their total portfolio. These three have all turned to foreign investors and the capital markets as a means to build expertise, improve risk management systems and recapitalise.

2 China Banking Regulatory Commission: www.cbrc.gov.cn
3 ICBC IPO prospectus and company web sites: www.bank-of-china.com/en/static/index.html; www.ccb.com/portal/en/home/index.html
4 "Reuters Summit-FACTBOX-China's biggest banks," Reuters News, 5 September 2006

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CCB, which is 9.1 percent-owned by Bank of America and 5.1 percent-owned by Temasek, raised USD 9.2 billion in an October 2005 Hong Kong listing. BOC, which is working with a number of foreign partners and minority shareholders including Royal Bank of Scotland, completed a USD 11.2 billion Hong Kong IPO in June 2006.[5]

ICBC raised USD 21.9 billion in a simultaneous debut in Hong Kong and Shanghai in October, making it the world's largest ever IPO.[6] It has also attracted foreign expertise — and USD 3.8 billion — from Wall Street firm Goldman Sachs, Germany's Allianz and credit card giant American Express. These partners, and particularly Goldman Sachs, have been helping the bank to revamp its risk management and internal controls.[7]

ABC may go through a similar process. It reported more than USD 90 billion in non-performing loans at the end of 2005, but Beijing has taken steps to improve operations and make the bank more competitive.[8]

These state privatisations have been accompanied by the IPOs in Hong Kong or China of other major mainland lenders such as Bank of Communications, China Merchants Bank and Industrial Bank.

Mainland banks are increasingly confident that their products, services and IT systems are catching up with those of their foreign rivals, a view perhaps best summed up by Zhu Min, executive assistant president for BOC: "Before, we competed with pistols," he explained. "Now we have AK-47s and cannons."[9]

That kind of artillery must be continually upgraded, as the portfolio-driven nature of managing risk in retail banking requires analysis using sophisticated systems that track the behaviour of different customer segments.

Systems and performance may be improving, but in the retail sphere China's domestic banks face further challenges. These include how to improve customer satisfaction and develop innovative products that suit an increasingly sophisticated base of customers.

Providing a better customer experience — shorter waiting lines, more knowledgeable staff and higher quality branches — can be a critical advantage. A recent survey of China's banking sector showed that customer satisfaction levels were lowest among the big state-run banks.[10]

5 "FACTBOX-Largest IPOs in China and the world," Reuters News, 12 October 2006
6 "UPDATE 1-ICBC exercises IPO over-allotment option, stock up," Reuters News, 7 November 2006
7 Source: ICBC research report by China International Capital Corp., 23 September 2006
8 "China Ag Bank names outside auditor in reform step," Reuters News, 16 August 2006
9 "Chinese banks welcome market opening," Reuters News, 8 September 2006
10 "INTERVIEW-Chinese banks risk losing wealthy customers," Reuters News, 27 July 2006

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Bank market share		
Type of bank	Deposits (RMB trillion)	Market share
State-owned commercial banks	22.54	51.3%
Joint stock commercial banks	7.14	16.2%
City commercial banks	2.59	5.9%
Other banking institutions	11.67	26.6%
Total	**43.95**	

Source: China Banking Regulatory Commission, Q4 2006

The contenders

There are more than 70 overseas banks operating in China. Some have entered through direct investments in domestic lenders, others by building their own franchises. Many of the largest international banks have chosen to invest directly in domestic banks as well as grow their own business organically. Among the companies taking this route are Citigroup and HSBC; both have identified China as one of their priority markets for retail banking.

Under the new rules in November, foreign banks can now incorporate locally in China with 1 billion yuan (USD 129 million) in paid-in capital and RMB 100 million in operating capital per branch.[11]

International banks hope that their experience in managing risk combined with well-honed marketing strategies, will give them a competitive advantage in a market where retail banking services are at a relatively early stage of development.

BOC, for example, reported that non-interest based income accounted for 19 percent of total operating income in the first nine months of 2006.[12] This is typical for many of the domestic banks in China. By contrast, Hong Kong's Hang Seng Bank made 54 percent of its 2006 operating income from non-interest based activities.[13]

The market is growing more sophisticated as personal wealth in China grows along with its booming economy, and the new WTO rules allow foreign banks to work with local retail clients and roll out innovative new products and marketing programmes.

11 "FACTBOX-China's new rules covering foreign banks," Reuters News, 16 November 2006
12 Company announcement: www.bank-of-china.com/cms/uploadFiles/2006-3rd-qrenh.pdf
13 Hang Seng Bank: 2006 Annual Report (Consolidated Income Statement)

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The first wave

In December 2006 the China Banking Regulatory Commission granted approval for the following nine foreign banks to prepare for local incorporation:

- ABN AMRO
- Bank of East Asia
- Bank of Tokyo-Mitsubishi
- Citigroup
- DBS Group Holdings
- Hang Seng Bank
- HSBC
- Mizhuo Corporate Bank
- Standard Chartered[14]

Despite the recent accession to the WTO, several international bank executives acknowledged that they expected certain restrictions to remain. Regulatory changes are occurring slowly, but most foreign executives are satisfied that the reform process is moving in the right direction. Hong Kong's Hang Seng Bank, Standard Chartered and ABN AMRO are among the foreign lenders planning to incorporate in China and take advantage of the new WTO rules *(see table, left).*

Besides growing on their own, many banks are also furthering their alliances with local banking partners. A consortium led by Citigroup has won control of southern China's Guangdong Development Bank, taking an 85 percent stake for USD 3.1 billion.[15] Citigroup beat an investment team led by France's Société Générale in a process that stretched for more than one year, demonstrating the lengths to which overseas players will go to increase their footholds in the mainland market.

Citigroup is also planning to increase its stake in Shanghai Pudong Development Bank to the maximum 19.9 percent from its current level of 4.6 percent.

HSBC, which was founded in Hong Kong and Shanghai in 1865, has purchased 19.9 percent stakes in Bank of Communications, the country's fifth-largest lender, and life insurer Ping An Insurance, to complement its network of more than 30 mainland locations. It has also acquired an 8 percent stake in Bank of Shanghai.

Other interesting China models include that of Bank of America, which has pinned its retail hopes on its cooperation and 9.1 percent stake investment in CCB.

On the other side of the spectrum is Hong Kong-based Bank of East Asia, which has branches and sub-branches in 12 cities, as well as five representative offices. Despite having resisted making any investments in mainland lenders, Bank of East Asia's Chinese business made up 11.6 percent of total 2005 earnings, compared with 6.4 percent in 2004.[16]

A recent development has been foreign interest in Taiwan, with Standard Chartered taking over a local bank and Citigroup exploring similar opportunities.[17] Taiwan companies have invested heavily in China, where their home banks are forbidden to operate. Foreign banks, facing no such restrictions, could leverage a footprint in Taiwan to serve the needs of its companies on the mainland.

The Asia chief executive of a global financial services firm said his biggest management challenge was not in finding good business opportunities but choosing the most lucrative ones, and executing a business plan accordingly.

14 "Nine foreign banks get first China registration nod," Reuters News, 24 December 2006
15 "UPDATE 4-Citigroup wins $3.1 bln battle for Guangdong Bank," Reuters News, 17 November 2006
16 "Bank of East Asia profit rises on fee income, trading," Reuters News, 10 February 2006
17 "ANALYSIS-Taiwan bank M&A on way after years of false starts," Reuters News, 19 October 2006

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Foreign investment in mainland Chinese banks

Chinese Bank	Foreign Investor	Stake (as a percentage)	USD (million)
Industrial & Commercial Bank of China	Goldman Sachs, American Express and Allianz Group	8.45%	3800
China Construction Bank	Bank of America Temasek Holdings	9.10% 5.10%	2500 1460
Dalian City Commercial Bank	International Finance Corporation (IFC)	5%	
Bank of China	Royal Bank of Scotland Merrill Lynch, Li Ka-Shing Temasek Holdings UBS Asian Development Bank	10% 5% 5% 1.60% 0.24%	3100 1500 1500 500 75
Bank of Communications	HSBC	19.90%	1747
Shanghai Pudong Development Bank	Citigroup	4.6% (may increase to 19.9%)	67
Minsheng Bank	IFC Temasek Holdings	1.60% 4.60%	23 110
Industrial Bank	Hang Seng Bank IFC GIC Special Investments of Singapore	15.98% 4% 5%	208 52 65
Huaxia Bank	Deutsche Bank Sal Oppenheim Pangaea Capital Management [4]	9.90% 4.08% 6.90%	327 150
Shenzhen Development Bank	Newbridge Capital GE Capital	17.98% (will drop) 7.3% (pending)	150 100
Guangdong Development Bank	Citigroup[1] IBM	20% 4.74%	697 165
Bank of Beijing	ING Group IFC	19.90% 5%	215 54
Bank of Shanghai	HSBC IFC	8% 7%	63 47
Nanjing City Commercial Bank	IFC[2] BNP Paribas	15% 19.20%	27 87
Tianjin Bohai Bank	Standard Chartered	19.99%	123
Hangzhou City Commercial Bank	Commonwealth Bank of Australia Asian Development Bank	19.99% 4.99%	78 30
Jinan City Commercial Bank	Commonwealth Bank of Australia	11%	17
Xian City Commercial Bank	IFC Bank of Nova Scotia	12.50% 12.40%	N/A N/A
Ping An Bank[3]	HSBC	27%	N/A
United Rural Cooperative Bank of Hangzhou	Rabobank IFC	10% 5%	31
Nanchong City Commercial Bank	Deutsche Investitions-und Entwicklungsgesellschaft (DEG) Sparkassen International Development Trust (SIDT)	10% 3.30%	4 1.5
Ningbo City Commercial Bank	Oversea-Chinese Banking Corp.	12.20%	70
China Everbright Bank	IFC	4.90%	19
Tianjin City Commercial Bank	ANZ Bank	19.90%	120
Shanghai Rural Bank	ANZ Bank	19.90%	252
CITIC Bank	Banco Bilbao Vizcay Argentaria	5%	648
Qingdao International Bank[6]	Hana Bank	72.31%	25
Xiamen Commercial Bank[7]	Fubon Financial Holding	20%	62
Nan Tung Bank[5]	Morgan Stanley	100%	N/A
Chongqing Commercial Bank	Carlyle Group Dah Sing Bank	8% 17%	N/A 89

Source: Publicly available information

1 On 16 November 2006, a Citigroup-led consortium won the right to buy 85% of China's Guangdong Development Bank
2 Total investment in Nanjing City Commercial Bank still remains below 25% as IFC's stake was reduced upon BNP Paribas' purchase
3 Previously called Fujian Asia Bank
4 Pangaea made the purchase but the China Banking Regulatory Commission declined to approve the deal in the end
5 Morgan Stanley was able to acquire this bank because Nan Tung is a foreign-funded bank formerly owned by Bank of China's Macao subsidiary
6 This bank is a joint venture between Hana Bank and ICBC, hence why Hana Bank has a controlling stake
7 The Financial Supervisory Committee of Taiwan has held up the deal although its jurisdiction in this case is unclear as the deal is going through a Hong Kong subsidiary of Fubon Financial

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Credit cards: The first frontier

Key findings

- **Credit card use is on the rise in China, but still lags behind use of bank debit cards as customers remain averse to spending on credit. Some products in China are marketed as credit cards, yet bear more of the characteristics of debit cards.**
- **Steep competition from an ever-growing number of providers has led to fee erosion and pressure for reduced rates and overseas players still cannot issue cards on their own.**
- **China's banking framework can make it difficult to move money between banks, potentially hindering the willingness of customers to switch banks for different products.**
- **The marketing and product design strategies so prized by foreign banks have been successfully mimicked by many local providers, eroding a potential advantage for the overseas players.**

Credit cards have been the lead-in product for a clutch of foreign banks in China. Banks such as Citigroup, HSBC and Hang Seng have issued the first Sino-foreign co-branded cards and rivals like Bank of America and Deutsche Bank are waiting in the wings to launch their own products.

The current regulatory regime does not allow for formal joint ventures so while a foreign bank can provide expertise, it still cannot share in the profits. Foreign executives are hopeful that formal joint ventures will eventually be approved.

The market's potential is huge, as executives estimate that there are roughly 25 million dual-currency credit cards issued for a population of 1.3 billion people. This contrasts sharply with the 700 million debit cards in circulation.[18] Although total card transactions in China have risen dramatically over the past five years *(see table, right)*, the picture that emerges is that this growth has been driven overwhelmingly by the use of debit cards. China Merchants Bank, a leading provider of card services, predicted in November 2006 that its credit card issuance would hit 10 million by the end of the year, double its amount at the end of 2005.[19]

18 "China's Big Four get ready for market", Retail Banker International, 12 May 2006
19 "UPDATE 1-INTERVIEW-China Merchants Bank sees 10 mln credit cards," Reuters News, 30 November 2006

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Over the past five years, the underlying infrastructure and technologies for debit and credit cards have spread rapidly across China, to the point where China UnionPay has established a nationwide network of ATM facilities serving all the main domestic banks. The infrastructure for credit cards is also being established, suggesting credit cards could soon play a more significant role, relative to debit cards.

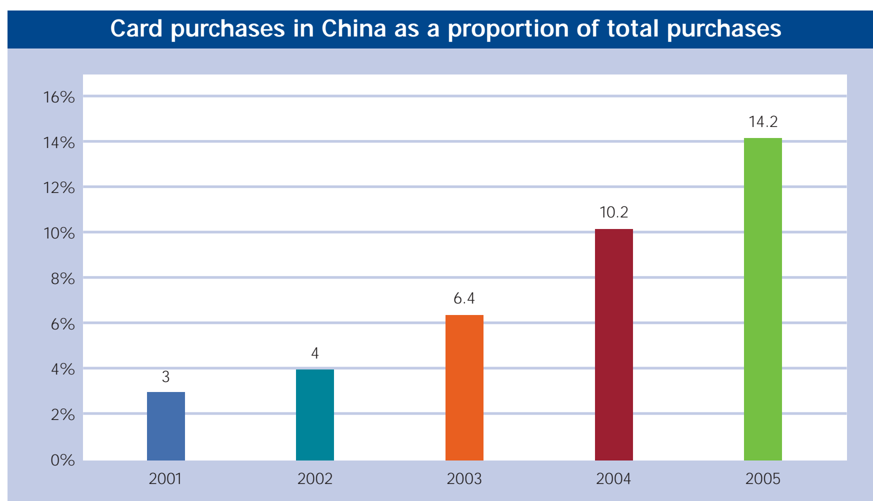
One Shanghai-based executive indicated that he believed the credit card market could grow four-fold in the next two years and jump to 200 million cards by 2010. This kind of spectacular growth has been seen in many other industries in recent years. For example, the number of mobile phone subscribers in China hit 461 million at the end of 2006, up 71 percent from the end of 2003.[20]

The projected figures still pale in comparison to more developed markets. The United States credit card industry has more than 640 million cards in circulation[21], while in South Korea, with a population of about 48 million people, the average person owned more than three credit cards at the end of 2005.[22]

This enthusiasm surrounding the market's fast development is accompanied by a strong dose of concern about the market share mentality of local banks, which have turned to credit card business as a way to quickly diversify their revenue mix away from traditional lending operations.

China Merchants Bank has been one of the fastest in developing its credit card business after bringing in expertise from Chinatrust in 2002. The fact that it subsequently jettisoned this relationship serves to show how willing mainland lenders are to strike out on their own when the opportunity arises.

Issuers have struggled to keep pace with the growth in the market, particularly when it comes to strengthening their back office staff and systems. The market is booming but competition is fierce. As consumers in wealthier cities like Shanghai start to carry multiple cards, customer service is sure to become a more important differentiating factor.



Source: People's Bank of China, 2006

20 Data from Ministry of Information Industry, China's telecoms regulator
21 "UPDATE 2-Critics urge US lawmakers to curb credit card abuses," Reuters News, 26 January 2007
22 "UPDATE 1-S. Korea warns of slow private consumption growth," Reuters News, 2 November 2006

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Cracking the market

Chinese lenders have some immediate advantages in the credit card market. State-owned giants like ICBC, CCB and BOC are *de facto* banks for many of the nation's biggest companies, which means their employees have no choice but to open accounts at a particular "house bank."

Those banks would then have easy cross-selling opportunities with a huge base of customers — ICBC, for example, has more than 150 million retail customers.[23] Moving money between banks is also problematic as the nationwide inter-bank system is still developing. This means some customers will prefer to just pay off their own card from their deposit account rather than deal with the inconvenience of paying off another bank, especially if that involves withdrawing cash in one branch and bringing it to another branch in person.

Foreign bankers are less intimidated by this network, however, as they stress that the clients they are targeting are not likely to be employees of state-owned enterprises.

Citigroup, HSBC, and its rivals are targeting relatively wealthy customers with average annual incomes of at least USD 5,000. Investment bank China International Capital Corp. put the size of that market at approximately 76 million people.[24] The average annual individual income in China in 2005 was USD 1,290, according to the World Bank.

Citigroup launched a card with partner Shanghai Pudong Development Bank in February 2004.[25] HSBC and its partner, Bank of Communications, have already issued more than 1 million cards,[26] while Bank of America hopes to formalise a card joint venture with CCB by next year.[27]

Purely domestic card issuers are more likely to go downstream than their overseas rivals, targeting people aged 18-45 with annual incomes in the USD 2,000 range.

Some will even take on students who come from solid family backgrounds and have part-time jobs, while they also seem more likely to take into account customers with less conventional or stable incomes. Global banks may have a hard time accepting the risk profiles of such clients.

Banks have been trying to capture customers in a number of ways, but most troubling to foreign players has been the erosion of fees, as lenders fight tooth and nail to win market share, even at the expense of profits.

One foreign executive wondered whether doubling or tripling his bank's market share was even the right strategy, considering the possible further losses on servicing the cards, and projected a glum profitability target for the year 2013, when McKinsey & Co. estimates total industry profits could hit USD 1.6 billion.[28]

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23 Source: ICBC research report by Deutsche Bank, 22 September 2006
24 Source: ICBC research report by CICC, 23 September 2006
25 "Citigroup brings in big guns in China quest," Reuters News, 4 February 2004
26 "Bank of Communications' credit card issuance exceeds one million pieces," China Industry Daily News, 20 June 2006
27 "INTERVIEW-Bank of America bets on 2007 China card venture," Reuters News, 18 September 2006
28 "China credit cards loss-making until 2008-McKinsey," Reuters News, 8 September 2005

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Credit cards in China: Learning from the experience of South Korea

South Korean banks and consumer credit card companies are still digging themselves out of a massive consumer credit bubble three years ago, when a reckless expansion in cash advances and card loans led to an industry bailout. A similar bubble has emerged in Taiwan, where there are 520,000 problem debtors out of a population of 23 million,[29] with overdue debts averaging USD 9,620 per person in May.

Some have questioned whether China's credit card surge could create similar problems in a country where consumer growth is on the rise and young people are clamoring for pricey goods like iPods, Nikes and flat-screen TVs but have little experience with credit.

Executives are quick to dismiss such fears, in large part because the market is so small that even a huge increase in defaults could be handled by the healthier banking system now in place. They also point to Beijing's maximum credit limits of RMB 50,000, with some higher exceptions for premium cards, that puts a cap on spending.

But the situation in South Korea provides some valuable lessons for Chinese officials, as it was partly driven by the Korean government's desire to drive out black-market lending. Seoul decided to stimulate credit card spending through tax breaks, which helped card financing spiral out of control.

The dangers of such policies should be carefully considered as Beijing tries to shift its economy from a huge manufacturing base to a nation of consumers. Regulators began teaming up with UK credit reference agency Experian to set up a national credit bureau in 2005,[30] and many of the big Chinese lenders are only beginning to assign credit ratings to their clients, making credit risk one of the sector's major concerns.[31]

The prospects for China's credit market rest on the shoulders of its youth — professionals below the age of 30 are good transactors and are more likely to carry over balances on their cards. However, many executives saw a notable difference in paying habits among customers over the age of 35. These customers have become frequent card users but tend to pay off their balances every month. Research by TNS indicates that almost two-thirds of credit card holders always pay off their full balance, with only 7 percent admitting to regularly paying off less than the full amount.[32] With average merchant fees of only around 60 basis points, that means little profit is left for the issuer.

29 "FEATURE-Taiwan's credit card slaves labour to repay debts," Reuters News, 17 May 2006
30 "Central bank plans to build State Credit Bureau," Xinhua News Agency, 15 June 2005
31 "INTERVIEW-StanChart pushes for China credit checking bureau," Reuters News, 3 February 2004
32 TNS: China Banking Service Marketing Forum 2007

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"Many executives saw a notable difference in paying habits among customers over the age of 35. These customers have become frequent card users but tend to pay off their balances every month."

Younger customers are more confident about the future, as many have seen nothing but good times and a booming economy since they joined the workforce. This optimism does not come without risk — see South Korea sidebar on page 13 — but it leaves foreign card issuers far more confident about the profitability of cards over the medium term.

To capture younger and wealthier customers, banks have taken to aggressive marketing plans that include direct mailing, cross-selling at their branches and in some cases, approaching potential customers on the street. Dual-branded cards have also become popular, with links to retailers, air miles programmes and even rebates on fuel purchases becoming familiar to Chinese cardholders.

Customers in bigger cities like Shanghai have become particularly savvy to these co-branding techniques and will use some cards only when the retail partner is holding a particular sales program, similar to the behaviour of Hong Kong cardholders.

But no bank wants to miss out on what could be one of the largest consumer markets in the world, and to that end executives are pouring resources into the IT systems, risk management and customer service centres necessary to provide customers with international quality standards.

The need for such supporting infrastructure means that the pay-off for investments is invariably a long-term one. It is essential for credit card providers to differentiate themselves by choosing the most attractive co-branding partners and targeting the most affluent and free-spending part of the Chinese population.

One bright spot is China's push for more vendors to accept credit cards, traditionally the biggest hurdle to higher credit card spending in a country filled with smaller merchants. MasterCard estimates that there are only roughly 100,000 merchants, out of several million, that accept credit cards and only about 10,000 ATMs for cash advances.

The availability of vendors provides some potential for the areas of growth in card usage. Research by TNS indicates that up to 80 percent of credit card holders used their cards for supermarket purchases and for large ticket items such as household appliances. However the use of cards was lower in service sectors, with only 62 percent using their cards at restaurants and only 19 percent using their cards for transport purchases such as rail or air tickets.[33]

[33] TNS: China Banking Service Marketing Forum 2007

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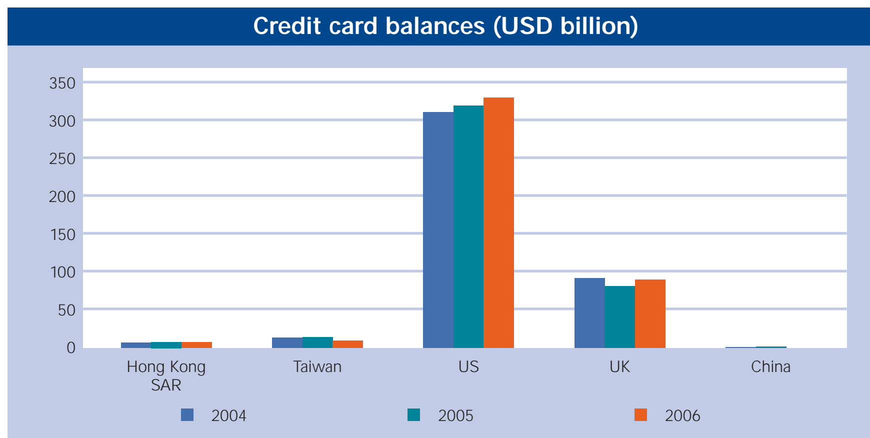
The influx of credit-card carrying foreigners, visiting for both business and pleasure, has officials keen to promote the acceptance of international credit cards, particularly as they anticipate a flood of visitors during the 2008 Beijing Olympics. The central government is encouraging local authorities to increase acceptance rates. "Even the cities are rated by the percentage of non-cash sales you have — if you're a mayor that is one metric you're measured by," said one foreign bank executive, adding that the goal is to increase urban non-cash transactions to 30 percent of total transactions by the end of 2008 from the current level of around 15 percent.

The rules

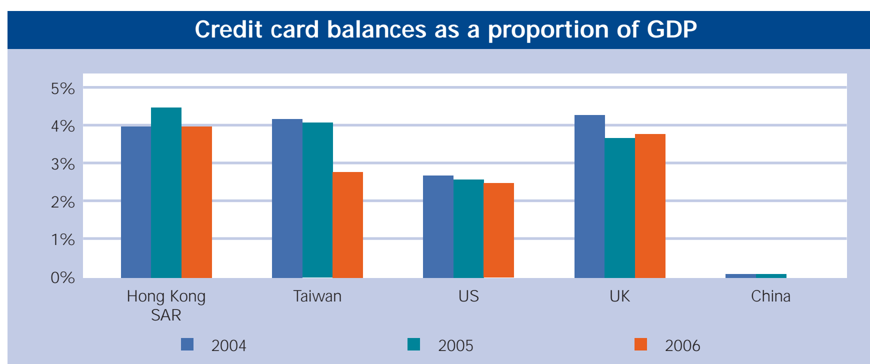
Most foreign executives expressed optimism that regulators will change the rules to allow formal joint ventures in the card business. This could give overseas players greater benefits and control over their existing partnerships.

Other reforms are also considered likely but may take longer to be carried through. Regulators may, for example, lift the caps on credit limits — and many banks can get around the current ceiling of 50,000 RMB with special programmes for higher-income clients — but there is as yet no timeframe for changing the fixed interest rate of 18.25 percent for cards.

Credit card balances (USD billion)



Credit card balances as a proportion of GDP



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EIU Views Wire: Five-year Country Forecasts.
Note:
USD amounts are based on prevailing year-end exchange rates.

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Mortgages: Worth the risk?

Key findings

- **Foreign banks are considering domestic mortgages warily. While the market is opening up to foreign banks, local lenders hold a dominant market share through their close ties with big developers.**
- **The inability of many salaried employees to choose their own bank — Chinese companies choose an individual bank for payroll deposits — is another barrier as most of those customers use the "house bank" for their financing needs.**
- **China is still in the process of developing a network of credit bureaus, making it difficult for banks to price loans and evaluate potential customers.**
- **Cost of funds is low, allowing for higher margins, but industry players worry that intense competition will hit profits if lending rates are deregulated.**

With the steady migration of workers from the countryside to urban centres, and private ownership of property still in its infancy, it's not hard to envision the potential for growth in China's mortgage market.

In less than ten years, mortgage lending has grown from nothing to be the largest form of consumer lending, accounting for over 75 percent of total consumer lending, and comprising 11.4 percent of all total outstanding loans at the end of 2004, a figure that is quite low compared to developed economies, providing ample room for growth.[34]

CCB, the leading mortgage lender in China, only started making commercial loans to individuals in 2000 but by 2006 mortgage lending accounted for more than 13 percent of total loans.[35]

34 "China's Big Four get ready for market," Retail Banker International, 12 May 2006
35 China Construction Bank: 2006 Interim Annual Report

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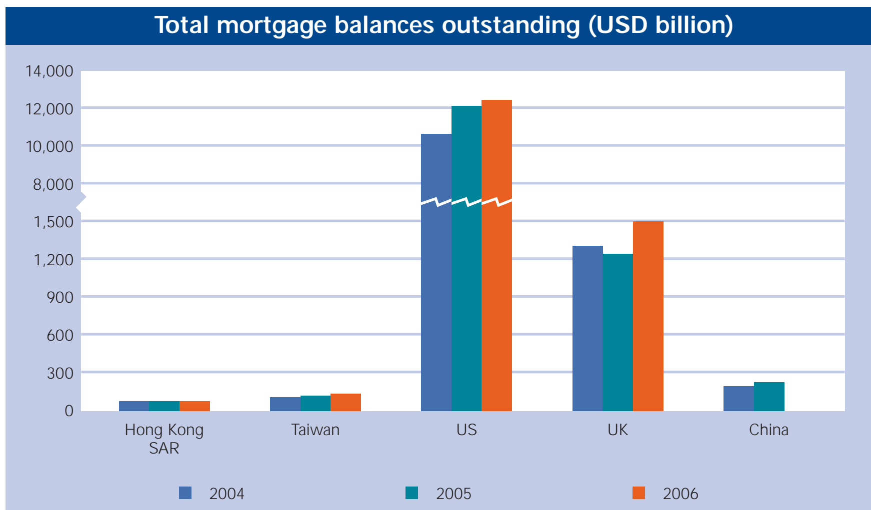
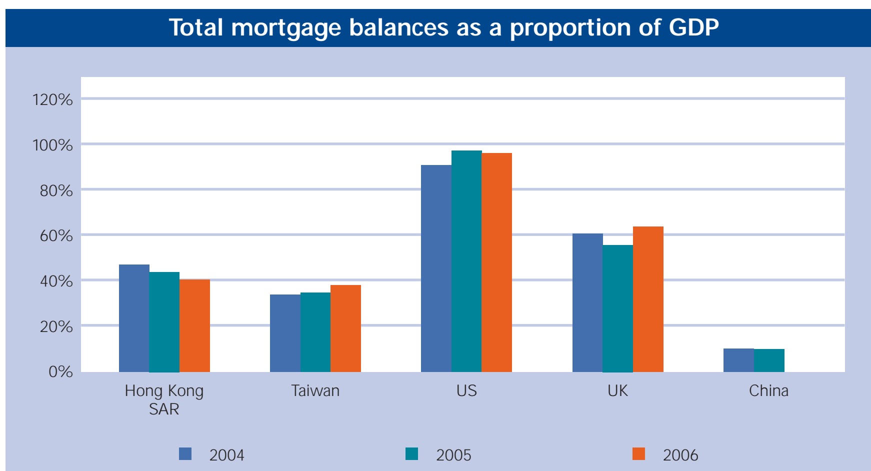
Total mortgage balances outstanding (USD billion)



Total mortgage balances as a proportion of GDP



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EIU Views Wire: Five-year Country Forecasts;
Housing Finance in East Asia, Loic Chiquier, The World Bank, December 2006.
Note:
Hong Kong figure is provisional as of September 2006; US figure is provisional as of June 2007, USD amounts are based on prevailing year-end exchange rates.

The government is taking steps to curb spending for potentially overheated sectors such as property and construction, most recently implementing a 5 percent business tax on homes sold within five years of purchase and a capital gains tax on luxury housing.[36]

36 "ANALYSIS-China cooling: déjà vu for developers, with a sting," Reuters News, 20 June 2006

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"City commercial banks have been pushing high-margin mortgage products and may well benefit from being closer to their customers and more knowledgeable of their urban market."

Against this backdrop, a number of executives from both domestic and international banks raised concerns about the application of government regulations governing the property sector, registration and approval processes, and the lack of a proper credit bureau to determine risk for individuals. Losing RMB 50,000 on a credit card is manageable, but missing payments on a property loan is a much costlier proposition for banks, particularly given the difficulties in recovering loans from repossessed collateral due to problems in the secondary market for property.

This will have foreign banks moving very carefully into the domestic mortgage market, with state-owned lenders also developing strategies to better manage customer risk. However, given the currently very low disclosed NPL ratios in the market (typically 0.5 to 1.75 percent), the state-owned lenders will continue to focus on expanding mortgage lending.

The big four state banks have sought to win business by linking up with property developers. These companies are the first point of contact and then channel their homebuyers to the bank they work with. "Developers are a quick way to win customers," said one executive at a big Chinese bank. "The banks and developers help each other."

Sourcing customers from property developers is also crucial as many state lenders (and many joint stock and city commercial banks) have insufficient relationship managers to target and service the accounts of the middle-level salary earners. The bank can help with additional vetting of the potential client, gathering information about their age, family status, occupation, salary and credit history. The banks have captured a steady pool of customers in this way, as development booms across major Eastern cities and, increasingly, in second-tier urban centres such as Tianjin, Xi'an and Chengdu.

Domestic banks are training up sales and management staff to deal with wealthier clients. However several executives acknowledged that the mass market for mortgages has not yet become lucrative enough to warrant such high levels of individual attention.

City commercial banks have been pushing high-margin mortgage products and may well benefit from being closer to their customer and more knowledgeable of their urban market. They may however carry a higher risk because of their inability to diversify geographically.

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Foreign banks have got their foot in the door by providing home financing for expatriates living in China. This has been a good business with low rates of default, but it is also a limited market, with far less potential for growth over time.

Foreign bank executives told us they were unlikely to adopt the property developer tie-up approach. Many said they would first roll out their domestic mortgage services for existing clients, rather than use it as a lead product.

There is no denying the potential of the mortgage business as cost of funds is low, a factor that has been driving domestic earnings for the past couple of years. One year benchmark deposit and lending rates are 2.52 percent and 6.12 percent, respectively, after Beijing raised interest rates in August.[37] The move was taken partly to dampen property speculation, although first-time homebuyers are eligible for a 15 percent mortgage rate deduction.[38]

Despite the current strong margins, there is legitimate concern on behalf of overseas players that, as in credit cards, greater competition means that profit margins will be the first to go if the government relaxes interest rate regulation.

A steady, prudent entry into the more developed markets like Shanghai and Beijing seems to be the smartest initial play, although fears of a property bubble are never far from a banker's thoughts.

37 "UPDATE 4-China raises interest rates to curb credit boom," Reuters News, 18 August 2006
38 "Banks Rush to Lower Mortgage Lending Rates," China Daily, 23 August 2006

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Wealth management: A black box

Key findings

- **Many foreign and local bankers see wealth management as a black box. They are excited by the prospects and the pent-up demand for a broader range of investment products, but they are not clear how the universe of investment products will expand or develop over the next five to ten years.**
- **Overseas players, which have won licenses and quotas to invest in foreign securities for their Chinese clients, have long histories in product creation and can access people with the necessary know-how in a particular area more quickly.**
- **Chinese banks have tremendous distribution capability, making them formidable competitors despite their relative inexperience in the wealth management business.**
- **The rules surrounding wealth management are still being clarified and all new products must be vetted by regulators.**
- **Some foreign companies and banks have been frustrated by the pace of regulatory developments. Others appear to be less concerned, believing it will take time for the market to develop an interest and understanding in more sophisticated investment products.**

Wealth management is viewed by many bankers as the business with the highest potential, as corporate and individual customers have for years been forced to channel their cash into low-yielding investments like bank deposits or government debt.

Wealth management is also a business where the foreign and local banks may be more likely to bump heads — under CBRC rules, customers must invest RMB 50,000 (USD 6,250) in each product; this is an unfathomable amount for most of the population and products are therefore targeted at the higher end of the market.

The alternative for domestic investors has been the country's traditionally weak-performing stock markets, which have only recently rallied. Traditionally, China's top companies have listed in Hong Kong or, to a lesser extent, overseas bourses such as New York and London. Tight restrictions on overseas investments have prevented Chinese investors from profiting from the high returns on overseas listings.

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The government in Beijing is now making strong capital markets a priority and has encouraged top-tier companies like BOC, Air China and China Life to list shares in Shanghai or Shenzhen to give domestic investors access to blue-chip investments. A gradual relaxation on the types of investment products available to local customers has executives eagerly anticipating the ability to attract new clients with yield-enhancing investments.

Foreign banks are confident that they can position themselves among the leaders in the market for wealth management, given their experience in marketing and product development. They can also draw personnel through more attractive compensation packages and career opportunities.

Yet once again, the way forward is uncertain. Chinese regulators are wary of creating market disruption by allowing too many speculative vehicles to hit the market. Thus far, the products approved are quite conservative and offer little room for the ingenuity that sets the big investment banks apart.

The investment experience of typical Chinese banking customers is also highly limited. Few have yet gained exposure to structured products like mutual funds that have become portfolio staples in markets from the United States to Spain to South Korea.

Distribution, product variety and employee training are three crucial factors for succeeding in the wealth management business.

Distribution

The battle for distribution is really no contest: Chinese banks dominate, and likely always will as their branch networks will never be matched by foreign competitors.

While the big four banks boast tens of thousands of branches, foreign lenders are lucky to have a network of more than 10 outlets as there are restrictions on their organic expansions. The application process can be time consuming and a bank may need to hit certain growth or profitability targets at its existing branches before it is allowed to open new ones.

The disparity means that many foreign banks will reach out to their local partner, where they have one, to sell their products through the local bank's network. Many banks are also considering teaming up with Chinese insurers, since these companies boast huge networks and sales infrastructure. Local banks can do their part with large advertising campaigns around the launch of a new product.

As with credit cards, making transfers between banks can be cumbersome. This has hindered growth in the wealth management market and underscores the importance of an extensive bank network.

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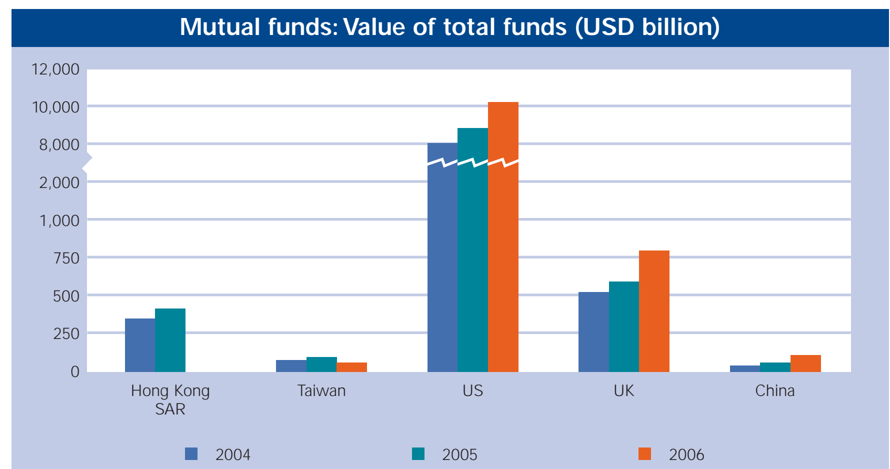

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US Census Bureau: Statistical Abstract — The national data book;
Summary of funds under management by asset class 1995-2006 from Investment Management Association (ima);
"Mutual Funds Net Record High Yields," Xinhua News Agency, 13 January 2007.
Notes:
USD amounts are based on prevailing year-end excaharge rates.
These statistics are taken from differing sources and should therefore be used only for broad comparison and reference.

Private banking

Private banking for wealthy Chinese (considered to be those with non-property investable income of greater than roughly USD 1 million) is an area many banking executives see as wide open. Most Chinese banks have not set up private banking operations, and foreign lenders are gearing up to have that business in place as the market opens under WTO.

Creating an attractive client environment will be crucial, as these customers are used to the highest levels of service and performance. This segment could offer a big win for the overseas players which have already provided plush facilities for gleaming new offices in places like Shanghai's Pudong district or ritzy shopping areas like the city's Times Square.

Much as they have in other parts of Asia, foreign banks have targeted wealthy clients and simultaneously raised awareness of their brand by sponsoring sporting and cultural events, often with a high-profile athlete or exhibit as a draw and a large marketing campaign built around it.

Chinese banks, meanwhile, are only just starting to set up sections of their branches for wealthier, high priority customers. Foreign banks are also betting that their Internet platforms can be easily transferred to the Chinese market.

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Products

The biggest frustration facing foreign banks in the wealth management business is their current inability to introduce some of their more creative products that would allow them to stand out from the pack. However, many executives acknowledged that a relatively slow regulatory approval process had its advantages, as allowing too many products too quickly could be destabilising.

"Chinese regulators are wary of creating market disruption by allowing too many speculative vehicles to hit the market."

Investor interest in new and seemingly exciting products like Qualified Domestic Institutional Investor (QDII) funds, allowing Chinese nationals to invest abroad, has been muted, to say the least. The government in Beijing has granted more than USD 13 billion of QDII quotas, but as of December 2006 actual investment in QDII products was less than USD 400 million as QDII funds are still confined largely to low-yield fixed-income investments.[39] Bank executives also complain that the funds must carry a currency risk hedge function, which can crimp returns.

"With hedges, the real return on the product is just a little bit higher than the return on local currency products," explained one Chinese bank manager.

There is also considerable fee pressure in the world of wealth management, especially given how similar the products are. Mutual funds have become increasingly popular — foreign players ranging from Fortis and Prudential to Credit Suisse and Merrill Lynch have set up mainland fund joint ventures — but fees can sometimes be lower than 1 percent, compared with up to 5 percent in other markets.[40]

This is unlikely to change. In fact fees may fall even further, if the range of product offerings remains static.

Foreign banks have deepened their understanding of Chinese customer profiles, and most have come to the conclusion that while many investors are hungry for big returns, they tend to be unwilling to take on the corresponding risks.

This, coupled with the tight regulations, leaves banks pushing money market funds and conservative, lower-yielding dividend products. What customers really want is a stable payout. This has led to the development of products with a principal in RMB but a dividend linked to foreign exchange that offers the possibility of enhanced returns.

For foreign banks, success in wealth management will hinge upon developing new products to bring forth to regulators, with the accompanying hope that they can create unique investments for their customers.

39 "China eyes opening QDII to stock funds-media," Reuters News, 7 December 2006
40 "Welcome to China's Mutual Fund Jungle," BusinessWeek, 7 March 2005

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Training

When asked to comment on the needs for training, one foreign bank executive commented that, "The sophistication of the banks will outpace the sophistication of the markets."

That sentiment, echoed by executives from overseas and Chinese lenders alike, highlights the significant risk of selling something to the wrong customer in a market where consumer awareness of many investor products is quite low.

It is also another area in which foreign banks have an advantage, as they boast stronger training programmes for employees — well honed by years of experience in markets abroad — and their smaller staff sizes make this kind of training more manageable.

ICBC, for example, has more than 3,000 wealth managers, while few foreign banks boast total China staff equal to that amount. ICBC's total staff is a staggering 361,632 people, larger than that of CCB and Bank of Communications combined.[41] HSBC, the world's second-largest bank by market value, had 279,393 staff spread across the world at the end of the first half of 2006.[42]

Staff retention is a problem in almost every sector of the Chinese economy, and financial services companies provide some of the most extreme examples. Turnover rates can be extremely high as qualified employees jump ship for pay raises that are modest by Western standards but can make a significant difference for lower-paid staff.

ICBC, for example, increased its compensation by 46 percent in the first half of 2006 from a year previously. The average compensation per ICBC employee now stands at about USD 6,000 a year, not including benefits.[43] Foreign banks still have deeper pockets to reach into when they need specialised talent, but the gap is narrowing.

Foreign banks could therefore have an advantage in attracting and retaining product development specialists, particularly as the range of investment vehicles grows broader and more sophisticated.

"We have asked human resources for staff increases, but our (compensation) package is not as attractive," admitted a wealth management executive with one of China's largest banks.

41 Source: Industrial and Commercial Bank of China research report from Deutsche Bank, 23 September 2006
42 Source: HSBC Interim Report 2006
43 Source: ICBC research report by CICC, 23 September 2006

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How to enter the market

Despite opening up in line with its WTO commitments, China's banking system is still governed by many restrictions. Foreign banks wishing to enter the market on their own are faced with a slow, complex process of changing from branch status to locally-incorporated bank. The alternative partnership route is individual investments in local lenders which are capped at 20 percent.

Still, there is room for improvisation as Beijing has long proved itself open to new ideas that it finds to be in the country's benefit. Standard Chartered's ability to help build a new national bank is one example, while Morgan Stanley recently bought Nan Tung Bank, allowing it to apply to offer RMB-denominated products.

Morgan Stanley was able to buy 100 percent of the bank as it is considered a foreign-funded bank, not a local lender, and was formerly owned by a Macau-based unit of BOC.[44]

Most big financial services companies, ranging from American International Group to Credit Suisse, have also set up fund management joint ventures to capture the growing popularity of mutual funds. As a relatively inexpensive entry to the market — far less than paying more than USD 1 billion for a stake in a state bank, for example — foreign firms can begin building brand recognition and market knowledge.

China's approval processes can be multi-layered and involve liaising with both local and central authorities. But the system is getting more streamlined as regulators and banks work in closer alignment, giving foreign executives solace that their efforts are not in vain. While Chinese guidelines governing product development remain strict, regulators have in the past proved amenable to new ideas, particularly when they can demonstrate their value to the overall development of the country's capital markets.

Benefits of incorporation

	Foreign bank branch	Locally incorporated WFOE or joint venture
Access to local renminbi business	Cannot provide retail renminbi business to Chinese citizens except for acceptance of deposits in excess of RMB 1 million	No restriction
Minimum registered	RMB 200 million minimum operation funds	RMB 1 billion in freely convertible currency
Statutory reserves	Must set aside 30 percent of operating funds for statutory reserves	No requirement
Loan to deposit ratio	No restriction	Must be less than 75 percent (however a grace period to 31 December 2011 is provided)

44 "UPDATE 4-Morgan Stanley buys bank to gain China access," Reuters News, 3 October 2006

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Tax considerations for banks in China

China's accession to the World Trade Organisation (WTO) will present important tax implications for banks during 2007. The government is moving to harmonise corporate income taxes to provide a level playing field between foreign investors and domestic companies. At present lower tax rates still apply to many foreign companies, including foreign banks. Lower corporate income tax rates for foreign currency business and withholding tax exemption on profit repatriation are examples of tax incentives that may not be available to foreign banks under future corporate income tax regimes.

The liberalisation of the banking sector in China and increasing penetration of foreign institutions brings with it the risk of transfer pricing reducing the Chinese tax base. China's tax authorities may become more assertive in assessing the tax liabilities arising from related party transactions between and within financial institutions.

Compared to companies in many other sectors, financial institutions are often highly integrated functionally across borders. This can make it harder to identify which entities are performing high value or low value activities, or to justify their judgements in the eyes of local tax authorities. The volume and complexity of transactions, particularly on ongoing global trades, make all forms of tax reporting especially challenging.

Incorporation of foreign banks

Related to these questions are the tax implications for those banks seeking to incorporate locally. Foreign banks can incorporate by establishing a Wholly Foreign-Owned Enterprise (WFOE) or converting their existing branch offices.

In so doing, they must address the possibility for changes to their tax liabilities and even the loss of certain tax holidays and exemptions.

Key considerations include:

- Foreign Enterprise Income Tax: Can the assets and liabilities of the branches be transferred to the WFOE tax-free?
- Treatment of tax holidays and tax losses: Can unutilised tax holidays and tax losses of the branches be carried forward to the WFOE?
- Business Tax: Will the transfer of properties and intangible assets during the transformation process be be subject to business tax?
- Tax filings: What will the tax filing and payment requirement be if incorporation occurs mid-year?

The latest indications from the tax authorities suggest they want to treat the WFOE as "continuation" of the branch offices and will likely announce measures to ensure a smooth transition from an existing structure to a WFOE structure.

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Conclusion: The end game

Bank executives, local and foreign alike, are encouraged by the progress China is making in reforming its financial services industry and excited by the prospect that China could quickly become one of the largest banking markets in the world. For overseas players, the enthusiasm is tempered by the constraints, natural or regulatory, that still exist.

Our discussions with executives of foreign and domestic banks in China have revealed several common themes.

The credit card business is viewed by many international banks as a first step into China. They see it as an effective brand building exercise, targeting the mid- to high end of the market. These banks seem somewhat reluctant to compete with their domestic peers at the mass market level, where they expect fee competition to be fierce. Banking executives are also somewhat sceptical about the prospects of a significant change in mindset of consumers, who remain highly averse to using credit, when compared with consumers in the US, the UK and even many other parts of Asia.

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Most executives saw far greater potential for growth, over the medium and long-term, in the markets for mortgages and wealth management. However even here achieving success will require patience and commitment.

One executive noted wryly that despite his best efforts, the business he is building will not bear profits until he is long gone, as profitability remains elusive in businesses such as credit cards and wealth management. But the opportunity for growth is too large to ignore, and banks from Spain to Singapore have won backing from their boards to open up their coffers for investment in China.

Likewise, the interest displayed by foreign banks in incorporating locally is testament to international banks' view of the China market.

The support of head office is crucial. Executives on the ground grapple with intense competition, constraints on available talent and a remaining raft of government restrictions. Foreign banks must keep refining their China strategies and take care of valuable employees.

Overseas lenders need to find creative distribution channels — mobile phone banking or a partnership with a large insurance company, for example — to overcome the immense network advantage enjoyed by the state-backed banks.

Banks that build a strong brand by creating innovative and relevant products to retail customers will win small but lucrative niches within the Chinese market. Those that rely on plain-vanilla offerings may win initial success and market share, but may fail to capture the higher end of a market where wealth is being created as fast as anywhere else in the world.

First-mover advantage is important — China Merchants Bank dominates the credit card business after getting a head start on local and foreign rivals four years ago — but the market is growing fast enough to accommodate strong newcomers with a shrewd business plan.

The growth of consumer markets is now the biggest story in China. Foreign banks are jostling for position, building up networks in the country's richest cities and preparing to serve the increasingly sophisticated needs of China's middle classes. There is no single blueprint for building a successful financial services franchise in China. Some banks have chosen to take on the expense of building a network from scratch, while others paid for goodwill in a joint venture structure. Organisations will continue to explore a number of other avenues to fully serve their clients on the mainland, which could also include teaming up with insurance companies and forming securities joint ventures.

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KPMG contacts

Northern China

Beijing
8th Floor, Tower E2,
Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel : +86 (10) 8508 5000
Fax : +86 (10) 8518 5111

Qingdao
4th Floor, Inter Royal Building
15 Donghai West Road
Qingdao 266071, China
Tel : +86 (532) 8907 1688
Fax : +86 (532) 8907 1689

Eastern and Western China

Shanghai
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel : +86 (21) 2212 2888
Fax : +86 (21) 6288 1889

Chengdu
18th Floor, Tower 1, Plaza Central
8 Shuncheng Avenue
Chengdu 610016, China
Tel : +86 (28) 8673 3888
Fax : +86 (28) 8673 3838

Hangzhou
8th Floor, West Tower, Julong Building
9 Hangda Road
Hangzhou 310007, China
Tel : +86 (571) 2803 8000
Fax : +86 (571) 2803 8111

Southern China

Guangzhou
29th Floor, Guangzhou International
Electronics Tower
403 Huanshi Dong Road
Guangzhou 510095, China
Tel : +86 (20) 8732 2832
Fax : +86 (20) 8732 2883

Shenzhen
9th Floor, China Resources Building
5001 Shennan East Road
Shenzhen 518001, China
Tel : +86 (755) 2547 1000
Fax : +86 (755) 8266 8930

Special Administrative Regions

Hong Kong
8th Floor, Prince s Building
10 Chater Road
Central, Hong Kong
Tel : +852 2522 6022
Fax : +852 2845 2588

Macau
23rd Floor, D, Bank of China Building
Avenida Doutor Mario Soares, Macau
Tel : +853 2878 1092
Fax : +853 2878 1096

REUTERS contacts

Hong Kong
10th Floor
Cityplaza 3
Taikoo Shing
Hong Kong
Tel : +852 2520 3688

Beijing
6/F Beijing Sunflower Tower
No.37 Maizidianbei Street
Chaoyang District
Beijing 100026, China
Tel : +86 (10) 6586 5566

Shanghai
30th Floor, Azia Center
Luijiazui Huan Road
Pudong
Shanghai 200120, China
Tel : +86 (21) 6104 1688

Shenzhen
Unit 09, 27th Floor
Diwang Commercial Center
Shun Hing Square
No. 5002 Shennan East Road
Luohu District
Shenzhen 518008, China
Tel : +86 (755) 8246 3318

Macau
13th Floor
Nam Kwong Building
223-225 Av. Dr. Rodrigo Rodrigues
Macau
Tel : +853 713 863