



China's card market: Primed for rapid evolution

China's credit card market is at the center of an evolving, high-stakes competition among domestic and foreign financial institutions. Although still relatively small, it is growing rapidly and may soon become Asia's most important card market. Last year, China issued approximately 50 million cards, more than any other market and about equal to the total number of cards presently active in France. By 2013, total cards issued in China will likely surpass 300 million – more than double today's level. Notably, increasing card usage and penetration of credit-needy segments will soon enable the nation's card industry to achieve profitability for the first time. More broadly, the rise of urban middle-class consumers will present lucrative opportunities in payments and other personal financial services. In short, this market is at a critical juncture, where strategic decisions will be key determinants of long-term success.

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China's credit card market not only has vast potential, it is also unique. Unlike most, it evolved after debit cards and the Internet had gained popularity. China tightly regulates its card industry, allowing narrow operating flexibility that constrains profitability. Meanwhile, on-line payment providers and other innovative attackers are breaking down market barriers and offering new services. Innovation and risk management will be critical factors in this natural selection process. Success will require that players differentiate their strategies by local market, use customer analytics and advanced risk decision-making to help drive their businesses, develop innovative product offerings, and experiment with alternative business models.

Fertile ground

Despite the worldwide economic crisis, China's fast economic growth and urbanization will continue, further increasing the ranks of its already-burgeoning middle class – consumers with modest disposable income who are the core of the credit card market. This group has been projected to surpass 52 million people by 2013. Forecasters also expect the middle class, previously concentrated in coastal cities, to become more evenly distributed across major urban centers, thus increasing industry rivalry as competitors pursue growth opportunities.

While the Bank of China issued the nation's first credit cards in the 1980s, the industry began to take off fewer than 10 years ago.

Today, approximately 5 percent of Chinese have credit cards, a sharp contrast with the U.S., where about 60 percent of the population has one or more. Despite relatively low penetration rates, card issuance in China is rapidly gaining speed. In 2003, only 3 million cards were in use, but in 2008 card issuance soared by 50 million new cards to over 100 million total cards – a higher rate than in any other major country, and a higher level than in Brazil, Mexico or Taiwan. Moreover, while card spending remains low, it too is growing fast. In a land where cash still dominates, credit cards account for about 6 percent of China's retail purchases (Exhibit 1), compared with close to 20 percent in the U.S. and almost 50 percent in South Korea. Card acceptance is also growing. By 2007 1.2 million POS terminals were in use, partly due to the government's encouragement to build a broader payments acceptance infrastructure, especially prior to the 2008 Beijing Olympics.

The outlook for cards in China is bright. Usage growth is expected to continue rap-

idly, with total cards surpassing 300 million by 2013 (Exhibit 2 on page 12). Allowing for owners of multiple cards, the number of cardholders should more than double to about 130 million. Our research suggests that card spending will more than triple over the next five years – from RMB 640 billion (\$92 billion) to RMB 2.2 trillion (\$316 billion) – as issuance and increasing spend-per-card drive volumes higher. Revolving will also gain acceptance as cardholders become more comfortable using credit, thus causing balances and issuance rates to climb.

Environmental forces: markets, customers and regulations

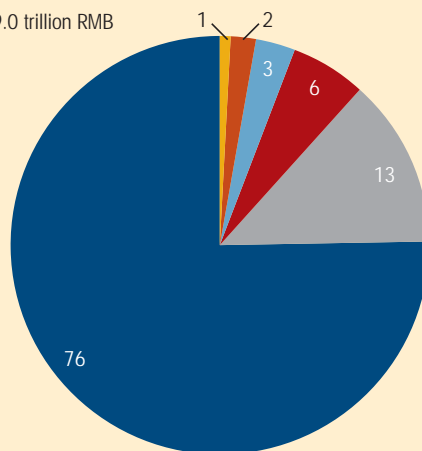
China is an atypical market comprising many unique local markets at various levels of development, each requiring understanding at a granular level. Based on GDP and card penetration, we classify local markets as maturing, emerging or nascent, and accordingly foresee maturity occurring in three waves. With economic growth spurring card penetration, each market

Exhibit 1

Cash still dominates China's payments landscape, but credit cards and other instruments have made gains

Personal Consumption Expenditure share by payment method, 2007
Percent

100% = 9.0 trillion RMB



- All others
- Credit card
- Quasi-credit card
- Debit card*
- Check
- Cash

Cash

Dominant form of payment for consumer purchases in most areas of the country

Debit cards

Launched in the mid-1990s, debit cards are growing in usage, particularly in certain large ticket categories

Credit cards

Launched in the early-2000s, credit cards are expanding rapidly, although still concentrated in major urban centers

Check

Limited usage of checks due to fragmented and rudimentary inter-bank check network

Quasi-credit cards

Charge cards that require the customer to deposit a certain amount of standby money and allow overdraft within the given line of credit

All others

Numerous alternative payment instruments under development including prepaid and online payments

* Debit card spending estimates are difficult to determine due to reporting differences in retail spending figures from available sources

Source: PBOC, CRBC, EIU, McKinsey Payments Practice

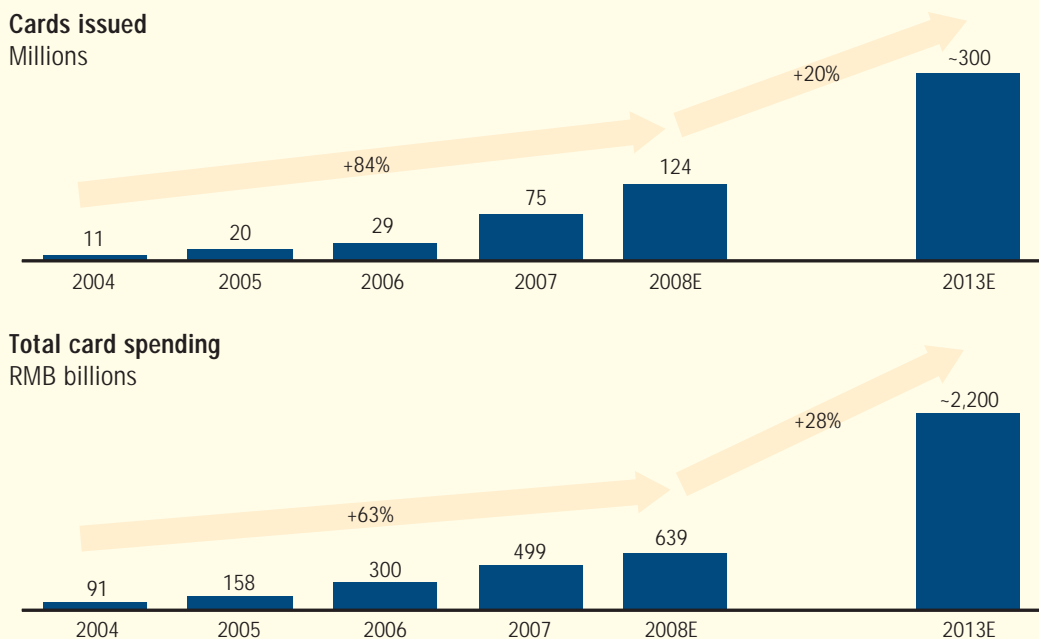
group will in turn ascend a development curve in the next five years (Exhibit 3).

Most card growth to date has occurred in China's more mature coastal markets, including Beijing, Shanghai, Shenzhen and Guangzhou. These are the most sophisticated, established and deeply penetrated of China's card markets, and are similar in many ways to the more advanced markets of Hong Kong and Taiwan. Maturing markets account for over a third of China's issued credit cards. By contrast, emerging markets are more geographically dispersed, middle-tier urban centers, such as Wuhan, Nanjing, Tianjin and Xiamen. Markets in this group show accelerating growth and will become increasingly important. Finally, we see nascent markets offering significant untapped development potential; cities such as Urumqi, Qinhuangdao and Shaoxing are just beginning to adopt credit cards, giving this group the longest development curve. Issuers should tailor their strategies by local market and risk profile. For instance, in mature markets differentiated high-end products such as platinum cards are likely to be profitable, while in nascent markets basic and even locally co-branded cards would be a better offer.

Beyond focusing on market development, participants need to devote attention to consumer evolution and trends. Credit cards are becoming mainstream with demand growing across affluent, mass market and non-affluent segments. With the highest penetration rate (18 percent), affluent consumers led early market growth and remain a vital target. Next, mass-market consumers present major growth opportunities; by 2013, one of every five middle-class Chinese consumers will be a cardholder, triple the 2007 level. The non-affluent segment also offers opportunities for growth, but is, as yet, a riskier, less understood group. The transition, therefore, from cards being a relatively exclusive financial product to a mainstream one could cut two ways, increasing risk as well as revenue.

Close attention to other customer data (including age, education, profession, vintage and spending patterns) is also necessary. Heavy spenders and heavy revolvers, for example, generate many times the revenue of average customers (Exhibit 4 on page 14). In addition, students appear to be heavy card users and therefore more likely to revolve balances. Although now a small

Exhibit 2
China's credit card market has grown rapidly over the past 5 years, with more of the same projected



Source: McKinsey Payments Practice

segment, students could quickly become a key revenue source. Managing anticipated transitions across customer segments and geography will be challenging, so accurately identifying the most valuable of them in each region will require a multi-dimensional perspective.

Finally, China's regulatory environment is yet another important factor shaping the competitive landscape. China sets low levels for interchange rates and credit lines, for example, and allows only one interest rate for credit cards, currently about 18 percent. Consequently, card issuers cannot base card rates on creditworthiness and have limited product options. This could change unexpectedly, however, so savvy issuers will have appropriate product strategies ready to implement.

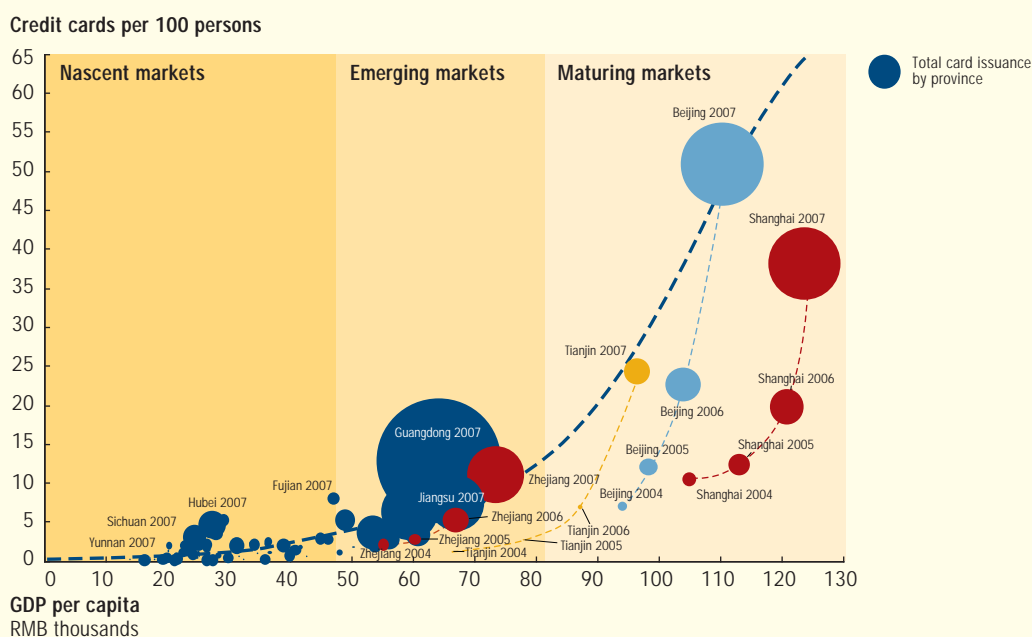
The players

China's card market comprises four broad participant categories: regional joint-stock banks, state banks, foreign entrants and non-bank institutions. China Merchants Bank and other regional joint-stock banks pioneered credit cards in China, eventually capturing significant share in a still-small market by focusing on segments, regions or

specialized products. Guangdong Development Bank, for instance, became a leader in the affluent Guangzhou and Shenzhen markets. More recently, state banks have pursued credit card opportunities. ICBC has become the largest issuer in China while Agricultural Bank of China seeks to triple the number of cards it issues. With massive branch networks and tens of millions of existing customers, these institutions are well-positioned to capture significant market shares. As noted in "China's new card game" in the February 2008 issue of *McKinsey on Payments*, branches have become the leading acquisition channel for card products, thus branch networks impart a key competitive advantage.

Foreign issuers have a limited but expanding presence in China. Last year, the Bank of East Asia became the first offshore bank to issue RMB-denominated credit cards. Other foreign banks, including HSBC, are focusing on premier customers in the maturing and emerging sectors. And importantly, non-financial entrants might gain a foothold by launching innovative payment offerings. E-commerce firms, for instance, could introduce virtual-payment platforms and partner

Exhibit 3
Local markets will evolve in waves based on their current development level



Source: McKinsey Payments Practice

with network providers to create compelling offerings aimed at online consumers.

Profitability arrives by 2013

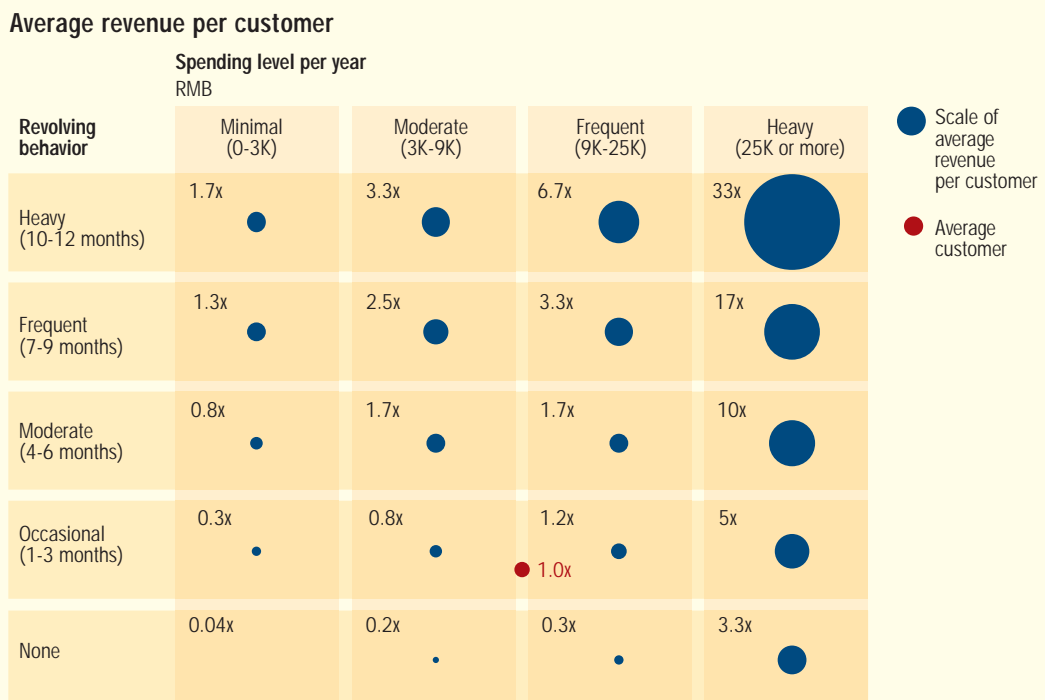
Low revolving rates and interchange fees along with intense competition have kept China's credit card industry unprofitable despite its substantial growth. Losses for 2007 are estimated at RMB 3.8 billion (\$550 million), and only three issuers reported profits in 2008. But change is underway. By 2013, we estimate that China's credit card market will generate modest profits of RMB 4 billion (\$575 million).

Three factors will drive profit growth. First, rapidly growing card issuance and volume will increase scale economies thereby reducing average fixed costs per card. Second, increasing comfort with card use and borrowing should produce modest growth in revolving, thereby improving profits. In fact, we note younger cardholders are already more comfortable with revolving balances and increased usage. Lastly, competition will slowly reach a plateau, where recent declines in fee income will halt.

As mentioned, credit cards will likely achieve profitability by 2013, but levels will vary widely by market. We see just seven provinces turning profitable by then, with most profits being generated in Guangdong, Shanghai, Beijing, Zhejiang, Jiangsu, Fujian and Liaoning (Exhibit 5). Collectively, these markets should return profits of RMB 8.3 billion (\$1.2 billion); however, losses elsewhere will reduce nationwide profits to RMB 4 billion (\$575 million). The lesson: choose markets carefully.

All these projections come with a caveat: credit and fraud risk heavily affect the nation's card profits. As in other countries, credit card and unsecured consumer credit markets will experience boom and bust credit cycles. Although charge-off rates have been low (less than 1 percent), several banks have experienced spikes of 1.5 to 3.7 percent. As credit cards go mainstream, the risk of unhealthy credit extension will grow – especially among risky borrowers – and today's financial crisis could deepen China's consumer credit losses. Success will hinge, therefore, on effective execution of well-

Exhibit 4
High revolvers and spenders are most profitable, but are currently a small portion of the customer base



Source: McKinsey Payments Practice

defined strategies and building superior risk management capabilities.

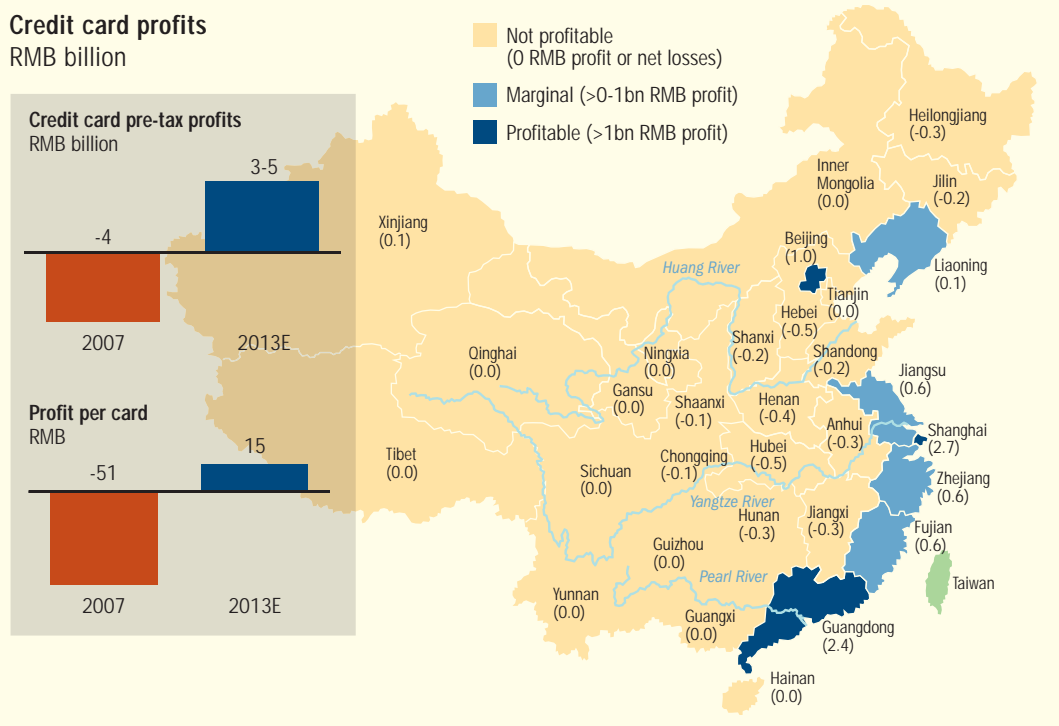
Adapting to market evolution

As in many industries, only a handful of credit card rivals will ultimately thrive while others struggle to balance growth with profitability. Maintaining this critical balance requires skill, adaptability and sophistication. To succeed, participants must weigh their alternatives carefully, design well-targeted strategies, and execute them attentively. We see three primary strategies taking shape. First, the familiar “land grab” approach, aimed at rapidly achieving scale by capturing a large customer base and market share. Second, a premium strategy that focuses solely on high-end customers in major urban markets where credit cards are already an anchor product. Third, a newly emerging portfolio strategy that targets profitable sub-segments differentiated by customer, product and local market.

Issuers also need to manage the following crucial areas with particular care:

- China must be recognized as a collection of distinct local markets, each with its unique consumer preferences, characteristics and development level. Uniform approaches are bound to fail.
- Strong customer analytics and risk management capabilities should be developed. Superior analytics help banks understand, manage and price risk, target promotions and motivate spending and borrowing.
- Frequent innovation in products and services is critical because customer needs change and regulations could soon loosen. Issuers should therefore be prepared to differentiate their offerings by adding or revising such features as flexible credit lines, differentiated risk-based interest rates, balance transfers, rewards programs, POS loans and cash advances.
- The shift of focus from card growth to profit growth and vice-versa must be carefully plotted. For example, China Merchants Bank initially pursued a land-grab strategy then shifted to a profitability focus. In doing this, managing and motivating re-

Exhibit 5
Only seven provinces will be profitable for issuers in 2013



Source: McKinsey Payments Practice

volving behavior and retaining high-value customers are critical components.

- Think differently about strategy. Because China's card industry is new and evolving rapidly, adherence to traditional models could mean losing opportunities to radically redefine a high-potential market.
- Organizational structure must be adaptive. As the credit card business grows, retail banks will need to reshape their organizational structures, incentive programs and management teams. Successful cross-sell models with broader retail bank products will become more critical as strategies evolve.

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China's credit card market will undoubtedly yield many attractive opportunities, but

risk, adaptability and innovation will be the major determinants of success. Some participants may enjoy early success only to find others ascending as the processes of natural selection unfold. The most skilled and sophisticated will adapt and apply their competencies with selectivity and adroitness. Our experience in China's credit card market suggests that the forces of evolution could well cause the nation's leading institutions to change places many times in the years ahead, making it difficult to know which will ultimately emerge to become industry leaders.

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