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China's changing wholesale landscape

The right strategy is key to finding success in this growing market.

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Mainland China's wholesale banking market is projected to grow at more than 10 percent per annum over the next five years. At that pace, it is set to overtake Japan's as the largest in Asia by 2015. National development strategies, such as urbanization and industrialization, will continue to drive double-digit annual increases in the sector's assets and revenues. This said, the landscape is changing, and both local banks and their foreign-owned counterparts face a more challenging competitive and regulatory environment. Loan growth is slowing, margins on corporate lending are under pressure, nonperforming loans (NPLs) are on the rise, and new capital is needed to meet tougher capital-adequacy requirements.

In the future, all banks may therefore have to move a bit outside their comfort zone and target five attractive opportunities: a new age of infrastructure financing, untapped potential in relationship banking, better intermediation of capital flows, the neglected small-business sector, and the modernization of China's capital markets.

Access to these opportunities is unequal, however, and will dictate different strategies. Local banks will need to move beyond their traditional corporate deposit and loan business into higher-margin products, grow their fee business, and control costs even more tightly. Foreign banks risk being marginalized if they do not find

sustainable sources of new growth. While some will choose to remain focused on high-margin and cross-border businesses, others will go deeper into the local market. With the right strategy, both sorts of bank can find success in China's burgeoning corporate and investment-banking (CIB) market.

The outlook for CIB

Local and foreign players have adopted radically different strategies for their wholesale banking businesses—and both have enjoyed considerable success.

Local national banks, for example, have traditionally focused on high-volume, plain-vanilla lending products. They have benefited from China's unique corporate lending market, distinguished by the way it is funded with corporate and institutional deposits rather than retail deposits. (Total corporate and institutional deposits amounted to $5.1 trillion at the end of 2009, compared with $3.9 trillion of personal deposits.) This structure explains the banks' relatively low cost-to-income ratios (35 percent to 40 percent for most national banks), and, combined with a very low loan-loss ratio (0.2 percent to 0.3 percent of assets at present), provided the ingredients for healthy margins and a highly profitable wholesale business in recent years.

Foreign banks, meanwhile, with just 1.77 percent of total assets in China's banking market and a minute share of the local capital market activity, have concentrated on niche businesses, such as fixed income, currencies, and commodities (FICC) and international trade finance. These have been profitable. Notwithstanding the heavy investments they have made to build up their franchises in China and their mostly loss-making retail operations, many are already generating double-digit returns on equity on their wholesale activities.

Several important trends are now reshaping this benign landscape:

- The pace of loan growth is slowing. Corporate lending growth averaged 20 percent per annum from 2006 to 2009, culminating in a stimulus-induced $1.5 trillion lending bonanza in 2009 (up almost a third on the previous year). Over the next five years, however (from 2011 to 2015), real annual GDP growth in China is expected to drop from an estimated 10 percent to 11 percent in 2010 to around 9 percent, a big factor in the projected slowdown of annual bank loan growth to around 13 percent.

- Margins will remain under pressure. With interest income still accounting for about 80 percent of the revenues of Chinese banks, interest margins are critical. Between late 2008 and early 2009, largely due to asymmetric rate adjustments by the People's Bank of China, the Chinese central bank, margins declined by 70 basis points, to about 230 basis points. While they have since recovered slightly, to around 240 basis points, we do not expect them to move up any further.

- NPLs are on the rise. NPL ratios have been on a decade-long decline, thanks to better risk management and the impact of rapid loan growth. With slower loan growth, on the other hand, the NPL ratio will likely rise steadily for most banks, even if loan quality during the stimulus-induced boom of 2009 turns out to be the same as in preceding years—a generous assumption.

- Regulatory pressure is intensifying. The China Banking Regulatory Commission (CBRC) has been raising standards for banks, in line with global best practice. It has increased the capital-adequacy ratio to 7 percent for core assets and 11.5 percent for total assets for state-owned banks, and it intends to raise it to 10 percent for total assets for joint-stock banks. Banks have already raised substantial amounts of new equity and subordinated debt from the market ($46 billion as of July 2010), but this is well short of the need, which some estimates put at $80 billion.

Exhibit 1 shows a likely scenario for the growth of wholesale banking revenue in China over the coming five years. Despite the slower loan growth, total revenue is still likely to grow at 9 percent per year. Investment banking, while much smaller, will grow more rapidly, at 15 percent per year over this period. Sales and trading, still dominated by retail brokerage, is likely to see continued volatility and is expected to grow more slowly, at 5 percent per year.

Should this scenario play out, mainland China will overtake Japan to become the largest wholesale banking market in Asia by 2015.

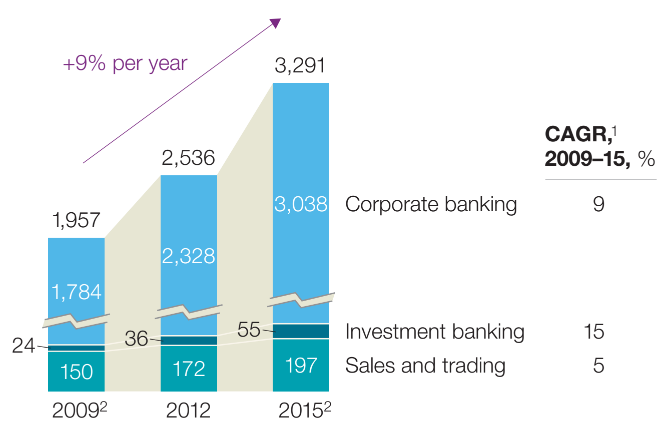
Profitable growth opportunities

Tapping this impressive potential will require banks to strategically target five business opportunities. Some will be more attractive to local banks; others will appeal more to foreigners.

Exhibit 1

Corporate and investment banking in China is set for continued growth.

China wholesale banking revenue pools, RMB billion



[1]Compound annual growth rate.
[2]Figures do not sum to totals, because of rounding.

Fixed-asset investment, driven by increasing urbanization, is expected to remain the top contributor to GDP over the next five years.

Infrastructure financing

New policies have been devised in China in an effort to boost consumption. But fixed-asset investment, driven by increasing urbanization, is expected to remain the top contributor to GDP over the next five years. Between 2010 and 2015, about $10 trillion of urbanization-related infrastructure investment will be required. The large national banks funding much of the recent infrastructure expansion are deepening their expertise, a trend we expect to continue as others go beyond a purely relationship-driven approach.

China Industrial Bank, the country's tenth-largest local bank, for example, worked closely with the International Finance Corporation to build an energy-efficiency lending program. Key innovations included new approaches to risk sharing, minimal or no collateral requirements, and repayment terms tied to energy-efficiency savings. Two phases are complete, total lending now exceeds $330 million, and none of the loans has gone bad. This expertise has enabled the partners to build real competence and competitive strengths and to capture other lending opportunities in this area.

Primary relationships through transaction banking

The domestic transaction banking market has remained relatively undifferentiated, with leading state-owned banks dominating the market. As has been the case in many Western and Asian markets, however, transaction capabilities will be a key success factor in domestic commercial banking. A few opportunities warrant particular attention:

- Managing cash. China has the highest corporate deposit-to-GDP ratio globally among large economies, with 56 percent of bank deposits coming from corporate customers. Traditional, relationship-based corporate deposit gathering is likely to remain the norm—but more sophisticated corporate chief financial officers and treasurers will increasingly demand advanced cash-management services. Cash-management systems and capabilities will be a priority for all banks aiming to develop primary banking relationships. China Merchants Bank (CMB) developed its cash-management business over six years and now manages around $100 billion, or two-thirds of its total corporate deposit base.

- Integrating domestic supply chains. Local banks are already building capabilities to integrate the end-to-end financial needs of supply chains. These more sophisticated solutions optimize the use of cash and working capital along the value chain, allowing banks to develop a much better view of the credit risks they are taking. Shenzhen Development Bank, for example, has built capabilities in key industry verticals, such as trading, manufacturing, and automotives.

The intermediation of corporate trade and investment flows

We see several opportunities where banks can direct such traditional services as trade finance, M&A advisory, and product development.

- Fund China's import-export engine. In 2009, China's trade with the world stood at $2.2 trillion. Intra-Asia trade in particular is becoming increasingly important, especially the critical triangle trade flow between mainland China, Hong Kong, and Taiwan.

- Support international expansion. In 2009 alone, Chinese enterprises spent $30 billion on overseas M&A. While much current overseas acquisition focuses on natural resources, corporate M&A, like that of Geely's acquisition of Volvo, will gather momentum.

- Facilitate the internationalization of the renminbi (RMB). A series of new policies aimed at accelerating the internationalization of the RMB were unveiled this year, expanding the year-old pilot program to companies in all countries and from 5 Chinese cities to 20 provinces. Any company in the world can open an RMB bank account in Hong Kong and exchange RMB as it pleases. This liberalization has already provided the impetus for a rash of new RMB-denominated financial products in the Hong Kong market, including the landmark Hopewell Highway Infrastructure's first nonbank RMB-denominated bond. This is a strategically important opportunity for foreign banks, particularly those with a strong presence in Hong Kong. However, for domestic banks, this remains quite small compared with domestic RMB opportunities.

Small-business growth

Small businesses are a key engine of China's economic growth, accounting for 44 percent of employment and 35 percent of GDP. Yet as Exhibit 2 demonstrates, they represented only 17 percent of banks' assets in 2008. Our research shows that although 70 percent of small businesses currently borrow money, the banks fail to meet almost half of their financing needs. Moreover, the CBRC is encouraging banks of all sizes to increase their exposure to small businesses. The potential here is not just to grow this business but to increase loan yields at a time when margins are under pressure.

Research we carried out jointly with the CBRC in 2009 identified three main characteristics of winning models in small-business lending. First, while banks generally start with secured or asset-based lending, they enhance pricing by reducing collateral requirements over time. Second, they attract deposits so as to make this business partially self-funding. Third, they capture synergies by combining lending with the provision of retail financial services to small-business owners and their employees. China Minsheng Bank, the country's ninth-largest local bank, for example, recently launched a small-business lending program using personal assets as collateral. The balance-sheet value of this activity had exceeded $15 billion by August 2010, one year after its launch, and thanks to better pricing, the bank also significantly boosted margins and loan yields.

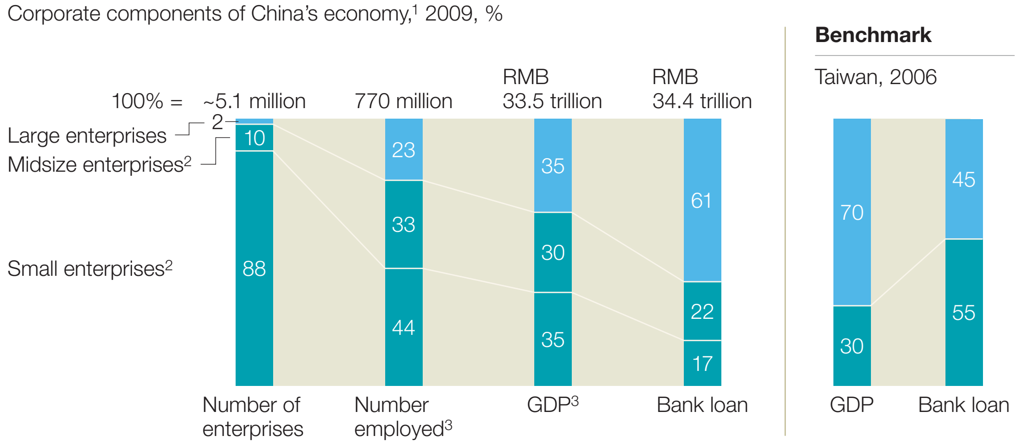
Modern capital markets

China's financial stock has risen sharply, reaching 336 percent of GDP in 2009, and it is approaching the US level of 415 percent. However, as Exhibit 3 shows, key capital market products, such as debt capital markets (DCM)

Exhibit 2

Small enterprises dominate the Chinese economy, but they are underserved by corporate banks.

Corporate components of China's economy,[1] 2009, %



[1]Excludes individual proprietors. Loans to individuals are classified as personal business loans rather than corporate loans.
[2]The definition of small and midsize enterprises is taken from "Provision of the criteria of SMEs," issued by four Chinese ministries.
[3]Excludes small industrial enterprises; this definition is taken from the *China Statistical Yearbook*.

Source: China Banking Regulatory Commission; *China Statistical Yearbook*; McKinsey analysis

Exhibit 3

Many products have considerable scope for further growth.

Selected wholesale banking products, 2008, volume as % of GDP

	Corporate lending	**Debt capital markets**	**Foreign exchange (FX)**[1]	**Rates**[2]
China	83.2	1.6	0.2	78.4
Hong Kong	110.4	2.6	81.1	1,901.8
Taiwan	63.5	3.0	3.7	227.6
Korea	50.6	6.9	3.6	323.8
United States	16.8	9.6	4.7	2,859.9
Germany	54.7	10.1	2.7	860.1

[1]Bank for International Settlements (BIS) FX Turnover Triennial Survey, 2007.
[2]Proxy by government bonds and rate derivatives trading.

Source: BIS; World Federation of Exchanges; McKinsey Global Banking Pool; McKinsey Asia trade finance model and rates-based trading, have barely caught on. By 2012, we estimate that total revenue from investment banking and sales and trading activities could reach $33 billion, up from $27 billion in 2009 (at current exchange rates).

Under current regulations, domestic banks (including locally incorporated foreign banks) only have limited access to capital market products, such as DCM, bond trading, and over-the-counter derivatives trading. Leading foreign banks in China have leveraged their global strength to build substantial capital market businesses, focusing primarily on FICC.

Local banks, meanwhile, are also developing relevant capital market capabilities within their treasury departments, including bond issuance, bond trading, and new-product development. While foreign banks will likely stay ahead, Chinese banks with large-scale operations can undoubtedly build a vibrant capital market business.

Implications for foreign banks

As of July 2009, 34 foreign banks had incorporated in mainland China, and more than 100 had established a branch. However, most foreign banks have struggled to grow, and their collective market share has been stuck at around 2 percent; worse, it has actually started to fall in the recent credit boom. By contrast, foreign banks have a significant share of local blue-chip business in most open Asian markets and as much as a 6 percent share of assets in places like India.

Ambitious foreign banks, for which wholesale is the foundation of all current activities, must approach the future in China with the following strategies in mind:

- Double down and defend high-margin businesses. Foreign banks are naturally constrained from lending in the local currency because of their limited RMB deposit base. They must therefore defend their important capital market businesses, including FICC and cross-border trade finance. A number of foreign banks are building integrated wholesale franchises that combine a presence in local securities, commodities, and financial futures. One global bank is investing heavily in building a large energy and commodity team, leveraging its global strength in the sector.

Exhibit 4

Bank lending will be concentrated in the biggest cities.

Total loan volume for the top 10 city clusters in China, RMB billion, nominal

	2008	+ Net increase, 2008–15	= 2015[1]
Yangtze River Delta	6,010	10,592	16,601
Beijing-Tianjin-Hebei	3,677	8,329	12,006
Pearl River Delta	2,562	3,694	6,256
Chengdu-Chongqing	1,514	3,802	5,316
Shandong Peninsula	1,246	1,769	3,016
Central/South Liaoning	1,059	1,102	2,161
West coast	746	1,225	1,971
Central plains	652	1,058	1,710
Wuhan	535	943	1,478
Changsha-Zhuzhou-Xiangtan	513	772	1,285

[1] Figures may not sum to totals, because of rounding,

- Dig deep in select local markets. Some 70 percent of all banking business will be concentrated in 23 city clusters (11 established and 12 emerging). For example, loan growth in the Chengdu-Chongqing cluster in western China will be the third highest by volume of all the city clusters over the next five years (Exhibit 4), making it a strategically important market for all banks, both domestic and foreign.

- Continue to test new opportunities. Foreign banks will continue to face constraints on traditional routes to growth, and they will likely not significantly increase their share of the Chinese market in the foreseeable future. They will therefore need to continue to experiment with new approaches. A number of wholesale-focused global players are already gaining access to the local securities market through joint ventures, thereby potentially enabling them to provide a more integrated offering for their CIB clients. Given the strict separation of the banking and securities business, this is not something local banks can do. But few, if any, have truly leveraged their stakes in domestic banks to build domestic wholesale businesses that combine local knowledge and global muscle.

Implications for local banks

Local banks can look forward to tremendous opportunities for growth in wholesale banking—but competitive pressures are also mounting. The implications are fourfold:

- Expand into new segments. Given the strength of the competition to serve well-known state-owned enterprises and midsize corporates, local banks should focus on the small-business segment as a way to grow their loan volumes and increase yields. Strong risk management and risk-based pricing capabilities will need to be part of the business model—something Chinese banks must build quickly. They can, meanwhile, leverage these lending relationships to capture deposit and personal-financial-services opportunities.

- Strengthen capabilities in transaction services and treasury. Capturing primary banking relationships will require first-rate transaction banking capabilities. Many banks are seeking to upgrade their core banking systems and to improve their transaction-processing skills. Doing so should put joint-stock banks in a stronger competitive position against large state-owned banks.

  Banks can also strive to make treasury a real contributor to profit growth. China Industrial Bank, for example, has built a platform that provides a range of services for smaller banks, from IT platform outsourcing to settlement and wealth-management product sales.

- Build functional capabilities. Some leading Chinese banks are making substantial improvements in multiple functional areas, from the centralizing of operations to better pricing and risk management. Others must follow. Only by making improvements here can they help close the gap with foreign banks and find new sources of value creation.

- Drive innovation and execution. An ability to develop new businesses and new products will be critical to local banks' chances of winning in a fast-changing environment. For example, banks that moved early to capture third-party custodian accounts when the stock market fell dramatically a few years ago have obtained large retail deposits at low cost.

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We believe the wholesale banking market in China will be an exciting growth opportunity, even in the face of a more challenging environment. Local and foreign banks that are able to make the adjustment and capture the next wave of growth opportunities stand to create substantial value in China.

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