

Banks on the move

Midwestern China the regional service delivery location of the future?

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Management summary

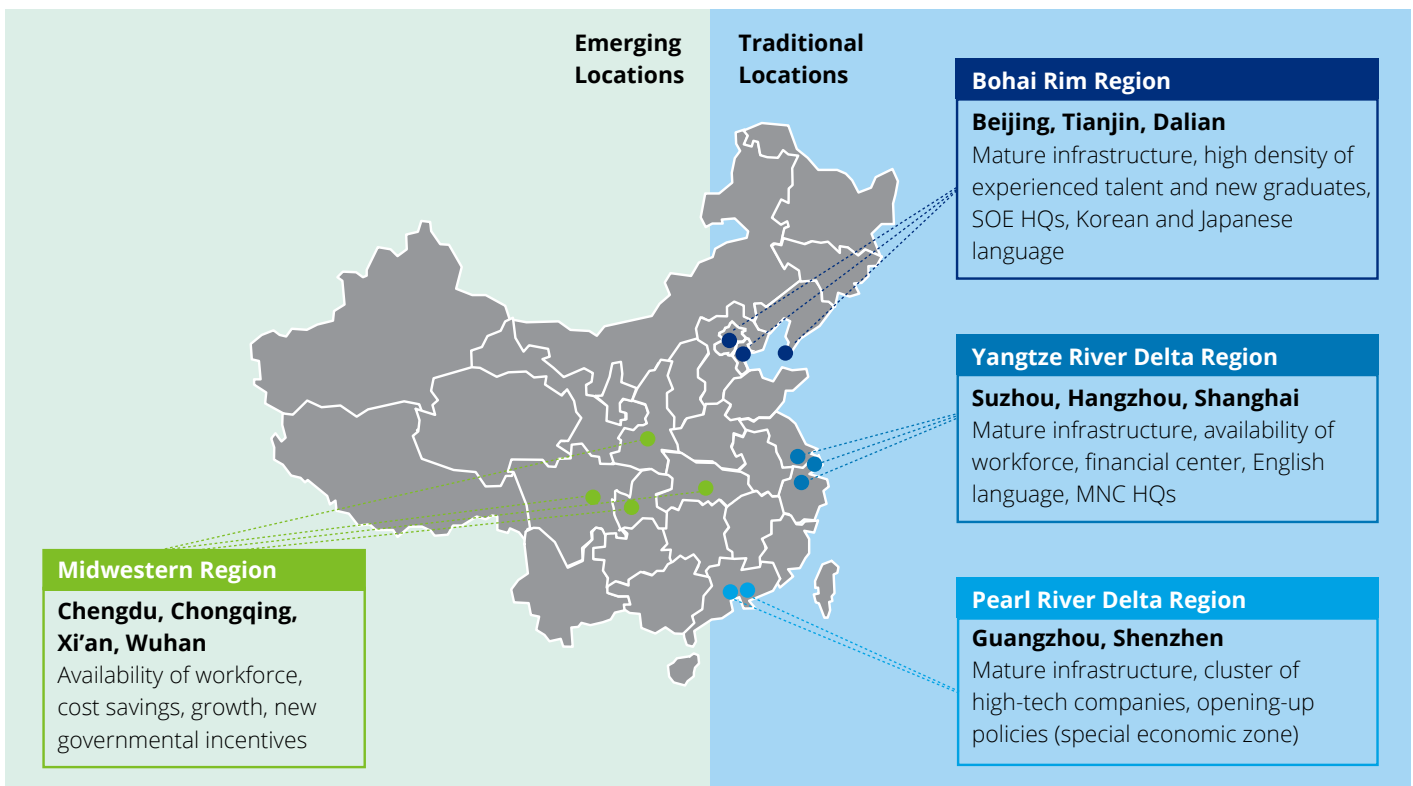
China's aim of attracting multinational corporations to establish service delivery centers — offshore centers that perform designated functions for organizations — is embedded as part of the 13th Five-Year Plan for Economic and Social Development (2016-2020). This goes hand in hand with its strategy to shift from a heavy industrial and manufacturing economy to a consumption and service driven economy.

From international banks' perspective, Mainland China has remained an alluring and viable service delivery center option, due to its well-educated labor pool, rising innovation and technology focus and an acceptable cost-base supported by governmental incentives. It is expected that the support needs of international banks in Greater China will continue to grow, which raises the question — where in Mainland China

should international banks invest in service delivery center capabilities?

To form a view, Deloitte looked at the historic service delivery center footprint for international banks, Chinese banks, and IT service providers as well as trends in location strategy decision factors. Based on our analysis, we found the following:

1. There are four key regions for banking service delivery centers, each with different advantages:



Graph 1: Emerging vs. traditional service delivery center locations

Source: Deloitte Research

2. Location options are becoming less concentrated:

Historically, the coastal regions (Bohai Rim, Yangtze River Delta, and Pearl River Delta) were hubs for both Chinese and International IT and banking service delivery centers due to sound business infrastructure, abundant talent, early governmental incentives as well as proximity to clients and existing operations. Development in the Midwestern region of China, combined with a large available talent pool, lower labor costs, and novel government incentives is pulling service delivery centers toward Midwestern China, a large inland zone centered on the municipality of Chongqing, creating more location options.

3. International banks' investment decisions have shifted from "if China" to "how China":

A growing share of affluent individuals, paired with the Chinese governments more open policy, is prompting foreign banking players to rethink their China strategy. Rising education levels and supply of talent are likely to overrule pure economic evaluation criteria, in an aspiration to not miss out on China's prosperous future. We are likely to see more service delivery centers being placed in China as more banking players enter the market and respective licenses will be granted.



General trends

China is not a new name among service delivery center location options. In the mid 90's, many international banks developed technology, operations and risk management centers in China, capitalizing on the favorable cost structures, as well as effectively sourcing language skills such as Korean and Japanese. At the same time, many domestic Chinese banks have set up their software development, IT support, research and training facilities away from their headquarters. All this has

taken place, as well as global IT service providers having established presence and further expansion in China.

At present, banking institutions continue to monitor the increasing potential of China for service delivery center establishment, serving both domestic and Asia Pacific customers. For many international institutions, Chinese centers are typically considered as additional service nodes to traditional hubs such as India, Malaysia and the Philippines.

This is especially the case for IT and banking operation functions. Key differentiators compared to other popular global outsourcing hubs include China's noticeable transformation to a service driven economy paired with a significant and growing supply of well-educated and tech-savvy talent. Additionally, on a provincial level, government incentives encouraging selection of special economic zones and IT parks for service delivery centers.

Graph 2: Service delivery center overview in China¹



Source: Deloitte Research

1. Banking providers assessed in this study: Australia and New Zealand Banking Group (ANZ), Bank of China, China Construction Bank, Citibank, HSBC, ICBC, Morgan Stanley, Nomura, Standard Chartered and UBS.
IT service providers assessed in this study: Accenture, Arvato, Capgemini, Genpact, HCL, Hewlett Packard, IBM, Infosys, Sutherland Global Services, TCS, Xerox, Wipro and WNS.

The graph above provides an overview of key service delivery center locations of representative international banks (blue), Chinese banks (green) and IT service providers (aquamarine), covering a range of IT and banking operations. These three groups have traditionally favored more developed regions, surrounding tier-one cities² along the east-coast region due to abundant talent, governmental incentives as well as proximity to clients and existing operations. In recent years, the establishment of service delivery centers inland, in China's Midwestern region, has seen a steady growth in momentum given the continuous development of the region paired with a large available talent pool, lower labor and occupancy costs, and novel government incentives. As an example, for a decade already, China Construction Bank has an operations center in the city of Chengdu, in the Midwestern province of Sichuan. Likewise, in 2011, ANZ set up an operations hub in the same city with the aim to support the bank's growth across the region. Furthermore

also Deloitte China launched its own Global Delivery Center in Chongqing, Midwestern China, in early 2015. The center focuses on IT delivery, finance and tax as well as human resources services and employs more than 1,400 members of staff.

Nonetheless, most international banks, whilst maintaining a presence in China for decades, have made relatively little progress in the geographic diversification of their service delivery centers location strategy beyond their core operations sites. This is understandable, as some players do not yet possess a full banking licence, or operate through a joint venture. Furthermore, international banks typically have comparably smaller operations, which do not justify major investment into service delivery centers. However, as announced by the Chinese government, more international banks will be granted licenses in the financial market and we will likely see more of these banks to set up Chinese service delivery centers in the future.

Chinese banks tend to have two or more service delivery center locations; some opting for proximity to their headquarters while many others choose a geographically dispersed footprint. A key reason for the geographical dispersion is due to the operations of Chinese banks' being much larger and farther reaching than international players, both in terms of customer base and branch network. This, coupled with their desire to establish centers close to these established operations can account for the scattered footprint.

In contrast, IT service providers tend to have multiple service delivery centers established across the country and rarely elect to operate centers within close-proximity of each other. It can be assumed that IT service providers prefer to leverage their centers to support local clients directly and therefore they are more likely to operate on a larger scale in locations where their clients are based and talent is abundant.

2. Traditional tier-one cities are defined by Chinese authorities by all or at least two of the following factors; GDP over USD 300 billion, more than 15 million inhabitants and/or directly controlled by central government (e.g. Beijing, Shanghai, Shenzhen and Guangzhou).

Traditional and emerging hubs

China can be split into four key regions. Traditional hubs are the **Bohai Rim Region**, surrounding Beijing and Tianjin; the **Yangtze River Delta** around Shanghai; the **Pearl River Delta** encompassing Guangzhou and Shenzhen; and an emerging hub in the **Midwest**, a large inland zone centered

on the municipality of Chongqing. For comparative purposes, we have defined each region based on specific provinces (see graph 3).

Although coastal regions have a longer history of national and international focus and investment, the Midwestern

region displays some promise when comparing key selection criteria: high-level macro-economic prosperity, infrastructure readiness, availability and quality of talent and operational cost considerations.



Growth and Foreign Direct Investment (FDI) flows have shifted

Macro-Economic factors³ such as Gross Domestic Product (GDP) and FDI differ greatly in size across the four regions. Whereas the Bohai Rim region observes the slowest growth, the Yangtze River and Pearl River Delta regions are on par with the overall national growth rate. In contrast, the

Midwest region is growing the fastest and above the national average, at 8.7% (five year) CAGR. Crucially, the Midwest is the only one of the four regions where FDI growth is positive, increasing by three percent over the last five years.



Business infrastructure readiness by region is converging

In terms of business infrastructure readiness, the country as a whole has benefited from huge advancements over the past decade. Comparing communication infrastructure, such as availability and speed of broadband internet, as well as connectivity via fixed and mobile phone lines, all coastal areas are comparably well developed. The Midwest however, has a slightly less competitive internet speed and a higher potential of interruptions in some areas. The situation is similar with regards

to transportation (national and international air routes, national train routes and highways); Bohai Rim and Yangtze River regions lead the way, followed by the Pearl River Delta region, which demonstrates good infrastructure but with slightly lower availability on international air connections. The Midwest, although having obtained a good base, has remaining improvement potential across all factors assessed: highway, rail and air infrastructure.

3. Based on the latest available data from 2017.



An enormous resource pool with varying debt of relevant skills

Availability and sustainability of skilled labor is a critical factor — oftentimes the key criteria, of strategic location selection. Attrition rates across all the regions are high, relative to mature markets abroad. While the Midwest reportedly has a slightly lower attrition rate, it is increasing due to the wide range of career opportunities and the demand from competitor companies vying for finite skills. The Bohai Rim region, with its rich stable of well-regarded tertiary education institutions (see graph 4) has the largest college

graduate pool. Furthermore, English language ability is higher, and cities within the region such as Dalian, known as hub for Japanese or Korean speakers, allow companies to source a larger number of multilingual resources. The Midwest presents an increasingly viable alternative, with its very significant and improving resource pool. However, it should be noted that service delivery quality and language skills, although making positive progress, still lag behind the coastal hubs.



Cost arbitrage opportunities cannot be ignored

With increasing economic and social development in China, the cost base for service delivery center establishment (including labor cost, commercial rent and other operating expenses) is rising across China. Most prominently, salary levels have increased significantly according to the National Bureau of Statistics of China. Over the years between 2007 and 2016, national average compensation has risen by 12% annually to USD 10,800 p.a. IT sector specific salaries, starting from a higher base, similarly increased by 11% to USD 19,500 p.a. over the same time period.

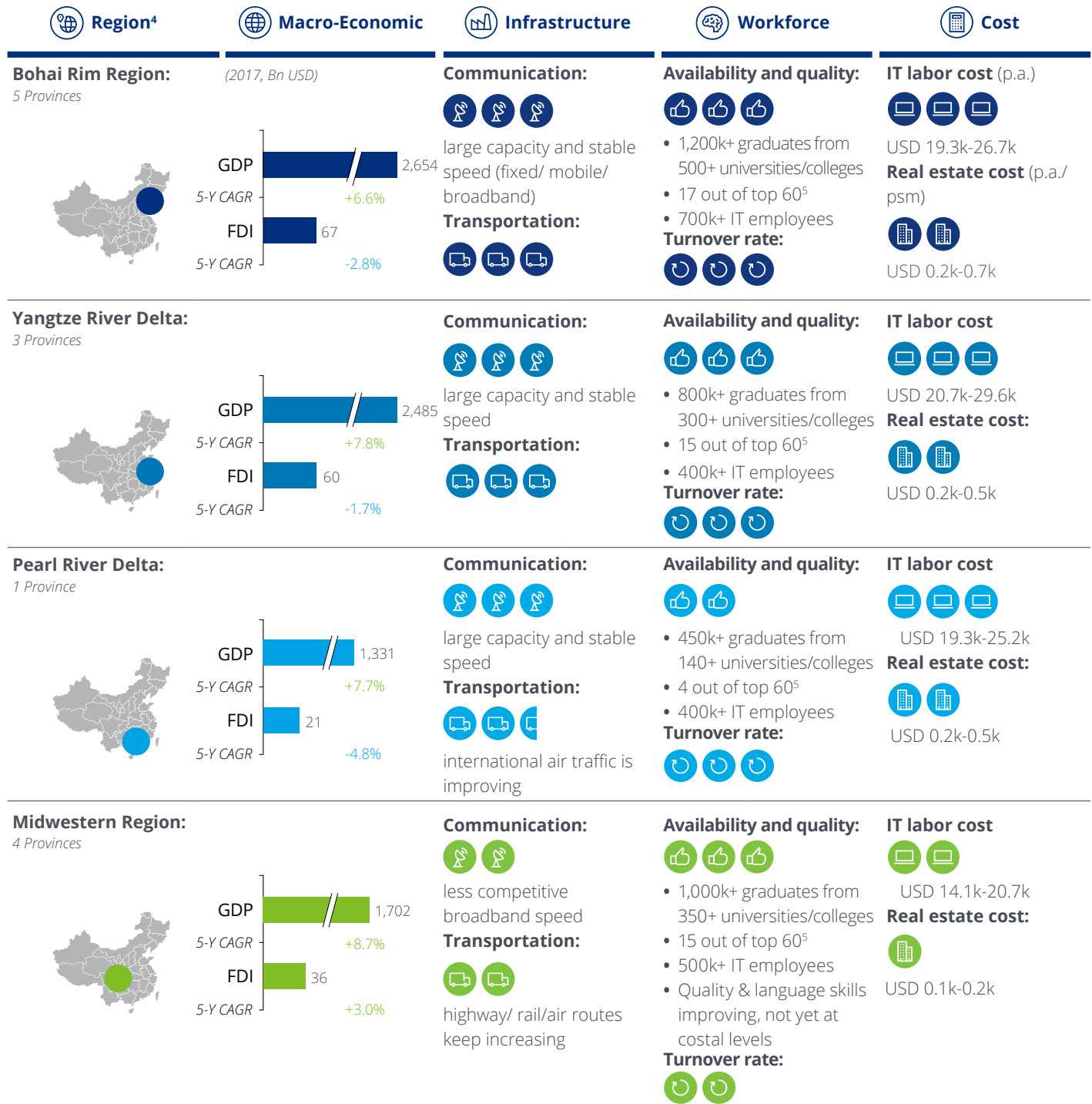
While China's three coastal regions demonstrate a similar cost structure, the Midwestern region presents a considerably cheaper alternative. This is especially the case for real estate related expenses. In many cases, real estate and occupancy costs in the Midwest are up to 50% lower than the coastal locations. Similarly, we observe the upper end of the Midwestern salary bands barely reaching the lower end of the salary

bands in the other three regions. While this considerably lower cost base will likely experience upward pressure as new players enter the region, disturbing the existing supply and demand for educated talent and office space, the gap is likely to be meaningful for the foreseeable future.

It is important to note that average labor cost analysis can be deceptive. Highly experienced or specialist resources can earn a multiple of the average salary cost stated before and these levels are by no means lower than similar roles in western countries. Hudson, a recruiting firm, provided indicative ranges for senior IT resources in tier one cities with an experience of eight to twelve years are as follows:

- IT management:
USD 85,000 — 141,000 p.a.
- Software development:
USD 70,000 — 110,000 p.a.
- Solution architect:
USD 78,000 — 118,000 p.a.

Graph 3: Overview of four main regions for service delivery center establishment



Source: Deloitte Research, National Bureau of Statistics of China

Legend	
●●●	high/advanced
●●	moderate
●	low

4. (A) Bohai Rim: Beijing, Hebei, Liaoning, Shandong, and Tianjin;
 (B) Yangtze River Delta: Jiangsu, Shanghai, and Zhejiang;
 (C) Pearl River Delta: Guangdong;
 (D) Midwest: Chongqing, Hubei, Shaanxi and Sichuan.
5. According to Times Higher Education 2018 University Rankings, 60 of the Global Top 1,000 Universities are located in China.

The rising midwest

Midwestern China encompasses the Sichuan, Shaanxi and Hubei provinces amongst others, and the municipality of Chongqing. The latter has been one of the focuses of the Chinese development agenda over recent years, as the country refocuses

its development efforts to the non-coastal regions. Midwestern China, along with other locations, shifted into the international spotlight with the announcement of the "One Belt and One Road Initiative"⁶, activating significant development efforts of the Chinese government in the region.

In recent years, the Midwestern region has experienced a variety of macro-economic, social and governmental driven changes, all of which have played a role in enhancing location selection options for Mainland service delivery centre establishment.



The Midwest is becoming a growth engine for China

China's GDP growth rate over the past decade has been steadily declining from over 14% in 2007 to under 7% over the past couple of years, with a ten year average of slightly over 8%. Whereas urbanized coastal areas contributed a fair share of early growth, recent years indicate the Midwestern region as an additional

driving force, with a compounded average GDP growth rate (five years) of 8.7% compared with 7.4% in the coastal region. Regional growth has a verity of positive side effects, one of it being that it attracts talent and therefore fosters opportunities for delivery centers too.



Population in the Midwest is growing faster than China as a whole

Growth triggering economic prosperity and growing opportunities for the individual, have affected population growth numbers within different parts of China. While comparing average compounded population growth rates between the costal and Midwestern regions, it becomes apparent that:

- growth rates on the coast have declined from 1.2% at the beginning of the century (2000-2011) to 0.7% in more recent years (2011-2016)
- growth in the Midwest, during the same period, are up from zero to 0.5%, newly reaching the countries average growth rate

6. The One Belt and One Road Initiative aims to foster economic interconnectivity and establishment of two significant trading routes, the northern land route "Silk Road Economic Belt" (from China, over central Asia to Iran, Turkey, Russia to Central and West Europe) and the corresponding Maritime Silk Road. The project includes significant investments into an infrastructure net between China and over 60 nations in Asia, Europe and Africa.



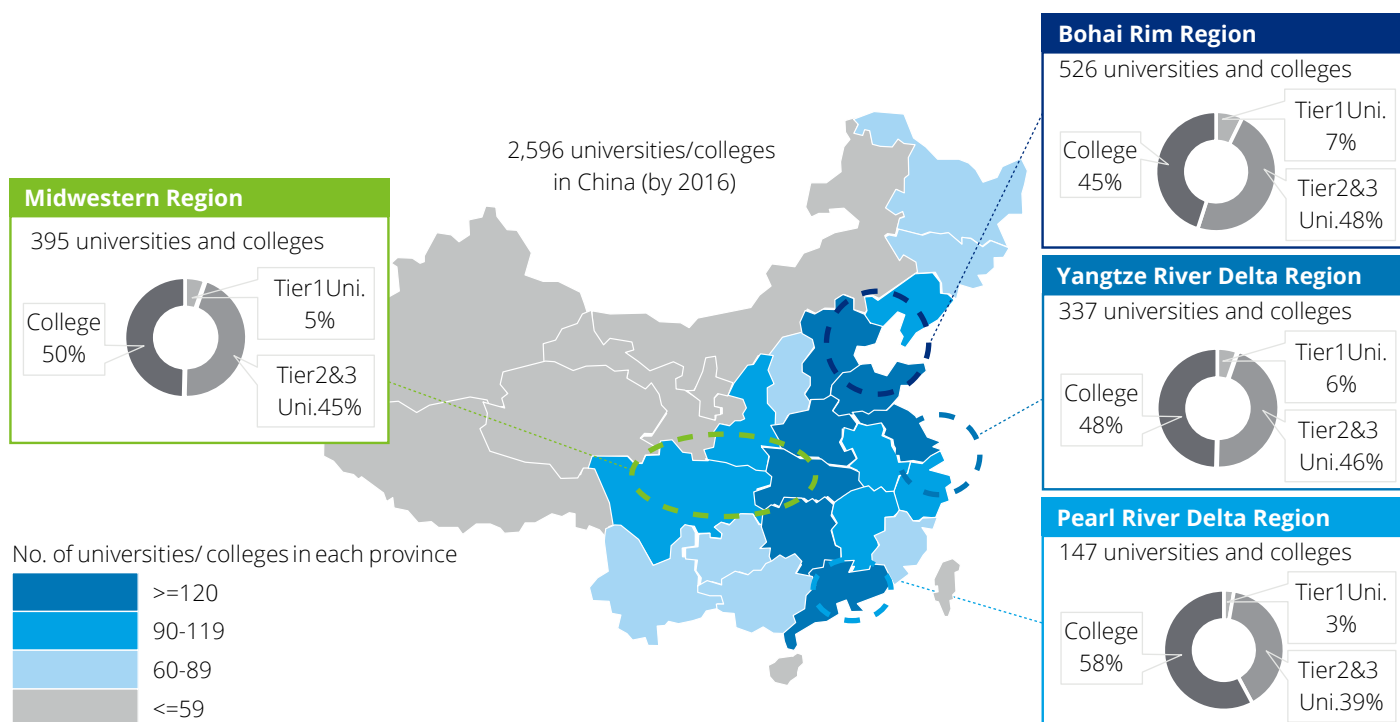
Educational output is outstripping the rest of China

Along with population shifts, changes in the academic landscape are also apparent in China. According to the Ministry of Education of the Peoples Republic of China, the largest number of colleges and universities, as well as the highest concentration of top education institutions in the country, can be found in the Bohai Rim region, in particular in Beijing. Furthermore, we see a concentration along an inland belt, from the province of Hebei over Henan down to Hubei and Guangdong, with an average of more than 120 universities per province. Furthermore, the North Yangtze River Delta region, and in particular Shanghai, is home to many Chinese top tier universities.

Nonetheless, 21 of 116 educational institutions ranked as tier one within the 211 program⁷, run by the Chinese government, are located in the Midwest region. The city of Wuhan alone hosts three of the top 15 universities in the country. As a result of both the density and quality of education in the region, Chinese students continue to flock to the Midwest. When comparing compounded annual growth rates of Chinese graduates, we observe a widening gap between the Midwest and coastal regions:

- 2005-2011: Midwest: 10%; coast: 11%
- 2011-2016: Midwest: 7%; coast: 4%

Graph 4: Higher education landscape in China



Source: Deloitte Research, Ministry of Education of the Peoples Republic of China

7. Project 211, initiated by the China Ministry of Education, includes 116 institutions which meet certain scientific, technical, and human resources standards, and generally require the highest entrance scores in the admission exams (3 universities belong to the Chinese Army and have not been included in this study).



Costs are escalating at a slower rate

Inflation, rising education levels and competition among employers for talents are just some of the factors driving up labor costs. As outlined previously, according to the National Bureau of Statistics of China, salary levels can differ significantly between provinces; the labor cost gap between

the coastal and Midwestern region rose by a factor of approximately 2.5 over the past ten years

- Gap in 2007:
~USD 2,700 p.a. (IT sector ~USD 2,500 p.a.)
- Gap in 2016:
~USD 6,800 p.a. (IT sector ~USD 5,500 p.a.)



The Chinese government is promoting investment in the Midwest

In line with its 13th Five-Year Plan for Economic and Social Development, the Chinese government is steering regional development via the implementation of preferential policies and incentives:

- Five new free trade zones were established in the Midwestern region in addition to the existing six on the coast

- Tax incentives for 31 cities — nine in the Midwest — were introduced to encourage business process outsourcing services
- Additional incentives may be negotiated with local governments for the establishment of service delivery centers within specific economic zones and IT parks

Tying everything together: location strategy considerations

There is no one location that is right for every bank. As a part of the location strategy assessment, a bank should consider its priorities for a variety of critical factors such as cost, talent sustainability and risk, among others. Additionally, factors such as proximity to clients, proximity to existing operations, and change tolerance (e.g. the willingness to invest in an area that may undergo political or cost-base











changes in the foreseeable future) are to be considered. For example, a bank that requires a high level of English proficiency, is less cost-sensitive, and has existing operations near Shanghai may lean towards establishing a service delivery center in the Yangtze River Delta region. In contrast, a bank with higher cost sensitivity, primarily Mandarin language skill needs, and an openness to investing in an area

that may see economic and social alterations, may lean more toward Midwestern China.

To select the best location for one's business, it's critical to choose the right strategy, weighting relevant location factors to enable an objective comparison between different sites.



Graph 5: Representative critical location selection factors

Critical location factors	Guiding principles ("The ideal location should:")	Typical considerations	
 Cost	<ul style="list-style-type: none"> provide a competitive cost structure while enhancing prospects of attracting and retaining high caliber talent with language skills 	<ul style="list-style-type: none"> Labor (compensation, benefits, language premiums, escalation, etc.) 	<ul style="list-style-type: none"> Real Estate (lease, service charges, escalation, etc.)
 Language Scalability	<ul style="list-style-type: none"> offer a ready-supply of appropriate language and technical skills to enable ramp-up to planned scale without extensive recruiting management 	<ul style="list-style-type: none"> Ramp-up of languages Technical skills, quality, productivity 	<ul style="list-style-type: none"> Education attainment Demographic trends Hiring speed to market
 Talent Sustainability	<ul style="list-style-type: none"> support continued talent retention over the moderate and long term, without extensive mitigation programs 	<ul style="list-style-type: none"> Retention and turnover Talent pipeline and demographic forecasts 	<ul style="list-style-type: none"> Education output Competitive environment Location attractiveness
 Competitive Environment	<ul style="list-style-type: none"> demonstrate evidence of similar investment by multinational corporations, and language servicing 	<ul style="list-style-type: none"> Number/job creation in comparable centers 	<ul style="list-style-type: none"> Strategic government prioritization
 Value Platform	<ul style="list-style-type: none"> allow for future headcount growth via higher-value activities and/or added functionality 	<ul style="list-style-type: none"> Market maturity Value chain progression 	<ul style="list-style-type: none"> Skill set diversity
 Strategic Relevance	<ul style="list-style-type: none"> align with overall corporate strategy, culture, and current footprint and drive regional strategy 	<ul style="list-style-type: none"> Leveraging of existing operations and knowledge base 	<ul style="list-style-type: none"> Strategic initiatives Alignment with company culture
 Business Climate	<ul style="list-style-type: none"> facilitate and support efficient business operating conditions, including favorable/flexible labour regulations 	<ul style="list-style-type: none"> Labor regulations Employee relations Burden of bureaucracy 	<ul style="list-style-type: none"> Legal enforcement Taxation Government support
 Risk	<ul style="list-style-type: none"> optimize risk stability and minimize potential for business disruption 	<ul style="list-style-type: none"> Economic, political Security, crime, corruption 	<ul style="list-style-type: none"> Natural disaster Legal
 Access	<ul style="list-style-type: none"> allow reasonable access to key locations across the region/globe 	<ul style="list-style-type: none"> Air connectivity 	<ul style="list-style-type: none"> Time zone compatibility
 Real Estate and Infrastructure	<ul style="list-style-type: none"> offer appropriate, diverse, and reliable physical infrastructure; including flexibility for growth 	<ul style="list-style-type: none"> Infrastructure quality, reliability and availability 	<ul style="list-style-type: none"> Real estate supply, quality and flexibility

In summary, when exploring the feasibility of establishing or expanding a delivery center presence on the Mainland, companies must carefully assess their priorities and gain clear alignment before embarking

their location selection journey. The aforementioned factors combined, present a positive outlook for China and in particular for the Midwestern region as a future leading delivery center hub.

To learn more about Deloitte's location strategy services please feel free to contact one of our service delivery center specialists.

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