OLIVER WYMAN

Financial Services

THE GROWTH - PROFITABILITY CONUNDRUM

TIME FOR GLOBAL BANKS TO GET THE BALANCE RIGHT IN CHINESE WHOLESALE BANKING

MARSH & McLENNAN COMPANIES

INTRODUCTION

Foreign banks have rushed into the market since China opened its financial services sector under its WTO commitments in the early 2000s. They have established onshore platforms across a broad range of wholesale businesses, in the form of Sino-foreign joint ventures, wholly- owned subsidiaries and financial investments in local institutions.

Yet foreign banks remain marginal players in this vast market. This is due to structural constraints, such as stringent local regulations and limited access to the domestic corporate and institutional client base. As a result, nearly all foreign banks suffer from sub-scale operations and consequently low profitability of their wholesale banking businesses in China.

Most banks still hope that further growth will solve the problem. We believe this hope to be unfounded. Over the next five years we expect foreign banks will continue to derive little profit from their investments as structural constraints persist and competition from maturing local banks intensifies. Supported by regulatory advantages, strong ties with government-backed enterprises, a deep deposit base and extensive distribution networks, local banks will continue to dominate Chinese wholesale banking for the foreseeable future. Global banks will struggle significantly to improve economics with market growth alone. Now it is time to treat sub-scale and low profitability operations in China as a long-term problem.

Combined with increased scrutiny for 'growth budgets' in the light of the on-going financial crisis, foreign banks need to strategically review their onshore business portfolios and explore alternative approaches to enhance scale, efficiency and profitability. We see four ways foreign banks can improve performance:

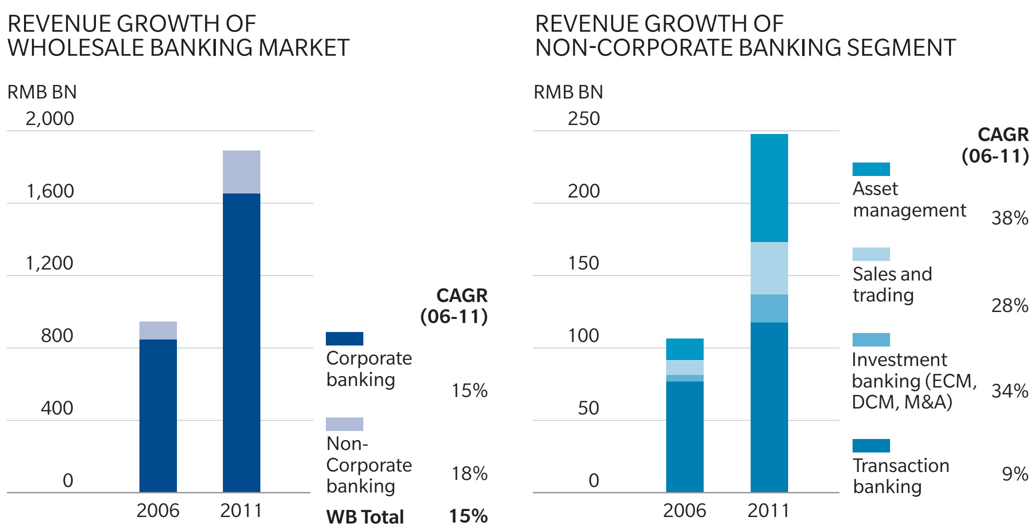
A. Maximise synergies from platform consolidation and product linkages
B. Develop true product or sector propositions to become a niche market leader
C. Cooperate with local banks to gain scale and minimise setup investments
D. Invest in local wholesale institutions and take advantage of value creation from structural growth in the industry.

In this paper, we discuss the rationale, application and sustainability of these models.

CHINA'S WHOLESALE BANKING MARKET: THE STATUS QUO

China's wholesale banking market has seen a 15% compound annual growth over the last five years with total revenues now at RMB 1.9 TR (~US$300 BN) up from RMB 0.9 TR[1] (~US$140 BN) in 2006. This contrasts sharply with the more mature markets, such as the US and Europe, where revenue pools either remained flat or contracted over the same period. Now accounting for nearly 30% of the Asia Pacific overall wholesale revenue pool, China has become one of the largest and most important wholesale markets globally.

EXHIBIT 1: WHOLESALE BANKING (WB) REVENUE IN CHINA (2006-2011)



Source: PBOC, CBRC, CSRC, SAC, CTA, SAFE, China Bond, NAFMII, company annual reports, analyst reports, news release, Oliver Wyman proprietary data and analysis

However, the structure of wholesale banking in China differs substantially from those observed in more mature countries. Bank-originated assets account for over 90% of wholesale-related financial assets in the market while the same ratio in the US is only at ~50%. This difference is a result of China's under-developed securities and asset management sectors. Consequently, the wholesale banking revenue pool is dominated by corporate lending activities (Exhibit 1). Yet, while non-corporate banking activities currently represent less than 15% of the wholesale revenue pool, these business lines have grown at a faster pace. This is primarily due to the explosive growth of capital markets-related activities (30-40% annual growth over 06-11), which benefited from the continued development of capital markets in China and increasing sophistication of domestic clients in using financial products. Transaction banking, the largest non-lending business, experienced strong growth (~25%) up to 2008 but has been slowed somewhat by the global financial crisis and slower global trade flows.

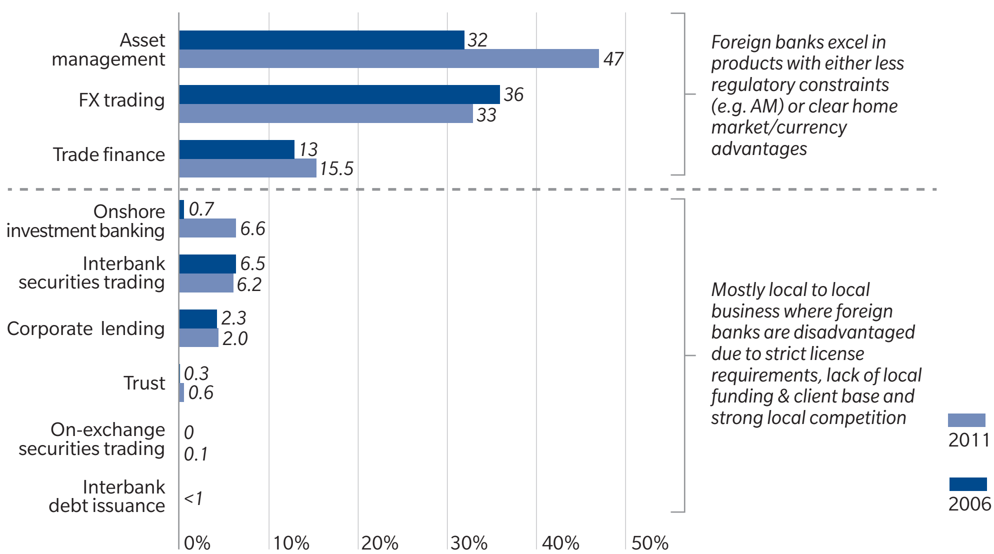
1 Includes corporate banking, transaction banking, capital markets (IBD and sales & trading) and asset management. Excludes Hong Kong and Taiwan wholesale banking revenues, excludes retail brokerage

Attracted by this exponential growth and China's long-term prospects, foreign banks piled into the country. By the end of 2011, 325 foreign banks were operating in Mainland China. While many still operate through local representative offices or branches, leading players have set up locally-incorporated subsidiaries to gain more complete access to the onshore market, especially in RMB products. The number of locally incorporated foreign subsidiaries reached 37 at the end of 2011 and is still growing. Foreign banks have expanded into non-lending sectors in China, particularly asset management, securities businesses and trusts where, subject to regulatory constraints, they typically operate as junior partners in Sino-foreign joint-ventures. At the end of 2011, there were 55 such joint ventures in China, twice the number in 2005.

While getting a foot in the door of this heavily regulated market has been a difficult process for foreign banks, growing their business has proven to be even harder. A decade after China opened its financial services industry to outsiders, foreign banks are still struggling to gain share across most of the product lines in wholesale banking (see Exhibit 2).

EXHIBIT 2: MARKET SHARE OF FOREIGN/SINO-FOREIGN JV PLAYERS BY PRODUCT LINES (2006 vs. 2011)

MARKET SHARE OF FOREIGN/JV PLAYERS BY LOB (2011) IN %



Source: PBOC, CBRC, CSRC, SAC, CTA, SAFE, China Bond, NAFMII, company annual reports, analyst reports, news releases, Oliver Wyman proprietary data and analysis

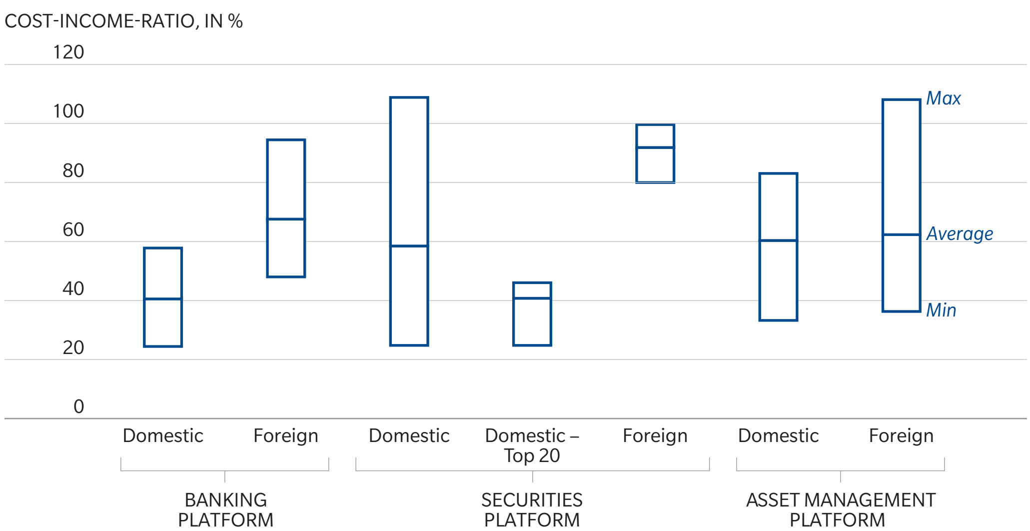
Apart from asset management, which is still a nascent sector with comparatively less onerous regulatory constraints, FX as well as trade finance, where foreign banks have clear advantages from their global networks, foreign penetration in all other products is in the range of 1-6%. Furthermore, we have not observed significant improvements in foreign banks' market share over the last few years. Low penetration in some cases is driven by hard regulatory barriers, such as in securities trading and inter-bank bond issuance, where most of foreign banks still have not been awarded the required licences. In other areas, such as corporate lending, foreign banks suffer from limited access to deposit funding and penetration of the client base.

Foreign banks' performance in China compares poorly with their success in other emerging markets. For example, leading foreign banks collectively account for over 60% of the capital markets revenue pool in Brazil, with particular strengths in advisory, rates and FX derivatives, structured products and offshore product distribution and trading (particularly in hard currency debt). As a result, even with a smaller overall market revenue pool in Brazil (<40% of China's), top foreign players still earn 3-4 times more in Brazil than in China.

A natural corollary of sub-scale operations is poor profitability (Exhibit 3). Across business platforms, the average cost-to-income ratio is higher for foreign players than for their local counterparts. The largest difference is observed in the securities business, where high personnel costs coupled with low transaction volumes have pushed average cost-income ratio above 90% at many Sino-foreign joint ventures. This contrasts with an industry average of 60%, with leading domestic players even in the 40-50% range. In banking products foreign players also lag domestic banks in profitability with a gap of 20-30 percentage points in cost-income ratio, with weaker players operating at razor-thin profit margins. Even in asset management, where foreign players are comparatively well positioned in terms of scale, we observe a greater variation in their profitability, and sub-scale players are running at negative operating margins.

So far, the headquarters of foreign banks have accommodated low profitability in China with great patience because of the strategic importance of the market. But they are now under pressure to reduce their costs, and are increasingly questioning their ability to support low margin operations in China over the medium- to long- run.

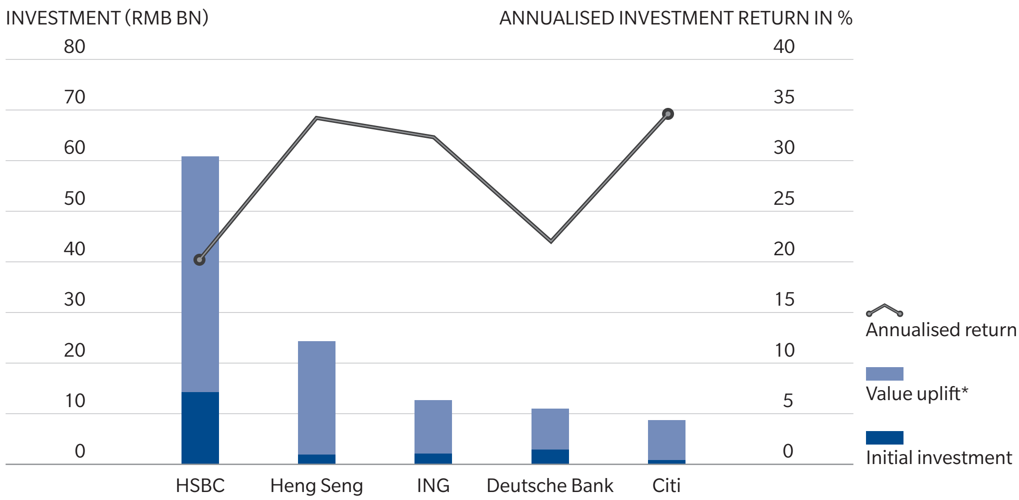
EXHIBIT 3: PROFITABILITY BY BUSINESS PLATFORM
COST-INCOME-RATIO COMPARISON (FOREIGN vs. DOMESTIC, 2010)



Source: Company reports, press articles, Oliver Wyman proprietary data and analysis

Notwithstanding these profitability concerns, foreign banks' participation in China has its bright spots. Despite the frustrations they have faced in organic build-outs, some foreign banks have achieved outstanding returns from investing in local institutions between 2003 and 2005 (Exhibit 4). Even though market values have been reduced by the financial crisis, these investments are still up 4-15 times, with annualised returns ranging between 20% and 40%. In addition to capital appreciation, foreign banks have benefited from substantial earnings distribution. For example, up to 80% of HSBC's 2011 total earnings in China came from Bank of Communications, Ping An and other local 'associates'.

EXHIBIT 4: FOREIGN INVESTMENT IN CHINESE BANKS



Target	*BoComm*	*Industrial*	*Beijing*	*Huaxia*	*SPDB*
Year of initial investment	*2004*	*2003*	*2005*	*2005*	*2003*

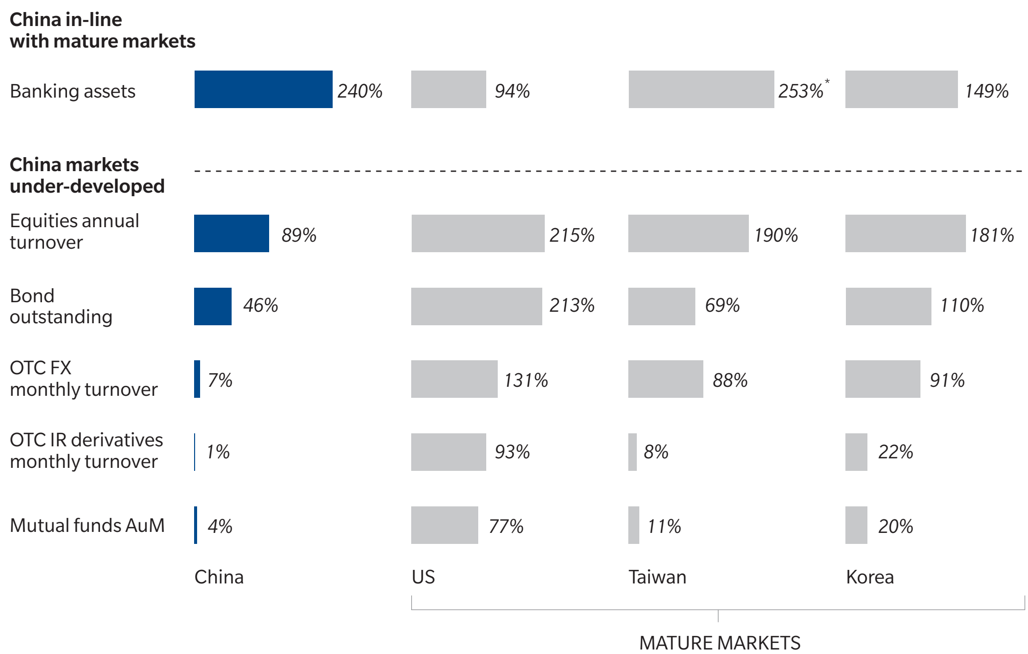
* As of 20th Feb 2012

Source: Press releases, company reports, Oliver Wyman proprietary data and analysis

OUTLOOK FOR CHINA'S WHOLESALE BANKING MARKET

China's wholesale banking market still has considerable scope to grow (Exhibit 5). Relative to its GDP, China is comparable to developed markets only in total banking assets and equity turnover. In other product areas such as corporate credit, FX, fixed income derivatives and asset management, China is still a fraction of the relative sizes seen in the US or even South Korea.

EXHIBIT 5: SIZE OF WHOLESALE BANKING SECTOR/PRODUCT (RELATIVE TO GDP)
MARKET METRICS vs. GDP (AS % OF NOMINAL GDP, 2011)



* High penetration driven by large number of family-owned banks which are part of large conglomerates in Taiwan
Source: WFE, Lipper, central banks, Asia bond online, ICI, PBOC, CIRC, Wind, EIU, SIFMA, Oliver Wyman proprietary data and analysis

Recognising the need to increase the breadth and depth of the wholesale banking market, Chinese regulators have laid out an ambitious plan for product innovation and development (Exhibit 6). Over the next five years, they aim to grow the onshore market to become top three in credit and top five in derivatives globally, while maintaining the world's leading position in equity issuance and listed commodity derivatives.

EXHIBIT 6: NEW/EXISTING PRODUCT DEVELOPMENT MAP

PRODUCT GROUP	PRIORITISED EXISTING PRODUCTS BY REGULATOR	NEW PRODUCTS	GROWTH POTENTIAL
IBD	• Corporate bonds • Panda bonds • SME equity issuance • Foreign currency bonds	• International board • High yield bonds	
Equity	• Stock index futures	• ETFs with domestic underlying • ETFs based on international indices • Structured equity products/ equity options	
Fixed income	• Credit mitigation instrument (CDS) • FX/rates derivatives • Bond futures	• REITs • MBS, ABS (auto loan) • Structured FI products	
Commodities	• Metal futures (Gold, Zinc)	• Gold ETF and porpezite trading • New energy futures	
Trade/ structured finance	• RMB export buyer's credit	• Risk hedging tool for trading enterprise • RMB-based Trade finance • Innovative transportation finance /leasing products	
Asset management	• Structured funds • Alternative asset funds • Industry investment funds/ ETFs • Special situation funds (quasi hedge funds)	• Long/short funds • Absolute return funds	

Growth potential: High Medium Low

Source: '12th 5-year plan- building Shanghai into an international financial centre', press releases, Oliver Wyman proprietary data and analysis

Regulatory liberalisation and continued market modernisation are expected to support growth of under-developed products. This will drive the expansion of wholesale banking in China. Fixed income and transaction banking are likely to benefit most from policy relaxation and product innovation initiatives. Expected interest rate liberalisation, for example, will lead to greater use of fixed income derivates by corporate and institutional clients looking to hedge their trade and investment exposures. Greater diversity of fixed income instruments should also foster the development of more tailor-made investment products for corporate and retail clients. In addition, on-going RMB internationalisation and growth in the offshore RMB pool will create rich opportunities to innovate in trade finance and transaction banking, both domestically and internationally.

In summary, we expect the Chinese wholesale banking market to continue growing at an average annual rate of about10% over the next decade and reach RMB 4 TR (~US$ 630 BN) in terms of wholesale banking revenues by 2020. This growth will be skewed towards non-corporate banking activities, especially securities and transaction banking, where compound annual growth rates are expected to be in the range of 15-20%. As a result, non-corporate banking revenues will triple in size and account for ~20% of the overall wholesale banking revenue pool.

However, we believe the benefits of growth will mostly accrue to domestic institutions. Foreign banks hoping to significantly improve profitability by growing with the market will be disappointed, as the structural constraints which hindered their onshore business to date will largely remain in place.

While we can foresee a scenario under which the People's Bank of China will provide foreign banks access to its borrowing window in order to speed up the internationalisation of the RMB, interest rates cannot be significantly liberalised in the short-term as the global economy remains shattered and higher non-performing loans loom. In combination with limited branch networks, foreign banks will therefore continue to struggle to secure stable and sufficient funding sources needed to expand in China.

In addition, we believe client relationships with state-owned enterprises and large corporates will continue to be dominated by the large domestic champions, driven by their strong government connections and deep balance sheets. While demand from these clients is forecast to grow strongly in response to their increased financial product sophistication, foreign banks will find it difficult to secure these relationships, either for basic services or for value-add product sales.

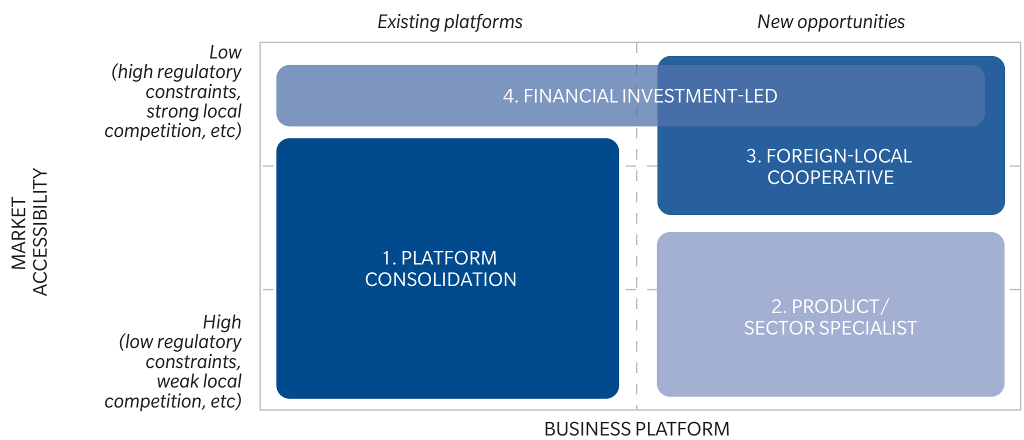
Finally, foreign banks will continue to suffer from licensing constraints, for example in corporate derivatives. Past experience has proved that any market liberalisation and product development in China will be a gradual process which is heavily protected from foreign competition. Domestic banks will be able to acquire a dominant market share and leave little room for foreign banks to grow even if the new product areas are eventually liberalised.

In summary, China will remain a challenging market for foreign banks. Sub-scale operations and poor profitability will not disappear as the market grows bigger and deeper. Foreign banks should now review their onshore operations and re-design their strategy.

ALTERNATIVE APPROACHES TO WHOLESALE BANKING IN CHINA

We have identified four approaches for foreign banks to gain scale and improve the profitability of their Chinese subsidiaries. Exhibit 7 provides an overview of these approaches and their applicability depending on market accessibility and banks' existing setups.

EXHIBIT 7: ALTERNATIVE APPROACHES TO WHOLESALE BANKING IN CHINA



1. PLATFORM CONSOLIDATION

For businesses with relatively low regulatory barriers (e.g. FX, trade finance, M&A) there are opportunities for foreign banks to establish better linkages across the product platforms to extract business synergies and reduce operational costs. The core of this approach is to develop a more integrated model for client, product or market coverage and is suited to banks with multiple established platforms and cross-product capabilities in China. Based on our experience of working with global banks in China, we see three dimensions along which operations can be better integrated:

- **Client coverage and servicing:** Despite ever-growing complexity and sophistication in domestic clients' demand, local banks in China have been slow to react and continue to operate largely siloed client coverage models. For example, even within transaction banking, most Chinese domestic banks still cover their clients based on product lines, such as domestic versus international payments, FX and trade finance with limited to no coordination across the overall transaction banking platform. This provides an opportunity for foreign banks that can operate under more comprehensive coverage models. Successful applications seen in other emerging markets range from more active referrals between product lines to joint account planning to a product-neutral coverage model.

However, due to strict local firewalls between legal entities on sharing client information and data, client coverage models in China need be carefully designed and successful experiences in foreign markets cannot necessarily be applied. Some banks have used their China offshore client coverage teams to better understand how to serve the needs of clients in the onshore Chinese market.

- **Business vertical build out:** With the multiple platforms established in China spanning from origination to distribution, foreign players are well positioned to develop better linkages between product lines along business verticals to aggregate flows and extract mark-ups along the value chain. For example, banks can re-package assets originated from their corporate lending business into lightly structured products and distribute them via their commercial banking or private banking client base. Banks with a local trust partnership can use this versatile vehicle for the distribution and packaging of a wide range of assets originated from their banking, securities and investment businesses to the high net worth (HNW) sectors in China. This model will not only reduce foreign banks' need for local funding but also provide them with an opportunity to use their superior structuring and product design capabilities to serve the growing sector of wealthy clients in China.
- **Market linkage:** Relaxing regulation and fast growing cross-border trade and investment flows are driving ever closer linkages across the Greater China markets (China, Taiwan, and Hong Kong). This has fuelled demand for cross-market solutions from corporates and investors. Global banks, with an established presence across these markets are ideally positioned to develop pan-regional operations that tap into these cross-border opportunities. Recent economic agreements across the Greater China markets have created opportunities for foreign banks to partner with local institutions in Hong Kong and Taiwan to compete in China. For example, Taiwanese banks, with their deep know-how in SME financing, cultural proximity to China and favourable regulatory treatments under ECFA, could be suitable partners for global banks in setting up set up a guarantee business to support Mainland suppliers of Taiwanese corporates.

2. SPECIALIST

The changing Chinese economic structure and fast-evolving financial market provides foreign banks growth opportunities in several emerging sectors and products. In pursuing these opportunities, foreign banks should focus on areas where sophistication is important and where domestic players' scale and distribution advantages are less pronounced: for example, this includes securities structuring, structured commodity finance, and high-tech sector financing. By leveraging their strong structuring capabilities and distribution networks with alternative investors, foreign banks can help domestic institutions transfer risks and off-load illiquid assets (e.g. loan funds) to investors such as private equity funds seeking long-term yields and China exposure. Recent transactions by PAG and ADM Capital have highlighted a growing investor demand for credit exposures with physical underlyings (e.g. SME loans). However, banks choosing this approach need to continuously innovate to ensure they have a sustainable edge over local banks, which are fast learners and can quickly catch up.

3. FOREIGN-LOCAL PARTNERSHIP

An alternative route for foreign banks is to partner with Chinese institutions. Local partners can bring several benefits, such as an understanding of local clients and markets, immediate access to a client base and distribution networks, access to local funding, and required product licences. However, this strategy has often failed, with foreign players eventually having to pull out of the joint ventures. There are several pitfalls commonly observed in Sino-foreign joint ventures which can derail even the best-intended partnerships (Exhibit 8).

EXHIBIT 8: COMMON PITFALLS OBSERVED IN SINO-FOREIGN JOINT VENTURES

Local partners with insufficient resources and weak government ties

- JV often relies on the local partner to provide sufficient contacts/networks with government agencies and regulators
- In some cases local partners fail to contribute and end up in a role close to a passive equity investor

Culture conflicts between foreign and local partners

- Foreign banks tend to project western business culture onto the Chinese working environment which is often deemed as culturally unsuitable by local partners
- Failure in resolving such conflicts can impact operational efficiency of the JV and may even result in a divorce

Foreign banks' lack of long-term commitment in the market and resources put into the JV

- Adopting a long-term strategy is necessary for a JV to survive the fierce competition in Chinese capital market
- Foreign banks need to reach certain scale and capability to commit long-term in a JV

Lack of a clear division of responsibilities between foreign and local partners

- In cases where no clear division of responsibilities is pre-defined, significant additional internal cost is created with both parties fighting for control of crucial production factors

Other pitfalls include failure in retaining talent, insufficient political awareness, poor risk management and timing in entering the market

Having the right partner is necessary but insufficient for success. Even with the right partners, foreign banks face a substantial risk of being marginalised in the long-run as local partners typically not only hold controlling stakes in the joint venture, but also hold the key 'production factors'. On the other hand, foreign banks' contributions to the joint ventures are often on the soft side, such as management practice, risk control and client service models, which are replicable by the local partners in the long-run. Without the ability to bring sustained business benefits to the joint venture or control production factors, foreign banks will have little bargaining power with local partners once the latter have internalised the foreign banks' contributions.

A recent example, however, demonstrates that a successful joint venture is possible in China. Australia's CBA started a partnership with Bank of Hangzhou (BoH) in SME banking after taking a 20% minority stake in BoH in 2005. Since then, CBA instituted a series of knowledge transfer programs, covering risk management, technology, treasury and SME banking. In 2009, CBA supported BoH in developing a separate SME unit which has since experienced exceptional growth and turned BoH into one of the leading SME banks in the local area. In return, CBA obtained access to BoH's client base in the Yangtze River Delta and successfully expanded its trade finance business with local SMEs. In working with BoH, CBA used active rotation programs to develop a mutual understanding of both sides and leveraged its placement of CBA personnel in senior management roles at the joint venture to ensure a deep involvement in the overall operations. Building on their success, CBA and BoH plan to establish five to seven additional banks together in other provinces across China, targeting the growing number of SMEs in rural parts of the country.

4. FINANCIAL INVESTMENT-LED

The franchise value of Chinese financial institutions is likely to grow as wholesale revenue pools further expand and local players upgrade their operations. For foreign banks with a strong capital base and the ability to take medium- to long-term investment risks, there is a case for making passive investments in local institutions. With this approach, financial returns and a long-term optionality would be the primary objective. But foreign banks can also try to exploit operational synergies from cooperation with local institutions.

The non-bank sector, which remains relatively under-developed in China, is poised to grow as the overall economy expands and financial markets modernise. Within this sector, we see three niche areas which have significant potential for value creation (Exhibit 9).

Such investments can come with substantial regulatory risks. The recent crackdown on unauthorised exchange platforms is a good example. Sudden changes in regulatory schemes caused disruptions in local markets and forced the closure of a large number of market participants' operations. In the areas highlighted in Exhibit 9, trusts face relatively high regulatory risk. The recent proliferation of trusts in China, especially the banks' use of trust vehicles for disguised deposit gathering, has drawn attention from the regulators who have followed through with a series of 'ramification measures'. While the regulator is currently comfortable with the risks in the trust sector, there are growing concerns among investors about size and growth of this sector, particularly in relation to the build up of property-related exposures. When making such investments, it is important for foreign banks to evaluate the entire business model with a view to avoid any business in grey zones or with unclear client exposures.

EXHIBIT 9: POTENTIAL AREAS FOR FINANCIAL INVESTMENTS

NICHE MARKETS	RATIONALE	POTENTIAL OPERATION SYNERGY	POTENTIAL RISK	POTENTIAL
Leasing	• Stellar historical growth (CAGR[1] of >200% during 06-11) • Attractive return with ROE[2] of 10%-15% • Penetration remains low compared to mature markets[3] • Relatively less regulated in terms of product offerings, capital requirement, network expansion, etc. • No constraint on foreign investment	• Synergy with corporate banking business – Leasing/microfinance/trust: lower funding cost – Banking: higher yield; lower capital charge • Enhanced offerings of holistic WB solutions – SME – Infrastructure/aviation/ manufacturing	• Credit risk • Capital constraints	
Trust	• Strong historical growth momentum (Total asset CAGR of >60% during 06-11) • Attractive long-term growth potential driven by increasing HNWI population • Relatively light regulation and a broad activity license covering private equity, asset managers and banking services	• Synergy with securities (e.g. research) and wealth management business	• Regulatory uncertainties • Risk management	
Futures	• The industry is struggling to make profit due to its retail focused nature and homogenous competition • Opportunities arise with the introduction of new financial futures products • Industry consolidation currently in progress • Potentially acquiring stakes in the winners to capture the opportunity	• Synergy between futures and securities business – Integrated offering of investment and hedging products	• Industry-wise low profitability and unclear prospect • Strictly regulated, difficult to get entry approvals	

Growth potential: High Medium Low

1. Calculated based on total financial leasing assets outstanding
2. Based on financials of listed financial leasing companies
3. Growth momentum driven by increasing lease penetration rate (CN 4% vs. mature markets 20% vs. US 30% in 2010)

Source: '12th 5-year plan- building Shanghai into an international financial centre', press release, Oliver Wyman proprietary data and analysis

CONCLUSIONS

The Chinese wholesale banking market has witnessed rapid growth over the past decade. Despite a number of risk factors we remain bullish about the long-term prospects of the market. However, a 'more of the same' approach will not allow foreign banks to benefit from China's growth. We have outlined four potential models for success. They are not mutually exclusive and the winners will be those who can successfully identify the models that best fit with their platform and product strengths.

In this context, senior management face a set of questions that must be answered to facilitate sustainable growth of their wholesale operations in China:

- Which of the existing business operations should be retained in the long-run? Which ones should be exited?
- What is the most suitable approach to increasing the linkage among the existing platforms and to extract synergies, subject to local regulatory constraints?
- What products, markets and sectors provide the greatest growth potential and should be focused on for expansion?
- In which areas should the bank partner with local institutions to gain growth momentum?
- What is the profile of a suitable partner and how should the partnership be structured to ensure long-term success?
- In which product areas is organic expansion expected to be most challenging and where should a financial investment-led approach be considered?
- When making financial investments, which sectors have the best return potential? And what are the qualities of a suitable investment target?

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialised expertise in strategy, operations, risk management, organisational transformation, and leadership development.

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