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Asia Retail Banking Practice

Next-generation retail banking in China

Building eight transformational capabilities

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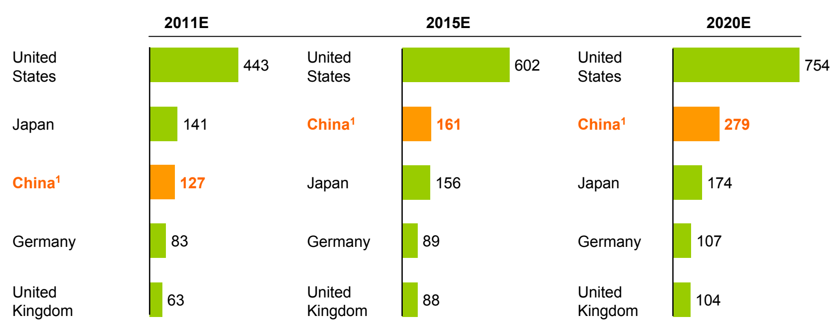
Rapid but uneven growth, weak return

Retail banking in China has grown at breakneck speed in the last decade. During the period 2000–10, retail deposits grew by 4.5 times and loans by a staggering 17 times. Products per customer have increased to four from just above one. All banks combined, there are more than 200,000 employees dedicated to retail today compared with almost none ten years ago. Retail product offerings, the talent pool, channels, and infrastructure have all grown dramatically in scale and quality.

More exciting days are ahead. By 2015, China will become the second-largest retail banking market in the world, after the United States. By 2020, total retail banking revenue is expected to reach $280 billion[1] a year from $127 billion today, new research from McKinsey & Company shows (Exhibit 1).

Exhibit 1 China will become the second-largest retail banking market in the world by 2015, with an annual revenue pool of around $280 billion by 2020.

Revenue of retail banking post-risk, top 5 countries
$ billion



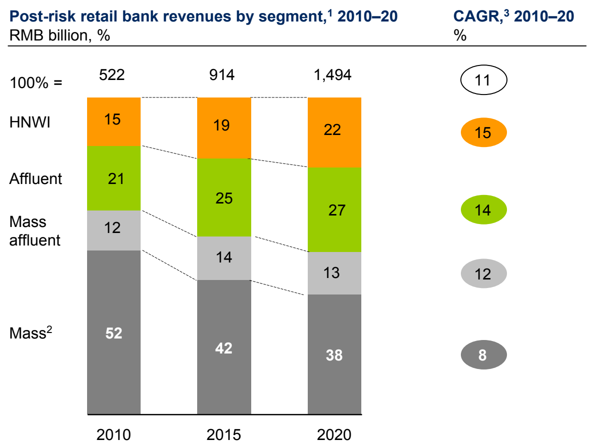
1 China forecast based on conservative scenario.

Source: McKinsey Global Banking Pools

China is a diverse market, though, and the historic and expected growth rates in retail banking are uneven across customer segments, products, and geographies. Our research finds that wealthy segments will play an even more

1 Based on an exchange rate of USD to RMB of 6.4 in 2011 and 5.4 in 2020 from Global Insight.

Exhibit 2 High-net-worth individuals (HNWIs) and affluent customers will contribute almost half of retail banking revenue by 2020.



1 Assets-under-management threshold for each segment: HNWI, RMB 7 million; affluent, RMB 500,000; mass affluent, RMB 50,000; mass, RMB 10,000; this assumes constant threshold throughout forecast period.
2 Mass includes the urban and rural market.
3 Compound annual growth rate.

important role in the future than they do today (Exhibit 2). High-net-worth individuals and affluent customers will represent nearly 50 percent of retail banking revenue by 2020. They will also be the fastest-growing segments.

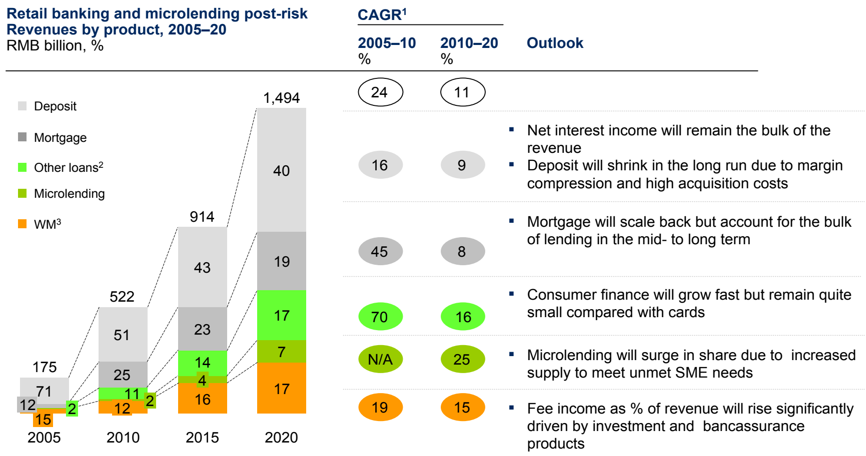
From a product perspective, wealth-management products, including mutual funds and bancassurance, and consumer finance, including credit cards, personal loans, and auto loans, will be the fastest-growing product categories between 2010 and 2020 (Exhibit 3). Microbusiness lending will take off, with forecast loan balances of RMB 3.7 trillion by 2020, as banks—encouraged by the government—increase credit supply to meet the needs of small and micro enterprises and try to lock in higher loan yields. Mortgages will remain the bulk of retail lending in the mid to long run, but market growth will slow as the government acts to rein in soaring property prices, making real estate a less attractive investment.

The top 50 Chinese cities drove the growth of retail banking in the last decade, accounting for 46 percent of revenue increases. We anticipate that these cities will continue to be the major growth engines, contributing 56 percent of revenue growth in the next 10 years. Even within these cities, however, growth rates and sources of growth will be highly divergent.

While growing at a rapid pace, retail banking in China offers relatively low returns today. With the exception of the “Big Four” banks, which benefit from massive scale, most Chinese retail banks show low profitability, with cost-to-income ratios greater than 75 percent for most of them,[2] compared with less than 50 percent for most of their international peers.

2 Many Chinese banks still have difficulties assessing the true profitability of their retail banking business because of inconsistent funds-transfer-pricing practices and nontransparent allocation of costs by business line, in particular at the branch and sub-branch level.

Exhibit 3 Wealth management, consumer finance, and microbusiness lending will lead retail banking revenue growth in the next 10 years.



1 Compound annual growth rate.
2 Includes credit card, unsecured personal loans, and auto loans.
3 Wealth management; includes structured deposits, mutual fund, bancassurance, and other fee-only products.

There are several underlying causes of low profitability in Chinese retail banking, but two in particular stick out: retail banking was at its early developing stage in the past decade with significant investment in infrastructure and the "land grab" approach that most local banks have pursued, resulting in costly customer acquisition and an homogeneous offering.

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The case for change

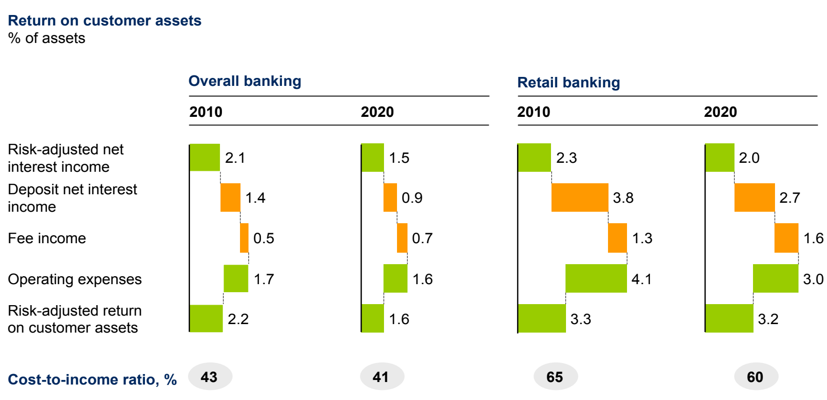
For Chinese banks, the staggering growth of the retail banking market offers a major opportunity. To seize it profitably, banks will need a thoughtful strategy and a transformation of their current operating model. The traditional "land grab" approach will be under great pressure in the face of a strong need for improved profitability, maturing marketplaces, and a retail landscape marked by changing customer behavior, rising funding costs, intensifying competition, technological innovation, and escalating regulatory pressure.

THE NEED FOR PROFITABILITY

The last decade of frenzied growth in corporate-banking loan balances, widening of interest margins, and a benign credit environment allowed banks to focus on increasing scale rather than profitability in retail. Given the anticipated pressure on the overall return on assets[3] of Chinese banks, they will put more emphasis on profitability of their growing retail franchise. McKinsey forecasts a significant compression of structural return on customer assets for Chinese banks overall, from 2.2 percent to 1.6 percent by 2020, because of interest-rate deregulation and increasing risk costs. Retail banking returns will also slip, from 3.3 percent to 3.2 percent by 2020 (Exhibit 4).

Exhibit 4 The overall profitability of Chinese banks will be under pressure, leading to a stronger need for retail banking to improve the bottom line.

ESTIMATES



3 The overall return on assets of Chinese banks is considerably lower than the return on customer assets because nearly 50 percent of assets on Chinese balance sheets are not customer-related.

MATURING MARKETPLACES

The growth of the Chinese retail banking market will be slower compared with the past decade, as GDP growth is expected to fall to a compound annual rate of 7 to 8 percent in the next decade from the compound annual rate of 10.5 percent in the past ten years, according to the latest McKinsey Global Institute estimates. We forecast that the post-risk retail banking revenue pool will rise 11 percent annually in the next decade (or 40 to 60 percent above GDP growth), compared with 24 percent in the last five years.

Some marketplaces are becoming saturated and future growth will no longer come from acquiring new customers. Take credit cards: over the past decade, almost all revenue growth in Tier 1 and Tier 2 cities came from newly acquired customers. Over the next decade, we estimate that more than 50 percent of credit card revenue growth will come from deepening existing customer relationships.

In the future, Chinese retail banks must develop a thoughtful strategy on where and how to play. Banks can focus on the pockets of growth in customer segments, product lines, and geographies, depending on their specific capabilities. In the past, the strategies, product offerings, and operational models of Chinese retail banks were largely homogeneous. That time is past.

CHANGING INDUSTRY LANDSCAPE

Chinese retail banks will face fundamental changes in the external market environment, including changing consumer behavior, rising funding costs, intensifying competition, new technologies, and heavier regulation.

Changing consumer behavior. Chinese consumers are becoming more sophisticated, more demanding, and less loyal, McKinsey's personal financial services survey found last year. They hold more financial products—the average number of financial products per customer increased from 3.6 in 2007 to 4 in 2011—and are more open to financial advice. In our survey, 67 percent of customers in China said they were open to investment advice and assistance, compared with an Asia average of 50 percent.

Chinese customers are less satisfied, more reluctant to recommend, and less willing to stay with their primary banks than other consumers in Asia. Some 80 percent of Chinese customers are satisfied with their primary bank, compared with an average of 84 percent in Growth Asia markets. Only 55 percent of them would reselect their existing bank as their primary bank, lower than the 58 percent Asia average and much lower than the 66 percent average for Developed Asia markets. Finally, only 47 percent of customers would recommend their primary bank, down from 57 percent in 2007 and much lower than the 60 percent Growth Asia average level. As a result, customers prefer to regularly shop around for financial products. Our survey shows that almost 70 percent of Chinese consumers believe "shopping around for financial products is worth the effort," higher than the Asia average of 60 percent and much higher than the 40 to 50 percent for affluent segments in mature Asian markets.

Chinese customers are also more demanding. The need for a better customer-service experience and more professional advice drives customers away from big banks, especially in more affluent segments. For example, while about 80 percent of Chinese consumers continue to choose the Big Four as their primary banks, the percentage of secondary banking relationships owned by the Big Four has declined sharply, from 75 percent in 2004 to 60 percent in 2011.

Also, alternative banking channels are picking up fast. Penetration of automated teller machines rose from 53 percent in 2007 to 84 percent in 2011; telephone banking, from 4 to 12 percent; Internet banking, from 3 to 18 percent; and mobile banking, from 1 to 3 percent. Very importantly, we observe that popularity of alternative channels is consistent across city tiers and age groups. Therefore, a multichannel, multiaccess customer interaction model is essential to the success of next-generation Chinese retail banks.

Rising funding costs. We believe the structural shift in personal financial assets from deposits will continue, driven by inflation-adjusted negative interest rates and increasing awareness and availability of alternative wealth-management products. In 2005, deposits represented 73 percent of personal financial assets. Today, they are at 60 percent, still well above the 22 percent in the United States and 17 percent in Hong Kong. Given the regulatory upper-limit loan-to-deposit ratio of 75 percent, and despite the fact that for most banks in China retail deposits already account for less than 30 percent of their total funding base, retail deposits are becoming an increasingly scarce and highly valuable resource. As a result, the battle for deposits is fierce and effective deposit rates have already increased. For example, there has been a surge in sales of risk-free structural deposit products—their volume more than doubled in the last two years, while returns edged up by as much as 200 basis points. As banks earn little from these costly funding instruments, their profitability will be hurt quite substantially.

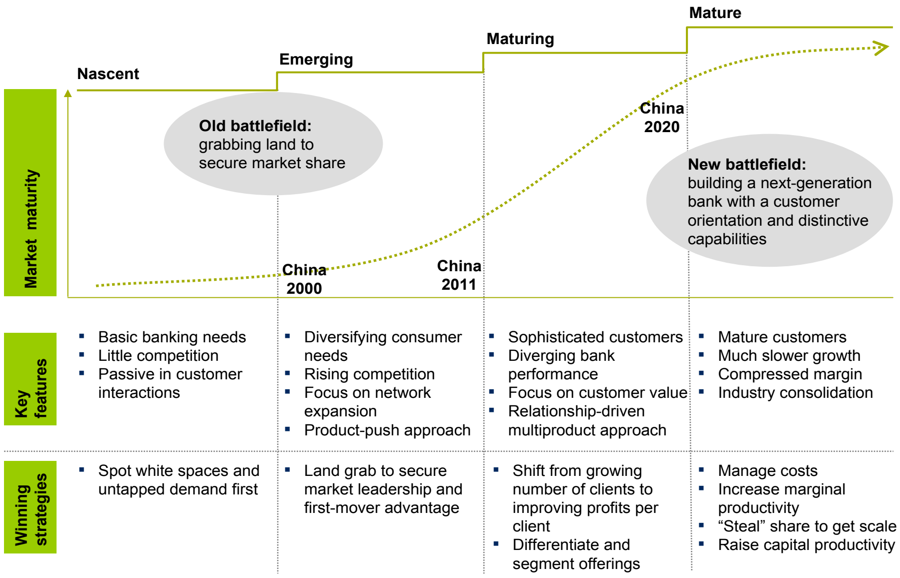
Intensifying competition. Aside from the fierce competition on deposits and other sources of funding, the number of bank branches has increased steadily over the last few years. Despite the financial crisis, 7,340 new branches were opened in China in 2009 and 2010 alone. Bank branch density in Beijing and Shanghai already matches Hong Kong and Taiwan; for example, the number of bank branches per 10,000 people in Beijing and in Hong Kong was 1.8 in 2010. In Shanghai and Taiwan, there were 1.4.

Emergence of new technologies. Four technological trends—the ability to address customer needs in real time, the Internet of things, cloud computing, and technology-driven business models—are shaping customer behavior and banks' operating model in areas such as online and mobile payment, marketing campaigns through the Internet, and data-driven risk management.

Escalating regulatory pressure. Interest rate deregulation is one of the clear trends for the Chinese banking industry in the next decade. The impact will be gradual compression of net interest margins and the need to build better risk, pricing, and marketing capabilities to maintain higher margins. Regulators have begun to eliminate certain retail banking fees while acting to increase fee transparency. This will lead to lower-than-expected growth in transactional fee income.

In this changing landscape, Chinese retail banks must retool themselves by building new capabilities (Exhibit 5).

Exhibit 5 Retail banking in China is entering a new era.



The successful retail banks in China have built their franchise with capabilities that were valuable in the early phases of market development, including spotting white spaces and excelling in the “land grab” for customers. In the next decade, a new set of capabilities will be required.

Winning the retail banking game

Winners in Chinese retail banking in the next decade will be those that can build not only a sizable franchise, but a profitable one too. The new market realities call for a different model: Chinese banks must shift attention from increasing the number of customers to improving profit per customer. In our experience, this will require a holistic transformation.

BUILDING PRIMARY BANKING RELATIONSHIPS

Our research shows that Chinese consumers, across segments, place nearly 70 percent of assets with their primary bank. According to our personal financial services survey, converting primary banking relationships from mere frequent usage (primary or secondary relations) is also the biggest bottleneck for most Chinese banks. For example, these conversion rates range from 12 percent to 30 percent for non-Big Four Chinese banks, compared with 54 percent for Japanese banks and 51 percent for Taiwanese banks (Exhibit 6).

Exhibit 6 Converting primary banking relationships is the most important bottleneck for many Chinese banks.

Number of customers in survey sample (China = 3,005, Japan = 400, Taiwan = 404), %

x Conversion ratio (%)

	Use[1]	x	Primary or secondary relation	x	Primary relationship	x	Recommend
Big Four	5,227	78	4,095	45	1,846	21	391
Joint stock bank	1,247	56	697	24	168	11	18
City commercial bank	287	58	168	30	50	13	7
Foreign bank	17	31	5	12	1	12	0
Japan	1,312	57	743	54	400	8	31
Taiwan	1,500	53	790	51	404	21	83

1 N = 3,005; the same person using more than one bank is counted multiple times.

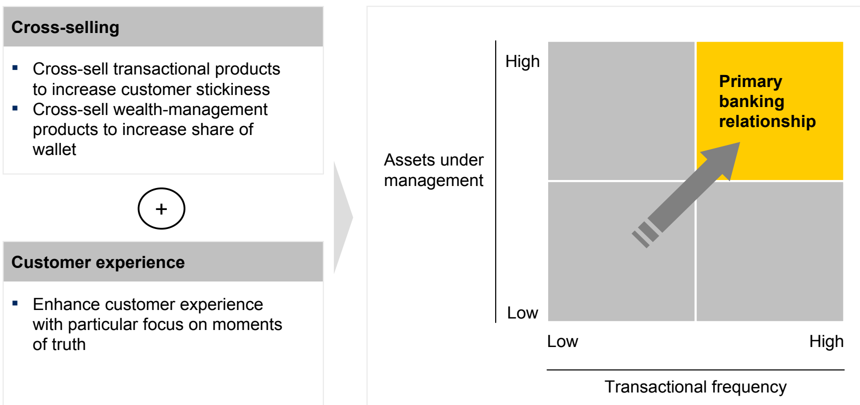
Source: McKinsey survey on personal financial services in China, 2011

In our experience, effective cross-selling and superior customer experience are the critical path to building more primary banking relationships (Exhibit 7).

Cross-selling of “high stickiness” transaction and wealth-management products is a very effective way to drive customer loyalty. In the context of China, we found the choice of primary bank for customers is highly driven by the usage of products like payroll, utility payment, trading of stocks, and other investment accounts, but less driven by credit card and lending products.

Internationally, Wells Fargo, the second-largest retail bank in the United States, has customer insight and cross-selling at the core of its strategy with the

Exhibit 7 Effective cross-selling and delivery of superior customer experiences are essential to build more primary banking relationships.



“Gr-eight” vision (each customer holding at least eight products with them). As its company value and mission statement says: “The more we give our customers what they need, the more we know about them. The more we know about their other financial needs, the easier it is for them to bring us more of their business. The more business they do with us, the better value they receive, the more loyal they are. The longer they stay with us, the more opportunities we have to satisfy even more of their financial needs.” With this vision firmly established across the organization, Wells Fargo managed to navigate the financial crisis relatively unscathed and ranks as one of the most valuable banks in the world.

Customer experience plays another critical role in building primary banking relationship. Chinese retail banks typically suffer 30 to 40 percent customer attrition, defined as a migration to a lower assets-under-management band within a year. This is well above the experiences of their international peers. Our personal financial services survey has found that 12 of the top 15 loyalty drivers are customer-experience related (Exhibit 8). Therefore, delivering a first class, end-to-end customer experience is a critical building block in acquiring and retaining primary banking relationships.

Exhibit 8 Customer attrition is high in China and customer experience is critical to drive loyalty.

12 of the 15 loyalty drivers are related to customer experience

Relate to customer experience

Importance	Loyalty drivers in order of importance
High	1. Employees are familiar with bank procedures
	2. Branch offices are in locations that are convenient for me to visit
	3. The company rarely makes mistakes with my account
	4. The ATMs are in convenient locations
	5. Employees are courteous and provide friendly service
	6. The company respects my privacy
	7. They offer a full range of financial products and services
	8. The company delivers on its promises to its customers
	9. If there is a problem with my account, the company is quick to resolve it
	10. Employees are knowledgeable about the products and services available
	11. The physical layout of the branch and the signage make it easy for me
	12. Employees are willing to go out of their way to help me
	13. The company is a leading brand in the market
	14. I feel secure that I will get my money back if something happens to the bank
Low	15. Employees try to understand my needs and make sure I get appropriate product/service

Source: McKinsey survey on personal financial services in China, 2011

BUILDING EIGHT TRANSFORMATIONAL CAPABILITIES

The new market realities call for a different model that could fulfill three strategic objectives: building more profitable and sustainable primary relationships, carrying out smarter and more focused customer acquisition, and developing a low-cost and scalable operating model. To achieve these objectives, Chinese banks must build capabilities to manage customers for value, improve customer experiences and operational efficiency, build organization enablers, as well as manage capital and funding efficiency. We have identified eight transformational capabilities that will set the winners apart from the losers (Exhibit 9).

Exhibit 9 Eight transformational capabilities must be built.

Manage customers for value	1	Big data–enabled customer analytics for effective cross-selling
	2	“Pricing 2.0” as a source of competitive edge
	3	“New risk paradigm” to manage risks in a scalable and profitable manner
Deliver better customer service at lower cost	4	End-to-end transformation to enhance customer experience and operational efficiency
	5	Innovative institution leveraging ubiquitous technology
Advance organization and people	6	“Big retail” with more vertical, professional, and nimble retail organization structure
	7	“Capability for performance” to deliver sustained performance
Manage capital and funding efficiency	8	Next-generation asset-liability management as a means of improving loan yields and reducing funding costs

Manage customers for value

1. Big data for more effective cross-selling. One common indicator for depth of a customer relationship with a bank is product holdings per customer. In China, the average is just 1.6, well behind international best practice of 5 to 8. Banks can move the needle on cross-selling and deepening customer's wallet share by bringing the power of data analytics to their front line and to the customer. Through exploitation of data across the organization, banks acquire a much deeper understanding of customer segments and their value. With these insights, banks can offer customers much more tailored, more innovative, and integrated product bundles, and deliver highly targeted next-product-to-sell campaigns. For example, through effective data-mining and stringent execution, we have seen a joint stock bank successfully convert 15 percent of its mortgage customers to mass affluent wealth-management customers.

2. "Pricing 2.0" as a source of competitive edge. Our experience with several banking clients in China shows that pricing can be a powerful performance lever. In China, banks should build the tools and capabilities necessary to optimize list prices on a frequent basis, do continuous price benchmarking across the network, introduce discount monitoring, and develop advanced pricing models to support the frontline, incorporating customer elasticity and risk scores. To execute these changes, pricing should become an explicit function within the bank, with experts focused on supporting the business. Management information systems must offer a clear understanding of the impact of pricing decisions on volumes and profitability. This runs from simple frontline information to track leakage and from how the front line uses its discretion on pricing to more elaborate tools to optimize pricing decisions across products and customer relationships.

3. "New risk paradigm" to manage risks in a scalable and profitable manner. In the aftermath of the financial crisis, banks worldwide are rethinking their risk-management model. Banks globally are recognizing that relegating risk management to a "machine room" that produces complex analyses and "black box" models is not sufficient. It is equally important for Chinese banks to establish a scalable and profitable risk paradigm, with emphasis on transparency, risk ownership, and governance. Four pillars would underpin a new risk approach for Chinese banks: developing early warning systems and stress testing through cycles and scenarios; assigning clear, natural risk ownership and accountability; a governance structure that forces business units to account for risk, not just the chief risk officer; and ensuring that incentives are fully aligned with the risk appetite of the bank. For Chinese retail banks, operational risks and fraud prevention are often a bigger challenge than customer default. Hence, it is even more important to look beyond the risk model and focus on building the right risk culture through proper organizational setup and incentives. Furthermore, better risk understanding will also help in identifying potential loan customers within the banks' existing customer base, and thus allowing banks to acquire them more effectively with pre-approved credit lines and loan products.

Deliver better customer service at lower cost

4. End-to-end transformation to enhance customer experience and operational efficiency. Despite the CBRC call for transforming from a “department bank” into a “process bank,” very few Chinese banks have cracked the code in this journey. By “end-to-end transformation,” we mean a customer-centric, cross-functional approach to simplify radically the banking process and dramatically improve customer experience. To accomplish this, banks should undertake a detailed mapping and redesign of customer experiences, with a particular focus on moments of truth—interactions when consumers invest a high amount of emotional energy in the outcome (such as a lost credit card). In Asia, we have seen banks improve customer satisfaction levels by 20 percent (defined as the percentage of customers who rate experience with the bank as “distinctive” and “very satisfied”) through a two-year, end-to-end transformation of eight critical customer processes. The typical challenge faced by Chinese banks is that the current organization structure does not support cross-function collaboration. Therefore, a CEO-championed transformation with a strong project management office to coordinate and drive change is critical for Chinese banks who want to embark on this journey.

The other value of an end-to-end transformation is cost reduction. By applying lean principles, an end-to-end transformation can help reduce unit costs by 20 to 30 percent. For example, a Southeast Asian bank reduced its total operating costs by 20 percent through standardization of 70 to 80 percent of transaction processing and automation of more than 50 percent of credit approvals in retail and small business segments.

5. Building an innovative institution leveraging ubiquitous technology. On the one hand, technology is a fundamental enabler for all the other transformation capabilities. Without state-of-the-art business technology at the core of their operational model, banks can hardly meet increasingly sophisticated customer needs, or effectively compete with peers in the future retail banking game. On the other hand, the advancement in technology has made it possible for nontraditional players to create disruptive business models. Third-party payment companies already represent one-quarter of transactions in China after just five years of operation. Once regulation permits, these companies will try to leverage the payment flows to cross-sell investment, insurance, and lending products to customers, threatening the core of retail banks’ business. Retail banks in China will have to respond decisively and forcefully before it is too late.

Taking the next step in technology will require banks to revamp their business-technology infrastructure and related operational processes, while setting up a truly innovative organization for the future. An “innovative institution” of the future needs to establish dedicated organizational units, recruit nontraditional talent (for example, from Internet companies), and allocate sufficient funding for innovation. Banks must build a culture of innovation through key performance indicators and management processes.

Advance organization and people

6. “Big retail,” with more vertical, professional, and nimble organization structure. One of the key constraints for many Chinese retail banks is weak execution at the branch and sub-branch level because of a geography-oriented organizational setup. Resources are not dedicated to retail and are redirected to other functions for short-term profitability reasons or control concern. The unequal caliber of people running retail business results in highly divergent performance. Implementation of new business models is harder because of the different level of understanding and focus of each branch and sub-branch manager. In the future, we envision that winning retail banks will move toward a more vertical, professional, and nimble organization structure, although they will not be able to copy exactly the Western bank model because of complexities such as the geography-based regulatory regime in China.

7. "Capability for performance" to deliver sustained performance. Successful transformation hinges on people. McKinsey research has shown that 70 percent of transformations fail because of people issues. Take branch transformation: almost all Chinese retail banks have gone through one or multiple rounds of branch transformation, yet most failed to deliver sustained impact. The main reason is that the banks approach the transformation as a quick top-down campaign without addressing their fundamental capability gaps. A common pitfall is equating capability building with training. McKinsey research has found that pure classroom training is actually one of the least effective ways to develop people. Job rotation, special project assignment, and effective mentoring and coaching are much more powerful ways to develop employees.

Manage capital and funding efficiency

8. Next-generation asset-liability management as a means of improving loan yields and reducing funding costs. The current business model of all Chinese banks optimizes for growth rather than return on equity. That makes a lot of sense in an environment where winning the most customers was key. In the coming era, however, managing funding and capital becomes more important. This transformation starts with developing a deep understanding of the risk-adjusted return of loans to different segments and cost of funding of different types of deposits and making conscious choices about how to achieve an optimal balance sheet structure. For example, one of our clients managed to lift its net interest margin by 50 basis points through careful planning and execution of an asset-liability-management strategy.

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A customer-centric transformation to build the eight capabilities is not easy, but it is essential. Winners in Chinese retail banking in the next decade will be those that can transform themselves in response to the new market realities and refocus on customer value. To do this, Chinese retail banking executives must define an integrated transformation agenda and a clear plan for how the eight transformational capabilities mentioned above will be developed and nurtured. They must also build an infrastructure to support the change as well as address the "soft" cultural aspects of change in parallel with the "hard" business issues.

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