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5. SUMMARY – A MORE BALANCED PERSPECTIVE, A CALL FOR ACTION . 30
Looking back at the past 20 years, the agenda of Chinese banks has been shaped by waves of evolution as below:

• Marketisation – from late 90s to early 2000s, when major banks transformed themselves from government-alike organisations into more commercialised ones, and also when joint-stock banks emerged. The resulting agenda included the cleaning up of bad debts, introduction of foreign strategic investors, establishment of corporate governance and going IPO

• Infrastructure – big foundational efforts during early till late 2000s to bring the infrastructure up to global standards, leading to agenda such as data centralisation, IT system (especially core banking) development and risk management implementation (especially Basel)

• Operating model – starting from late 2000s, the efforts shifted towards operating model transformation, represented by three key agenda: go vertical and BU/branch matrix; branch transformation; back-room operations process redesign and centralisation (i.e. the “process bank”)

Today, China is in the midst of another wave, with its business model transforming from one relying only on traditional lending business, towards one with a wider range of services and high proportion of fee revenues. This started from 2010, where banks began to offer bank wealth management and trust products, which were still lending/deposit replacement in nature; now banks are looking into areas such as broader wholesale solutions and wealth/asset management. At the same time, the industry is encountering amplifying credit challenges. All these have provoked a range of views over the current state of China’s banking system and raised a variety of questions over its future.

This paper does not aim to provide another exhaustive description of the current state and challenges of China’s banking sector. Rather, our purpose is to identify a list of agenda for practical action today, which applies both to domestic banks and to global banks that operate in China or are planning to do so.
SECTION 1 summarises the current state of China’s financial system, which is facing soaring levels of debt, worsening credit quality and liquidity, and diminishing margins. The section then looks forward to anticipated changes away from the traditional system centred on services for large corporations.

SECTION 2 suggests how banks could tackle the credit challenge and gain confidence among their stakeholders (agendas #1 to #3). A sharper NPL management toolkit and some degree of recapitalisation and bailout are required to fundamentally tackle the problem. The industry must also upgrade its risk management, incorporate this into its business, and make its data more transparent.

SECTION 3 discusses how banks should transform the business model of corporate and institutional banking (agendas #4 to #6). The banking sector will have to be sharper and more creative in identifying client needs, optimise the traditional lending business and develop full suite of wholesale banking products and solutions.

SECTION 4 highlights four major opportunities (agendas #7 to #10). The rapid growth of Fintech has disrupted China’s otherwise traditional industry, while opening the doors for new partnerships and revenue models. There is an opportunity to provide new products to the retail and SME sectors, whose financing needs are still largely unmet by product offerings that remain at a very basic level. The rapid growth of both retail and institutional wealth will create huge demand for professional asset- and wealth-management. Finally, RMB-denominated products will become increasingly important on the back of China’s growing regional and global economic presence.

SECTION 5 summarises the opportunities presented by the current troubles in the Chinese banking sector. We hold a more balanced perspective of the concerns that have recently been raised. Leading banks need to respond to the challenges immediately and over the coming decade, but it is equally critical for them to think even longer-term, advance their market propositions, and develop a roadmap for capturing the opportunities emerging in the Chinese banking sector of tomorrow.
1. A PERSPECTIVE ON CHINESE BANKING

It is first important to consider the structural imbalances in the financial system that have been driving China's economic development over the past 30 years. The model can be briefly summarised as follows:

- Banks are primarily state-owned, and provide debt financing mainly for large industrial corporates, which are also primarily state-owned (Exhibit 3).
- Retail and SME financing is largely underdeveloped. This includes mortgages, where leverage is low, representing a major unmet need that has to be addressed for further economic growth.
- Low-cost funding is provided by retail and corporate deposits; corporate deposits have traditionally provided strong collateral (Exhibit 2).

Exhibit 2: China’s banking assets and liabilities

<table>
<thead>
<tr>
<th>Year</th>
<th>Loan AS % of GDP</th>
<th>Deposit AS % of GDP</th>
<th>LDR ratio (banks)</th>
<th>LDR ratio (all FIs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>108%</td>
<td>175%</td>
<td>15%</td>
<td>55%</td>
</tr>
<tr>
<td>2008</td>
<td>123%</td>
<td>177%</td>
<td>11%</td>
<td>55%</td>
</tr>
<tr>
<td>2009</td>
<td>123%</td>
<td>175%</td>
<td>12%</td>
<td>55%</td>
</tr>
<tr>
<td>2010</td>
<td>132%</td>
<td>185%</td>
<td>12%</td>
<td>55%</td>
</tr>
<tr>
<td>2011</td>
<td>144%</td>
<td>203%</td>
<td>14%</td>
<td>55%</td>
</tr>
</tbody>
</table>

*1 LDR ratio (all FIs) calculated as total loans by all financial institutions divided by total deposits of all financial institutions. LDR ratio (banks) refers to the LDR of all commercial banks reported by CBRC since 2011.
*2 Financial institutions include PBOC, banking depository financial institutions and banking non-depository financial institutions.
*3 Includes ICBC, CCB, BOC, ABC, BoCom, CMB, CITIC, CMBC, CIB, SPDB, HXB, PAB, CEB, BOB, NJCB, NBCB.
*4 Total liabilities excluding accrued expenses. For comparison purposes, only data from Bank of America, Citigroup, JPMorgan Chase and Wells Fargo is used.

Source: PBOC, CBRC, CEIC Data Company Limited, company annual reports, Oliver Wyman analysis
This model has proven to be a very powerful growth engine for China, and has resulted in some large and profitable Chinese names on global banking league tables (Exhibit 4). ICBC, the largest bank by assets globally, has achieved average annual growth of 14.6% in income and 22.0% in profit over the past decade.
However, the marginal economic impact from China’s banking model has been diminishing. Our analysis shows that it now takes three-and-a-half yuan of new credit to generate an additional yuan of GDP, compared to just one yuan of new credit before the financial crisis. This is resulting in massive debts with deteriorating underlying quality. China’s overall debt-to-GDP ratio has soared from 152% to 255% over a decade, while loans provided by financial institutions are equivalent to 144% of GDP. Although China’s overall debt level is similar to that of the US (251% of GDP) and the euro area (266% of GDP), its credit growth has been rapid: about 100% of GDP in China vs. 35%-45% of GDP in the US and the euro area over a decade. China’s overall debt is also significantly higher than the average in emerging markets, which is at 179%.

The official NPL ratio has risen to 1.67%, while analysts think the true NPL ratio could be several times higher. Credit quality is deteriorating, as more new debt is actually used to refinance existing loans. A growing number of firms pay more in interest than they earn before tax. Net interest margins (NIM) have also begun to compress, from 2.6%-2.7% in 2011-2014 to 2.35% in 2016Q1.

The 2015 annual reports of major listed Chinese banks provided a clear signal that the good times are over. Income growth of the “Big Four” banks slowed from 11.2% in 2014 to 5.1%, while profit growth fell from 6.6% to 0.6%. In 2016Q1, all the Big Four banks reported quarter-on-quarter declines in net interest income.

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1 Estimates from Bank for International Settlements. Measured as total credit to the non-financial sector. Only credit to private sector and government sector are included.
2 China Banking Regulatory Commission.
Chinese banks’ price-to-book (P/B) ratios, which are generally seen as indicators of investor confidence, have fallen sharply due to the above mentioned negative factors and uncertainties (Exhibit 5).

Exhibit 5: P/B valuations in global banking

In our recent report, “Bringing Light Upon Shadow”, we argued that China has the political strength and economic resources to address the challenges caused by the credit cycle in the banking system. While the necessary actions will have substantial domestic economic costs, the Chinese economy is capable of bearing these. Likewise, despite concerns over the shadow-banking sector, we believe the overall Chinese economy is not overly indebted: the sovereign government balance sheet is healthy, and Chinese households have low levels of debt.3

On the flip side, the hard landing for NIM is driving banks in China to look for new business opportunities. Going forward, we anticipate four major macroeconomic trends that will set the agenda:

- The economy – and, thus, the banking system – is evolving from a model driven by investment, the export-oriented industries and large established corporations, to one that is also fuelled by consumption, the services industry, as well as retail and SME customers.
- Corporate financing will change. The legacy model consists of heavy reliance on indirect financing for large corporates, which is based on cheap funding via deposits, generating moderate but large-scale net interest margins for banks. This will evolve towards direct financing and more-demanding funding structures. Fee-based income will increasingly complement NIM as a source of revenues.
- Both institutional and retail investors will demand more-sophisticated products amid the continued growth of investable wealth. The product landscape is expected to evolve, as it will no longer be sustainable to offer an implicit guarantee of products amid an economic slowdown with gradually emerging credit-risk exposure.
- The global connectedness of the Chinese economy and its financial system will further increase, leading to a balanced, evolutionary opening of China’s capital accounts, capital markets, currency, and wider banking landscape. The quota and licensing system is likely to become less rigid.

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3 Refer to Oliver Wyman publication “Bringing Light Upon the Shadow (2014)” for more details.
2. GAINING CONFIDENCE AND TACKLING THE CREDIT CHALLENGE

Banks in China are now facing acute challenges, as the economic slowdown begins to amplify their exposure to credit risk. While tackling such challenges is important in the short term, banks also need to think beyond them and take measures to boost confidence, such as instilling greater transparency and professionalising risk management.

AGENDA 1
ALLOWING TRANSPARENCY

Many of the current concerns in the banking sector are caused by a lack of trust in the data presented. NPLs are the best example, as different analysts speculate about the true ratio, with estimates ranging from 5%-20% (Exhibit 6). For example, some banks have structured risky loans into wealth management products known as directional asset management plans (DAMP) and trust beneficiary rights (TBR), which may help them avoid scrutiny and lessen capital requirements. Such practices lead to an underestimation of the true credit risks faced by the banks. These “shadow loans” now represent roughly 16% of standard loans, up from 4% in 2012. This does not contribute to transparency and trust.

Exhibit 6: Analyst estimates of “true” NPL ratio and “shadow loans”

<table>
<thead>
<tr>
<th>ANALYST ESTIMATES OF “TRUE” NPL RATIO</th>
<th>“SHADOW LOAN” OF CHINESE BANKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>CBRC official (2015YE)</td>
<td>1.7%</td>
</tr>
<tr>
<td>HSBC (2016 March)</td>
<td>5.5%</td>
</tr>
<tr>
<td>JP Morgan (2016 Feb)</td>
<td>~7.0%</td>
</tr>
<tr>
<td>Goldman (2016 Feb)</td>
<td>8.9%</td>
</tr>
<tr>
<td>Deutsche (2016 Feb)</td>
<td>8.6%-11.6%</td>
</tr>
<tr>
<td>CLSA (2016 May)</td>
<td>15%-19%</td>
</tr>
<tr>
<td>Analyst average = 9.6%</td>
<td></td>
</tr>
</tbody>
</table>

1. According to a UBS study, some of the disclosures of individual banks make very clear that DAMPs and TBRs are effectively loans: “the banks’ TBRs and DAMPs are focused on investment in the bank’s own loans...”, “the bank goes through trust loans to issue loans to corporate clients as an additional channel beyond normal credit lines...”, “the bank’s investments into TBRs and DAMPs are “mainly to meet the bank’s customer financing needs...”.

2. UBS estimation as at June 2016, based on financial information from 156 banks across China.

Source: UBS, CBRC, HSBC (“China Banks: not yet a turning point, but watch the NPL-ABS”, 1 Mar 2016), JPMorgan (“China banks: The roadmap out of the credit cycle, Part I: Quantifying NPLs and capital needs”, 26 Feb 2016), Goldman Sachs (“NPL and liquidity outlook turning less certain, banks to muddle through; 7 rating changes”, 19 Feb 2016), Deutsche Bank (“Chinese Banks: the degree of evergreening – Part I”, 22 Feb 2016), CLSA (“Bad-debt epidemic NPLs reaching crisis level”, 4 May 2016), news search, Oliver Wyman analysis

4. UBS, 2 June 2016, “Shadow loan books, WMPs and a RMB 1 trillion capital hole”.

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Moreover, the current credit infrastructure of rating agencies and credit bureaus is insufficient to establish trust and transparency. The unfavourable macroeconomic environment, combined with doubts over data reliability, has reduced investor confidence in Chinese banks, which is clearly reflected in their low price-to-book (P/B) valuations.

The eurozone and the US provide interesting case studies in the pitfalls of transparency. While US regulators and banks were upfront and proceeded to establish transparency relatively quickly, Europe kept a certain opaqueness for quite a long time. Finally, the ECB asset-quality reviews and stress tests had a calming influence, and eurozone banks began to tackle their challenges in a rational way.

If there were more transparency and trust in the underlying data, potentially exaggerated concerns could be alleviated and market participants could look at Chinese banks more rationally again. They could also appreciate the underlying strength and stability that the Chinese banking system gains from its large and stable deposit base; its collaterals; its low contagion risk; and the powerful balancing role the government can play. Undoubtedly this will be a lengthy process requiring a change in mindset by the banks, regulators, policymakers, and public. But the transition will bring about an enormous improvement in perceptions of the banks and, hence, their valuations.

Key considerations for banks:

• While the Big Four Chinese banks and most tier-2 banks have already increased their emphasis on the objective valuation of assets through quality reviews and stress tests, small banks too need to implement these. All banks need to gradually increase the transparency of their business data, especially their credit situations, and to proactively guide analysts, investors and the public in understanding the data.

• Global banks need to provide the best-possible data transparency to their global investors, who may have incomplete views of the banks’ businesses in China. They need to let transparent data inform their views on the strength and stability of the Chinese banking system.
AGENDA 2
BRINGING RISK MANAGEMENT INTO BUSINESS

According to a survey by the Bankers Association of the Republic of China in 2015, 68.6% of senior bankers regarded “improving risk management capabilities” as the top strategic agenda, up from 42.4% in 2011. 71.4% cited “the lack of comprehensive risk management capabilities amid more complicated risk environment” as the major challenge ahead.

The Basel II and III frameworks and models have been widely implemented in most banks in China. The challenge is thus not so much the basic underlying infrastructure, but rather to develop more sophisticated risk management approaches and to integrate risk management into overall management of the bank (Exhibit 7):

• Risk management is generally seen as the job for the dedicated risk management departments. The front offices do not appreciate enough the benefits of risk management, sometimes leading to attitude of “justifying business decisions” rather than actually managing risk, despite the roles as the “first line of defence”. This requires an enhanced risk culture. Risk management should be seen less as a necessary instrument of hygiene, and more as a fundamental enabler of success – as a business partner across the organisation.

• Although internal control mechanisms are in place, incidence of external fraud has increased since 2015. This indicates weakness in the systems which may be potentially exploited. For example, decision making authority is typically concentrated in a few key executives. Stronger governance is required as “checks and balances” to properly represent stakeholders and provide management with alternative viewpoints.

• Risk management practices are geared towards a rather “plain vanilla” banking model of deposits and loans. With growing innovation, risk management methods and models need to advance across financial risk categories (market, liquidity, interest rate). Non-financial risks (conduct, regulation, operations) are less in focus, and their potential impact is often underestimated. In addition, a better understanding of stress testing and asset quality is needed to test business strategies and resilience.

Exhibit 7: Indicative outside-in assessment of risk management in China


Source: Oliver Wyman project experience

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These new needs should not come as a surprise, given the fastpaced development in Chinese banking. They also follow a pattern seen in the evolution of banking sectors in other regions of the world. However, Chinese banking has now reached an inflection point and we think it is a pivotal moment for professionalising risk management and placing it at banks’ cores.

Key considerations for banks:

• Chinese banks should recognise broader risk management as a valuable investment to support their businesses and help them achieve excellence, and not just to cover the basics at the lowest possible cost. More fundamentally, they should develop the right mindset towards risk management, and see that it is about understanding risk and taking the right risks given the potential returns, rather than simply avoiding risk.

• Global banks should employ existing risk management expertise as a first stage, while also developing further insights into risks in China, which could be very different from those in mature markets. They should correspondingly adjust their risk appetite and risk management approaches for a China-specific context.

AGENDA 3
TACKLING NPLS HEAD-ON

It is well known that the Chinese debt situation has significantly worsened since the global financial crisis, with the official NPL ratio for commercial banks standing at 1.67% by 2015 yearend, compared to about 1% in 2012 (Exhibit 8). NPLs are an issue because of their high leverage and strong correlation with further excess capacity. They pose a possible contagion risk considering the importance of China for global economic growth, their inter-connectedness with capital markets, and the RMB’s emergence as a major currency for international trade.

Exhibit 8: Historical NPL ratio and driving factors

FACTORS DRIVING NPLs AND DETERIORATING CREDIT QUALITY

1. WEAKENING ECONOMIC MOMENTUM
   • Slower economic growth (6.9% in 2015) coupled with weak domestic consumption
   • Growth-reviving tools ineffective in boosting growth

2. DOWNTURN OF OVERCAPACITY INDUSTRIES
   • Loan exposure at RMB 4.0 trillion
   • Wiping out of laggards in overcapacity industry expected to trigger bad debts realisation

3. REGIONAL AND LOCAL GOVERNMENT (RLG) DEBT
   • RLG debt building up due to slowing income growth, amid consistently rising expenditure and local infrastructure projects
   • Amounted to RMB 24 trillion by 2014 YE

4. POTENTIAL “PROPERTY MARKET BUBBLE”
   • Persisting fears in driven by overcapacity
   • Rising leverage due to unregulated innovation e.g. P2P platforms and earlier lending products on down-payment (now prohibited)

Source: CBRC, CEIC Data Company Limited, Oliver Wyman analysis
The economic downturn has, in particular, revealed the NPL challenges for industries suffering from overcapacity – steel, coal, cement, non-ferrous metal – where total outstanding liabilities amount to more than RMB 11 trillion. Of these, 4 trillion are in bank loans and 1 trillion in trusts (Exhibit 9).

Exhibit 9: Capacity and debt situation in selected industries

LOW UTILISATION % OBSERVED AMONG “OVERCAPACITY” INDUSTRY*1

2015

<table>
<thead>
<tr>
<th>Industry</th>
<th>Coal</th>
<th>Steel</th>
<th>Non-ferrous metal</th>
<th>Cement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low Utilisation %</td>
<td>65%</td>
<td>70%</td>
<td>72%</td>
<td>70%</td>
</tr>
</tbody>
</table>

LEVERAGE RATIO FOR “OVERCAPACITY” INDUSTRIES SHOOTING UP

2011-2015

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cement</td>
<td>55%</td>
<td>60%</td>
<td>65%</td>
<td>70%</td>
<td>72%</td>
</tr>
<tr>
<td>Steel</td>
<td>55%</td>
<td>60%</td>
<td>65%</td>
<td>70%</td>
<td>72%</td>
</tr>
<tr>
<td>Coal</td>
<td>55%</td>
<td>60%</td>
<td>65%</td>
<td>70%</td>
<td>72%</td>
</tr>
<tr>
<td>Metal</td>
<td>55%</td>
<td>60%</td>
<td>65%</td>
<td>70%</td>
<td>72%</td>
</tr>
</tbody>
</table>

BANKS HEAVILY EXPOSED TO LOANS TO OVERCAPACITY INDUSTRIES

RMB TRILLION, 2015 YE

<table>
<thead>
<tr>
<th>Industry</th>
<th>Total Liab</th>
<th>Int. Paying Liab</th>
<th>Bond</th>
<th>Trust</th>
<th>Bank Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cement</td>
<td>11.4</td>
<td>3.7</td>
<td>4.4</td>
<td>2.4</td>
<td>1.7</td>
</tr>
<tr>
<td>Steel</td>
<td>6.7</td>
<td>2.2</td>
<td>2.2</td>
<td>0.9</td>
<td>1.0</td>
</tr>
<tr>
<td>Coal</td>
<td>4.0</td>
<td>1.3</td>
<td>0.5</td>
<td>0.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Metal</td>
<td>4.0</td>
<td>1.3</td>
<td>0.5</td>
<td>0.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Cement</td>
<td>11.4</td>
<td>3.7</td>
<td>4.4</td>
<td>2.4</td>
<td>1.7</td>
</tr>
</tbody>
</table>

*1 2012 data used for non-ferrous metal industry.

Source: WIND, CICC ("Debt-to-equity conversion: A possible way to solve the risk of NPL" (债转股：化解不良贷款风险的可行选择), 11 Mar 2016), Oliver Wyman analysis
How best to tackle the NPLs is a major issue that has not yet been resolved. NPLs can typically be addressed in three ways, which may overlap in practice:

- Banks can try to “kick the can down the road,” by packaging NPLs into investments; extending and modifying loans; entering debt-for-equity swaps, and essentially hoping for a recovery, or at least a smooth digestion of losses.
- Banks can assess their NPLs objectively, apply professional methods in identifying, managing and restructuring them, and also take a hit from mark-to-market valuations. This may, however, lead to losses of shareholder funds and the need to recapitalise banks from private or public funds, including overseas capital.
- The public sector can bail out banks with direct funding, bad-bank solutions, regulatory support, and the use of the central bank’s monetary arsenal. All this essentially socialises the losses by moving them from banks to the public accounts. This is what happened in the 1990s, when China’s Big Four asset management companies were established to absorb the distressed assets of the Big Four banks.

Conceptually, a market-based clean-up and restructuring is theoretically the most appropriate response. Realistically however, only a combination of all three routes will be practical and viable for China. The debt challenges in China in the early 2000s were dealt with through a combination of socialisation via public bad banks, mitigation via securitisation, and restructuring with only very minor direct mark-to-market write-downs on bank balance sheets. Most recently, China has been exploring debt-for-equity swaps, as well as the design of NPL-asset-backed securities issued by Bank of China.

The most critical endeavour now is to develop a NPL management upgrade plan (Exhibit 10), on the levels of both industry and individual banks, across the full portfolio of possible actions. First and foremost, the toolkit of NPL response actions needs to be sharpened. This includes more-thorough analysis to anticipate NPL risks, an effective Early Alert process, as well as the spectrum of responses including collections, amendments in terms, prolongations, and restructuring measures. This toolkit could also benefit from opening up access to such non-performing assets to global distressed-debt investors, who may have more appetite due to a wider diversification in their portfolios. This would essentially be a cross-border approach to mitigate underlying risks that would otherwise be trapped and snowballing in China.
More fundamentally, banks need to instil a culture that rewards relationship managers from spotting problems, and to pass on the problem loans to dedicated workout unit specialists in a timely and disciplined manner. Banks should also develop the talent for NPL management, as the long bonanza and growth since Asia Financial Crisis has left the industry with insufficient number of bankers that are experienced in dealing with a downturn.

We see the NPL management toolkit as a much needed “cure”. But it is equally important for banks to embark on a journey of professionalising risk management and providing better transparency to fundamentally address the challenges ahead.

Key considerations for banks:

- Chinese banks should upgrade their NPL management capabilities, including developing professional NPL management tools and adopting advanced mitigation mechanisms like securitisation, and cross-border mitigation.
- Global banks should leverage their existing NPL management expertise to develop tailored plans appropriate for the Chinese context (e.g. different data quality and infrastructure readiness). More importantly, they should consider a cross-border distressed asset management business that would link global funding and domestic distressed assets.
3. TRANSFORMING CORPORATE AND INSTITUTIONAL BANKING

Corporate Banking has been the major form of business and generated lucrative profits for Chinese banks over the last decades. However, as China evolves towards the next stage of its economic development, the needs by corporations also become more sophisticated. Chinese banks need to re-think their client focus and coverage model, optimise the core corporate lending function, and develop a full suite of Wholesale Banking offerings.

AGENDA 4
REDEFINING CLIENT FOCUS AND COVERAGE

Significant changes are taking place across the corporate scene in China. Large, state-owned, industrial corporates, which are the traditional large borrowers of Chinese banks, have been experiencing mounting challenges due to structural reforms and economic downturn.

On the other hand, new client segments are rapidly emerging. For example, the Services sector (e.g. tourism, education, medical services, etc.), where growth is fuelled by the increasing quest for better living standards and life experience, represents potential opportunities for banks. Similarly, domestic banks could also explore other client segments, like multi-national companies and new forms of financial institutions such as private funds, exchanges, etc., which are growing on the back of further opening up of the economy and innovations in the financial system.

This requires banks to reconsider their client strategy across three dimensions:

- **Client targeting and selection.** Chinese banks would have to shift away from the mindset where “big lenders mean large profits”. Banks have to think beyond lending, but to judge a client’s revenue and profit upside by also considering the cross-selling potential of wholesale banking solutions. Doing so would help banks to go down the credit grade slope and capture business opportunities in the myriad new companies that are on their way to success. In addition, banks should take an “ecosystem” view in client targeting, which means identifying the anchor clients within each ecosystem, and to leverage the anchor clients to connect with other players in the value chain or even the entire ecosystem.

- **Client understanding.** It is of paramount importance for Chinese banks to deepen the understanding of the clients and their respective sectors, which help banks to better identify needs by their clients and to develop truly value-adding solutions that differentiate themselves from competitors.

- **Client coverage.** Banks would need to optimise the client coverage model in order to better develop client relationship. For example, bank should ensure multi-point coverage at both headquarters and branch levels, as well as dedicated coverage for key buyers and influencers such as the CEO and the CFO. While it may seem logical to set up vertical sector teams that specialise in certain sectors, some banks in China have found such organisation model difficult to implement and rolled back. Given the historically branch-driven organisation model, Chinese banks must carefully balance the interests between the branches and the headquarters when they consider any forms of reorganisation.
In our recent report, “Sector Strategies: Creating Sustainable Competitive Advantage through Ecosystem Solutions”, we discussed that banks can differentiate themselves by developing solutions that address specific pain points across sector participants (Exhibit 11). This requires a holistic view of the ecosystem and the understanding of how different players work together in the sector, and to build on this to understand what leads to inefficiencies. However, it is important to note that not all sectors are suitable for applying sector strategies. For example, sectors that are concentrated with a few dominating players, or those where the pain points are specific to each type of player, are not good fits for sector strategies.

Exhibit 11: Comparison of sector solutions against other bank strategies

Key considerations for banks:

- Chinese banks need to broaden their client focus from corporates in traditional industries to include also those in emerging segments. More thorough understanding of the clients and their industry is needed in order to better fulfil the needs of the clients and address underlying pain points across the sectors. Chinese banks should optimise their coverage model, while striving to balance the interests between the branches and the headquarters.

- Global banks should develop deep understanding of local clients using more localised perspectives. They can gain scale by focusing on segments that are currently underserved by Chinese banks.
China has pushed ahead with its plans to liberalise interest rates. Historically, the Chinese banks were blessed with a combination of a cap on deposit rates and a floor on lending rates for years which ensured fat margins. However, the Central Bank announced the elimination of the cap on deposit rates in 2015, following moves to gradually loosen the cap over the past two years. The loan-rate floor was eliminated in 2013. This has led to shrinking net interest margins, which put Chinese banks’ corporate lending business in threat.

As a result, banks would have to think about how to improve or maintain margin for their lending business, and to differentiate themselves from competitors by improving efficiency and customer satisfaction.

First of all, pricing will become an increasingly important capability for banks in China. Historically, banks focused only in what were deemed to be high quality lenders. Administrative measures such as the loan-to-deposit ratio resulted in banks’ preferences in focusing to lend to big state-owned enterprises. Lending rates were often undifferentiated and did not consider sufficiently the risk profile of the borrowers. Going forward, as banks go down the credit grade slope, they would have to develop improved risk informed pricing mechanisms, including pricing tools, pricing guidelines and approval process, and tailor it against the Chinese context (Exhibit 12).

It is important to balance individual relationship manager discretion with more stringent management of pricing guidelines, to avoid underpricing loans for non-strategic reasons. Similarly, banks should be rational and disciplined in the use of cross-product subsidies, especially as they evolve towards a wholesale solutions provider model, to ensure that investments in the client relationship are made only for those with real cross-sell potential.

Global banks are increasingly seeking to leverage big data or digital solutions to build more intelligent pricing tools. Simple-to-use tools are designed with improved algorithms to identify price sensitivities based on multiple available data sources, such as internal benchmarks, market benchmarks, and client behaviour. While it may be restricted by the current credit infrastructure, Chinese banks should explore the possibility of developing such tools.
On the other hand, banks should also attempt to reduce costs and improve customer satisfaction through automation and service industrialisation, while ensuring no jeopardy of risk management and compliance requirements. The credit process, which often represents more than 40% of the total operational cost basis of corporate banks, is the best known example of the benefits of process automation⁶. In order to facilitate efficient but professionalised credit origination and underwriting, leading banks are putting in place a delegation grid based on risk rating, authority level and type of transaction. Some banks also simplify the underwriting process by allowing decisions to be made by just the business and credit risk representatives for smaller credits, while maintaining a full credit committee for large credits. Many banks have taken the initiative to shorten and standardise credit approval forms. Some banks are also centralising their loan administration functions to improve control and reduce costs.

Banks could deliver a differentiated service portfolio to clients tailoring to their specific needs. Globally, some sophisticated banks have adopted predictive analytical tools to develop more detailed, bespoke analysis of client needs, which helps the banks in differentiating their service model towards clients with heterogeneous needs.

Key considerations for banks:

- Chinese banks should begin to develop more sophisticated pricing capabilities, in particular moving towards risk-informed pricing approach and ensuring better pricing discipline across strategy and relationship managers. They can also automate and redesign certain process to improve efficiency, with credit underwriting process being one to potentially begin with.

- Global banks should deepen their understanding of the domestic borrowers and their respective industries in order to tailor their global or central risk-based pricing toolkit for the Chinese context. They can pioneer automation and service industrialisation in China, as part of their global or regional effort.

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⁶ Refer to Oliver Wyman publication “Delivering Excellence in Corporate Banking: How to Protect the Business Model and Improve Performance (2015)” for more details.
An increasingly complex macro economy means corporates in China are beginning to have more sophisticated needs in financing, investing and transaction. For example, top credit Chinese corporates will need to depend more on direct financing, to enhance their competitiveness by better managing their cash cycles, to turn traditional trade into faster, sharper solutions for their trading partners, to acquire and divest corporations, to expand overseas, as well as to modify their currency and interest rate exposures.

Today, Chinese banking and capital markets lack some major features of financial deepening (Exhibits 13 & 14). Three highly visible examples are:

• Direct financing. The Chinese economy still heavily relies on indirect financing via bank loans. Direct financing via bonds and hybrid debt-equity financial instruments are less developed.

• Structuring and derivatives. Chinese capital markets are still only beginning to use structured products, securitisation, and derivatives. While these need to be carefully monitored and regulated, they can be effective tools for risk mitigation, maturity transformation, and financing.

• Market makers. Stock markets are still dominated by short-term retail investors who turn equity markets into a big casino. At the same time, macro messaging may cause significant swings, as there is no sufficient market capacity to damp the resulting volatility. China lacks institutional investors and market makers who have a longer-term perspective and a more-passive or index-driven investment style.

Exhibit 13: Structure of China’s financial system

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Indirect and direct financing</td>
<td></td>
<td></td>
<td>60%</td>
<td>114%</td>
<td></td>
</tr>
<tr>
<td>Stock trading volume</td>
<td></td>
<td></td>
<td>166%</td>
<td>247%</td>
<td>295%</td>
</tr>
<tr>
<td>Cash and deposit</td>
<td></td>
<td></td>
<td>86%</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>Corporate bonds outstanding</td>
<td></td>
<td></td>
<td>25%</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>Securitised products outstanding</td>
<td></td>
<td></td>
<td>1%</td>
<td>1%</td>
<td>56%</td>
</tr>
<tr>
<td>OTC derivatives daily average</td>
<td></td>
<td></td>
<td>1%</td>
<td>1%</td>
<td></td>
</tr>
</tbody>
</table>

*1 Including bank loans, foreign currency-denominated loans, entrusted loans, trust loans, undisclosed bankers’ acceptances

Source: CBRC, PBOC, Wind, SIFMA, FRB, Bloomberg, BIS, Oliver Wyman analysis
### Exhibit 14: Availability of financial products in China

<table>
<thead>
<tr>
<th>EQUITY</th>
<th>FIXED INCOME</th>
<th>COMMODITIES</th>
<th>FX</th>
<th>OTHER ALTERNATIVES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash equities</td>
<td>Money market instruments</td>
<td>Oil &amp; gas futures</td>
<td>FX spot/forward</td>
<td>PE/VC</td>
</tr>
<tr>
<td>ETFs</td>
<td>Interest rate swaps</td>
<td>Precious metals futures (2008)</td>
<td>FX swap</td>
<td>Quant/ algo funds</td>
</tr>
<tr>
<td>Margin financing</td>
<td>Interest rate options</td>
<td>Agricultural futures (2013)</td>
<td>FX options</td>
<td>REITs</td>
</tr>
<tr>
<td>Index options (2015)</td>
<td>Corporate bonds</td>
<td>Commodity options</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Synthetics</td>
<td>Credit derivatives</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Oliver Wyman analysis

The capital market and alternative players (e.g. P2P) are already actively trying to respond to such needs by providing more options than basic corporate payment/deposit/lending to the Chinese corporates. In order to capture the opportunities, banks would need to quickly expand beyond their traditional focus of lending.

Banks should innovate and develop a broader suite of products and solutions, based on strategic strength assessment and their chosen client focus. In particular, the addition of capital market (investment banking and financial markets, etc.) and transaction banking (trade finance, cash management, bill processing, etc.) solutions would best fulfill the emerging financing and transaction demand of today’s Chinese corporates.

As banks venture into capital markets and transaction banking, they need to be able to cope with new types of risk on top of credit risk from traditional lending business. As discussed in Agenda 2, risk management methods and models have to advance across financial risk and non-financial risks categories.

Some banks in China have begun to re-organise themselves to better deliver solutions. For example, some have established dedicated transaction banking department at the headquarter level, strengthening and bringing together existing capabilities in cash management and trade finance. Due to the level of complexity in developing such new products and the scarcity in such talents in China, banks should consider centralising and developing such product teams at the headquarter levels during the initial stage. As the product capability matures, the headquarters can then begin to incubate the branches.

**Key considerations for banks:**

- Chinese banks should develop a more complete suite of products to fulfil the emerging needs of their clients. They need to consider adopting new organisational and governance models, and adjust their incentive models to compete against investment banks, while avoiding the dangers of exaggerated rewards for risky deal making. These could be key enablers of innovation in legacy organisations, and could attract and retain talent currently working in Chinese capital markets, as well as from overseas.
- Global banks should closely monitor regulation and import global expertise in more-sophisticated financial products, such as structuring and derivatives.
4. ADVANCING THE MARKET PROPOSITION

It is easy to be overwhelmed by the rising credit issues in Chinese banking and forget the wide range of emerging opportunities. As discussed, China has begun to move away from its old economic model and to further globalise. Unprecedented opportunities are also created by the accumulation of wealth and technological advances. Banks need to develop and offer more attractive market propositions.

AGENDA 7
FINDING THE “RIGHT” LINK WITH FINTECH

While only representing roughly 1% of the total revenue pool in 2014, about RMB 80 billion, Chinese Fintech innovation has gained major global attention and has become a driving force for growth, innovation, and disruption.

Fintech has been truly game-changing in three main sectors in China (Exhibit 15):

- **Digital retail and business financing.** This segment has seen enormous growth across the retail sector, and is having an impact from SMEs to large corporations, where payments are processed by P2P as well as via bank or trust balance sheets. Fintech and digital players now represent between 35% and 40% of all SME financing, posing a direct challenge to banks’ financing businesses.

- **Digital investments and wealth.** While traditional private banking has struggled onshore in China, digital wealth businesses are prospering, and have grown quickly to around RMB 2,000 billion in AuM. Though a product-push approach is still largely followed, players such as Lufax are trying to advance into more comprehensive wealth services.

- **Digital payments.** With credit cards only slowly gaining penetration, digital payments have soared to reach billions of transactions. Ant Financial has become the de facto standard, reaching a market share of around 50% of all digital payments.
<table>
<thead>
<tr>
<th>MARKET SEGMENT</th>
<th>DESCRIPTION</th>
</tr>
</thead>
</table>
| DIGITAL RETAIL LENDING | • Expected CAGR 10%-30% p.a. to 2020E  
• Fintech accounts for 35%-40% of small loan industry – gaining share fast  
• Players are moving from offline to online and ecosystem models  
• Innovative channels are used to overcome balance sheet constraint |
| DIGITAL BUSINESS LENDING | • Expected CAGR 60%-80% p.a. to 2020E  
• Large players tend to originate larger loans with longer maturity  
• Strong motivation for commercial banks to capture P2P opportunity and link digital lending with offline |
| DIGITAL WEALTH | • Expected CAGR 60%-80% p.a. to 2020E  
• Online wealth management is still at a nascent stage of products sales  
• Some players are trying to develop managed solutions online, roboadvisory gradually emerging |
| DIGITAL PAYMENTS | • Explosive growth from low levels  
• Started from mobile/online payment  
• Recently steps into bank’s traditional investment and financing  
• Banks are also moving fast from offline to online to enhance customer experience and operating efficiency |

**MARKET SIZE AND TRENDS**

<table>
<thead>
<tr>
<th>RMB BILLION</th>
<th>EXAMPLE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>P2P transaction volume</strong>&lt;sup&gt;1&lt;/sup&gt;</td>
<td><img src="image1" alt="Graph" /></td>
</tr>
<tr>
<td>Business</td>
<td>20.0</td>
</tr>
<tr>
<td>Retail</td>
<td>1.8</td>
</tr>
<tr>
<td>&lt;2012</td>
<td>18.2</td>
</tr>
<tr>
<td>2013</td>
<td>252.8</td>
</tr>
<tr>
<td>2014</td>
<td>252.8</td>
</tr>
</tbody>
</table>

**AuM by online WM platforms**<sup>2</sup> |

| Source: CBRC, PBOC, Wangdaizhijia, P2Peye, J.D.Power, iResearch, InnoTree, Oliver Wyman analysis |

Following banks’ efforts to integrate financing, payments, and investment and wealth management, some Fintech companies in China are also trying to do the same. Some of these, including Ant Financial, have already been licensed.

Incumbent banks need to find the right links and responses to the Fintech world. Typically, banks consider three options:

- **“Beat them”:** Building their own Fintech-type capabilities and trying to grab the business in direct competition.
- **“Join them”:** Trying to develop joint efforts that leverage their own strengths, including bank licenses and balance sheets, and also tap into Fintech strengths in technology and customer engagement.
- **“Ignore them”:** Focusing on areas not affected by Fintech innovation (for now), and bypassing the competition in digital lending, wealth and payments.

The most realistic approach is a combination of all three options.
Nevertheless, the high speed of innovation presents a challenge for regulators to catch up in order to protect consumers and avoid negative market disruptions. Overall, we expect a gradual tightening of regulation and oversight requirements, which may pose a challenge to certain players. But we expect Chinese Fintech businesses to achieve long-term sustainable growth and expand their businesses internationally.

Key considerations for banks:

• Chinese banks need to adopt the right combination of “beat, join, ignore” towards the Fintech sector and build new partnerships to leverage Fintech as an incremental part of their strategies. Chinese banks also need to adopt a trial-and-error mindset and a venture capital-style investment strategy towards Fintech-related initiatives.

• Global banks should consider investment opportunities in the Fintech sector (e.g., P2P platforms and financial asset trading platforms, etc.) as a way to enter areas that are used to be difficult for them to penetrate. One reason for the opportunity here is that the Fintech sector is less regulated in terms of foreign ownership. Another is that such investments could potentially enable the export of proven ideas to other developing markets with similar needs to China.

AGENDA 8
IMPROVING RESPONSE TO NEW CONSUMER AND SME NEEDS

Chinese retail and SME customers still pay comparably high interest-rate spreads and receive quite plain-vanilla service. Many are still not properly served at all. Private household debt is low, credit card adoption is only emerging, and most savings are still in simple deposits. Our analysis shows that the outstanding balance of mortgage and auto loans combined was equivalent to just 22% of GDP in 2015, compared with 58% in the US. Similarly, consumer loans are only equivalent to 6% of China’s GDP, a third of that in the US, which is 19%.

SMEs struggle to get financing and therefore turn to P2P lending and other shadow-banking services. A 2013 study conducted by the International Finance Corporation showed that only 10% of SMEs had access to credit in China, compared to a global average of 31%.

The shift in the Chinese economy from exports and capital investments towards domestic consumption and services will require a fundamental advance in financial services to cater to new consumers and SMEs. It will be important to provide more-sophisticated offerings in deposits, credit cards, and retail savings and investment, as well as in consumer finance, SME funding, and mortgages. These services will protect banks’ income streams via fees and higher penetration, even while NIMs are likely squeezed as they have been in other maturing markets. We expect significant growth in these areas, and forecast 10%-25% CAGR in selected product categories such as cards, digital payments, consumer lending, mortgages, and SME financing (Exhibit 16).
However, building a successful SME franchise is not at all easy. Such offerings will require more sophisticated customer ratings, credit underwriting processes, and client onboarding. The increasing importance of targeted advice will boost the need for professional conduct and the control of mis-selling risks.

Key considerations for banks:

- Chinese banks should embark on improving their product and service offerings to retail customers and SMEs in the areas of saving, investment, consumer finance, and cards. They should also develop the required enablers in customer analytics, customer onboarding, risk scoring and service quality. Considering the potentially high fraud ratio in both consumer and SME financing, new risk control methodologies and technologies need to be adopted, such as location-based data analytics.

- For global banks, a niche strategy that leverages partners and global anchor clients will be most appropriate. One approach would be to engage online or offline distribution partners to start consumer finance businesses on top of their own branch networks. Another would be to increase their presence through existing global “anchor clients” such as Walmart, whose suppliers are SMEs with cross-border business activities. These suppliers will be interested not only in basic working capital and cash-flow solutions, but also in sector, supply-chain and cross-product strategies, as well as local-currency settlement services.
AGENDA 9
DESIGNING A CHINESE VERSION OF ASSET AND WEALTH MANAGEMENT

China's total investable wealth pool is set to continue to grow at a pace of 10%-15% CAGR until 2020, with wealth addressable by asset managers reaching around RMB 215-265 trillion, doubling today's numbers (Exhibit 15). We expect the highest growth will still come from the HNW segment. A major characteristic of China's current asset allocation is the high share of cash and deposits, at around 50%, which is partly related to the lack of asset management services and offerings. We see strong potential for this to change over the years both through the spread of traditional and new digital-wealth offerings and through a more diverse retail investment portfolio. We foresee a doubling of non-cash financial investments. In line with this growth potential, the percentage of fee income in retail banks in China should rise substantially, from the current modest level of 25%-35% of the total.

Exhibit 17: China asset management sizing

CHINA TOTAL WEALTH BY INVESTOR TYPE
RMB TRILLION, 2011, 2015 & 2020E

*1 Including financial assets (both self-directed and managed), deposits and real estate (retail only). Numbers may not match with the next exhibit, in which deposits are carved out for illustration.
Source: AMAC, PBoC, CIRC, CSRC, Forbes / Credit Ease, Wealth Insight, Oliver Wyman analysis

Our investigation of the value chain in asset and wealth management indicates that banks are best positioned to capture the strategic control points in distribution and product manufacture (Exhibit 18). They dominate the retail channel and have the largest share of product manufacturing. This gives them a strategic advantage that can be further utilised by widening their offerings and tailoring their coverage and service models for HNWs.
Yet a slowing economy will lead to deteriorating fundamentals in corporates, especially in excess-capacity industries, making it more challenging for banks to offer financial products with attractive returns under “implicit guarantee”. Even though “implicit guarantee” is widely expected to be phased out gradually, it is going to take a long time for investor behaviour to change. That implies that it is imperative for banks to actively expand their suite of financial products to fulfil customer demand.

As part of growing professionalisation, we expect a further transition from self-directed investing towards more use of “outsourced” institutional asset managers. Our analysis shows that “outsourced” asset managers’ share of total assets already rose from 6% to 13% between 2011 and 2015, and we expect this share to rise by another five percentage points by 2020.
On top of the above mentioned demand for asset and wealth management, we also see the emergence of ultra-high-net-worth individuals (UHNWIs), of whom more than 80% are entrepreneurs owning their businesses. While there are differences in characteristics and demand depending on the nature of the wealth (i.e. international tycoons, “new money”, “old money”), this group requires a broad range of private banking offerings, including asset- and wealth-management services, capital markets solutions, and cross-border solutions (Exhibit 19). This represents a growing opportunity, especially for foreign banks with proven offerings.

Exhibit 19: Characteristics and core needs of Chinese UHNWIs/Entrepreneurs

| Sub-segment          | Risk Appetite     | Financial Sophistication | Balance sheet – Strategic % financial assets*1 | Balance sheet – Overseas financial assets | Balance Sheet – D/E | Cash Flow – Illiquidity
|----------------------|-------------------|--------------------------|-----------------------------------------------|------------------------------------------|---------------------|------------------------
| International tycoon | Entrepreneurial   | Sophisticated with multiple bankers | 70%                                          | Internationalised                        | Little leverage     | Sufficient cash for personal lifestyle |
| Rising “new money”   | Entrepreneurial   | Sophisticated with multiple bankers | 95%                                          | Going international                     | Growing business, not yet cashed-out | Not yet cashed-out |
| 1st gen “old money”  | Retiring/conservative | Informed             | 80%                                          | Localised mind-set                      | Self-sustaining lifestyle       | Sufficient cash for personal lifestyle |
| 2nd gen “old money”  | Transformative    | Sophisticated with overseas education | 30%                                          | Overseas background                     | Borrow to transform business | Managed liquidity    |

*1 Financial assets include investment assets in stocks and bonds, and also include alternative investments such as real estate. Strategic assets refer to equity stakes in an entrepreneur’s business

Source: CEIC Data Company Limited, Hurun, Oliver Wyman analysis

Key considerations for banks:

- Chinese banks, as the largest distributors, should provide a greater variety of products and services in order to broaden their retail wealth-management offerings; their HNW/affluent services and coverage concepts; and their private-banking propositions. They should also enhance asset management capabilities across equities, fixed income and alternative assets, either directly or by tapping into external asset managers, in order to better manage the large volume of funding coming from self-manufactured wealth-management products.
- Global banks should develop thorough understanding of different pockets of opportunities under UHNWI and develop tailored, comprehensive proposition and coverage.
AGENDA 10
WORKING WITH THE RMB

The RMB has already become a global currency, the world’s largest in terms of M3 liquidity and the fifth largest in international payments. The new Cross-Border Inter-Bank Payment System (CIPS) allows for more liquidity and more efficient transactions at lower cost.

Macro-economic initiatives such as “One Belt One Road”, the establishment of new Free Trade Zones, growth in intra-Asian trade, and growing Chinese foreign direct investment will continue to foster the role of the RMB as a global trade and investment currency.

As a result, we expect continued growth in trade settlements in RMB. These have already grown by a factor of six since 2011 and now account for 27% of China’s total foreign trade. According to a 2013 BIS survey, the RMB has become the ninth most-traded currency against the US$, with daily average OTC turnover volume amounting to US$ 120 billion.

Dim Sum Bond issuance also grew rapidly to RMB 370 billion by 2014. RMB-denominated loans in Hong Kong are now worth RMB 297 billion, compared to deposits of 851 billion, implying a loan-to-deposit ratio of merely 35% and leaving a massive potential upside for further growth (Exhibit 18).

Source: HKMA, CEIC Data Company Limited, Dealogic Limited, Standard Chartered, Oliver Wyman analysis
However, the development trajectory of RMB business is not free of volatility. For example, the strong growth of Dim Sum Bond issuance and RMB-denominated deposits in Hong Kong was dampened in 2015 partly by the uncertainties of government intervention and the devaluation of the currency. It will still take time for the RMB to become a fully liberalised global currency, and market participants for now need to continue to work with the CNY/CNH dual currency regime and the multiple limitations on the use of RMB. Still, the journey towards an international RMB is visible and demands action now.

At this point, only selected Chinese banks and a few global transaction and network banking specialists have comprehensive RMB capabilities. Chinese banks’ offshore business is mostly limited to RMB-denominated lending. For many of the global banks, funding will remain a sensitive aspect of working with the RMB, given their lack of RMB deposits and the high cost of alternative funding options. With their different strengths and challenges, Chinese and global banks could actively explore partnering opportunities to complement one another along the value chain of RMB business and grow the pie together. For example, Chinese banks could leverage their strong RMB deposit bases and provide treasury solutions for global banks, which need the liquidity and funding.

Key considerations for banks:

- Chinese banks could start by providing liquidity to offshore RMB-denominated products through proprietary trading. They could then gradually identify and understand offshore RMB product and service demand from existing customers, and expand their offerings by forming stronger strategic links with overseas banks that have offshore RMB needs.
- Global banks should set out their positions in the RMB space, including suitable network cooperation and the expansion of capabilities and infrastructure.
5. SUMMARY – A MORE BALANCED PERSPECTIVE, A CALL FOR ACTION

The Chinese banking sector undoubtedly has significant challenges ahead. Outstanding loans are equivalent to 255% of GDP, including corporate debt worth 144% of GDP, and the value creation from additional loans is declining. It is as if a huge black cloud were blocking the sun.

However, on closer observation, we see rays of sunlight peeping round the sides of the cloud, creating a fine silver lining around its edges: Our overall assessment is more nuanced, and comes with a call to action.

A balanced view of Chinese debt takes into consideration the inner stabilising factors of the system, notably the high corporate- and private-deposit base, funding from continued high savings, and the government’s influence. It is important not to look at individual factors in isolation, but instead to consider systemic interdependencies and their mitigating and balancing effects.

We call for banks to take three kinds of action:

- Alleviate the negative developments by introducing confidence-building measures. These should include greater transparency, the linking of professional risk management to business decisions, and tackling the credit and NPL challenge.
- Support the evolution of the Chinese corporates by transforming from corporate lenders to broader solutions provider. This begins with redefining the customer segment and target, optimising the traditional corporate lending business and developing a full arsenal of solutions across capital market and transaction banking.
- Make the best of the new opportunities, by finding the right response to Fintech, supporting China's economic transition towards a more retail and SME-led system, professionalising asset and wealth management, and preparing for full use of the RMB.

The priorities and focus for Chinese and global banks may, however, be different:

- Chinese banks should steady themselves amid the current volatilities, and embark on a longer-term transformation focusing on “re-portfolioing” their income structure, professionalising their services, and serving growing segments that have historically been underserved.
- Global banks should leverage their proven capabilities in risk management, product innovation, and more sophisticated solutions. They should also proactively explore not only how to better serve their global clients with cross-border needs, but also how to participate more deeply in domestic capital markets as institutional players.
## Exhibit 21: Summary of key considerations for banks and other players

<table>
<thead>
<tr>
<th>AGENDA</th>
<th>CHINESE BANKS</th>
<th>GLOBAL BANKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>• Allow transparency&lt;br&gt; • Value assets objectively with quality reviews/stress tests&lt;br&gt; • Gradually increase data transparency&lt;br&gt; • Guide investors to understand data</td>
<td>• Provide best-possible data transparency to investors, linking it with a view on strength and stability</td>
</tr>
<tr>
<td>2</td>
<td>• Bringing risk management into business&lt;br&gt; • Recognise risk management as valuable investment&lt;br&gt; • Aim for higher quality as opposed to lowest cost&lt;br&gt; • Understand the risk-return relationship, rather than just simple risk avoidance</td>
<td>• Adopt existing expertise while tailoring risk appetite and toolkits for China-specific context&lt;br&gt; • Develop deeper insights into risks in China</td>
</tr>
<tr>
<td>3</td>
<td>• Tackling NPLs head-on&lt;br&gt; • Upgrade NPL management plan and mitigation tools (e.g. securitisation)&lt;br&gt; • Participate in cross-border distressed asset management&lt;br&gt; • Leverage existing and build China-specific NPL management expertise</td>
<td>• Consider cross-border distressed asset management business (link global funding and domestic assets)</td>
</tr>
<tr>
<td>4</td>
<td>• Redefining client focus and coverage&lt;br&gt; • Broden client focus from large corporates to include those in emerging segments&lt;br&gt; • Deepen client understanding and optimise coverage model&lt;br&gt; • Develop client understanding with local perspective&lt;br&gt; • Focus on segments underserved by Chinese banks</td>
<td>• Develop client understanding with local perspective</td>
</tr>
<tr>
<td>5</td>
<td>• Optimising the corporate lending function&lt;br&gt; • Begin to develop risk-informed pricing approach, ensure better pricing disciplines and develop intelligent pricing tools&lt;br&gt; • Automate and resign process to improve efficiency&lt;br&gt; • Tailor existing risk-based pricing toolkit for the Chinese context&lt;br&gt; • Pioneer automation and service industrialisation in China, as part of global/regional effort</td>
<td>• Import global expertise in more sophisticated financial products (e.g. structuring and derivatives)</td>
</tr>
<tr>
<td>6</td>
<td>• Developing full suite of wholesale banking offerings&lt;br&gt; • Broaden product suite and upgrade risk management capabilities accordingly&lt;br&gt; • Refresh new organisation and governance models to encourage innovation and attract talent&lt;br&gt; • Consider investment opportunities in Fintech&lt;br&gt; • Export proven ideas to other developing markets</td>
<td>• Broaden and improve product/service offerings&lt;br&gt; • Develop required enablers e.g. customer analytics, risk control methodologies&lt;br&gt; • Tap into the relationship with global “anchor clients” that have broad networks of SME business partners&lt;br&gt; • Offer cross-product solutions</td>
</tr>
<tr>
<td>7</td>
<td>• Finding the “right” link with Fintech&lt;br&gt; • Adopt mix of “beat, join, ignore” towards Fintech&lt;br&gt; • Build new partnerships&lt;br&gt; • Adopt “trial-and-error” mindset and VC-style investment strategy&lt;br&gt; • Consider investment opportunities in Fintech&lt;br&gt; • Export proven ideas to other developing markets</td>
<td>• Broaden and improve product/service offerings&lt;br&gt; • Develop required enablers e.g. customer analytics, risk control methodologies&lt;br&gt; • Tap into the relationship with global “anchor clients” that have broad networks of SME business partners&lt;br&gt; • Offer cross-product solutions</td>
</tr>
<tr>
<td>8</td>
<td>• Improving response to new consumer and SME needs&lt;br&gt; • Broaden retail wealth management and private banking proposition by sourcing a range of products/services&lt;br&gt; • Tap into external asset managers to enhance asset management capabilities&lt;br&gt; • Develop thorough understanding of different pockets of opportunities under UHNWI&lt;br&gt; • Deepen local coverage and understanding</td>
<td>• Provide liquidity to offshore RMB denominated products&lt;br&gt; • Broaden offshore RMB offerings&lt;br&gt; • Form strategic links with overseas RMB solution providers&lt;br&gt; • Set out position in the RMB space&lt;br&gt; • Expand capabilities and infrastructure</td>
</tr>
<tr>
<td>9</td>
<td>• Designing a Chinese version of asset and wealth management&lt;br&gt; • Broaden retail wealth management and private banking proposition by sourcing a range of products/services&lt;br&gt; • Tap into external asset managers to enhance asset management capabilities&lt;br&gt; • Develop thorough understanding of different pockets of opportunities under UHNWI&lt;br&gt; • Deepen local coverage and understanding</td>
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<td>10</td>
<td>• Working with the RMB&lt;br&gt; • Provide liquidity to offshore RMB denominated products&lt;br&gt; • Broaden offshore RMB offerings&lt;br&gt; • Form strategic links with overseas RMB solution providers&lt;br&gt; • Set out position in the RMB space&lt;br&gt; • Expand capabilities and infrastructure</td>
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Despite their different focus, the relationship between the Chinese and global banks will become increasingly symbiotic. With each playing on their strengths, both types of bank could actively explore opportunities for meaningful collaboration. We believe there could be strong synergies between the two groups.

Delivery of the ten prioritised agenda is not possible without building a comprehensive and skilled talent pool. This is made more difficult by the exodus of bankers to other financial industries and leading Fintech players. To better attract and retain talent, banks would need to develop more attractive career propositions combining a transparent and flexible career advancement scheme, meritocracy, market-oriented compensation system and perhaps improved work-life balance.

The agenda for banks is rich and complex, and will require recognition of the problems and a determined plan for immediate and sustained action. But it is eminently doable, while Chinese society has demonstrated the resilience, hard work and ingenuity to surmount larger challenges.

Those banks that make the right moves in the changing landscape will harvest the fruits of the world’s largest banking market, whether they are domestic or international players.
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