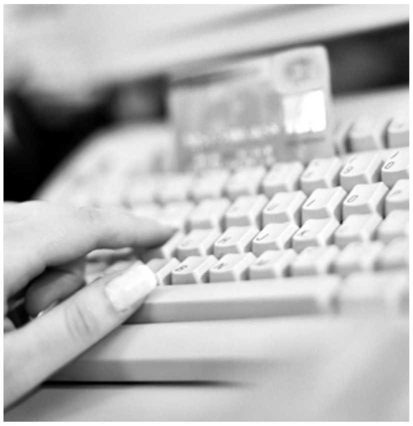
IBM Business Consulting Services

Credit cards

Conduits for value creation in Chinese retail banking



deeper

Executive brief

With domestic and foreign competitors encroaching and both private and governmental shareholders seeking additional capital, China's mid-tier banks are struggling to improve their financial standing and fund future growth. Meanwhile, the Chinese government is promoting consumer spending as one of its pillars for continued national economic expansion. But is there opportunity to do both – shore up bank valuations while simultaneously encouraging economic growth? The credit card business seems to offer a plausible answer – but only if banks can enter the market quickly and reach the point of profitability sooner than competitors.

Banking success rooted in retail expansion

Across China, mid-tier banks are beginning to realize the tough decisions that must be made and made soon. To acquire capital, whether domestic or foreign, to fund future growth, they need better valuations. Currently, the assets held by Chinese banks are heavily skewed toward the commercial side of their businesses, with retail lending making up only a small fraction of all loans.[1] Even more distressing, an estimated 25 percent of those loans are nonperforming.[2]

Although the Chinese banks have millions of individual customers as depositors, they lack experience in consumer credit. China banks' push into consumer lending can be traced to only a few years ago, with the 1999 issuance of "Guidelines for Conducting Personal Consumer Credit" by the People's Bank of China. This document provided general permission for Chinese banks to offer consumer credit to the public, resulting in an increase of loans outstanding to consumers from US$2.1 billion in 1997 to US$84.8 billion in 2001.[3] However, in China, consumer loans currently account for less than 10 percent of loans outstanding,[4] leaving Chinese banks with fewer retail assets. And as current shareholders seek outside investors to share bank ownership, illustrated by Citibank's 5 percent investment in Shanghai Pudong Development Bank[5], shaky financial positions only become more evident with portfolios coming under greater scrutiny.

In contrast, during the ramp up period of retail banking and credit card lending in the U.S. from 1985 through 1996, on average across all commercial banks, retail loans saw a compounded annual growth rate (CAGR) of 8.8 percent, accounting for almost 47.3 percent of total loans outstanding with commercial banks in 1995.[6] Today, they account for 65 percent of total loans outstanding.[7]

To drive profitability and improve overall financial health, mid-tier Chinese banks are increasingly dependent on the success of their retail banking activities. A more diversified portfolio helps dilute the impact of nonperforming assets, and signs of retail banking growth – for instance, offering new retail products – can encourage higher market valuations. In turn, these increased valuations allow banks to attract additional investors and gain the capital needed for expansion.

Why credit cards?

Fortunately, banks' growing need to supply retail banking products is aligning with this increased market demand. The Chinese government has taken actions to stimulate economic growth through consumer spending, including a 20 percent withholding tax on savings deposits and creation of the 'Golden Week' holiday, a week-long celebration of the country's birth.[8] The DaVinci Institute highlighted the coming credit card boom in China as one of its top ten trends impacting the future of money at its October 2003 summit, predicting that Chinese consumers will adopt credit services at a rapid pace.[9] Plus, an increasing money supply, a result of a steadily increasing trade surplus and actions required by Beijing to maintain the Yuan's peg with the U.S. dollar, has resulted in excess funds that must be put to use by banks.[10] With consumer spending – and the need for credit – escalating, mid-tier banks now have an ideal market entrée: the credit card business.

Figure 1. In China's financial market, 2003 has been aptly dubbed "the year of the credit card."

In July 2002	By June 2003
Market size unknown	Market size projected to be somewhere between 160 and 500 million cards in force by 2012
500,000 local currency credit cards in force	Some 1.5 million local or dual currency credit cards issued
Three local currency issuers	Nine local currency issuers
Foreign issuers not active	Several foreign players enter market by investing in mid- sized banks

Source: "First Data taps growing China credit card market," Reuters News, August 14, 2003; IBM Business Consulting Services analysis.

Besides the sheer size of the market opportunity, the credit card business offers some very attractive advantages over other retail banking products:

- *Lower risk:* The business involves smaller loans that are spread across millions of customers, diluting the potential impact of default.
- *Volume approval process:* Businesses approve credit product programs for entire customer segments.
- *Valuable way to learn:* A credit card offering provides insight into aggregate patterns of consumer loan behavior and builds banking expertise that is transferable to other consumer lending offerings.
- *Higher margins:* Credit card businesses typically offer a better return on assets than commercial lending and consumer mortgages. In the first quarter of 2003, for example, U.S. credit card banks averaged a return on assets of 3.66 percent, more than double the banking average of 1.38 percent.[11]
- *Faster adoption:* For a population whose spending has been constrained to available income, consumer credit brings a welcome lifestyle boost.

In short, credit card receivables diversify the risk in an otherwise concentrated loan portfolio, helping stabilize income and improve bank valuations.

Complexity inherent in credit card business

Although the business opportunity is attractive, running a credit card operation is a complex undertaking. Operational characteristics are more onerous for credit card businesses than those of other banking products:

- Transactions demand 24 x 7 availability
- Transaction volumes are high – with wide swings in volume
- Authorization decisions are complex and constant

Since credit cards are among the most innovative banking products, they demand a fair amount of sophistication in terms of business practices and processing software. Operational procedures related to fraud detection, dispute resolution and charge-backs, for example, must weave through a complicated web of credit card association guidelines while tracing transactions from customer to merchant. Competitive market pressures force the need for quick development of new product combinations, which must be supported by flexible, cutting-edge application functionality.[12] However, this sophistication comes at a price; some best-in-class packages, particularly in the fraud and credit risk management area, are simply too expensive for all but the very largest banks to own or license and operate.[13]

Establishing the necessary processing environment is a complicated endeavor too – with many different components that must be integrated before the first card can ever be issued. And operational challenges don't stop when the processes and infrastructure are up and running. With the major credit card brands continually changing compliance requirements, it's difficult for banks to maintain an up-to-date processing environment.

Tapping into the credit card opportunity

So, how can your bank conquer the inherent complexity and capture your share of this major market? Based on our analysis of early forays into the Chinese credit card market and our experience working with clients in other geographies, here are some suggestions that can help you realize the full potential of the opportunity before you.

Start with strategy

Establishing a profitable credit card business involves answering many critical questions such as:

- *What part should your credit card business play in your overall mission?* Will it be part of an integrated offering (a relationship management approach) or a single, standalone line of business (a "monoline" approach)? Or should it be positioned somewhere in between? The choices made here ripple through other strategic and organizational decisions as well. Take the customer acquisition strategy, for example. Banks leaning toward relationship management will target existing customers, while those with a "monoline" strategy will head to the broader market. When it comes to channels, relationship managers will rely heavily on their existing physical footprint, while banks following a "monoline" strategy will likely expand into mail and telemarketing. Even the degree of organizational centralization will probably be different – heavily centralized under monoline strategy but more dispersed under relationship management to empower local branches.

"*Monoline*" *in motion*

Capital One, a monoline and one of the top ten credit card issuers in the U.S., began life as the credit card division of Signet Bank. After experiencing exponential growth, the division outgrew the bank and was eventually spun-off from the bank entirely.[14]

Rolling with relationship management

China Merchants Bank is targeting premium clients – in this case, students from well-to-do families wishing to study in Britain– with a bundled set of services. This group, dubbed the "sunflower segment," was selected based on their higher than average net worth. Services provided include issuing international credit cards, arranging study consulting, handling private purchase of foreign currencies and granting student loans.[15]

- *What is your market entry strategy? How will potential customers be segmented and what products will be offered? How will you manage risk?* Within Chinese banks, the large number of retail deposit holders is fertile ground for sowing a new offering – but uptake will depend on targeting the right customer with the right message. Make sure you have the data and analytical capabilities to segment existing customers based on factors such as age, deposit balance history, spending patterns and tenure. Then, develop promotional plans for specific segments that include a consumer educational component, an offer or incentive, the medium and the promotional message. Your strategy and marketing operations need to be adaptive too – with the flexibility to make adjustments as you sense marketplace reactions.

Figure 2. Elements of a sample promotional plan.

Segment	Young families with sizable balances and high transaction activity
Educational message	Credit cards can be used as a convenient way to spread the purchase price of a large expenditure over several months
Offer	Receive a credit card when the consumer makes a large purchase from a specific electronics manufacturer that the bank is partnering with on this promotion
Medium	Mass advertising – in places such as buses, subways and newspapers; deposit account statement insert
Promotional message	Leverage your purchasing power as a valued bank customer
Early results	Five percent response to statement insert
Adjustments made	Include promotional material on select computers, sound systems and home theater equipment offered by promotional partner

Source: IBM Business Consulting Services analysis.

The right product at the right time

Royal Bank of Canada (RBC) bases its segmentation strategy on customer life stages. The bank identified first time homebuyers as an attractive target group and designed a program for this segment that features an attractive mortgage rate, free informational resources, free coupons for home-related purchases and a contribution to an investment account by the bank. Besides easing the initial constraints that keep renters from becoming buyers, this package helps new homeowners jumpstart their long-term savings plans and better secure their futures.[16]

- *How will you manage risk?* Consumer credit risk is a new competency for your bank. With little decision-making data available, consider building a best-estimate "scorecard" using basic data from your existing customers such as income, age, address and deposits. Then, adjust and add data to the credit scorecard as you gain experience with the credit worthiness of your customers, applying this knowledge as you score each new customer. The credit scorecard can also guide your decisions on collections, authorizations and whether to increase or decrease lines of credit.

Know your customer

The Chinese market has recently experienced an explosion in auto ownership, accompanied by a rise in auto lending. Unfortunately, defaults on auto loans have been surprisingly dramatic. The culprit is a lack of knowledge about borrowers, and inconsistent processes for credit and verification, which is increasing banks' loan risk.[17]

While it may be easier to launch into more concrete aspects like infrastructure than grapple with more complex challenges like segmentation and risk, it's critical to *focus* on what matters most. The choices made on marketing and managing credit risk will differentiate your offering in the marketplace – and, more importantly, determine its profitability. Becoming engrossed in establishing transaction-processing infrastructure can become a distraction – preventing you from taking strategic steps that will likely dictate eventual market share.

Assess capabilities across all operational areas

Many processes are involved in running a credit card business – and while mid-tier Chinese banks might have relevant capabilities from their debit card issuance and call center operations, they will likely be breaking new ground in areas such as sales, marketing and credit risk management. In particular, global credit card issuers view transaction processing as an area that can be efficiently provided via an outsourced solution. Experience has shown transaction processing to be a scale business that is typically best served by those providing cost efficiencies. All of the top 11 global credit card issuers have developed an outsourced or shared processing approach.[18]

As you prepare to enter this new market, it's critical to evaluate the skills and expertise available in-house and identify places where outside assistance can provide a better, often less expensive, means of providing a particular piece of the operation. The decision to outsource specific processes should be made in conjunction with your overall strategic direction and not in isolation. According to Lynda Applegate, Harvard Business School professor and expert on using IT to gain competitive

Figure 3. Global credit card issuer transaction processing.

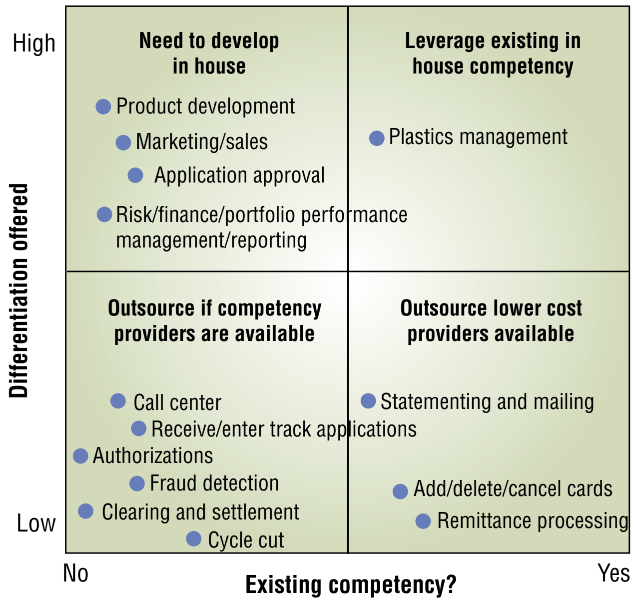
Rank by # of cards	Credit card issuer	Countries	# cards* (millions)	Volume* ($US billions)	US Processing **	Non-US processing**
1	Citibank	>50 countries	88.23	$212.95	Proprietary	Shared processing
2	Bank One (First USA)	US	60.12	$150.90	Outsourced	N/A
3	MBNA	US, UK, Spain, Portugal	53.23	$134.99	Proprietary	Outsourced
4	Bank of America	US, Canada	45.70	$94.44	Outsourced	N/A
5	Capital One	US, UK, Canada, France	45.24	$53.87	Proprietary	Outsourced
6	JP Morgan Chase	US	35.40	$76.80	Outsourced	N/A
7	HSBC/Household	30 countries	32.21	$63.44	Proprietary	Shared in-house system
8	Bradesco	Brazil	28.96	$3.88	N/A	Outsourced and proprietary
9	Providian	US	25.05	$30.50	Outsourced	N/A
10	Wells Fargo	US, Canada	22.96	$39.74	Outsourced	Proprietary
11	Barclays	UK	18.34	$89.96	N/A	Outsourced and proprietary

*Sources: * The Nilson Report, Issue Number 778, December 2002. Data as of December 2001.*
*** IBM analysis and intellectual capital.*

advantage, "Outsourcing is an essential strategic management tool. In the past, outsourcing was viewed as 'giving up' control over non-strategic assets. In the network economy, firms leverage core assets among a network of partners to increase return on assets while also achieving network economies of scale and scope."[19] A careful evaluation of which processes can provide competitive differentiation helps guide decisions on where outsourcing might be most advantageous and where internal resources should focus.

Also, don't underestimate the amount of organizational change involved in establishing a brand new line of business. A comprehensive change management plan – from high-level organizational design down to detailed job descriptions – can help you transition in a focused and systematic manner.

Figure 4. Sample assessment of process areas.



Source: IBM Business Consulting Services analysis.

Move fast

Timing is critical. The credit card opportunity before mid-tiers banks will not last long. Bigger Chinese banks and new foreign entrants are already encroaching on mid-sized banks' domestic opportunity:

- Nine local currency issuers are active in Chinese market – including Guangdong Development Bank, Industrial and Commercial Bank of China and Bank of Shanghai.[20]
- Citibank, with its five percent equity ownership of Shanghai Pudong Development Bank (SPDB), intends to launch a major joint credit card marketing program.[21]
- Global names, like HSBC Group, as well as other Asian regional banks such as Bank of East Asia, are actively prospecting, trying to find footholds in China's credit card market.[22]
- Changes in regulations allow banks from Hong Kong to enter the market even sooner.[23]

Gaining market share *early* is extremely important. Without a fast start, rivals can siphon away potential credit card users, leaving mid-tier banks far short of the customer base needed for a profitable business. Potential delays in getting to market can arise from any number of different business changes that are required, including business processes, organizational design and infrastructure. For example, IBM's analysis of entries into the Chinese credit card market reveals that infrastructure implementations have stretched up to 18 months. And perhaps more damaging, delayed focus on implementation of business operations such as customer service, origination, credit risk management and marketing have postponed profitability by 12 to 24 months. As you formulate plans for launching a new credit card operation, it's important to manage change – and find ways to respond rapidly to this opportunity.

Connect costs to incoming revenue

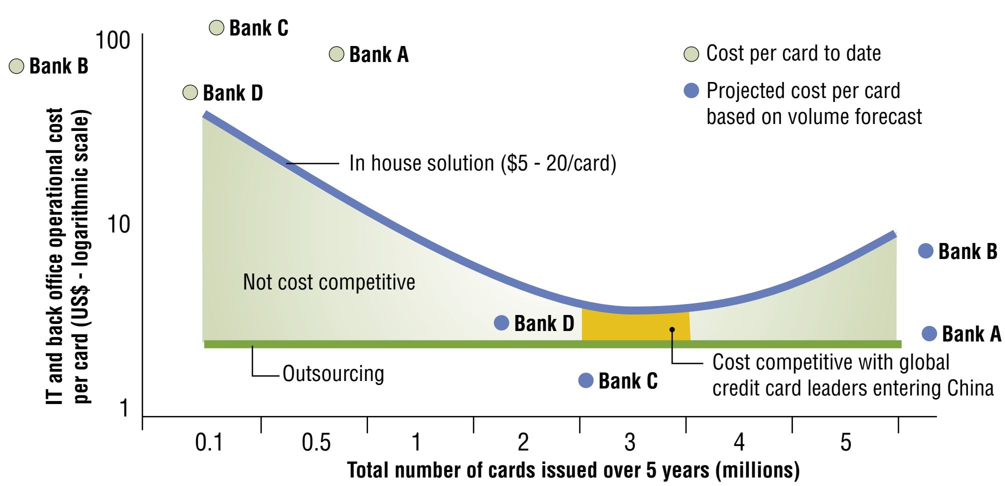
Entering the credit card business can require a fair amount of up-front investment – from hardware and software purchases to systems integration and setup support.

When trying to attract investors, the decision on how much up-front investment you can afford becomes even more difficult. If your balance sheet is under close scrutiny, tying up US$3 to 6 million of capital in hardware and processing software may not be prudent.

Ongoing costs – such as data center personnel, disaster recovery, association fees, hardware and software maintenance and changes to support new products and programs – can be even more daunting. And don't forget the front- and back-office operational costs associated with charge backs, lost and stolen cards, customer service, research and exception management.

When providing all of these IT and front- and back-office operations in-house, achieving an affordable annual cost per card is tricky and requires hitting a narrow range of acceptable volumes. Several Chinese banks that have attempted to build and manage in-house credit card operations have exceeded their initial cost projections and experienced delays in acquiring the anticipated number of customers.

Figure 5. Staying cost-competitive can be a challenge with an in house approach.



CIF by end of year 5	30K	60K	500K	1M	1.2M	1.5M	1.9M	11M

Source: IBM Business Consulting Services.

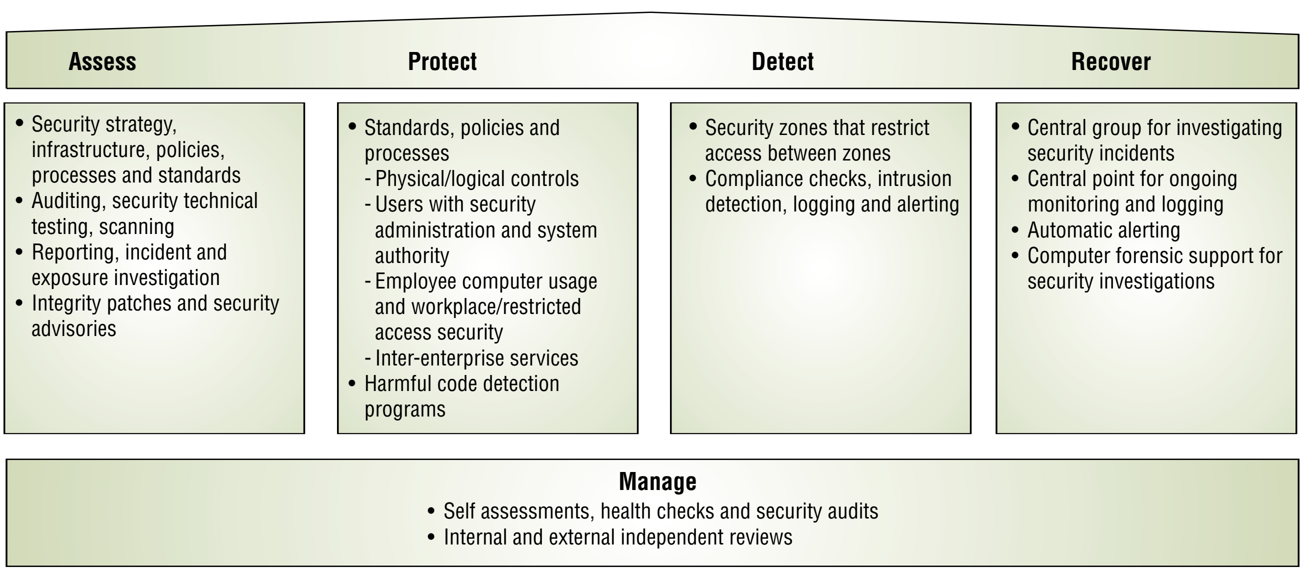
Based on IBM analysis of the Chinese credit card market, the actual cost of infrastructure and back-office operations has been between US$80-100 per card per year – not even close to the cost per card rate achieved by best-in-class, large-scale processors (see Figure 5).

The financial risk involved in an in-house approach is causing banks to rethink fixed cost approaches and consider variable cost models instead. Transaction processors and back-office process managers often charge based on the number of cards issued, allowing banks to offset cost per card with revenue generated from fees per card. Although outsourcing usually brings to mind support of automated components like authorization, transaction processing and settlement, people-oriented processes like customer service are also candidates for pay-per-card arrangements. Simply put, gaining and maintaining a profitable foothold in the credit card market, depends on how closely costs are tied to the variable ebb and flow of revenue streams.

Step up security

When you are responsible for safeguarding credit card databases that contain private financial information belonging to millions of customers, security has to be a top concern. Security breaches that divulge consumer data or allow hackers to gain access to China's sensitive economic data can devastate a bank's reputation, expose it to financial risk and perhaps even subject it to government intervention.

Figure 6. To gain resilience, credit card security must be an end-to-end proposition – from strategy to a carefully managed implementation.



Credit card businesses also open new avenues for fraudsters. Nearby neighbors, Malaysia and Taiwan, have the highest credit card fraud rates in Asia.[24] And some pundits speculate that China might be the next hot spot for credit card crime.[25] To avoid being an easy target, you'll need to incorporate resilient security and fraud management practices into your new credit card business. Leaders in security, for example, keep comprehensive audit logs that track each and every access of sensitive information, maintain security clearance profiles on all employees and use advanced neural network tools to help detect fraud in realtime. Meeting the central bank's data security requirements and reducing risk to your own reputation and financial stability requires end-to-end security features that help you assess exposure, protect assets, detect threats, recover rapidly from incidents and manage overall compliance with security programs.

Capitalize on comparative advantage

Leverage the fact that you're local. You have a head start over foreign competitors in many areas including access to local customers and knowledge of Chinese customer preferences. In fact, foreign financial institutions lack some of the basics, such as: business licenses, physical premises and the basic trust of Chinese customers.

A quick start into the market can help you make the most of the three years remaining until WTO accessions lift encumbrances on multinationals that are anxious to enter the Chinese banking market. And for those considering a partnership with a foreign bank as a means to enter the retail banking space, the value of an existing, local operational environment should not be underestimated.

Charge ahead

Credit card businesses can provide much needed diversification within mid-tier Chinese banks' portfolios – creating a new source of growth and improved financial standing in a very competitive marketplace. When launching a new credit card business, success depends on getting to market quickly and achieving a profitable stance earlier than your competitors. To browse through other resources for business executives, we invite you to visit our Web site:

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