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Four Trends Shaping China's Retail Banking Landscape

Results of the 2014 McKinsey Personal Financial Services Survey

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China's retail banking revenues have grown 30 percent a year since 2009 and could exceed RMB 2.6 trillion (over US$430 billion) by 2020, making the country the largest retail banking market in Asia.[1] Intense competition for the Chinese retail banking consumer's wallet has accompanied this fast growth. Meanwhile, the retail banking landscape has faced several challenges, including interest rate liberalization, major regulatory changes, and the rise of digital finance.

To better understand Chinese banking customers, McKinsey conducted in 2014 a personal financial services survey of more than 3,500 consumers across Tier 1, 2, 3, and 4 cities. (McKinsey has done similar personal financial services surveys since 1998, and most recently in 2007 and 2011.)

Highlights of our current research include:

- Chinese consumers are still among the least loyal in Asia. For example, less than half of Chinese consumers will remain loyal to their primary bank when offered more attractive pricing terms from competitors, compared with nearly 70 percent in emerging Asia.[2]

- Consumer needs and behaviors are becoming increasingly similar across China. For example, penetration of several banking products now varies by less than 5 percent across tier cities.

- The country's "Big Four"[3] banks are less dominant. For example, their market share is eroding across tier cities and income segments.

- Digital banking is going mainstream. Today, more than 70 percent of Chinese consumers say they would open an account with a pure digital bank.

Implications for traditional retail banks and Internet players are far-reaching. For retail banks, a key to success in the future is moving toward more of a total relationship model.[4] Internet players, for their part, must better understand how to integrate financial services with the Chinese consumer's digital lifestyle.

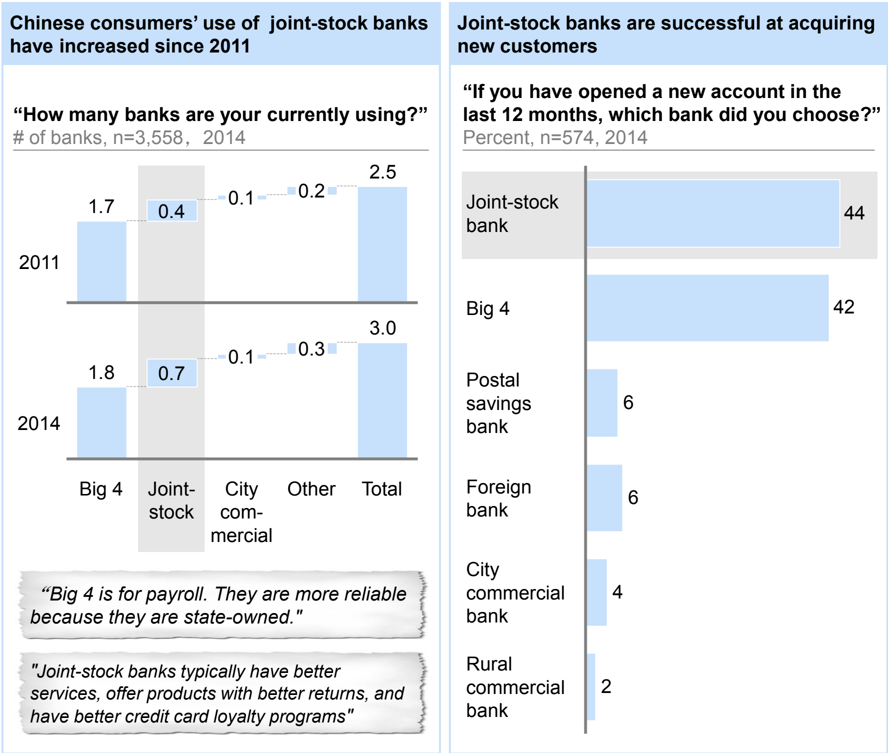
1 McKinsey's Global Banking Revenue Pools
2 Emerging Asia here includes India, Indonesia, Malaysia, Philippines, Thailand, and Vietnam
3 The "Big Four" state-owned commercial banks are Bank of China, China Construction Bank, Industrial and Commercial Bank of China, and Agricultural Bank of China
4 A total relationship model is defined as a go-to-market approach where a financial services provider is able to service all aspects of a customer needs (for example, across all product categories)

Chinese consumers: diminishing loyalty

Chinese consumers are becoming increasingly open to multiple banking relationships. Our research found that the average number of banking relationships per Chinese consumer has risen from 2.5 in 2011 to 3 in 2014. Joint stock banks[5] are mainly responsible for the creation of these new banking relationships. (Exhibit 1)

EXHIBIT 1

China's joint stock banks are gaining momentum



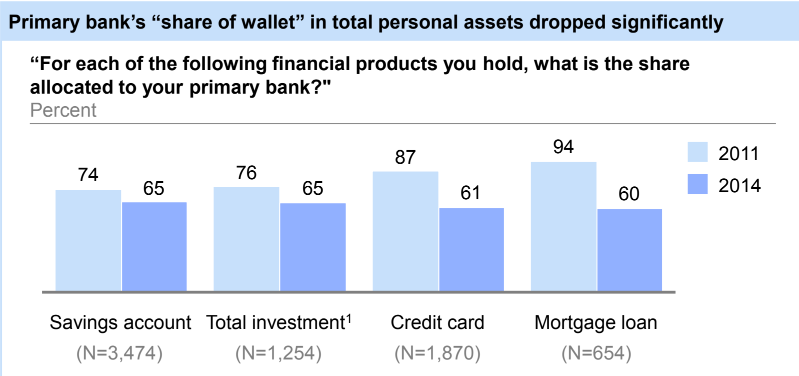
SOURCE: McKinsey Asia PFS survey (2014); focus groups; team analysis

Meanwhile, Chinese consumers are becoming less attached to their primary bank. For example, less than half of Chinese consumers will remain loyal to their primary bank when offered more attractive pricing terms from competitors, compared with nearly 70 percent in emerging Asia. As a result, the primary bank's share of wallet across products has eroded. (Exhibit 2) Products are now driving loyalty rather than specific institutions; in other words, Chinese consumers are willing to try new products and services that are offered at better terms than what their primary bank has proposed.

5 "Joint stock banks" refer to banks with a mix of public and private ownership and include Bank of Communications, China Bohai Bank, China Everbright Bank, China Merchants Bank, China Minsheng Bank, China Zheshang Bank, CITIC Bank, Evergrowing Bank, Guangdong Development Bank, Huaxia Bank, Industrial Bank, Shanghai Pudong Bank and PingAn Bank

EXHIBIT 2

Primary banks have lost substantial share of wallet in personal assets



1 Percentage of bond investment in 2011 and percentage of overall investment (including equity and mutual fund) in 2014

SOURCE: McKinsey Asia PFS survey (2011, 2014); team analysis

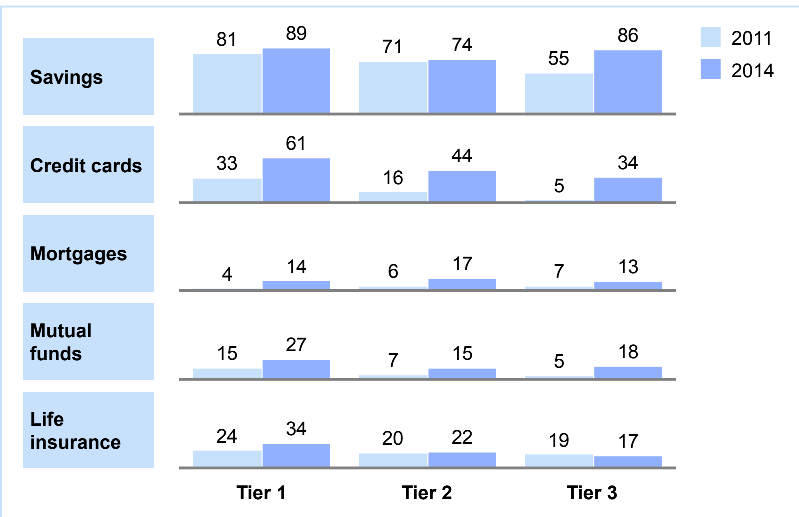
Consumer needs and behaviors converging across China

Chinese consumer behavior across tier cities continues to converge. Over the last few years, penetration of products such as savings accounts, credit cards, personal loans, investments, and insurance in Tier 3 and 4 cities has risen at an extraordinary pace, narrowing the gap with Tier 1 and 2 cities. (Exhibit 3) Fast economic development of non-Tier 1 cities accounts in large part for the change. Meanwhile, as financial planning becomes more prominent among Chinese investors, we see consumers' interest levels in Tier 3 and 4 cities approaching those of Tier 1 and 2. (Exhibit 4) However, the actual use of financial advisors remains low – about 15 percent throughout China compared with more than 25 percent in emerging Asia. Lastly, nearly 70 percent of affluent Chinese say they remain risk averse. Principal protection is their primary investment consideration.

EXHIBIT 3

Product penetration gap cross different city tiers has begun to narrow

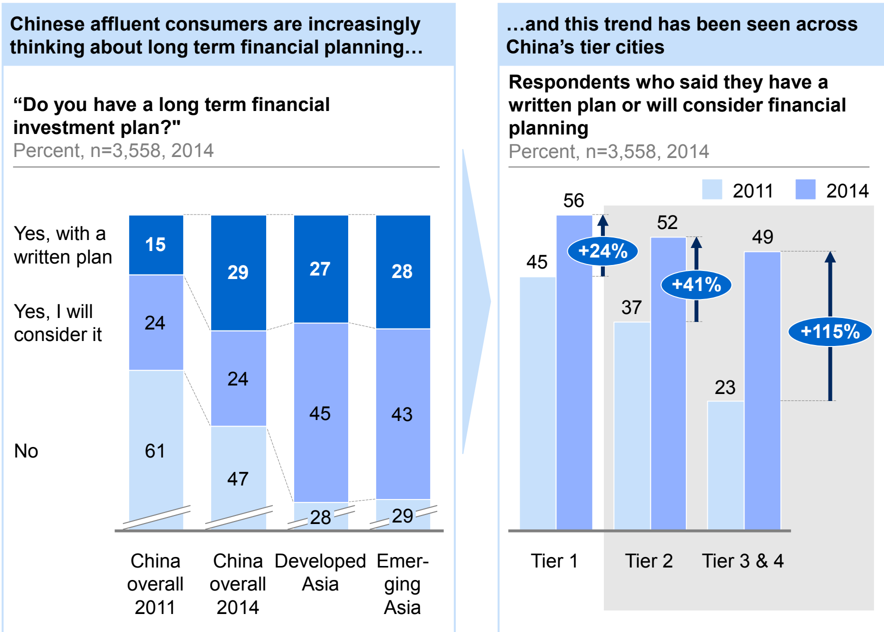
Percent, n=3,558, 2014



SOURCE: McKinsey Asia PFS survey (2011,2014); team analysis

EXHIBIT 4

Rising awareness of financial planning, especially among consumers of Tier 2 & 3 cities



SOURCE: McKinsey Asia PFS survey (2011,2014); team analysis

The Big Four's shrinking share

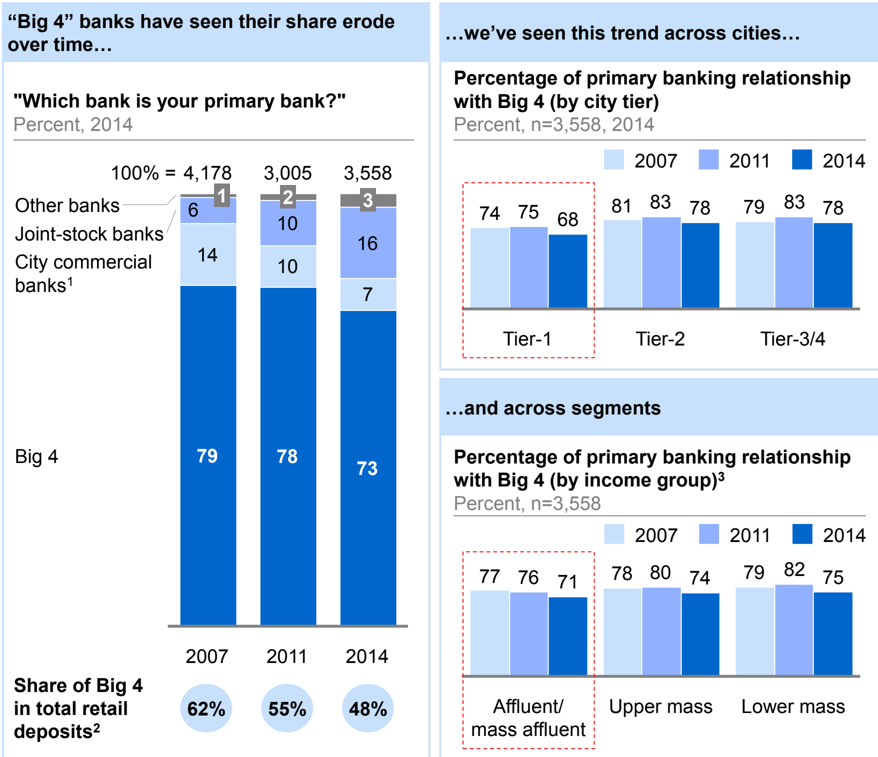
China's largest four state-owned banks remain the primary financial institutions for more than 70 percent of Chinese consumers, but this share continues to erode. The trend is playing out across the tier cities and wealth segments although it is most pronounced in Tier 1 and the affluent and mass affluent segments. The beneficiaries are China's joint stock banks – their market share in primary banking relationships has increased from just 6 percent in 2007 to 16 percent in 2014. (Exhibit 5) Consumers rate their product and service offerings higher than those of the Big Four.

In many ways, the Big Four banks are still very much generalists in the eyes of the Chinese consumer, serving all segments and across all tier cities. Over the years, however, we've seen "specialist" archetypes[6] emerging among their competitors – joint stock banks, city commercial banks, rural commercial banks, and foreign banks. (Exhibit 6) Joint stock banks have attracted relatively affluent, educated Tier 1 residents while foreign banks have lured the highest proportion of affluent consumers and those holding a graduate degree. Meanwhile, city commercial banks have attracted a relatively elderly customer base and more of the mass affluent segment in Tier 1 and 2 cities. Lastly, rural commercial banks get most of their consumers from Tier 3 and 4 cities as well as from lower income brackets.

6 "Specialist" archetypes, in contrast to "generalist" archetypes, refers to those archetypes that target specific customer segments (for example, affluent customers)

EXHIBIT 5

"Big 4" banks are losing share, especially to the joint stock banks and especially in Tier 1 cities and the affluent / mass affluent segments

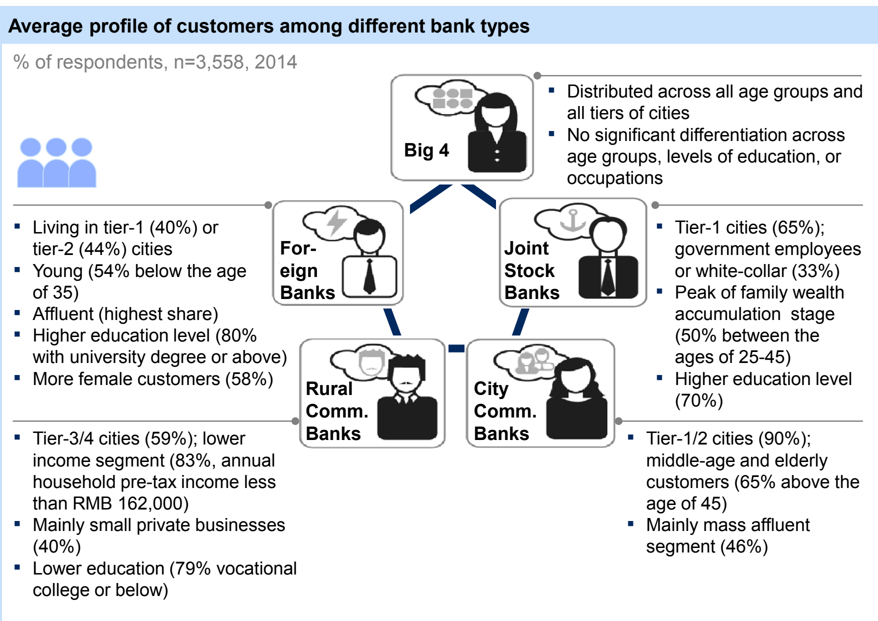


1 Includes China Postal Bank and various city commercial banks
2 Year-end data for 2007 and 2011 and Q1 data for 2014
3 Affluent segment are those whose pre-tax household income exceeds RMB228,000; mass-affluent between RMB162,000 and RMB228,000; upper mass between RMB88,000 and 162,000; lower mass between RMB53,000 and RMB88,000

SOURCE: McKinsey Asia PFS survey (2007, 2011, 2014); team analysis

EXHIBIT 6

Non-Big 4 banks are attracting customer segments with distinctive profiles and needs



SOURCE: McKinsey Asia PFS survey (2014); team analysis

Digital goes mainstream

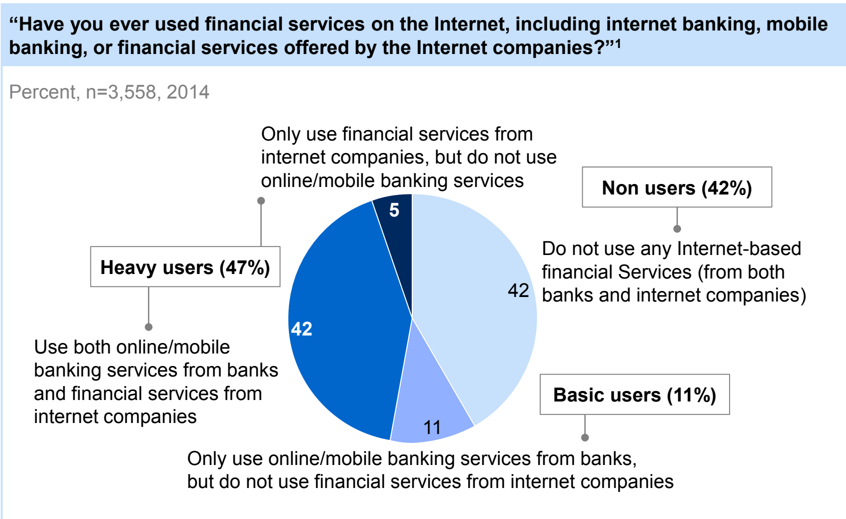
Digitization is taking China by storm. Roughly 60 percent of survey respondents answered yes to the question, “Have you ever used financial services on the Internet, including Internet banking, mobile banking, or a financial service platform offered by Internet companies.” Three forces are driving this trend:

- The changing needs and behavior of the Chinese consumer, including the importance of social media and word of mouth
- A supportive stance by regulators toward innovation, including inviting Internet players to enter the financial services industry
- Attackers entering the market, including Alibaba, Baidu, and Tencent, as well as incumbent banks that are changing their business models, including launching direct banks

Given this, China’s consumers are evolving into three main types, driven by their acceptance level of digital financial services. (Exhibit 7)

EXHIBIT 7

There are 3 main types of financial services consumers in China



1 Financial services provided by the Internet companies refer to those provided by non-conventional financial institutions, e.g. Taobao, Tencent, P2P lending websites, etc. Adjusted based on population statistics by city tier at macro level

SOURCE: McKinsey Asia PFS survey (2014); team analysis

- “Heavy users” (47 percent of financial services consumers in China) are those that use both online and mobile banking services and/or financial services from Internet companies
- “Basic users” (11 percent) are those that use only online and mobile banking services, but do not use financial services from Internet companies
- “Non-users” (42 percent) are those that use neither online and mobile banking services nor financial services from Internet companies

Our research suggests that for heavy and basic users, the main reason for using digital financial services continues to be convenience (“anytime anywhere"). For non-users, the main reason for not using digital financial services is concerns about security, especially for Internet players. Overall, half of all users say that they trust financial services of traditional banks more than Internet companies.

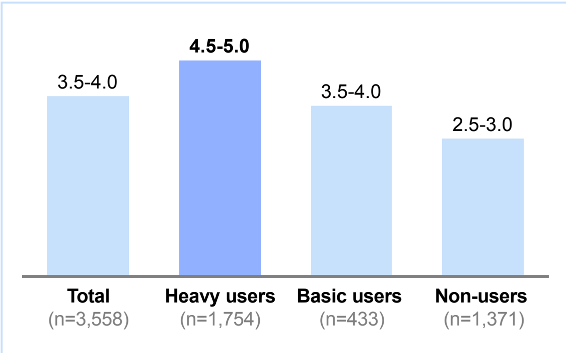
Heavy users may be the most prized digital consumer for both banks and Internet companies. These consumers have an average of 4.5 to 6.0 banking products compared with 2.5 to 3.0 products for a non-user. For basic users, the average number of products is 3.5 to 4.0. (Exhibit 8)

In addition, we found that more than 70 percent of Chinese consumers would consider opening an account with a pure digital bank. More interestingly, nearly 70 percent of Chinese consumers would consider a pure digital bank as their primary bank. (Exhibit 9)

EXHIBIT 8

"Heavy users" are the most prized digital consumer in China today

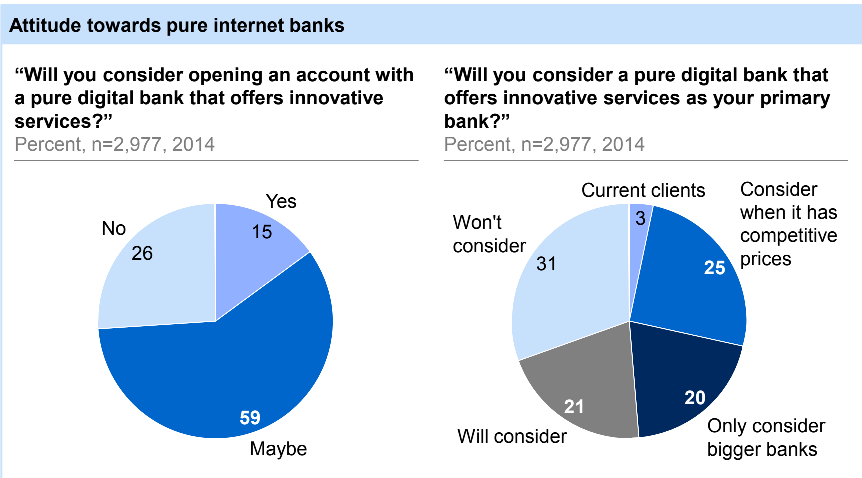
No. of products owned, %, 2014



SOURCE: McKinsey Asia PFS Survey (2014); team analysis

EXHIBIT 9

More than 70% of respondents would consider opening an account with a pure digital bank. Nearly the same number would consider making a digital bank their primary bank



SOURCE: McKinsey Asia PFS Survey (2014); team analysis

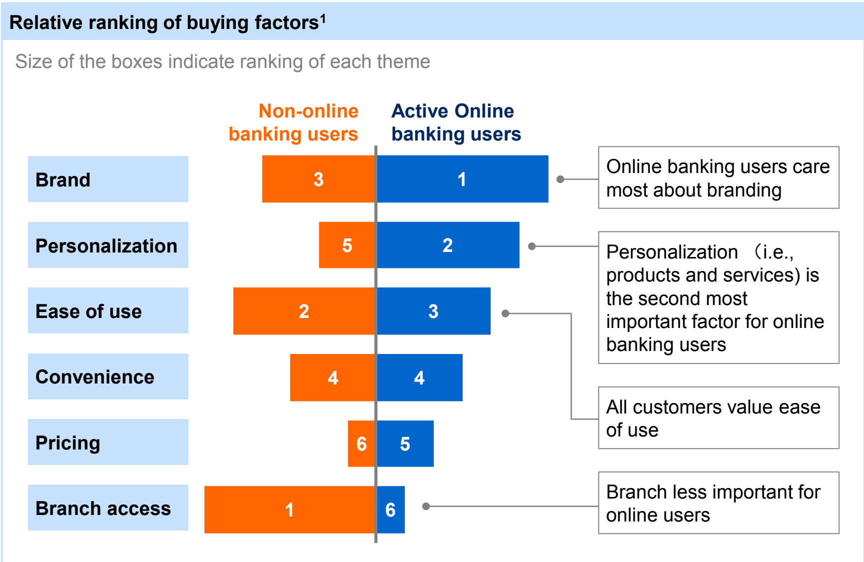
Implications for retail banks

Our survey findings suggest several ways forward for retail banks looking to capture a bigger share of the Chinese consumer's wallet:

- Adopt a total-relationship model instead of a product-led approach for target consumer segments. This is because we believe that a product-led model is economically unsustainable in the long term and consumer loyalty or stickiness is extremely hard to maintain.
- Target less price-sensitive and more affluent digital sub-segments that value customer experience over pricing.
- Develop three basic value propositions centered on brand, personalization and ease of use. (Exhibit 10) Personalization and ease of use of products are key to driving customer experience for the more affluent digital sub-segments

EXHIBIT 10

Different strategic archetypes will need to address what's most important to the digital customer: personalization, ease of use, and convenience



1 Consumer survey of 3000 retail banking customers in China. Correlation analysis between willingness to recommend primary bank & importance of buying factors

SOURCE: Asia PFS CDJ/multichannel booster survey 2011, N=3000 Consumers in China

Implications for Internet companies

Our findings also suggested a way forward for Internet companies seeking to increase their share of the retail market:

- Target the traditionally "un-bankable" segment (for example, "lower mass"[7]) that financial services companies do not traditionally focus on and develop an "affluent-like" value proposition that can only be delivered economically

7 The "lower mass" segment refers to those consumers in China whose annual household income is between RMB53,000 to RMB88,000

by Internet companies (for example, personalized portfolio management delivered via a large Internet company's platform).

- Capture the digital wallet share of heavy and basic users with a value proposition fully integrated with the digital lifestyles of these segments (for example, providing highly personalized interface and services to housewives, retired people, and businessmen, based on their different life styles).

- Strengthen marketing to generate user traffic and comfort around the security risk associated with online purchases of financial products. Explore the possibility of setting up an offline presence (for example, flagship locations or experience centers offering limited services) to build trust in consumers who might gain a greater sense of comfort if they could physically "see" their bank.

China's retail banking landscape is undergoing a revolution with the advent of interest-rate liberalization, changes in the regulatory landscape, and the rise of digital finance. At the same time, as the country grows richer, consumer behavior is evolving. It's imperative for traditional retail banks and their emerging Internet counterparts to stay on top of the trends. Our research suggests that by 2020, we'll be looking at a very different Chinese retail banking market. Is your bank in a position to help shape that market?

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