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Chinese Credit Card Market Analysis

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***Developing the Consumer Credit Card Segment in Mainland China:
A Market Analysis and Strategic Agenda***



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Executive Summary –

The People's Republic of China is a Communist nation, coming to grips with its embrace of a mercantilist system and market reforms. China is a land of enormous promise to potential investors, with a growing economy, the highest population of consumers in the world, the world's principal manufacturing platforms, and increasing levels of openness and integration with international business. Most notably, China's ascension to the World Trade Organization in 2001 introduced a free market discipline and opened opportunities for international investment.

Consumer credit labels seeking entry into China are offered an underdeveloped, virtually untapped market. China's prosperous coastal cities boast a rapidly growing population of some 72 million individuals, but only one million true credit cards are circulated among the whole of China. Growth in middle-income segments, growth in discretionary spending commensurate with economic growth, and consumer's expressed demand for financial services support the precept that latent demand for consumer credit exists in China.

Notwithstanding the promise of the marketplace, substantial uncertainty remains. Although WTO provisions aim to afford foreign banks the same privileges as domestic banks, side legislation has recently surfaced hindering unencumbered entry into the financial sector. Infrastructure serving bank and financial networks is markedly underdeveloped. Extant information on consumer credit history is

virtually nonexistent. Chinese consumers are unschooled in the use of credit, and may not readily adopt revolving credit patterns. At the same time, unsophisticated credit consumers may disproportionately default on credit debt.

Credit companies entering China should anticipate losses over the short term. Companies will have to expend resources structuring joint partnerships, building a consumer base and educating consumers. Nonetheless, over the long term, predicted continued economic growth, liberalization, and growth in consumer credit demand will render the Chinese market profitable for foreign financial service firms.

Macroeconomic Overview

Economic Growth –

China is the most populous country in the world. With the third largest geography, it began to open its doors to international investment in 1978.

Through 1996 to 2001 China saw a period of accelerated and managed growth, culminating in its ascension to the WTO. Since 2001, the Chinese economy has continued to open, and expand. China has emerged as a leading world economy, a principal exporter, and a primary destination for companies with expanding multinational operations. Currently boasting the 6th largest economy, with a GDP of 1.23 trillion US dollars, China now accounts for 3.8 % of the world GDP. The Chinese economy continues to grow at rates of 8% a year, accounting for more than 15% of global economic growth.ⁱ Despite temporal depression of economic growth due to SARS concerns, over the long term the Chinese economy is expected to continue to grow at accelerated speeds.ⁱⁱ Table 1 compares key macroeconomic indicators for the years 1995 and 2000.

As the economy has expanded, Chinese consumers have enjoyed increased GNI per capita and commensurate reductions in poverty. Currently, countrywide per capita GNI is \$850 USD. The country's marked geographic disparity in income reduces the rural per capita income to only one-third of the national income. This

	1995	2000
GNI per capita (US\$, PPP)	2650	3940
Population mid year (Millions)	1205	1261
GDP Growth	12.1	8.2
Openness (Imports+Exports/GDP)	45.7	47.1
Private Investment (% GDP)	15.8	16.7
Public Investment (% GDP)	18.9	19.2
FDI Inflows (Net, % GDP)	5.1	3.9

variance means that the 66% of the population living in rural areas earn only \$280 a year. The rural – urban disparity is even more apparent in the average per capita income that China’s three most affluent cities have attained. Average GNI per capita in Beijing, Shanghai, and Guangdong nears \$7000.

Population Structure –

China’s strict enforcement of the one child policy has restrained population growth. China’s population currently numbers 1.19 billion people, and is projected to grow to 1.47 billion people by 2025.^{iv} Currently, more than a quarter of the country’s citizens are under age 15, and only 7% are over age 65. China is poised to exploit a demographic dividend – its young population structure means that huge numbers of Chinese youth will provide the country with a productive labor supply and a voracious appetite for consumption for years to come.^v

Currency & Inflation –

Since the Asian economic crisis of 1997, the stability of the Chinese currency has played a significant role in smoothing the region’s economy. China employs a managed float, and maintains the Yuan at about 8.28 Yuan to the dollar. Inflation in China was relatively low through the 1990s, and has been virtually nonexistent since 2000. China’s currency controls are affected via a system of state backed bank purchase of foreign currency, and subsequent control of the supply of domestic currency by repurchasing Yuan for state issued treasury bonds.^{vi} Since 2001, some indicators have shown that the economy is suffering from deflation.

The consumer price index has intermittently decreased, but remains within a 1% range of price stability; analysts hope that the China will emerge from any deflationary cycle within the year. ^{vii}

Analysis of the Business Investment Climate

Foreign Direct Investment (FDI) –

China received a record \$52 billion in foreign direct investment in 2002.^{viii} By 2003, China surpassed the United States as the leading destination for FDI. Though investment numbers are slightly inflated due to national business interests ‘round-tripping’ (‘double counting’ investments as business interests move between Hong Kong and the mainland), China nonetheless remains a leading destination for global investors. Figure 1 compares the flows of FDI to China and the other Asean countries.

Countrywide, half of China’s exports are manufactured by foreign financed enterprises.^{ix} The growing investment climate in China is affected most saliently by four factors: infrastructure, market entry and exit, access to finance, and private sector development.

Infrastructure –

Determinants for FDI depend on existing country infrastructure. Success rates strongly rely on fully developed communication and energy networks. Access to power sources is a main concern for businesses entering the Chinese market,

specifically for manufacturing firms and companies dependant on integrated communication networks. Chinese power availability is on par with other countries in the East Asian arena, such as Thailand and the Philippines. At least 30% of businesses operating in China deem it necessary to own a back up generator, and 2% of production capacity is lost each year due to power outages. Any power disruptions could negatively affect the credit card transaction market.^x

China trails much of the developing world telephone line penetration ratios. For every 100 Chinese residents, there are only 14 land phone lines available. However, due to the influx of mobile phone technology, China now has more mobile telephones than any country in the world, and that figure is expected to continue to grow. Thanks to the increasing use of mobile phone networks, telecommunications are not problematic for business in China^{xi}.

Shipping is the lifeblood of international business, and particularly important to China's reliance on the export of manufactured goods. China has relatively efficient ports in which business is conducted daily. Business flows through Chinese customs procedures with relative ease when compared to other large Asian countries. Currently, it takes about 9 days for a shipment to clear customs in China, as opposed to 14 days in India. In the developing world, China has achieved economies of scale in shipping through ports, and an advantage in the time required for materials to clear customs.

Entry and Exit –

The length of time needed to set up a business within a given country varies across borders. On average, it takes 47 days and six permits to set up a company globally^{xii}. However, in China's up to 92 days and a series of 12 procedures are required to start a business. Strict regulations and lengthy startup costs can dampen the velocity of market growth and flows of investment.

Access to Finance –

China's financial system is based upon debt, with 27% of capital coming from direct bank loans. As a result, many banks in China are faced with a growing bad debt problem. Domestically, the Chinese banking sector debt problem threatens access to capital for businesses in China. The bad debt problem may carry further repercussions, as principal Chinese banks are state backed. Multinational businesses with access to international capital markets are less affected by this problem even when within Chinese borders. Domestic access to financing and poor market liquidity may develop as a problem for domestic firms.

Government Influence –

Governmental influence, spanning rule of law, investment laws, corruption, industry regulations, also influences the Chinese investment climate. Though China is politically stable, and on par with other developing economies in measures of governmental effectiveness, regulations and rule of law. Conversely, it is ranked as relatively corrupt when compared with other

developing countries. Measures of interaction with bureaucracy place China ahead of rival economies: businesses in China spend at least 9% of their time dealing with public officials. Though this represents a substantial time investment, it is much less than is required in India and other developing nations with entrenched bureaucracies. Shan Gooptu, Senior Country Economist at the World Bank says, “Ultimately, the Chinese government has committed to providing an environment that is economically, if not politically, conducive to the private sector.”

Principal Geographies for Investment

“China has globalized internationally, but failed to integrate domestically,” says Shan Gooptu. The huge social divide between the city and countryside is among China’s leading challenges. Nearly two-thirds of China’s population lives in ‘lagging regions,’ as poorer rural areas are known; those individuals earn only one-third of the per capita income that their urban counterparts garner. Falling even further behind are China’s rural poor – who number some 30 million. Previously, China’s population was limited in movement by the hukou system, a policy dictating the immobility of people to live and work in different areas. Since 1982, when economic reforms loosened restrictions on the movements of ordinary Chinese, more than 100 million people have moved from rural to urban areas, harbingers of what demographers predict will be the largest population migration in history.^{xiii} The World Trade Organization (WTO) anticipates that with the blessing of China’s government in hand, the population will continue to

urbanize, and expects that 70% of the population will reside in cities within 25 years.^{xiv}

Urbanization already underway poses challenges in and of itself. As China’s youth move from rural to urban settings – huge employment, housing and infrastructure problems are generated. The World Bank’s Gooptu believes China’s government is ready to meet these challenges, having “embraced a philosophical agenda of growth, and willingness to plan long term infrastructure needs.”

The principal beneficiaries of FDI in China have been Beijing, Shanghai, Guangdong and Chongqing. Not coincidentally, these four cities are also China’s most prosperous.

Average income in each of these cities is shown in Table 2.

The level of affluence attained in these markets far exceeds rural areas. For better or worse, the affluence in urban areas is expected to increase, as rural areas become

City	\$
Beijing	6583
Shanghai	6831
Guangzhou	7841
Chongqing	3287

poorer still.^{xv} In both the short and long term, concentrated population centers of affluent consumers will provide a deep customer base for multinationals moving into China. Both demographic and income trends dictate that China’s affluent cities will be the areas of interest for financial services firms seeking business opportunities in China.

Credit Card Industry: Revenue Model

Overview –

The general business model in the credit card industry draws from three primary revenue streams:

- Transaction fees
- Service fees
- Interest earned on revolving balances

Transaction fees are generated from the branches of the credit card business network: merchants, clearinghouses (e.g., Visa and MasterCard), and financial institutions. At the front lines of the network are merchants – businesses set up to accept credit cards as a form of payment for their products and services. The network of merchants is developed and maintained by acquirers, whose responsibility is not just to establish a group of merchants, but also to provide timely payment to the merchants. As compensation, the clearinghouse garners a percentage of each sale. With each sale, the merchant typically receives 98% of the selling price; the remaining 2% is divided between the clearinghouse and the financial institution.^{xvi} For clearinghouse, this fee represents their primary source of revenue. For financial institutions, on the other hand, this represents only a fraction of the credit card yields.

Service fees are the third largest revenue source for credit companies. Service fees include membership fees and late charges. Most membership fees are linked to affinity cards that provide a value added benefits. For example, the

Citibank AAdvantage card carries a \$75 annual membership fee for mileage rewards. Other non-affinity credit cards (such as American Express) require an annual fee for use. While fees do not translate into profits, they effectively subsidize the cost of providing card services to the consumer. In addition, heavy price competition and shrinking margins have placed increased pressure on credit companies to provide affinity offerings to consumers.

Late fees are increasingly becoming a more important part of a credit card company's revenue model. A recent study found that late fee revenue generated to bank credit card issuers increased from \$1.7 billion annually to \$7.3 billion in 2002. During this time, credit card fees have increased from an average of about \$13.00 per month to \$28.00 per month and grace periods have decreased from about 30 days to 21 days. In reverse correlation to these changes, more customers now pay late fees. Late payment is profitable for credit card firms, up to the point that late paying customers carry a default risk.

Issuers are the financial institutions that extend credit to consumers and ultimately supply the money to compensate the merchants (via repurchase of clearinghouse debt). These institutions extend a pre-determined line of credit to customers at a specified interest rate. The cardholder can use this credit to make purchases or receive cash advances. Once a

transaction is made, the cardholder is offered a grace period of approximately 30 days. Once this grace period passes, the financial institution begins to charge interest. Table 3 shows the average interest rates on credit cards issued in the United States by credit card banks, (credit card banks are defined as those with assets over 200 Million), with the average interest rate

Year	Interest Rate	Year	Interest Rate
1972	17.21	1988	17.78
1973	17.21	1989	18.02
1974	17.2	1990	18.17
1975	17.16	1991	18.23
1976	17.05	1992	17.78
1977	16.88	1993	16.83
1978	17.03	1994	15.77
1979	17.03	1995	15.79
1980	17.31	1996	15.5
1981	17.78	1997	15.57
1982	18.51	1998	15.59
1983	18.78	1999	14.81
1984	18.77	2000	14.91
1986	18.26	2001	14.44
1987	17.92		

charged of 16.67% between 1972 and 2001.

The financial institution is ultimately responsible for payment to the merchants. In order to fund this obligation, these entities turn to capital markets to borrow the necessary funds. The average interest rate at which the major banks in the US borrow is around 5%. The interest revenue generated is the spread between the firm's cost of capital and the interest rates charged to consumers. The gross average margin of interest revenue for US banks is typically around 11%, (16.67% lend to consumers minus the 5% cost of borrowing).^{xvii}

Between 1986 and 1996, the net before tax average earnings for US credit companies, as a percentage of outstanding dollar balances was approximately 3%. (Table 4.)

The reduction in margins from an 11% gross to a net average of 3% is primarily due to operating expenses and write-offs. Operating costs including labor, transactions and marketing. Credit card

Table 4: Before Tax Average Earnings^{xviii}

Year	Earnings ²	Year	Earnings ²
1986	3.45	1992	3.13
1987	3.33	1993	4.06
1988	2.78	1994	3.98
1989	2.83	1995	2.71
1990	3.1	1996	2.14
1991	2.57		

companies go to considerable expense to acquire customers. Credit industry executives cite operating costs reduce gross margins by 3 to 4%, the bulk of this cost coming from marketing and advertising efforts. The most significant expense taken by issuing banks is write-offs. Write-offs are loans the financial institutions conclude will not be paid back.

Defaults on loans account for the largest marginal cost in the credit card business.^{xix}As a result lending institutions have gone to considerable lengths to develop scoring models and analysis techniques to better manage their lending portfolios. The output generated by these complex models helps lending institutions more accurately balance their level of high risk borrowers, generate appropriate pricing strategies, loan amounts, credit loss forecasts (bankruptcies), collection strategies, and overall portfolio management. The critical component of these models is the information collected by the financial institutions. The models are only successful when extensive accurate information can be

collected. Jeffrey Bower, a senior manager in KPMG financial services consulting practice, concluded in a meeting with the Payment Card Center of the Federal Reserve Bank of Philadelphia, “The future of consumer credit risk management lies in organization portfolio performance and account level detail into databases; and then, applying refined analytical models to discern patterns or trends.”^{xx}

Securitization –

A more recent development, and revenue generator in the credit card business is concept of the securitization of credit card receivables. Commercial banks have a strong incentive to sell their loan assets in order to reduce risk, and reduce interest rates. As a result, the securitization on credit card receivables has emerged. ^{xxi}The financial institution owning the receivables assets, sells the asset and the right to accrued interest receivables to a trust. This sale removes the asset from the bank's balance sheet. In return for the sale, the issuing financial institution receives a fee and finance charge, providing profits on credit card receivables. The transaction simultaneously takes the asset off the books, reducing exposure to debt and cost of capital.^{xxii}

On the whole, the credit card industry is a high risk – high return business. Table

5 shows rates of return for various types of commercial and consumer lending.

Though the average return for credit lending fell behind real estate, commercial, and

	Credit card lending	Real estate mortgage lending	Commercial and other lending	Installment lending
1974-96 average	1.77*	2.48	2.25	2.15
Standard deviation	2.05	.71	1.21	.59
*Net earnings rates are weighted averages for three size categories of banks reported in the <i>National Average Commercial Bank Report, Functional Cost Analysis</i> , annual issues, 1974-96.				

installment lending, the range – or risk – represented in these returns by the average’s standard deviation is highest for credit lending. In addition, recent developments in the securitization of credit receivables have boosted net earnings from 1.77 to 2.71, with a lower level of risk (standard deviation =1.1).^{xxiv}

Chinese Commercial Banking Regulatory Climate

WTO Ascension and Foreign Bank Constraints –

As a precursor to entering the WTO, Chinese officials were required to equalize domestic and foreign opportunities. Prior to the provisions outlined in the WTO agreement, foreign bank operations were limited to foreign currency denominations. Despite Chinas ascension into the WTO foreign banks are still banned from issuing credit in RMB until 2007. Accordingly, foreign entities are constrained to an \$80 billion market – this represents less than 10% of the savings of Chinese citizens.^{xxv} Added constraints non national banks have created a difficult climate in which to compete. Chinese government control of interest and deposit rates limits competitive leverage. Additionally, the cost of

capital to foreign banks induces restrictions. Foreign banks limited to issuing foreign currency must depend on state-owned banks to exchange currency. Costly foreign exchange rates encumber foreign profitability and provide significant cost advantages to local players. In order to overcome some of these obstacles, foreign banks have taken advantage of provisions allowing for minority stake ownership in domestic units. Currently, foreign banks are only allowed to operate in joint ventures with small and mid-size domestic banks, with a percentage of ownership at a maximum of around 20%.^{xxvi}

While minority ownership stakes help to alleviate some of the disadvantage posed by current market limitations, further relaxation of restrictions will provide necessary traction for increased viability. By 2005, foreign banks will be able to “freely” lend domestic currency to corporate entities or other banks. These extensions will apply to the consumer segment by 2007.

The easing of the standards in 2007 is the just the tip of the iceberg in terms of regulations. The WTO believes that equal footing for all banks in China is a non-negotiable term. Yet, Chinese officials still push for regulations to hinder foreign business and to shelter domestic banks. After the 2007 regulations cease to exist, other regulations will take their place. The following are a series of laws recently passed:

- Foreign banks entering China will have to pay \$12 million per branch opening in China.

- Only one branch opening will be allowed per year.
- Foreign banks will only be allowed to bank in RMB after they have shown two out of three years of operating profits. Only then will they be allowed to apply for a license to deal in RMB.
- Other regulations include having \$600 million RMB on hand (\$70 million US equivalent).

At a first glance, the WTO mandate seems to be reducing the formidable banking restrictions, thereby opening the doors to China's financial markets. However, the Chinese government's recognition of the competitive threats posed to domestic banks, and its protectionism has led to extended bureaucracy. Government attempts to further inhibit the success of foreign banks may not only impede overall industry growth, but also limit the advancement of potentially lucrative fledgling businesses.

Barriers to market growth

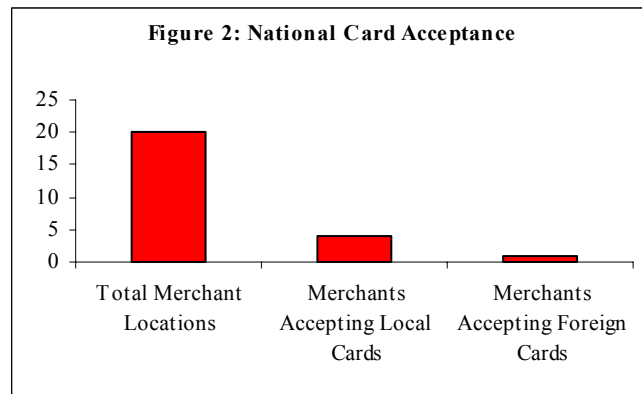
China has a number of factors that pose a challenge to the development and mass proliferation of consumer credit cards. Three principle issues constrict general growth of the credit card segment: undeveloped, fragmented transaction networks, inadequate credit bureaus and rating agencies, and a social ethos deeply rooted in cash transactions.

Fragmented Network –

China’s transaction infrastructure is limited to the major urban centers and suffers from lack of uniformity and limited penetration among merchants. In terms of market penetration, of the total 20 million Chinese nationwide merchants, just 400,000 accept local currency denominated bankcards just one-fourth of those merchants accept foreign denominated bankcards (Figure 2). The network

fragmentation issue provides an even more distressing concern.

In Shanghai, for example, there are sixteen different networks intermittently dispersed among a number of participating



merchants. Accordingly, this requires consumers to carry multiple cards in order to take advantage of bankcard transactions. This fragmentation not only precludes consumers from effectively using bankcards, but also provides a disincentive for merchants to offer this convenience. Businesses are reluctant to adopt a transaction system utilized by a few customers who happen to carry a card supported by a particular network. This quandary poses a challenge and begs for a response to the proverbial “chicken and egg argument.”^{xxvii} Should merchants adopt a uniform system and hope that consumers will conform or will critical mass from increased credit card adoption create demand for merchants to implement transaction networks?

China UnionPay, an integrated payment and cash card network formed by Chinese banks, including the four major lending institutions and 80 Mainland card issuing banks^{xxviii}, is working to remedy this situation.^{xxix} UnionPay aims to establish a uniform national payment system by 2005.^{xxx} China UnionPay's sights are set on an increase of merchant acceptance to the tune of 25% over the next five years - bringing the total to 30%. With the 2008 Beijing Olympics in the offing as well as the amplified influx of foreign travelers – estimates posted inbound tourism at around 97.9 million in 2002 – these forecasts are nominal expectations for infrastructure development. In contrast, international merchant acceptance rates in South Korea and the US hover around 87% and 71% respectively.^{xxxi} Since this network will be developed and controlled by the domestic players, foreign banks and credit labels must aggressively insert themselves in the development and support of the infrastructure. Partnering with UnionPay will be a bit thorny since the competitive threat of foreign banks renders the large state-owned banks keen to maintain a slight chasm between overseas and local organizations. Collaboration, however, is already palpable with the recent business fair co-sponsorship between MasterCard International and China UnionPay. The MasterCard/UnionPay partnership will serve to help educate the banking sector on the promise and importance of the payment card market. Additionally, they will help prepare bankers to launch effective sales strategies and improve orientation toward tailored consumer product offerings and marketing programs.^{xxxii}

Emerging Credit Bureaus –

In main land China, credit rating instruments are scarce. China only established public institutions to record credit information as recently as 1999.^{xxxiii} Much of this latency is a result of lengths are taken to protect consumer privacy. A lack of an integrated credit scoring system has contributed to the high default rates in neighboring Asian economies that carry parallel shortcomings. The impact of the inability of financial institutions to evaluate the credit worthiness of individuals is readily apparent in the record of individual bankruptcies in Hong Kong. An evaluation of the Hong Kong market revealed that the average bankrupt individual has borrowed from 12 financial institutions – amounting to debts that exceed 55 times monthly income. In the US, where consumer credit rating instruments are far more established, debt in individual bankruptcy filings accounts for 21 times monthly income.^{xxxiv} China, like its Asian counterparts, is adverse to publishing information that could potentially shed an unfavorable light on individuals. The incentive to provide and collect credit histories has been limited. In the past, Chinese government housing subsidies discouraged both consumers and consumer credit institutions to value credit worthiness assessments. As the paradigm shifts, the lack of a nationwide credit-rating bureau not only increases default risk for banks, but also makes card procurement difficult for consumers.

The Shaanxi Credit Bureau (SCB) is the first private, national credit network to establish a presence in China. SCB is majority-owned by Chinese businesses,

but the driving force of its efforts comes from a number of key US executives. In order to effectively evaluate credit worthiness of Chinese citizens, SCB will launch its own credit card. This credit card will simply be used as a means to monitor behavior and establish baseline ratings of consumers in a controlled environment. Once the agency gains critical mass from increases in merchant and financial institution membership, they will rely on sophisticated networks and information sharing to effectively appraise consumer credit ratings. SCB plans to have its operations fully functioning by the 2007 WTO deadline and estimates short-term demand for its credit card and rating services at a conservative 1 million users. US executives at SCB believe that they are in a unique position as industry first-movers because of their sensitivity to both Chinese businesses and consumers. An interview with Rhonda Sunes, a US-based spokesperson for SCB, revealed an optimistic outlook for the imminent success and mass proliferation of the rating concept. "We understand the mentality of Chinese consumers and employing sensitivity and education will ultimately enhance our prominence." SCB believes that increased discretionary income purchasing power, the ubiquity of e-commerce, and increased purchases of durable goods and homes will fuel rapid expansion. The establishment of a nationwide credit system is pivotal to the long-term success of the credit card segment. As other Asian countries have demonstrated, lack of a highly developed network rating system significantly impacts the viability and profit structure of financial institutions. Economists predict that, as credit ratings begin to gain credibility as

a tool for providing increased access to capital, Chinese consumers will increasingly rely on credit histories as a gateway to increased buying power.^{xxxv}

Psychological Reforms –

China's legacy of cash transactions provides a psychological hurdle to the prevalence of credit card usage. By evidence of the proliferation of debit cards versus true credit cards (500 million to 1 million), Chinese consumers are cautious to use financial tools that may facilitate them spending beyond their means. Currently, credit card purchases account for just 3% of total spending and credit card dispersion in the major urban centers hovers around a paltry 0.018 cards per person.^{xxxvi} Social and economic forces of change, however, will likely help the population transition. Zhao Jun, a Washington, DC Chinese Embassy official, believes that the consumer mindset will ultimately transform in favor of increased use of credit cards and debt instruments. "Credit cards are an incentive for consumers because they are easier to use and open opportunities for purchasing choices. From a psychological perspective, the prestige and sophistication that accompany this modern practice will ultimately drive demand." The market is already seeing marked interest from China's young adult consumers seeking to improve their purchasing power. Although true credit card penetration is limited, industry insiders estimate the number of eligible cardholders will reach close to 100 million by year's end. "Members of the high income group favored by banks include people who are aged 20-34, well-educated, without children, able to adapt to the market and earning at least USD

\$5,000 a year. About 90 million Chinese residents fall into that category, and the group will grow within three years to about 100 million.”^{xxxvii}

Credit Card Analysis China & Region

Chinese Banking Sector Domestic Institutions –

The Chinese domestic banking industry is comprised of XXX banks, but 70% of the market share is concentrated in four state-owned banks; Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and Agricultural Bank of China. While the WTO regulations serve to protect domestic banks from foreign competitor domination, sweeping reforms in domestic industry are essential long-term viability. Chinese banks are over run with inefficient transaction systems, large amounts of bad debt, sub-prime credit customers and a lack of modern banking services and practices.^{xxxviii}.

For several decades, domestic banks have served as financiers to debt-ridden public institutions. The shift from central planning to market orientation in the early-1990's further compounded this by obliging state-owned commercial banks to lend money to unsophisticated, poorly managed state-owned businesses. These loans, in combination with other corporate lending, have precipitated exceedingly high default rates and have rendered cash-strapped domestic institutions largely insolvent. Currently, failed loans account for \$500 billion - this represents about fifty percent of China's total economic output.^{xxxix} To combat China's hemorrhaging defaults, extensions of consumer banking arms and

lending diversification is imperative. The lure of the potentially lucrative credit card segment does not only offer offsets of mounting corporate debt, but also offers the promise of largely more profitable returns – the risk-adjusted return-on-assets for the credit cards yields 5%. In comparison, corporate lending generates an anemic .02% return.

The value proposition of the credit card segment has compelled domestic players to enter the market, but the limitations of penetration – largely due to infrastructure and credit rating shortcomings – create a difficult development climate. Additionally, consumer banking is a new arena for domestic banks that do not possess the expertise and experience to market and tailor products to individuals. Domestic banks now face the challenge of upgrading consumer offerings, customer service policies and infrastructure. While Chinese banks remain poised to combat threats from foreign entrants, competition will provide an incentive to sharply reduce the learning curve and expedite market maturity.

Chinese Banking Sector: Foreign Institutions –

The foreign sector is comprised of 190 individual institutions and accounts for just 2% of the total market. Five major institutions form the thrust of the foreign presence. These include Citibank, Standard Chartered, Bank of East Asia, Hongkong and Shanghai Banking Corp (HSBC) and Bank of China (International).

While foreign bank wisdom and technological savvy pose a threat to domestic industry and, as such, decelerate reform agendas, China's financial industry can benefit greatly from experienced leaders. As the restriction on these institutions relax, there is an opportunity not only to foster competition, but also help to inform the market and expedite development. Minority stake ownership opportunities appear to offer mutual gains to domestic and foreign players alike. The provision allows overseas banks a means of footprint expansion and increased market entry. Concurrently, domestic banks reap the benefits of longstanding market know-how, developed technology assets, and extensive consumer insights. The opportunities for minority ownership are not focused on China's major industrial players. Rather, foreign banks have focused their efforts on purchasing interest in mid-size institutions that are more amenable to partnerships. Small and mid-size banks are less cash-strapped than the behemoth domestic brethren. Consequently, increased stability, combined with the dexterity to gain rapid traction the credit card market, attract foreign investment.

The People's Bank of China recently approved Citibank's bid for a 5% stake in Shanghai Pudong Development Bank. Through this partnership, Citibank could be allowed to enter the consumer credit card market prior to the 2007 deadline. Currently, plans outline a co-branded local currency card to launch sometime near the end of the year. HSBC's 8% interest in Bank of Shanghai further demonstrates the prominence of minority stake investments.

Chinese Consumer Credit Demand (Current vs. Forecasted) -

The limited circulation of true credit cards offer extraordinary potential for

increased penetration. Given that

the industry is in a pre-growth

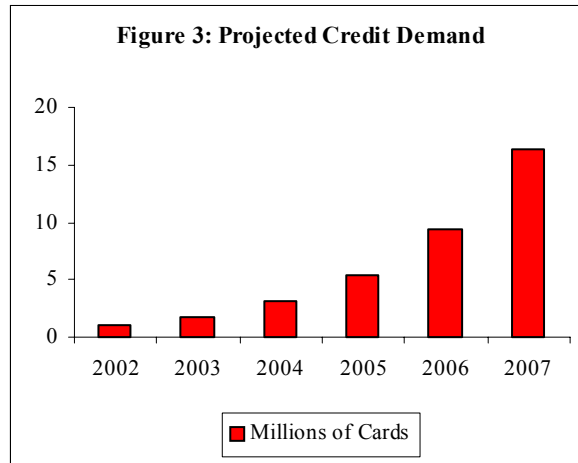
phase, it is not surprising that both

Visa and MasterCard international

portend minimum annual growth

rates of 75%. Figure 3 shows a

projection of credit card circulation



through 2007. Growth projections are based not only on the significant market

potential but also on indicators of latent demand extant in several sectors of the

economy. Cell phone use is correlated with the type of discretionary spending

that would be associated with credit card use. The number of handsets among

Chinese consumers has grown to nearly 200 million.^{xi} Additionally, consumer

lending is at an all time high. Mortgage lending and personal loans are more

numerous now than they have ever been. Mortgage loans now account for 80%

of personal loans.^{xii} Lastly, the GNI growth that China's most affluent cities have

experienced means that critical levels of affluence have been attained. Analysts

estimate that for every dollar of income over \$5,000, \$0.60 cents might be used

for discretionary income.^{xiii} Credit card companies hope to take advantage of

these growing trends in consumer discretionary spending.

Analysts' surveys also indicate consumer interest in credit cards. ACNielsen, in a survey of Shanghai, Beijing and Guangzhou, found that people express a strong interest in individual financial services, such as banking, credit cards, and life insurance. Some segments warrant particular attention for credit companies. For example, among 18-24 Shanghainese 65% of the population whose income is more than \$301 USD are interested in possessing an international credit card.^{xliii}

Credit Use in Nearby Regions –

Credit use in Hong Kong and South Korea serves as a historical precedent for the development of China's credit card segment. Parallels in cultural practices and economic development are instructive to the pattern of credit development in a market such as China.

Both Hong Kong and Korea have experienced alarmingly high rates of bad debt write-offs. This expense constitutes the single largest loss in credit card businesses. In contrast to the US, where delinquency rates hover around 5%, South Korean 2002 delinquency on credit card debt was 9.12%. In Hong Kong, the average delinquency ratio for 2002 was 11.57%, a 131% increase over average US rates.^{xliiv} While the US market earns credit providers consistently positive rates of return, the private banking sector in Hong Kong and Korea have consistently under-performed due in large part to the high write off of bad debt on credit receivables.^{xliv}

The difficulties presented to credit labels by high level of delinquency rates in Hong Kong and South Korea are compounded by the limited availability of consumer credit information. For example, in Hong Kong, limited consumer credit information can be shared between financial institutions. Without this information, the sophisticated scoring models developed in the United States to segment customers are not nearly as effective.^{xlvi} The result is offering credit card loans to ineligible consumers, or offering rates to consumers inconsistent with their credit profile.

Strategic Agenda and Five-Year Outlook

Challenge –

Forays into a marketplace with a populace uneducated on the market offering bear the risk of loss. Credit companies moving into China will face a double-sided challenge – increasing demand by convincing broad numbers Chinese to adopt credit, while simultaneously establishing instruments that will effectively evaluate and score credit worthiness and manage risk exposure. In the opening of the market, while moving from a debit to credit culture, defaults should be expected. It is not yet clear how the Chinese consumer will react to the use of credit, however, surrounding economies with similar cultures, and high rates of credit default, serve as a cautionary flag to the burgeoning industry in China. Paradoxically, though future profitability depends on building a large consumer base quickly, the faster companies grow, the more money will be lost on the front end. Credit labels should anticipate losses over the short term. However based

on demand forecasts of upwards of 15 million true credit accounts by 2007, companies should maintain the expectation that future revenue streams will compensate for start up costs.

Opportunity –

It is indubitable that the Chinese credit card segment is ripe for expansion. Driven by future profit potential, infrastructure shortcomings are likely to dissipate, and credit rating agencies likewise will undergo substantial development and expansion. Although foreign investors are limited by short-term government regulations and an infant industry, the opportunity to play a significant role in the development in this segment is substantial. Short-term strategies require substantial collaboration with incumbent Chinese institutions. This minority investment opportunity provides a unique entry mechanism. Over the short term, financial institutions should plant to attain three principal goals: capitalize on minority ownership investment opportunities; work collaboratively with government-owned entities, clearinghouses and nascent reform initiatives to improve market conditions; and use discretionary spending and parallel industry growth indicators as guides for demand forecasts.

As Shan Gooptu summarizes, “The reform is there, the deadline is there, the path is there. People who are getting in now are acting on expectations.” Credit card companies, by entering the Chinese market are poised to reap substantive returns. The large population, the growing consumer affluence, free market

reforms, and the opening of the banking sector provide models that multinational credit companies can not forego. Analysis indicates that latent consumer demand for credit offerings does exist. For credit companies, overcoming a period of initial loss will depend on the velocity at which a credit base can be built. Credit companies should act now to avail themselves of first mover advantages in this nascent market. Over the long term foreign financial firms entering the Chinese market should be cognizant of sustainable competitive advantages: proprietary intellectual capital, experience curve position and industry knowledge from comparable market development.

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