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GLOBALISATION 2.0 FOR CHINESE FINANCIAL INSTITUTIONS

Fast-forward to a multipolar banking system

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CONTENTS

EXECUTIVE SUMMARY

A rapidly evolving domestic and international landscape is shaping a new wave of internationalisation opportunities for Chinese Financial Institutions ("FIs"). In addition to opportunities, there is a defensive motive too: the opening up of the Chinese Financial Services ("FS") industry to foreign players creates additional pressure and urgency to internationalise to maintain competitive positioning and expand existing relationships with Chinese clients.

While the COVID-19 pandemic has triggered worldwide discussions on "de-globalization", the situation has seemingly increased China's commitment to becoming open to the world. As such, this might accelerate rather than slow down the process of globalization for Chinese FIs.

This report discusses the varying opportunities for Chinese FIs to internationalise, outlines our views on the key strategic agenda for outbound trategies, and highlights key battlegrounds likely to determine winners.

Section 1 explores the urgency and opportunities for Chinese FIs to internationalise. The state-driven push for global Chinese champions, financing requirements for the Belt and Road Initiative ("BRI"), listing of Chinese corporates, and resulting creation of a new generation of (ultra-)high net-worth individuals ("(U)HNWIs") has shifted the macroeconomic narrative. This creates global needs to serve Chinese clients across investment banking, corporate banking, asset management, and private banking..

At the core Chinese FIs will continue to follow local clients as they pursue global opportunities. Chinese FIs have a clear advantage here: global players have found it challenging to maintain strong performance and capital efficiency across international geographies. However, internationalization beyond serving local clients remains challenging for Chinese FIs. Asian FIs have not typically been able to sustain their global success, with most that expanded still earning a majority of revenues in their home markets.

Section 2 highlights five key strategic topics for Chinese FIs to consider as they articulate their positioning and value propositions in order to become truly competitive in the global arena.

We see an opportunity for Chinese players to develop global businesses that offer their clients universal banking solutions, mirroring the success global peers have had in offering holistic solutions that both increased investment banking revenues and secured additional net new assets. Further, Chinese players can grow in scale and offering breadth through partnerships with FinTechs and regional FIs. This has the additional benefit of being "capital light". Chinese players will also transform global approaches, with a distinct approach to connectivity and unique business models (which are increasingly becoming the benchmark in emerging markets).

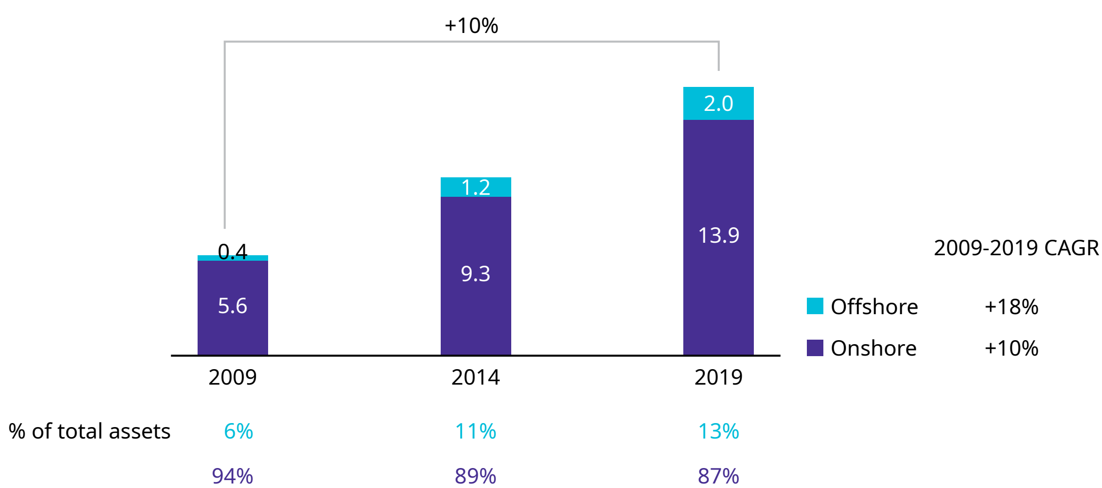
Broad opportunities notwithstanding, Chinese FIs need to selectively identify the overseas markets to grow, using a top-down steering approach. Tracking the typical emigration and offshore allocation hubs of Chinese (U)HNWIs and global financial centres is a good place to start. Chinese FIs also need to design operational setups to align with overseas aspirations, and ensure they develop sound governance models compatible with global best-practices.

Section 3 identifies three key battlegrounds for the future of the FS business, with specific focus on areas we see overlap between Chinese and Global FIs. As Chinese players internationalise we see intense competition, but also opportunities for collaboration. The three key battlegrounds include pan-Asian and BRI markets, onshore Chinese markets, and the established home markets of Global FIs with strong Chinese "real economy" presence.

1. A NEW ERA OF INTERNATIONALISATION

Over the last decade, Chinese FIs have gained substantial scale. The five major Chinese banks boast nearly US$16 trillion total assets. To put their sizes in context, the profit before tax for Industrial and Commercial Bank of China, the largest Chinese bank among all, reached US$55 billion in 2019, which was comparable to the market capitalization of some of the large American or European banks. At the same time, Chinese FIs have been actively following their customers as they "go global". Overseas assets of the five major Chinese banks now exceeds US$2 trillion, accounting for 13% of their total asset base (see Exhibit 1).

Exhibit 1. Total assets of five major Chinese banks (offshore vs. onshore)
US$ trillion



Note: Includes Industrial and Commercial Bank of China, Bank of China, Agricultural Bank of China, China Construction Bank, Bank of Communications

Source: Capital IQ, Oliver Wyman Analysis

There is now more urgency to internationalise. The opening up of the onshore Chinese financial industry means Global FIs will gradually be able to develop relationships with the large Chinese corporates, by offering an integrated onshore-offshore proposition.

As the Chinese economy matures, leading Chinese corporates increasingly service the needs of the global real economy and are actively expanding their footprint overseas. They are also seeking funding in global markets: over 2000 Chinese companies are now listed abroad. This wave of global IPOs has led to the rise of a new-generation of Chinese (U)HNWIs with material offshore wealth. We estimate that total investable assets by Chinese HNWIs (defined as total investable assets of US$1.5 million or above) has reached US$9.5 trillion by 2019, with 20-25% of assets located offshore.

Policy-makers are also encouraging the internationalization process of Chinese FIs. In part this is in support of the “Belt and Road” initiative, but more fundamentally due to political desire to build Chinese domestic champions into global leaders. As an example, from 2017 the China Securities Regulatory Commission (“CSRC”) has measured “percentage of overseas revenue out of total revenue” as one of the key criteria to evaluate the competitiveness of securities companies[1].

(The objective is) to support securities and fund management capabilities fulfilling the requirements to “go abroad” … to gradually improve cross-border financial service capabilities and offshore competitiveness.

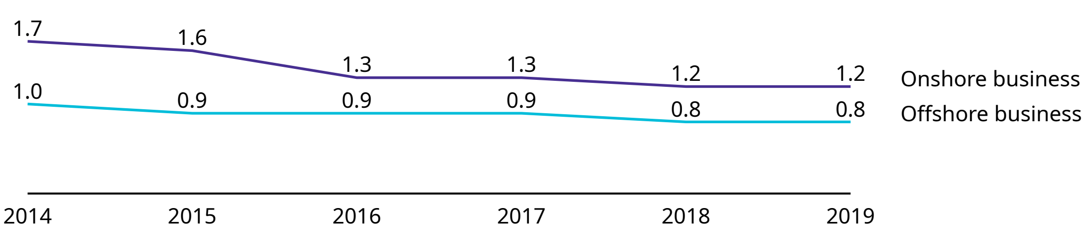
Qingming Yan, Vice Chairman, CSRC [2]

The massive restructuring of the global FS landscape provides a unique opportunity for outbound Chinese financial institutions. We have seen global players cutting down business lines, outsourcing operations, and retreating from underperforming Asian markets. Amid the COVID-19 pandemic, we anticipate revenue and profitability pressure may lead to further consolidation of smaller players, although it is less likely for major global players to run into solvency challenges given the sufficient capital and liquidity buffers built over the last decade[3]. Chinese FIs can take advantage of the retreat of global players. Greater risk appetites, larger balance sheets, and longer profitability horizons enables them to pursue such expansion.

Internationalization is not without challenges. There are limited examples of truly successful global Asian FIs. While Chinese banks have now attained a meaningful proportion of overseas assets and revenues, the profitability of their overseas business is still much lower than that of the domestic business (see Exhibit 2). In the next section, we provide several practical recommendations to build stronger international businesses.

Exhibit 2. ROA of five major Chinese banks’ onshore vs. offshore businesses

%, 2014-2019



Note: Includes Industrial and Commercial Bank of China, Bank of China, Agricultural Bank of China, China Construction Bank, Bank of Communication. Formula: ROA (T) = Segment profit before tax (T) / Average segment assets (T, T-1)

Source: Capital IQ, Oliver Wyman Analysis

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1 Regulations on Classified Supervision of Securities Companies. The evaluation result is typically considered when deciding which securities companies would be awarded the qualifications of innovative businesses.

2 China Securities Regulatory Commission. Speech by Vice Chairman Yan Qingming at the General Meeting of the 2019 Financial Street Forum Annual Meeting. China Securities Regulatory Commission. (3 June 2019). Retrieved from: http://www.csrc.gov.cn/pub/newsite/zjhxwfb/xwdd/201906/t20190603_356699.html

3 Refer to our joint publication with Morgan Stanley: Corporate & Investment Banks — Steering Through the Next Cycle (2020)

2. STRATEGIC AGENDA FOR CHINESE PLAYERS INTERNATIONALISING

Chinese players need to clearly identify and articulate their positioning and value proposition in order to become competitive in the global arena. Today's global FIs anchored around their core positioning (for example, EU banks on their private banking and corporate banking solutions, and US banks traditionally on their investment banking capabilities). Regional FIs have adopted varying models for their international business. For example, the Japanese megabanks lead with their balance sheets; while the Canadian and Australian banks anchored their strategies around their sectoral experience, especially in commodities.

The space for Chinese FIs is not yet obvious. While a "leading with lending" approach to outbound expansion may appear straightforward (given the enormous balance sheet strength), the reality is that the needs of end-users are growing increasingly complex, and deploying cross-border funding is challenging given currency-controls. Amid diminishing returns in lending, Chinese FIs may get stuck with large balance sheet commitments without cross-sell opportunities. In addition, it is critical that outgoing Chinese FIs carefully manage potential risks and navigate compliance challenges.

In this Chapter, we will lay out five key strategic agendas we see for Chinese FIs as they look overseas.

2.1 BREAKING DOWN THE TRADITIONAL BUSINESS MODEL "SILOS"

Chinese FIs operate largely in a "compartmentalised" fashion, driven by the entity-based regulatory regimes in mainland China. This has diminished the attractiveness of their offerings to clients overseas, when compared to global banks who adopt a universal banking model which allows them to provide a one-stop-shop solution to clients with sophisticated demands.

Outside of FS, Chinese giants have demonstrable success challenging legacy business models. Similarly, Chinese FIs should look to better integrate their businesses and offerings in their outbound expansion attempts. One approach entails replicating global banks that pursue an integrated Investment Banking ("IB") and Private Banking ("PB") model to fully penetrate both the personal and corporate wallets of their clients (see Exhibit 4). The model has proved successful for others: leading global players have realized up to 10-15% additional investment banking revenue and 10-20% additional net new assets under management by adopting a universal approach.

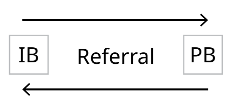
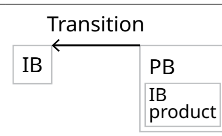
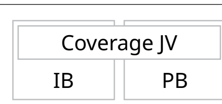
This model is highly relevant for Chinese players, given their privileged access to the rapidly emerging Chinese business owners and entrepreneurs. On the business side, these companies will need access to financing solutions as they pursue their growth ambitions. Concurrently, owners of these huge companies require wealth management services for their offshore assets and wealth.

In order to take advantage of this opportunity Chinese FIs need to break the silos between their IB business (that typically sit under the securities entity) and the PB business (that sit under the banking entity). To successfully execute on this, Chinese FIs need to design an effective coverage model across different businesses, clear incentive schemes to reward cross-sell activities and develop corresponding trainings to up-skill their teams (see Exhibit 3).

Similarly, Chinese FIs should also break the siloes between the business (for example, sales and trading and private side teams) and teams responsible for making balance sheet decisions, in order to capture cross selling opportunities between low margin lending and hedging products.

As a side note, Chinese FIs can also treat the business model innovation for their offshore businesses as a means to test the universal banking approach. The experiences can be leveraged to drive future innovation in their onshore models, especially if current regulatory constraints were to be relaxed.

Exhibit 3. Potential coverage models to encourage IB-PB collaboration

Model	Description	Illustration	OW perspectives
Formalized referral model	• Formalized revenue-sharing Joint Venture ("JV") to incentivize cross-sell within single organization or with a third-party		• Introduction of revenue share creates additional upside for collaboration • Revenue sharing mechanism (for example, hard vs. soft dollar, group vs. individual attribution) critical to incentives efficacy
Embedded coverage	• Wealth Management ("WM") sells embedded IB product, but transitions ownership to IB post-sale • Unilateral referral relationship from WM to IB		• Increases sales of IB products to WM clients • Miss opportunity of referring IB clients to WM business
Joint coverage	• Coverage jointly owned by IB and WM with share of revenues across divisions • Potentially with own branding		• Shared responsibility enables strong leverage of both IB and WM expertise • Holistically addresses client needs — effective for UHNWIs and entrepreneurs • Requires closer coordination and set-up

Source: Oliver Wyman Analysis

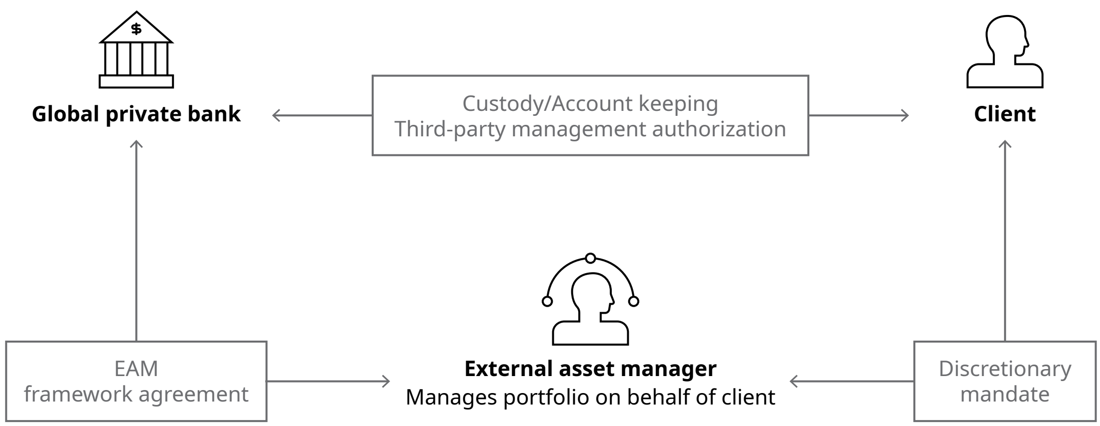
2.2 EXPLORING PARTNERSHIPS TO ACCELERATE GROWTH

While Chinese FIs have strong access to customers, they currently often lack comprehensive global solutions. Building such capabilities internally will take considerable time and capital. To accelerate growth Chinese players should explore "partnership" approaches in parallel to existing organic build plans.

Within the capital markets space, Chinese FIs can leverage the proliferation of financial technologies across the trading value chain, from pre-trade, trade, through to post-trade solutions. This could include working with a range of electronic dealer-brokers, research aggregators and non-bank liquidity providers to provide a seamless full-service offering to clients.

In the wealth management space, leading global players have opened up their proprietary product platforms through external asset manager ("EAM") models. Such EAM partnerships can immediately provide Chinese players with a comprehensive global product shelf. This would allow Chinese wealth managers quickly monetize their existing client relationships by fulfilling clients' offshore wealth management mandate (See Exhibit 4).

Exhibit 4. Illustration of External Asset Manager Model

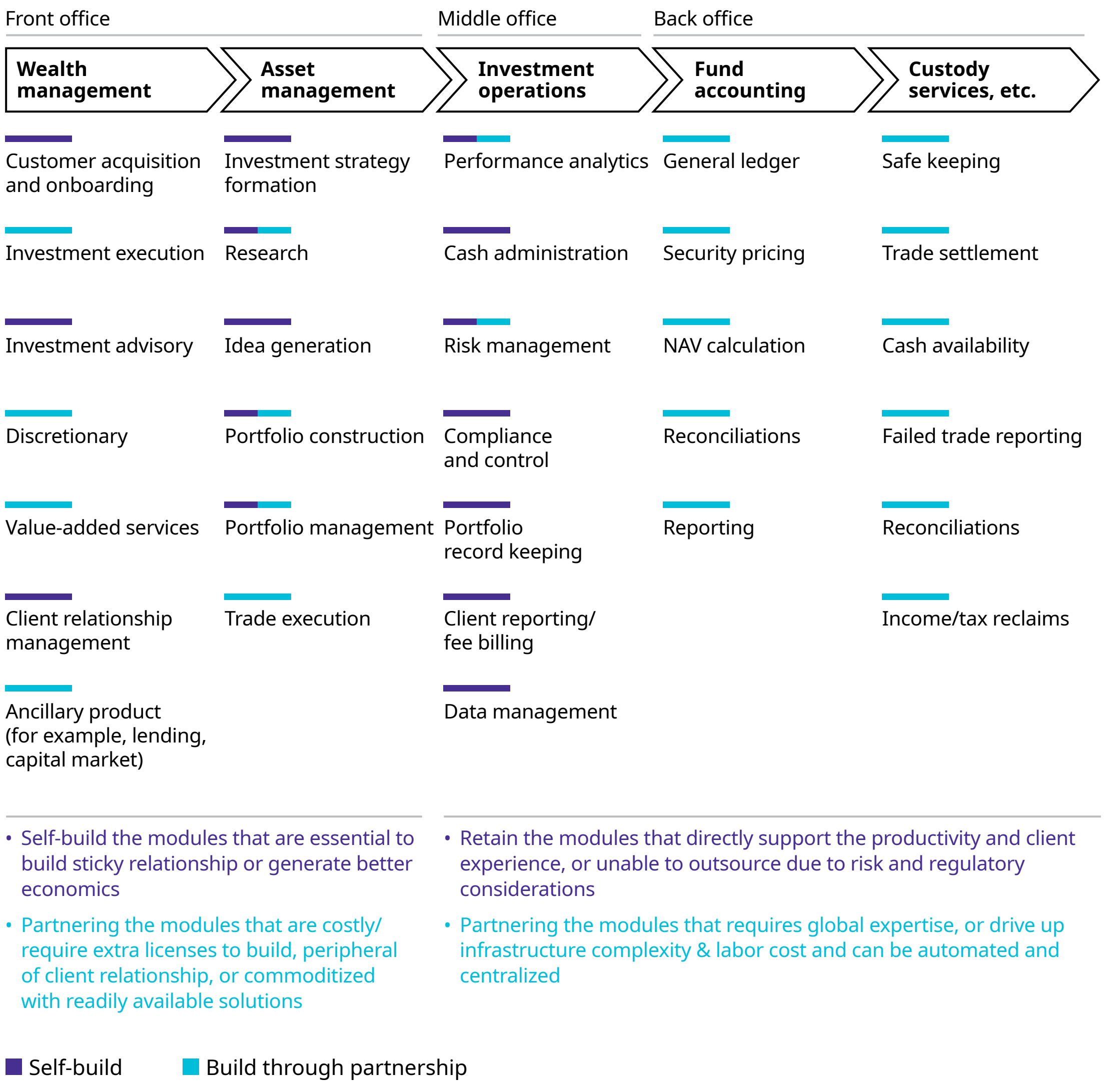


Source: Oliver Wyman Analysis

Chinese FIs should carefully determine which elements of the value chain to build, buy or rent from partners. This decision will depend on their outbound aspirations, customer segments, and associated value propositions, as well as an objective evaluation of their own strengths and capabilities. In addition, partnership might offer a temporary solution prior to insourcing the capability, where economics or product design flexibility over the longer term make that attractive.

As an example, within the wealth and asset management value chain we think it is critical that Chinese players own the components related with building customer trust and leveraging client relationships. On the other hand, Chinese FIs can look to partner on components which do not touch the client, benefit from scale, are capital intensive, require technology builds, or require obtaining additional licenses (see Exhibit 5).

Exhibit 5. Self-build vs. partnership design along the wealth and asset management value chain



Source: Oliver Wyman Analysis

2.3 EXPORTING CHINESE KNOW-HOW TO GLOBAL MARKETS

While Chinese FIs have a lot to develop, global players are taking inspiration from Chinese FIs to enhance their service offerings to clients. One example includes the tech-led banking revolution that Chinese FIs have spearheaded, with direct retail participation across financial services rather than a dependence on financial intermediaries. We see great opportunities for Chinese FIs to pioneer the export of their know-how to the rest of the world.

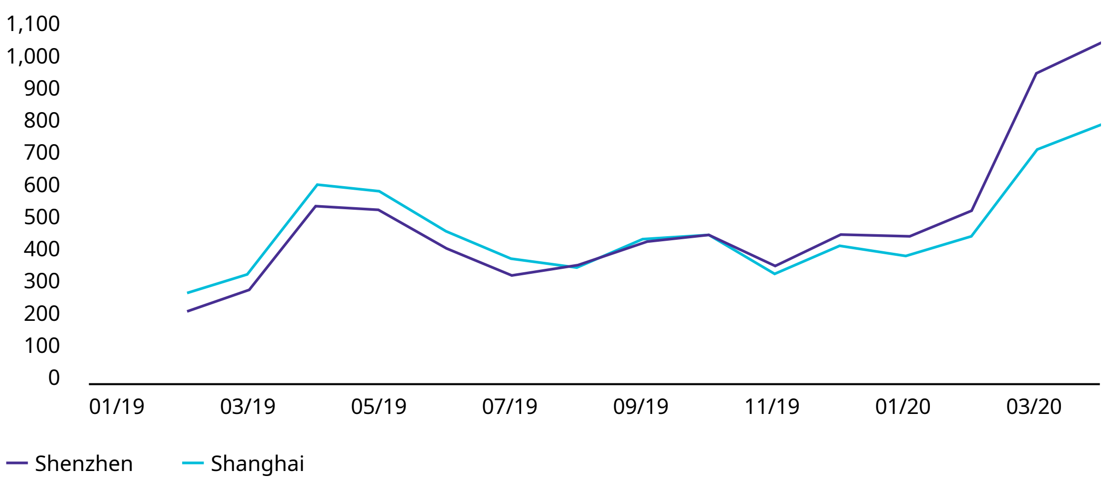
Leverage China connectivity

In recent years, Chinese regulators and FIs have focussed on bringing increasing connectivity of financial services to the world. The continued development of inbound schemes (for example, Stock Connect) and the removal of quota restrictions of the Qualified Foreign Institutional Investor ("QFII") scheme are two such examples. Global investors have doubled down on their China commitments; even the ongoing COVID-19 pandemic has failed to curtail the explosive growth in northbound Stock Connect turnover (see Exhibit 6).

Much like the significant cost it takes for Chinese FIs to build global investment capabilities, Global FIs find it costly to build competitive China capabilities. There is an opportunity for Chinese FIs to partner with Global FIs to export China connectivity. Chinese FIs are able to fully monetize their content and access by leveraging the global partners' client networks (for example, American and European pension and endowment clients) which would otherwise be out of reach. Global FIs gain by providing their clients with access to rapidly-growing Chinese investment opportunities. We have seen increasing Global-Asia partnership, for example in the investment banking space, where Kepler Cheuvreux has formed partnership with Macquarie, and Jeffries with BOC International.

Exhibit 6. Total northbound stock-connect traded volumes

Total monthly traded volume
RMB million, Jan 2019 – Mar 2020

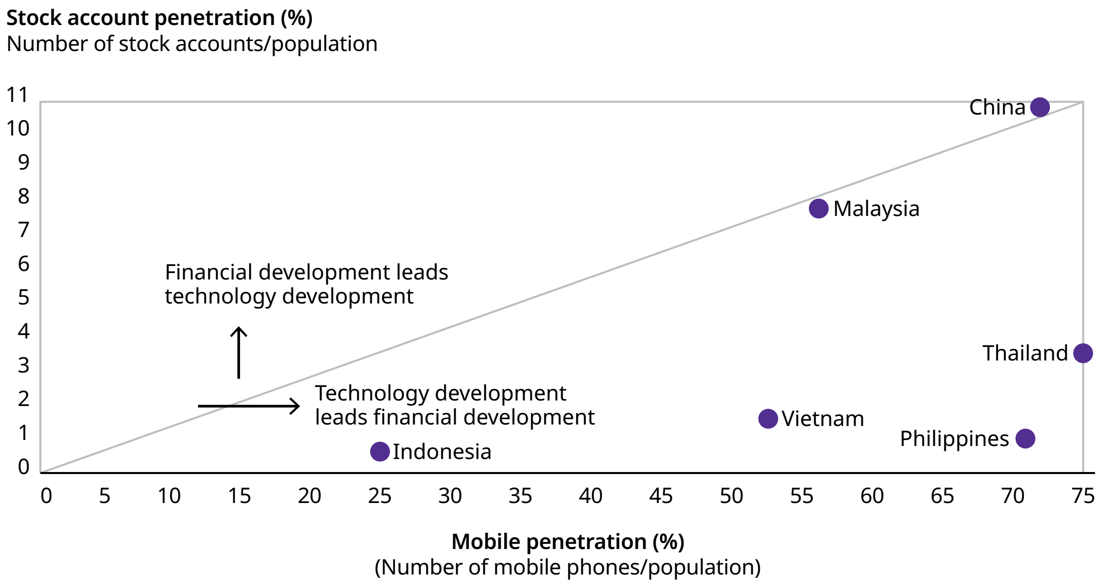


Source: Hong Kong Exchanges and Clearing Limited

Export China model

The experience of Chinese financial institutions from the last decade is also relevant for emerging markets (for example, Southeast Asia). Many of these markets are expected to experience similar development as what China has gone through in the last decade, hence would contribute more growth compared to the mature economies. These markets have also demonstrated more advancement in digital technology compared to the financial services, where there are potential opportunities for digital players to fill the financial gaps as it happened in China (see Exhibit 7).

Exhibit 7. Comparison of financial & investment development of various Asian markets



Note: 2019 data

Source: Bursa Malaysia, Stock Exchange of Thailand, Vietnam Securities Depository, Philippine Stock Exchange, Indonesia Central Securities Depository, Eastmoney, BMI, EIU, Credit Suisse, Oliver Wyman Analysis

Local digital ecosystem champions (for example, Grab, GoJek) in emerging Asia are trying to replicate the tech-led banking revolution experiences from China. The rapidly growing internet penetration and significant unbanked population led local governments to invite Chinese FIs to drive innovation and increase retail participation in financial markets.

These may provide opportunities for leading Chinese players to invest into local players and/or shaping up new joint ventures to bring together local connection and expertise from China.

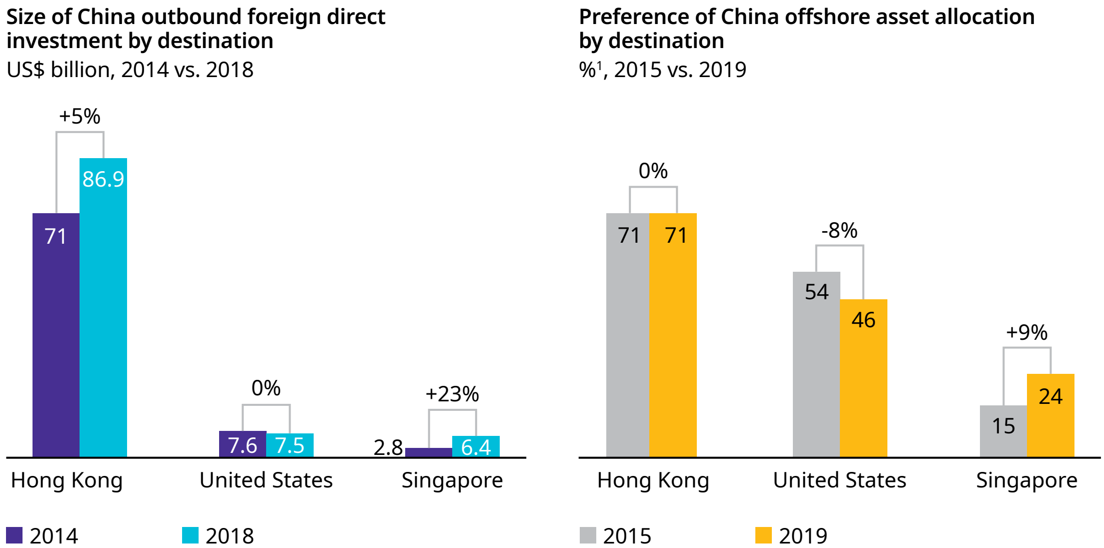
2.4 DEVELOPING ADDITIONAL — BUT COORDINATED — FOOTPRINTS

While Hong Kong has traditionally been the main international hub for Chinese FI outbound expansion and will remain as such, Chinese FIs should consider a broader footprint across different markets to capitalize on the changing global socioeconomic and geopolitical dynamics. Chinese FIs should develop a clear assessment of their aspirations, and top-down portfolio strategy to determine the specific markets to expand into.

To date Chinese FIs have considered typical emigration and offshore allocation hubs of Chinese (U)HNWIs (for example, Singapore, Australia, UK) and global financial centres for securities and asset management propositions (for example, New York, London).

Wealthy Chinese individuals have continued to open accounts and purchase property in Singapore, which has also become a popular alternative remote booking centre to Hong Kong in recent years. In addition, Singapore has been actively aiming to become a capital markets leader in the region, with huge emphasis in driving debt markets, presenting attractive opportunities for capital parked in Singapore. The impact has been a material increase in China outbound foreign direct investment (see Exhibit 8).

Exhibit 8. Comparison of preferences in outbound locations for Chinese capital



1. Do not add up to 100%. Multiple choice survey

Source: MOFCM, China Merchant Bank, Oliver Wyman Analysis

In addition to following Chinese money, we believe there is now an opportunity for Chinese players to inorganically acquire existing FIs to accelerate their footprints overseas, especially as the economic crisis following COVID-19 has materially depressed valuations. However, outbound-looking Chinese FIs need to carefully evaluate these opportunities, understand the market dynamics of which the targets operate in, and think through how the targets would fit into their overall global strategies. In the last decade, several Chinese players that acquired some mid-sized global banks were challenged from low revenue and return on investment, as they have underestimated the complexity and the macro headwinds of the acquired business and subsequent integration.

2.5 ADAPTING GOVERNANCE MODEL FOR GLOBAL BUSINESS

To ensure sustainable overseas expansion, Chinese FIs need to develop sound governance models that are compatible with compliance and legal frameworks in each jurisdiction. The stakes for financial institutions are high amid strict foreign regulators. In 2018 and 2019, the Hong Kong Securities and Finance Commission ("SFC") doled out about HKD100 million in fines to Chinese players.

Firstly, Chinese players need to strike the right balance between building a centralised middle- and back-office support team in their headquarters with building localised functional capabilities in overseas markets. While it is tempting to maximize the economics of scale with one centralized support team, it is important to ensure in-depth local market knowledge (for example, compliance, HR) to point out potential issues early (see Exhibit 9).

Exhibit 9. Key questions for target operating model for the overseas business

1. Organization

- What should be the **local office setup**? What positions and functions do we need in each overseas market?
- What are the **boundaries and limitations of operations** in each market (for example, license constraints)?
- What is the **hierarchy and reporting relationship** within and between local offices and headquarter?
- What are the **roles and responsibilities** of local offices and headquarter respectively?

2. Governance

- What is the **governing and decision-making process** between loca offices
and headquarter across different functions such as HR, compliance, strategy?
- To what extent should **decisions** be **centralized/decentralized** and how to ensure accountability?
- How should people be **motivated, evaluated and rewarded**?

3. Personnel

- What activities and which positions should be **localized**?
- What activities can be efficiently **organized and shared across local offices**/headquarter, for mid to back office roles?
- How should these activities be shared?

4. Process

What are the **key capabilities** and **end-to-end process**s required to achieve the strategic goals in each local office, such as:

- Synergy/referral?
- Operational coordination?
- Strategy/culture communications?
- ...

5. System

- What **management system**s (for example, MIS, risk management, feedback mechanisms) do we need in order to embed the operating processes within the organization?
- To what extend should systems be **standardized while meeting local needs** (for example, regulatory requirements, reporting needs)?

Source: Oliver Wyman Analysis

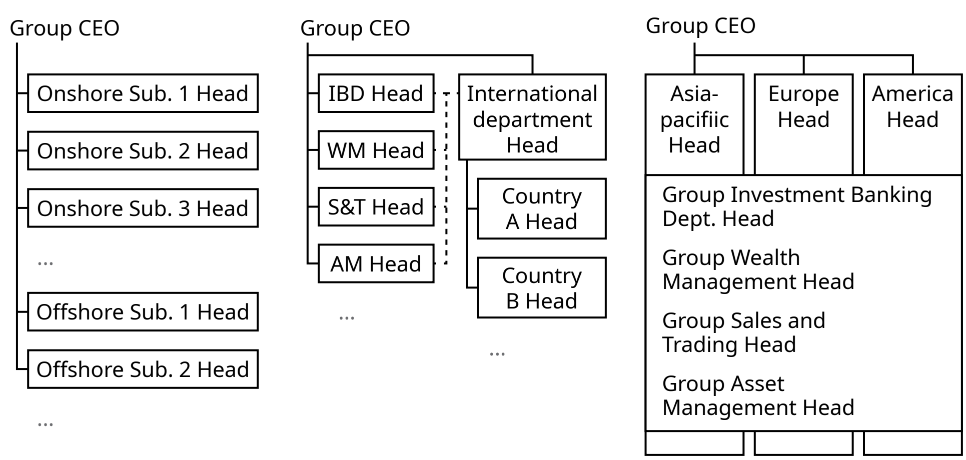
Another typical challenge is to strike the right balance between the entrepreneurial — or sometimes sales-driven — mentality with a need for prudent risk management and regulatory-compliance. This often requires a cultural shift. For example, in the wealth management space, Chinese relationship managers need to carefully manage their product-push models amid stronger fiduciary duty requirements in offshore markets. Further, there can be a need to adapt compensation schemes to consider not only sales targets, but also other key performance indicators that drive behaviours in developing comprehensive client understanding and ensuring portfolio and product suitability.

Chinese players also need to adapt their organization structure and governance models to ensure appropriate degree of oversight and management of their overseas operations is balanced with the practical need for independence and national-level decision-making. This is also critical for attracting and retaining global talents that are much needed for Chinese FIs to compete in the global arena. The largest Chinese players have set up an international business department that is responsible for overseeing all offshore entities in a coordinated fashion and developing centralised capabilities to support all the overseas offices. However, often the major barriers to success are found to be cultural rather than organization-design related. When Chinese players become truly global in scale, they may need to further consider developing a matrix-based organization that is typically adopted by global banks (see Exhibit 10).

Exhibit 10. Different organization structure models for overseas business

Overseas business maturity	**Early stage**	**Transition stage**	**Mature stage**
Model	**Standalone entity**	**Offshore consolidated**	**Matrix**

Illustration



Example players	Typical for Chinese banks/securities	Typical for regional banks (for example, Japanese and European banks)	Typical for global banks

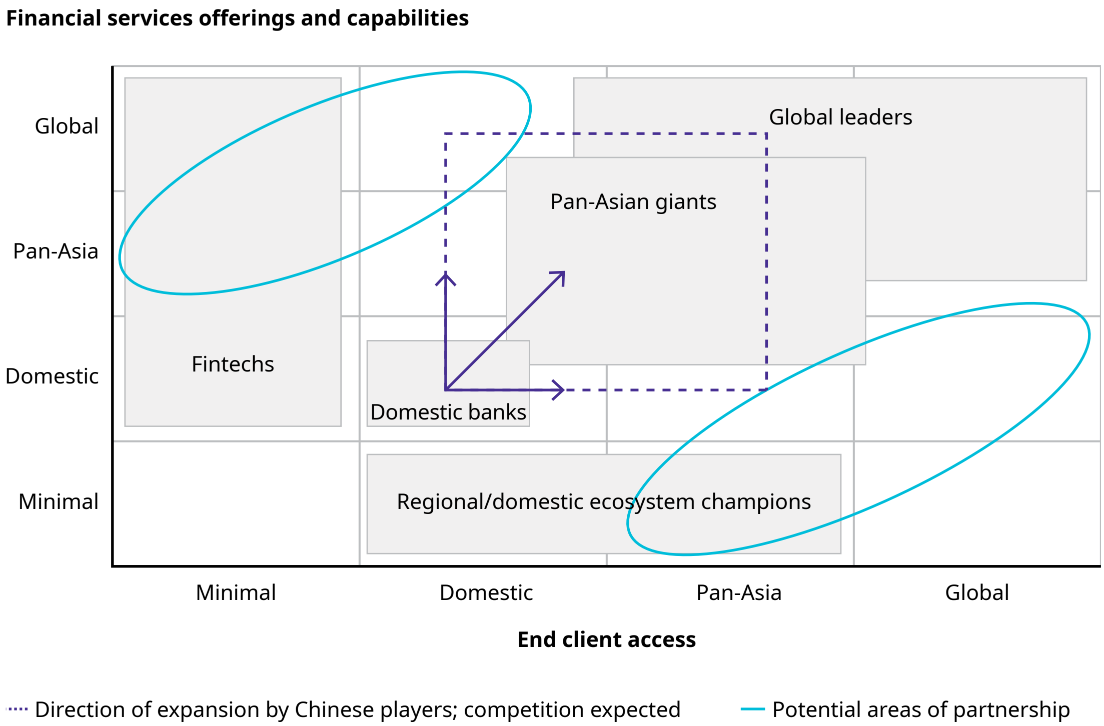
— Primary reporting line   - - - Secondary reporting line

Source: Company annual reports, Oliver Wyman Analysis

3. IMPLICATIONS FOR GLOBAL PLAYERS

The internationalisation of Chinese FIs will lead to fundamental changes to FS globally. While we anticipate ever-increasing competition between incumbents the largest Chinese FIs in serving the largest global clients, we also see new collaborative opportunities being created (see Exhibit 11).

Exhibit 11. Future competitive landscape between different types of players



Source: Oliver Wyman Analysis

Chinese FIs will need time to develop global product capabilities and solutions that would truly position in a position to truly compete with global FIs in Europe and the Americas. But be in no doubt: this is coming, and the much longer-term planning horizon driving Chinese decision-making will make this a huge challenge. In the near-term, we see three key battlegrounds:

Onshore China: The current regulatory climate is increasingly receptive to foreign players that seek an onshore China presence. Further, the political system is actively seeking global best-practices to enhance the bank-driven funding model still prevalent in China. This is especially true in the development of the wealth and asset management spaces, which to-date have been more susceptible to higher-risk products and shadow banking.

The de-regulation, however, does not change the significant advantages presented to incumbent Chinese FIs. Instead, Global FIs should look to develop anchor client relationships, and invest intelligently to build up an onshore China footprint. A possible option entails leveraging their offshore partnerships with Chinese banks for onshore partnership in return to curate a win-win scenario for both sides.

Pan-Asia and BRI Markets: This is likely to be the battleground with the most heads-on competition across Chinese, global and existing pan-Asian FIs. These markets remain a source of growth for all players, without a clear leader. Pan-Asian FIs have been attempting to grow market share, but recent focus has also shifted to home markets given the retrenchment of global players. Winning in BRI markets will require clear strategies and value propositions that differ from global and Chinese players.

Global players also struggle at times in BRI markets — with limited risk appetites and compliance-related concerns. In addition, the size and scale of each individual market means they are often not a priority, and finding the right teams, with culture, relationships and approach is a real challenge.

While Chinese FIs often start from behind, and suffer similar concerns to global peers, they also have distinct advantages. First, the linkage between infrastructure projects (often built by Chinese SOEs and financed by Chinese banks) with the real economic development provides a unique insight. Further, their ability to tap-into political linkages is strong, and the funding provided by large Chinese public-private funds (such as the Silk Road Fund) can also provide a unique edge.

Selected global markets: The size and profitability of Chinese banks will allow them to grow, both organically and inorganically, in global markets. We believe that the initial entry will likely be in those markets that are currently sub-scale, have a digitally-savvy population, and where banks suffer from relative lack of capital and/or funding. This would include certain European and South East Asian markets.

The outbound expansion plans by Chinese FIs will require rear-guard action from Global FIs. Specifically, Global FIs can take advantage of Chinese FIs' lack of global solutions to engage in partnership/outsourcing plays so as to fully leverage their existing platforms and find additional revenue streams to make the best out of the fixed costs. Concurrently, the onus is on Global FIs to develop products that allow their existing customers to access Chinese investment opportunities (for example, RMB trading, access to Chinese bond and equity markets).

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