

**The credit card market in mainland China:
Billion dollar gamble or 1.3 billion person bonanza?**

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Miss Yuan, a high school language teacher, has been investing in money market funds for the past several years instead of keeping her money in savings. Recently, she applied for a credit card and quickly discovered a new use for it. Every month when she gets paid, she keeps 1000 yuan in cash, and uses her credit card as much as she can for all her other regular consumption. She invests the rest of her monthly salary in money market funds that expire the day before she needs to pay off her credit card. Although the money market fund interest is only about 2%, it's still higher than interest on a savings account. She then pays her monthly credit card charges off, thereby making a small profit on the short-term loan her credit card provides her with ("Money Makes Money").

A. Introduction: Just how big is the potential bonanza?

From virtually no loans to individuals in 1995, the consumer credit market in China has exploded over the past several years.¹ Banks are now competing with each other for consumer loan customers with home loans, home improvement loans, car loans, student loans, loans for vacations, everyday consumption, medical expenses, getting married—not to mention the virtual explosion of credit, debit and smart card services. Bankcard transactions have risen about 30% per cent annually from 2001-2004. As of mid-2005, China had issued more than 800 million banks cards—about 150-times the figure ten years ago ("Chinese Banks Should Upgrade ATMs"). Still, only a small fraction of Chinese have a card ("Credit Habits in China"), which makes bankers, both in China and abroad, very optimistic about the future of cards in China. And, as the opening story shows, Chinese people have learned quickly how to beat the system and get the most out of their cards.

To get a brief sense of the growth potential, think about the following facts about the Chinese bankcard market from a U.S. company with an equity stake in China's card processing giant, UnionPay²:

- 875 million general purpose bankcards in 2005, up from less than 1 million in 1993.
- 11 million revolving credit cards (Yiu 2006)
- 200 million revolving credit cards are projected to be in circulation by 2008.
- Bankcard penetration: 0.01 cards per person in China, compared with a penetration rate in Hong Kong of 1.9 cards per capita and 3.87 in the US (Yiu 2006)
- Nationwide retail consumption with bankcards: 5 percent in 2004, up from 2 percent in 2001.
- Bankcard expenditures in metropolitan markets: more than 20 percent.
- Growth rate of card acceptance among merchants: 45.7 percent from 2001 to 2004
- Less than 10 percent of Chinese businesses are set up to accept bankcards (Wang 2005)

These facts exhibit multiple reasons for optimism. One is that the growth in the last 12 years has been absolutely astounding and, guess what? It's expected to keep growing! Credit card penetration represents a mere tip of the proverbial iceberg, even in China's biggest cities where credit cards are fairly common. As of early 2006, there were only about 4 international credit cards for every 1,000 people on the mainland, compared to about one card per person in Hong Kong and Taiwan ("Central Bank Urges Non-Cash Payment").

Only one third of the urban population in China's 10 largest cities have cards, while just 26% of Chinese urbanites in general report having a card (Arora, 2005). Furthermore, only 5% of rural-dwellers—who make up two-thirds of China's total population—report having a card. Similarly, credit card payments account for about 1% of total consumer spending in China; compare that to 19.6% in the U.S. and 12.6% in South Korea (Chang 2004). Clearly, there is much room for growth.

Add to mix, the fact that Chinese people have US\$ 1.7 trillion in savings ("Pudong Bank Ties Won't Limit Expansion"), and card issuers are trying their best to persuade the public to spend it on consumer

goods and services. However, this high savings rate, partly a result of a cultural tradition of Confucian frugality, is precisely why some believe that the projections for the credit card market are overblown.

Another source of optimism about the potential of the Chinese credit card market is focused exactly upon sweeping cultural changes that have been afoot in China for a generation. The advent of market reforms in the 1980s seems to have had a profound impact on the generation that has come of age since then. One commentator sees younger Chinese taking to buying on credit like “fish to water (Noi 2003).” Having grown up during a time when there is more personal wealth, more consumer goods available, more exposure to international consumer culture, less reliance on the state for personal well-being, China’s younger generations are very different in spending patterns and attitude toward credit from those who grew up in the 1940s, 1950s and 1960s (McGregor 2003b). This makes them irresistible targets of buoyant credit card marketing efforts.

Analysts at Bain, an international consulting firm, project that mainland credit card spending will grow 20 % annually until 2010 and then 8% each year over the subsequent decade (Hu 2004). This would mean credit card spending would increase to US\$ 363 billion in 2020, which is more than 13 times the US\$ 27 billion spent in 2000. Zhang Lemeng, a board member of McKinsey, predicts that by 2013 14% of profits in Chinese banking will come from the credit card business, second only to the mortgage business (“Bank to Introduce Credit Card”). Clearly, the bonanza could be huge.

B. Card types, scope of use, and market players

Bankcards (银行卡) include three main types: true credit cards (贷记卡 or 信用卡), deferred debit cards, “secured” or “quasi-credit” cards (准贷卡)³, and debit cards (借记卡). Credit cards with high credit limits and monthly payments over extended periods have been expanding rapidly in China, though only a fraction of cards—true credit cards or “international cards” (国际卡)—can as yet be used outside of China. Because the vast majority of bankcards in China are deposit cards that do not allow overdrafts, for the purposes of this paper, “credit cards” and “cards” refer to deferred debit (also known as secured or quasi-credit) cards that do allow overdrafts, domestic credit cards, and international credit cards, while “bankcards” are all cards including simple debit cards.

Most domestic bankcards are calculated in the Chinese currency, *renminbi* (RMB), which is still not openly convertible on international markets. Many domestic debit and credit cards are Visa, MasterCard or JCB (Japanese Commercial Bank) brand cards issued through the various local banks, although at present the big international banks have no control over the terms of the cards or how accounts are managed in China (Lee 2003).⁴ The most common “credit” card used in China is essentially a debit card that allows limited overdrafts, with various stipulations on minimum balances, collateral, guarantors, allowable overdraft amounts, etc. As of the end of 2004, there were 875 million bankcards (“Bank Card Numbers Approach 1 Billion in China”) – up dramatically from 427 million bankcards in 2002 (Kuykendall 2002; “China’s Entry into WTO”; Lee 2003). Of those bankcards, however, only a fraction was true credit cards: 35 million cards in mid-2005 were true credit cards (Emloh and Wang 2005), while another 25-50 million were “secured” cards (“HSBC and Partner Offer Credit Card in China”). “Secured” cards are quasi-credit or deferred credit cards that require a bank deposit in order to be obtained and often, a bank balance must be maintained in order to use the card.

Domestic Bank Competition

Up until 2003, only five mainland banks⁵ were approved to issue international credit cards. Since then, several smaller commercial banks have begun issuing international credit cards or will do so soon. As

of early 2006, there were at least 15 national and local banks issuing 106 types of cards that issuing limited overdraft, domestic credit cards and/or international credit cards (See Table 1).

In fact, there is not much difference between the various credit card products at each bank. State regulation means that there is a fixed interest rate, so the variation is limited to the extent of a bank's ATM and POS networks, annual fees, usage points and customer service.

Each of the four major state-run commercial banks in China, as well as many of their local branches and smaller regional banks, now issue their own domestic and international cards. At the end of 2005, credit cards issued by the four banks accounted for 50% of the credit card market ("Credit Card to Become Fastest-Growing Retail Banking Business in China"). This is mainly a result of the huge network of local branches that each of the big four has, familiarity with these state-run banks, as well as the fact that many companies have set up payroll deposit through these banks.

The state banks, however, are getting a run for their money as smaller banks attempt to lure away market share by offering often more diverse and customer-friendly services. Both China Merchants Bank and Guangdong Development Bank, a joint-stock commercial bank based in the more affluent Guangdong Province, have launched what appears to be successful, aggressive marketing campaigns aimed at attracting cardholders and giving them incentives to pay for purchases with cards ("Chinese Card Issuers Struggle to Break Even"). China Merchants Bank was even chosen in the "2006 Best of the Best" awards in two categories: Best Personal Financial Services (RMB) and Best Bank for Issuing Credit Cards ("Nation's Richest Divulge Luxury Taste"). Voting for the awards were a pool of 600 mainland Chinese people worth 10 million yuan (US\$ 1.25 million) or more.

Foreign involvement in China's burgeoning card industry

Perhaps the most important challenge to the emerging credit card industry is China's entry into the World Trade Organization (WTO) in 2001.⁶ According to the terms of China's entry, foreign banks in China will be allowed to issue credit cards on their own in China by 2007 (Worthington 2005: 389).⁷ The Chinese are painfully aware of the quality and quantity of experience foreign banks have when it comes to credit card services and are reportedly preparing themselves as best they can for this eventuality before the market opens up.⁸

By early 2006, a few of the larger Chinese banks had joined forces with foreign banks in starting up or upgrading their credit cards and other retail banking services. In fact, several of China's banks have joined together with foreign banks or bankcard companies: China Construction Bank and Bank of America, Bank of China and both JCB and Royal Bank of Scotland Group (RBS), Industrial and Commercial Bank and American Express, Bank of Communications and Hongkong and Shanghai Banking Corporation (HSBC) and Industrial Bank and the Hong Kong-based Hang Seng Bank, and CitiGroup was recently approved to invest in both Guangdong and Pudong Development Banks.⁹ No doubt, there will be more joint-ventures and foreign investment and cooperation in coming years. These serve both parties: Chinese banks take advantage of well-tested management and operation

systems while foreign banks take advantage of the huge web of local branches belonging to their Chinese counterparts.

The collaboration between the Hongkong and Shanghai Banking Corporation (HSBC) and the Bank of Communications was particularly successful in 2005. In the first five months after issuing the first card, they issued 650,000 co-branded dual currency credit cards, reportedly beating the sales target by 44 per cent, and gave this particular card a “comfortable lead over international rivals” (Hu 2006). In order to get their card business off the ground, the two banks set up the Pacific Credit Card Centre in Shanghai, which is owned by the mainland lender, and run by an Australian banker nominated by HSBC. In addition, there are 17 other HSBC experts employed by the center and about 730 other staff.

As for the big foreign card brands in China, according to one observer, “VISA and MasterCard have made killings...[and] have nearly monopolized dual-currency bankcards” (Wei 2004). VISA and MasterCard have both been working in China since the inception of credit cards and have been cooperating with virtually all of the Chinese banks. This does not mean that VISA and MC have actually been involved with the credit card operations of the banks, in fact, in most cases they have not. However, consumer recognition of these brands has undoubtedly been worth the investment. The purchase volume for VISA and MasterCard in China was over US\$ 15 billion in 2004, an increase of 68% over the previous year and the highest increase in the Asia-Pacific region (*The Nilson Report* 2005).

Other foreign companies are working with Chinese banks to set up credit risk control systems, procedures for deciding which potential clients to issue cards to, helping combat the use of fake cards and monitoring repayment and spending patterns to identify bad debts as well as chase overdue loans (Yiu 2006).

The cooperation is not just one-way. In order to better serve Chinese cardholders, China UnionPay (CUP), China’s own credit card network, has been working hard to get its own brand accepted abroad. At the end of 2005, Discover began accepting *renminbi*-denominated UnionPay cards in the U.S. market (“*Renminbi* Denominated China UnionPay Card Accepted in the US”) and JCB, the premier Japanese card brand began accepting *renminbi*-denominated UnionPay cards in Japan (“JCB Complete ATM Gateway Agreement with China UnionPay”). Although it will be very difficult for UnionPay to compete on the mature international card market, if CUP can serve Chinese who travel abroad, that promises to be a very big chunk of the future market (Wang 2005).

At the same time as CUP and foreign card brands set up mutual network usage agreements, there are still challenges for China’s domestic brand. Visa and Mastercard pay Chinese card issuers about US\$ 1.20 as a premium for the sale of one card (“China Bankcard Brand Eyes Globally”). Unfortunately CUP cannot afford to do this, which may be a huge barrier for China’s own CUP brand in 2006 and beyond when foreign banks are allowed to provide *renminbi* services.

Card makers and processors are also getting in on the China game. First Data Corporation is reportedly very “excited” about the growth of cards in China and the explosive future potential (“World's E-Business Giant Favors China's Banking Card Market”). Chinese clients of First Data Corp. include the three of the four biggest banks, Industrial and Commercial Bank of China, the Agricultural Bank of China, and the Bank of China.

Similarly, the U.S. private equity firm, RRE Ventures, has invested heavily in SmartPay, a Shanghai-based company that specializes in helping customers pay bills, and purchase products and services via cell phone (“Mobile Payment Touted as Future of Paying for Products, Services”). Currently SmartPay serves 300,000 customers in 10 regions, but the CEO of RRE Ventures believes that this figure will skyrocket to an astounding 40 million customers in just one year by partnering with mobile operators, banks and merchants. Another leader in the international payment world, TSYS purchased more than one-third equity interest in the payment-processing arm of China UnionPay, and will reportedly increase this stake to 45% in 2006, if regulatory approval is obtained (“TSYS Acquires Equity Interest In China UnionPay Data”).

All, however, is not rosy. There is considerable opposition in China about too much foreign bank involvement in China’s financial sector (O’Neill 2006), not to mention many reasons that foreign banks and card issuers should be cautious in their bid to jump into the Chinese card market. The latter is discussed further in Sections E and F below.

C. Shanghai and the history of the card market

The fact that yuan-denominated credit cards have only been around since 1985, at first in the designated Special Economic Zones in coastal China to a very select few (Ministry of Science and Technology 2001; “The China Card”), means that there is much work to be done to develop infrastructure and risk management tools supporting the provision of credit cards.¹⁰ An indication of how recent personal credit card services are is that a 500+ page textbook published in 2000 on the new types of services offered by mainland commercial banks had no information on credit card services—although about one quarter of the book dealt with personal finance, primarily the many types of standard consumer bank loans (Li and Liu, 2000).¹¹

Shanghai banks and bank branches emerged early as a leader in providing broad access to consumer loans (not just credit given through bank cards) meant that huge numbers of loan customers—680,000 loans in 1999 alone—were going through the Chinese banking system (Xiao 2000: 183). This prompted the central bank, by administrative fiat, to demand that a creditworthiness system be put into place to more quickly and efficiently manage all the loan applications. With the government behind the plan, the necessary public security, social service and court organizations were asked to comply with orders to provide the necessary background information on potential loan customers (Xiao 2000: 186). By the year 2000, banking histories for 1.5 million Shanghai residents had been put into a database, of which 1.18 million were those holding bankcards with allowable overdrafts (Zhang 2002: 195). In addition, all fifteen Shanghai commercial banks were ordered to provide all consumer loan account and customer information since June of 1998 to the People’s Bank of China, Shanghai Branch to be entered into the system (Xiao 2000: 184).

As of early 2003, the fifteen Shanghai-based banks that had contributed to the credit bureau were sharing consumer loan information on 2.8 million consumers (“Non-Income Factors Drive Chinese

Consumption”). The availability of credit history and related information in Shanghai prompted the creation of the first credit bureau in Shanghai in June of 1999 to assess individual credit worthiness (Yu, Lin and Sun 2000:197).¹² With the support of the Shanghai Municipal government, Shanghai was chosen as an experimental site for a credit investigation bureau. The Shanghai Credit Company, Ltd. is spearheaded by the People’s Bank of China (China’s central bank), Shanghai Branch, but is also composed of several government organs. By June 2005, a nationwide reporting bureau was in operation collecting information on mortgages, auto loans, other consumer loans and credit card usage (see the credit bureau section below). The fact that the Shanghai credit bureau and nationwide efforts are being spearheaded by the central government, again, underscores the continuing role of the state in China’s economy.

On the other hand, the government cannot claim all of the credit for Shanghai’s banking successes. Evidence of the savvy of even the smaller Shanghai banks is that the first bank to become a foreign-listed bank was the Bank of Communications (BoCom). By bringing up its credit management system it was not only able to go public, but it also received a World Bank grant to help it improve its lending process. A year later, Price Waterhouse began advising the bank (“BoCom Takes Credit Rating Initiative”).

With the emergence of the first credit bureau in Shanghai, credit rating agencies were not far behind. Again, government support has been instrumental. The government has asked for credit reports on companies and individuals that are involved in transactions such as hiring staff, government procurement, bidding for land and other property rights, transactions, etc. (“Credit Rating Firms Expect Rosy Business”). The Shanghai government is reportedly also working on setting up a credit network with its closest neighbors, Jiangsu and Zhejiang provinces. As of early 2004, there were 20 credit rating firms in Shanghai.

Further testament to Shanghai’s role in the finance industry are the fact that the Shanghai Stock Exchange, Shanghai Gold Exchange, Shanghai Futures Exchange, China Foreign Exchange Trade System, not to mention China UnionPay, numerous bank branches, credit rating agencies, credit card centers, etc. are located in Shanghai (“Merchants Bank Eyes Eastward”). Most foreign banks have established headquarters in Shanghai, as have card makers, processors and consultants. Shanghai has indeed reemerged as the banking capital of China in the 21st century.

Market segmentation

Another issue, of which the rebirth of Shanghai is just one element, is the segmentation of the Chinese credit card market. Given the relative residential stability for most Chinese people, as well as the current lack of a truly national banking system in China, the result is substantial market segmentation of banking services by location. Albert Shiung, Visa’s top official in China, notes, “China’s market is huge and diverse. Every region differs from the other... You can’t take one business model and use it throughout the country” (Lowe 2004).

The problems of market segmentation around China are partly to do with varying local conditions and partly to do with the fact that, until very recently, most Chinese bank branches really only needed to be concerned with their own mostly immobile customers. Therefore, up through 2005, most cards could only be used at branches of the issuing banks; this is especially true in China’s smaller cities and towns. For example, an Industrial Bank cardholder who visits Xi’an will be able to withdraw money from her account at the Xi’an Branch of the Industrial Bank but she will not be able to use the Everbright Bank branch ATM machine right next to her Beijing home to withdraw money (Feng, 2001:297; “China—Prospects for a Role on the International Stage”). Similarly, due to the lack of coordination, one may

find several different types of POS (point-of-sale) machines littering checkout counters in big department stores because of the lack of coordination between banks' numerical codes (Lawrence 1998; "China Anticipates Vast Cards Growth"). This was still true in both Beijing and Shanghai in the summer of 2004. However, in addition to the technology lag there is now a new reason for the lack of coordination: intense competition among banks ("Interview"). This is especially true of the bigger banks with more branches and infrastructure that do not want to share the playing field with smaller, often more versatile and innovative, banks (Wei 2004; "Small Banks in China").

Currently, credit and debit cards can be used in large cities at large department stores, grocery stores, better hotels and, generally, only the best restaurants ("Bank Card Numbers Approach 1 Billion in China"). A recent survey found that 35 percent of all cardholders can be found in the four cities of Beijing, Shanghai, Guangzhou and Shenzhen ("Construction Bank, BoA to Form Credit Card JV"), but this still varies significantly between cities. Lowe (2004) quotes one card-processing official as saying that "ten percent of merchants in Shanghai accept cards compared with 30% in Shenzhen."

As far as credit card infrastructure and even credit card use goes, Shanghai may lead the rest of the nation, but not without a heavy dose of government support.

D. Government facilitation of the credit card market

The Chinese government's role in organizing and overseeing the development of electronic payment systems in China cannot be overestimated. The government wants to keep control of the card-payment system in order to use the network to modernize its currency transfer and check-clearing system ("A Golden Opportunity in China"), to facilitate payments among enterprises and government organs, as well as to crack down on fraud, increase tax revenues, improve monetary policy in the future (Lawrence 1998), and regularize the market for consumer credit which it sees as crucial to increasing domestic consumption (Zhao, 2002: 185).

In the early 1990s, the central government decided to set up a bank card network service center in twelve cities along with a national bank card network system on an experimental basis with the aim of linking all the banks together electronically (Chen 1998; Feng 2001: 297). In early 2002, this project was extended with the setting up of the China UnionPay Company (CUP), which is a national interbank card payment network. Initially, cards with the UnionPay logo were only available in Beijing, Shanghai, Guangzhou, Hangzhou and Shenzhen, although they were reportedly going to be useable in all prefecture-level Chinese cities ("Huge Potential"). By the end of 2004, only one quarter of cards issued in China had the CUP logo (Wei 2004). Since that time, CUP cards could be used in Hong Kong, Macau, Singapore, South Korea, Thailand and the United States ("China UnionPay Selects AT&T To Support Its Rapid Global Expansion Plans"). At the end of 2005, CUP had 60,000 ATMs, 340,000 merchant locations, 18 branches and 165 members, of which 23 are overseas financial institutions ("China Bankcard Brand Eyes Globally").¹³

UnionPay was expected to connect all domestic payment systems by the end of 2005 (Lee 2003; Chang 2003) and universalize card holding for 300 million urbanites.¹⁴ If it meets the government's target, 30% of merchants would be set up to accept UnionPay cards by the 2008 Beijing Olympics (which would alleviate the dueling POS system problem). Presently this merchant acceptance figure is still very low in comparison with the merchant acceptance rates internationally: comparable rates in South Korea are 87% and 77% in the US ("Non-Income Factors Drive Chinese Consumption").

Comment [tp1]: Keep checking the news for updates.

One can be sure the government will do everything in its power to get the nationalized electronic payment system into place to take advantage of the potential buying power of the athletes, officials and

spectators coming, credit cards in hand, to China for the 2008 Olympic Games in China.¹⁵ To reach full card use anywhere in China, however, will take another few years, given that there are over 100 different types of cards (“China—Prospects for a Role on the International Stage”). Even as recently as early 2003, in the most card-friendly city in China, one would reportedly have needed 16 separate cards to use the ATMs and POS outlets of Shanghai’s sixteen banks (“Non-Income Factors Drive Chinese Consumption”). The standardization of electronic payment systems will also go a long way to increase the effectiveness and attractiveness of using cards. If Chinese banks were to cooperate in this area, use of credit and deferred debit cards would no doubt also increase.

In early 2006, yet another government push for non-cash payment occurred by announcing a plan to establish regional and national centers to process the settlement of checks, bank drafts and electronic payments for both commercial and domestic use (“Central Bank Urges Non-Cash Payment”).

The state has also been working to increase card use more indirectly through state-run enterprises and government workplaces. A huge number of cards are issued to workers at various companies and organizations, both as a vehicle for direct deposit of wages as well as ID purposes for employers rather than customers themselves applying for cards as a convenient way to make purchases (Lee 2003; “New Type of Credit Card Issued in Beijing”). The workplace is, therefore, often the primary motivator for card issuing and use in China.

A credit card especially for civil servants was issued to employees of the Shanghai Foreign Affairs Office and the Shanghai Municipal Exchange and Cooperation Office at the end of 2005 “in an attempt to make spending more transparent and reduce corruption” (“Credit Cards for Civil Servants to Spur Transparency”). Usually, government employees spend their own money on business trips and provide receipts for reimbursement later, often adding receipts from personal consumption in to increase the reimbursement allowance. Credit card purchases would allow a closer tracking of expenses and hopefully prevent abuse.

To further finance the system and keep it up-to-date, the Chinese government has been taking advantage of foreign banks’ interests in getting a foothold in the potentially huge China card market. Visa International has been investing heavily in building an international telecommunications network in the mainland since 1987, putting lines in Guangzhou, Shenzhen, Shanghai, and Beijing which both facilitate use of international cards by foreign visitors – but are serving the domestic card market as well (“Hong Kong: Gateway to China”).

E. Legal and other institutional and organizational support – and limitations

The legal system with respect to consumer loans is in the process of being developed, with many new guidelines and rules emerging in 2004 and 2005. In China, there are both laws and administrative regulations. The first administrative regulation that might pertain to credit cards was the 1999 “Guidelines for Conducting Personal Consumer Credit.” It basically says that banks in China can make their own rules based upon local conditions, but that they should register these rules with the People’s Bank of China (PBoC). These guidelines also forbid foreign banks from issuing cards on their own (“Major Moves in Credit Card Business”). Despite its limitations, these guidelines resulted in dramatic increase of consumer loans: from US\$2.1 billion in 1997 to US\$84.8 billion in 2001 (He Liping, and Fan Gang 2002).

More recently in October 2005, the PBoC issued the “Guidance on E-Payment” which outlines regulations for banks and customers in regard to internet, phone, mobile, POS and ATM transactions. A PBoC official said that the “Guidance” was intended to be a loose and flexible set of guidelines

during this time of “innovation and development” and that “when conditions are mature, the Guidance shall then be upgraded to rules, laws or regulations of regulating agencies” (PBoC 2005). There is undoubtedly much room for development of legal and administrative guidelines surrounding the use of credit cards.

The PBoC also published a set of Provisional Rules on the establishment of a personal credit information database in late 2005 (explained in more detail below). The purpose of the database, as laid out in Chapter I, Article 1 of the Rules is to:

safeguard the financial stability, prevent and mitigate credit risks of commercial banks, promote development of individual credit business and ensure the secure and legitimate use of personal credit information, according to the *Law of The People's Republic of China on The People's Bank of China* (PBoC 9/9/05).

Perhaps surprising to most Western readers is that the guidelines around protecting privacy of personal information are, for the most part, left up to individual banks to work out, although these are to be kept on file with PBoC. The fines for bank and credit information service center breaches of data security are minimal (US \$1,200-\$4,000). The Provisional Rules do not contain any specific rules governing the types, scope and use of information that can be collected by the national database. Given the fact that Chinese consumers have been found to be more concerned about having personal or financial information lost or stolen than the worldwide average, the lack of rigor in the Chinese credit database guidelines are especially glaring (“Theft of Data, Major Concern for Consumers”).¹⁶

The National People’s Congress passed revisions of the Criminal Law in late 2004. Earlier legislation had a clause on credit card crimes, but did not provide a precise definition of what a ‘credit card’ is (“China Redefines Credit Card Law”). In late 2005, the Criminal Law was updated yet again to include harsh penalties—up to life in prison—for credit card crimes, such as using fake IDs along with credit cards, holding and using fake credit cards and vicious overdraft of credit cards (“China Imposes Criminal Sanction on Credit Card Crimes”). This was most likely in response to a dramatic increase in credit card crimes in China that year.¹⁷

Another area of concern is that the collateral law has not been updated to include stipulations about the terms of collateral on consumption credit; the result is that because banks are afraid of risk, they tend to require very high standards for customers they issue cards to (“Credit Consumption Crucial”).

All in all, the legal infrastructure surrounding the emerging credit market in China is still more akin to simple scaffolding.

Credit bureaus and credit reporting

Aside from the actual physical infrastructure, other institutions that support consumer credit markets internationally are credit reporting agencies which keep records on cardholder debt, national identification systems (such as social security or driver’s licenses), institutions which make income reporting more reliable (e.g. IRS), relevant laws and corresponding law enforcement agencies (Guseva and Rona-Tas 2001).¹⁸

The lack of credible, systematic credit information on individuals has been the most intractable obstacle in further development of a credit card market in China (Zhao, 2002;

“Overdraft Plagues Card Industry”). Only in 2004 did UnionPay begin collecting information on bad credit card and other consumer loans (“China UnionPay to Share Bad Records of Bank Card Holders”). That same year, the PBoC announced that a national credit reporting system that had operated on a trial basis the previous year would be formalized (PBoC 9/9/05). Commercial banks are now required to submit information for all personal loans into a central database. They can then access the information when reviewing the following types of cases: application for personal loans, personal credit card or quasi-credit cards, the guarantee with an individual as the guarantor, the post-approval risk management of personal loans already disbursed, etc. (PBoC 1/26/06).

At the end of December, 2005, the national database held records for 340 million natural persons (but only 35 million individual credit records), a total of 2.2 trillion yuan worth of outstanding personal loans that accounted for almost 97.5 percent of the total outstanding consumer credit in the country (PBoC 1/26/06). A large chunk of the database is undoubtedly comprised of Shanghainese due to the origins of the database. However, this has not prevented the rapid increase of database usage: from 1000 credit reports requested per day in 2004, by early 2006 there were 110,000 inquiries per day (“Consumer Credit Database Established”).

In China’s largest cities, regional credit management consultants¹⁹ have been springing up to compete with the nascent nationwide credit bureau. One of these, Hua Xia Credit International (with offices in Shanghai, Guangzhou and Tibet), does credit management training, credit risk consulting, consumer credit reporting, and even background checks on potential employees.²⁰ According to its website, Hua Xia reportedly was asked to set up Beijing’s Consumer Credit Reporting System in 1999, and in 2001 it helped set up department store provided consumer credit systems (<http://www.huaxiacredit.com>), essentially equivalent to store-based credit cards like Sears or J.C. Penny cards in the U.S.

Another private credit consulting company is Decision Engine Risk Management, Inc. (决策引擎风险管理科技有限公司 www.bjde.com) which was set up in 2003 by a Stanford-trained Chinese statistician and provides banks with credit risk management consulting, conducts analyses of potential clients using predictive credit scoring models, and provides credit risk management software as an official affiliate of TransUnion, the international credit reporting and business intelligence company.

How effective these services are and how much banks make use of these services themselves or continue to do their investigations in house is unclear. That the national credit bureau is made up primarily of Shanghai residents reinforces the high degree of market segmentation and makes high credit limits all the more risky. Despite the advent of the new national credit bureau, one foreign bank official predicts that this “will be no substitute for using the banks’ own resources and experience” (McGregor 2003b).

F. Obstacles to continued rapid growth of the credit card industry

At the same time as foreign banks, card issuers and related businesses are clamoring at China’s door hoping to get a piece of the bonanza, there are still reasons to temper the optimism.

Infrastructure

Lack of coordination and poor infrastructure mean that cardholders with all types of credit and debit cards are not necessarily able to use any ATM. Not all retail establishments accept cards. Changing these two situations alone will no doubt greatly increase the numbers of people wishing to join the cardholding ranks. Currently, there are about 40 ATMs for every million Chinese people, while in the US the figure is over 500 ATMs per million (“Overdraft Plagues Card Industry”). The most recent estimates are that there are 20 million merchant locations in China, while only 337,000 accept cards at all, and about a third accept international credit cards (“Non-Income Factors”; “Bank Card Numbers”). Again, this situation really varies from city to city in China. Some observers believe that merchants may be waiting for cardholders to make more purchases with cards before they invest in the POS stations (“Non-Income Factors”), which makes the situation rather circular. The profitability of the card business is also adversely affected by pressure from merchants and retailers to reduce interchange fees—already low by international comparisons (Hu 2006).

Increasing the network of POS and ATM stations and issuing credit cards that can be used around the county also has drawbacks until all banks are actually linked electronically to the central registry in real time. A fascinating piece of investigative journalism in Beijing turned up a “financial intermediary company” that helped clients obtain “lifelong interest free loans” (“Ten Credit Cards Wash Out Lifetime Interest-Free Loans”). The intermediary, in this case a small office in suburban Beijing with three staff, two computers and a POS machine, help their clients obtain ten credit cards. Then, clients take out the maximum 250,000 yuan (US\$30,500) total in cash on five cards. When the grace period is up 50-60 days later, the client takes out another 250,000 on the next five cards via the intermediary’s POS machine and pays off the first five cards. As long as the clients want to keep doing this, they get their loan interest free, though a small sum gets paid to the intermediary for the service.²¹ In many ways, this is another version of Miss Yuan’s strategy. No doubt, innovative Chinese citizens have come up with other ways to get the most out of their credit cards. Unfortunately for card issuers, these strategies probably do not involve paying the 18% interest that would make the credit card business profitable for banks.

Unapproved overdrafts, bad debts, fraud and other risk

However, the main nightmare for managers at Chinese banks is the unapproved overdraft on secured cards (“Overdraft Plagues Card Industry”). With the expansion of the number of true credit cards in the past few years, this has graduated to bad debt. The general manager of an international risk management firm working with some of the largest Chinese banks noted, “China is such a big country that when a credit card is issued for nationwide usage, it requires a national network to collect the unpaid loans” (Yiu 2006). He went on to say that until recently Chinese banks had to deal with relatively small number of firms that had very large debts.²² The challenge now is to handle millions of personal loan defaults that are relatively small. His firm has invested US\$8 million in a computer system and hired and trained 120 staff to deal with the collection.

Chinese banks have not been quick to try to solve the problem of bad card customers. Only with heavy government intervention has made it possible for Chinese banks to share credit worthiness information about potential customers. Although some banks in some locations shared blacklists of the names of those with bad credit before the national database emerged, the currency and use of blacklists was marginal (“China—Prospects for a Role on the International Stage”; Fu 2003). In this regard China is not alone. Countries whose banks share both positive and negative information about individual consumers are in the minority – reportedly only the US, UK, and a few countries in Latin America (Lucas 2002). However, not having positive information such as credit and loan balances seems not to

have affected the enthusiasm of the big international players such as VISA and MasterCard out of the market.

Afraid of the potential risk, however, Chinese banks have set stringent application requirements and very low credit limits for overdrafts. Add to this interest limits imposed by the central bank, and it is not surprising that cards get issued at all. This situation began to change in late 2004 and 2005 as the bad credit list and trial national database were developed and individual banks had built up enough of a card and customer base to be able to tease out what type of customer should be allowed to have a how high a credit limit.

Cultural proclivity to save and spend cash

In addition to the issues mentioned above, there are strong cultural factors that make going into debt extremely undesirable in China (as well as among ethnic Chinese elsewhere in the world). In fact, the founder of Hua Xia Credit holds that while trustworthy people in the U.S. are those who borrow and repay on time, in China being trustworthy means never borrowing at all (Cao 2000).²³ Those in the People's Republic also prefer to carry cash: reportedly 97% of purchases were made with cash in 2002 ("Non-Income Factors Drive Chinese Consumption"). This is certainly much more practical in the more remote areas of China where a working ATM or POS outlet is rare indeed.

Given the cultural hesitation to go into debt, it is not surprising that Chinese people with cards often do not use them. A large proportion of cards that have been issued have never been activated. When they are activated, their main function is to withdraw cash from ATMs ("Credit Card Business in China Faces Cultural and Financial Hurdles").²⁴ Or, as in the case of Miss Yuan discussed at the beginning of this article, Chinese consumers find other creative uses for short-term credit card loans that do not necessarily bode well for card issuers.

Research by a major Chinese bank in 2002 found that the average balance carried on personal credit cards was only US\$2 for regional banks and US\$7.50 for major national banks (Marcelo 2003). More than 50% of cards were used rarely, if at all, and retail purchases using credit cards are a tiny fraction of all credit card use. The first quarter of 2005 found that only 1.7% (185 billion yuan) of total consumer transactions were made with credit cards in the period ("Interview - China BoComm Expects Profits in Credit Card Unit Within 4 Yrs"). Figures for MasterCard and Visa in China released by *The Nilson Report* found a purchase volume of about US\$ 114 per card or about US\$ 1 per purchase transaction in 2004.²⁵

High level officials at McKinsey and Company's Shanghai office note that "more than half of Chinese cardholders today are unprofitable customers; a mere 2 per cent classify themselves as 'frequent revolvers' - consumers who almost always leave a balance on their credit card - while more than 85 per cent of cardholders pay off their entire monthly bill" (Von Emloh and Wang 2005). Add to this the high percentage of unscrupulous overdrafts, and one wonders if the predicted bonanza may actually a big gamble.

Other limits on card industry profitability

Relatively speaking, the cost of card issuing in China is high and, given the lackluster interest Chinese consumers have had to date in actually using their credit cards and paying back gradually, the much-touted potential profits in the card industry simply have not materialized. Therefore, Chinese banks have had to turn to annual fees and other transaction fees to try to make their card business profitable, but in the race to get customers, banks have begun competing to have the lowest fees, compounding the problem.

Now that banks are more aware of the risks in issuing cards to just anyone, the competition for that minority of good card customers that actually do revolve credit—and repay over a period of months—has given rise to a host of incentives, such as waiving annual cardholders fees, giving purchase points, cash back, or gifts. McKinsey reports that based on the average 200 yuan (US\$24) cost of issuing, advertising and maintaining a bankcard, Chinese commercial banks break even only when a credit cardholder makes payment of 10,000 yuan (US\$1,200) each year (Von Emloh and Wang 2005; “Ten Thousand Yuan in Annual Card Use”). Add to this the pressure from merchants and retailers to reduce interchange fees—already low by international comparison—and the bonanza seems just that much more elusive (Yiu 2006).

Given all the attractive incentives, Chinese cardholders have not proven to be loyal, and few banks have developed effective means to keep them loyal (Von Emloh and Wang 2005). New strategies to create loyalty among cardholders have been introduced to keep existing bankcard clients, but have so far been limited mainly to frequent flyer and public transport programs. Six million consumers using Shanghai Public Transportation Cards earn SmartPoints, which can also be gathered at partner retailers including McDonalds, bookstores and movie theatres (“Loyalty Programmes Set to Bloom in China”). Similarly, department stores and other vendors use incentive programs such as free gifts for reaching a certain level of usage, and insurance for those using cards to purchase airline tickets (McGregor, 2003a).²⁶

In the next few years, there will undoubtedly be a plethora of innovative products, services and perks provided via credit cards as the competition for market share heats up. Currently, there is even a web resource listing the various credit card promotions, fees and conditions Chinese banks are offering facilitating consumer choice of the card that best fits their needs and desires (www.51credit.com). Whether these innovations can keep up with the challenges that economic, political and consumer behavior pose will, to a large extent, determine the future of credit cards in China.

Macroeconomic and political conditions and the credit card industry

Beyond the ability of banks to find the right mix of profitable customers, get the appropriate infrastructure set up, etc., conditions in the macroeconomic environment in China also impact the nascent credit card industry.

For the past twenty-five years, economic conditions in China have changed—and continue to change—extremely rapidly. The rise of a fairly well-to-do urban middle class in the past decade has definitely fueled credit card growth, although lay-offs from government organs and state-run enterprises beginning in the 1990s has meant declining incomes and income volatility and uncertainty for a growing number of urbanites (Xiao 2000:193).²⁷ The predictions of great profits for the credit card industry are based upon the assumption that the small Chinese upper-middle class will continue to grow rapidly (“HSBC and Partner Offer Credit Card in China”; Hu 2004; Von Emloh and Wang 2005).

Domestic banks are still weak from years of state-run management. Even today they are often still obliged to give loans to state-run enterprises deemed politically important despite poor economic performance (Chowdury 2000). Therefore, to be solvent, domestic banks must find other sources of income. Financing the country’s growing consumption through consumer loans is seen as precisely one way to do this, especially when consumer credit default rates are less than 1%, while bank’s overall bad debt ratios were 27% (“China—Prospects for a Role on the International Stage”). With interest rates at 18% for credit card debt, and cost to banks of only about 2% to borrow funds, issuing credit

cards would seem to be one important way banks could hold their ground (Lowe 2004).

Indeed the Chinese government has been trying to facilitate the use of credit cards for many reasons: to help capture information for personal income tax purposes, to set up a way to track transactions digitally, to act as a temper on corruption, to make the move from an export-oriented economy to one that is based more on domestic consumption. The disastrous impact of a series of government policies to encourage domestic consumption via credit card popularization in South Korea was that card issuers found themselves buried in debt deep enough to lead to a national economic crisis (Lowe 2004). Even the chief economist for MasterCard international in Asia says that Chinese banks couldn't survive a crisis like South Korea's: "A consumer-credit bubble would finish many of them. They have to get this right" (quoted in Karmin 2003). This lesson may put a damper on the Chinese credit card market if there is any hint of a similar situation.

Foreign participation in the Chinese card market has, to date, primarily been one of consulting on technical and management issues. Since China's WTO entry promises to open the personal financial services market up, the Chinese government has been encouraging domestic banks to partner with foreign firms to get up to speed before both full foreign financial market participation and the 2008 Olympics. Foreign firms trying to get in on the bonanza may find themselves regulated out if certain segments of the industry get their way:

"The excess introduction of foreign capital into our financial institutions will easily lead to a loss of control over our economy and threaten national financial security. We must abandon policies that are making China's economy a colony, like Latin America" (O'Neill 2006).

The Shanghai financial newspaper article this quote came from further went on to challenge the Chinese government's plan to sell stakes in domestic financial institutions to foreigners in order to update outmoded technology and management experience. The article then came out and said that foreigners simply wanted to "control China's financial system and siphon off the profits and resources for themselves" (O'Neill 2006). While the government has continued to support the controlled introduction of foreign financial organizations and expertise into China, there is no doubt that the brakes could be applied if the foreign competition—especially in consumer finance—was perceived to be the reason for Chinese bank stagnation or failure.

G. Conclusion: gamble or bonanza?

There is certainly much to be both optimistic and cautious about when it comes to the future of the credit card market in China. In the end, the challenges of infrastructure, legislation and technology to support a healthy credit card market can be overcome. After all, many rapid advances in these areas have already been made in just a few short years.

Moreover, Chinese consumers have already embraced credit cards and the convenience that they provide. In fact, credit cards have become a signifier of affluence and cool in urban China. One of the signs that credit cards have entered the ranks of status symbols in China was the recent introduction of a tiny credit card for the fashion conscious: the mini credit card issued by a bank in Chongqing can be worn as earring or on other parts of the body such as one's belly button ("West").

The real issue is one of cultural change and the *interaction* of new technology—credit cards—with existing cultural norms. Preliminary and as yet anecdotal evidence points to the possibility that credit cards may not be embraced as a way to obtain goods and services that people could not otherwise afford so much that they provide a convenient way to pay for what they can already afford. Miss Yuan

and the Beijing financial intermediaries show that credit cards may be more readily embraced as investment tools among the savvy, upper middle class that banks currently believe to be their most important and potentially profitable credit card customers.

Japanese cultural norms with regard to credit and savings are similar to those in China. A look at the more mature, but still small, credit card market in Japan is instructive:

In Japan, it is perfectly acceptable to borrow money to fund major purchases: housing, cars, consumer durables, etc. However, it is not culturally acceptable to be in debt for everyday living expenses, or to live above one's means. For those Japanese who are in this situation, it is important that others do not find out about their predicament. For these reasons, revolving credit on cards, which must be publicly declared at the point of sale, is not popular ("Consumer Credit Asia-Pacific Style").

The credit card industry in other developing countries also shows reluctance on the part of cardholders to rack up credit card charges for more than the grace period. For example, the number of credit cards in Brazil has grown an average of over 17% per year between 1999 and 2004, but Brazilians tend to pay off their monthly bills rather than accumulate debt ("Making advances; Credit cards"). Instead, much like Chinese cardholders, Brazilians use their cards as a convenient way to pay. Tellingly, the inflation-adjusted amount of annual spending on credit cards in Brazil actually fell over the five-year period. Most Brazilian issuers make their small profits from various fees on credit cards.

One reason that the Brazilians were reportedly not interested in long-term borrowing on credit cards is the availability of other, cheaper loans. Chinese people have traditionally tended to borrow from friends and relatives with little or no interest. If this is possible, why spend 18% in interest on credit card borrowing?

Until the interest rates decline and social practices around borrowing and debt change, the huge bonanza predicted by foreign financial consultants may be quite a bit smaller. In the end, it might very well be the Chinese banks, which have gained important expertise, technological help and infrastructure improvements from foreign firms, who laugh all the way to the bank.

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Notes

¹ There is one notable exception, Shanghai, where 15,000 people reportedly took out consumer loans in 1995. By 1999 the number had skyrocketed to 680,000 people receiving consumer loans (Xiao, 2000: 183).

² Unless otherwise noted, all the information in this section comes from “TSYS Acquires Equity Interest In China UnionPay Data.”

³ Lu 2002. An English-language synopsis can be found in *Asian Banker Journal*, May 15, 2003.

⁴ In fact, one of the ways the Chinese banks are trying to modernize and standardize their credit management practices is by offering foreign banks a share (“Expert: Chinese Banks Brace for Mounting Foreign Competition”).

⁵ The five banks are: Industrial & Commercial Bank of China (ICBC), Bank of China (BoC), China Construction Bank (CCB), China Merchants Bank (CMB) and Guangdong Development Bank.

⁶ Without all WTO regulations in effect, the Chinese government is able to control both interest and deposit rates, and prohibits “more competitive offerings from foreign banks seeking to leverage their efficiency or credit- and risk-management systems” (Krebsbach 2002:67).

⁷ According to Krebsbach (2002:67), foreign banks will be able to “offer every product Chinese banks sell, including a full range of services to individuals and both foreign and domestic firms” in 2007.

⁸ However, although foreign card issuers doubt that China will remain closed to foreign competition, it is still possible that the UnionPay may not share its network with foreign players after WTO entry opens in 2007 despite the current cooperation. That would mean a UnionPay monopoly on the domestic credit card business which foreign banks have been eyeing for years (“Non-Income Factors Drive Chinese Consumption”).

⁹ However, in order to invest in Guangdong Development Bank, CitiGroup had to sign an agreement that they would not share in the Guangdong bank’s credit card operations (“Citigroup Aims for Major Piece of GDB”).

¹⁰ Initially, the first cardholders in China were mostly foreign business people and representatives of Chinese companies doing business with foreigners.

¹¹ The other main sections of the book cover investment services, insurance, accounting, import-export bank services, foreign exchange services, business consulting, and other (security boxes, notary, web-based banking, etc.).

¹² It is not a coincidence that the first credit bureau set up in the early 1900s and the first to be set up almost 100 years later were both located in Shanghai. Shanghai has traditionally been China’s financial capital, and continues to be the case today.

¹³ Domestically, CUP’s network included over 4,700 ATMs and 46,000 POS machines (“China UnionPay Issued Over 3MN Debit Cards in Beijing in 2005”).

¹⁴ As of early 2006, there was no news in the Chinese press or on the UnionPay website about whether the target had been reached, which likely means that it was not reached.

¹⁵ While foreign card issuers doubt that China will remain closed to foreign competition, it is still possible that the UnionPay may not share its network with foreign players after WTO entry opens in 2007 and therefore have a monopoly on the domestic credit card business which foreign banks have been eyeing for years (“Non-Income Factors Drive Chinese Consumption”).

¹⁶ “China recorded an even higher concern level with information security compared to the worldwide average, with 77 per cent of Chinese indicating that they were highly concerned about having personal or financial information lost or stolen. The global response to theft or loss of information surpassed environmental degradation (62 per cent) and terrorism (58 per cent) as a cause of concern” (“Theft of Data, Major Concern for Consumers”).

¹⁷ Another solution to the increasing credit card fraud problem is the “smart card.” At a launch ceremony for a new smart card, a PBoC official said, “If China doesn't move fast, it may become the world's centre of bank card fraud” (“New Chip Bank Cards Launched to Tackle Fraud”).

¹⁸ I should also mention black lists. Those used in China seem to be regional in nature and operated by the individual banks. I have been unable to confirm how widely and systematically they are used or how up-to-date they are.

¹⁹ From what I gather, these are most likely joint-venture companies with the government, rather than truly private and independent entities.

²⁰ Hua Xia Credit was reportedly in negotiations to set up a joint-venture with Fair Isaac (Xiao 2000:165), though there is no mention of this on the Hua Xia website accessed on 11/10/02.

²¹ The author has a Chinese friend in the U.S. who financed his car this way: he charged the car on his credit card and then takes advantage of the plethora of 0%-interest-for-six-months offers he received in the mail to transfer the balance to a new card before he is required to pay interest. For him it means that he may not ever have to pay for his car!

²² The only concrete information found on the amount of overdrafts was for the ICBC's Peony Card. While purchase volume was 3.43 billion yuan, only 2.7% of the total overdrafts were bad (“Consumption of Peony Card totaled CNY69.3bn in 2005”).

²³ I would actually dispute Cao's generalization. For many people who do not have access to bank loans, borrowing from friends and family – and repaying on time – is the only way to be assured access to this type of informal credit in the future.

²⁴ Given the relatively low handling fees associated with credit card use, it might seem strange that a huge challenge for Chinese banks has been trying to get cardholders to use their cards.

²⁵ *The Nilson Report*, in the note at the bottom of the table (pgs. 6-7) explains that purchase volume is the volume of money spent on all goods and services and direct marketing but excludes cash advances and withdrawals.

²⁶ Although many countries have been using telephone credit card payment for many years, only in 2006 will the first bank in China, CITIC Bank, offer such a product. The card will allow consumers to use their land line phone number to pay for telecom expenditures such as international IP calls, Internet access fees in addition to all the other usual bank services. Customers will also be able to accumulate points allowing them preferential prices for their phone calls (“Credit Card-Phone Binding Products to Debut in China Next Year”).

²⁷ Enterprise layoffs are hitting some areas harder than others. Liaoning province in northeast China has been hit especially hard (Goodman 1997).