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Financial Services

PLAYING TO WIN

RETAIL BANKING STRATEGIES FOR EMERGING MARKETS

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EXECUTIVE SUMMARY

In this report, we focus on 12 emerging markets[1] (referred to as the EM12) that have accounted for two-thirds of the global revenue growth in retail banking over the last five years. We have identified common threads in their evolutionary patterns, adding predictability to a volatile, fast-evolving market landscape. These threads also point to common opportunities for growth across these markets.

Our key findings are as follows:

- We expect a general slowdown in growth across most of the EM12. The total retail banking revenue pool in these markets will grow at nine percent a year over the next five years, down from 14 percent over the last five. Declines in growth will be most pronounced in China, Brazil, Mexico, Thailand and Saudi Arabia.
- In spite of the slowdown, the EM12 will continue to be the driver of global growth in retail banking: The top 10 developed markets are expected to grow by only two percent a year over the next five years. Over this period, EM12 retail banking revenue pool will grow by more than $450 billion, as financial services are extended to an additional 250 million households, and as another 90 million transition from the mass-market segment to the mass-affluent.
- We believe four key opportunities will define the future shape of these markets:
  - Adoption of digital channels, products and business models
  - The untapped opportunity presented by small- and medium-sized enterprises (SMEs)
  - Sustainable growth in retail credit
  - Development of an affordable banking proposition
- Collectively these opportunities will drive more than 70 percent of the total growth across the EM12, and institutions' responses to these opportunities will increase the distance between the winners and the laggards. For example, winner banks in Indonesia may be able to increase their risk-adjusted retail revenue by ten percent a year over the next five years, while the laggards will struggle to grow at more than two or three percent.

The rest of this section provides a general description of the strategic agenda for each of these opportunities. We have also highlighted the relevance and importance of each of these opportunities for individual EM12 markets.

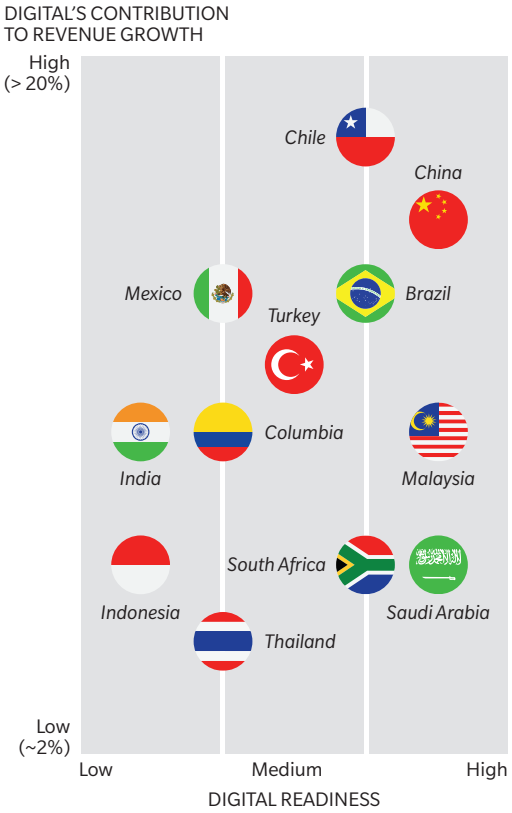
For adoption of digital channels, products, and business models, we recommend that initiatives be categorized as either "digital baseline" or "digital leadership". Failure to realize digital baseline initiatives will make a bank a digital laggard. However, the degree to which a bank needs to pursue a digital leadership agenda over the next

1 For the scope of this report, emerging markets are China, Indonesia, Malaysia, Thailand, India, Saudi Arabia, Turkey, South Africa, Brazil, Mexico, Chile and Colombia.

five years depends on the significance[2] and readiness[3] of the digital opportunity in the country it operates in, as well as the client base. For example, we expect 12 to 15 percent of the retail revenue growth in China – which is very digitally ready – to be driven by digital customer platforms and products, but only four to six percent in a market like Thailand, which is less digitally ready.

The table below summarises our views on digital initiatives, and gives assessments of countries' levels of digital opportunity and readiness.

Adoption of digital channels



AGENDA 1: DIGITAL BASELINE

- Use digital tools (i.e. tablets) and self-service terminals to improve productivity, efficiency and customer experience
- Improve front-to back productivity through digitization of processes and interfaces
- Enhance customer experience/remove hassles in customer journey via digital applications

AGENDA 2: DIGITAL LEADERSHIP

- Better understand customer need/behaviour based on their digital footprint; invest in digital data analytics
- Develop modular platforms and open architecture solutions embedded in digital ecosystems
- Drive an institution wide coordinated response – investment strategy, partnership approach, and organisational set up to promote digital innovation
- Develop internal capabilities to drive accelerated delivery of digital initiatives; agile solution development, rapid IT delivery, digital marketing and brand building

Source: Oliver Wyman analysis

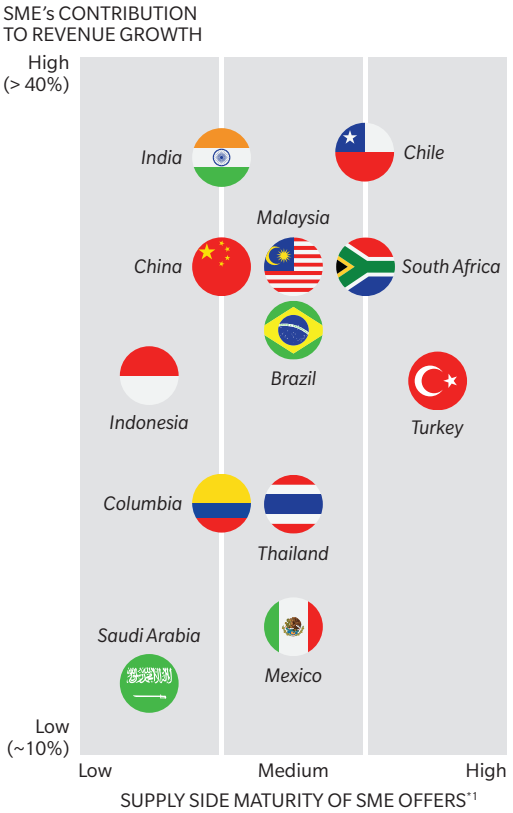
2 We have assessed the significance of the digital opportunity based on an estimation of the digital contribution to retail revenue growth in the country over the next five years (2016-2020). This includes revenue generated by digitally driven customer platforms (e.g. financial services aggregators, e-commerce sites, and online acquisition channels), as well as digital-only products (e.g. small business loans offered via digital channels).

3 Digital readiness has been measured based on a combination of smartphone penetration and e-commerce penetration (the share of Internet users buying online).

SMEs drive economic growth in most emerging markets, and represent a significant financial services opportunity for banks. However, getting SME banking right is often difficult, because of organisational and operational challenges. We recommend a staged approach to developing an SME proposition. This should take into account the size and stage of development of the SME opportunity in the specific market.

The table below summarises our market-level recommendations.

Addressing the untapped SME[4] opportunity



AGENDA 1: GETTING SME BASIC RIGHT

- Set up SME as a dedicated organisational segment with focused functional resources and define a clear segment value proposition that fits the market maturity and incumbent's strengths
- Establish an operating model that leverages retail footprint, standardised processes and wholesale relationships to deliver on the customer proposition
- Develop a tailored credit process for SMEs that delivers credit in a simple and fast manner while managing risks and cost to serve

AGENDA 2: BUILDING THE NEXT GENERATION BUSINESS MODEL

- Build on wholesale linkages (e.g. transaction banking functionalities, sector specific solutions)
- Create distinct segment capabilities (e.g. digital credit process, new data based credit analytics, risk based pricing delivered via RM applications)
- Address emerging and unmet needs of SME customers (e.g. cash flow volatility loans, cash management solutions, digital VAS)

Source: Oliver Wyman analysis

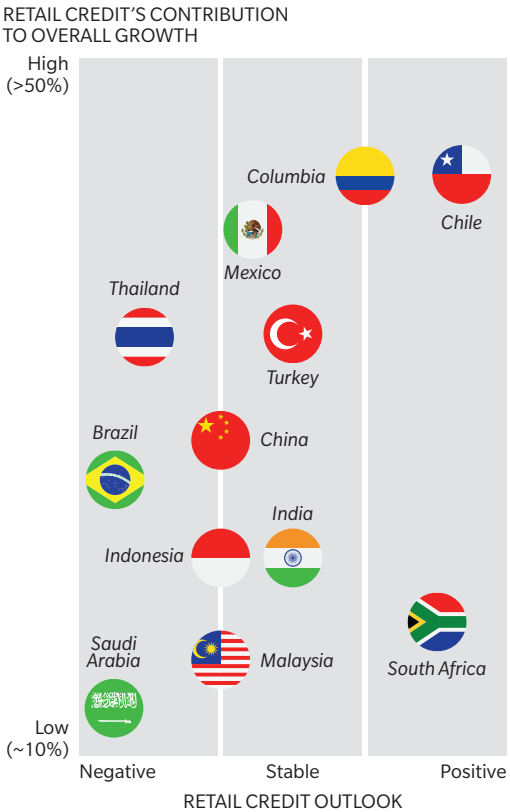
4 We define SMEs as businesses with an annual turnover in the range of $100,000 to $10 million.

*1 Supply side maturity of SME offers take into account the prevalence of SME specific banking products and solution currently offered in the market, efficiency of SME credit delivery and efforts undertaken by banks in delivering a holistic segment proposition beyond standard banking products.

Retail credit is expected to remain a major component of retail banking growth in emerging markets, generally accounting for 20 to 50 percent of total revenue growth over the next five years. However, credit quality has started to deteriorate in a number of EM12 markets, and it looks poised to worsen in some markets due to negative macroeconomic outlooks and alarmingly high ratios of debt to disposable income. We recommend building out risk management capabilities, while pursuing growth strategies that take into account the retail credit outlook and infrastructure in specific markets.

A summary of our recommendations and country-level assessments is presented in the table below.

Driving sustainable growth in retail credit



AGENDA 1: RETAIL CREDIT FUNDAMENTALS

- Drive cross sales of retail credit products via branches leveraging proprietary customer data
- Design credit scorecards to leverage multiple traditional data sources and strengthen collections capabilities
- Establish faster credit processes through automated decision making, including pre-approvals and real-time decisions for lower ticket sizes

AGENDA 2: RETAIL CREDIT NEXT STEPS

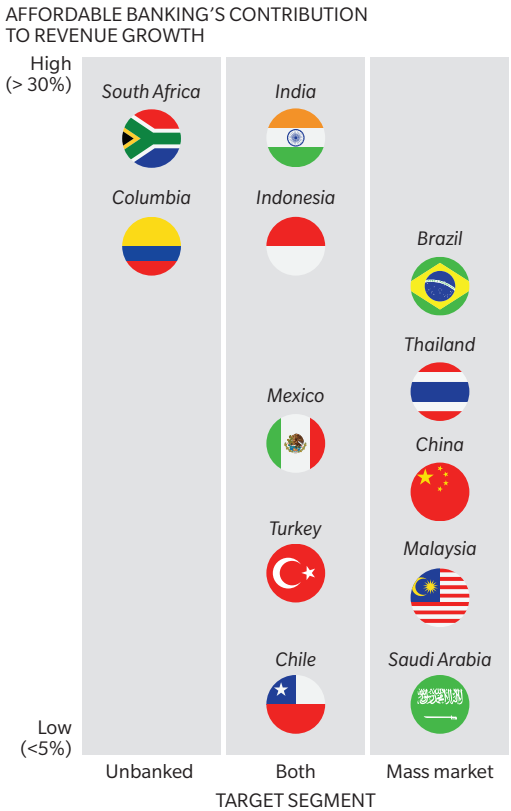
- Improve customer targeting with segmentation, augmented data and tailored products
- Start managing value levers (e.g. risk, price, balance and attrition) via advanced analytics and targeted customer level actions
- Invest in NPL management, including – early warning signals and high limit management for SMEs, consolidation and professionalization of internal and third party collections across channels

Source: Oliver Wyman analysis

Developing an affordable, cost-effective banking proposition should be a high priority for banks in most of those EM12 that have large populations. The relevant segments are the unbanked population and the parts of the mass-market segment that are currently either underserved or not economically viable for banks. The challenge in both cases is to develop banking propositions that are both affordable for the target client segment and profitable for banks.

Our recommendations and assessments for different markets are summarised in the table below.

Developing affordable banking proposition



AGENDA 1: BANKING FOR THE UNBANKED

- Develop feature phone led banking proposition: fast, lean and easy (viability may depend on regulatory framework)
- Leverage a non-bank partner distribution network to originate new relationships and service existing clients (e.g., retail stores working as banking transaction points)
- Leverage alternate data sources (e.g., Telco usage) to underwrite credit and manage fraud risk

AGENDA 2: RE-INVENTING MASS MARKET BANKING

- Manage cost to serve via streamlined and heavily digitally supported savings and payments products
- Offer basic loan products to individuals with highly automated risk process and pre-approvals (e.g., based on payment and checking account history or where available Social security/pension information)
- Proactively graduate customers to higher level of service and product proposition based on historical behaviour

Source: Oliver Wyman analysis

We believe that incumbent banks' performances in the EM12 over the next five years will be driven by the effectiveness of their strategic responses to the four opportunities above.

1. EVOLUTIONARY TRENDS IN RETAIL BANKING

1.1. HOW RETAIL BANKING MARKETS DEVELOP

Four stages of evolution

Retail banking markets evolve in four stages. This evolution relates to their increasing size and financial deepening, competition levels, breadth of product offerings, and customers' evolving needs and expectations.

Exhibit 1: The four stages of retail banking development

THE EVOLUTIONARY PATH OF RETAIL BANKING MARKETS

	1. NACENT MARKETS	2. RETAIL EMERGENCE	3. RETAIL MATURATION	4. CUSTOMER EXPERIENCE DIFFERENTIATION
	• Brick-and-mortar institutions providing basic savings accounts • Limited focus on SME/retail lending • Wealth concentrated at top with few individuals • Banking assets are concentrated in corporate/commercial	• Cherry picking on low-risk consumers with simple credit, e.g., auto loans, payroll loans • Term deposits with differentiated rates/packages • Dedicated SME proposition starts developing	• Working capital loans, consumer finance, growth in mortgages • Advent of simple investment products, and proliferation of innovative channels, e.g., online banking • Differentiated SME offerings	• Differentiation via customer segment centric offers and experiences • Institutionalization of retail via wealth and asset management • Focus on service/delivery innovation as products become commoditized
BASIS OF CLASSIFICATION				
Demand View	< $3,000 GDP per capital (PPP)	$3,000 to $10,000 GDP per capital (PPP)	$10,000 to $25,000 GDP per capital (PPP)	> $25,000 GDP per capital (PPP)
Supply view	<5% retail assets to GDP (PPP)	$3,000 to $10,000 GDP per capital (PPP)	20%-50% retail assets to GDP (PPP)	> 50% retail assets to GDP (PPP)
EXAMPLES				
	Cambodia *Bangladesh*	*Indonesia* *Columbia* *Mexico* *Brazil* *Turkey* *China* *Chile* *India* *South Africa* *Thailand* *Saudi Arabia* *Malaysia*	*Singapore* *United States* *Hong Kong*	

Focus markets for this report

Note: We have considered Saudi Arabia's non-oil-related GDP to categorise its market evolution, as we believe that is more indicative of its market maturity than full GDP.
Source: Oliver Wyman analysis, World Bank Database

It is possible to place global retail markets in these stages using indicators for demand (GDP per capita) and supply (ratio of retail assets to GDP).

This report focuses on emerging markets in Stages 2 and 3. These stages feature accelerated retail growth characterised by steeply increasing demand for retail financial services; significant supply-side changes, such as intensifying competition and the entry of specialist players; and modifications to regulatory frameworks.

We have chosen 12 markets that collectively represent more than 80 percent of the retail banking revenue pool in global emerging markets. They are expected to account for two-thirds of the global revenue growth in retail banking over the next five years.

Required generalisations

To fit each of these markets into a single stage of evolution often requires two generalisations:

1. Many of these individual markets are in reality a collection of sizable micro markets which may be in different phases of evolution.

   Mainland China is a good example of a collection of micro markets. The overall market may still be classified as Stage 3, based on criteria such as GDP per capita ($14,107[5] in 2015) and retail asset penetration[6] (29 percent in 2015). Closer inspection, however, reveals significant differences in the maturity of the retail ecosystem in different geographies – in terms of customer profile, financial service providers, and product and service offerings. Coastal metropolitan cities, such as Shanghai and Guangzhou, may be significantly more evolved than tier two cities and rural areas, which look more like Stage 2 markets.

2. A market that as a whole fits a particular stage of development may have evolved further in specific areas, such as products, platforms, or market infrastructure.

   For example, the credit bureau in Malaysia has been in operation since 1982 – a long time even by developed-market standards, and far ahead of its peers in emerging Asia.

5 World Bank Database

6 Retail asset penetration defined as retail assets/GDP in each market

3. The evolution of regulatory frameworks and political support can also contribute significantly to market development. But this might not be captured by the objective framework laid out earlier in this section.

   For example, Brazil, Chile, and South Africa have mature institutional savings segments that are more typical of Stage 4 markets, as a result of long-standing public pension schemes and more-recent reforms of their pension systems.

   Nonetheless, we find this classification a useful basis for evaluating markets' strategic imperatives. It provides us with a starting point from which to conduct a more detailed analysis of a bank's strategy, based on its presence in a particular country or countries.

1.2. SHIFTING GROWTH DYNAMICS

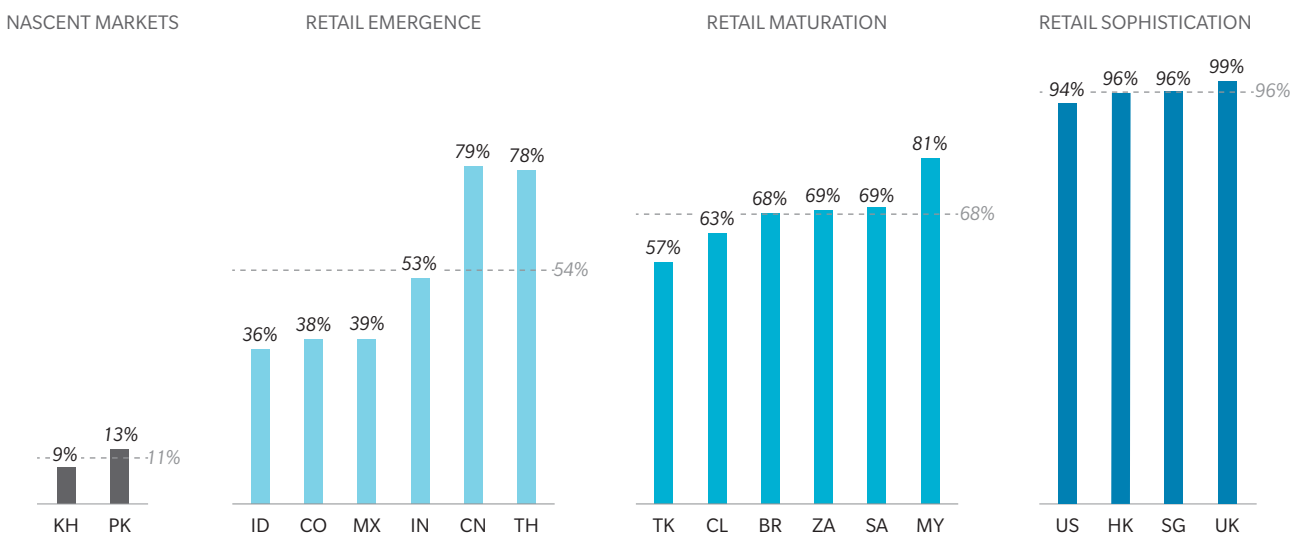
We observe a number of themes that are common to markets at the same stage, and differentiate markets at different stages.

1.2.1. Increasing reach of financial services

The transition from Stage 1 to Stage 2 is typically associated with a significant increase in the reach of financial services, and corresponding rapid growth in retail assets. (See Exhibit 2.)

Exhibit 2: Increasing financial services reach across markets at different stages

PERCENT OF POPULATION (AGE 15+) WITH BANK ACCOUNT AT A FINANCIAL INSTITUTION (YEAR 2014)



Source: Global Findex Database

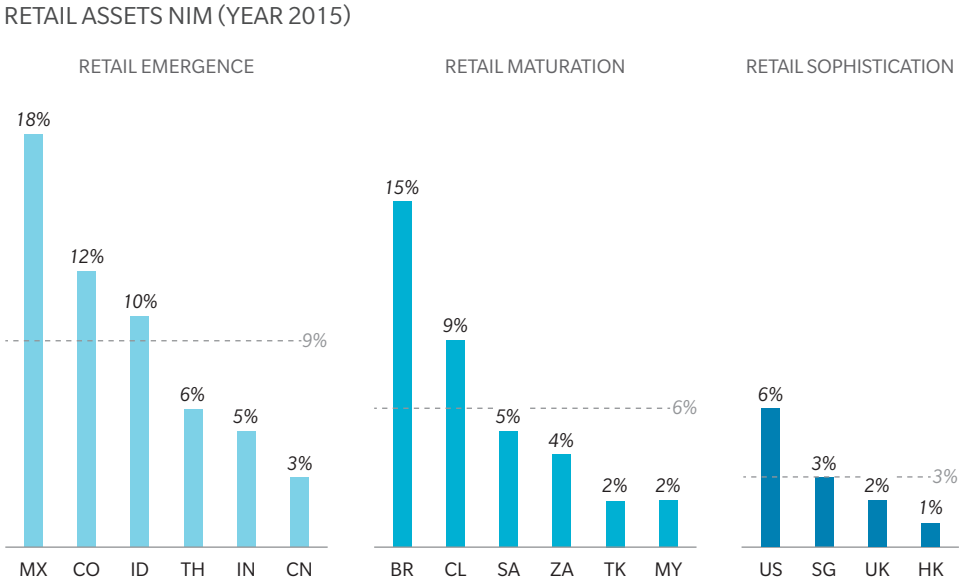
1.2.2. Increasing competition and declining net interest margins

Net interest margins (NIM) are a broad indicator of market efficiency and competitive intensity, and they tend to decline at higher stages. Notably, there is a sharp fall from Stage 2 to Stage 3, before NIMs level out somewhat in Stage 4. (See Exhibit 3.)

1.2.3. Increasing product holding and share of fee income

As markets reach saturation point for basic products, such as savings accounts for individuals and current accounts for businesses, the focus shifts to the cross-selling of products and services. Advisory services and investment and protection products become more common in the individual retail segment; payments and cash management solutions become more routine in the SME segment. Many of these products generate fee income rather than interest income, so the transition from Stage 2 to Stage 3 is often marked by an increase in fee revenue as a share of the total.

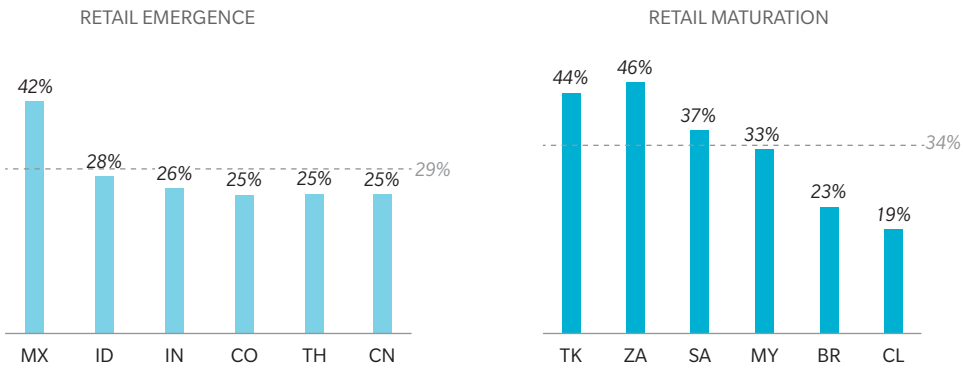
Exhibit 3: Retail banking NIM in markets at different stages



Source: Oliver Wyman analysis

Exhibit 4: Deepening relationship: Fee income as a percentage of total retail banking revenue in markets at different stages

SHARE OF INCOME FROM FEES IN TOTAL RETAIL REVENUES (YEAR 2015)



Source: Oliver Wyman analysis

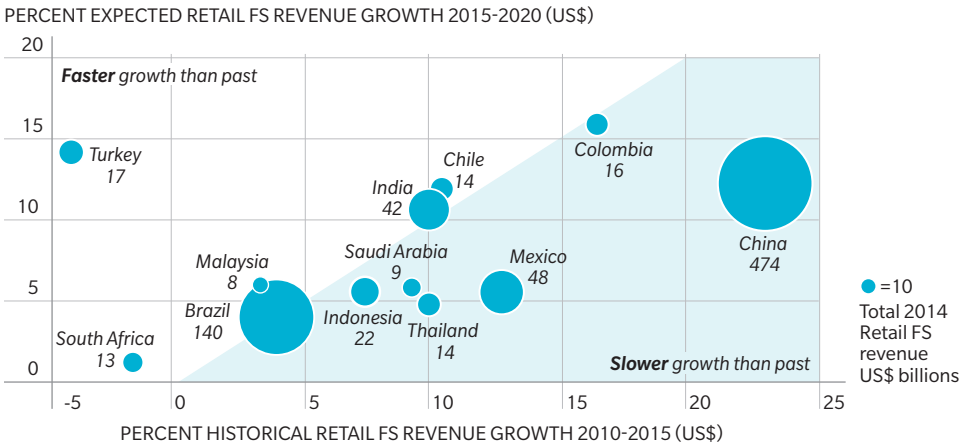
2. OUTLOOK FOR RETAIL GROWTH IN EMERGING MARKETS

2.1. GROWTH OUTLOOK IN FOCUS COUNTRIES

The first three years of this decade saw rapid growth – an average of 18 percent a year – of retail banking revenue across most of the EM12. This was fuelled by rises in household income and strong macroeconomic conditions, among other factors. These markets accounted for more than 75 percent of global financial services revenue growth between 2010 and 2013. But there has been a significant slowdown across a number of major markets over the past two years, on account of slowing GDP growth, increasing volatility in currency markets, and changing credit cycles. Some of the most impacted markets are China, Brazil, Turkey, Indonesia, and Thailand.

We expect slower growth to continue over the next five years, with overall retail revenue growth in the EM12 falling from 14 percent a year between 2010 and 2015 to nine percent between 2015 and 2020. Growth will slow particularly in China, Brazil, Mexico, and Saudi Arabia, while Indonesia and Thailand will at best have slow-paced recoveries. (See Exhibit 5.)

Exhibit 5: Retail banking revenue growth rates across selected emerging markets: Recent past (2010-15) compared with near future (expected 2015-2020)



Notes: Past and expected growth figures are in local currency terms and not in $US. This may imply historical (or future) growth numbers are significantly different relative interpretations in $US. China not to scale.

Source: Oliver Wyman analysis

Despite the relative slowdown, the EM12 will continue to drive global growth in retail banking, as the top ten developed markets are expected to grow by only two percent annually over the next five years. During this period, EM12 retail banking revenue will grow by more than $450 billion, as financial services are extended to an additional 250 million households, and another 90 million transition from the mass-market segment to the mass-affluent.

2.2. SOME STRUCTURAL DRIVERS OF GROWTH THAT REMAIN IN PLACE

For many of the EM12 markets, strong structural drivers of growth remain in place:

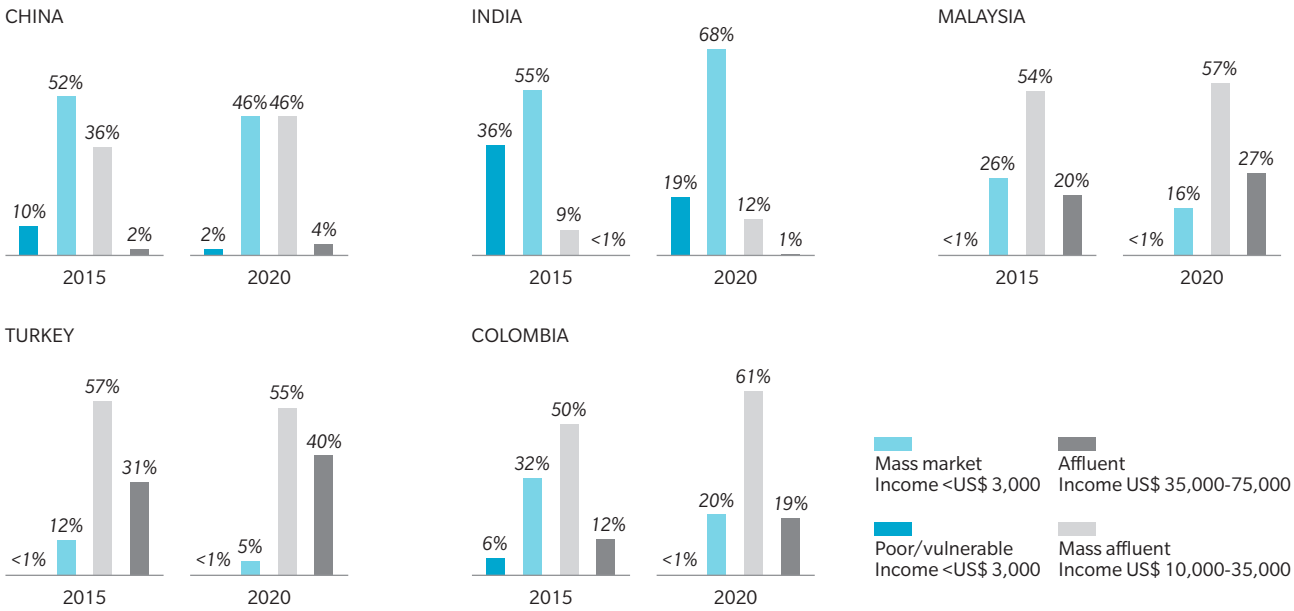
- Rises in income
- Improving credit infrastructure from both public and private stakeholders
- Continued government support to build a financial infrastructure that boosts growth in the real economy

Rises in household income: A principal driver of retail banking revenue growth in emerging markets is the rise in household incomes as GDP grows. This effect is often complemented by favourable demographics, which lead to a corresponding increase in the proportion of the population that make up the productive workforce.

As households' income increases, the share of their spending that goes on financial services rises disproportionately. This means that significantly greater financial services revenue can be generated from households in higher income brackets. We estimate the revenue from an affluent household is more than 30 times that from a mass-market household. (This is based on the South East Asia consumer wallet survey:

Improving credit infrastructure: We note a consistent institutional effort across most emerging markets to improve their retail and SME credit infrastructures. Measures include private and public credit bureaus; national identity databases and digital know-your-customer (KYC) infrastructure; collateral registries; and a better-defined – and often more favourable – legal environment for creditor rights.

Exhibit 6: Expected migration of households across income bands (only markets with significant shifts shown)



Source: EIU, Oliver Wyman analysis

Almost all relevant emerging markets now offer information on debtors through public credit registries or private credit bureaus. However, the extent of their history and coverage varies, with the Chinese and Indian institutions covering less than 30 percent of their populations. Some emerging markets have developed national identity databases and digital KYC infrastructure, such as Aadhaar in India, that make it easier for financial service providers to on-board new customers. We explore these developments in further detail in the next section, on growth opportunities.

Government support in building financial infrastructure: Government support is expected to increase growth opportunities for financial services in emerging markets, particularly in the SME and affordable banking areas.

- For SMEs, support is often provided by government-backed bank credit guarantee schemes and dedicated development banks.
  - Examples of guarantee schemes include the Chilean auction-based FOGAPE[7]; Brazil's FAMPE[8], which requires proof of denied finance in the market due to lack of collateral; the KDG[9] in Turkey; and the Indian CGMSE[10].
  - Direct funding is provided by dedicated development banks, such as the SME banks in Thailand and Malaysia, and Cartaõ BNDES in Brazil.
- The expansion of the formal financial system is facilitated by government initiatives that target rural areas and low-income segments of the population. For example, Colombia exempts low-income accounts – below a volume of $200 in transactions per month – from the usual transaction tax[11], and Malaysia offers subsidised deposit rates for the indigenous Malay population.

3. IMPLICATIONS AND GROWTH OPPORTUNITIES

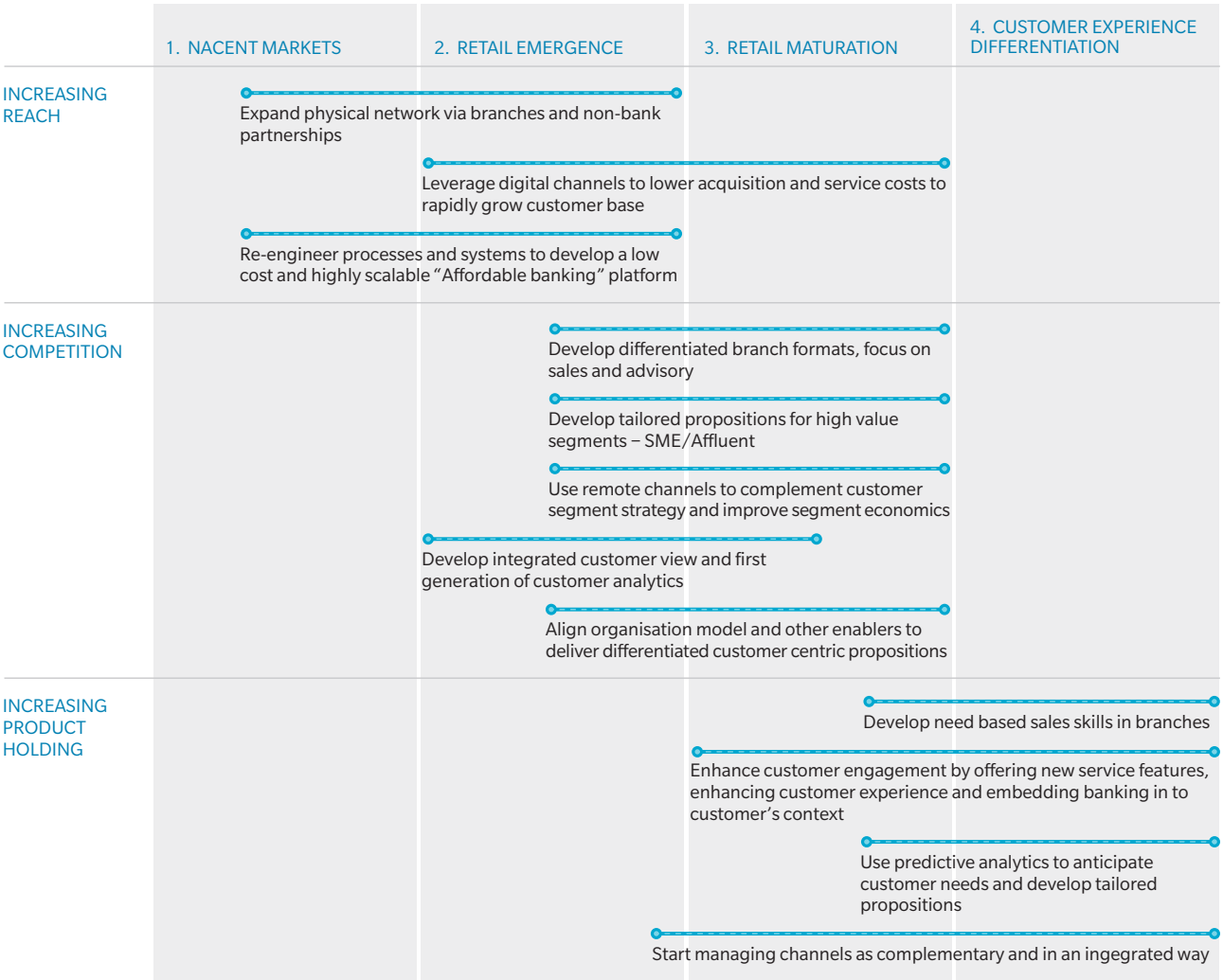
3.1. STRATEGIC IMPLICATIONS FOR BANKS

Exhibit 7 presents our views on the broad strategic agenda that banks should follow in markets – or regions within markets – at different stages of evolution.

7 Fondo de Garantía para Pequeños Empresarios
8 Fundo de Avail às Micro e Pequenas Empresa
9 Kredi Garanti Fonu
10 Guarantee Fund Scheme for Micro and Small Enterprises
11 Cuatro por mil

Exhibit 7: Broad strategic implications of different evolutionary stages of retail banking

STRATEGIC PRIORITIES FOR BANKS ACROSS DIFFERENT PHASES OF RETAIL MARKET EVOLUTION



Source: Oliver Wyman analysis

Many incumbent banks operate across markets – or regions – that span different stages of evolution. These banks need either to focus on specific segments, such as the rich urban centres that represent Stages 3 and 4, or develop enough management discipline to accommodate different strategies without losing focus. We have identified significant implicit subsidies from one segment to another in those banks that do not have this discipline.

This implies that the strategic agenda above needs to be prioritised for institutions in specific markets. To aid this process, we have combined our assessment of the longer-term evolutionary direction with an analysis of shorter-term revenue and its drivers. We have identified four main growth opportunities that have strong relevance across most of our focus markets, and will together define the future of these markets:

- Adoption of digital channels, products and business models
- The untapped opportunity presented by small- and medium-sized enterprises (SMEs)
- Sustainable growth in retail credit
- Development of an affordable banking proposition

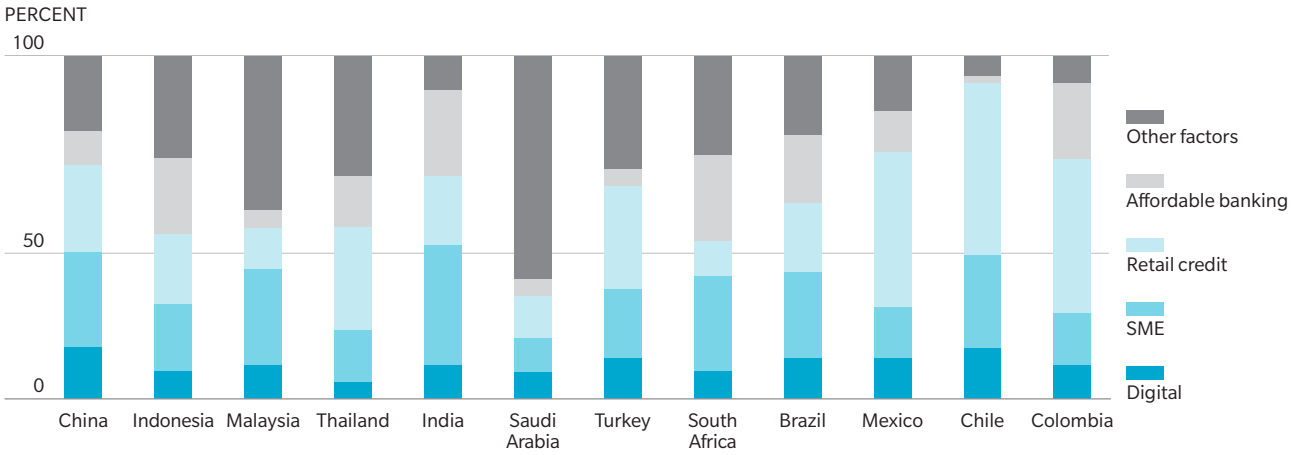
These are also the topics that came up most frequently as growth priorities when we interviewed more than 20 retail banking leaders in emerging markets as part of our research.

Other topics have of course emerged too, such as China's diversification of savings and investment. However, while these may be important in specific markets, they were not consistently cited with similar conviction in a large number of markets.

3.2. KEY GROWTH OPPORTUNITIES

Four key growth opportunities will shape the trajectory of retail banking in the EM12, by contributing an average of more than 70 percent of their revenue growth. The exhibit below shows the relative contribution of each opportunity to the next five years' of growth. (See Exhibit 8.)

Exhibit 8: Relative contribution of each opportunity to retail revenue growth by country (2015-2020)



Source: Oliver Wyman analysis

Incumbent banks in these markets should aspire to develop leadership capabilities across these growth areas in order to maintain their market positions. The exhibit below summarises our view of the strategic agenda that these institutions need to follow.(See Exhibit 9.)

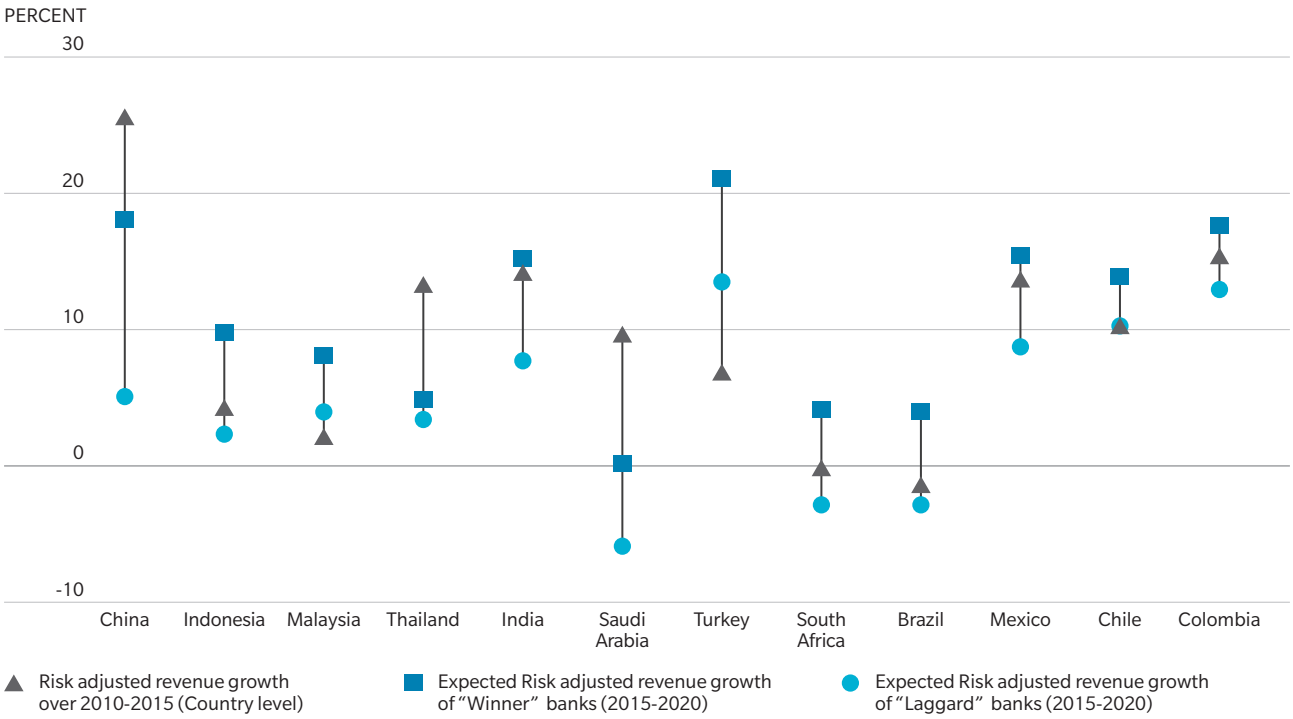
Exhibit 9: Summary of strategic response agenda to key growth opportunities

	BASELINE RESPONSE	LEADERSHIP RESPONSE
Digital adoption	**Digital baseline** • Promote use of digital tools (e.g., tablets) and self-service terminals in sales and servicing • Improve front-to-back productivity via digitisation • Remove hassle in customer journey	**Digital leadership** • Better understand customer behaviour via digital footprint; invest in digital data analytics • Drive an institution wide coordinated digital response • Develop capability to drive accelerated delivery of digital initiatives
Untapped SME opportunity	**Getting SME basics right** • Set up dedicated SME organisation • Establish an operating model that leverages strengths of retail and wholesale banking • Develop a tailored credit process: Fast and simple while managing risks and costs to serve	**Building the next generation business model** • Build on wholesale linkages (e.g., transaction banking functionalities, sector solutions) • Create distinct segment capabilities (e.g., digital credit process, new data based credit analytics) • Address unmet and emerging needs (e.g., cash flow volatility loans, cash management solutions)
Sustainable growth in retail credit	**Retail credit fundamentals** • Drive cross sales in retail credit via branches leveraging proprietary customer data • Design scorecards using bank wide data and strengthen collection capabilities • Establish faster credit process and better customer experience using automated decisions	**Retail credit next steps** • Improve customer targeting with segmentation, augmented data and tailored products • Start managing value levers (i.e., Risk, Price, Balance and Attrition) via advanced analytics and targeted customer level actions • Invest in NPL management – early warning, dynamic risk limits
Affordable banking	**Banking for the unbanked** • Develop mobile-led banking proposition • Leverage non bank partnership opportunities (e.g., Agent network, Retail stores, Post offices) • Leverage alternate data sources to underwrite credit and manage fraud risk	**Re-inventing mass market banking** • Manage cost to serve via streamlined and heavily digitally supported savings and payments • Offer basic loan products with highly automated risk processes • Proactively graduate customers to upper tiers

Source: Oliver Wyman analysis

The different degrees of effectiveness of incumbents' responses to these opportunities will create increasing distances between the winners and the laggards. For example, winner banks in Indonesia may be able to increase their risk-adjusted retail revenues by 10 percent each year over the next five years, while the laggards will struggle to grow at more than two or three percent. The exhibit below shows our expectations of the growth trajectories of winners and laggards (in terms of risk-adjusted retail revenue growth) over the next five years across the EM12. (See Exhibit 10.)

Exhibit 10: Expected risk-adjusted retail revenue growth over the next five years of winner and laggard institutions across the EM12



Source: Oliver Wyman analysis

3.2.1. Adoption of Digital channels, products and business models

The last decade of digitisation has established two key trends in emerging markets:

- An exponential rise in access to digital services via mobile phones and, increasingly, smartphones. Penetration levels are growing faster in emerging markets than in developed markets, and are already catching up: Smartphone penetration in China is about 47 percent, while in Germany it is 40 percent.
- The rise of digital commerce ecosystems has started shaping consumption trends and customer expectations.

While these trends have already disrupted industries such as travel, electronics, and retailing, their impact on financial services across the EM12 has in general been more limited. Still, digital has gained significant share as a servicing and transaction channel in financial services. For example, more than two-thirds of consumer payments in Malaysia are now being made via mobile phones and the Internet. But the rise of digital-led or digital-only business models has been slower. China has more than 2,000 peer-to-peer platforms for marketplace lending, but this is the exception rather than the rule across the EM12.

However, there is reason to believe that digital services will bring more structural changes to the financial services industry in the EM12 over the next decade than have been observed so far. Three trends will have a particular impact:

- Powerful consumer platforms are emerging which can disintermediate banks and attract their own demand for financial services. For example, Alibaba and Tencent have started providing a full spectrum of banking services in China.
- Some regulators are pushing regulations that will reduce barriers to entry in banking, so as to further their objective of financial inclusion. For example, the Indian banking regulator has issued payments bank licenses to more than ten new players and small bank licenses to another ten institutions.
- A large number of Fintechs have started focussing on these markets, sensing a growth opportunity. For example, more than 300 Fintechs have emerged in the past five years in Southeast Asia alone.

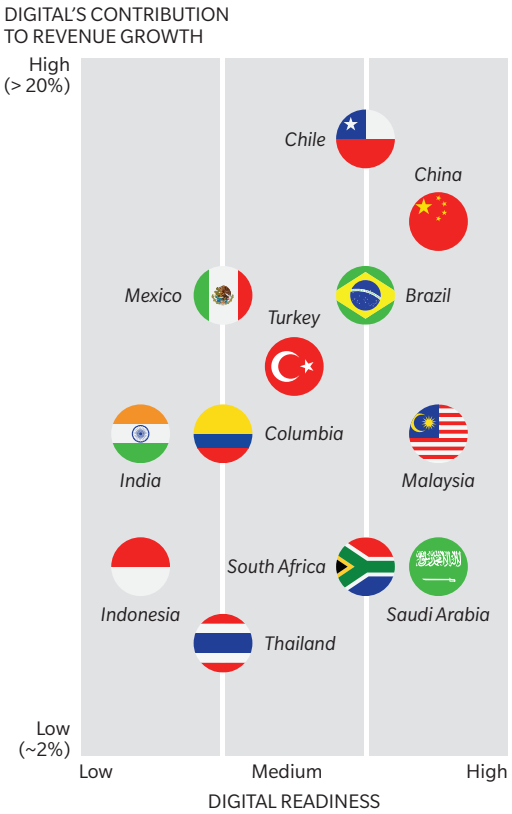
While much of this sounds like bad news for incumbent banks, we believe large integrated financial services institutions across the EM12 have significant advantages over new entrants on at least three counts:

- Banks continue to enjoy privileged access to low-cost funding. This has proven defensible even in developed markets, and will continue to give them an advantage in all credit-driven businesses.
- Access to banks through physical channels continues to be important in emerging markets as a means of trust building, cash handling, and customer-risk assessment. Banks with existing branch or partnership networks have significant advantages.
- Large existing customer bases and integrated product offerings – often sourced internally across group entities – offer an ideal setup for building deep customer relationships powered by smarter analytics and a low marginal cost of acquisition.

In summary, we believe that in the future of digital financial services, Fintechs will not replace banks, but banks and Fintechs will compete, as well as collaborate to drive innovation. Leading banks have been investing in digital capabilities for three or four years and gained strong leadership over their competitors, particularly in data infrastructure, big data analytics, data-driven marketing, and agile management practices. However, the degree to which a bank needs to pursue a digital leadership

agenda over the next five years depends on the significance[12] and readiness[13] of the digital opportunity of the country in which it operates. Incumbent institutions need to manage carefully the balance of investments going into digital platforms in coming years and the benefits they expect. Exhibit 11 summarises our views on digital initiatives and provides country-level assessments of digital opportunity and readiness.

Exhibit 11: Summary of digital initiatives with country-level assessments



AGENDA 1: DIGITAL BASELINE

- Use digital tools (i.e. tablets) and self-service terminals to improve productivity, efficiency and customer experience
- Improve front-to back productivity through digitization of processes and interfaces
- Enhance customer experience/remove hassles in customer journey via digital applications

AGENDA 2: DIGITAL LEADERSHIP

- Better understand customer need/behaviour based on their digital footprint; invest in digital data analytics
- Develop modular platforms and open architecture solutions embedded in digital ecosystems
- Drive an institution wide coordinated response – investment strategy, partnership approach, and organisational set up to promote digital innovation
- Develop internal capabilities to drive accelerated delivery of digital initiatives; agile solution development, rapid IT delivery, digital marketing and brand building

Source: Oliver Wyman analysis

3.2.2. The SME opportunity

Economic development in emerging markets relies significantly on the SME[14] segment. In recent years, SMEs have accounted for more than a third of GDP growth in many emerging markets, and they are expected to remain a cornerstone of growth.

12 We have assessed the significance of the digital opportunity based on estimates of digital's contribution to retail revenue growth in each country over the next five years (2015-20). This includes revenue generated by digitally driven customer platforms (e.g., financial services aggregators, e-commerce sites, and online acquisition channels), as well as digital-only products (e.g., small business loans offered via digital channels).

13 Digital readiness has been measured through a combination of smartphone penetration and e-commerce penetration (the share of Internet users buying online).

14 We define SMEs as businesses with an annual turnover in the range of $100,000 to $10 million.

The relative importance of SMEs also extends to the banking sector. Revenue generated from SME loans alone typically accounts for more than 20 percent of overall retail banking revenues in the EM12. SMEs also play an equally important, and often underappreciated, role as a source of low-cost funding. In a survey of the Association of Southeast Asian Nations (ASEAN), we found that SMEs take up more than 40 percent of the low-cost funding provided by retail banks in Indonesia.

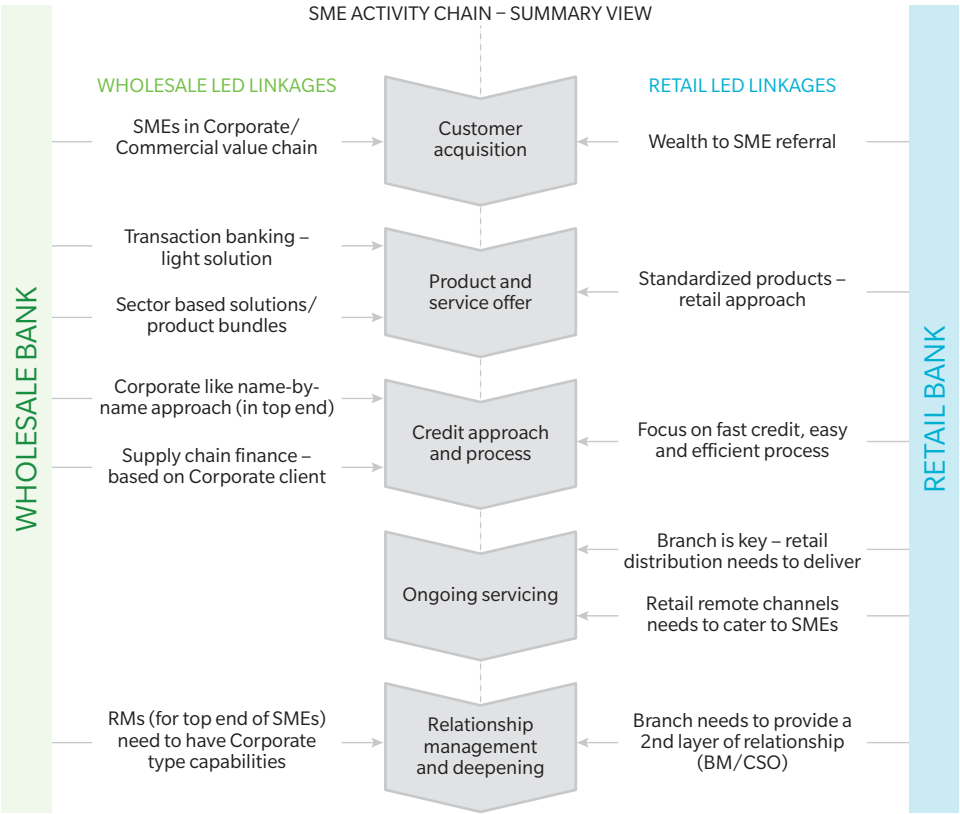
However, tapping into the SME segment presents a number of challenges:

The best of retail and wholesale banks on one platform

To serve the segment well, a typical bank must combine the best of both its wholesale and its retail capabilities. This requires getting several structural enablers right. For example, it needs to align key performance indicators (KPIs) and incentives across businesses, and to foster a collaborative culture between divisions within the bank that are otherwise self-contained. (See exhibit 12.)

Banks which get this right often operate an SME segment business with a cost-income ratio of 40 percent, while those who struggle operate at more than 60 percent.

Exhibit 12: Linkages: Wholesale – SME – Retail



Source: Oliver Wyman analysis

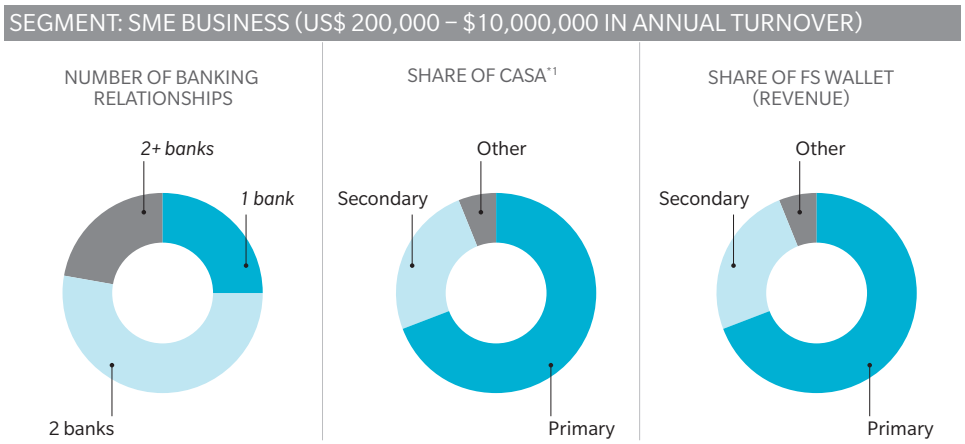
Managing through-the-cycle credit economics

Lending to the SME segment can often be challenging given the lack of credit and legal infrastructure, the questionable reliability of disclosed accounting information, and the lack of transparency of real cash flows in a cash-based economy. As a consequence, SME loan growth often trails retail loan growth in emerging markets, in spite of significant pent-up demand. The performance implications of getting SME credit right are very significant: Between the winners and the laggards in SME lending, we have seen spreads of two or three times in through-the-cycle losses without any meaningful difference in through-the-cycle growth rates.

Becoming the primary bank

Lastly, while SMEs often maintain multiple banking relationships, the primary bank dominates the SME wallet, capturing between 60 and 70 percent of the financial services revenue opportunity. These relationships, revolving around the main transacting account, are generally very durable, making the segment difficult for newcomers to enter.

Exhibit 13: Banking relationships and wallet share of banks in the SME segment – example of the Indonesian market



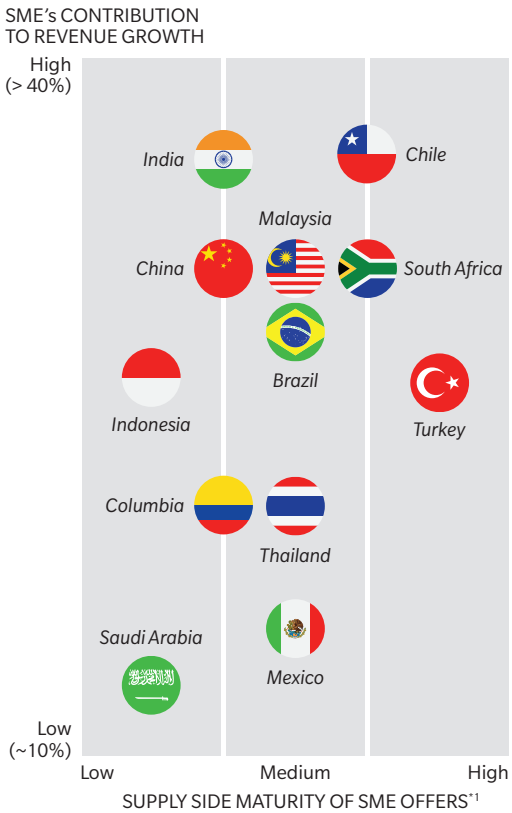
Source: Oliver Wyman survey of ASEAN SMEs, 2015

*1 CASA: current account savings account balance

Getting it right

In spite of the challenges, banks can build an attractive SME business in most emerging markets, with a return on equity of more than 20 percent. Indeed, such examples exist in each market. We recommend a staged approach in developing a successful SME proposition, taking into account the size and stage of development of the SME opportunity in the market in question. Exhibit 14 summarises our recommendations for addressing the untapped SME opportunity.

Exhibit 14: Summary of SME initiatives with country-level assessments



AGENDA 1: GETTING SME BASIC RIGHT

- Set up SME as a dedicated organisational segment with focused functional resources and define a clear segment value proposition that fits the market maturity and incumbent's strengths
- Establish an operating model that leverages retail footprint, standardised processes and wholesale relationships to deliver on the customer proposition
- Develop a tailored credit process for SMEs that delivers credit in a simple and fast manner while managing risks and cost to serve

AGENDA 2: BUILDING THE NEXT GENERATION BUSINESS MODEL

- Build on wholesale linkages (e.g. transaction banking functionalities, sector specific solutions)
- Create distinct segment capabilities (e.g. digital credit process, new data based credit analytics, risk based pricing delivered via RM applications)
- Address emerging and unmet needs of SME customers (e.g. cash flow volatility loans, cash management solutions, digital VAS)

Source: Oliver Wyman analysis

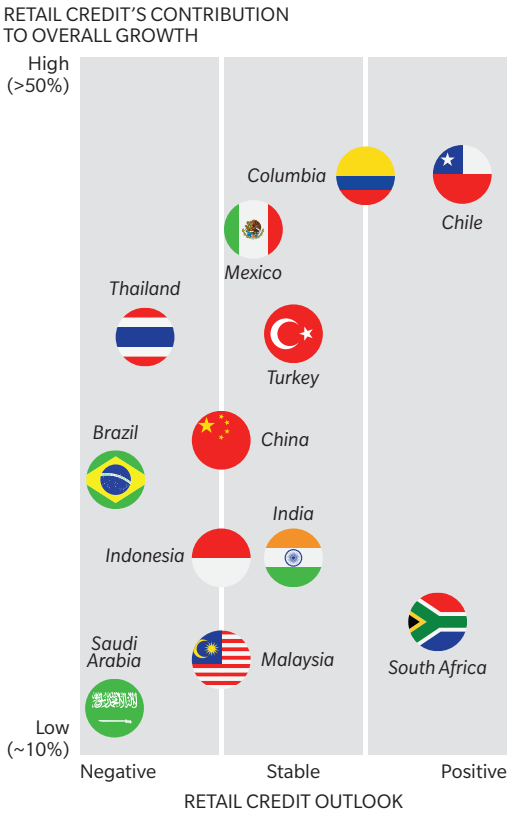
3.2.3. Driving sustainable growth in retail credit

Retail credit penetration in the EM12 is still low, despite the strong growth in retail loans in past years. All the emerging markets we focus on, with the exception of China, lie significantly below developed markets in retail credit penetration.

Retail credit expansion will remain a key driver of growth across these markets over the next five years, contributing between 20 and 50 percent of total retail revenue growth. However, we expect to see greater disparity in the bottom line performances of individual banks in these markets, particularly in markets where the credit cycle has started turning negative, such as Brazil, Mexico, Saudi Arabia, Thailand, and Malaysia.

In summary, to operate successfully in the retail credit segment, banks will need to maintain a balance of initiatives that drive growth on the one hand, and enhance risk management capabilities on the other. Our recommendations and country-level assessments are presented in Exhibit 15.

Exhibit 15: Summary of sustainable retail credit initiatives, with country-level assessments



AGENDA 1: RETAIL CREDIT FUNDAMENTALS

- Drive cross sales of retail credit products via branches leveraging proprietary customer data
- Design credit scorecards to leverage multiple traditional data sources and strengthen collections capabilities
- Establish faster credit processes through automated decision making, including pre-approvals and real-time decisions for lower ticket sizes

AGENDA 2: RETAIL CREDIT NEXT STEPS

- Improve customer targeting with segmentation, augmented data and tailored products
- Start managing value levers (e.g. risk, price, balance and attrition) via advanced analytics and targeted customer level actions
- Invest in NPL management, including – early warning signals and high limit management for SMEs, consolidation and professionalization of internal and third party collections across channels

Source: Oliver Wyman analysis

3.2.4. Developing an affordable banking proposition

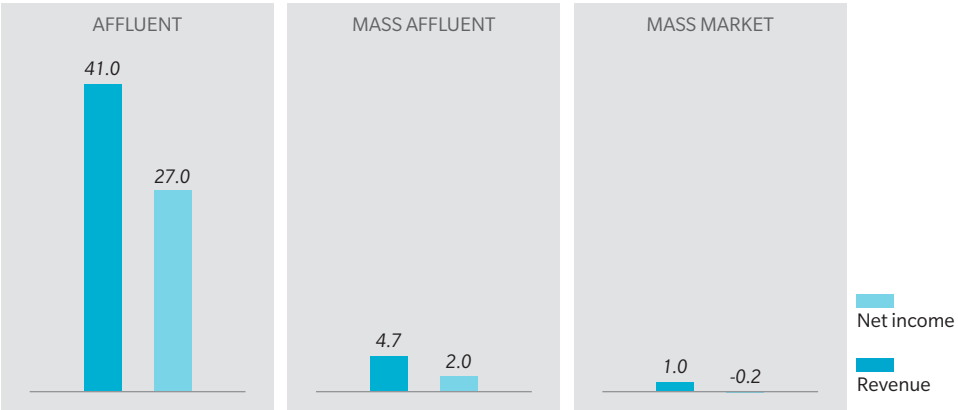
Opportunity

Building affordable banking is a focus in many of the large EM12. For the purposes of this report, we define the affordable banking segment as including both the unbanked population, and the section of the mass market[15] that is currently underserved by banks or not an economically viable proposition for banks. This definition is based on our belief that the challenges and potential solutions in these two groups overlap. The segment currently covers approximately 575 million households across the EM12. The challenge is to develop banking propositions that are both affordable for the target client segment and profitable for the banks.

Challenges

While the target segment is large, its potential to generate profit for banks is limited, particularly with current banking business models. Adverse factors include individual households' small financial services wallets; the relatively high cost of providing services given the need to use the traditional banking model; and the often-challenging geographic locations of these customers, which make it even more difficult to access and serve them. All these factors make this segment look unprofitable on a per-customer level. (See Exhibit 16.)

Exhibit 16: Annual bank revenue and profit per household across income segment – the Indonesian market (mass-market revenue = 1)



Note: The mass-market segment is defined as households with annual income between $3,000 and $10,000. The mass-affluent segment is defined as households with annual income between $10,000 and $35,000. The affluent segment is defined as households with annual income greater than $35,000.

Source: Oliver Wyman analysis

15 The mass-market segment is defined as households with annual income between $3,000 and $10,000.

Arguments for developing an affordable banking solution

We believe there are three main reasons why emerging market banks should develop an affordable banking solution:

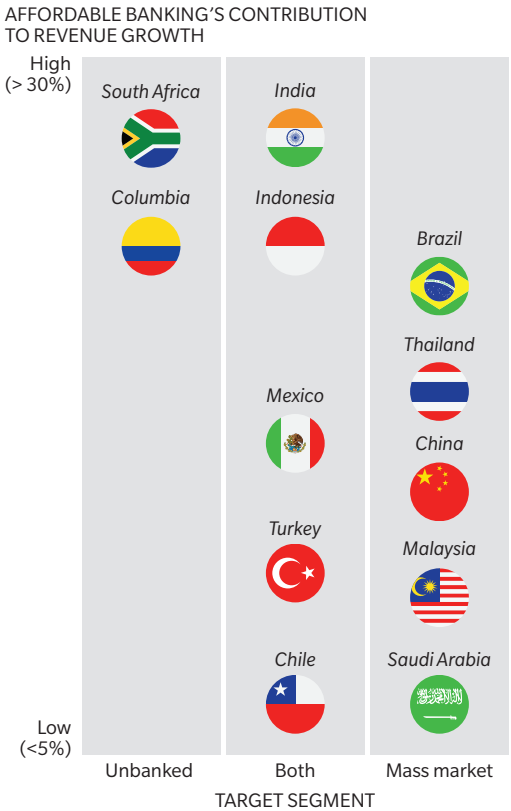
For many banks in emerging markets, serving low-income customers is a core part of their business:

- Most large retail banks already have low-income customers who do not generate profits, and are not well-served by the bank's current proposition.
- Banking regulators in emerging markets often have prescriptive guidelines that require banks to offer banking services to the unbanked, or under-banked, population. For example, in India the government's financial inclusion program, Pradhan Mantri Jan-Dhan Yojana (PMJDY), led to the opening of more than 125 million accounts in just eight months after its launch in August 2014. The average account balance (for accounts with non-zero balances) is only about $40.

Innovations in affordable banking have broader benefits for the rest of the bank. A mobile banking platform, initially with a set of basic functionalities, can later offer a more sophisticated suite of services, and be expanded to a broader client base.

Our recommendations and country-level assessments of affordable banking opportunities are summarised in the Exhibit 17.

Exhibit 17: Summary of affordable banking initiatives, with country-level assessments



AGENDA 1: BANKING FOR THE UNBANKED

- Develop feature phone led banking proposition: fast, lean and easy (viability may depend on regulatory framework)
- Leverage a non-bank partner distribution network to originate new relationships and service existing clients (e.g., retail stores working as banking transaction points)
- Leverage alternate data sources (e.g., Telco usage) to underwrite credit and manage fraud risk

AGENDA 2: RE-INVENTING MASS MARKET BANKING

- Manage cost to serve via streamlined and heavily digitally supported savings and payments products
- Offer basic loan products to individuals with highly automated risk process and pre-approvals (e.g., based on payment and checking account history or where available Social security/pension information)
- Proactively graduate customers to higher level of service and product proposition based on historical behaviour

Source: Oliver Wyman analysis

4. KEY TAKEAWAYS

In conclusion, we believe that retail banking growth in the EM12 is undergoing a major change. Secular growth shared by incumbents will give way to more differentiated trajectories and a clearer separation between winners and laggards.

Four key opportunities will define future growth in these markets. The fates of both incumbents and challenger institutions will be decided by their responses to these:

- Adoption of digital channels, products, and business models
- Untapped opportunities presented by SMEs
- Sustainable growth in retail credit
- Development of an affordable banking proposition

Incumbents need to pursue an agenda of market leadership across these growth areas in order to maintain their market positions. Effective responses will lead to accelerated growth in risk-adjusted performance, enabling market leaders to grow as much as two to four times as fast as lagging institutions.

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