



Banking in emerging markets  
Investing for success



**EY**

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working world



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# Introduction

Last year we launched EY's inaugural *Banking in emerging markets* survey to help track changes in sentiment among bank executives in the emerging markets and to provide insight into opportunities and challenges for both domestic and international banks operating in those markets.

**W**e surveyed rapid growth markets (RGMs) at different stages of financial maturity to understand where growth was expected, what products customers wanted, how demand for financial services would evolve as the countries matured and how banks were planning to respond.

Shortly after our first survey, we witnessed the disruption of many emerging markets following the announcement that quantitative easing (QE) in the US would be scaled back. In this report, we have returned to those markets to see how this turn of events, combined with other domestic and international developments, has affected the prospects for banks. Is the demand for financial services still expected to grow at a rapid pace? How has the changing landscape impacted banks' priorities? And more importantly, what investments do banks need to make to operate successfully in such volatile markets?

This report also incorporates results from EY's *Global Consumer Banking Survey 2014* to help our clients better understand what motivates their emerging market retail customers. We identify what customers look for in a financial services provider and how customers' priorities map to banks' priorities, to determine how financial institutions can better win the most profitable customers.

While emerging markets are very different in nature, we believe there are also distinct similarities between them at different stages of maturity. We see demand for certain products pick up at particular points, and we see banks in these markets facing similar challenges. We believe some of the lessons and experiences of banks in one market can be extrapolated to other markets at a similar stage of maturity.

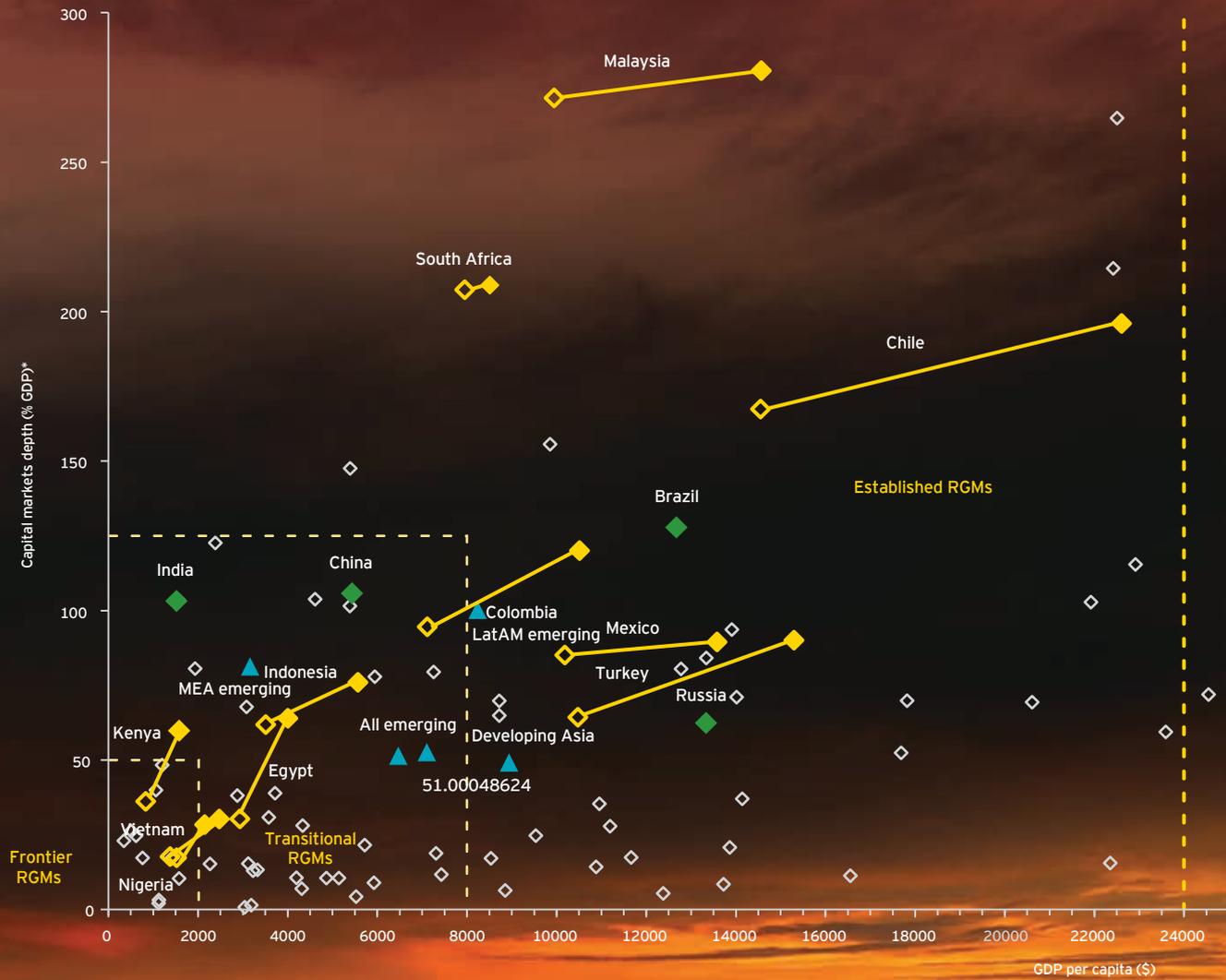
We have identified three stages of maturity in the emerging markets. Frontier RGMs have per capita GDP below US\$2,000, the point at which deposit and savings products typically appear. They also have nascent capital markets with a capital market depth under 50% of GDP. Established RGMs have all exceeded US\$8,000 per capita GDP, the point at which credit products become established, or have a capital market depth of over 125% of GDP. Transitional markets lie between the two (see Figure 1).

Drawing on the findings from our *Banking in emerging markets survey* and our *Global Consumer Banking Survey 2014*, this report covers 11 RGMs that our clients have identified as members of the next wave of developing markets beyond the BRICs. We have chosen these markets because they offer a proxy for other countries at similar stages of evolution.

- ▶ **Frontier RGMs:** Kenya, Nigeria, Vietnam
- ▶ **Transitional RGMs:** Colombia, Egypt, Indonesia
- ▶ **Established RGMs:** Chile, Malaysia, Mexico, South Africa, Turkey

Banks that are successful in the emerging world will be those that are able to identify and learn the lessons of other institutions in similar markets and can adapt them to their local context. By surveying and interviewing senior executives from more than 50 major institutions operating across these markets, which account for more than one-third of their total banking assets, and through a survey of over 9,000 of their retail customers, this report identifies the common threads among the countries. It highlights their challenges and sets out the investments banks must make if they are to be successful.

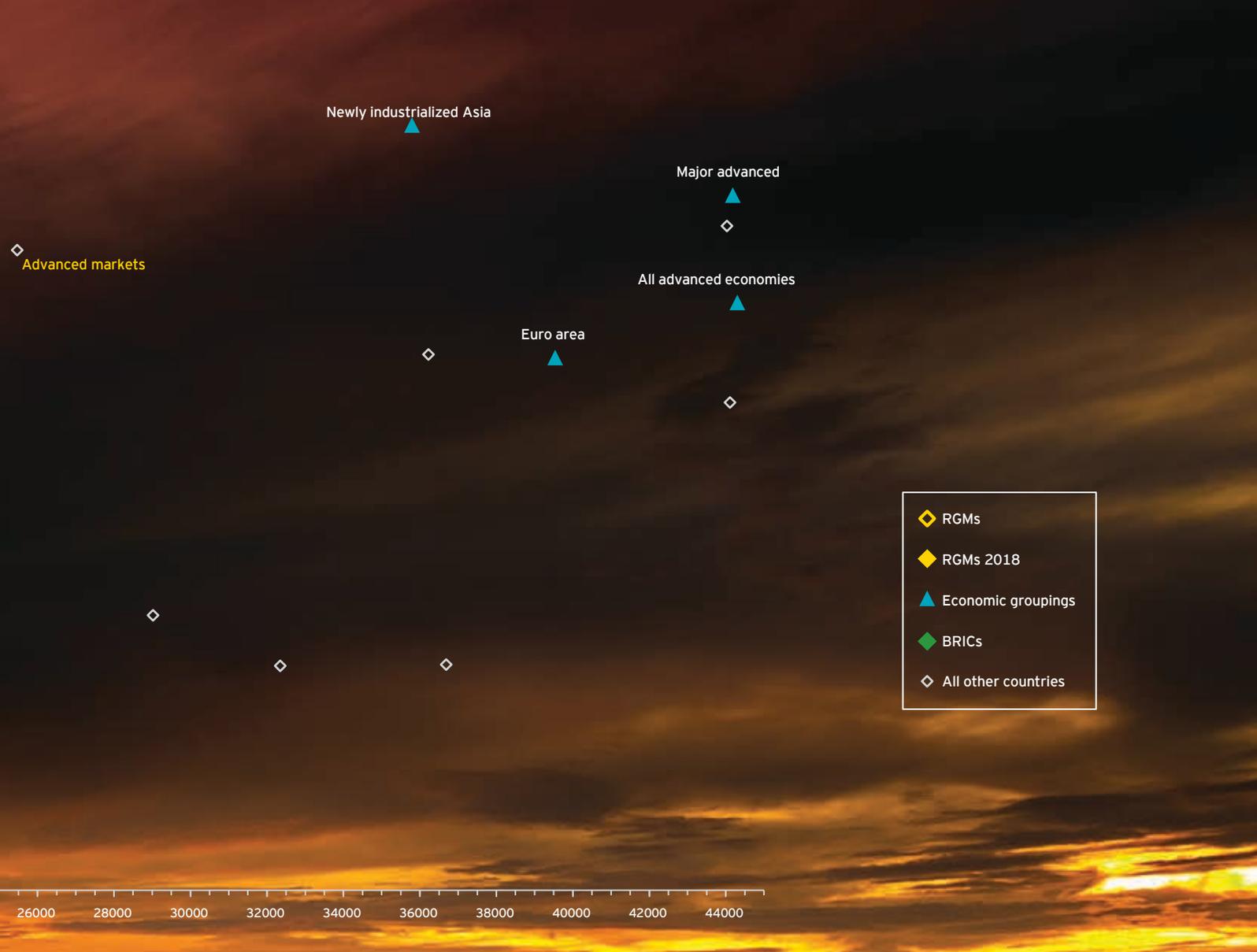
**Figure 1:** Stages of financial maturity. Demand for financial products and the development of capital markets are closely linked to economic growth.



Market	Threshold (GDP per capita)	Threshold (Capital markets depth)	Description
<b>Frontier RGMs:</b> Kenya Nigeria Vietnam	<US\$2,000	<50%	<ul style="list-style-type: none"> <li>Economies begin to monetize and demand for financial services begins to emerge.</li> </ul>
<b>Transitional RGMs:</b> Colombia Egypt Indonesia	US\$2,000-US\$8,000	50%-125%	<ul style="list-style-type: none"> <li>Demand for financial services begins to establish itself as financial inclusion increases. Over 30% of the population typically has bank accounts by the time per capita GDP reaches US\$2,000. Individuals increasingly seek finance for consumption, education and training, and housing.</li> <li>Continued monetization leads to the gray economy being displaced by SMEs. Businesses seek increased financing for investment.</li> <li>Capital markets begin to develop.</li> </ul>
<b>Established RGMs:</b> Chile Malaysia Mexico South Africa Turkey	\$US8,000- about US\$20,000	>125%	<ul style="list-style-type: none"> <li>Demand for all forms of credit for individual consumption continues to grow.</li> <li>As the capital markets continue to develop, businesses seek longer-term, more complex financing and risk management products.</li> </ul>

Source: World Bank data, IMF, EY Estimates. Analysis uses latest publicly available data.

\*Capital markets depth is a measurement of the evolution of capital markets. It represents a country's stock market capitalization, plus its domestic and international debt outstanding, as a percentage of GDP.



	Which financial products are common?	Who provides financial services?
	<ul style="list-style-type: none"> <li>▶ There is limited take-up of deposit and savings accounts.</li> <li>▶ Retail and business customers begin to request small loans.</li> </ul>	<ul style="list-style-type: none"> <li>▶ Community-based savings and credit groups in the poorest communities.</li> <li>▶ Micro-finance institutions serve urban and rural poor.</li> <li>▶ Commercial banks are typically focused on wealthier urban communities.</li> </ul>
	<ul style="list-style-type: none"> <li>▶ Deposit and savings accounts become more common.</li> <li>▶ Demand for retail credit emerges, with increased use of credit and debit cards and auto and payroll loans.</li> <li>▶ Mortgages and formal (non-micro) bank loans emerge.</li> <li>▶ SME lending picks up, as well as specialized forms of finance, such as factoring.</li> <li>▶ The largest companies begin to use bond and equity financing.</li> </ul>	<ul style="list-style-type: none"> <li>▶ Micro-finance institutions still serve poorer customers.</li> <li>▶ Non-banks play a significant role in the provision of credit (e.g., leasing companies providing auto loans).</li> <li>▶ Credit card companies enter the market.</li> <li>▶ Commercial banks become increasingly dominant.</li> </ul>
	<ul style="list-style-type: none"> <li>▶ Formal bank loans become the standard credit product for retail and small business customers. Repayment terms of loans can be significantly longer.</li> <li>▶ Project finance becomes increasingly popular.</li> <li>▶ Demand for hedging products becomes embedded.</li> <li>▶ Capital markets financing becomes increasingly common.</li> </ul>	<ul style="list-style-type: none"> <li>▶ Micro-finance and specialized finance companies still serve customers, but commercial banks dominate the market.</li> </ul>

\*\*Country GDP/Capita are the latest available World Bank figures (typically 2012). South Africa is classified as an established RGM; although South African GDP is under \$8,000, the depth of South Africa's capital markets is in excess of 125% of GDP.

# Executive summary

Growth is a defining feature of the emerging markets. Our 11 RGMs are growing at twice the rate of the developed markets. This growth makes them an attractive proposition for banks as the customer base expands and demands a wider range of products and services. But not all customers will be equally profitable. Banks cannot serve everyone, and they must maximize the profitability of those they do serve. Being successful in the emerging markets is not straightforward.

**V**olatility is another defining feature of the emerging markets and has a wide variety of causes: political or social upheaval; the creation and destruction of bubbles; and the amplified repercussions resulting from events and decisions in global financial markets. Banks must cope with this volatility if they are to thrive.

These two forces – growth and volatility – have been evident during the past five years. Faced with sluggish growth and low yields in the developed world, investors turned to new markets. As “hot money” in search of yield flooded these markets, businesses found their cost of funding reduced. But as yields ticked up in the developed world following the tapering of QE, capital flows slowed or reversed. In the first two months of this year, more money flowed out of emerging market funds than had done so over the whole of 2013.

As a result, interest rates have been raised in a number of the emerging markets as central banks try to prop up their currencies; thus, borrowers are coming under pressure, and banks may see their non-performing loans increase. But most banks in emerging markets are sufficiently capitalized to weather a storm, and growth will pick up again, driven by underlying fundamentals in most markets. The question many banks are struggling with is how to generate maximum return from this market growth.

Banks must combat three headwinds – tougher regulation, intensifying competition and increasing costs – if they are to weather the volatility of the markets and seize the profitable opportunities they present.

A raft of regulation – to improve stability, to protect customers, to address supervisory weaknesses and to align the interests of foreign banks to local objectives – is putting compliance departments under pressure.

The opportunities in these markets (we estimate that over the next five years, bank credit to the private sector in our 11 RGMs will grow by more than US\$1.5t) are attracting new entrants to the banking sector. These competitors are

beginning to lure the most profitable customers away from incumbents with their broader reach or more specialized capabilities.

Banks must also grapple with cost pressures. Funding costs are rising; minimum wage increases and staff shortages are driving up labor costs, and banks need to invest more in technology as they seek to improve their business efficiency and provide customers with better service.

In response to these pressures, we see banks focusing on three areas:

- ▶ **Strengthening risk management.** Credit risk management is central not only to managing volatility, but also to growing business. With many emerging markets lacking credit bureau coverage, banks are looking at new ways to assess and manage credit risk. They are also focused on improving risk management more generally across their business – for example, through improving governance to reassure investors.
- ▶ **Improving capital and business efficiency.** As demand for credit grows, banks are looking for the most effective way to deploy their balance sheets. Banks that can better target lending will be able to maintain higher interest margins. But to avoid losing customers, they also need to find alternative methods to finance those they don't lend to.

As banks invest in growth, they are seeking new ways to improve the efficiency of their cost base and widen their operating jaws. Banks are looking for new, low-cost ways to reach customers in these markets.

- ▶ **Winning profitable customers.** The growth of the emerging markets offers huge scope for banks to expand their business. But new entrants mean that competition over a small segment of profitable customers is incredibly intense. Banks are looking at ways to profitably serve customers that were hitherto considered unattractive.

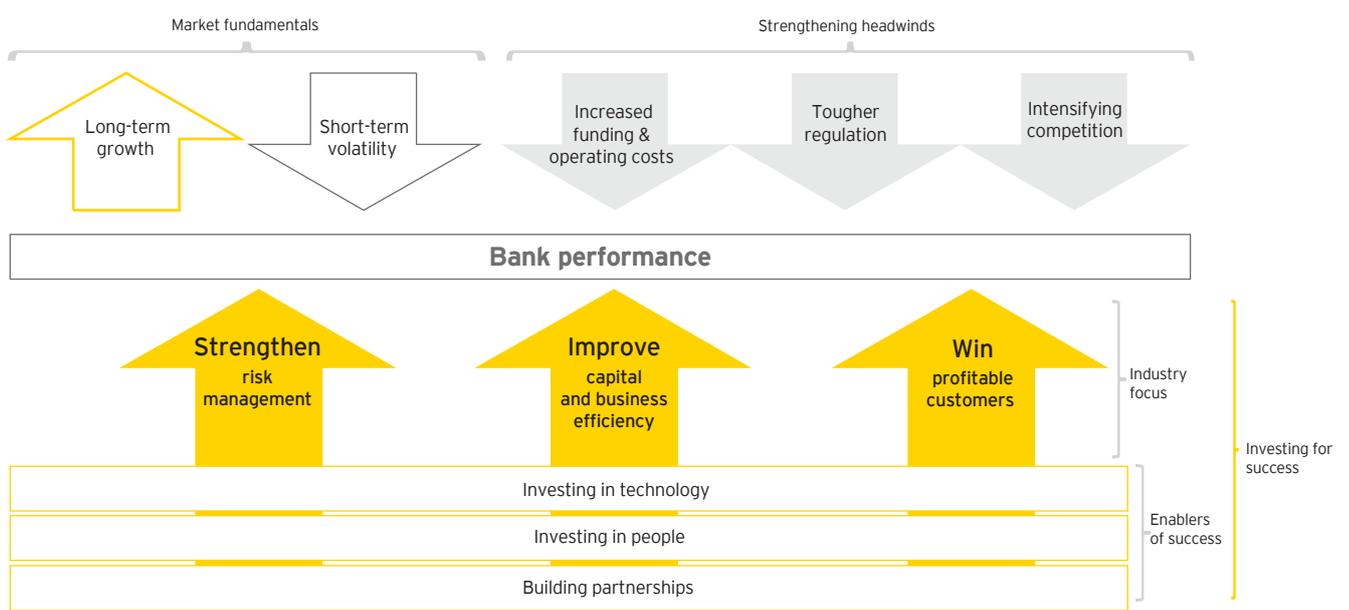
We don't believe that focusing on these areas will be enough to make banks successful in the emerging markets. We believe that banks must look to invest beyond them to develop genuinely differentiated skills and capabilities. To do this, banks must make targeted investments in three enablers of success.

1. **Technology.** Investments should be made to provide new, low-cost ways to reach customers in markets with limited infrastructure, better assess credit risks, build enduring relationships with their customers and improve the efficiency and effectiveness of their internal operations
2. **People.** Highly skilled IT staff will be essential to delivering transformative technology programs in the front office by providing premier clients high-touch service and serving the critical function of assessing risk in unbanked communities, and in the back office to drive innovation and efficiency programs.

3. **Partnerships.** To do what banks can't do themselves, collaborating with other financial institutions, technology firms or firms from other sectors will be central to plugging skills gaps in the short term and improving banks' capabilities in the long term. This will be essential for banks looking to expand into areas of the market in which they have not previously operated and in the provision of new services to customers

The best route to success will vary from institution to institution and country to country. What is clear is that success will be hard to achieve without significant investment in technology, people and partnerships. However, banks don't need to start with a blank page. They can learn from those who have gone before them: institutions that have developed programs to address the challenges and seize on the opportunities the emerging markets offer. The most successful banks in these markets will be those that adapt, rather than copy, and innovate to find new ways of doing business.

Figure 2: Investing for success in the emerging markets





# I. An engine of global growth

The emerging markets have been the principal driver of global growth over the last five years. And despite recent turbulence, we expect them to remain central to global growth over the next decade and beyond.

In the wake of the financial crisis, as developed markets were gripped by recession, investors' eyes turned to the emerging markets – understandably so. Although the rapid growth markets we focus on in this report did experience economic contraction, it was brief. By the end of this year, their aggregate GDP will have risen almost 50% since 2008. By contrast, the UK and Eurozone will only exceed pre-crisis GDP later this year or next. By the end of this year, even the US, which suffered a less prolonged recession, will have grown only about 5% since the start of crisis (Figure 3).

Despite recent market turbulence, the underlying growth in the emerging markets is set to continue. Forecasts suggest that the aggregate GDP of our 11 RGMs will grow by 42% between the end of 2013 and the end of 2018 – from US\$5.1t to US\$7.2t. The broader emerging markets will also see a growth rate of 42% over the same period, but the GDP of advanced economies will only grow 26%.<sup>1</sup>

Economic growth – or lack of it – has been central to the financial performance of banks. Since the financial crisis, the developed markets have stagnated, and the average return on equity (ROE) for developed market banks has collapsed. At a little over 6%, the average post-crisis ROE for these institutions

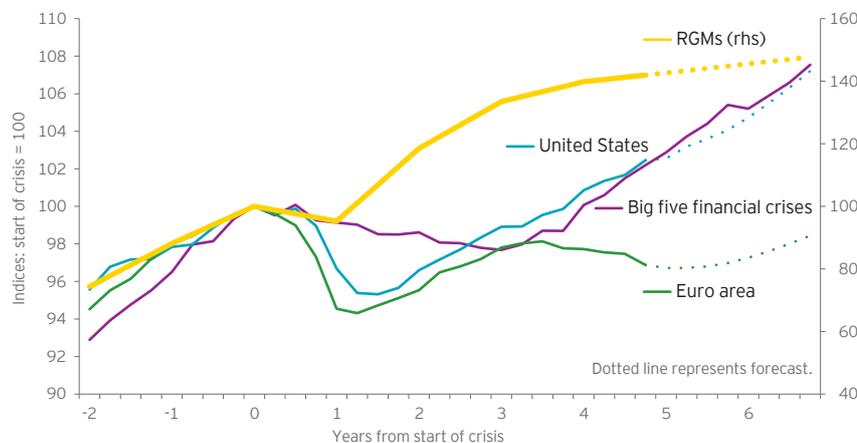
is well below the average cost of equity as many have faced huge credit losses and seen their margins crushed by ultra-low interest rates. By contrast, banks operating in the emerging markets have been able to sustain returns on equity in the mid-to-high teens (Figure 4), aided by economic growth, a favorable interest-rate environment and the fact that most banks have avoided the large write-downs seen in developed markets.

## Volatile markets

This doesn't mean emerging markets are a banking utopia. These economies are volatile; growth may be derailed by political or social upheaval, and banks suffer the consequences. This is recognized as a key risk by bankers across our RGMs. When asked about the key issues facing their economies, 51% of respondents were concerned about socioeconomic issues, 41% were worried about their government's fiscal position, and 36% thought political instability was an issue.

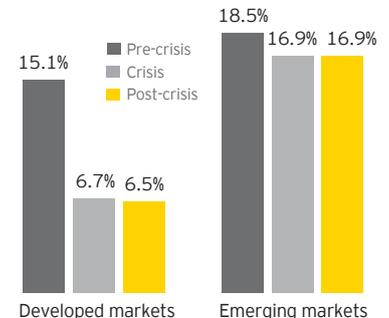
These are frustrations with which many emerging market firms are intimately familiar. In 2013, mass protests or political uncertainty stymied investment confidence in a number of

**Figure 3:** The evolution of GDP around financial crises



Source: Bank of England, Oxford Economics, IMF, EY analysis

**Figure 4:** Bank\* median ROEs and the financial crisis



Source: SNL Financial, EY analysis  
\*Largest 200 banks globally, by assets

<sup>1</sup> IMF World Economic Outlook, October 2013.

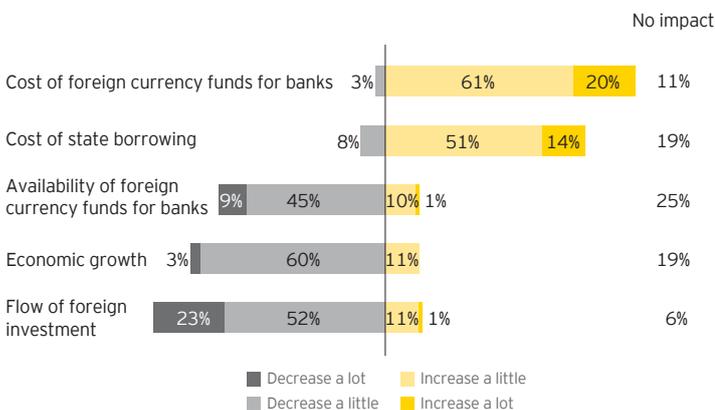
markets: Colombia suffered from industrial unrest in the coal and coffee industries; Nigeria saw a resurgence in terrorism, kidnappings and pipeline vandalism; and in Egypt, stability has yet to return in the wake of the Arab Spring. The impact such turbulence has on bank performance is also clear. Across our RGMs, ROE for 2013 varied from 9.2% in Vietnam to 23.5% in Chile. Net interest margins (NIM) and returns on assets also varied widely. Malaysian banks reported an average NIM of 2.5%, but at the other end of the scale, Nigerian banks achieved 8.3%. Returns on average assets varied from 0.8% in Vietnam to 4.2% in Kenya.

## The shadow of monetary tightening

The political and social concerns of 2013 may have diminished to some degree, but the emerging markets began 2014 under a new cloud – that of monetary tightening. This will shape investment flows and influence growth rates of RGMs this year as the tapering of QE hampers economic growth and leads to outflows of foreign investment across the emerging markets (Figure 5). The first six weeks of 2014 saw outflows of US\$29.7b from funds investing in emerging markets, compared with US\$29.2b throughout the whole of 2013.

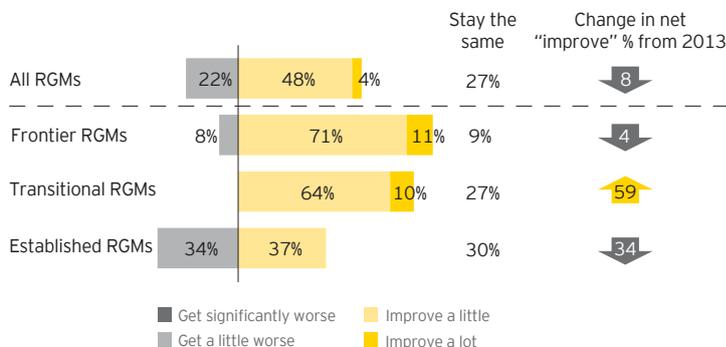
A decline in the flow of foreign investment is likely to lead to slower growth in our RGMs. This is reflected in our survey. Overall, a net majority of respondents still anticipate economic growth in 2014 – but their optimism has moderated slightly since the last survey. Only 52% now expect the economic condition of their country to improve in the next 12 months, compared with 56% last year. Twenty-two percent of respondents expect the economy to deteriorate, compared with just 17% last year (Figure 6).

**Figure 5:** If the US Federal Reserve began to reduce QE, how would you expect it to impact each of the following in your country?



Note: % "Don't know" not displayed.

**Figure 6:** How, if at all, do you expect your country's economic condition to change over the next 12 months?



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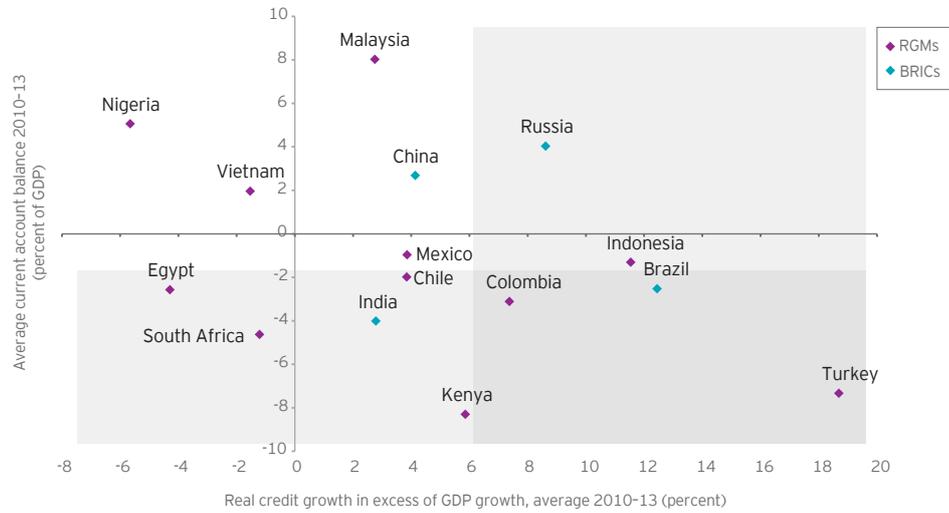
However, there is a wide range of views, depending on the situation in each particular market. Frontier and Transitional economies are the most optimistic. In these markets, lower GDP per capita and underdeveloped capital markets leave considerable room for growth. Transitional countries have seen a rapid turnaround in expectations as disruption – particularly in Colombia and presently in Egypt – has subsided.

## Fiscal fragility

Turkey and South Africa (two of the so-called "Fragile Five" most at risk from tapering; the others are Brazil, India and Indonesia) have been widely discussed as being subject to investment outflows due to their large current account deficits and reliance on external financing. In fact, the optimism of bankers across the Established markets has evaporated, with many of these markets particularly vulnerable as a result of both their current account deficits and rapid credit growth. Malaysia was the only Established RGM where most respondents expected the economy to improve.

Tapering will be particularly challenging for banks in markets that have seen rapid credit growth as the expected economic slowdown and higher interest rates (raised by central banks to bolster their currencies) put pressure on borrowers (Figure 7). Turkey's exposure stands out, given the rapid growth of its lending to small and medium-sized enterprises (SMEs) and consumers, including credit card debt. Although non-performing loans in Turkey are currently less than 3%, monetary tightening is liable to squeeze borrowers, and loans that were previously judged prudent may turn sour. Such an occurrence would bring back unwelcome memories of the global financial crisis, when the rate of non-performing SME loans in Turkey jumped from less than 5% to almost 8%.

Figure 7: Internal and external vulnerabilities



Source: IMF, EY analysis

## Weathering the storm

QE tapering has underscored just how volatile emerging markets can be. Banks are already looking to insulate themselves from the risks that slower growth will bring. Across our RGMs, more bankers this year expect provisions against loan losses to increase than did last year (Figure 8). Banks in Frontier markets are most likely to raise provisions, but it is banks in the Established markets that have typically experienced more rapid credit growth and may be at greater risk from rising non-performing loans. In the Established RGMs, a significant proportion of respondents expect to raise provisions too.

The move by so many banks in these markets to raise provisions demonstrates the importance of sound risk management in volatile markets. Not only must these banks

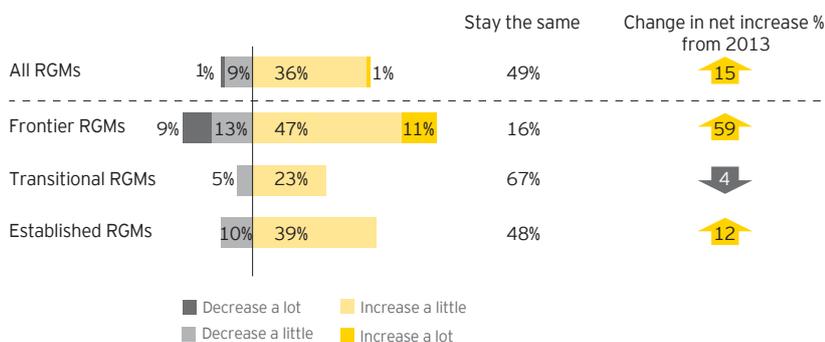
be in a position to deal with existing loans if they go bad, but they must also ensure the loans they make in the future are either of higher quality or better adjusted for risk. Banks must be able to effectively manage broader risks too, as they seek to demonstrate sound governance in an attempt to attract a greater share of diminishing foreign funding. The institutions that succeed in this will be better able to weather volatility and take advantage of the underlying potential of these markets.

## Long(er)-term potential

Banks operating in these markets cannot always escape crises, but they should look beyond short-term hiccups and be reassured by the medium- and longer-term growth trend. The expansion of the middle classes will drive demand for goods and services across all sectors, including banking. By 2022, we expect there to be over 10 million households in Turkey with

income in excess of US\$35,000. In Nigeria, a Frontier market, the number of households with incomes over US\$10,000 will nearly double, from 6 million in 2012 to just over 11 million in 2022.<sup>2</sup> As these countries mature financially (i.e., as incomes and GDP per capita rise), the scale and complexity of demand for financial products and services will increase – not just from individuals, but from companies and governments as well.

Figure 8: Over the next 12 months, do you expect provisions against loan losses to ... ?



Note: % "Don't know" not displayed.

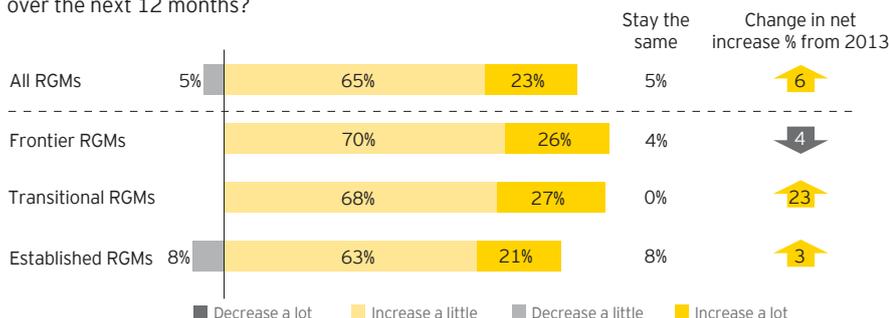
<sup>2</sup> EY Rapid-Growth Markets Forecast: February 2014

QE tapering, bankers are even more optimistic now than they were in 2013 (Figure 9). This overwhelming optimism is in stark contrast to the views of bankers in Europe. EY's *European Banking Barometer 2H13* revealed that, even with sovereign debt concerns receding, just 60% of European bankers expect their institution's performance to improve.

but, as social and political unrest has diminished and allowed businesses to focus on expansion, they are now the most optimistic group.

The outlook for project finance has also improved in Transitional economies, as well as in Frontier RGMs, as a number of these countries press ahead with infrastructure initiatives. For example, in Egypt, the interim government has unveiled a series of major projects over the last six months, including extending utilities to homes and industrial zones and developing the corridor around the Suez Canal. In November of last year, the Indonesian Government announced plans for more than 50 infrastructure projects that will include developing seaports, airports, railways and utilities. At the same time, the Kenyan Government announced a flagship railway project, improving connections between the port of Mombasa and the capital, Nairobi.

**Figure 9:** How, if at all, do you expect your bank's overall financial performance to change over the next 12 months?



Note: % "Don't know" not displayed.

In fact, bankers in our RGMs expect the outlook for their institutions to improve across almost all business lines. Respondents are particularly optimistic about all forms of lending, with over 60% anticipating improvement in the outlook for retail and corporate lending and over 70% anticipating improvement in the outlook for commercial lending (Figure 11). Credit is, of course, critical to the expansion of any economy, and we expect that between 2013 and 2018, domestic credit in these RGMs will grow at a much greater rate than in developed markets. We estimate that bank credit to the private sector will grow from about US\$3.5t in 2013 to US\$5.1t in 2018 (Figure 10).

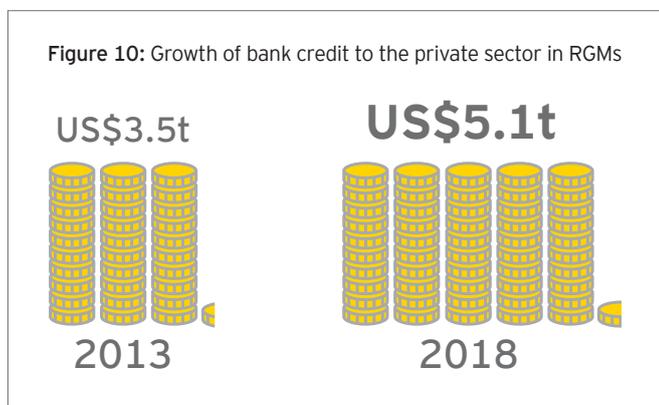
In contrast, respondents in Established RGMs have gone from being the most optimistic to being the least optimistic about project finance. Recent market turbulence and capital outflows from markets such as Turkey are likely to make the long-term financing of major infrastructure projects more difficult.

Respondents are positive about their deposit business – particularly for retail and commercial customers – but slightly less so than in our previous survey. It might be expected that recent rate increases in a number of markets would support wider deposit margins. However, our survey suggests that they may not provide any significant benefit to banks. Despite recent central bank rate hikes in Indonesia and Turkey, bankers are in fact less optimistic about their deposit business than they were last year.

Respondents were also less optimistic about the outlook for elements of corporate and investment banking, as well as wealth management and private banking, with capital outflows likely to have a detrimental effect on these business areas.

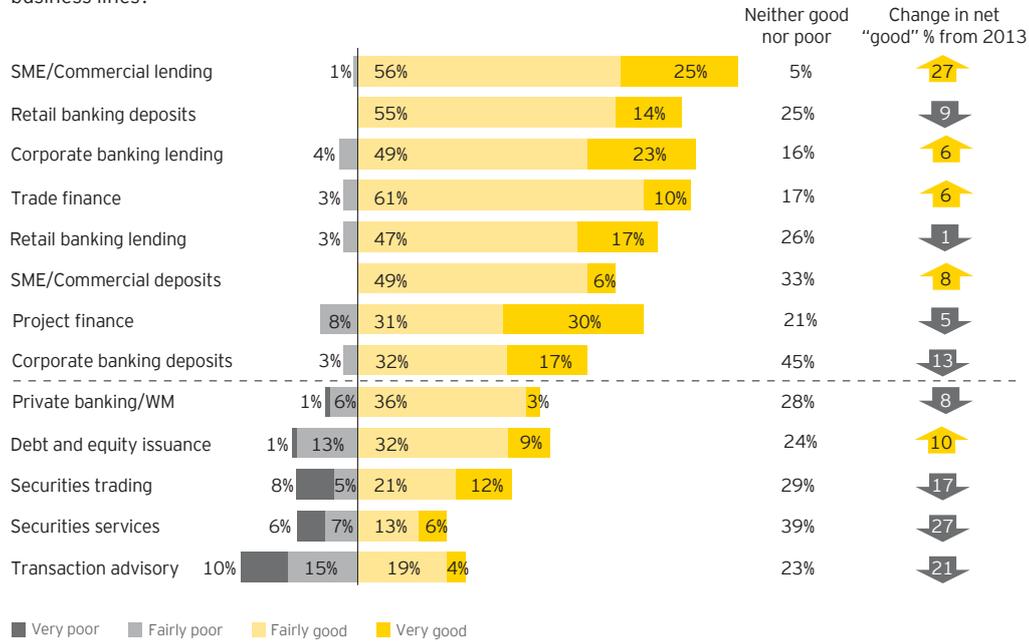
## Opportunities: at home and abroad?

Overall, however, the picture our survey presents is one of optimism – improvement in banks' financial performance and a brighter outlook for almost all business lines. As a consequence, most banks intend to focus on building their domestic presence.



Bankers are also positive about the prospects for trade finance and project finance. Institutions in Transitional RGMs were the least optimistic about trade finance in our previous survey

**Figure 11:** How do you rate the outlook for your bank over the next 12 months in each of the following business lines?

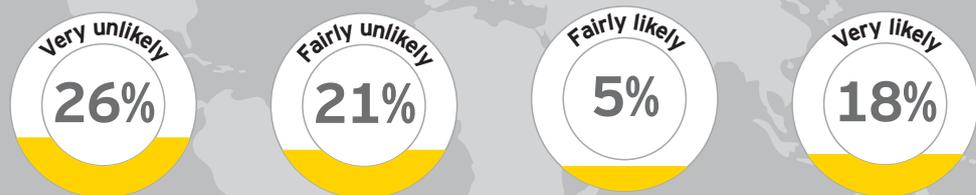


Note: % "Don't know" not displayed.

A few bankers, especially in Established markets, are also considering overseas expansion (Figure 12). However, such expansion will be carefully targeted as institutions look to support clients who are engaged in more cross-border activity or where there is a large migrant population. For example, South African banks are focused only on expansion across Africa; Malaysian banks are considering expanding across the ASEAN region; and Turkish banks are looking at Qatar and Germany.

Outside of the Established RGMs, only banks in Vietnam and Colombia expect to expand their geographic footprint. However, we expect a stronger pattern of RGM banks expanding into neighboring countries and across their regions as these markets mature. The emerging market banks that are most successful will become embedded as major regional players.

**Figure 12:** Over the next 12 months, how likely or unlikely are you to change the number of countries in which you operate?



Remainder of respondents said "Neither likely nor unlikely."



## II. Strengthening headwinds

As the emerging markets continue to grow, they offer a range of opportunities to those global, regional and local banks that can navigate their volatility. But the ability of banks to manage volatility will not guarantee their success. As the markets grow, we also expect strong headwinds to become more challenging. Banks must deal with three fundamental challenges – tougher regulation, intensifying competition and increasing costs – that, while not new, will be crucial determinants of success or failure.

It is imperative that banks be able to deal with the rising costs of doing business in these markets, driven by an increasing regulatory burden, as well as by rising funding and labor costs. And they must be able to respond to competition from both traditional banks and alternative financial services providers as the underlying growth of the emerging markets leads to global, regional and local banks, as well as niche providers, all attempting to expand their customer footprint in these countries.

### Regulatory pressures

As in developed markets, the banks we surveyed face a growing compliance burden. Eighty-one percent of the bankers we asked expect an increase in the level of regulation in their countries over the next year (Figure 13).

All the respondents in Chile and Indonesia expect the regulatory burden to grow significantly in the coming year. Indonesian banks must get used to a new regulator as micro-prudential regulation was transferred from Bank Indonesia to the Indonesia Financial Services Authority at the end of last year. South Africa will also experience a supervisory change – a draft bill detailing its move to a “twin peaks” regulation model was published in December 2013, with phased implementation expected over 2014 and 2015. The

change in regulatory approach will force banks to change their own approach to compliance. In Turkey, the regulator plans to tighten regulations on credit card payments and private consumer loans. In Nigeria, the cash reserve requirement on public sector deposits was raised from 50% to 75% at the start of the year. The volume of regulation has been a major burden for banks in developed markets for the last five years, and RGMs are now catching up.

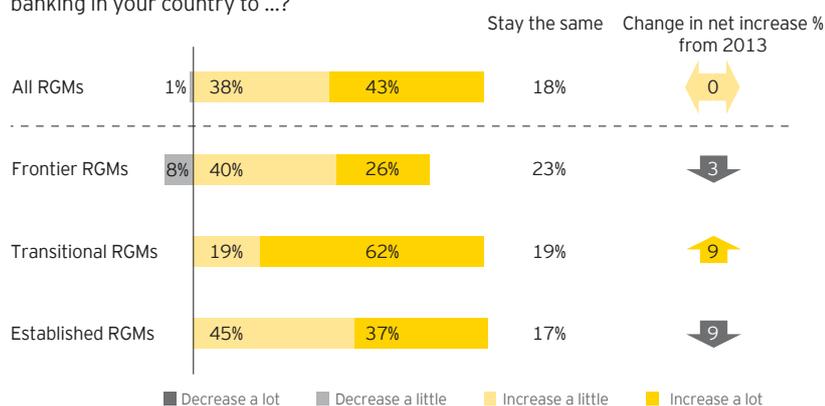
Regulation may yet emerge as a key battlefield between domestic and international banks operating in emerging markets. Regulators in these markets have been implementing regulatory changes to align the interests of international banks to those of their domestic market, requiring foreign banks to establish separately capitalized local subsidiaries, for example, or, as in Indonesia, setting lending quotas that require institutions to direct lending to specific segments, such as SMEs. This may make establishing operations in these markets significantly more challenging for international institutions, particularly as they will have to allocate more capital to their subsidiaries.

At the same time, our discussions with domestic institutions in the RGMs reveal they are concerned that international banks are encouraging regulators in their markets to ensure local regulation reflects the requirements in developed markets. Basel III poses a particular problem for domestic banks in

emerging markets. Because sovereign ratings normally place a ceiling on domestically rated corporate bonds, banks in markets that are rated lower than AA- may experience a limited supply of qualifying bonds to meet their liquidity requirements.

It is challenging for global and regional banks to operate across a range of jurisdictions with widely varying regulatory requirements. Reflecting on global capital requirements shows just how widely these basic regulations can vary; for example, while India requires banks to hold total capital of about 10% (including 8% common equity), the UK may require banks to hold up to 20% capital (including up to 11% common equity). Should emerging markets begin to move

**Figure 13:** Over the next 12 months, do you expect the level of regulation affecting banking in your country to ...?



Note: % “Don’t know” not displayed.

to regulatory standards consistent with those in developed markets, domestic banks may struggle with the additional weight of compliance. They may also find their own expansion plans forestalled.

## Competitive pressures

Secondly, as the expanding customer demand lures new entrants to the emerging markets, it is strengthening another headwind for banks – competition. Incumbents are striving to enhance engagement with their existing customers as they look to increase their share of wallet. Local and international competitors are likely to target specific segments or use technology to deliver services to an underserved or uncommitted customer base. International banks will aim to exploit their advanced capabilities and international footprint to attract corporate and affluent clients, cherry-picking the most profitable customers.

### Threats: foreign and domestic

Just how great a threat competition is in these markets is illustrated by how many bankers expect a reshaping of the banking landscape to be driven by the acquisition of domestic banks by foreign banks (Figure 14). This is most evident in Transitional markets, where almost half of all bankers expect acquisition of domestic banks by foreign banks.

It is perhaps surprising that the specter of acquisition by foreign banks looms so large. Although these markets offer great opportunities, it is our experience that many developed market banks are tied up with legacy issues in their domestic markets and are therefore reluctant to consider inorganic expansion overseas.

On closer inspection, however, what our survey highlights is the continued development of regional trading and banking blocs – for example, pan-Latin American and pan-Asian configurations. The emergence of these trading blocs has been accelerated by political unions, such as the Union of South American Nations (UNASUR) and the Association of Southeast Asian Nations (ASEAN), creating single markets. It is no coincidence that all Chilean and Colombian bankers are wary of institutions from neighboring markets when the UNASUR is breaking down trade barriers by eliminating trade tariffs between 2014 and 2019. ASEAN countries have also been reducing tariffs in recent years, with the aim of establishing a single-market ASEAN Economic Community by 2015. Unsurprisingly, 67% of Malaysian respondents see banks in neighboring countries as a threat. In fact, one-quarter of all respondents believed that banks from nearby countries would be their principal source of competition (Figure 15).

The results also underscore the targeted nature of expansion by developed market banks into these countries. European banks are considered a threat in Egypt by 60% of respondents, as well as in South Africa (50%), Turkey (40%) and Vietnam (47%). Japanese banks are considered a threat in Indonesia (100%) and Vietnam (53%). The pre-crisis scatter-gun approach to geographic expansion is clearly over. Developed market banks are now much more focused when building their footprint in new markets. This more-considered approach is likely to make life more difficult for domestic banks.

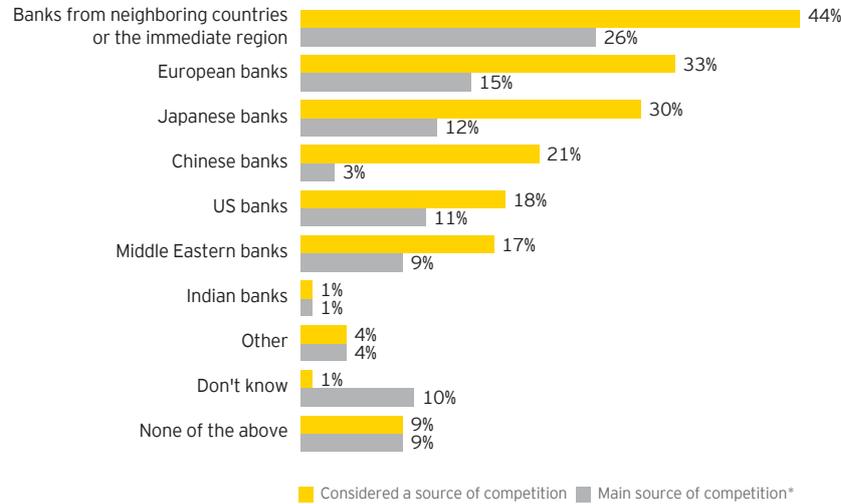
In addition to foreign acquisitions, many banks also expect in-market consolidation driven by domestic M&A. This suggests that some banks in these markets will be unable to compete effectively to meet the increasingly exacting demands of a range of retail and business customers in their markets.

**Figure 14:** To what extent do you agree that in the next 12 months, there will be a significant change in the banking landscape in this country?



\*Percentage of those who agree there will be a significant change to the banking landscape in their country

**Figure 15:** Thinking about foreign banks in relation to your market, which, if any, of the following do you think will be the main sources of competition?



\*Percentage of those who considered foreign banks would be a source of competition

## The battle for profitable business clients

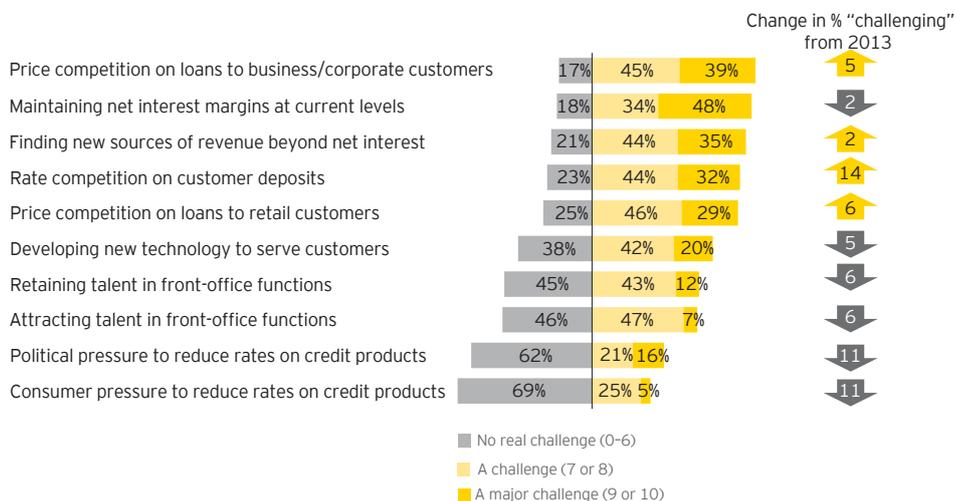
Bankers in the emerging markets are concerned that, as competition intensifies, margins will come under further pressure.

Price competition on business loans is seen as a key challenge to the industry by 84% of respondents (Figure 16). Competition for retail loans is also intensifying – this is seen as a challenge to the industry by 75% of respondents, compared with just 59% in our previous survey. Competition on loan pricing is typically most acute in the Established RGMs. This is highlighted by the fact that all Malaysian and Turkish banks expect price competition on loans to both retail and business sectors to be an industry-wide challenge in the next year.

As it gets harder for domestic banks to access market funding, and as a number of countries raise interest rates to support their currencies, rate competition on deposits will also increase.

Furthermore, as regulators in these markets pay increasing attention to liquidity, there is a drive for banks to attract more stable deposits. In some markets, competition for deposits is exacerbated by new “non-bank” entrants to the market offering higher returns to investors than traditional banks can offer. In China, an online money market fund, launched only last summer, offers annual interest at almost twice the rate of traditional banks; by mid-March of this year, it had attracted US\$81b, making it one of the largest money-market funds in the world.

**Figure 16:** How challenging are the following to serving customers profitably in the industry?



Note: % “Don’t know” not displayed.

Seventy-nine percent of respondents now see rate competition on deposits as a challenge to the industry, compared with just 65% in our previous survey. This is less troubling for Frontier markets, where just 38% of respondents expect rate competition to be some form of challenge. However, 82% of respondents in Established and Transitional markets expect competition for deposits to be a challenge, with 43% and 15%, respectively, expecting it to be a major challenge in the year ahead.

In investment banking, competition between global, regional and local banks is intensifying and market turbulence is making companies in key markets more nervous about major investments. As a result, more bankers now expect the outlook for transaction advisory to deteriorate than expect it to improve. The outlook is split, however. Respondents in South Africa and Colombia are much more optimistic than in our previous survey. Respondents in Indonesia – where this year's general elections introduce some political uncertainty – and Chile, the majority of whom expected the outlook for their advisory business to improve in our last survey, now expect the outlook to deteriorate.

Where we expect to see increasing competition among domestic, regional and global banks is in the provision of cash management and hedging products and services. Typically, domestic institutions provide the vast majority of these services to local companies. However, these institutions generally provide only vanilla products. More complex cash management and hedging solutions – which command higher fees – will be critical for banks that want to retain their business customers as their needs evolve. As companies, particularly those in more established RGMs, expand their presence beyond domestic borders, they will need support to manage the risks and complexities of international trade. Although domestic banks already play a leading role in the provision of cash management and hedging products to local businesses, they will lose out to regional and global players with more advanced capabilities unless they invest to develop more advanced products. They risk being left to provide lower-margin cash and risk management solutions and basic credit products, while regional and global institutions acquire the more complex and higher-value business.

One would expect that the impact of recent uncertainty in these markets would increase demand for risk management products, particularly where companies need to ensure large currency risks are hedged and local borrowings protected against rising interest rates. It is perhaps surprising then that the bankers we surveyed actually anticipate that growth in demand for hedging products will slow substantially. Just 46% of respondents expect demand for these products to increase, compared with 69% in our previous survey. It is likely this reflects the fact that most basic interest rate risks are

already hedged, and that the current turbulence will slow the expansion of companies into new markets and temporarily dampen demand for more complex products. We believe that local banks will invest in more complex cash management and hedging solutions as they look to retain client business and compete with regional institutions.

## Competing in capital markets

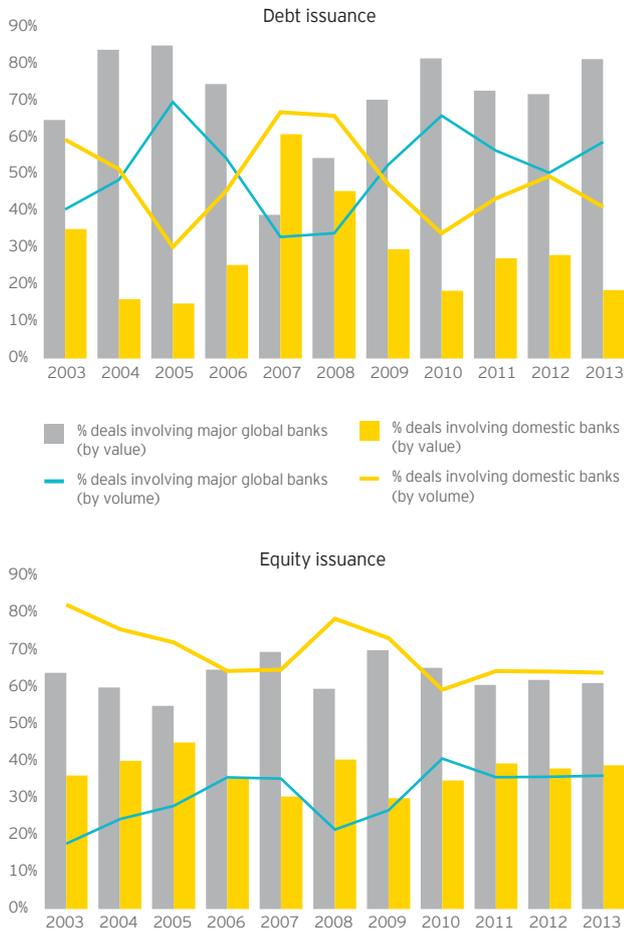
Companies in the emerging markets are heavily reliant on bank lending to meet their financing needs, but we expect growth in demand for credit to outstrip supply, particularly as banks move to global capital and liquidity standards. This means growth in these markets may be constrained if alternative ways to finance businesses can't be found. The capital markets offer this alternative route.

The size of the capital markets relative to GDP illustrates just how much potential capacity there is for financing through bonds and equity. In Established RGMs, the average financial depth (the sum of the value of outstanding bonds and capitalization of the stock market as a percentage of GDP) is about 178%. In Transitional markets, it is 62%, and in Frontier markets, just 18%. In advanced economies the ratio is about 230%. If the capital markets of RGMs – and particularly their bond markets – can be developed, it would go a long way to plugging the financing gap. Even in the Established RGMs, the value of outstanding private-sector bonds is typically only about one-third of the value of bank debt. In advanced economies, the value of outstanding private-sector bonds is often more than the value of bank debt.

Nevertheless, a shift in the balance of financing presents a real challenge for local banks, and many lack the capabilities to help clients access the capital markets. In our previous report, we argued that if domestic institutions were unable to develop their capital market financing capabilities, they would be unable to meet the financing needs of their largest clients and would risk losing them to regional or global banks with stronger balance sheets and better access to the capital markets.

We believe that recent developments are likely to strengthen the position of the global and regional players in these markets. The corporate debt market in these countries experienced significant growth over the last five years, driven by low yields in the developed world. This enabled domestic institutions to go from underwriting 34% of all bond issues in these markets in 2010 to underwriting 50% in 2012, as smaller corporates were able to tap the capital markets. However, with developed market yields rising in the wake of QE reduction, there has been capital flight from the RGMs, and local banks have lost ground. In 2013, domestic institutions were involved in only 41% of all bond issues (Figure 17).

**Figure 17: Major global banks dominate large-value issuance in RGMs**



Source: ThomsonOne data, EY analysis

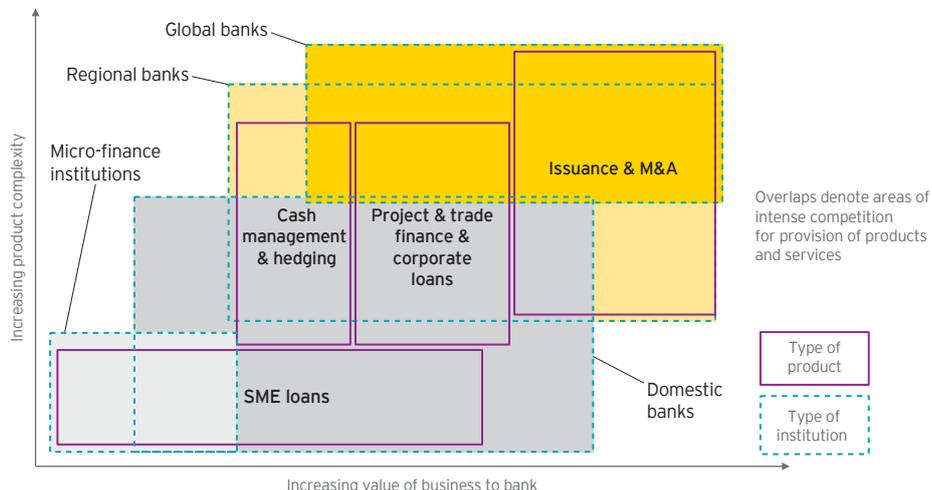
The capital markets still offer the potential to bridge the gap between demand for credit from the largest corporates and the ability of banks to lend. Global investment banks will continue to help these firms access funding. What is less clear is how the gap will be bridged for smaller corporates. That 27% of respondents to our survey think the outlook for debt and equity issuance is positive, compared with just 17% last year, suggests local banks may be hopeful that their fortunes will rebound as stability returns to these markets. That may occur, but unless domestic banks invest in their capabilities, they risk being squeezed out by regional players.

Although local banks dominate in SME, trade finance and most corporate lending, companies begin to turn to regional and global banks as they expand and their requirements evolve. We believe global and regional banks are likely to focus on countries where more complex cash management and hedging products are needed or where larger corporates are seeking financing through debt and equity issuance. Traditionally, this has meant Established RGMs, but Transitional and Frontier markets are beginning to look increasingly tempting (Figure 18).

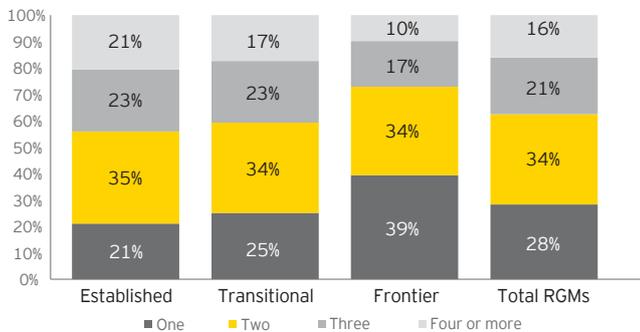
### The fragmentation of retail banking

Retail banking in the emerging markets is already very competitive. EY's *Global Consumer Banking Survey 2014* revealed that across our RGMs, 55% of retail banking customers have relationships with more than one bank. And those relationships are not just with traditional banks, either. When looking at the broader ecosystem of financial services providers, including credit card companies and e-commerce, 71% of customers in RGMs have financial relationships with multiple companies (Figure 19).

**Figure 18: The competitive landscape in emerging markets – serving businesses**



**Figure 19:** How many companies do you have a financial relationship with?



Source: EY Global Consumer Banking Survey 2014

Furthermore, competition intensifies as an economy matures; the number of financial relationships a customer has tends to multiply. In Frontier RGMs, 39% of customers still have only one financial relationship, but in Established RGMs, this falls to 21%. Some banks in Frontier markets may feel quite comfortable in their current position as the primary provider of financial services for their customers, but they won't be for long.

Although traditional banks remain the predominant providers of financial services to individuals, their preeminence is already being eroded. In our Transitional markets, banks are the primary providers of financial services for just 80% of customers. Specialist firms and new, technology-driven firms, including mobile providers, are now seen as the primary financial services providers for 15% of the market.

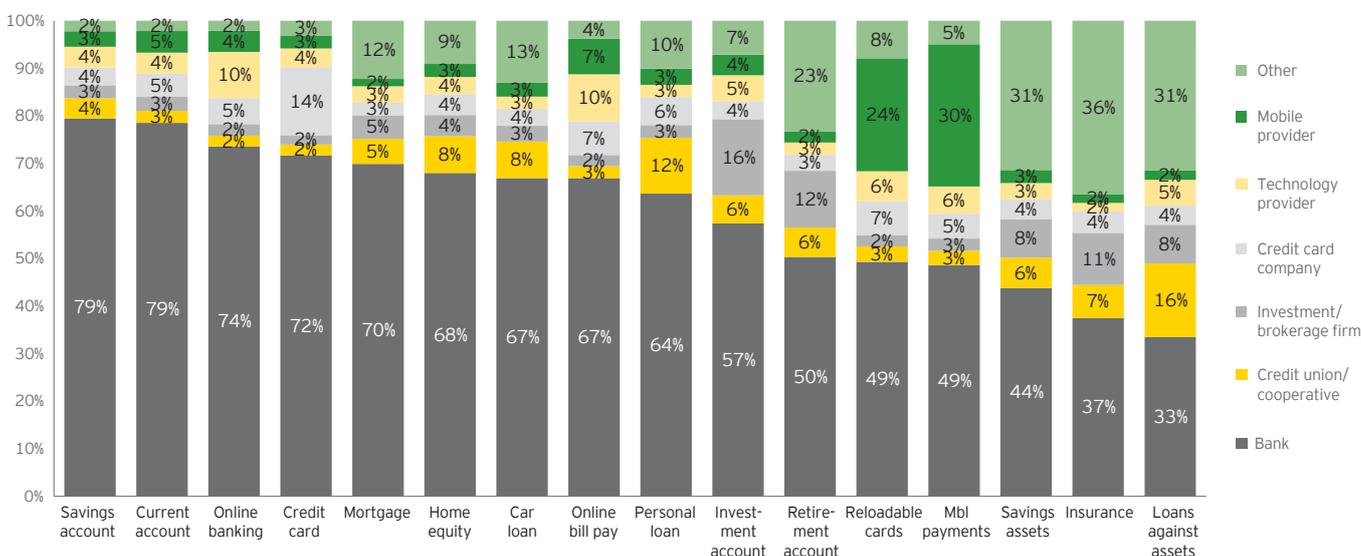
Admittedly, traditional banks have a more secure foothold in the Established and Frontier markets, where they are the primary providers to 89% of customers, but we believe they will struggle to maintain this position across key product lines.

Looking beyond the primary banking relationship, we already see technology firms in emerging markets providing 10% of online banking services and online payments. Specialist companies directly provide 14% of the credit cards in these markets. Brokerage firms provide 16% of investment accounts. Mobile network operators are responsible for 30% of mobile payments and 24% of reloadable cards (Figure 20). Focused firms, with distinct core capabilities, are building a presence in the markets. Although these new firms may be the primary provider of financial services to only a minority of customers, they have established a foothold in the market, and their presence is likely to drive up the cost of customer acquisition and drive down margins for traditional players.

### Chasing the wealthy

Competition is intensifying beyond traditional retail customers as well. The volatility of these markets, and the lack of investment opportunities, means that the wealthiest investors typically favor offshore wealth management solutions. Hence, they turn to institutions with a global reach, an international banking network and products that are managed by world-class investment managers with long track records. This is especially true in periods of extreme volatility. For example, in Indonesia and Turkey, where high-net-worth individuals have been hit particularly hard by market disruption, bankers are significantly less optimistic about the outlook for wealth

**Figure 20:** Who provides customers with products?



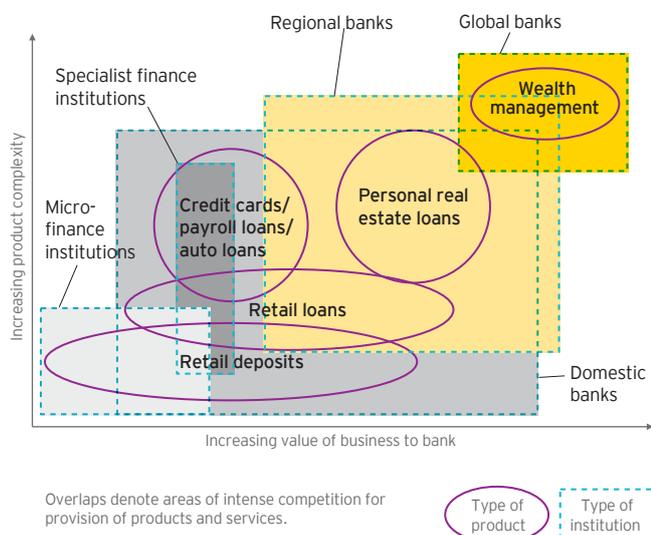
Source: EY Global Consumer Banking Survey 2014

management and private banking than they were in our previous survey. Established global wealth management brands clearly have the advantage where high-net-worth individuals are concerned.

However, due to the cost of establishing a branch network, these global institutions typically serve only high-end customers; they don't target customers further down the wealth spectrum. As a result, local banks have a huge opportunity to develop products and services for mass affluent customers. Furthermore, as these markets become more stable, we expect a greater share of wealth to be kept onshore. As we noted in our previous *Banking in emerging markets* report, domestic banks can play a leading role in developing these onshore investment opportunities – but they will need to act quickly, before regional or global players start to compete in this area. Nevertheless, we expect competition for mass affluent customers to intensify, particularly as regional banks develop their own offerings.

Global, regional and domestic banks are fighting for the growing pool of wealthy customers. At the other end of the spectrum, regional, domestic and specialist providers will compete for lower-value retail customers (Figure 21). As the growth of the economies continues, and as the ever-increasing demand for products and services attracts more financial firms into the market, the quality of customer service will be critical to the ability of banks to capture, nurture and retain the most profitable customers. Increased competition is also likely to drive down margins. The most successful banks will be those that focus not just on top-line revenue growth, but on profitability.

**Figure 21:** The competitive landscape in emerging markets – serving individuals



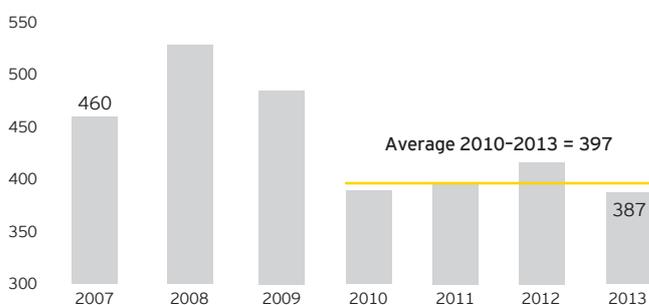
## Cost pressures

Finally, banks in emerging markets are confronted with rising costs on several fronts.

## Funding

Firstly, they are encountering increased funding costs. The flow of “hot money” to the emerging markets in the wake of quantitative easing drove down banks’ funding costs. We estimate that across the largest banks in emerging markets, the average cost of funding since 2010 has been more than 60 basis points lower than pre-crisis (Figure 22).

**Figure 22:** Average cost of funds across key emerging markets (b.p.)



Source: SNL Financial, EY analysis

But QE tapering is expected to reverse this, pushing up funding costs. Eighty-one percent of the bankers we surveyed anticipate an increase in the cost of foreign currency funds for banks as a result of this reversal.

However, this should not be a serious problem for most institutions. Emerging market banks typically rely less on wholesale funding than banks in developed markets do. Not only are they generally able to fund themselves through deposits but, as a result of higher currency volatility, they are deliberately less reliant on wholesale funding.

More importantly, QE tapering is likely to drive up the cost of domestic funding as central banks raise interest rates to support their currencies. This will also result in higher retail funding costs. Additionally, unless banks are able to re-price loans, their margins may come under pressure. This will be a particular problem in markets such as Turkey, where there is a large proportion of fixed-rate lending. It may be less of an issue in markets with fewer longer-term fixed-rate loans, where rate increases can be swiftly passed on to customers. Nevertheless, a rise in rates may exacerbate competition for customers, based on deposit and lending rates.

## Operational challenges

The average operating expense for the 50 leading emerging market banks has risen 81% over the past five years, from US\$3.6b in 2009 to US\$6.5b in 2013. Banks also face a range of increased operational costs. For example, minimum wage rules and resource shortages in a number of markets are driving up labor costs. Malaysia introduced a minimum wage of between US\$240 and US\$270 per month on 1 January 2014. Jakarta, in Indonesia, has raised its minimum wage level to US\$211 per month, up almost 10% from US\$194 in 2013, which in turn was a 44% increase from 2012. The minimum wage in Shenzhen Province in China has risen by about 10% so far this year. As wages in these markets rise, the opportunities for labor arbitrage diminish. For developed market banks operating there, the traditional offshoring benefits previously found have been eroded. In addition to minimum wages, where there is a shortage of capabilities, competition for talent is driving up pay rates.

Operating banking infrastructure is also expensive. In the Asia Pacific region, for example, IT maintenance costs for banks are expected to grow 21% by 2016 (Figure 23). This increase

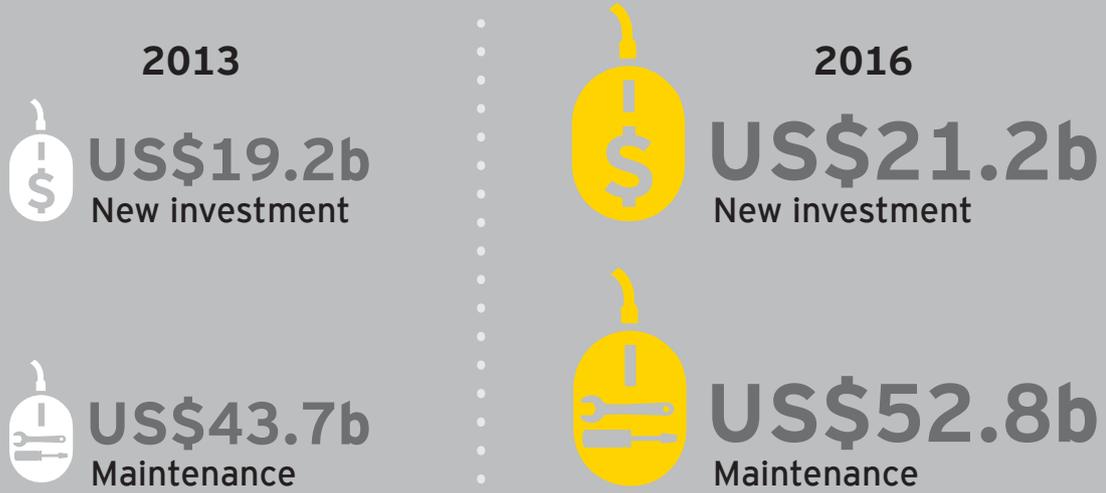
in costs will be exacerbated where political objectives push regulators to restrict charges on customers for using key banking infrastructure. This is already evident in Nigeria, where banks have been grappling with the removal of ATM charges. Therefore, it is imperative that banks invest in technology to run their institutions more efficiently.

The simple fact is, operating banking infrastructure is expensive, and there are no signs of the costs falling. Total bank spend on IT is expected to rise by 14% during the next four years, and we expect the most rapid growth will be in the emerging markets.

Emerging market banks typically boast cost-income ratios that would be the envy of many banks in developed markets – the average cost-to-income ratio of the 50 largest emerging market banks was just 47% for FY13, compared to 63% for banks in Europe and North America – but we expect banks' funding and operating costs will continue to rise over the next five years. The growth of these markets may present easy opportunities to boost top-line revenues, but the most successful institutions will be those that do so while focused on driving down cost-to-income ratios.



Figure 23: Expected growth in information-technology spending by Asia Pacific banks



Source: Celent





# III. Investing for success

Banks in the emerging markets are acutely aware of the challenges posed by market volatility and the headwinds of tougher regulation, intensifying competition and rising costs. However, our survey suggests that the banks are likely to grapple with these issues individually rather than holistically. We believe that as well as trying to combat the headwinds by strengthening risk management, improving efficiency and winning profitable customers, banks should invest in the fundamental enablers of success – technology, people and partnerships.

## Combatting headwinds

Almost three-quarters of all respondents in our RGMs expect the industry will struggle to maintain current ROE in the next year (Figure 24). Only in Indonesia do a majority of banks believe it unlikely they will struggle to maintain their current ROE although they are anticipating that building up capital and liquidity will be a challenge.

We expect banks to focus on three areas to combat the headwinds: strengthening risk management, improving efficiency and winning profitable customers.

## Strengthening risk management

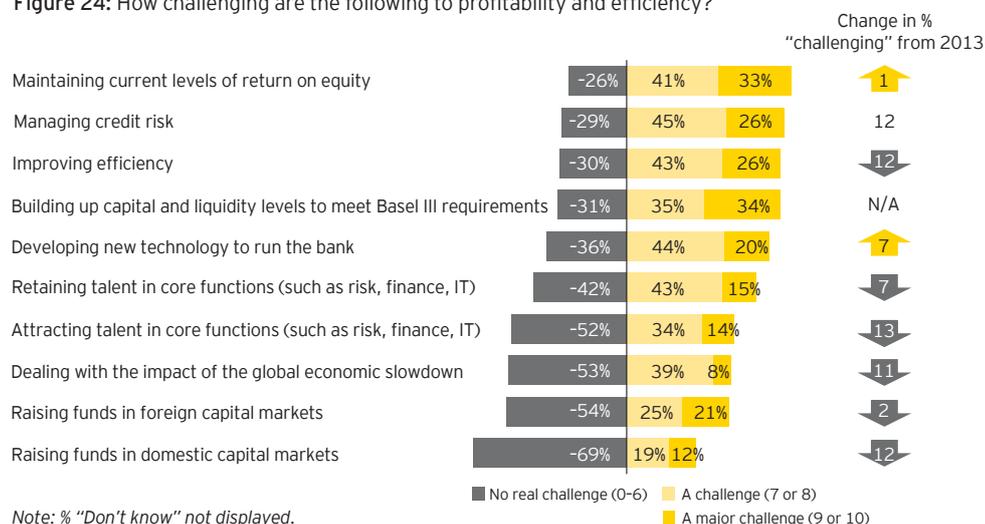
Seventy-one percent of all respondents expect managing credit risk to be a challenge for the industry, highlighting the risk the volatility of emerging markets poses to the banks operating there. In our previous survey, this was seen as a challenge by only 59% of respondents. Credit risk is a particular challenge in Frontier markets, where 58% of banks expect to raise provisions against loan losses over the next 12 months. In the Established RGMs, with the exception of Turkey, bankers expect it to be less of a challenge. In Malaysia, only 33% of respondents saw credit risk as a challenge.

The importance of enhancing credit risk management is highlighted by the opportunity the SME sector provides. In our previous report, we suggested that the balance sheets of domestic banks would struggle to meet the increased demand for lending we are seeing across these markets. Our survey reveals that this is truer now than ever. There is little change anticipated in the strong growth in demand for credit, but actual lending growth is expected to slow, suggesting a widening gap between credit supply and demand.

This gap is most evident in the SME sector. Estimates suggest that the financing needs of more than 17 million SMEs remain unmet – a financing gap between US\$900b and US\$1.1t.<sup>3</sup> This should present a major opportunity to banks in emerging markets, but in reality the gap is likely to widen even more.

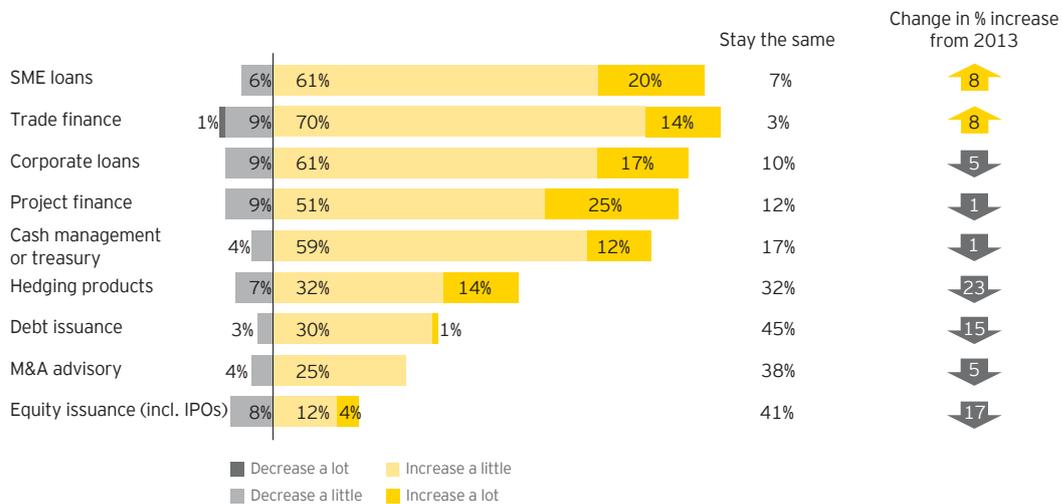
Respondents to our survey anticipate an even greater increase in demand for credit from SMEs this year than they did last year. Eighty-one percent of respondents across all markets foresee increased demand for SME loans (Figure 25). Demand is forecast to be strongest in the Established markets, with 84% expecting it will pick up. However, it is only slightly weaker in Transitional and Frontier markets, with 77% and 74%, respectively, expecting heightened demand.

Figure 24: How challenging are the following to profitability and efficiency?



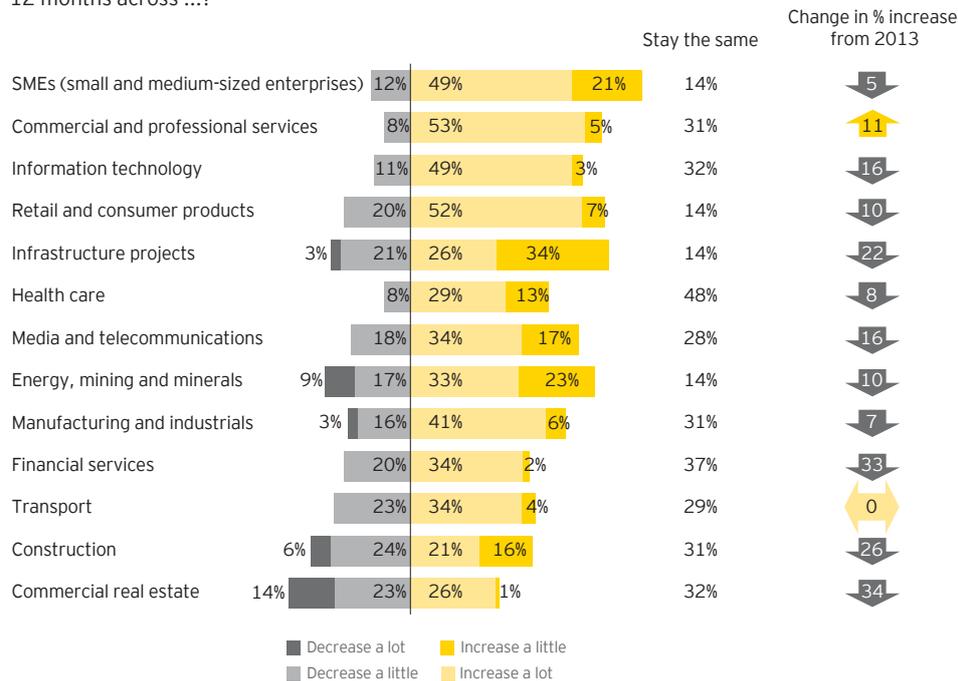
<sup>3</sup> International Finance Corporation, <http://tinyurl.com/nvkhf5d>.

**Figure 25:** To what extent do you expect customer demand for the following commercial and corporate banking products at your bank to change over the next 12 months?



Note: % "Don't know" not displayed.

**Figure 26:** How do you expect lending levels by banks in your country to change, if at all, in the next 12 months across ...?



Note: % "Don't know" and "Not answered" are not displayed.

By contrast, just 70% of all bankers surveyed expect SME lending by their bank to increase (Figure 26). The supply of credit is likely to be tightest for SMEs in Transitional markets. Just 51% of bankers in these markets see an increase in lending to the sector. More bankers in Frontier markets (71%) and Established markets (78%) expect lending to SMEs to grow, but even there, a widening gap between supply and demand is likely.

Why is the gap widening? Because it can be difficult for banks to properly price loans to SMEs in these markets. Many businesses may only recently have emerged from the informal sector; they have little or no credit history and unreliable governance. Additionally, banks may face competition from micro-finance institutions that are better able to serve parts of this market or from social initiatives, in which profit is not necessarily the primary concern. Furthermore, loans

to SMEs are assigned a relatively high-risk weighting under Basel III and, as a result, banks often prefer to lend to larger, more established companies whose credit needs are greater and whose credit history is less opaque. This means that the competition to serve a limited pool of more established SMEs is intense. We believe that where banks make the necessary investments to develop better ways to price risk, they will be able to target the smaller and less established segments of the SME sector and reap major rewards.

Banks are focused on improving risk management (including credit risk management) to better manage market volatility. Eighty percent of respondents to our survey see strengthening credit risk assessment as important to their bank, and 77% believe it is important to improve risk management generally across the business (Figure 27). Unsurprisingly, banks in Frontier markets place the greatest emphasis on strengthening credit risk assessment, reflecting their concerns about their ability to manage risk at an industry level. Ninety-two percent of bankers in Frontier markets believe strengthening credit risk is important, but just 78% of Transitional and Established market bankers do.

Similarly, when looking at improving risk management generally across the business, 96% of Frontier market banks believe it is important, but just 77% of banks in Transitional markets and 73% of those in Established markets do.

An ability to manage risks more broadly across the business is critical to institutions that have expanded rapidly in these markets, where growth in staff numbers affects the organization's culture or operational risks are heightened because of stretched resources. It is vital for banks that are

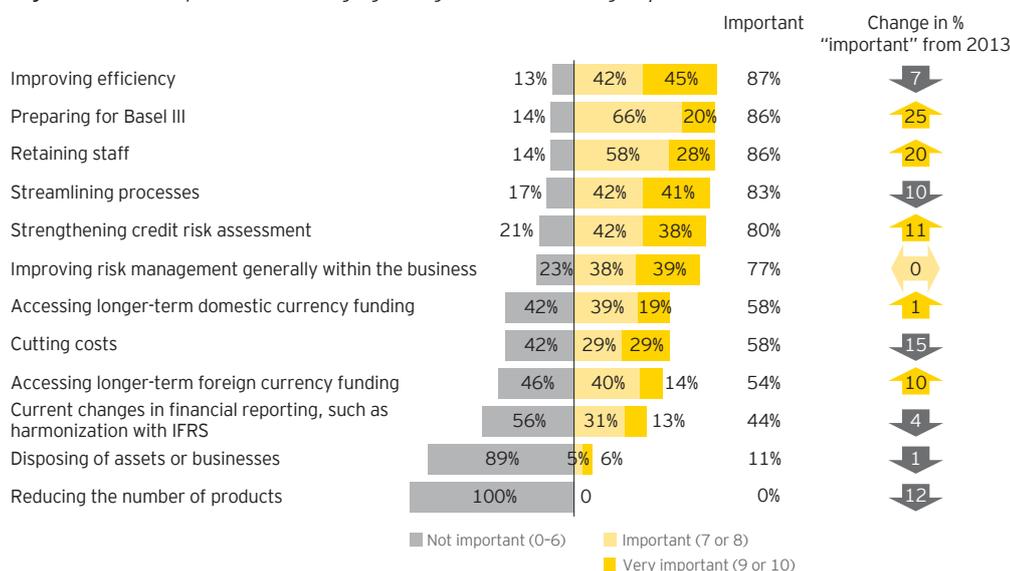
heavily reliant on agent networks for product distribution in more remote regions. Such institutions will need to ensure sales staff are properly trained and provided with incentives to avoid the sort of mis-selling scandals that have recently blighted many developed markets.

Banks must also focus on compliance risk. As regulations become tougher and regulators more assertive, it is more important than ever to ensure regulatory compliance. Last year, 22 Indian banks were fined for violating know-your-customer and anti-money-laundering requirements. In countries where data on customers may be limited, it is critical that banks ensure they have robust processes for identifying and dealing with customers.

### Improving capital and business efficiency

Sixty-nine percent of respondents to our survey are worried that the industry will struggle to build up capital and liquidity to meet new global standards. Building capital is a particular concern for Asian banks, with all Indonesian and Malaysian banks expecting it to be a challenge as they move toward the global capital standards set out under Basel III. Institutions in these markets face investor pressure to expand lending and grow their balance sheets, which will lead to the requirement to hold additional capital. Margin compression means shareholders are faced with the prospect of diminishing returns. We expect banks to focus on growing lending to offset a squeeze on profits; however, the experience of the developed markets shows that as balance sheets expand, the quality of the balance sheet typically deteriorates. As banks are required to hold more capital against assets, they must become smarter about the way they deploy existing capital.

Figure 27: How important to managing change are the following at your bank?



Note: Ranked by % "important;" % "No answer" is not shown.

Capital allocation is particularly important because, as previously noted, the gap between supply and demand for credit is widening. This isn't happening only in the SME sector; we also expect domestic banks to struggle to keep up with demand for project and trade finance, as well as corporate lending, particularly in the Established RGMs. Seventy-six percent of respondents expect demand for project finance to increase over the next year. It will be critical for funding major infrastructure projects, such as the high-speed Mombasa-Nairobi rail link or the myriad projects recently announced by the Indonesian Government. However, with the furor over QE tapering demonstrating the volatility of the emerging markets, banks are likely to be less willing to commit to financing these projects in view of their long investment horizons. This is revealed by a marked deterioration in the outlook for lending for infrastructure projects; although 70% of respondents still expect lending to this sector to grow, 24% now expect lending to decrease compared to 12% in our last survey, yet governments are still announcing new projects.

The growth of demand for corporate loans has hardly abated since last year, and 78% of respondents expect demand to increase. Only in Chile and Turkey, two of our Established markets, did any respondents believe demand might diminish. However, the growth of lending to most industries is expected to slow across the board in the Established RGMs and in key industries in the Transitional and Frontier markets, leaving demand unfulfilled. As a result, banks must consider the most efficient way to deploy their capital to maximize their returns. Seventy-nine percent of respondents believed that finding new sources of revenue beyond net interest income was a challenge to the industry. It is increasingly important for banks to be able to determine which clients are best served through balance sheet lending and which are best served through alternative forms of finance. And they will also need to build the capabilities to provide these alternative forms of finance so that their capital can be allocated as efficiently as possible.

Cost pressures are also at the forefront of bankers' concerns. Sixty-nine percent of respondents expect improving efficiency to be a challenge for the industry, including all respondents in Egypt, South Africa and Indonesia (Figure 24), but 87% believe it important for their bank to improve efficiency (Figure 27). It is the number one priority across most markets and is cited as important by 92% of banks in Established markets, 74% of banks in Transitional markets and 91% of those in Frontier markets.

With 79% of all respondents expecting the regulatory burden to increase over the next year, regulation will clearly add to the operating costs of most banks. Institutions will not only need to recruit staff to analyze and implement new regulations, but will also need to invest in systems to standardize processes and reduce operational risks.

Furthermore, where banks have expanded rapidly or made acquisitions in these markets, they have often been left with sub-optimal operating models and cost inefficiencies. The global financial crisis illustrated how banks that had expanded rapidly in developed markets, without successfully initiating strategic programs to reshape their operating models and drive efficiencies, ran into difficulties. Banks in the emerging markets should take heed!

Institutions in these markets will try to reduce their cost burden; however, the approaches that institutions take to improve efficiency are likely to vary according to market maturity. In Frontier markets, banks may be able to reduce this burden through tactical cost-cutting, but in more mature markets, banks must focus on strategic cost reduction initiatives, such as streamlining processes. Eighty percent of bankers in Frontier markets see cutting costs as important, but only 42% of banks in Transitional markets, and 61% of banks in Established RGMs do. By contrast, 88% of banks in Established markets believe streamlining processes is important, compared with 77% in Transitional markets and 72% in Frontier markets.

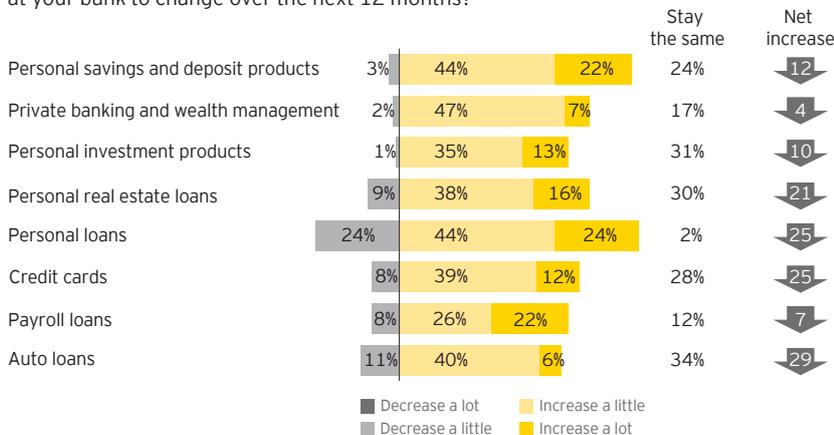
Furthermore, when banks begin to consider expanding their customer base, they recognize that it is essential to do so in a low-cost way, prioritizing the development of new customer channels rather than expanding their branch networks (Figure 30).

## Winning profitable customers

Increased customer demand should present many banks with an opportunity to expand and grow their revenues. This opportunity is particularly evident in retail banking. Respondents to our survey expect increased demand across the range of retail banking products (Figure 28). As we observed in our previous *Banking in emerging markets* report, there are still a significant proportion of unbanked and under-banked individuals in these markets who will drive demand for savings and deposit accounts.

There will also be a healthy increase in demand for retail credit – although at a slightly slower rate than suggested by our previous survey. The slackening in demand for credit is most evident in the Established emerging markets: 64% of respondents in these countries still anticipate growth in demand for personal loans, but 36% expect demand to decrease. Many of the markets have seen interest rates rise, which may dampen appetite for borrowing in the near term, especially for more expensive unsecured credit products. Demand for credit will remain strong in our other markets: 87% of respondents in Frontier markets and 71% in Transitional markets expect demand for personal loans to increase, and nowhere is it expected to decrease.

**Figure 28:** To what extent do you expect customer demand for the following retail products at your bank to change over the next 12 months?



respondents expect demand for wealth management services to increase and no one expects it to decrease.

The increase in demand is good news for banks in the emerging markets. The customer pool is expanding, and customers are getting wealthier. However, this will not necessarily translate into increased profitability for banks. We believe that heightened competition will present a real challenge to banks as it drives down their margins and drives up their costs-to-serve. And in some segments, it is unclear whether local banks even have the right capabilities to serve customers effectively. While 54% of all bankers

Demand for wealth management and investment products is also expected to remain resilient. We have already discussed the burgeoning middle classes that are central to demand for investment products; when looking at ultra-high-net-worth individuals, the trend is perhaps even more impressive. The number of billionaires in emerging markets overtook the number of billionaires in Europe in 2006, and in 2010, it overtook all the developed markets combined, excluding the US. Since 2011, there have been more billionaires in the emerging markets than in the US. These 607 individuals are worth more than US\$1.9t and account for 35% of the wealth of all billionaires globally (Figure 29).

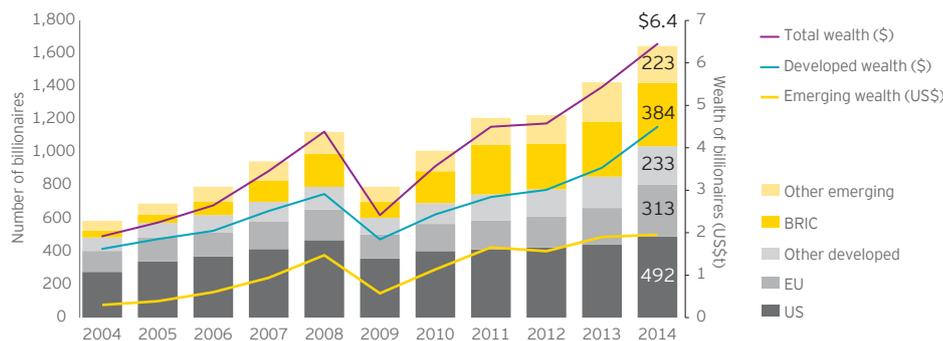
see demand for wealth management services increasing, only 32% rate the outlook for their wealth management business as good. This gap in expectations suggests many domestic institutions don't believe they will be able to meet the new demand for wealth services.

In addition to the super-rich, there are growing numbers of high-net-worth and mass affluent customers who are driving demand for wealth management services. The outlook for wealth management is closely tied to the overall wealth of a country, so demand is expected to be stronger in Established markets than in Transitional markets. Demand is still weakest in the Frontier markets, where only 38% of respondents anticipate that demand for wealth products will increase while 4% expect it to decline. However, as these markets evolve, demand will strengthen. In Established markets, 61% of

We expect banks to address the competitive pressures in these markets by targeting the most profitable customers within specific segments. Banks already recognize that this process will depend on broadening their existing relationships with customers. Ninety-two percent of bankers across the RGMs believe that it is important to improve penetration rates with their existing customers (Figure 30). The focus on improving penetration rates is near universal: all respondents in Transitional markets believe it is important; 91% in Established markets and 80% in Frontier markets do too. Specialization has the potential to be a major differentiator.

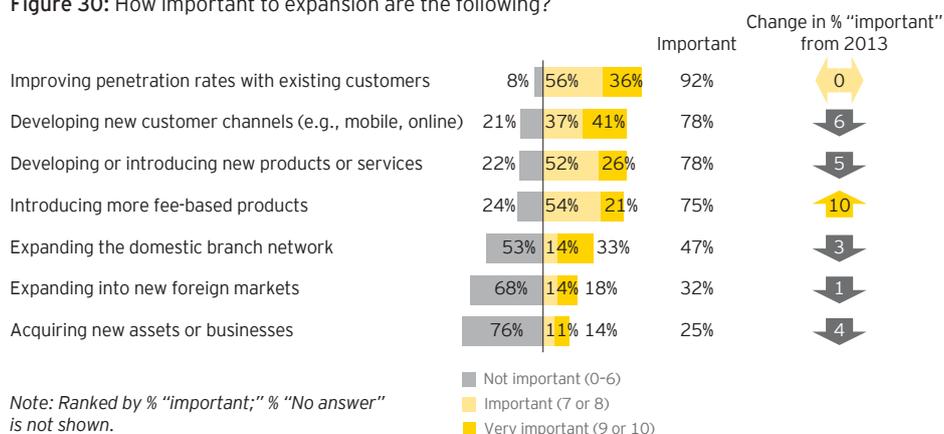
With customers increasingly expressing a preference for managing some transactions digitally, many banks are, as previously noted, investing in their digital channels. However, if banks want to grow in these markets, they will need to spend even more on infrastructure to reach new customers

**Figure 29:** The rise of the wealthy



Source: Forbes data, EY analysis

**Figure 30: How important to expansion are the following?**



and deliver the levels of service they demand – but they must not do so to the exclusion of the branch networks. Although mobile banking is a more important driver of engagement for customers than branch access, 31% of customers still use a branch at least weekly, and the branch remains a vital sales channel. Mobile and online are typically the preferred channels for banking transactions such as money transfers and balance enquiries, but 50% of customers in these markets still seek financial advice in their branch, 41% buy and sell investments through their branch, and 62% apply for loans in their branch. That only 47% of respondents believe expanding their branch network is important to expansion suggests that some banks are focused on a digital channel strategy rather than an “omni-channel” strategy. Although these banks may be able to drive down transaction costs, they risk losing business to other institutions that are able to revolutionize their branches as sales hubs.

## Enablers of success

Banks recognize the challenges they face in these markets, but success in capitalizing on the opportunities the markets offer will be defined by how they are addressed. There can be little doubt that taking action to improve risk management and efficiency and win customers will help banks operate more effectively in these markets. Nevertheless, we believe that the institutions that will be most successful will be those that look beyond these areas to the fundamental enablers that underpin all of them. Banks must invest in technological innovation and in people, and build partnerships.

## Investing in technology

Technology-driven innovation is critical for banks’ ability to grow and run their business more efficiently in the emerging markets.

First, technology innovation can help banks reach new customers in markets with low banking penetration or limited credit bureau coverage (Figure 31). Traditionally, banks have invested in their branch networks to do this. Some of the most innovative banks have developed itinerant branches to reach remote locations, for example, in Sri Lanka, Peru and Indonesia. However, such approaches have security implications, and thus, many remote communities remain underserved.

Innovative application of technology can reduce the cost-to-serve. This is particularly important in Frontier and Transitional RGMs, where the cost of owning an account is a significant barrier to financial inclusion. The introduction of automated branches and next-generation ATMs in urban areas in some emerging markets has already radically reduced operating costs for banks – savings that can then be passed on to customers. Nevertheless, although branches remain important to banks’ growth, many are also looking at alternative approaches to enlarge their footprint.

The widespread adoption of mobile technology throughout the emerging markets offers banks a new way to reach customers. In Frontier and Transitional RGMs, numerous banks are developing low-cost, basic services for rural and poorer customers, such as point-of-sale and simple mobile payments technologies. To date, 233 mobile money services for the unbanked have been deployed globally, and a further 112 are planned.<sup>4</sup> Smartphone penetration is expected to grow over the next five years from about 50% to 90% in Latin America, and from about 30% to almost 70% in the Middle East and Africa.

Mobile technology does not just offer banks a more efficient channel to reach customers. When combined with analytics, it provides a tool to revolutionize banking in these markets – for example, by changing the way banks assess credit risk.

<sup>4</sup> Mobile Money for the Unbanked Deployment Tracker, <http://tinyurl.com/lyn6heg>, accessed April 2014.



# How investment in technology can help

## Improve risk management

- ▶ In Tanzania, a technology firm has introduced a credit-scoring system based on how often individuals replenish mobile airtime, buy bundles of data and interact with their social network.
- ▶ Another technology company is working with an African bank to develop a tool to score customers for unsecured loans that would be directly deposited into an applicant's mobile wallet.

## Improve efficiency

- ▶ In Malaysia, a major bank has launched a network of small-footprint, sales-focused "branches" equipped with self-service terminals. These branches distribute a simple menu of pre-packaged financial products, offering quick and consistent service. The branches have significantly lower setup and operating costs than traditional branches.
- ▶ A major Indian bank uses tablets to pre-process customers while they are waiting to be served in branches.

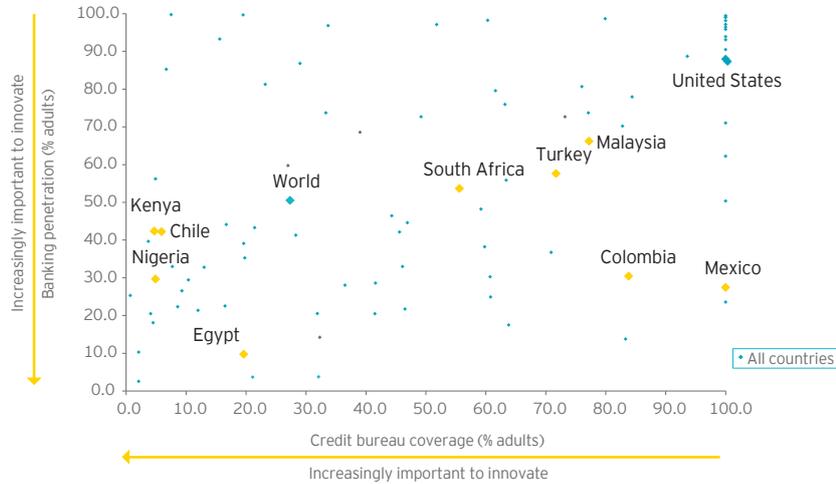
## Win customers

- ▶ In Nigeria, a major bank has launched a "social banking" service on Facebook. The offering allows account holders to transfer money, purchase airtime, pay bills and confirm their account balance on Facebook. In India, a major bank has also launched a Facebook app that allows customers to carry out a wide range of financial and non-financial transactions through the social media site. A leading Turkish bank also offers full-service banking functionality through Facebook, allowing customers to check balances, transfer money and apply for loans and credit cards.
- ▶ In Papua New Guinea, one bank has pioneered a mobile banking service targeted at the commercial sector. Commodity buyers are able to transfer payments to farmers' bank accounts via text messages on their mobile phones. This money can be withdrawn using a bank card through ATMs, bank branches or banking agents. This has reduced the risk of robbery typically associated with cash transactions. More than 3,000 farmers have opened accounts since the bank launched this service.
- ▶ In South Africa, a major bank has pioneered cashless branches that offer a digital banking experience. In their branches, customers can not only apply for, access and use digital banking services, but they can also browse and purchase smartphones

and tablets, encouraging the adoption of mobile services by the customer base.

- ▶ A Turkish bank provides customers a mobile dashboard. This integrates some 23 financial functions into a single app, giving customers access to a range of personal finance tools and the ability to make financial transactions. One of the most popular tools allows customers to forecast how much they will spend.
- ▶ The same Turkish bank has combined technology with product innovation to serve their SME customers. They provide a high-speed loan approval process that allows SMEs to apply for and receive loans directly through the machines in the bank's nationwide point-of-sale network. To do this, they provide industry-specific loan packages tailored to the needs of 17 small-business sectors. The loan via point-of-sale program is designed to address the periodic need by SMEs for urgent financing.
- ▶ Another Turkish bank has made "gamification" central to its digital strategy, to drive customer loyalty and product and channel usage.
- ▶ In 2011, a major Colombian bank launched a mobile wallet, with the aim of increasing financial inclusion. By 2013, it had grown to almost 2 million users, most of whom were previously unbanked.

**Figure 31: Driving growth through technology innovation**



Source: World Bank, EY analysis

Many emerging markets have poor credit bureau coverage, but the way customers use their phones can tell a bank a lot about them. How regularly they top up air-time or how they interact with their social networks can furnish clues to their credit risk. Banks that invest in their mobile analytics capabilities will have the potential to tap into a large customer pool that their rivals cannot service.

Combining mobile technology with analytics will also help banks strengthen their relationships with existing clients. By better understanding their customers, they will be able to improve service levels. For example, banks will be able to offer customers more bespoke banking solutions, tailored to their specific needs, or relevant non-banking deals, such as discounts on consumer goods – and fundamentally, they will be able to deliver products and services where and when customers want them.

Beyond mobile, analytics can help banks in other ways. In markets such as Malaysia and Indonesia, where there is no real-time gross settlement, we see a small group of banks becoming payment “flow monsters,” owning and operating the majority of the country’s payments network. The volume of transactions these banks are involved in should give them a huge advantage over other banks in the market. They have more frequent customer interactions and access to more customer data. But as yet, there is little to suggest the banks are really leveraging this position to generate customer insights. Such institutions will need to invest in their analytics capabilities to harness the information they have access to. As soon as they do, they will have a real edge over rivals.

Innovative technologies are also helping banks to improve their business efficiency. Investment in reporting tools, for example, will ensure that bank management has the information available to improve strategic decision-making and to comply with international regulatory standards, as well as to enhance controls and reduce operational risk.

Investment in the newest core banking technology will improve efficiency and streamline processes. Automation and straight-through processing will not only lead to more robust processes and procedures, but will reduce the need for manual intervention. This will enable banks to rebalance employees from manual back-office roles to the front office to support growth areas. This will become increasingly important as Frontier and Transitional economies become more established. And when banks do recruit new front-office staff, technology will be essential to training and enabling them to deliver excellent service to clients. Banks can utilize innovative technology to guide staff through processes that deliver a consistent experience to customers whenever they interact with their bank.

### Investing in people

While greater use of technology may allow banks to rebalance their staffing profile, it will not solve all of their problems. With 44% of bankers expecting headcount to grow, we see the war for talent becoming even fiercer as banks look to grow their retail and SME banking business and transform their back office (Figure 32). Part of the challenge for banks in the RGMs will be to find ways of attracting and retaining staff that do not dramatically increase their overall operating costs – otherwise, they will find it even more difficult to compete against new players entering the market.



## How investment in people can help

### Improve risk management

- ▶ As part of its succession-planning exercise, a major Indian bank has initiated a program to groom senior officers for leadership roles. Around 100 such senior officers have been identified under this program. This allows the bank to have a pipeline of leaders to match its growth in India.

### Improve efficiency

- ▶ In South Africa, a major bank operates an “Innovators” program. This initiative provides financial incentives for staff that come up with innovative ideas to deliver effective systems and procedures. To date, over 5,000 innovations have been implemented.
- ▶ In 2009, a Malaysian bank launched a transformation strategy, which comprised 30 initiatives (including 6 talent-specific initiatives). The transformation program focused on three major pillars: domestic leadership, regional growth and talent management. Among its goals was to create a more innovative corporate culture. Employees were encouraged to come up with ideas to rethink established processes, add value to current products and services and provide solutions to particular challenges.

### Win customers

- ▶ An Indian financial services firm that targets the unbanked discovered that mobile banking required specialized sales staff, and it now delivers specific support and training to banking agents offering new products.
- ▶ In 2011, a Malaysian bank initiated an innovation program to encourage innovation and lateral thinking within the organization. The program offered a monthly reward to winners from each sector. Innovations included an internet banking solution.
- ▶ In 2012, the same bank introduced an innovation program targeted at specific business areas. This initiative brought together 25 high-performing staff to develop “game-changing ideas” that would allow them to sustain a competitive advantage, particularly by delivering service-related changes to customers.
- ▶ A major global bank and wealth manager has partnered with Malaysia’s University of Islamic Finance to launch an Islamic banking center for wealth management. This allows the bank to build and brand its suite of Islamic banking products in the region.

In the front office, banks need to attract and retain an outstanding workforce to win new customers and a greater share of wallet from existing customers in an increasingly competitive market. We believe local and global banks looking to build out their corporate and investment capability may also struggle to find the high-quality workforce they need. For retail banks, high-quality service is central to the ability to retain customers.

Recruiting the high-quality staff banks need is not always easy. This is particularly true in Transitional markets, where 82% of bankers believe it will be a challenge to attract front-office talent, and 76% believe it will be a challenge to retain this talent. Bankers in Frontier and Established markets are less pessimistic, but this is likely to be only a temporary state of mind, and banks in both markets are likely to find it more challenging to recruit front-office staff over the longer term. Talent will be particularly scarce in key segments, such as wealth management and investment banking, where the capabilities of local banks are less developed.

Banks must also attract and retain back-office staff. Regulation, cost and competitive pressures are driving the need for more skilled staff across a range of core functions. To address regulatory challenges, banks must expand their compliance teams. Institutions that are focusing on technology – to improve the customer experience or to drive efficiency – will need to employ highly skilled IT professionals. This is liable to lead to a shortage of both compliance and IT personnel. Banks are already increasingly concerned about retaining their existing staff to support change initiatives. Eighty-six percent of respondents believe retaining staff is important for their

bank, compared with just 66% in our last survey. The talent shortage is likely to be most acute in Transitional and Frontier markets that are typically less technologically mature. As a result, bankers in those markets are even more concerned about their ability to attract and retain back-office staff than those in the Established markets.

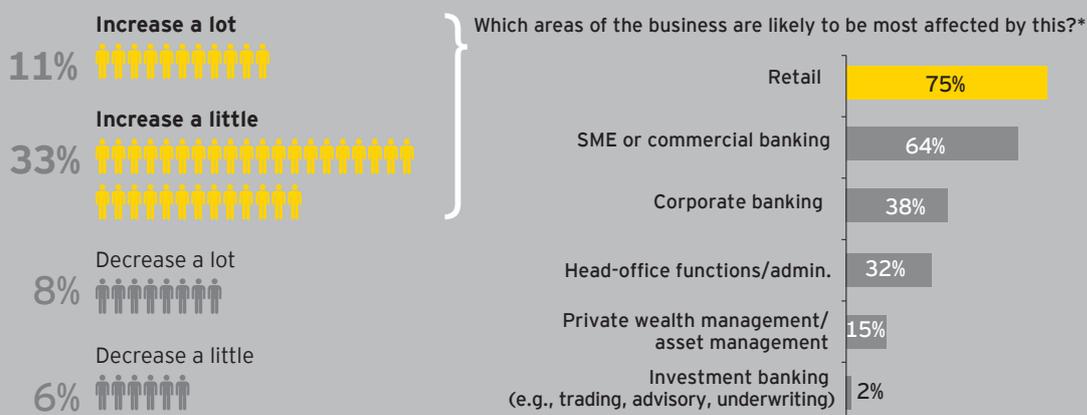
Banks should invest in training initiatives to build the skills of their existing workforce. Other markets could learn from Malaysia which, since 1985, has operated an industry staff-training fund to encourage banks to develop their own staff rather than poach talent from competitors. Banks recruiting staff from rivals have to contribute up to six months of their salary to the fund if they have not been approved for release by their previous employer. Finally, banks may have to look beyond their local markets for key talent.

### Building partnerships

Even with leading technology and outstanding staff, many institutions operating in the emerging markets will have capability gaps. However, they will be able to overcome these gaps, reduce costs and improve credit risk management by building partnerships that are beneficial to all involved.

Global and regional banks may lack detailed knowledge of, or relationships in, a new market. But by partnering with local institutions, they will be able to gain local knowledge and access to new markets without large investments in distribution networks. For example, global wealth managers may be able to sell key products through their partner bank's distribution channels.

Figure 32: Over the next 12 months, do you expect the headcount of your bank to ... ?



% "Don't know" not displayed. \*Percentage of all who say they expect headcount to increase.



## How building partnerships can help

### Improve risk management

- ▶ In Colombia, a utility provider entered the financial services sector and was able to supplement credit reference agency data with its own customer data. It was also able to use its existing billing and payments infrastructure to advertise, disburse and collect loans. Eight years after launching, it sold a stake in the financial services business to a bank, which took over responsibility for credit assessment and loan monitoring and began offering existing customers a range of new products. The utility company still runs its own customer service, invoicing and loan recovery operations.

### Improve efficiency

- ▶ In India, one bank has partnered with a US technology company that provides debit and credit card management, digital and mobile banking, asset-liability management and ATM management. This relationship allows the Indian bank to focus on acquiring and servicing its customers and meeting its financial inclusion objectives.
- ▶ A major Chinese bank has collaborated with a mobile text and voice-messaging communication service to provide a payments service. Users of the communication service

can check their bank card details through the digital platform and use its interface to access transaction records. This has allowed the Chinese bank to send user information through the communication service instead of SMS, which is more expensive.

### Win customers

- ▶ In 2014, a global bank acquired a large stake in a South African peer-to-peer (P2P) lender, to complement its existing lending business in the region and give it a foothold in the emerging P2P market. The investment will allow the P2P lender to start developing its corporate product range.
- ▶ In South Africa, a mobile money provider has entered into a partnership with a domestic bank to offer micro-savings, credit and insurance products.
- ▶ In Kenya, a partnership between a regional bank, a mobile network operator and a card provider launched a virtual shopping card that enables users to access a range of banking services through their mobile phones.
- ▶ In 2012, in India, a domestic bank partnered with a global bank to provide currency remittance facilities to the global bank's customers. The Indian bank does not charge for these transfers. This is particularly useful to

attract foreign currency deposits from non-resident Indians. Last year, when the Reserve Bank of India announced a special concessional dollar-swap window to attract foreign deposits, the Indian bank was able to mobilize the largest foreign currency deposit base.

- ▶ In 2012, a South African bank signed a business cooperation agreement with a major Japanese bank, under which the two banks would partner to assist Japanese companies in Africa.
- ▶ In 2012, an Indian bank entered into a Memorandum of Understanding with a pan-African banking conglomerate. These banks will collaborate to extend banking services across their combined footprint in India and Africa.
- ▶ In Mexico, a large micro-lender is partnering with other providers to expand its offerings. In return, the micro-lender encourages loan customers to deposit their savings with partner banks.
- ▶ In Malaysia, a major Malaysian bank has partnered with a budget airline to offer account holders promotional airfares and priority bookings to airline destinations. By the third anniversary of the account's launch, it had attracted 300,000 customers – and the average account balance was 50% more than other savings accounts.

Local banks may lack the skills to attempt to develop the new products and services required to retain customers. By collaborating with a regional or global institution, they can gain access to stronger balance sheets and greater technical know-how. This offers the local institutions an easy way to build the skills and capabilities of their employees as the war for talent intensifies.

At the other end of the spectrum, partnerships with micro-finance institutions can give local banks with strong balance sheets the opportunity to diversify into higher-margin segments without recruiting an extended network of skilled agents to assess customers. Micro-finance institutions will also benefit through access to more funds. Such alliances will enable local banks to target a higher-yielding customer segment and will also help banks in some countries meet government policy requirements to target lending to the SME sector.

Partnerships with telecommunications companies can give banks across the emerging markets access to a large customer base without significant investment costs. Most telecommunications providers are unlikely to develop their own suite of banking products as they would be subject to increased regulation and capital requirements and would require a larger balance sheet to support lending. By forming alliances with such firms, banks can gain customers among the rural and unbanked segments more efficiently than by establishing a branch network. As bank customers begin to demand more than just transactional mobile banking, technology firms may be able to help banks develop apps that deliver an enhanced experience to higher-value customers.

There is the potential for banks to radically reduce their costs through sharing infrastructure. In some developed markets, we are beginning to see collaboration between institutions in which IT systems are seen as delivering a competitive advantage. For example, some corporate and investment

banks are considering collaborating to establish an industry utility to provide customer checks. Such a move would radically reduce back-office costs. Banks in emerging markets typically have less-established systems of their own, and are therefore even better placed than most developed market banks to explore such cost-sharing solutions.

Alliances can also give banks access to better customer data. For example, if they are able to build relationships and share data with utility providers or insurance firms, they may be able to get a better view of customers' credit risk or pre-qualify them for sales of certain products – although data protection regulations in many of the emerging markets can make such partnerships difficult and add significantly to the compliance burden.

It is evident that by building partnerships, many institutions can eliminate their capability gaps, but doing so will not be easy. Banks will need to embrace collaboration with firms that at first glance may look to be competitors that are eroding their market share. Furthermore, as much as a successful partnership can offer the potential to bring tangible value to an organization, it is critical to find the right partner to solve a specific problem, and one that is a good cultural and organizational fit. A faulty partnership will see little return on investment.

We believe that although banks are focused on fighting the headwinds they face in these markets, they are not yet addressing the underlying issues of people, technology and partnerships – or at least, where they are addressing these issues, they are not doing so in a focused and cohesive manner. The emerging markets clearly offer huge potential for banks, but we anticipate that those banks that are successful in the long term will be the ones that look beyond short-term crises and concentrate on developing differentiated skills and capabilities. And it will not be possible for banks to do this without significant investment in the crucial areas we have discussed.



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