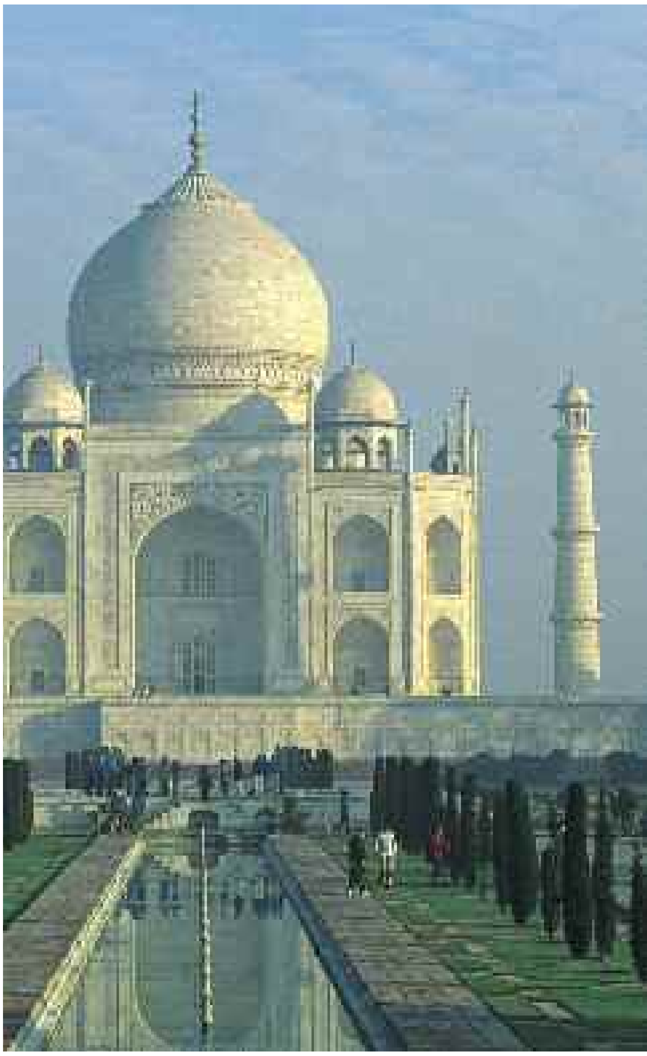
Project Blue

Capitalising on the growth and global interconnectivity of the emerging markets: Financial services in India



Reaping the rewards of the new global economy

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Foreword

Welcome to 'Capitalising on the growth and global interconnectivity of the emerging markets: Financial services in India'. The paper is an India-focused companion to our global paper: 'Capitalising on the rise and interconnectivity of the emerging markets', the latest viewpoint in our Project Blue framework.

Project Blue explores the major trends that are reshaping the competitive environment for financial services (FS) businesses worldwide. Our clients are using the framework to help them judge the implications of these developments for their particular business, and look at how to take advantage of the changes ahead.

The rise and interconnectivity of the emerging markets of South America, Asia, Africa and the Middle East (together these regions form what PwC terms 'SAAAME') is in many ways the most far-reaching of the developments facing the FS sector. Trade within SAAAME is growing much faster than the flows between developed-to-developed and developed-to-emerging markets.

India's businesses are well-placed to take advantage of this shift in the focus of global growth and investment. Yet, they face strong competition from Chinese, Brazilian and other SAAAME multinationals, as well as businesses from the West. India's FS businesses are set to play a key role in supporting their customers as they seek to make the most of the acceleration in intra-SAAAME trade. As we examine in this paper, key considerations include how to develop the presence on the ground needed to support clients' overseas expansion and how to manage risk and talent across more complex and diverse international operations. New approaches to growth and organisational design may be needed as a result.

I hope you find this paper interesting and useful. If you would like to discuss any of the issues raised, please feel free to contact either me or my colleague, Robin Roy (contact details on page 14).

Manoj Kashyap
PwC (India)
Financial Services Leader

What do we mean by SAAAME?

'SAAAME' refers to South America, Africa, Asia and the Middle East. SAAAME doesn't include Japan as this is a developed G7 economy. Mexico is excluded as it trades mainly within the North American Free Trade Agreement zone and less with SAAAME. For now, Russia and the Commonwealth of Independent States (CIS) are also excluded from SAAAME, as trade is largely internal or with Europe.

Section one: Emerging superpower

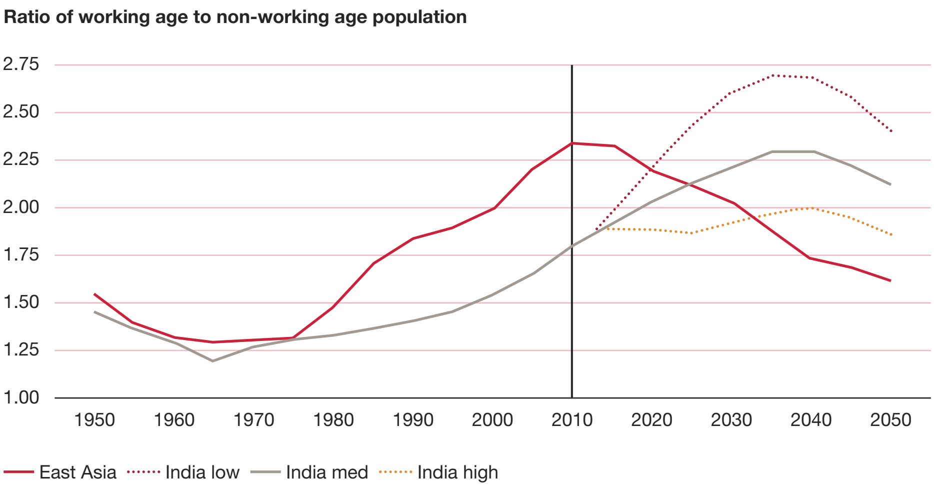
As India's economy evolves and customer expectations increase, its FS sector will need to keep pace. FS businesses will also need to find ways to follow or help their customers into new markets and help them capitalise on the increase in intra-SAAAME commerce.

India's emergence as an economic superpower over the past 20 years has been meteoric. While it may be difficult to sustain such a high rate of growth in the coming years, the long-term potential remains strong.

India's key strengths include the 'demographic dividend' of a young and expanding population. Figure 1 compares India's working age population to East Asia. If we compare India to China, China's working age population will begin to decline from 2014, but India's will continue to grow.[1]

Further potential comes from the increasing sophistication of India's global delivery model, a key engine of growth, particularly in the services sector. Business service companies are moving up the value chain to create centres of excellence in areas such as software programming, financial reporting and legal support. Global FS businesses are following suit as their shared service centres here build up their delivery capabilities in target areas such as trade finance, treasury settlements and transaction banking. Many of these centres employ 10,000 people or more. They could provide increasing competition for domestic FS businesses as international groups use them as a platform for expansion within India and Asia as a whole.

Figure 1: Growth of the working age to non-working age ratio in India



Source: United Nations

1 Euromonitor International, 17.10.10

Domestic opportunities and challenges

Anticipated growth within the FS sector reflects the continued expansion in the overall economy. In particular, India is set to become the third largest domestic banking sector after China and the US by 2050.[2] Much of this potential is built around the increasing affluence of the population (see Figure 2).

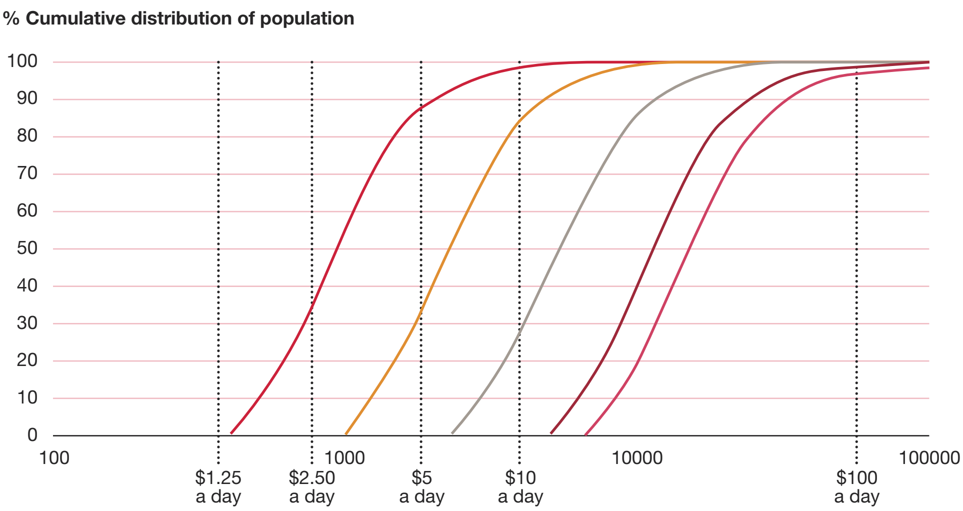
However, structural challenges remain. The high level of state ownership and control – particularly within the banking sector – is reflected in significant mandatory lending to priority segments like SMEs and agriculture, accounting for almost 35% of deposits raised by the large state-owned banks.

Encouraging savers to move funds to capital market investments would help to generate more finance for infrastructure and other key economic priorities – India's savings rate is more than 30% of GDP, one of the highest in the world.[3] Yet, as savers can often get better and more consistent returns on their bank deposits than potentially riskier investments where the returns are linked to market movements (mutual funds, other fixed income products), encouraging them to switch is a key challenge for banks, insurers and asset managers.

India doesn't have a state-sponsored social security system and therefore further development of the pension and annuities sectors is vital. The National Pension Scheme (NPS), which is targeted towards the unorganised sectors, has been a slow starter and many modifications are required to encourage both the intermediaries (banks, insurance companies, post offices) and pension fund managers to participate more tangibly. Businesses in these sectors can also contribute to the development of long-term money markets and help fund infrastructure development.

India's millennial generation is likely to be an important target market for investment businesses as they may be prepared to take more risk over a longer period of time than their older and more conservative counterparts. The challenge is how to make sure that pursuit of these opportunities doesn't lead to mis-selling or risk creating a market bubble. This will require both effective regulatory controls and a more mature product distribution structure, led by a well-supported independent financial adviser's network.

Figure 2: India's increasing influence



India's income distribution 2005–2039
Source: Brookings Institution

2 'Banking in 2050', 2011 update, published by PwC on 18.05.11

3 www.tradingeconomics.com, 30.05.12

More than 50% of the population does not have a bank account.[4] Bringing this unbanked population into formal FS services is a key focus of the government's 'inclusive growth agenda', reflected in the five-year plans and long-term growth plans of the economy.[5] Reaching out into rural areas and bringing their financial savings into the formal banking system is going to be critical, using a mix of intermediaries and innovative partnerships. Among these are plans to capitalise on well-established distribution chains like the network of post offices, where the rural and semi-urban population deposit much of their cash savings, indicating the strong element of trust. At the same time, making use of mobile phones for quicker and efficient payments is also going to be important as technology and regulations are converging to make such peer-to-peer transactions easier.

At US$61, insurance premiums per capita are some way behind China (US$158), Brazil (US$329) and South Africa (US$1,055),[6] highlighting room for further growth. But while health insurance is growing strongly, life and non-life businesses continue to face difficult challenges on profitability and maintaining increasing solvency ratios.

The life insurance sector is undergoing a significant overhaul, following the introduction of caps on agent commissions for unit-linked insurance plans (ULIPs). ULIPs had been the mainstay of the sector over the last few years, accounting for the bulk of new business. The curbs on ULIP commissions precipitated a 9% fall in overall life premiums in 2011.[7] The difficulties within the ULIP market are leading to a shift towards more traditional products such as whole life insurance. The pressure on top-line growth should also provide the impetus for better cost control and customer focus.

The mainstay of non-life insurance business continues to be property and casualty, motor (including mandatory third-party motor covers) and health. Some good traction has been seen in travel-related products. Yet, the premiums in the non-life sector are failing to cover the losses, particularly in motor, due to high claims' ratios. The challenge will be how to develop the potential in other areas including comprehensive motor, home cover, personal asset cover and health, while improving the quality of underwriting overall.

Looking ahead, insurers will need to contend with a combination of tighter regulation and the difficult global economic environment, calling for changes in strategy, governance and risk management, as well as opening the way for M&A and consolidation within the market.

4 New York Times reporting SBI, 29.09.11

5 Indian Banking Sector: Towards the Next Orbit, Inaugural address delivered by Dr K. C. Chakrabarty, Deputy Governor, Reserve Bank of India at 9th Advanced Management Programme at IMI, Delhi, 13.02.12

6 Swiss Re Sigma, World Insurance in 2010

7 Financial Times, 27.05.12

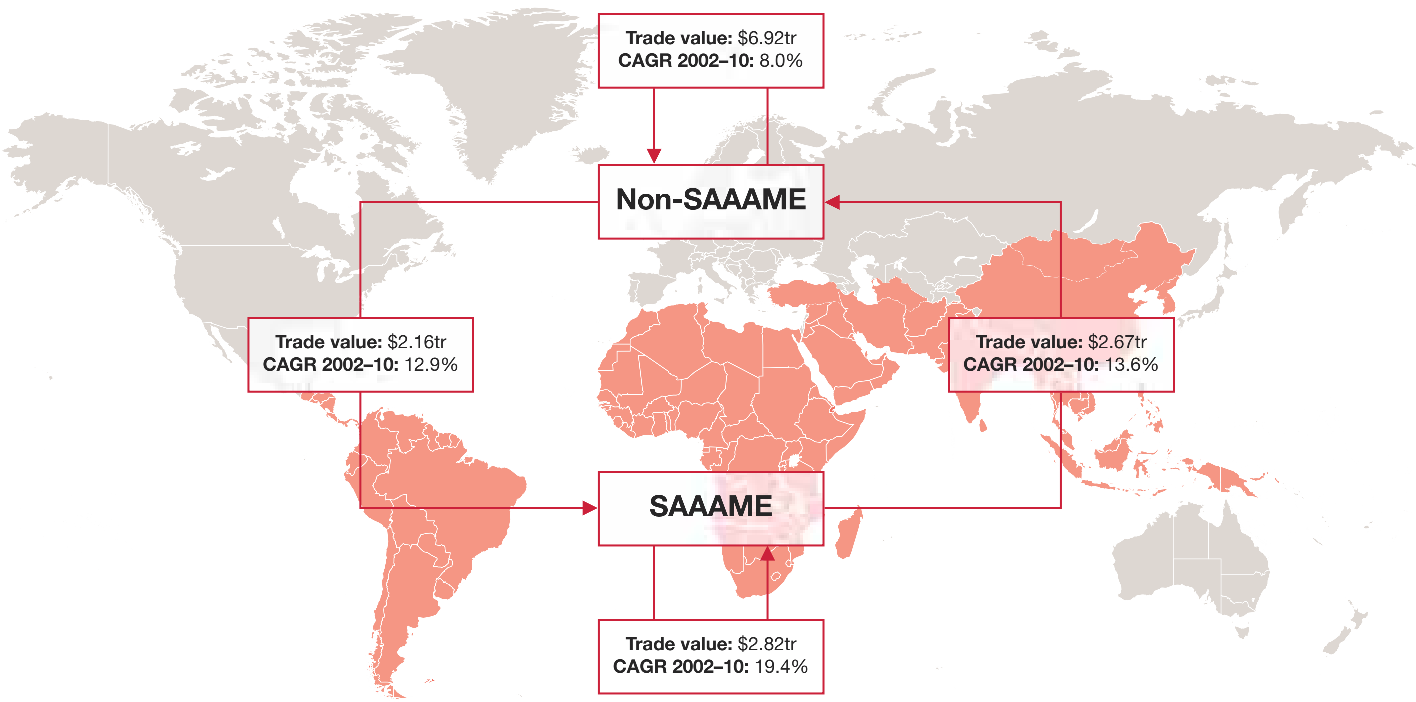
FS follows intra-SAAAME trade flows

Alongside domestic growth, the rapid rise in intra-SAAAME trade opens up significant opportunities for the FS sector. Emerging-to-emerging market commerce is now more valuable and growing much more quickly that emerging-to-developed and developed-to-developed trade (see Figure 3). As Figure 4 highlights, among the fastest growing trade routes are those between Asia and Africa and Asia and South America.

At present, SAAAME trade flows are dominated by commodities, but as consumer markets continue to expand on the back of rising affluence (see Figure 5), the pattern of trade will be increasingly focused on manufactured goods.

India's growing presence on the SAAAME and wider global stage is exemplified by multinational conglomerates such as Tata. Tata employs more than 2,000 people in China and generated sales of more than $3 billion in the country in 2010.[8] In South America, its companies employ more than 5,000 people.

Figure 3: Transformation in global trade flows



Sources: WTO and PwC analysis
Note: Russia and the Commonwealth of Independent States (CIS) have not been included in SAAAME definition because trade is largely international and/or with Europe. Mexico is excluded as it trades mainly within the North American Free Trade Agreement zone and less with SAAAME. Both areas remain very important growth markets and should be considered in relation to the SAAAME region.

8 www.tata.com, 30.05.12

Figure 4: Trading hot spots (growth in value of imports and exports)

DESTINATION

ORIGIN	N America	Europe	CIS	South and Central America	Africa	Asia	Middle East
N America	5.4	8.0	13.4	13.7	13.5	9.1	12.9
Europe	4.5	8.6	17.5	11.3	12.6	12.0	11.7
CIS	17.7	18.8	17.2	5.4	16.4	19.3	16.4
South and Central America	8.8	13.6	16.0	16.8	17.9	25.6	18.0
Africa	19.2	12.6	21.2	21.6	19.0	24.5	27.8
Asia	8.7	14.7	29.9	24.1	22.5	15.2	18.7
Middle East	10.0	12.8	24.1	15.1	15.7	18.9	20.2

CAGR % 2002–2010: <5 5–10 10–15 15–20 20–25 >25

SAAAME

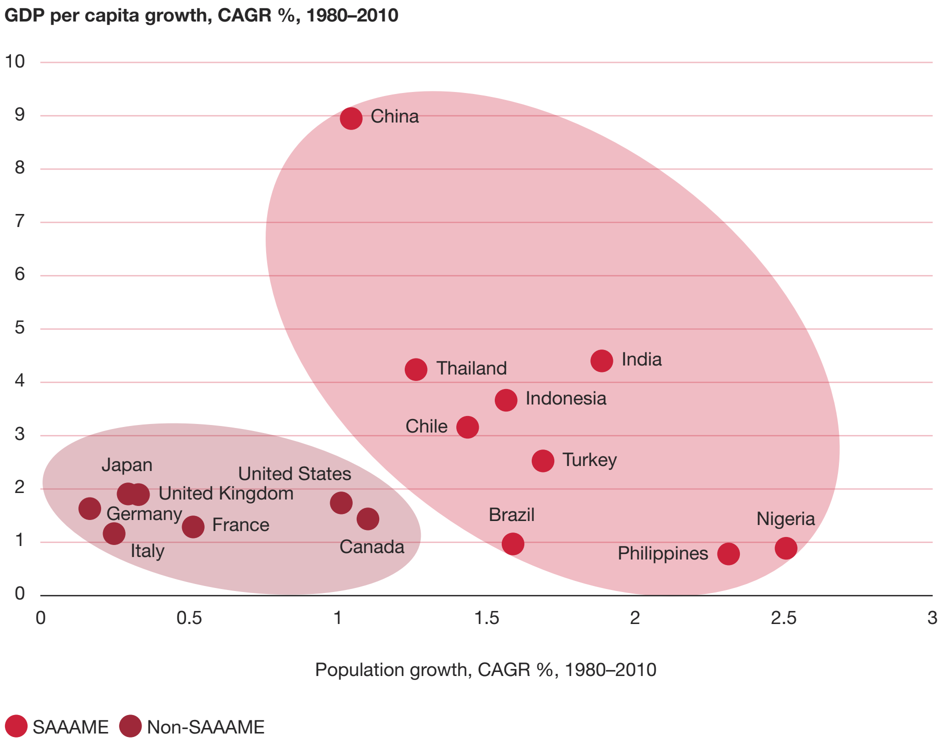
Sources: WTO and PwC analysis
Notes: North America includes Mexico; Asia includes Japan, Australia and New Zealand

The challenge for other businesses is how to follow the lead of groups like Tata by developing and strengthening trade links and operations within SAAAME. In doing so, they will face strong competition from other countries, notably China and Brazil, which have been moving quickly to secure resources and tap into rising demand. India's exports to China increased in 2011, but the deficit was still $27 billion on overall trade of $74 billion and India's businesses will be looking to close the gap. Notably, Brazil maintains a net surplus on trade with China.[9]

Africa is emerging as a key competitive arena. India's trade with Africa has grown from $620 million in 2001 to $62 billion in 2011. But China–Africa trade has developed quicker, rising from $10.6 billion to more than $160 billion during this period.[10]

Clients are looking to FS institutions to provide trade finance, insurance, merger and acquisition services, and debt finance in export markets. Serving Indian communities abroad has already given Indian banks and insurers a presence on the ground in many SAAAME countries. The challenge will be how to build on this bridgehead and move into new markets.

Figure 5: Increasing affluence in SAAAME markets



Sources: United Nations Population Division; World Bank World Development Indicators and PwC analysis
Notes: GDP per capita is in constant 2005 US$

9 Brazil-China Fact Sheet, www.brazil.gov, 30.05.12
10 Economic Times, 17.03.12

Section two:
Creating a platform for expansion

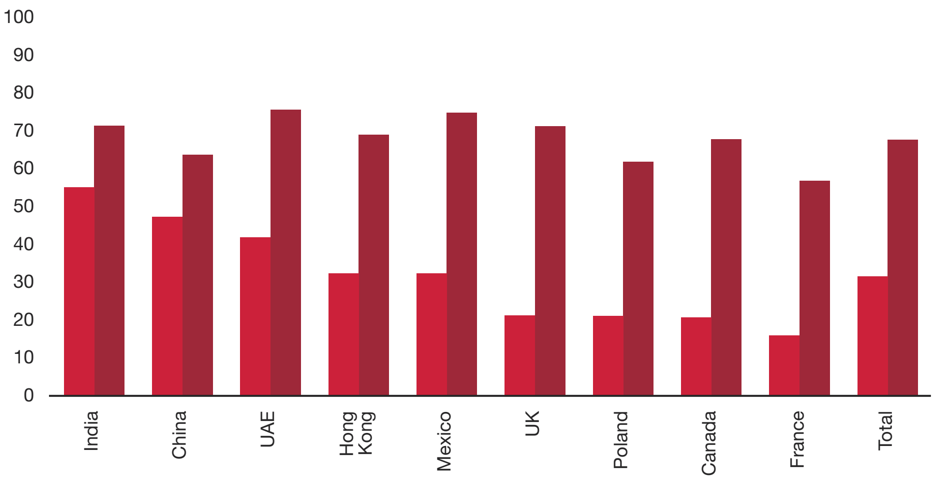
The ability to develop effective digital services, forge partnerships in hard-to-access territories and move ahead of competitors in seeking out untapped markets will be crucial in helping FS institutions to build a platform for sustainable domestic and international growth.

Using innovation to build market share

India was one of the countries analysed in a recent PwC study of digital banking. Demand and usage are exceptionally high in comparison to both developed and emerging markets (see Figure 6).

Digital FS can enhance customer insight and engagement and allow financial institutions to move into new markets without the need for branch or agency networks on the ground. It could be especially important in serving the highly connected millennial generation. It can also provide unbanked and remote customers with access to payment and deposits via the mobile phone network – successful models include Kenya's M-Pesa, which now has 15 million customers, more than all of the country's banks put together.[11] Moreover, digital banking is going to be a key element of wealth management, offering intuitive and interactive anytime and anywhere services.

Figure 6: The global usage of internet and mobile usage in banking



■ % who currently use mobiles to purchase financial products

■ % who currently use the internet to purchase financial products

Source: 3,800 consumers were polled for 'The new digital tipping point', a report published by PwC in January 2012

11 www.thinkm-pesa.com, 16.04.12

One way to augment technological capabilities would be to buy a Western institution. This could also provide access to additional product expertise, or experience of managing international operations. Takeover prices in some developed markets are generally favourable for now, especially within the mid-market, but may not be so for long.

Reaching into new markets

Prior to the global financial crisis, a number of leading international FS groups were able to make multiple acquisitions to rapidly build up their presence in SAAAME. The problem is that this type of fast acquisitive growth is now much more difficult, at least within the most attractive SAAAME markets.

Prospective entrants may face ceilings on foreign holdings, China and the Middle East being notable examples. Even in open markets such as Brazil, there may be little market share for sale and it may be prohibitively expensive if it is. Entrants may also face entrenched competition from dominant local rivals, especially within the core savings and credit markets.

In many of the hard-to-access markets, the main route to customers is therefore going to be joint ventures. But with many leading local firms having partners already, it will be important to think about what to offer them that existing partners and potential rivals cannot. This might be particular product or credit risk expertise. It might also be complementary international coverage, or access to customers and investment opportunities within India. Very few groups are going to be able to cover all the key markets. So collaboration between competitors (co-opetition) is going to become evermore common in the future.

Moving into some of the frontier and still largely unsaturated markets in Africa or South America could provide an important foundation for future growth. The ability to support infrastructure development and facilitate two-way trade is going to be important in winning over governments and customers.

Reinventing the organisation

A new approach to organisational design may be needed as India's FS businesses seek to create more nimble and adaptive operational capabilities and make sure their talent, structure and governance reflect their increasingly international horizons.

Businesses also need to contend with a more complex risk profile. SAAAME countries have varied legal and regulatory frameworks, political systems, business ethics and cultures. It's important for Indian groups to develop the timely and reliable management information and risk management systems needed to operate in new and unfamiliar markets.

Operating models will need to reflect the changing geographical focus of the business. They will also need to deal with more extensive partnership and co-opetition arrangements and be sufficiently agile to respond quickly to unfamiliar market conditions, distribution channels and cultural preferences.

The underlying challenge is securing sufficient talent in markets where suitably qualified and experienced people may already be in short supply. Short-term and reactive approaches, be this seeking to lure key people from competitors, or bringing in large numbers of expatriate personnel are likely to prove excessively costly and may still fail to provide the people needed to meet strategic objectives. A more systematic and forward-looking workforce plan, capable of anticipating and meeting skills' needs could reduce costs and allow FS organisations to build a more sustainable platform for business development.

Moving into India

International businesses looking to move into India face a number of challenges. Difficulties in securing licences, tight restrictions on foreign ownership (5% limit for each firm and 74% overall) and restricted voting rights have deterred inbound investment in the banking sector. Foreign stakes in Indian insurers are limited to 26%, though M&A and IPO rules are under review. A more straightforward route into India may be investment in non-bank financial institutions, which allow 100% foreign ownership and offer access to fast-growing segments such as mortgages, vehicle finance, credit cards distribution and stockbroking.

Opening up new frontiers

India's financial institutions have developed rapidly in recent years. But they can no longer rely on the country's GDP growth to deliver assured profitability and expansion. They will need to meet rising customer expectations, increase financial inclusion and support corporate clients as they reach into new markets. Failure to keep pace could leave some players at risk of losing business to faster moving competitors, including Western or SAAAME groups.

We believe that there are five key questions that FS businesses should consider as they look at how to gear their strategy and operations to an increasingly competitive and globalised sector:

- How is technology reshaping the expectations of your customers and how can you develop the intuitive and interactive services that would put you at the forefront of the market?
- How are your corporate clients responding to the shift in the focus of global growth and how can you develop your services and geographical reach to support them more effectively?
- Are there opportunities to extend your regional and wider international footprint and what strengths would you be looking to leverage as part of such a strategy?
- Is your governance and risk management equipped to deal with a more complex and globalised sector?
- Is the recruitment, retention and development of talent within your organisation equipped to meet long-term strategic objectives and how can you develop a more proactive strategic plan?

Making sense of an uncertain future

We're working with a range of FS organisations to judge the impact of the mega-trends shaping their industry, and where and how they can compete most effectively. If you'd like to discuss any of the issues raised in this paper, or the impact of other trends examined in Project Blue, please contact either of those who are listed here, or your usual PwC contact.

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Project Blue framework

The Project Blue framework considers the major trends that are reshaping the global economy and transforming the behaviour of consumers, businesses and governments.

The Project Blue framework seen here begins with the considerations needed to adapt to the current instability. It then goes on to assess what FS businesses need to do to plan for, and ideally take advantage of, the changes ahead.

One of the main things we've been looking at is the extent to which these developments could disrupt existing business models. We've also been looking at how these trends are feeding off each other. A clear case in point is the extent to which rapid growth in emerging markets is spurring a mass influx of people into the cities.

Our clients are using the framework to help them judge the implications of these developments for their particular business, and look at how to take advantage of the changes ahead. Will business and operational models still be viable in this new landscape? What strengths within the business would allow it to develop a leading position? What talent and investment will need to be put in place now, to prepare for the changes ahead?

Figure 7: The Project Blue framework

Project Blue Framework

Adapt	Global instability		
	Regulatory environment	Fiscal pressures	Political and social unrest
Plan	**Rise and interconnectivity of the emerging markets (SAAAME)**	• Economic strength • Trade • Foreign direct investment	• Capital balances • Resource allocation • Population
	Demographic change	• Population growth discrepancies • Ageing populations	• Changing family structures • Belief structures
	Social and behavioural change	• Urbanisation • Global affluence • Talent	• Changing customer behaviours – social media • Attitudes to financial institutions
	Technological change	• Disruptive technologies impacting FS • Digital and mobile	• Technological and scientific research and development and innovation
	War for natural resources	• Oil, gas and fossil fuels • Food and water • Key commodities	• Ecosystems • Climate change and sustainability
	Rise of state-directed capitalism	• State intervention • Country/city economic strategies	• Investment strategies • Sovereign wealth funds/ development banks

Source: PwC Project Blue analysis

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