Banks miss US$100m yearly by failing to tap into wealth, SME lending segments

Wealth management and SME lending have pent-up demand in underserved markets, argued McKinsey.

Whilst Asia-Pacific banking could appear that it is strong and growing, closer scrutiny reveals that tapering growth is the most obvious sign of a weakening environment for Asia-Pacific banking. Notably, in 2018, Asia Pacific banking generated revenues of approximately US$1.6t. The region's profits (before taxes) topped US$700b in 2018, representing 37% of global banking profit pools.

However, whilst the region's banks enjoyed double-digit annual growth from 2010 to 2014, from 2014 to 2018, annual revenue growth shrank 5%, and growth in profit pools slowed down to 3%.

Whilst there was a slight recovery in banking profit pools in certain markets from 2017 to 2018, the longer trend of slowing GDP growth in China and India, Asia Pacific's two largest emerging economies, has weakened economic expansion for the entire region and dampened demand for banking services.

The average risk cost provision for the Asia-Pacific market was approximately 0.30% in 2018. This is the highest level of loan losses for the region since 2002, when the average risk cost provision for emerging and developed Asia-Pacific markets hit approximately 0.31%.

With new competitors entering the field even as growth is slowing, banks must act promptly to capture the US$100b annual opportunity for new revenue. This opportunity is spread across four business lines—wealth management, retail lending, SME lending, and transaction banking—each buoyed by pent-up demand in underserved markets.

To pursue these opportunities, banks must beat the attackers at their own game—establishing robust digital-first delivery and servicing platforms and developing advanced analytical decision engines to track real-time changes in the needs of individual customers.

To win in wealth management, banks need to strike the right balance between self-guided digital tools and high-touch consultation, according to the distinct needs of each segment.

To win in wealth management, banks need to strike the right balance between self-guided digital tools and high-touch consultation, according to the distinct needs of each segment.

Personal financial assets (PFA) in Asia Pacific are expected to total US$69t by 2025. Growth in the region's PFA is driven primarily by the increase in retirement assets in developed markets (as the population ages) and the expansion of the entrepreneurial class (especially mass affluent and high-net-worth segments) in emerging markets.

Wealth management opportunities

At the current annual growth rate of 9%, Asia Pacific will account for three-quarters of global PFA within six years. At present, however, this is a largely untapped market—an estimated 80% of Asia Pacific's

US$100b of revenue can be unlocked via wealth management, retail lending, SME lending, and transaction banking.

personal financial assets is not actively managed by third-party professional managers.

Investors in China will likely seek new onshore products as regulators tighten limitations on shadow banking, and the recent introduction of majority ownership in joint ventures and wholly owned foreign entity (WOFE) licenses broadens opportunities for foreign investment managers in China.

Partnerships and acquisitions provide an effective means to deliver sophisticated investment options to local markets. For example, Siam Commercial Bank (SCB) and Julius Baer announced in 2018 an agreement to combine SCB's expertise and large customer base in Thailand with Julius Baer's global wealth management capabilities and product suite.

Retail lending

Partnerships are an increasingly important means for extending market reach not only in wealth management but in practically all banking businesses. In retail lending, which is expected to grow from a total of US$12.8t in 2018 to US$21.2t in 2025, many banks are discovering that by partnering with a strong digital company—e.g., an e-commerce site, a telco company—they can reach new customers and collect richer data. This enables banks to generate highly reliable risk scores for the region's fast-growing middle class, which is expected to expand from 40% of all Asia Pacific households in 2018 to more than 60% in 2025.

Kotak Bank, for example, has partnered with telecommunications company Bharti Airtel, not only reducing the costs of new customer acquisition and service delivery but also gaining access to Airtel's network of 250,000 retail stores in India. In 2016, it extended further into the mass market of lower-income consumers through its acquisition of BSS Microfinance.

Various types of secured and unsecured consumer lending represent a big opportunity for Asia Pacific banks. However, in order to keep risk costs low whilst extending loans to consumers with limited or no credit history, banks will need to develop powerful diagnostic models not only to assess risk accurately but also to identify precisely the type of credit product best suited to individual users.

It is particularly important to restrict customised credit offers to segments where product penetration is low relative to GDP, as regulators are keen to reduce debt levels in overpenetrated segments. Banks should also prioritise "asset light" credit products in order to optimise the amount of capital they must set aside to meet Basel III capital requirements.

Bank lending to small and medium-size businesses accounts for more than a third of all bank loans in Asia Pacific, and the SME portfolio is expected to grow 9.1% annually to US$23t in 2025. Whilst the SME segment accounts for the biggest share of Asia Pacific lending, banks are still missing the better part of the opportunity. SMEs contribute 54% of GDP in Asia but generate only 25% of total banking revenues before risk costs. The vast majority of SMEs in Asia Pacific turn to non-bank sources to finance working capital.

SME lending loopholes

The challenge for most banks is that they lack the information they need to assess the creditworthiness of SMEs accurately and often make bad lending decisions. As a result, banks' risk costs for the SME segment in Asia Pacific are double those for the large corporate segment.

Lending to SMEs is potentially a highly profitable business for banks that can leverage digital channels to reach the mass market of SMEs and use advanced analytics to identify qualified borrowers for both secured and unsecured lending. CMB, for example, has built a fully digitised SME services platform, through which they offer a streamlined loan application process.

The automated review is completed within minutes, and customers can access funds immediately upon approval. Third parties provide additional services by linking to the platform through APIs, helping to increase activity on the platform. In 2018, CMB's NPL ratio was 1.36%, compared to an average of 1.8% for China.

Banks can tailor platform solutions for SMEs and use them both to acquire new customers and deepen existing relationships. CBA's Wiise, for example, is a cloud-based business management platform designed especially for SMEs. Services on the platform, which integrates seamlessly with CBA's invoicing platform, include accounting, payroll and banking,

SMEs contribute 54% of GDP in Asia but generate only 25% of total banking revenues before risk costs.

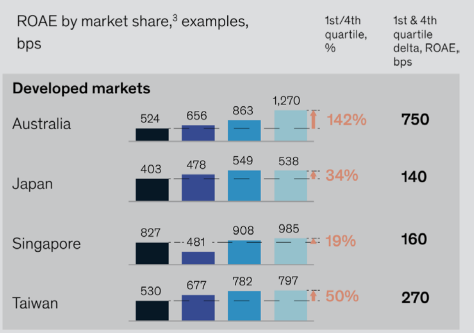
Return on average equity (ROAE) for Asia Pacific's developed markets

CAGR 2014-18: Below -1% | Between -1% and 0% | Between 0% and 1% | Above 1%

	ROAE 2014, %	+ Margin	+ Risk cost[2]	+ Cost efficiency[3]	+ Taxes	+ Fines and others[4]	+ Capital	= ROAE 2018,[5] %
Asia-Pacific	12.8%	-4.9%	-2.3%	3.2%	1.5%	0.0%	-0.2%	10.1% ▼
Developed markets								
Australia	14.6%	-2.6%	0.7%	1.2%	0.6%	-0.4%	-1.3%	12.9% ▼
Hong Kong	13.9%	-1.2%	0.4%	0.3%	0.3%	0.2%	-1.5%	12.3% ▼
Japan	6.3%	-5.2%	0.3%	2.7%	1.3%	0.0%	0.1%	5.4% ▼
Singapore	11.8%	-0.8%	0.8%	-0.1%	0.1%	0.0%	0.3%	12.1% ▲
South Korea	4.5%	-0.7%	3.4%	1.5%	-1.0%	-0.5%	1.3%	8.5% ▲
Taiwan	9.7%	-2.7%	0.1%	1.3%	0.2%	-0.6%	0.1%	8.2% ▼

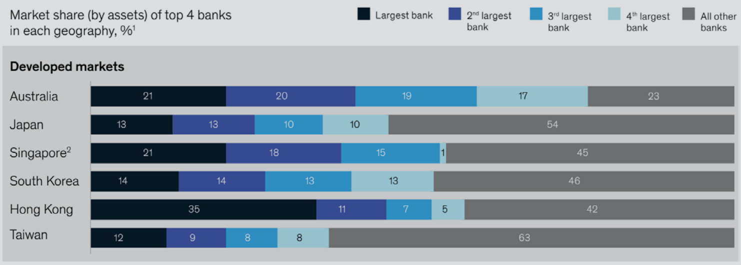
Source: McKinsey

ROAE in developed markets by market share



Source: McKinsey

Market share split across Asia-Pacific suggests varying potential for consolidation across markets.



Source: McKinsey

human resources, and inventory management.

In addition to helping banks reduce loan losses among SMEs, the vast and diverse types of customer data generated on an SME platform can enable banks to craft timely offers for investing excess cash, payroll management, accounting and reconciliation processes, etc.

Growth in transaction banking

Not only does transaction banking account for approximately a third of all banking revenues in the Asia Pacific, but the region also captures more than half of transaction banking revenues globally. During a decade of lacklustre growth in other regions (5% in the Americas and 2% in EMEA), transaction banking in Asia Pacific has grown 17% annually.

Finally, supply chain finance (SCF), which is expected to grow 14% annually, not only enables a bank to embed use cases within corporate treasury and trade operations, but also to strengthen relationships with corporate clients' suppliers, many of which are SMEs. There are various initiatives to establish SCF platforms using distributed ledger technology. These include IBM's partnerships with logistics and shipping companies, as well as government-led industry consortia, such as the Global Trade Connectivity Network, led jointly by the Monetary Authorities in Hong Kong and Singapore.

Industry consolidation incoming?

Given the competitive advantages that come with scale and being fast to market, some banks are finding that mergers and acquisitions—along with strategic partnerships—are an efficient way to enhance their customer propositions.

Findings show that 79% of leading banks have partnered with a fintech to foster innovation in payments, lending, investment, or other areas. Thailand's Kasikornbank and Grab have teamed up to launch GrabPay by KBank, a mobile wallet. BRI has partnered with Alipay to expand point-of-sale acceptance of mobile payments for Chinese tourists visiting Indonesia.

OCBC Bank has joined forces with personal finance portal MoneySmart to offer low-rate mortgages. UOB has partnered with OurCrowd, which enables consumers to invest small amounts in startups. Acting as an orchestrator or as one of several lead partners, a bank may establish a platform or digital ecosystem, developing APIs that enable third parties to link to the platform and introduce relevant services.

Banks should also improve the way they develop and deliver solutions by implementing the latest DevOps tools and methods across the development pipeline, which can speed up time-to-market by 80%, reduce time spent on diagnostics by 75%, and cut FTE by 75%. At Macquarie, for example, application development teams interface with a self-service development platform, moving rapidly through live-testing and application enhancements to full launch.

Many banks have adopted a "federated" governance framework (controls and responsibility shared among business units, domain owners and stewards, and CDO/data management centre) as the most effective approach. In addition, it is crucial to determine who owns the data and how to limit access to protected data. Managing metadata—how data sets are organised and labeled—also falls within the scope of governance.

Banks should also improve the way they develop and deliver solutions by implementing the latest DevOps tools and methods across the development pipeline, which can speed up time-to-market by 80%, reduce time spent on diagnostics by 75%, and cut FTE by 75%.

For certain types of data, partnerships can reduce storage costs and help banks comply with data privacy and security requirements. For example, ANZ, NAB, and Westpac have each invested in Australian start-up Data Republic, a data hub through which organisations can store, exchange, and collaborate on aggregated data projects in a secure environment.

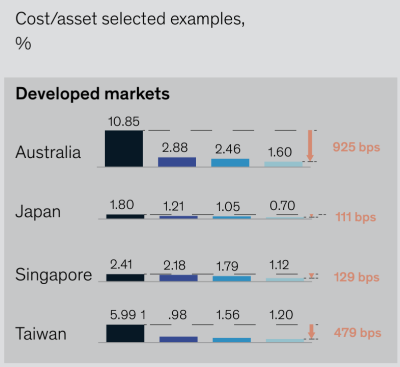
Amping up competitiveness

A special push is required to go the last mile and embed analytics in the everyday work of tens of thousands of employees. Breakaway analytics firms generally devote at least 50% of analytics investments to developing visualisation tools and training frontline staff, product managers, and others on the use of analytics insights in customer interactions

Moreover, 50% of banking jobs could see half of their activities automated by 2030. Investing in leaders is another critical element in building the workforce for a digital-first, data-driven organisation

Top digital talent is scarce, and companies from all industries are competing to fill fast-growing needs. Demand for digital capabilities is estimated to outstrip supply by a factor of four, and demand for big data talent is expected to be between 50 and 60% greater than the projected supply over the next three to five years.

Asia Pacific banks with larger scale perform better



Source: McKinsey

How banks in Asia-Pacific can survive in an age of declining profitability

Cutting down branches and migrating banking services to online and mobile channels are key to keeping costs down.

Joydeep Sengupta

There was no way it could have lasted forever. After enjoying double-digit annual revenue growth from 2010-2014, banks in Asia-Pacific are starting to witness tapering growth trends with annual revenue growth slowing to 5% in 2014-2018 and growth in profit pools easing to 3% over the same period, according to McKinsey's annual banking review.

The average return on equity for Asia-Pacific fell from 12.4% in 2010 to 10.1% in 2018, signalling what some argue to be the end to the Asian miracle, although the region's profitability still ranks above the global average of 9.5%. The negative trend can be observed across developed and emerging markets in the region with only lenders in Singapore, South Korea and Vietnam turning the tide and posting improved ROAEs in 2014-2018.

In an interview with *Asian Banking & Finance*, **Joydeep Sengupta**, Asia–Pacific banking practice leader at McKinsey and one of the primary authors of the report highlights best practices for banks in the region to survive the fintech threat as well as the four growth areas that banks can embrace to shift the narrative in their favour.

The conversation has been shifting towards cost efficiency and brand rationalisation with Japanese banks shutting down branch after another and Chinese ATMs gathering dust amidst the popularity of AliPay and WeChat. How do you see this trend developing?

If you look at a return on equity, and the pressure on return, this has come largely from declining margins across most product categories virtually across all markets. The other factor has been deteriorating risk environment, where the risk costs have systematically gone up across many markets.

Even though we've seen a lot of effort made by banks that have been in part successful in containing costs, in aggregate, the cost efficiency gains have not been sufficient to overcome the declining margins and the increasing risk costs - which is why we've seen this kind of decline.

Although the situation for Asia is fragmented, what's their regulatory situation like and how do they weigh in on earnings outlook for banks across the region?

By and large, regulators have been largely very progressive, meaning there is a lot of encouragement for innovation. You've seen a lot of regulatory interfaces, open banking, changes in payment systems and the creation of regulatory sandboxes. At the same time, we are also seeing regulators beginning to worry about systemic risk given the world that these players are creating and the disruption they bring. They're worried about data privacy and cyber security. The regulatory environment, whilst being progressive, will see more debate on how to ensure that institutions are allowed to provide the best deal for the customer whilst making sure that the system itself is stable. That is the fine line which many regulators are beginning to walk.

Fintech and bigtech have proven their merit in targeted areas although they have yet to fully capture the full-lending cycle. How do you see this landscape developing, especially when the conversation is shifting towards competition and cooperation?

Fintechs and bigtechs have had a profound impact on the market and the consumers. They have very strong analytical tools and capabilities and use data more intelligently and profusely in their lending models than many of the banks.

As a consequence, they have been driving digital lending into retail and the small business segment, but at the same time, putting a tremendous amount of pressure on bank margins, because their cost of acquisition is much lower than traditional banking models.

However, the quality of the loans need to be tested through a down cycle. Unlike the traditional banking model, which has gone through many up and down cycles over decades, I think this is a relatively new phenomenon that hasn't been tested in an economic down cycle. We're not saying that they won't hold true or they won't be solid but to confidently declare victory of fintechs, they need to be tested through a down cycle. From a banking point of view, their ability to claim a segment will depend a bit on the partnerships with fintechs, bigtechs, or other ecosystem players with whom it can access customers, and information at a much lower cost. We will certainly see some element of coexistence between the two.

Do you believe bank branches will remain relevant?

If you go back historically, the role of the branches, to a large extent had been threefold. One is really acquiring customers, a second is enabling and helping the transactions that customers do and a third is offering advice and cross selling other products.

What's happening with the whole digital plays is that a large part of the transaction business is disappearing. Most banks are seeing a sharp drop in transaction volume happening at their branches so many banks are trying to find a way of moving the transactions out to a call centre, to digital channels or even to the ATM. For many banks, today, 95-98% of transactions are done outside of branches.

In more mature markets, banks are also reorienting branches to focus on customer acquisition since there aren't that many new customers to acquire but are shifting towards advisory. This means that the look and role of the branch is shifting from an acquisition and a transaction point to advisory point. The role of the branches are changing and the kind of people that need those branches also change. That's the dynamic which we will see happen, as opposed to just a blind a shot at cutting the branches.