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*Size of bubble represents total banking assets*

**Source:** Central banks, IMF, The World Bank, The Banker database. All data from 2011.
These rapid growth markets (RGMs) are very diverse banking markets and are at different stages of financial maturity. We highlight some key differences across the 10.

**South Africa** is the most consolidated of our RGMs, with the top 5 banks accounting for over 90% of total assets. **Indonesia**, which has around 120 banks, is the least concentrated market, with the top 5 banks accounting for just 48% of industry assets.

Foreign banks play a leading role in **Mexico**. Although only 16 out of 42 banks are foreign owned, they account for over 70% of industry assets. **Malaysia** is the largest banking market, with industry assets valued at US$561b. **Nigeria** has the smallest banking sector, with just over US$118b in assets.

The established emerging markets tend to have much broader distribution networks than the less-developed markets.

**Turkey** has the highest ratio of branches to people, with 18.3 branches per 100,000 adults, while **Chile** has the highest ATM-to-person ratio, with 65.4 per 100,000 adults.

**Indonesia** has just 8.5 branches and 16.5 ATMs per 100,000 adults.

Three of our established RGMs – **Malaysia**, **Turkey** and **South Africa** – are the countries with the largest deposit and loan books.

These three established RGMs are followed by **Indonesia**, which, although it has a smaller per capita GDP, has the largest population of all our RGMs, at over 242 million.

**Chilean banks**, with the smallest population of all our RGMs at just 17.3 million, still hold over US$145b of deposits, while their combined loan book stands at US$163b.

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1This report contains specific analysis on each of our 10 rapid growth markets (RGMs), while the companion report deals with them at a global level. We have categorized the RGMs in this report as Frontier (Nigeria, Vietnam), Transitional (Egypt, Indonesia and Colombia) and Established (Chile, Malaysia, Mexico, South Africa and Turkey). A full explanation of the RGMs and their categorization can be found in the introduction to the global report.
Aflajna]k]ph]])ajZYfckÌh]j^gjeYf][lgaehjgn] as they meet strong demand across retail, commercial and corporate business lines. However, the growing cost of acquiring deposit funding is forcing banks to raise more funding in foreign capital markets to meet this demand for lending.

Respondents anticipate that political pressure will reduce rates on credit products. Recent customer regulation to drive pricing transparency is likely to lead to margin compression and we believe banks should consider investing in customer-focused initiatives to differentiate themselves on service rather than price.

The combination of margin compression and growing uncertainty about the economic outlook means banks expect credit risk management to be increasingly challenging over the next year. Currently, few banks plan to invest further in strengthening credit risk assessment, but we anticipate increased investment in this area should banks look to lend to higher-yielding customer segments to offset margin pressure.

As profitability comes under pressure, banks should also be diverting a greater proportion of investment spend toward streamlining processes and driving greater efficiency.

We expect that government action will help to strengthen the capital markets. This will enable large commercial banks to boost fee revenue from underwriting and ancillary services. With corporations increasingly likely to raise funding through the capital markets, bank balance sheets will be freed up to lend to the higher-margin small and medium-sized enterprises (SME) sector.

Respondents expect that any further consolidation in the industry is more likely to be driven by existing banks than by new entrants. Margin pressures at mid-tier banks may make them attractive targets for either larger domestic banks or already present foreign banks. Brand-new, potentially disruptive players are a possibility but, given current market concentration, they would really need to stand out.

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Points of note

• Interviewees expect their banks’ performance to improve as they meet strong demand across retail, commercial and corporate business lines. However, the growing cost of acquiring deposit funding is forcing banks to raise more funding in foreign capital markets to meet this demand for lending.

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Chile has the highest per capita GDP of our RGMs and, by 2017, it is expected to reach the current level of Eurozone countries. Consequently Chile has a highly evolved banking system with greater levels of penetration across a range of consumer products than most of our other RGMs. Penetration of credit cards, for example, is higher only in Turkey, Chile also has the deepest financial sector of the Latin American countries in this study. However, there is still room for growth, and interviewees expect continued strong demand for corporate, commercial and consumer products. As a result of this demand, almost all expect the performance of their banks to improve over the next year even though respondents have mixed outlooks on the economy overall (Figure 1).

With banks expecting to expand lending across a range of sectors, interviewees are acutely aware of the challenge of risk management. A financial crisis in the 1980s exposed weaknesses in Chile’s banks, when up to 30% of loans were categorized as non-performing. Subsequent reform of the banking system has improved supervision, boosted capital, reduced concentration risk and improved transparency. Chilean banks now have strong balance sheets, which helped them weather the global financial crisis.

Yet credit risk remains at the forefront of the minds of Chilean regulators. Chile will reform its banking laws this year to enable banks to reduce the rate of credit growth as banks become more risk averse and the cost of credit to companies and individuals increases (Figure 5). However, banks do not expect the transition to Basel III to have a significant effect on the availability of credit, as they have a strong domestic funding base.

The banks are also worried about credit risk. With uncertain economic expectations, most expect that managing credit risk will be a key challenge over the coming year. Surprisingly, however, they expect only a moderate increase in loan loss provisions and, unlike in our other established emerging markets, only a minority of interviewees see strengthening credit risk assessment as a crucial activity. This suggests banks think their existing assessment processes are sufficient; however, with increasing pressure on lending margins, they may revisit this issue to ensure the search for yield is not at the expense of robust credit risk management, particularly if banks start targeting higher-risk customer segments.

### Focusing on efficiency to combat margin pressure

Chilean banks have more inflation-linked assets than liabilities. This exposes them to inflation risk. An inflation rate of 1.5% in 2012 (much lower than the central bank’s target of 3%) has led to pressure on margins as interest income has grown more slowly than interest expense. As a result, all banks expect maintaining net interest margins (NIM) to be an increasing challenge over the next year.

Worries about NIM are being exacerbated by political pressure to reduce rates on credit products. Regulators are encouraging banks to reduce the rates on certain loans to boost credit growth in the economy. Furthermore, we expect the recent introduction of banks expecting to expand lending across a range of sectors, interviewees are acutely aware of the challenge of risk management. A financial crisis in the 1980s exposed weaknesses in Chile’s banks, when up to 30% of loans were categorized as non-performing. Subsequent reform of the banking system has improved supervision, boosted capital, reduced concentration risk and improved transparency. Chilean banks now have strong balance sheets, which helped them weather the global financial crisis.

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of consumer protection legislation, which forces banks to give clearer and comparable information to customers, will encourage retail customers to shop around for financial products. We believe that although Chilean banks currently have a good record of cross-selling to customers, the new regulation may change this. Banks looking to maintain the status quo as the default choice for their customers’ other products will need to focus on differentiating themselves through improved service levels.

Faced with potentially declining profitability, banks are focused both on developing lower-cost channels to serve customers, and improving efficiency. We expect banks to develop mobile banking services, which not only reduce branch costs but also can be a source of fee revenue. Most respondents see developing new customer channels and introducing more fee-based products as key activities for them over the next year.

The development of mobile services will also help banks expand their customer base. Despite Chile’s comparatively advanced financial sector, there is still a sizable unbanked population.

Figure 3: Business line outlook
How do you rate the outlook for your bank over the next 12 months on each of the following business lines?

<table>
<thead>
<tr>
<th>Business Line</th>
<th>All RGMs</th>
<th>Established RGMs</th>
<th>Chile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail deposits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate deposits</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Trade finance</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>SME or commercial banking deposits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate lending</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Project finance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail banking lending</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>SME or commercial lending</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private banking/wealth management</td>
<td></td>
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<tr>
<td>Securities trading</td>
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<td>Securities services</td>
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<td></td>
<td></td>
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<tr>
<td>Debt and equity issuance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transaction advisory</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
However, although respondents expect increased demand for savings and deposit products over the next year, (Figure 2) with 45% of the unbanked suggesting that it is too expensive to maintain an account, banks will need these low-cost channels to serve them. The investment needed to acquire these deposits will also reduce their benefit as a source of funding. As a result, large Chilean banks that are able to access comparatively cheap markets funding have been increasing their cross-border issuance of debt to improve their funding mix and reduce pressure on NIM; few respondents foresee any difficulties continuing with this diversification.

Focusing on SMEs as corporations turn to the capital markets

Chile has more developed capital markets than most Latin American peers. We think the launch of the MK Bicentenario reform package presents a key opportunity for banks. This package is a four-year program to further strengthen the capital markets. It contains a range of measures, including some aimed at strengthening corporate governance and improving transparency. Banks already anticipate growing demand for debt issuance over the next year, and we expect that increased issuance will enable large commercial banks to free up their balance sheets and focus lending on higher-margin segments, such as the SME segment (Figure 4).

However, without investing in key individuals to support the expansion of the capital markets divisions, domestic institutions will struggle to meet demand and risk losing business to the subsidiaries of international banks that can call on a global talent pool. Although few foresee problems recruiting or retaining staff in their front office functions, this is likely to become a key battleground for domestic institutions as they strengthen their investment banking divisions to take advantage of the expansion of the capital markets. To mitigate these resourcing challenges, we expect banks to look more closely at options to streamline the business and leverage technology.

Figure 4: Business banking products

To what extent, if at all, do you expect customer demand for the following commercial and corporate products at your bank to change over the next 12 months?

Mean score where significant decrease = -2 and significant increase = 2
Where no respondent answered “decrease slightly” or “decrease significantly,” these options have been removed from the chart.
Domestic opportunities mean few Chilean banks expect cross-border expansion

Only a minority of interviewees anticipate expansion into foreign markets, but those who do see it as a high priority for the next year. Expansion will be targeted at Latin American markets, illustrating the broader trends of banks building their presence across the continent. More broadly, however, expansion through acquisition or entering new markets is not a priority. With a large unbanked population, interviewees think it is more important to exploit the opportunities in their own market. However, we believe that continued margin pressures may lead some Chilean banks to consider expansion into new markets.

In the short term, domestic acquisitions are more likely, with the reshaping of the Chilean landscape driven by larger domestic banks taking over smaller rivals. Although the industry is fairly consolidated, there are a number of smaller banks that are struggling to compete. These institutions have the lowest NIM as they offer time deposits at rates above the banking industry average but offer commercial loans at lower rates due to stiff competition.

In light of this pressure, and without the access to lower-cost foreign funding, we believe they may become acquisition targets. Few interviewees expect new foreign institutions to enter the market. The industry is dominated by a small number of large players – the top five banks account for around 75% of banking assets. As a result, and given the relative maturity of the market, new entrants would find it harder to establish a presence. Brand-new, potentially disruptive players are a possibility but, given current market concentration, they would really need to stand out. Where respondents do anticipate foreign competition – aside from the two Spanish banks already operating in the market – is from banks from neighboring countries, highlighting the development of an increasingly pan-Latin American banking network.

**Figure 5: Basel III**

Thinking about the domestic banking market in this country, to what extent do you think transition toward Basel III will increase or decrease the following?

<table>
<thead>
<tr>
<th>Stability of the financial system</th>
<th>Capital strength of domestic banks</th>
<th>Credit costs for companies</th>
<th>Credit costs for retail customers</th>
<th>Availability of credit for trade finance</th>
<th>Availability of credit for households</th>
<th>Risk appetite of banks</th>
<th>Availability of credit for project finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease significantly</td>
<td>Decrease slightly</td>
<td>Stay about the same</td>
<td>Increase slightly</td>
<td>Increase significantly</td>
<td>Decrease significantly</td>
<td>Decrease significantly</td>
<td>Decrease significantly</td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
Colombian banks expect only a modest improvement in their performance, as industrial protests continue to affect the economic outlook. AflajojojafmhZYZglYadZYfcaf_hjgkhlkYf anticipate continued investment in channels and products to acquire new customers, as well as to strengthen cross-selling to existing customers.

Credit penetration remains low, and respondents see demand for credit cards and personal loans as a key growth opportunity, but we expect banks to institute measures to improve customer loyalty if they are to achieve their share-of-wallet aspirations.

Banks are facing growing regulatory pressures and are increasingly concerned about retaining key staff to support change programs. We believe banks will need to look at options for reducing overall staff costs to enable better incentives for key talent, including the use of technology to improve efficiency.

Colombian respondents are the most downbeat of all study participants about the prospects for corporate lending. Increased default risk for corporate clients, and margins are being squeezed by increased competition. However, demand for corporate lending is still growing, and with deposit funding unlikely to match demand, we believe banks will need to build up their investment banking divisions, and encourage clients to access capital markets financing, to address funding pressure and boost fee income.

Despite current pessimism about the economic outlook, Colombia is a rapidly developing financial market at the heart of an increasingly intertwined Central American banking landscape. The market offers significant scope for growth, and respondents expect increased competition as foreign entrants from neighboring markets acquire Colombian assets. At the same time, Colombian banks are acquiring the Central American assets of retrenching European banks.

Points of note

- Colombian banks expect only a modest improvement in their performance, as industrial protests continue to affect the economic outlook.
- Interviewees remain upbeat about retail banking prospects and anticipate continued investment in channels and products to acquire new customers, as well as to strengthen cross-selling to existing customers.
- Credit penetration remains low, and respondents see demand for credit cards and personal loans as a key growth opportunity, but we expect banks to institute measures to improve customer loyalty if they are to achieve their share-of-wallet aspirations.
- Banks are facing growing regulatory pressures and are increasingly concerned about retaining key staff to support change programs. We believe banks will need to look at options for reducing overall staff costs to enable better incentives for key talent, including the use of technology to improve efficiency.
- Colombian respondents are the most downbeat of all study participants about the prospects for corporate lending. Infrastructure programs have been delayed, labor unrest has increased default risk for corporate clients, and margins are being squeezed by increased competition. However, demand for corporate lending is still growing, and with deposit funding unlikely to match demand, we believe banks will need to build up their investment banking divisions, and encourage clients to access capital markets financing, to address funding pressure and boost fee income.
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Some commentators have dubbed Colombia the “new Brazil”: it’s profitable and well regulated, and it has promising prospects for growth. (The economy grew almost 25% from 2007 to 2012 and is expected to grow a further 27% by 2017.) The rapid growth of the banking sector has been attracting notice for some time, with a number of large foreign banks entering the market.

However, Colombia may be losing some of its gloss. Industrial unrest has disrupted the coal and coffee industries – Colombia’s second- and third-largest exports – resulting in marked pessimism about the growth prospects for the next year. With no one expecting the economy to improve in the next 12 months, Colombian respondents had the most pessimistic outlook in our study. Interviewees see low growth as one of the most serious challenges Colombia faces but remain hopeful that either it will be a temporary blip, or that any economic deterioration will be outweighed by increasing participation in financial services. Consequently, the majority of respondents expect only a modest improvement in their banks’ financial performance over the next year (Figure 1).

Savings culture central to retail profitability
Interviewees were upbeat about the prospects for retail and small and medium-sized enterprise (SME) banking (Figure 3). In the last six years more than 15% of the Colombian population has entered the banking system, and a strong savings culture means around 40% of the population have savings accounts. Low-cost accounts (accounts without management fees or minimum opening balances but restricted to the lowest income segment), combined with the continued expansion of branch and ATM networks and investment in electronic channels, have contributed to the dramatically increased financial inclusion in Colombia. Interviewees clearly expect this investment to continue, with all seeing the development of new channels and the introduction of new products and services as a high priority.

With the sector having expanded so rapidly, there are emerging concerns about whether continued investment in providing additional services to more rural and poorer customers will generate diminishing returns. All respondents see rate competition on customer deposits as a challenge. As a result, banks plan to focus on improving penetration with their existing customers, particularly through the expansion of credit, where interviewees anticipate little competitive pressure.

Interviewees expect the strongest demand to be for credit cards, although a majority also expect increased demand for personal loans (Figure 2). We believe banks will need to focus on loyalty schemes and improved customer service to capture this demand, because even though 70% of customers have their savings account at their main bank, just 49% hold a personal loan and 52% a credit card with the same provider.

Figure 1: Financial performance
How, if at all, do you expect your bank’s overall financial performance to change over the next 12 months?

<table>
<thead>
<tr>
<th></th>
<th>All RGMs</th>
<th>Traditional RGMs</th>
<th>Colombia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stay about the same</td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
</tr>
<tr>
<td>Increase slightly</td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
Where no respondent answered “decrease slightly” or “decrease significantly,” these options have been removed from the chart.

Figure 2: Product demand – retail banking
To what extent, if at all, do you expect customer demand for the following retail products at your bank to change over the next 12 months?

<table>
<thead>
<tr>
<th></th>
<th>All RGMs</th>
<th>Traditional RGMs</th>
<th>Colombia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal savings and deposit products</td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
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<tr>
<td>Personal loans</td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
</tr>
<tr>
<td>Credit cards</td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
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<tr>
<td>Personal real estate loans</td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
</tr>
<tr>
<td>Auto loans</td>
<td><img src="#" alt="Bar Graph" /></td>
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<td><img src="#" alt="Bar Graph" /></td>
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<tr>
<td>Private banking/wealth management</td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
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<tr>
<td>Personal investment products</td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
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<tr>
<td>Payroll loans</td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
<td><img src="#" alt="Bar Graph" /></td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
Where no respondent answered “decrease slightly” or “decrease significantly,” these options have been removed from the chart.
However, domestic banks may struggle to meet the increased demand for retail lending. With banks now working to meet Basel III capital requirements, the supply of credit from retail banks may be constrained. Interviewees expect their banks’ risk appetites to be diminished and the cost of credit to retail customers to increase (Figure 5). Although the Colombian banking sector is fairly consolidated – the five largest banks hold about 60% of banking assets and supply nearly 90% of all micro-credit and mortgages – suppliers of consumer and commercial credit are diverse. If banks are unable to build scale to meet increased demand for consumer lending, we anticipate there will be opportunities for new entrants in a profitable market segment.

A majority of interviewees also expect an increase in the volume of regulation, over and above Basel III. All respondents saw the adoption of international accounting standards as a critical activity for the year ahead but, beyond that, banks are also grappling with extra-territorial regulations emanating from the US and Europe.

With such a large volume of change, all respondents were concerned about their ability to attract and retain staff in core functions. A war for talent is brewing, and banks will need to look at options to reduce overall staff costs if key individuals need to be paid more. Interviewees expect staff numbers to increase only moderately, if at all, and are focused on improving efficiency and streamlining processes to reduce dependence on employees. We believe technology will be at the heart of this efficiency drive. As banks look for a competitive advantage, we are likely to see greater investment in this area, to support change programs and cut staff costs.

Figure 3: Business line outlook
How do you rate the outlook for your bank over the next 12 months on each of the following business lines?

<table>
<thead>
<tr>
<th>Business Line</th>
<th>All RGMs</th>
<th>Traditional RGMs</th>
<th>Colombia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail deposits</td>
<td></td>
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<tr>
<td>Corporate deposits</td>
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<tr>
<td>Trade finance</td>
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<tr>
<td>SME or commercial deposits</td>
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<tr>
<td>Corporate lending</td>
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<td>Project finance</td>
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<tr>
<td>Retail banking lend</td>
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<td>SME or commercial lending</td>
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<tr>
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<tr>
<td>Securities trading</td>
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<tr>
<td>Transaction advisory</td>
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</tr>
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</table>

Mean score where significant decrease = -2 and significant increase = 2. Where no respondent answered “decrease slightly” or “decrease significantly,” these options have been removed from the chart.
Weakest outlook for corporate lending of all RGMs

In contrast to the other RGMs in this study, a majority of Colombian interviewees are less optimistic about the outlook for corporate lending over the next year. Given the recent turmoil that has beset a number of key industries, the majority of interviewees expect to increase their provisions for loan losses. Labor market unrest has hit major export sectors including coal and coffee, in which growth has decelerated to around 6% from over 14% in 2011. The construction industry has also faced problems with delays to a number of government infrastructure projects. Meanwhile, appreciation of the peso has hit all export industries – with manufacturing experiencing a small contraction in 2012. Interviewees expect lending to contract over the next year for construction and manufacturing and to remain flat for energy and mining.

There were some rays of light, however. Lending is expected to increase most significantly in the telecommunications and IT sectors. Colombia has become a hub for IT services in Latin America, with a number of major global companies locating service centers there.

Additionally, while anticipated demand for most corporate banking products is muted, interviewees do expect moderately increased demand for project finance, suggesting issues with national infrastructure projects may be overcome (Figure 4).

Respondents are generally ambivalent about the prospects for their capital markets businesses, forecasting flat demand. The savings culture in Colombia means that banks have a strong deposit base to fund corporate lending. With all interviewees expecting fierce competition on corporate loan pricing, especially given muted demand, a number of banks are just beginning to look at introducing more fee-based services such as hedging and treasury management. If this price competition continues when demand for corporate lending picks up, we believe more banks may try to help more customers raise funding from the capital markets, which would boost fee income and avoid a race to the bottom on loan pricing.

Figure 4: Business banking products

To what extent, if at all, do you expect customer demand for the following commercial and corporate products at your bank to change over the next 12 months?

<table>
<thead>
<tr>
<th>Product</th>
<th>Stay about the same</th>
<th>Increase slightly</th>
<th>Increase significantly</th>
</tr>
</thead>
<tbody>
<tr>
<td>All RGMs</td>
<td>Traditional RGMs</td>
<td>Colombia</td>
<td></td>
</tr>
<tr>
<td>Corporate loans</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade finance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SME loans</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash management or treasury</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hedging products</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Project finance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt issuance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M&amp;A advisory</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity issuance or initial public offerings</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2. Where no respondent answered “decrease slightly” or “decrease significantly,” these options have been removed from the chart.
An emerging pan-Latin American banking network

Colombia has emerged from its financial crisis of the late 1990s. The banking industry has been recapitalized, and the sector is also benefiting from strengthened prudential regulation. The subsequent economic growth and credit boom, combined with improved security, have made it an attractive environment for new entrants.

A restriction on branch-based market entry has acted as a brake on the ability of foreign entrants to expand quickly, but reforms to liberalize the financial sector will permit branch entry, making the market even more attractive to foreign banks. Brazilian and Chilean banks have already expressed their intentions to acquire Colombian assets or bolster existing operations there. Half our interviewees expect the banking landscape to be changed by the acquisition of domestic banks by foreign entrants from neighboring countries.

Prudential regulation of Colombian banks imposed high capital levels, ensuring they were well-insulated from the effects of the global financial crisis. As a result, they are in a strong position to expand overseas and are becoming increasingly acquisitive. Larger Colombian banks already have been buying credit card and full banking operations from global banks exiting the region. We expect this trend to continue, with those banks that have strong balance sheets taking advantage as more European banks retrench.

The majority of the expansion has been in Central America, where low levels of banking penetration offer a wide customer pool and Colombian banks are able to utilize their experience of broadening access to financial services. Moving into these new markets has allowed Colombian banks to diversify their income streams and customer bases in a historically volatile part of the world. A new wave of expansion into South America may well follow, but to be successful we believe these banks must ensure the expansion is underpinned by their existing business models and they do not find themselves overstretched; otherwise they may find themselves vulnerable to foreign competitors at home as well as abroad.

Figure 5: Basel III
Thinking about the domestic banking market in this country, to what extent do you think transition toward Basel III will increase or decrease the following?

<table>
<thead>
<tr>
<th></th>
<th>All RGMs</th>
<th>Traditional RGMs</th>
<th>Colombia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stability of the financial system</td>
<td>Increase significantly</td>
<td>Increase slightly</td>
<td>Stay about the same</td>
</tr>
<tr>
<td>Capital strength of domestic banks</td>
<td>Increase significantly</td>
<td>Increase slightly</td>
<td>Stay about the same</td>
</tr>
<tr>
<td>Credit costs for companies</td>
<td>Increase significantly</td>
<td>Increase slightly</td>
<td>Stay about the same</td>
</tr>
<tr>
<td>Credit costs for retail customers</td>
<td>Increase significantly</td>
<td>Increase slightly</td>
<td>Stay about the same</td>
</tr>
<tr>
<td>Availability of credit for trade finance</td>
<td>Increase significantly</td>
<td>Increase slightly</td>
<td>Stay about the same</td>
</tr>
<tr>
<td>Availability of credit for households</td>
<td>Increase significantly</td>
<td>Increase slightly</td>
<td>Stay about the same</td>
</tr>
<tr>
<td>Risk appetite of banks</td>
<td>Increase significantly</td>
<td>Increase slightly</td>
<td>Stay about the same</td>
</tr>
<tr>
<td>Availability of credit for project finance</td>
<td>Increase significantly</td>
<td>Increase slightly</td>
<td>Stay about the same</td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
Country report

Egypt
Country contacts

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Points of note

• Egypt exemplifies the volatility of emerging markets, with opinions divided on economic prospects as a result of political instability and a lack of security. This has fed uncertainty about the outlook for banks across a range of business lines.

• Expectations of moderate improvement in bank performance are driven by retail deposits and lending, as well as the hope that sovereign yields will sustain net-interest margins. We expect banks to invest in credit risk management amid growing concerns about arrears and tightening spreads.

• Banks are facing their own credit crunch as they struggle to raise new funding, either through the capital markets or by capturing new deposits. While the unbanked population offers an untapped customer pool, investment in channels and offerings (including Sharia-compliant products) will be required to increase deposit funding. As banks face increasing competition, margin pressure on deposits and lending is forcing institutions to focus on finding alternative sources of revenues.

• Prospects for corporate lending are disappointing. Lending is expected to decline to all sectors until stability returns to the economy. The transition to Basel III will restrict the availability of credit to corporate customers even further. Demand for hedging products, however, will increase, as companies face increasing interest rate and foreign exchange risks.

• Beset by domestic problems, Egyptian banks are not looking to expand abroad, but they continue to invest in local banking infrastructure in the expectation of growth once stability returns.

• Despite political and economic uncertainty, Egypt remains a key financial market for the region, and foreign institutions should be wary of missing out on its longer-term potential. Foreign banks considering leaving, or nervous about committing to the market, should consider small, targeted investments, or developing partnerships with Egyptian banks, to ensure they are able to mobilize quickly when growth returns. New entrants from Middle Eastern countries with established Islamic banking offerings are particularly likely to benefit due to the limited range of Sharia products currently available.
Egypt exemplifies the volatility of emerging markets. In the wake of the Arab Spring, interviewees are concerned that political instability and a lack of security present a major threat to the economy. This uncertainty left respondents split on whether the economy would grow or contract. In fact interviewees are split on a whole host of subjects, such as the outlook for their bank across an array of business lines (Figure 3), and demand for retail and commercial banking products. One of the few points on which there is unanimity is that maintaining current levels of return on equity will be a challenge.

Banks are facing a funding crunch. Not only do interviewees expect a weak supply of deposits, but all banks expect it to be hard to raise funds in the markets over the next year. The banking sector’s aggregate holdings of government securities have risen rapidly in the past two years and account for approximately 37% of total assets, compared to only 35% for loans. While high yields on these securities have helped bolster interest margins, they have exposed Egyptian banks to significant sovereign risk, with the government facing a double-digit fiscal deficit and yet to come to an agreement over a loan from the International Monetary Fund.

A number of banks have had their credit ratings downgraded as a result of their exposure to Egyptian government bonds. In light of this pessimism it is perhaps surprising that a majority of interviewees actually expect their banks’ financial performance to improve over the next 12 months, revealing an underlying belief in the untapped potential of the banking sector (Figure 1).

**Hope lies with retail banking**

With a large unbanked population (only around 10% of adults have an account at a formal institution), there should be significant scope for expansion in retail banking products.

**Figure 1: Financial performance**

How, if at all, do you expect your bank’s overall financial performance to change over the next 12 months?

<table>
<thead>
<tr>
<th>All RGMs</th>
<th>Traditional RGMs</th>
<th>Egypt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean score where significant decrease = -2 and significant increase = 2</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Figure 2: Product demand — retail banking**

To what extent, if at all, do you expect customer demand for the following retail products at your bank to change over the next 12 months?

<table>
<thead>
<tr>
<th>Product Category</th>
<th>All RGMs</th>
<th>Traditional RGMs</th>
<th>Egypt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal savings and deposit products</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Personal loans</td>
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<tr>
<td>Credit cards</td>
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<tr>
<td>Personal real estate loans</td>
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<td></td>
<td></td>
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<tr>
<td>Auto loans</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Private banking/wealth management</td>
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<tr>
<td>Personal investment products</td>
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<tr>
<td>Payroll loans</td>
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</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
to grow the retail customer base, yet even here views on customer demand for deposit and credit products diverge (Figure 2). In part this reflects households converting their savings out of Egyptian pounds and into more stable currencies, such as US dollars, to avoid devaluation. Potential customers would rather not keep their money in the bank if it will merely devalue. A recent rise in interest rates may effectively stop the slide of the pound and attract deposits, but greater economic and political stability will probably be required first.

To make matters worse, interviewees are increasingly worried about credit risk, with a majority expecting increased provisions over the next year. As a result, most respondents see strengthening credit risk assessment as a key priority over the next year. It is perhaps surprising that this priority is not acknowledged by all, but we expect the emphasis on credit risk to intensify as retail interest margins come under further pressure and banks look to higher-yielding segments to offset this. Most respondents expect rate competition on customer deposits to increase alongside tighter margins on loans, exacerbating pressures on net income.

Nevertheless, banks are clearly looking at ways to reach new customers in the hope that, when the economy stabilizes, they will have an established customer base. A majority of

Figure 3: Business line outlook
How do you rate the outlook for your bank over the next 12 months on each of the following business lines?

<table>
<thead>
<tr>
<th>All RGMs</th>
<th>Traditional RGMs</th>
<th>Egypt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail deposits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate deposits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade finance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SME or commercial banking deposits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate lending</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Project finance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail banking lending</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SME or commercial lending</td>
<td></td>
<td></td>
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<tr>
<td>Private banking/wealth management</td>
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<td></td>
</tr>
<tr>
<td>Securities trading</td>
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</tr>
<tr>
<td>Securities services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt and equity issuance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transaction advisory</td>
<td></td>
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</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
respondents see developing new channels, products and services as important for the next year. A number of banks are not just expanding their branch networks but upgrading ATMs and internet banking platforms, and investing in mobile banking. Although they are operating in an uncertain environment, this investment clearly demonstrates that banks expect to reap dividends when stability returns to the market.

As it is uncertain when demand from new customers will really take off, banks are also focused on increasing share of wallet and looking at fee-based products to bolster revenues. We believe Egyptian bankers should consider the example of their Vietnamese counterparts in focusing on cards and insurance products to increase non-interest income, as well as examining how increased use of mobile channels can generate additional fee revenue. With few Islamic products on the market, the introduction of Sharia-compliant offerings may also attract new customers.

For foreign banks, the political and economic uncertainty presents a dilemma. Institutions are unlikely to commit significant resources to establish a major presence in the market either through organic expansion or acquisition. In fact, some foreign institutions have started withdrawing from Egypt. However, this risks missing out on the longer-term opportunities in a strategic market for the region, as greater economic stability leads to increased demand for deposit, savings and credit products. Those institutions that do see the long-term potential of the market can ensure they are in a position to mobilize swiftly, when growth returns, by considering targeted strategic investments or building partnerships with local banks.

Corporate and investment banking offers little relief

Given the economic challenges, interviewees expect lending to every sector of the economy to deteriorate, even in the face of increased demand for credit. The current instability has led thousands of factories to close and put the tourism industry under pressure, making banks wary of lending to businesses. As if that were not enough, banks expect the transition to Basel III to increase the cost of credit for companies and to reduce banks’ risk appetites, meaning that even though a few large corporations may still require financing, credit will be increasingly expensive and restricted (Figure 5).

The outlook for investment banking is similarly gloomy. Combined, Egyptian stock market capitalization and the value of debt outstanding are only around half of Egyptian GDP. With worries about the strength of the pound, and increasingly tight exchange controls, foreign investment may be discouraged and companies may struggle to raise funds in domestic capital markets, which remain underdeveloped.

However, there is some good news for banks. Foreign exchange and interest rate risk means companies will increasingly need hedging products to manage that risk. Companies engaged in cross-border trade are likely to need support with trade finance too. Both of these opportunities are recognized by all our interviewees (Figure 4).

Unfortunately, fees from swaps are unlikely to compensate for a collapse in lending levels and compressed margins. The biggest driver of profitability for Egyptian banks is high-yielding sovereign bonds, which come with significant liquidity risk. One interviewee said that yields on government bills was one of the most important issues facing the Egyptian banking sector this year, and indeed sovereign yields have boosted net interest margins over the past two years.

But for stable, long-term growth, banks need to position themselves for the eventual economic recovery and to prepare for more competition from foreign banks when that happens. We

<table>
<thead>
<tr>
<th>Figure 4: Business banking products</th>
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</thead>
<tbody>
<tr>
<td><strong>To what extent, if at all, do you expect customer demand for the following commercial and corporate products at your bank to change over the next 12 months?</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Product</th>
<th>All RGMs</th>
<th>Traditional RGMs</th>
<th>Egypt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate loans</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade finance</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>SME loans</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash management or treasury</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hedging products</td>
<td></td>
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<tr>
<td>Project finance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt issuance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>M&amp;A advisory</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity issuance or initial public offerings</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Stay about the same | Increase slightly | Increase significantly

Mean score where significant decrease = -2 and significant increase = 2
Where no respondent answered “decrease slightly” or “decrease significantly,” these options have been removed from the chart.
therefore expect banks to rebalance their portfolios back toward retail and corporate lending, which will require investment in these businesses to improve their efficiency. And banks seem to be thinking about this already. Although interviewees expect some recruitment in retail and corporate banking, and in head office functions, they are all adamant that they need to improve efficiency and cut costs. Those that take action now will be best placed to capture increased demand when stability returns.

A long-term bet for domestic and foreign banks

Egyptian banks expect any acquisitions to be limited to their own borders. There were muted suggestions from interviewees that larger domestic banks might acquire smaller institutions, but most believe it unlikely the sector would see any consolidation at all. Given the scope of the challenges Egyptian banks face in their home market, no interviewee expects overseas expansion.

While current market conditions might lead some foreign banks to reconsider their positions on the Egyptian market, there are distinct opportunities for new entrants and those that are able to maintain a presence in the market throughout its upheaval. Interviewees expect to see little reshaping of the Egyptian banking landscape across the next year, and where they do, they still expect to see the acquisition of domestic institutions by foreign entrants.

The existing Islamic banks in Egypt have small market shares and therefore provide potential attractive acquisition targets for banks with established Islamic offerings looking for a market entry point. Interviewees expect Middle Eastern banks to be the principal source of foreign competition over the next year. Following recent political change – and the passing of a new law that will legalize Islamic bonds by Egypt’s upper house – we anticipate Egypt eventually becoming a core market for Islamic banking. But there are currently few Sharia-compliant products on the market. Further regulatory clarity will be needed to develop Egypt as a core Islamic banking market, but a number of banks from countries including Bahrain, Qatar and the UAE have already acquired Egyptian assets.

Egypt clearly has significant long-term potential. International banks may be unlikely to make large investments there until greater political and social stability return, but we believe targeted investments or partnerships may position them to take advantage of growth when it does.

**Figure 5: Basel III**
Thinking about the domestic banking market in this country, to what extent do you think transition toward Basel III will increase or decrease the following?

<table>
<thead>
<tr>
<th></th>
<th>All RGMs</th>
<th>Traditional RGMs</th>
<th>Egypt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stability of the financial system</td>
<td>Decrease significantly</td>
<td>Decrease slightly</td>
<td>Stay about the same</td>
</tr>
<tr>
<td>Capital strength of domestic banks</td>
<td>Decrease significantly</td>
<td>Decrease slightly</td>
<td>Stay about the same</td>
</tr>
<tr>
<td>Credit costs for companies</td>
<td>Increase significantly</td>
<td>Increase slightly</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Credit costs for retail customers</td>
<td>Increase significantly</td>
<td>Increase slightly</td>
<td>Increase slightly</td>
</tr>
<tr>
<td>Availability of credit for trade finance</td>
<td>Stay about the same</td>
<td>Decrease slightly</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Availability of credit for households</td>
<td>Stay about the same</td>
<td>Decrease slightly</td>
<td>Increase slightly</td>
</tr>
<tr>
<td>Risk appetite of banks</td>
<td>Stay about the same</td>
<td>Decrease slightly</td>
<td>Increase slightly</td>
</tr>
<tr>
<td>Availability of credit for project finance</td>
<td>Stay about the same</td>
<td>Decrease slightly</td>
<td>Increase slightly</td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
Country contacts

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Points of note

- All interviewees are optimistic about the financial performance of their banks over the next year. The industry has recovered from the Asian crisis of the late 1990s and is now well-capitalized. Indonesia’s investment-grade rating on its sovereign debt will also help by reducing funding costs.

- Respondents anticipate that continued economic growth will drive demand for retail deposits and lending, and we expect banks to invest in lower-cost channels to capture this demand efficiently. However, increasing price competition on retail deposit and lending rates is compressing interest margins and encouraging banks to introduce more fee-based products.

- Banks expect strong growth in corporate lending. This will be most significant in infrastructure, with funding required for a number of government initiatives. Banks are also focused on lending to smaller enterprises. The central bank is phasing in a requirement for institutions to direct at least 20% of lending to small and medium-sized enterprises (SMEs) by 2018, and demand from this sector is expected to be significant. Domestic banks are also looking at expanding lending to the more profitable, albeit higher risk, micro-sector to boost margins. We anticipate that banks targeting this sector will focus on strengthening credit risk capabilities.

- We expect global banks to capitalize on growing demand for debt issuance, as capital adequacy requirements drive up the cost of bank loans and drive corporate customers toward cheaper capital markets funding.

- The Indonesian banking landscape is likely to see further consolidation over the next year through mergers between a long tail of small banks and the acquisition of small banks by both larger domestic and foreign players. We believe that foreign banks may use acquisition of, or partnerships with, smaller banks that are already active in the SME segment, to build their knowledge of the sector as well as help to meet their SME lending obligations.
All Indonesian banks expect their financial performance to improve over the next year (Figure 1). The majority expect significant improvement. Since the Asian crisis of the late 1990s, when Indonesia defaulted on its sovereign debt, there has been major reform of the financial sector, and banks are now well-capitalized, with most already exceeding Basel III requirements. Interviewees believe that Indonesia's return to investment grade status early last year will help banks by reducing funding costs.

These reforms, coupled with strong projections for economic growth (most interviewees expect continued growth over the next year), will help banks by reducing funding costs. These reforms, coupled with strong projections for economic growth (most interviewees expect continued growth over the next year), have made Indonesian bankers optimistic. They rate the outlook for their bank as either good or very good across all business lines (Figure 3) and expect growing demand from retail, corporate and commercial customers.

However, banks do face some challenges, particularly around recruiting and retaining talent. Interviewees expect to grapple with an increased volume of regulation and expect it to become increasingly challenging to attract and retain back office staff. They also expect problems attracting and retaining front office staff as they expand to meet growing demand for financial services. To avoid escalating a war for talent, we believe the sector should consider adopting the example of Malaysia, which has established a staff training fund to encourage banks to develop their own staff rather than poach key talent from competitors.

Demand for retail products, but narrowing margins

Most interviewees expect strong demand for savings and deposit products (Figure 2). To capture this growing demand, banks will invest in developing new customer channels and expanding their branch networks. Given the cost of operating branches, banks are developing mini-ATMs and electronic data capture devices to support mobile payments and mobile banking. We expect the mobile channel to evolve rapidly and become more popular, particularly with younger customers.

Banks are also looking at introducing new products and services. The top three Islamic banks share less than 5% of the market, yet Indonesia is home to the largest Muslim population in the world, and the Islamic banking industry is forecast to grow fivefold to US$83b by 2015. We believe this represents a significant opportunity for Islamic banks and their conventional counterparts.
However, interviewees expect to face increasing rate competition on deposits and price competition on loans to retail customers. To tackle these declining margins, respondents see cross-selling to existing customers as critical to driving profitability. With all interviewees expecting strong demand for payroll loans and mortgages, and a majority also anticipating growth across a range of other retail banking products, including personal loans, deposits and auto loans, there should be scope to do this.

Unfortunately, customer loyalty is a challenge and, with 87% of Indonesians multi-banked and high fees a key driver of attrition, banks will need to reduce the cost of products to customers to cross-sell effectively. Banks are aware of this; improving efficiency and streamlining processes are primary concerns for most interviewees. We believe there is considerable scope for cost savings if the industry can collaborate effectively. For example, there is currently very little sharing of ATM or POS machines, duplicating costs for banks.

Banks also expect to introduce more fee-based products. Although high fees are currently a driver of attrition, we expect there to be considerable opportunity to increase fees for transactions, ATM services and the administration of savings accounts, if these services are seen as delivering added value.

Indonesia also has one of the fastest-growing high-net-worth segments in the region – which we expect to be a key opportunity for international banks with large wealth management arms. With a growing and increasingly affluent middle class, domestic banks are also building their wealth and investment offerings. We believe life insurance will be a key growth area, particularly as pension provision remains relatively low.

Lending growth driven by infrastructure, but more banks looking at micro-lending

Within corporate and commercial banking, interviewees expect lending to grow across all sectors except mining over the next year, as the country’s economy continues to grow. Lending to infrastructure is expected to see the strongest growth, reflecting the government’s investment in infrastructure programs as outlined in its 2011-2015 Masterplan. As a result, all interviewees expect strong demand for project finance over the next year (Figure 4).

SME lending will be another strong growth area. The central bank recently required banks operating in Indonesia to direct at least 20% of their credit portfolios to the SME sector by 2018. But
banks have their sights set on even smaller businesses, and highly profitable micro-lending is emerging as an area of expansion for banks. Serving this segment requires up-front investment and a local network of agents embedded in local communities for regular collections. It is also higher risk than traditional SME lending. Still, some domestic banks may prefer to continue expanding in this area due to its many benefits. Interest margins are higher than for other business lending. It is less competitive than other segments and has significant potential as a source of credit growth, funds and fees. However, we believe banks targeting this segment will need to invest in strengthening credit risk capabilities. Although domestic banks rely principally on deposit funding to finance lending, Indonesia’s recently acquired investment grade rating should lower the cost of wholesale funding for banks, and enable them to improve their margins and more easily meet the anticipated demand for loans. The new rating may also encourage the largest corporations to raise funding through debt issuance, which may prove cheaper than bank debt if, as some interviewees expect, the transition to Basel III will drive up the cost of credit for companies (Figure 5). We expect international banks to play a leading role in debt finance due to their global reach and expertise. Domestic banks should look for opportunities to partner with international institutions or recruit key talent if they want to capture any of this potential demand.

Indonesian equity markets have attracted significant foreign investment in the past two years as investors have looked to generate returns in high-growth emerging markets. The market capitalization of the Indonesian Stock Exchange doubled between 2009 and 2012. Nevertheless, the markets are still relatively underdeveloped (with a market capitalization to GDP ratio of around 40% compared to over 100% in mature markets). With large corporations increasingly able to access the bond markets, and credit not yet significantly restricted for smaller firms, equity issuance is likely to be an expensive financing option, and demand for equity underwriting is likely to remain weak. Banks do expect increased demand for hedging products, however. Products are still relatively vanilla, but we expect this to evolve as more customers become more financially literate and some look to expand abroad. Ongoing concerns about inflation and currency stability will also drive demand in this area.

The banking landscape will be reshaped by domestic consolidation

Few interviewees expect to expand overseas, with the majority believing there is ample opportunity for growth in the domestic market. The market is already fairly consolidated – the largest 10 banks own around 70% of the industry’s assets – but with around 120 domestic banks in total, there is a long tail of small banks, which are difficult to regulate. As a result the central bank has encouraged smaller banks with weaker capital positions to consider mergers. Interviewees anticipate both mergers between smaller local banks and acquisition of small banks by larger, mainly domestic, banks.

As one of Asia’s fastest-growing economies, there are significant opportunities for foreign banks in the Indonesian market, but they will need to weigh the cost and benefits of operating there. The introduction of a series of restrictions on foreign banks, including

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**Figure 4: Business banking products**

To what extent, if at all, do you expect customer demand for the following commercial and corporate products at your bank to change over the next 12 months?

<table>
<thead>
<tr>
<th>Product Type</th>
<th>Total RGMs</th>
<th>Traditional RGMs</th>
<th>Indonesia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate loans</td>
<td>Stay about the same</td>
<td>Increase slightly</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Trade finance</td>
<td>Stay about the same</td>
<td>Increase slightly</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>SME loans</td>
<td>Stay about the same</td>
<td>Increase slightly</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Cash management or treasury</td>
<td>Stay about the same</td>
<td>Increase slightly</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Hedging products</td>
<td>Stay about the same</td>
<td>Increase slightly</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Project finance</td>
<td>Stay about the same</td>
<td>Increase slightly</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Debt issuance</td>
<td>Stay about the same</td>
<td>Increase slightly</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>M&amp;A advisory</td>
<td>Stay about the same</td>
<td>Increase slightly</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Equity issuance or initial public offerings</td>
<td>Stay about the same</td>
<td>Increase slightly</td>
<td>Increase significantly</td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2. Where no respondent answered “decrease slightly” or “increase significantly,” these options have been removed from the chart.

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Country report

Indonesia
a ruling that institutions currently operating as branches must convert into local subsidiaries, may make it harder for banks to profit from these opportunities. This conversion may lead to the Indonesian entities of foreign banks losing funding efficiency, as the international group will charge its Indonesian counterpart a risk premium for funding.

Furthermore, a new bill will prevent any investor taking a controlling share in more than one bank, even though the “single presence” policy unveiled by the central bank in November allowed investors to hold 25% of two or more banks as long as they form a holding company to oversee the operations. These changes will require a number of foreign banks already present in Indonesia to restructure.

Despite these restrictions, interviewees still believe that the opportunities in the market will continue to attract new entrants, particularly those from neighboring countries. Furthermore, the core business of foreign banks in Indonesia tends to be corporate and consumer banking. It will be a challenge for these institutions to meet their SME lending obligations by 2018, and we expect both new entrants and foreign banks already in the market to look at opportunities for acquiring or partnering with local banks to help them do so.

### Figure 5: Basel III

Thinking about the domestic banking market in this country, to what extent do you think transition toward Basel III will increase or decrease the following?

<table>
<thead>
<tr>
<th>Dimension</th>
<th>All RGMs</th>
<th>Traditional RGMs</th>
<th>Indonesia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stability of the financial system</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital strength of domestic banks</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Credit costs for companies</td>
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<tr>
<td>Credit costs for retail customers</td>
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<td></td>
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<tr>
<td>Availability of credit for trade finance</td>
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<tr>
<td>Availability of credit for households</td>
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<td></td>
<td></td>
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<tr>
<td>Risk appetite of banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Availability of credit for project finance</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
Country contacts

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Points of note

• Interviewees expect the financial performance of their banks to improve over the next year, despite only moderate expectations for economic growth due to concerns about political stability before and after the May 2013 general election.

• The ever-expanding regulatory burden is creating a shortage of skilled staff, but we believe developing new training programs or using contractors may help plug skill gaps.

• Margin compression is a key concern as retail deposit and lending rates are both under pressure. With banks nervous about repricing, they are increasingly looking to introduce fee-based products to preserve profitability. We believe banks should investigate introducing new fee structures to discourage the use of high-cost channels and payment methods and to drive the uptake of mobile and online solutions.

• Banks are focused on improving penetration rates with existing customers. With 91% of Malaysians multi-banked, we expect investment in customer loyalty schemes to improve profitability through cross-selling.

• Corporate lending is driven by demand to fund infrastructure projects. With fierce competition for deposits and keenly priced loans, tight margins mean we expect banks to increasingly look to capital markets to fund large projects, reduce maturity transformation risk and boost fee revenues.

• We believe consolidation of the small Islamic banks operating in Malaysia will help improve efficiency and build capacity within that customer segment.

• Although restrictions on ownership of domestic banks may discourage new foreign entrants, we believe the ongoing liberalization of the financial sector will create opportunities for partnerships between global and local institutions to deliver long-term project financing and grow the onshore wealth management industry.
Malaysian banks are slightly less optimistic than their established peers (Figure 1), with most respondents expecting only a modest improvement in performance across all business lines. Expectations of bank performance are closely linked to views on the economy, with a number of interviewees worrying about the impact of the May 2013 elections on the existing economic program. Beyond their macroeconomic concerns, respondents are worried about the potential effect that increased capital requirements and other regulatory demands, along with falling margins, might have on the industry (Figure 5). All interviewees expect an increase in the level of regulation affecting the banking sector across the next year, following the introduction of the Financial Services Act and the Islamic Financial Services Act. These acts are intended to increase transparency and accountability, as well as improve the operations of Malaysian banks.

In the face of such considerable change, and demands by regulators for enhanced credit and operational risk functions, banks are facing major talent shortages in risk and compliance. A majority of interviewees are concerned that they will struggle to attract and retain the right staff to support the likely array of changes. The Malaysian Staff Training Fund, established to encourage banking institutions to train their own personnel in areas where there are skill shortages, rather than poach staff from competitors, may help to avoid a war for talent, but it also makes it difficult to recruit skilled individuals quickly and cheaply. Under the terms of the fund, if a bank poaches restricted staff the acquiring bank must contribute a sum equivalent to six months’ salary to the Staff Training Fund. We believe banks will need to investigate ways to train staff quickly or look for ways to use contractors to plug temporary skill gaps.

Finding new sources of revenue to combat margin compression

Interviewees are particularly optimistic about the outlook for retail deposits (Figure 3), expecting strong customer demand for deposit and savings products (Figure 2). The consumer segment is still under-penetrated, and the majority of banks expect to expand their branch networks over the coming year to reach this new customer base. They also see investing in ATM, online and mobile solutions as critical to improving the efficiency of serving new and existing customers, allowing branch staff to focus on more profitable activities.

Across all retail lending products, banks anticipate the strongest demand to be for mortgages. However, there is fierce competition.
in this market, and low prices are damaging profitability. Unfortunately, individual banks are reluctant to make the first move to price more sensibly, and there may also be concerns about collusion if they do so collectively. The lifetime rates that are a feature of some mortgage products are also being extended to other types of loans, squeezing retail margins even further.

With banks unwilling to reprice loans, profitability is a serious issue for all our respondents. Everyone is concerned about price competition on retail lending and, notwithstanding rising demand, rate competition on customer deposits. Consequently, all respondents are looking for new sources of revenue and expect to introduce more fee-based products. As mobile payments are starting to increase and smartphones are becoming much more prevalent – helped by the autumn 2012 budget which offered rebates to low-income youngsters to encourage adoption – banks should look to exploit this channel as a source of fee revenue. We believe tiered fee systems could be used to encourage customers to abandon high-cost channels and payment methods, migrating to mobile and online solutions.

All respondents said they were looking to improve penetration rates with existing customers, but with 91% of Malaysian customers multi-banked, we expect banks will need to review their existing offerings and invest in improving customer service to achieve success. All interviewees suggested they are focused on developing new products and services, and Malaysian banks are beginning to look at ways to use social media platforms to engage more effectively with current and potential customers.

Additionally, with high fees a key driver of customer attrition, banks need to focus on efficiency to help them reduce costs. Reflecting this, respondents also suggested that developing new technology to run the bank will be a key challenge over the next year. As well as driving efficiency, this also should help banks focus their resources, and it also may alleviate talent shortages.

**Increased infrastructure funding through the capital markets**

Interviewees expect growth in lending across all sectors except transport and shipping. Malaysia’s Economic Transformation Program is driving a number of infrastructure projects, including the Kuala Lumpur mass rapid transit (MRT) project. Costing an estimated MYR37b, the MRT is one of the country’s largest infrastructure projects to date. As a result
of these initiatives, lending is forecast to increase most in construction and infrastructure, and interviewees expect a significant increase in demand for project finance (Figure 4).

Our survey revealed little concern that diverting funding to large infrastructure projects would squeeze the supply of credit to other sectors. However, with margins being squeezed through price competition on corporate lending, we believe some banks may encourage clients to secure capital markets funding for large projects. This would enable banks to direct lending to the more profitable SME sector, where they also expect significantly increased demand for credit. Financing infrastructure projects through the capital markets would reduce banks’ exposure to long-term credit risk and would be a useful source of fee revenue. Some banks are already taking some steps to do this, as well as rebalancing their own investment portfolios toward bonds issued by corporate and project-based

special purpose vehicles – these pay over 4.5% while the central bank’s short-term instruments yield only about 3.0%-3.3%.

Malaysia has more developed capital markets than most of our other RGMs – market capitalization to GDP is around 140%, in line with developed markets. Yet, surprisingly, banks expect little demand for raising equity over the coming year. Domestic banks face a skill and experience gap within their capital markets divisions and, as a result, global banks dominate equity underwriting in the Malaysian market. We believe domestic banks should take measures to address this skill gap – including developing partnerships with global institutions – so that the banks can take advantage of their strong existing relationships with smaller corporate customers and grow with them as they expand.

Many wealthy Malaysians still choose to have their wealth managed offshore, in regional wealth management centers, as a result of a limited range of products and lack of in-depth local research. Building investment banking skills might also enable domestic banks to develop more investment products that will encourage investors to keep their money onshore.

Sharia banking and global alliances – reshaping the Malaysian banking industry

Interviewees anticipate consolidation in the domestic banking industry, and we believe there is an opportunity for mergers between some of the small Islamic banks in the market. Although some of these are already owned by larger conventional banks, consolidation of Islamic banks might also enable them to improve their efficiency and to build their capacity for Sharia lending locally. Alongside this, a few interviewees anticipate their institutions expanding across Thailand, Indonesia and the Middle East. These banks are looking to countries with higher margins and – with the Malaysian Islamic banking model one of the most advanced in the world – for opportunities to roll out their Sharia offerings.

Interviewees believe that foreign institutions will continue to be attracted to the growing Malaysian market, with the liberalization of the Malaysian financial sector expected to continue under the Financial Sector Blueprint, 2011 to 2020. However, with restrictions on foreign stakes capped at 30% in domestic banks (or 70% in Islamic and investment banks), we expect market entry will be primarily through partnerships, or establishing their own operations in the country.
The government has indicated it may be more flexible with the foreign ownership cap, on a case-by-case basis, but we expect foreign banks will be more likely to operate in the corporate and investment banking space, as it would be very expensive to build out a branch network, and profits would be limited with new entrants struggling to differentiate themselves in an already highly competitive marketplace.

The government’s Blueprint sets out to promote alliances in corporate and investment banking, for example encouraging strategic partnerships between domestic and foreign financial institutions specializing in long-term project financing. A majority of respondents expect an increase in partnerships between domestic and foreign banks, and we believe domestic banks should seize the opportunity that these alliances present to develop the expertise of their staff. These partnerships will also give foreign banks better insight into the local market, as well as additional on-the-ground infrastructure. We also believe that such partnerships would help grow the onshore wealth management industry, as foreign banks with large wealth management divisions can combine their product, research and relationship management expertise with the local knowledge of domestic banks.

**Figure 5: Basel III**

Thinking about the domestic banking market in this country, to what extent do you think transition toward Basel III will increase or decrease the following?

<table>
<thead>
<tr>
<th>Aspect</th>
<th>All RGMs</th>
<th>Established RGMs</th>
<th>Malaysia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stability of the financial system</td>
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<tr>
<td>Capital strength of domestic banks</td>
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<tr>
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<tr>
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<td></td>
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<tr>
<td>Availability of credit for trade finance</td>
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<tr>
<td>Availability of credit for households</td>
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<tr>
<td>Risk appetite of banks</td>
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<tr>
<td>Availability of credit for project finance</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
Country report

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Points of note
- Interviewees anticipate only a moderate improvement in the performance of their banks. Despite a well-capitalized banking sector and an expanding economy, stringent lending standards are slowing lending growth.
- Lending growth to the small and medium-sized enterprises (SME) sector is also being held back by the opacity of SME financial accounts. Banks should consider collaborating with providers of supplier credit to build a more detailed picture of credit risk in the SME sector.
- While the unbanked population offers a sizable and profitable untapped customer pool, demand for simple savings and deposit products remains weak due to an inadequate network and stringent account opening procedures. Although agency banking can help improve financial access, we expect banks may also explore alliances with telecommunications providers to increase mobile banking.
- Broadening coverage of both the SME and unbanked retail sectors provides banks with clear potential for growth, but will require banks to invest in operational risk management to manage both partner relationships and the client base.
- Interviewees are also focused on increasing the share of wallet with existing customers. However, we believe banks will need to improve service and build customer loyalty, as individuals are typically reluctant to turn to their main bank for lending products.
- Although corporate lending dominates company financing, Mexican banks have taken significant steps to expand their capital markets businesses. Recent innovations have led to more direct investment in infrastructure through structured securities.
- Price competition in corporate lending is leading to margin pressure. We expect banks to invest in a series of efficiency programs over the next year to improve technology infrastructure and deliver operational efficiency. Finding the staff to support these programs may prove challenging, however, and a majority of interviewees expressed concerns about recruiting and retaining talent in core functions.
- We believe foreign banks will be able to use their capital markets expertise to capture investment banking market share, while international institutions with asset management divisions can create opportunities to invest directly in national infrastructure programs.
With banks anticipating that an improving economy will drive demand for lending across all sectors, most interviewees are modestly optimistic about the outlook for their banks (Figure 1). With its economic prospects closely tied to those of the United States, Mexico suffered the sharpest economic contraction of all our RGMs during the global financial crisis. However, banks were able to weather the storm, having learned from their own banking crisis in the mid-1990s, when irresponsible lending was exposed across the sector. As a result of that experience, banks have conservative lending standards and are so well capitalized that interviewees expected that Basel III capital requirements would have only a slight effect on the cost and availability of credit to customers (Figure 5).

Banks expect their own performance to improve as consumers and businesses return to spending and investing and demand for financial services picks up. Although the level of private debt to GDP is among the lowest in Latin America, offering significant scope to expand lending, banks continue to emphasize the importance of credit risk assessment, with a majority of interviewees anticipating further work in this area over the next year.

Given these positive fundamentals, it is perhaps surprising that respondents are not more bullish. However, price competition on lending means maintaining interest margins is becoming a major concern. This was identified as a problem by all our interviewees, and most expect this to make it challenging to maintain return on equity levels – which are currently over 15% for some banks.

Banks are also concerned about the impact of an array of new foreign regulations with which they have to comply, and most expect the level of regulation to increase over the year. This could lead to a shortage of staff in the back office. The growth of the IT sector may also exacerbate this problem for banks’ IT functions, and the expectation is that recruiting and retaining talent in core functions will be a challenge.

Investment needed to capture retail growth opportunities

Despite low levels of banking penetration for both deposits and loans, expectations of customer demand for deposit, savings and lending products are lower than in other established RGMs (Figure 2). This low demand stems not only from banks’ conservative lending standards, but also the difficulty financial institutions face in serving the unbanked customer base. Around 20% of the unbanked lack the necessary documentation to open an account, with a similar number complaining they are too far away from a branch.
While regulatory change may be required to ease account opening requirements, banks are beginning to look for ways to address the problem of distance. Few interviewees expect to expand their branch networks, but the comparatively recent adoption of an agency banking model is a more cost-effective method of addressing this problem. However, agency banking requires banks to focus on operational risk, as agent fraud, loss of customer records and data entry errors challenge banks’ existing procedures. As a result, interviewees expect improving risk management to be a key focus for the next year.

Alongside the agency model, a majority of banks are also focused on developing new customer channels such as mobile, to expand their reach and lower the cost of serving these new account holders. There is an opportunity for Mexican banks to leverage the lessons and experiences of banks in other emerging markets, and explore the possibility of traveling banking units and partnerships with telecommunication providers.

Banks that are able to overcome the challenges of distance and documentation should be able to tap into a highly profitable market segment; with few accounts offering above inflation interest rates, Mexico was the only RGM in this study where no respondent saw rate competition on deposits as a challenge.

With such difficulty reaching new customers, banks are keen to improve penetration rates with existing customers. However, we believe that expanding their consumer lending portfolios may prove challenging unless banks address product design and customer service issues.

Ernst & Young’s 2012 Global Consumer Banking Survey revealed that only 40% of customers would turn to their main bank for a personal loan, and just 21% would use it for a mortgage. Strict lending criteria make it is difficult for retail customers to secure loans and, even when they do, interest rates are steep. For products such as auto loans and mortgages many individuals have historically turned to non-banks such as Sofoles and Sofomes (limited and multipurpose financial companies focusing on specific lending segments) that rely on wholesale funding and government funds.

With these institutions having suffered as a result of the global financial crisis, banks can fill the gap, but they may struggle to capitalize on that opportunity and increase share of wallet unless they can address consumer complaints about poor service. Fortunately, banks are starting to respond to these criticisms. A majority anticipate that investing in new products and services, and in technology to serve customers, will be critical activities for the coming year.
Efficiency programs and investment banking may relieve margin pressure

As in most RGMs, infrastructure projects dominate corporate lending. Mexico’s National Infrastructure Program for 2013-18 will see the government spend US$400b on projects across a range of sectors. IT is expected to be another high-growth sector. Mexico is becoming popular as an alternative outsourcing hub for American companies, as they look for lower-cost locations closer to home than Asia. We expect the IT sector will continue to grow as salary inflation in Asian outsourcing hubs erodes the cost benefits of locating services there.

However, while respondents are broadly positive about the outlook for corporate lending, price competition on loans is becoming a major contributor to margin pressure. To maintain returns on equity banks are increasingly looking to institute efficiency programs and cut costs. All interviewees see these as key activities for the next years. Some banks have already invested significantly in their technology infrastructure – through partnerships and organic investments – to improve efficiency. Other banks will need to consider investments of a similar scale if they are to remain competitive.

With corporate lending margins coming under pressure, banks are also looking to help clients raise money from the capital markets. Mexico was notable among our RGMs for the optimism of interviewees about the capital markets business (Figure 3). It offers an instructive example of how investment in infrastructure can be coupled with demand for investment products to grow the capital markets. Mexican pension funds have grown from just 1.4% of GDP 15 years ago to over 10% of GDP today. Local asset managers have a track record of investing indirectly in infrastructure – through equity and bonds of companies associated with infrastructure – but recent innovations are leading to more direct investment through structured securities.

With banks expecting increased demand for wealth management and personal investment products, we believe these initiatives present banks with investment opportunities for their clients. The first peso-denominated fund focused solely on investment opportunities in Mexican infrastructure projects was launched by an Australian bank. We expect that international banks with wealth management operations and greater capital markets expertise may have the edge over some domestic competitors in this area.

Respondents are less optimistic about the outlook for SME financing, even though they expect significantly increased demand for credit from that sector (Figure 4). A large number of small Mexican businesses finance themselves through supplier credit; while this is an expensive form of finance it is often easier to access because of banks’ stringent lending criteria. Many SMEs have grown out of the unofficial (shadow) economy and, as a result, their financial accounts are often not robust enough for the banks. The government’s recently announced banking reform bill may lead to financial institutions loosening their lending criteria, as it makes it easier for banks to claim the assets of companies that default on loan repayments. We believe there is an opportunity for banks to route cheaper lending through larger, more established firms that offer supplier credit and, at the same time, build up better credit data on SMEs.

Figure 4: Business banking products
To what extent, if at all, do you expect customer demand for the following commercial and corporate products at your bank to change over the next 12 months?

<table>
<thead>
<tr>
<th>Product</th>
<th>All RGMs</th>
<th>Established RGMs</th>
<th>Mexico</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate loans</td>
<td></td>
<td></td>
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<tr>
<td>Trade finance</td>
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</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
Where no respondent answered “decrease slightly” or “decrease significantly,” these options have been removed from the chart.
Mexico – still a strategic priority for a number of foreign banks

With huge scope to expand lending in the domestic market, few interviewees expect their banks to expand internationally in the short term. With five banks controlling around three-quarters of the market, consolidation is most likely to be driven by mergers between smaller banks.

Prospects in the Mexican market will continue to attract foreign banks too. The global financial crisis led a number of global banks to close or shrink their operations in some emerging markets. Mexico, however, with significant growth potential, remains a strategic priority for many institutions with historical and cultural links to the market.

The pressure on European and US banks to raise capital has led a number of developed market banks to consider listing their Mexican operations. One Spanish bank has already done so, and with the Mexican subsidiaries of a number of US and Spanish banks having better credit ratings than their parents, more may follow. It is therefore unsurprising that interviewees see European and US banks continuing to be the principal sources of foreign competition. We expect these banks to use their experience of channel innovation, and their experience of allying with telecommunications providers, to gain market share in retail banking in Mexico, and to draw on their expertise in structured securities to grow their capital markets businesses.

Figure 5: Basel III
Thinking about the domestic banking market in this country, to what extent do you think transition toward Basel III will increase or decrease the following?

<table>
<thead>
<tr>
<th>Stability of the financial system</th>
<th>Capital strength of domestic banks</th>
<th>Credit costs for companies</th>
<th>Credit costs for retail customers</th>
<th>Availability of credit for trade finance</th>
<th>Availability of credit for households</th>
<th>Risk appetite of banks</th>
<th>Availability of credit for project finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decrease significantly</td>
<td>Decrease slightly</td>
<td>Stay about the same</td>
<td>Increase slightly</td>
<td>Increase significantly</td>
<td>Decrease slightly</td>
<td>Decrease slightly</td>
<td>Decrease significantly</td>
</tr>
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Points of note

• All interviewees in Nigeria expect their banks’ financial performance to improve over the next year, with the majority expecting significant improvement. It is a tale of remarkable recovery since the global financial crisis, which led to a series of bailouts, mergers and the creation of a “bad bank.” With more solid foundations, banks have been able to take advantage of rapidly increasing demand for credit, leading to double-digit revenue growth. However, with this credit provision expanding rapidly, strengthening credit risk will be critical for banks to guard against weakening asset quality.

• The financial sector is being strengthened. Improved corporate governance and regulatory oversight, as well as adoption of IFRS, are among measures designed to create greater transparency, attract investors and re-establish confidence in the financial sector.

• Low account penetration is driven largely by low incomes, but sustained economic growth will open up a sizable untapped customer pool. Nigeria is expected to cross the US$2,000 per capita GDP threshold, the point at which bank accounts become more frequent, by 2017. Banks are expanding branch networks as well as investing in lower-cost channels to reach a large number of unbanked.

• Banks are bullish about lending to all sectors, but with the economy so dependent on oil, and with banks acutely aware of failures during the financial crisis, interviewees are very concerned about credit risk management.

• From a corporate banking perspective, bankers are most bullish about project finance, which will play a key role in financing a number of joint public-private infrastructure programs. The government is also looking for ways to increase the financing of these projects using local capital markets. We believe this will lead to opportunities for international banks that are able to raise market funding from a broader investor base.

• Interviewees expect competition to come primarily from other African banks that are looking to build a pan-African banking network. Nigerian banks remain more focused on domestic opportunities than on cross-border expansion.
A banking crisis, bailouts and the creation of a “bad bank” – things were looking grim for the Nigerian banking sector in 2009. Since then, there has been a remarkable recovery. Central Bank intervention, including a recapitalization program, has improved corporate governance and regulatory oversight. The adoption of international accounting standards (which a majority of interviewees see as a key activity for the next year) has also left Nigeria’s banks significantly stronger.

All our interviewees expect their banks’ performance to improve over the next year (Figure 1). Respondents are positive about the outlook for almost all business lines – the exception being investment banking advisory and issuance, which is not unexpected given Nigeria’s emergent capital markets. Optimism about bank performance stems from positive expectations for the economy. The majority of respondents expect the economy to continue improving, which in turn has fed expectations of increased demand across a range of retail and corporate banking products.

However, it is not all good news. Having witnessed a recent resurgence in kidnappings and pipeline vandalism by extremists, interviewees are worried about threats to the economy from a lack of security, as well as a lack of adequate infrastructure. More immediate threats to banks’ performance from nonperforming loans are emerging too, and banks will be increasingly focused on credit risk over the next year, despite expectations of continued lending growth. At the height of Nigeria’s financial crisis, bad loans were estimated at 33% of total loans in some banks. This taught the whole sector a beneficial lesson. While the majority of interviewees expect provisions for loan losses to fall next year, they do not want to be caught out by rapid credit growth and declining asset quality.

Banks will also need to focus on improving efficiency. The financial crisis led to consolidation in the banking sector, as recapitalization of the industry led to four mergers (and further consolidation is anticipated), yet efficiency gains from these mergers have yet to be realized. All interviewees thought improving efficiency, cutting costs and streamlining processes would be very important over the next year.

Deposit growth key to retail banking

Nigerian per capita GDP was estimated at US$1,653 in 2012. By 2016-17, per capita GDP will have reached about US$2,000, the point at which transactional accounts typically become common. It is therefore unsurprising that interviewees were optimistic about the prospects for retail banking.

All expect the outlook for retail deposits to be good, and most feel similarly about lending as Nigeria continues on its growth trajectory (Figure 3). To meet this retail demand, all banks are planning to expand their distribution channels and services across the country (Figure 2). A number of banks are also planning to expand their branch networks and recruit additional staff as well. The majority of respondents were acutely aware of the risks of an emerging war for talent, highlighting how challenging it can
be to recruit high-quality staff in rapidly expanding markets and the importance of retaining the staff they already have. All banks are focused on streamlining processes to reduce this reliance on staff, yet few are considering investing in technology. We believe banks should also review their operating models and consider how investing in technology will help them to redeploy key personnel and improve overall efficiency.

As banks become increasingly concerned about maintaining returns on equity, they are starting to seek new revenue streams. While expanding the customer base may help, banks increasingly are looking to improve penetration rates with existing customers. This is a priority for all the banks. No banks see price competition on retail loans as a particular challenge. We believe expanding credit to these customers has the potential to be very lucrative, although banks must remain aware of the associated credit risk.

Nigeria has a relatively low level of domestic credit to GDP, which suggests there is considerable scope for lending growth, and consumer lending to the expanding middle class should be a major opportunity for retail banks in the market. The introduction of Basel III may help moderate the growth of consumer credit, however.

**Figure 3: Business line outlook**
How do you rate the outlook for your bank over the next 12 months on each of the following business lines?

<table>
<thead>
<tr>
<th>All RGMs</th>
<th>Frontier RGMs</th>
<th>Nigeria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail deposits</td>
<td></td>
<td></td>
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<tr>
<td>Corporate deposits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade finance</td>
<td></td>
<td></td>
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<tr>
<td>SME or commercial banking deposits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate lending</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Project finance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail banking lending</td>
<td></td>
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<tr>
<td>SME or commercial lending</td>
<td></td>
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<tr>
<td>Private banking/wealth management</td>
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<tr>
<td>Securities trading</td>
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<tr>
<td>Securities services</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt and equity issuance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transaction advisory</td>
<td></td>
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</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
A majority of respondents expect additional capital requirements to raise the cost of credit to customers and reduce its availability (Figure 5). As a result, most banks are looking to introduce more fee-based products. We believe banks should consider expanding their card and insurance offerings to grow fee revenue; these are avenues pursued by a number of Vietnamese banks that operate in a market at a stage of evolution similar to Nigeria’s.

Corporate funding still dominated by lending

Banks are bullish about lending to almost all sectors except commercial real estate. With the Nigerian economy heavily dependent on oil, it is unsurprising that banks are particularly optimistic about lending to the energy sector. However, banks are increasingly wary of credit risks. During the financial crisis, banks found that the quality of unsecured credit to the downstream oil sector was much lower than expected. Banks are proceeding with more caution this time around, and managing credit risk is a top challenge banks will be addressing over the next year.

All banks expect to see further demand for trade finance, as Nigerian firms look for opportunities to expand into new markets (Figure 4). As lending is principally to the oil sector, domestic banks are looking at mitigating the risk of vanilla lending through the use of structured commodity finance, import financing collateralized by warehouse receipts and export receivables-backed financing. We believe structured financing can reduce the overall cost of funding for businesses, but as this segment of the market grows, banks will need to invest in developing hedging products to enable companies to offset the risk of using volatile commodities as collateral. Banks will also need to invest in their own risk assessment capabilities to manage their exposure to the oil sector.

A majority of interviewees also expect to see growth in lending to infrastructure projects over the next year. All respondents thought the outlook for project finance was good, with public-private partnerships (PPP) becoming an increasingly popular way to finance infrastructure programs, including hydropower projects and the construction of a number of bridges.

With such an increase in demand anticipated for corporate lending and project finance, domestic banks, especially those outside the top tier, may struggle to raise sufficient deposits to fund this growth. Although banks plan to expand their networks, this is difficult to do quickly, and as most deposits would be small, that approach is unlikely to plug the funding gap. As a result, interviewees see raising funds in domestic and foreign capital markets as a critical activity. However, they also expect securing capital market funding to prove challenging. We believe that, in the near term, international banks with stronger balance sheets and better access to capital market financing may be better placed to exploit the demand for credit and expand their corporate operations in Nigeria. We also anticipate that global institutions may look to partner with their domestic counterparts, to exploit their local knowledge of businesses.

The Nigerian government is also looking at options to fund PPP through the capital markets. This may act as a catalyst for domestic banks to build up their investment banking operations, but there has been little impact to date. Interviewees expect the outlook for issuance to stay flat or deteriorate and as yet they show no signs of recruiting to their investment divisions. The Debt Management Office (DMO) is looking to launch a US$1b Eurobond to help Nigerian private sector companies access foreign funds at a low-
cost. The DMO is also considering a US$100m diaspora bond to enable Nigerians living abroad to invest in their nation’s development. We believe that international banks, given their global reach, are likely to play a key role in raising funds through the international capital markets, but domestic banks with local knowledge of companies will be critical to the distribution of those funds.

A hub for pan-African banking?

Only a minority of interviewees are focused on expansion into new countries over the next year. But we believe domestic uncertainty may push banks to start looking at opportunities to diversify their revenue streams through regional expansion. A fall in oil prices – similar to the collapse in prices seen during the global financial crisis – would put significant strain on an economy that has seen rapid expansion of credit but has yet to diversify into other sectors. International expansion may help reduce this concentration risk. We believe that Nigerian banks may follow their South African counterparts in branching out across the continent and that Nigeria may, in the medium term, become another hub for pan-African banking.

We also expect new entrants from other African countries to play a greater role in the Nigerian banking sector. While the Nigerian Central Bank was very open to foreign offers for distressed banks in the wake of the 2009 financial crisis, expressions of interest were limited. Concerns over governance and transparency, as well as asset prices, kept foreign institutions at bay.

Nevertheless, improvements in governance and regulatory oversight, as well as a move to IFRS, are beginning to attract international banks. The Central Bank has also suggested it is keen to benefit from foreign banks bringing their expertise to Nigeria and raising standards. Consequently, a majority of interviewees expect some further reshaping of the Nigerian banking landscape, driven primarily by the acquisition of domestic banks by foreign entrants new to Nigeria. We believe institutions from developed markets, focused on strengthening their domestic balance sheets, may be nervous about the cost and complexity of acquiring and integrating Nigerian institutions. Banks from neighboring countries are considered to be the main source of competition, as a number of them continue to build a pan-African network.

Figure 5: Basel III
Thinking about the domestic banking market in this country, to what extent do you think transition toward Basel III will increase or decrease the following?

<table>
<thead>
<tr>
<th>Category</th>
<th>All RGMs</th>
<th>Frontier RGMs</th>
<th>Nigeria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stability of the financial system</td>
<td></td>
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<tr>
<td>Capital strength of domestic banks</td>
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<td></td>
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<tr>
<td>Credit costs for companies</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Credit costs for retail customers</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Availability of credit for trade finance</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Availability of credit for households</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Risk appetite of banks</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Availability of credit for project finance</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
Despite concerns over social unrest and ambivalence about economic performance, banks are increasingly focused on “sweating assets,” and see streamlining processes and improving efficiency as essential to maintaining current ROE.

Demand for consumer credit will continue to grow, but the introduction of Basel III will lead to supply-side constraints. Banks expect to reduce their risk appetites, and tightening lending standards will increase the costs and decrease the availability of credit for retail customers.

With slower growth, all banks are seeking new sources of revenue. We expect them to invest in new products and channels as they look to expand their customer bases, alongside improving cross-sales to existing customers.

South African institutions are also looking to build a pan-African banking network, tapping into other, faster-growing markets. Optimism about the prospects for trade finance is based on South Africa’s position as a staging post for intra-continental expansion.

Government-championed infrastructure programs will drive corporate lending. Banks expect increased demand for project finance, but we expect international institutions to be preferred partners for accessing funding from global capital markets given their global reach and expertise. Domestic banks without existing connections should consider alliances with international institutions, to build their investment banking expertise and build their capital markets presence.

We believe South Africa offers an entry point for institutions looking to expand into Africa, but low growth expectations and labor unrest may discourage new foreign entrants.

Points of note

- Interviewees remain optimistic about the outlook for banking despite concerns over social unrest and ambivalence about economic performance.
- Faced with slow growth (by sub-Saharan standards), banks are increasingly focused on “sweating assets,” and see streamlining processes and improving efficiency as essential to maintaining current ROE.
- Demand for consumer credit will continue to grow, but the introduction of Basel III will lead to supply-side constraints. Banks expect to reduce their risk appetites, and tightening lending standards will increase the costs and decrease the availability of credit for retail customers.
- With slower growth, all banks are seeking new sources of revenue. We expect them to invest in new products and channels as they look to expand their customer bases, alongside improving cross-sales to existing customers.
- South African institutions are also looking to build a pan-African banking network, tapping into other, faster-growing markets. Optimism about the prospects for trade finance is based on South Africa’s position as a staging post for intra-continental expansion.
- Government-championed infrastructure programs will drive corporate lending. Banks expect increased demand for project finance, but we expect international institutions to be preferred partners for accessing funding from global capital markets given their global reach and expertise. Domestic banks without existing connections should consider alliances with international institutions, to build their investment banking expertise and build their capital markets presence.
- We believe South Africa offers an entry point for institutions looking to expand into Africa, but low growth expectations and labor unrest may discourage new foreign entrants.
South African banks are surprisingly optimistic about their performance for the next year given their ambivalent expectations for broader economic growth (Figure 1). Interviewees are worried about the impact on an already sluggish economy (by sub-Saharan standards) of social and industrial unrest in the mining and agricultural sectors. Consequently, respondents are split on South Africa’s economic outlook and expectations for loan losses. Interviewees’ optimism about their performance stems less from their expectations for the domestic economy than a view that South Africa is an entry point and base of operations for foreign and domestic companies looking to expand across the continent. This makes them particularly positive about the outlook for trade finance (Figure 3).

Faced with slow economic growth domestically, interviewees are concerned with maintaining return on equity through maximizing the value of existing assets. Streamlining processes and improving efficiency are seen as the most important change-related activities for banks over the next year, with all interviewees ranking them as important initiatives. With little optimism for their capital markets business, interviewees also anticipate rebalancing their headcount in favor of hiring across retail and commercial business lines.

Consumers demanding more credit, but banks are increasingly risk averse

Respondents are positive about the outlook for retail deposits, where they expect moderate growth in customer demand. Nevertheless, because South Africa has made greater inroads into financial inclusion than many RGM peers, future demand for deposit and savings products is likely to be lower than in some of our other RGMs (Figure 2). There are still many people without access to bank accounts, but reaching these new customers is likely to require investment in new products and channels to overcome some of the barriers to financial inclusion. We believe that mobile banking, particularly as low-cost smartphones become increasingly available, will play a key role in serving the unbanked population. Banks with the right value proposition and product offerings will be able to gain from serving these customers, and consequently the focus on innovation in the banking sector is particularly acute in this area, with banks, rather than technology or telecom firms, leading the development of mobile banking in South Africa.

Alongside growing their customer bases, banks will need to think about improving profitability through cross-selling to existing...
customers. Most banks recognize the importance of this and expect to invest in new products, services and channels to improve penetration rates. We believe that targeting specific customer segments will be critical to doing this successfully.

Demand for credit cards and loans typically picks up in emerging economies as per capita GDP reaches US$6,000–US$8,000. With South Africa expected to reach per capita GDP of US$10,000 by 2017, this growth in demand has already started. Banks have already begun to shift from lower-margin mortgage lending to more lucrative unsecured lending in recent years, and interviewees expect to face the increased demand from customers for credit cards, auto loans and personal loans.

However, the growth in unsecured lending may not be sustainable. With banks working toward implementing Basel III, interviewees expect the supply of credit to become constrained (Figure 5). Furthermore, price competition on loans means the rebalancing of banks’ portfolios toward higher-yielding products has already led to some concerns about non-performing loans. It is therefore perhaps surprising that strengthening credit risk is seen as a lower priority in South Africa, compared to some other established RGMs. We believe that this will become increasingly important if there is a rise in interest rates in the near future – a distinct possibility with rates at a record low for the past two years and inflation at the top of the central bank’s target range. We also expect banks to look for new sources of revenue. Fees, for example from mobile banking services, will help offset falling margins and provide additional income if lending growth slows.

### Banks are funding intra-continental expansion

For companies seeking expansion in Africa, South Africa is a staging post to the entire continent. With little scope for easy growth in a relatively mature home market, and disappointing economic projections relative to the rest of sub-Saharan Africa, domestic companies are increasingly looking for new sources of revenue beyond the Limpopo. This is particularly evident in the retail sector. One South African food retailer now operates more than 100 supermarkets in 15 other African countries. Another retailer plans to open more than 100 stores across Africa over the next 2-3 years. Multinationals are following this strategy too. Last year a major global retailer acquired a majority stake in a South African supermarket and has announced plans to launch over 1,000 stores.
across Africa by 2016. It is therefore unsurprising that interviewees were extremely positive about the prospects for trade finance. We expect that the banks that are well established in South Africa, and already have a strong footprint across the continent, will have the knowledge and relationships to help their clients as they look to expand. The majority of respondents expect increased demand for cash management and treasury services as these companies expand, and for hedging products to help them manage risks, such as fluctuating currency rates (Figure 4). Respondents were also optimistic about the outlook for project finance. The South African government recently launched an infrastructure plan, identifying 17 strategic projects requiring significant investment. The government intends to look at a range of funding options, including public-private partnerships (PPPs), which will drive demand for project finance. The government also intends to investigate domestic and foreign debt and equity funding. The search for capital markets funding for these projects is revealing. Although interviewees were optimistic about sales and trading they were much more downbeat about the prospects for the issuance and advisory businesses. This suggests that the domestic markets may struggle to fund the largest infrastructure initiatives. With the government looking at ways to develop these projects as investment opportunities for pension funds, we believe this should lead to an opportunity for domestic banks if they can build their investment banking capabilities. We expect banks will need to either hire staff directly or, for those without international ties, partner with global banks to build their existing employees’ skills. At the moment, however, no interviewee currently expects to recruit corporate and investment banking staff over the next year. Although South Africa, with a stock-market capitalization more than twice GDP, has clearly embraced the capital markets, we believe global banks – or those with existing links to international institutions – may be preferred partners for raising finance from the international markets until local banks build their skill base.

Figure 4: Business banking products
To what extent, if at all, do you expect customer demand for the following commercial and corporate products at your bank to change over the next 12 months?

<table>
<thead>
<tr>
<th>Product Type</th>
<th>Mean Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate loans</td>
<td>Stay about the same</td>
</tr>
<tr>
<td>Trade finance</td>
<td>Increase slightly</td>
</tr>
<tr>
<td>SME loans</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Cash management or treasury</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Hedging products</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Project finance</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Debt issuance</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>M&amp;A advisory</td>
<td>Increase significantly</td>
</tr>
<tr>
<td>Equity issuance or initial public offerings</td>
<td>Increase significantly</td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2 Where no respondent answered “decrease slightly” or “decrease significantly,” these options have been removed from the chart.

South Africa – entry point for other African markets

South African banks have been at the forefront of a trend toward pan-African banking. The growth of regional trade in sub-Saharan Africa has driven banks into new markets, with institutions expanding across the continent as they follow their customers and facilitate trade. One South African bank already operates in 18 African countries. These institutions are able to use their knowledge and experience of the unbanked in their domestic markets to tap a customer base beyond the usual purview of global banks. We believe South African banks are in a strong position to take advantage of expanding into neighboring markets, given their sound capital base and financing expertise within the most liquid capital markets in Africa.
All interviewees expect to increase the number of countries in which they operate over the next year, and a majority feel that expanding into new foreign markets is very important. These banks are looking to expand through a mix of acquisition, joint ventures and organic growth. South African banks are now key regional players, but although some have expanded beyond the boundaries of the continent, they are yet to truly establish themselves on a global basis.

The South African market has also been attractive to foreign banks, not only because of the latent potential there but also because, as with other sectors, it offers a route into other African markets. For example one Asian bank acquired a large stake in a leading South African bank to gain access to its already well-established African footprint. Interviewees see European and Chinese banks as the greatest foreign competitive threat. Nevertheless, in light of weak GDP growth and labor unrest, interviewees do not expect new entrants to effect significant change in the banking landscape over the next year.

**Figure 5: Basel III**

Thinking about the domestic banking market in this country, to what extent do you think transition toward Basel III will increase or decrease the following?

- Stability of the financial system
- Capital strength of domestic banks
- Credit costs for companies
- Credit costs for retail customers
- Availability of credit for trade finance
- Availability of credit for households
- Risk appetite of banks
- Availability of credit for project finance

Mean score where significant decrease = -2 and significant increase = 2
Country report

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Country contacts

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Points of note

- Interviewees are optimistic about the outlook for 2013. The Turkish government’s plans to develop Istanbul as an international financial center should establish an infrastructure and a regulatory environment that supports sector growth. Interviewees expect their banks’ performance to improve as a strong economy drives demand from individuals and small and medium-sized enterprises (SMEs).

- In spite of this, the risk of spillover from the ongoing Eurozone crisis means respondents are uncertain about the outlook for loan losses and are focused on strengthening credit risk management.

- While the unbanked population offers a sizable, untapped customer pool, banks are principally focused on increasing penetration rates with existing customers, as low levels of lending relative to GDP suggest scope to expand the retail loan book. We expect increased investment in technology, especially mobile and online channels, as banks look to expand their younger customer base.

- Corporate lending dominates company financing, but we believe there is significant scope to expand the capital markets. The corporate bond market is in its infancy but is expected to develop as banks and clients look for new ways to finance an increasing number of infrastructure projects.

- Interviewees expect further reshaping of the banking landscape, driven by domestic consolidation and further challenges from European banks. We believe small and medium-size domestic banks may be attractive acquisition targets for Middle Eastern players.

- However, domestic consolidation may be offset by new foreign entrants. With greater regulatory willingness to award new banking licenses, a number of foreign banks have applied. We expect that new entrants from the Middle East may be more likely to focus on Islamic banking, while European and Asian entrants target the corporate and commercial segment.
Turkish banks are more optimistic about the next year than most of our other RGMs (Figure 1). Interviewees have good reason to be bullish; the Turkish government is pushing hard for Istanbul to become an international financial center and has launched a comprehensive reform package, including improving technology infrastructure and building local skills, to achieve this. These reforms, coupled with strong projections for economic growth (all interviewees expect the economy to continue to grow), and a large untapped customer pool, should help the banking sector expand. While respondents clearly expect growth, they are also keen to ensure that expansion does not lead to lower profitability. As a result, interviewees are almost universally concerned with improving efficiency and streamlining processes.

Interviewees are also acutely aware of the risk of spillover from problems in the Eurozone (which accounts for about 25% of Turkey’s exports). As a result of this, Turkish respondents are split on whether provisions would rise over the next year and all stress the importance of strengthening credit risk assessment specifically, and improving risk management more generally.

**SME and retail banking — engines of growth**

Interviewees are particularly optimistic about the outlook for SME and retail banking (Figure 3). Increased demand for personal loans and mortgages is driving the retail business (Figure 2), while respondents also expect a significant increase in demand for SME loans (Figure 4).

Turkey currently has comparatively low levels of lending relative to GDP, indicating a large untapped customer pool. Almost nine times as many individuals borrow money from their families than borrow from a financial institution, and we believe this presents a significant opportunity for banks that can encourage greater take-up of formal loans. All interviewees stress the importance of improving penetration rates with existing customers. They also emphasize the importance of developing new customer channels and expanding their branch networks, which will be critical to more effectively serving these underbanked customers and capturing new unbanked ones.

With a particularly young population — more than 40% are under 25 — banks have looked for new ways to build their customer base across this segment. Consequently, Turkey has one of the most innovative markets for retail banking. Ernst & Young’s 2012 Global Consumer Banking Survey showed that customers in Turkey are not only particularly likely to be attracted by new technology, but also that social media play a key role in customers finding out
Figure 3: Business line outlook
How do you rate the outlook for your bank over the next 12 months on each of the following business lines?

- Retail deposits
- Corporate deposits
- Trade finance
- SME or commercial banking deposits
- Corporate lending
- Project finance
- Retail banking lending
- SME or commercial lending
- Private banking/wealth management
- Securities trading
- Securities services
- Debt and equity issuance
- Transaction advisory

Mean score where significant decrease = -2 and significant increase = 2

All RGMs  Established RGMs  Turkey
about products, accessing their accounts and providing feedback on services. We believe investment in customer-facing technology will be crucial to success in serving this young demographic. When asked about which business models were the priority focus for the next year, our interviewees highlighted social-media-based solutions as their principal priority, followed by new branch formats and new business lines, such as direct banking. Although interviewees do not see introducing fee-based products as a priority, we believe that mobile banking can also provide a source of additional revenue for banks that are facing growing pressure on interest margins.

**Figure 4: Business banking products**

To what extent, if at all, do you expect customer demand for the following commercial and corporate products at your bank to change over the next 12 months?

<table>
<thead>
<tr>
<th>Product Category</th>
<th>Mean Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate loans</td>
<td>2.0</td>
</tr>
<tr>
<td>Trade finance</td>
<td>1.5</td>
</tr>
<tr>
<td>SME loans</td>
<td>2.0</td>
</tr>
<tr>
<td>Cash management or treasury</td>
<td>1.5</td>
</tr>
<tr>
<td>Hedging products</td>
<td>1.5</td>
</tr>
<tr>
<td>Project finance</td>
<td>1.5</td>
</tr>
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<td>Debt issuance</td>
<td>1.5</td>
</tr>
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<td>M&amp;A advisory</td>
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</table>

Mean score where significant decrease = -2 and significant increase = 2. Where no respondent answered “decrease slightly” or “decrease significantly,” these options have been removed from the chart.

**Corporate funding – bank lending dominates, capital markets emerging**

Respondents expect lending to infrastructure projects to increase significantly, as the government moves ahead with its ambitious plans for infrastructure projects ahead of the Turkish Republic’s centenary in 2023. We believe demand for investment in infrastructure could provide a stimulus for banks’ capital markets divisions. While interviewees foresee increased demand for project finance they also anticipate Basel III will limit the availability of credit for these projects (Figure 5). We expect alternative financing methods will be required to fund the public-private partnership (PPP) programs that are central to these infrastructure initiatives.

Issuing bonds to finance the PPP initiatives would help to meet the growing demand that our survey respondents expect for investment products. PPP bonds can also match the revenues from long-term infrastructure assets to long-term pension liabilities. With all interviewees expressing concern that net interest margins are narrowing, driven by competition for deposits and lending, bond issuance could also provide additional fee revenue to offset this.

However, some Turkish banks may miss out on this opportunity. While interviewees expect a moderate increase in staffing levels, this will be across the retail and commercial segments. Without the staff to structure these complex deals, global institutions may step in to fill the gap. If investor demand for PPP bonds is weak, we believe that domestic banks could partner with global investment banks to provide dual bank debt and bond financing, bringing together the former’s local expertise and the latter’s capital market know-how.

Although there is significant scope to expand the capital markets, doing so is likely to be a slow process. Demand for equities has been hindered by investors preferring investments in gold, although the issue of Turkey’s first covered bond (and the world’s first SME-backed covered bond) in 2011 suggests there may be some demand for debt instruments. Furthermore, we believe that, with banks expecting increased demand for mortgages, they may look to fund them through covered bonds.
A regional banking hub for Eastern Europe and the Middle East

The Turkish market has long been attractive to foreign banks and, prior to the global financial crisis, was seen as a strategic priority for many global banks. The global financial crisis and the subsequent pressure to recapitalize has caused some of these foreign players to retrench and sell their Turkish acquisitions; other foreign institutions have taken their place, as Turkey remains a priority.

However, during the last 14 years only two new licenses have been awarded to banks entering the market – in October 2011 and December 2012. As a result of this, most entry into the market has been through the acquisition of local institutions. This has meant that foreign banks operating in the Turkish market have, through their acquisitions, had retail banking businesses. With the recent suggestion from the Turkish banking authority that more licenses could be awarded in the future, we expect more foreign banks to establish commercial and corporate banking operations in the market. An Asian bank has already expressed an interest in establishing operations in Turkey, while last year a Russian bank acquired a Turkish institution to capture Russian-Turkish trade flows.

We also believe that the more favorable attitude of the regulator may encourage more foreign Islamic banks to enter the market. Domestic Islamic institutions only have a small share of the overall banking market, making them potentially attractive targets for foreign banks with more established Sharia-compliant offerings. Such banks will have to act swiftly, however, as competition is likely to intensify, with some state-owned banks having already applied to establish Islamic banks.

Turkish banks have also been strengthening their overseas presence, looking to support their corporate clients operating in those countries. Their footprint is clearly regional, focused on Central and Eastern Europe and the Middle East. Interviewees were more reticent about the near-term prospects for further overseas expansion, however, suggesting they are more focused on exploiting opportunities closer to home.

Figure 5: Basel III
Thinking about the domestic banking market in this country, to what extent do you think transition toward Basel III will increase or decrease the following?

<table>
<thead>
<tr>
<th>Stability of the financial system</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital strength of domestic banks</td>
</tr>
<tr>
<td>Credit costs for companies</td>
</tr>
<tr>
<td>Credit costs for retail customers</td>
</tr>
<tr>
<td>Availability of credit for trade finance</td>
</tr>
<tr>
<td>Availability of credit for households</td>
</tr>
<tr>
<td>Risk appetite of banks</td>
</tr>
<tr>
<td>Availability of credit for project finance</td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
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Points of note

- Despite persistent high levels of non-performing loans across the sector, interviewees are surprisingly optimistic about the outlook for their banks over the next year. This optimism stems from the hope that government-led reform of the banking sector will address systemic problems with bad debts and reduce the level of poor-quality assets on bank balance sheets.

- Regulator-driven industry consolidation will lead to fewer small banks. We expect acquiring banks to focus on investment in technology to drive efficiency and gain a competitive advantage.

- Risk management remains a challenge. Following the recent exposure of a number of frauds, banks are focusing on strengthening operational risk management. We expect significant investment in technology will also be needed to improve credit risk assessment to address poor-quality lending.

- Interviewees expect increased demand for savings and investment products but are struggling to maintain net interest margins amid fierce competition on savings rates. To address margin pressure, banks are seeking opportunities to cross-sell to existing customers and to introduce more fee-based products such as insurance and credit cards.

- Banks are rebalancing their corporate lending following an accumulation of bad debts in the property sector. Regulatory rate caps on loans to small and medium-sized enterprises (SMEs) and high-tech customers will lead to increased demand in these sectors. Higher pricing of loans to other sectors may be likely as a result of this.

- Banks are also looking to boost corporate and commercial fee-based revenue, and we expect further diversification of their offerings to meet the growing demand for hedging products and trade-related offerings.

- Opportunities for global banks continue to emerge. With domestic banks relatively inexperienced in providing more complex corporate offerings, we expect international banks to forge alliances with local institutions to develop trade and capital-markets-related products. Providing services to the small, but growing, high-net-worth and mass affluent segments may also present the global banks that see Vietnam as a long-term strategic market with a potential entry point. Here too, alliances with local institutions may be the more expedient route to build both market share and local knowledge.
Vietnamese banks are optimistic about the next year, and all expect their banks’ performance to improve and the economy to grow (Figure 1). This optimism is perhaps surprising given the problems that the sector needs to address, both in terms of internal governance and high levels of non-performing loans (NPLs). After years of excessive credit growth, with numerous banks expanding their lending by 30%-50% per annum, many loans have turned sour, particularly those to state-owned enterprises and to fund property investment. One of our interviewees noted that although the rate of NPLs is declining, it still remains exceptionally high, at around 6%.

The government is taking action to restructure the banking sector and last year announced Decision 254, a “roadmap” to address the problem of institutions with poor-quality loan books. Stronger commercial and state-owned banks are being encouraged to acquire weaker ones. The State Bank of Vietnam (SBV) anticipates its five-year-long restructuring of the sector leaving around 15 banks that will dominate the Vietnamese market and will be able to compete on a regional basis. As the consolidation of the banking sector progresses, banks will face the challenges of IT and workforce integration. If the acquiring banks are to avoid the past mistakes of others, and overcome these challenges to build competitive advantage, redesigning operating models and investing in technology to drive efficiency will be critical initiatives.

The SBV is also seeking foreign investors to help recapitalize institutions. Estimates suggest that the recapitalization of the sector may cost 7% of GDP. The World Bank has offered support if needed, although the SBV has had success so far in attracting foreign funds, particularly from Japan. The government has also announced its intention to create the Vietnam Asset Management Corporation – essentially a bad bank – to relieve some of the pressure on the sector and encourage lending to the “real economy.”

Our interviewees repeatedly stressed their concerns about bad debts and the importance of successfully restructuring the industry. Respondents’ optimism about their banks seems to stem from a view that bad debts are falling (albeit slowly) and a hope that the government’s latest initiative to fix the sector will work, enabling the banking sector to support the broader economy more effectively and for both to realize their potential. Banks also will need to address institutional weaknesses. We believe investment will be needed in technology infrastructure as banks prepare for the transition to Basel II, as well as in operational risk management to reduce the scope for fraud in the banks. There have been a number of fraud-related arrests of bankers, and most interviewees see strengthening risk management as a vital activity for the next year.

**Improved financial performance driven by SME and retail banking**

All interviewees were positive about the outlook for retail deposits and lending (Figure 3). With per capita GDP expected to reach US$2,200 by 2017, it is not surprising that banks expect significant demand for deposits and savings products (Figure 2). However, capturing these deposits will not be easy. Respondents complained of the challenge of maintaining net interest margins.

**Figure 1: Financial performance**

How, if at all, do you expect your bank’s overall financial performance to change over the next 12 months?

<table>
<thead>
<tr>
<th></th>
<th>All RGMs</th>
<th>Frontier RGMs</th>
<th>Vietnam</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stay about the same</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase slightly</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase significantly</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2

Where no respondent answered “decrease slightly” or “decrease significantly,” these options have been removed from the chart.

**Figure 2: Product demand — retail banking**

To what extent, if at all, do you expect customer demand for the following retail products at your bank to change over the next 12 months?

<table>
<thead>
<tr>
<th>Product Type</th>
<th>All RGMs</th>
<th>Frontier RGMs</th>
<th>Vietnam</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal savings and deposit products</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Personal loans</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit cards</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Personal real estate loans</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auto loans</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private banking/wealth management</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal investment products</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payroll loans</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2

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with competition on deposit rates far more severe than price competition on lending. With a history of high inflation, it has sometimes seemed a safer option to keep dollars under the mattress than local currency in the bank, even though the latter was accruing interest at double-digit rates. The government has set targets to control inflation, which may drive additional demand for savings products.

To address margin pressures, banks expect to invest more in new products, services and channels and will try to improve penetration rates with existing customers. There is also a large unbanked constituency in rural areas that offers an attractive new customer pool if services can be delivered to them cheaply. Looking to the examples of other RGMs and considering partnerships with telecommunications firms may provide a more efficient route to delivering mobile banking to the unbanked.

Interviewees also expect growing demand for consumer lending. Both payroll loans and auto loans are a popular form of finance and, with an average of 1.3 vehicles per 100 people, all respondents

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**Figure 3: Business line outlook**

How do you rate the outlook for your bank over the next 12 months on each of the following business lines?

<table>
<thead>
<tr>
<th>Business Line</th>
<th>All RGMs</th>
<th>Frontier RGMs</th>
<th>Vietnam</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail deposits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate deposits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade finance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SME or commercial banking deposits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate lending</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Project finance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail banking lending</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SME or commercial lending</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private banking/ wealth management</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Securities trading</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Securities services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt and equity issuance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transaction advisory</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Mean score where significant decrease = -2 and significant increase = 2
expect demand for vehicle loans to rise next year. Demand for payroll loans is also expected to grow, and the security of these types of loans makes them an efficient product for managing credit risk in frontier markets such as Vietnam. However, as Vietnam becomes a transitional emerging market, consumer demand for formal bank loans will pick up, and we expect banks to invest in strengthening credit risk assessment. A majority of interviewees already see this as a core investment area for the next year.

Credit scoring companies are only starting to enter the market, and Vietnam faces a market-wide issue with customer credit data. We believe that banks should look at the examples in other markets, such as Brazil, and consider adopting new and innovative solutions to address these issues. With most of the population already having a mobile phone subscription, mobile-based credit scoring is a possibility for customers with little credit history.

Banks are also looking at introducing more fee-based products to boost non-interest income and offset the risk of poor-quality consumer lending. Banks have begun to focus on products such as cards and insurance, as well as improving fee collection. Surprisingly, however, the introduction of fee-based products was not a universal priority. We expect this to become an increasingly important area of focus as Vietnam evolves into a transitional RGM.

**Bank lending dominates corporate funding, with flickers of hope for capital markets**

A record of poor-quality lending to property investors and state-owned enterprises has made Vietnamese banks cautious about business lending. A majority of respondents expect the outlook for corporate lending to improve over the next year, but this stems from a rebalancing of their portfolios. Demand for credit from SME and high-tech sectors will increase as a result of SBV caps on lending rates. But with rates of interest charged to uncapped sectors remaining high and discouraging borrowing, lending to commercial real estate, infrastructure and construction will decline.

Banks are also increasingly looking for ways to diversify away from spread-based business into fee-based products for commercial and corporate customers. Interviewees anticipate increased demand for hedging products over the next year and are beginning to expand their product offerings to meet this demand (Figure 4).

Banks have adopted a number of other approaches to bolster margins and find new sources of revenue. One institution has diversified away from just lending to concentrate on five areas:

- Traditional lending, including syndicated loans, trade finance and guarantees
- Leasing
- Underwriting bond issues and direct equity investments in companies
- Acting as a paying agent for overseas development agencies (ODAs)
- Performing wholesale banking functions for the World Bank’s rural finance projects

Other banks have been looking to build their product offerings through strategic alliances and cooperation with foreign banks and international agencies. One bank has signed a cooperation pact with a South Korean bank to develop trade-related products, as well as to share technical know-how. With a majority of interviewees indicating that attracting and retaining front office staff would be a challenge over the next year, we expect such innovative partnerships to play a critical role in addressing some of these challenges.

The capital markets are still in the early stages of development, however. Debt issuance is dominated by government bonds and,
with more than 1,300 companies still state-owned, the equity market is heavily dependent on policy decisions. We believe further regulatory intervention to improve transparency, and corporate governance will be needed if these markets are to become more attractive to foreign investors and expand.

Consolidation in the banking sector will continue

The Vietnamese market still offers significant growth potential, and domestic banks expect to be focused on consolidation in Vietnam rather than on overseas expansion. Over the past two years nine banks have already agreed to merge or be taken over. The majority of interviewees expect further consolidation over the next year, anticipating both mergers between smaller banks and the acquisition of smaller banks by larger domestic banks.

Banks involved in such mergers are likely to prioritize investment in operational and credit risk management functions, to ensure that high-quality processes are rolled out across underperforming institutions. These mergers are also likely to exacerbate the need to retain and recruit excellent front and back office staff to address the failures of these weaker institutions. As previously discussed, investment in technology to drive efficiency will also be central to gaining competitive advantage in a more consolidated landscape.

The SBV has been trying to encourage foreign institutions to play a key role in the reshaping of the banking sector. We expect that this will happen, if governance issues can be resolved.

The SBV is looking to raise the cap on foreign stakes in local banks from 20% to 30% to encourage investment, and to help instill better governance. Interviewees expect Japanese, US and European banks to be sources of competition over the coming year and beyond.

A number of Japanese banks have already started investing in the sector. Nevertheless, being unable to take a majority stake in local banks limits the influence of foreign firms and, given ongoing governance issues, may dampen investment appetites. These institutions can also enter the market as a branch or subsidiary, but the expense of doing so (from a capital perspective, and establishing a branch network) is likely to restrict them to corporate and commercial business. However, Vietnam will remain a longer-term strategic market for many international banks, and more are likely to look at cheaper routes to market, such as alliances with local banks, to build their presence and local knowledge.

Figure 5: Basel III

Thinking about the domestic banking market in this country, to what extent do you think transition toward Basel III will increase or decrease the following?

- Stability of the financial system
- Capital strength of domestic banks
- Credit costs for companies
- Credit costs for retail customers
- Availability of credit for trade finance
- Availability of credit for households
- Risk appetite of banks
- Availability of credit for project finance

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