

BCG

OPPORTUNITIES
for ACTION

FINANCIAL SERVICES



■ *Financial exclusion is a defining characteristic of a distinct group of consumers—the next billion—whose potential to become viable banking customers has been greatly underestimated.*

■ *The next billion consumers can be found largely in Brazil, China, and India, but the segment also spreads across Africa and other parts of Asia.*

■ *The next billion consumers' demand for financial services has not been met by suitable offerings from the formal sector, owing to the lack of a clear commercial case for serving this group.*

■ *By embracing innovation, however, banks can upend the economics of reaching the next billion, creating opportunities for profitable growth.*

The Next Billion Banking Consumers

The problem of financial exclusion—individuals' limited access to or use of formal banking services—looms large around the world. It both reflects and contributes to the stark socioeconomic divide that pervades many emerging markets. In China and India, for example, only about one-third of the population participates in the formal banking sector. Among the excluded are a distinct and huge group of consumers—the *next billion*—whose potential to become viable banking customers has been greatly underestimated. Categorized by income, this group sits just above the poorest of the poor and just below those who are currently targeted by most banks.

Governments and microfinance institutions have made some headway in alleviating financial exclusion, but banks have lacked a clear commercial impetus to do so, stifling the development of business models that have the reach required to confront this problem. By embracing innovative business models, however, banks can upend the economics of reaching consumers long considered impossible or unattractive to serve. This approach would open up unparalleled opportunities for profitable expansion in some of the world's most rapidly growing economies.

Who Are the Next Billion?

The next billion consumers can be found largely in Brazil, China, and India, but the group also spreads across Africa and other parts of Asia. If the next billion constituted a nation by itself, it would be the tenth-largest economy in terms of GDP, ranking after Spain but ahead of Brazil, Russia, India, South Korea, and Mexico. In its development, the next billion "nation" stands today where India stood in the 1990s and China stood in the 1980s: on the cusp of high growth and voracious consumption.

The next billion consumers have no lack of interest in banking. Their demand is so strong, in fact, that they routinely en-

dures the trying, sometimes oppressive conditions that plague the informal sector, including limited choice, usurious rates, and exploitative terms. It is not unheard of for loans in the informal sector to be repaid through lifelong indentured service.

Rather than having opted out of the formal banking sector, most of the next billion have been excluded from participating by financial institutions unable or unwilling to invest in understanding their needs and in adapting business models to serve them profitably. Our definition of the next billion consumers also includes people whom banks are compelled to serve but who cannot be served profitably through conventional business models—for example, individuals in government-mandated priority sectors (such as low-income consumers) and employees of corporate clients. Banks believe they have little economic incentive to serve such consumers. Some even prefer to incur penalties rather than make the investments necessary to comply with government mandates. As a result, these consumers are chronically underserved.

In several emerging economies, however, a few financial institutions have recognized the potential of the next billion and are introducing innovative products and distribution methods in order to carve out broad avenues for reaching this segment.

What Do the Next Billion Need?

To field an offering that resonates with the next billion consumers, banks must first understand the barriers to participation in the formal sector.

The leading, if obvious, reason for financial exclusion is a lack of steady, substantial income. It is compounded by the cumbersome mechanics of cash-based economies, which circumvent financial institutions, making a relationship with a bank unnecessary and preventing individuals from building a credit history. This one-two punch minimizes the incentive to maintain a savings account and makes it difficult to qualify for a formal loan.

Poor proximity to banking services is another reason for exclusion. A study by The Boston Consulting Group in late 2006 and early 2007 found that in India, the rate of financial inclusion among urban households was more than double that of rural households—57 percent versus 26 percent—in part because banking outlets are

typically located far from rural areas, and people there often lack the means to make the trip.

Financial exclusion also stems from a scarcity of suitable products. The next billion consumers would like flexibility, especially the option to skip or make additional payments on a loan. Because many in this segment do not have steady incomes, such flexibility is a common feature in products available in the informal sector. Simplicity is also important. In our work in Brazil and India, we found that the next billion consumers are generally more concerned about manageable monthly installments than they are about interest rates.

Many of the next billion also desire easy access to small personal loans, but most banks find the expense of providing small-ticket financial products prohibitive. In addition, banks won't lend to individuals lacking collateral, a verifiable source of stable income, or a documented credit history. Moreover, in some emerging markets, banks in the formal sector can take up to six months to approve a loan—but a villager can meet with and secure a loan from a local moneylender virtually anytime.

Financial exclusion is exacerbated by poor relationships between banks and communities. Low-income people, particularly in rural areas, are often wary of banks and find branches intimidating. A profound lack of financial literacy only reinforces this sense of alienation.

Overcoming these barriers and altering the economics of serving the next billion require banks to pursue a variety of innovations—in product development, distribution, marketing, and organization structure. Innovations in marketing, for example, will play a critical role in engaging this untapped group. New approaches to distribution will be crucial in serving the segment profitably.

Developing Financial Products to Reach the Next Billion

Banks can address many of the problems that cause financial exclusion by developing products that are simple, flexible, and accessible. For example, offering a loan with a higher number of installment payments—and allowing the customer to increase or postpone payments with little or no penalty—would attract many of the next billion.

Also, linking products directly to individuals' sources of income could mitigate the risk that banks assume and thereby help make products more accessible to consumers. Banks in Brazil have adopted this approach, developing payroll- and pension-backed loans that have opened the credit market to many new consumers. These products now account for about half of all personal loans in Brazil, according to Banco Central do Brasil.

Unfortunately, regulations sometimes make it difficult—if not impossible—to offer products that suit the financial means of the next billion consumers. Our analysis shows, for example, that Indian banks would need to charge a 32 percent interest rate just to break even on the kind of small, short-term personal loan that the next billion consumers would want. Yet national regulations prohibit banks from charging interest rates to priority sectors that exceed the prime lending rate, which currently stands at about 12 percent. This problem underscores the need for regulatory reform that complements initiatives to reach the next billion consumers.

Distributing Financial Products to Reach the Next Billion

Banks that already have extensive physical networks should try to maximize the revenue per square foot of their branches by offering products in addition to financial services, provided that regulations will allow for this shift. Banks could, for example, set up local communications centers—public pay phones, fax machines, and Internet access—at rural branches to help make the outlets economically viable, and therefore more attractive to open and operate with a fully committed, sales-oriented level of service. They could also use the rural branches to disseminate commodity information and provide access to commodity exchanges.

At the same time, when one considers the physical and emotional barriers that prevent the next billion from using branches, it becomes clear that banks seeking to foster inclusion must also employ alternatives to their traditional outlets. Some banks in emerging markets have already begun to forgo branches, instead reaching underserved segments through nonbank channels. In Brazil, banks have added nearly 100,000 point-of-sale (POS) locations by striking deals with

post offices, pharmacies, supermarkets, and lottery shops. These channels, which have operating costs 12 times lower than those incurred by branches, are more convenient for consumers and help engage them in the formal banking sector. They now account for more than half of all bill-payment activity in Brazil.

South Africa's Mzansi account, launched in 2004, illustrates the appeal of nontraditional channels. This card-based product, which can be used in branches and ATMs but also in post offices and retail stores' POS locations, now has more than 4 million subscribers.

Self-help groups represent still another viable channel—and perhaps even a partner—for banks. In a typical self-help group in India, village women save money to underwrite loans to one another. Through the groups, money from the community is used in the community, creating a strong moral obligation for borrowers to repay their loans. By drawing on its personal connections, a self-help group can verify its borrowers' creditworthiness. If they also collaborated with banks by directing individuals to tailored commercial products, self-help groups could offer consumers a familiar path to the formal sector.

Marketing to Reach the Next Billion

Given the uneasy relationship that many low-income consumers have with banks, it is essential that the financial establishment foster trust among the next billion. Toward this end, expanding inclusion will require marketing through community-level partnerships—not just through radio, television, and print media. Moreover, by becoming a partner in a community's prosperity, a bank could forge bonds that would be difficult for new financial players to break or replicate.

Beyond promoting products and services, marketing campaigns will need to enhance financial literacy among the next billion. The most effective marketing campaigns could wind up being equal parts education and sales pitch. As an illustrative example, consider a leading public-sector bank in India that is currently promoting its credit-counseling services. These services include free advice on how consumers outside the formal sector can gain access to the bank's financial products.

Redefining a Bank's Organization Structure to Reach the Next Billion

Although all banks in emerging markets should have the next billion consumers on their radar screen, most of them are not yet ready to undertake the transformation required to serve this segment. In many larger institutions, a centralized, top-down approach to decision making discourages the types of initiatives needed to push the boundaries of product offerings. Their metrics and incentives also threaten to inhibit next billion initiatives in two major ways. First, performance targets, frequently measured by the volume of loans or savings and applied the same way to both rural and urban branches, motivate the sales force to court big-ticket customers. Second, many banks lack incentives to attract or retain staff in rural areas—a fact sometimes reflected in poorer levels of service in those locations and a disdain among workers there for low-income customers.

To overcome their own impediments to serving the next billion, banks must develop separate organizations dedicated to tapping this opportunity. These units' performance metrics and incentives should be aligned with the priorities for serving such customers. For example, banks could measure performance by the number of customers served, rather than the size of their wallets. Similarly, these units could be allowed to emphasize growth over profitability in the short term. To reinforce the importance of this opportunity, banks should create an executive-level position that focuses on the initiatives and reports directly to the CEO. One private-sector bank in India is leading the way by entrusting to a board-level executive its efforts to boost financial inclusion of the next billion.

Collaborating to Reach the Next Billion

The next billion consumers will not be constrained by traditional industry boundaries, and this factor, among others, will help set the stage for new players to encroach on what has been a stronghold of banks: basic payment and deposit transactions. When it comes to those services, the next billion won't necessarily distinguish between telecom providers and banks, for example, and they'll opt to use whichever providers offer the least cumbersome and lowest-cost offerings. Consequently, if regulators in emerging markets al-

low telecom operators to straddle industry boundaries, these players could mount a strong challenge to banks. In some rapidly developing economies, new mobile-phone customers are being added more quickly than new banking customers, and mobile phone services, in general, boast a significant cost advantage over branch-based banking.

Yet the relationship between the banking and telecom industries need not be adversarial. Before telecom players lay claim to traditional banking strongholds, banks should explore opportunities for collaboration, identifying ways to cross-sell their products by leveraging the ease of use, low cost to serve, and accessibility offered by mobile phones. Players from both industries can share elements of their offerings and value chains in ways that provide mutual benefits, including more attractive, targeted products. Banks in particular stand to benefit from a steep reduction in transaction costs, because transactions executed by mobile phones could cost as little as 10 percent of those executed at bank branches.

Mobile phone networks are already being used as effective channels for financial services in emerging economies. In Kenya, telecom customers can deposit money into an account on their mobile phones and transfer the funds to other mobile-phone users—even in remote areas. The telecom operator's local agent can then convert the money into cash, allowing people to avoid cumbersome and costly dealings with banks. In Zambia, telecom company Celtel introduced Celpay, a service that allows customers to make purchases, pay bills, and transfer funds through their mobile phones. Two percent of Zambia's GDP was transferred through Celpay in 2006, and even those Zambian communities that have little or no financial services infrastructure can now participate in the banking system.

Laying the Groundwork

The breadth of actions required to reach the next billion consumers may seem daunting, but banks can take several immediate steps to begin the process of unlocking this opportunity:

- *Understand the needs of the next billion consumers.* Which features do they value? What barriers prevent them from engaging in the formal sector?

- *Analyze product and channel economics.* For each element of the value chain, what are the opportunities to reduce the cost of serving the next billion?
- *Develop new marketing campaigns.* How can marketing improve financial literacy among the next billion consumers while promoting the benefits and simplicity of basic products and services?
- *Design a new organization model.* Which organization structure would best foster experimentation, including collaboration with other industries?
- *Create an empowered executive position.* Who will oversee the strategy for tapping the next billion opportunity?
- *Begin adapting the value chain.* Can the bank focus on core activities and use low-cost partners for all other activities, especially distribution?

Boosting financial inclusion will no doubt create economic opportunities for an overlooked and underserved segment. Socioeconomic imperatives aside, however, the prospect of reducing financial exclusion represents

a significant business opportunity for banks. Conventional banks that act in unconventional ways can transform the next billion consumers—the tenth-largest economy—into a source of profitable growth.

Janmejaya Sinha
Walter Piacsek
Arvind Subramanian
Michele Pikman

Janmejaya Sinha is a senior partner and managing director in the Mumbai office of The Boston Consulting Group. Walter Piacsek is a partner and managing director in the firm's São Paulo office. Arvind Subramanian is a principal in BCG's Mumbai office. Michele Pikman is a project leader in the firm's São Paulo office.

You may contact the authors by e-mail at:
sinha.janmejaya@bcg.com
piacsek.walter@bcg.com
subramanian.arvind@bcg.com
pikman.michele@bcg.com

To receive future publications in electronic form about this topic or others, please visit our subscription Web site at bcg.com/subscribe.

© The Boston Consulting Group, Inc. 2007.
All rights reserved. 6/07