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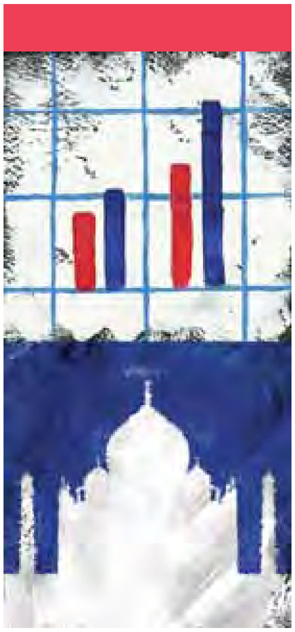

A strategic review of India's emerging payments market

India's 1.2 billion people represent approximately one-sixth of the world's population, making even modest market developments in this rapidly emerging economy significant. Its payments industry is approaching $14 billion in revenues, with most transactions flowing to and within the business sector. However, like China, India is a vast market comprising diverse segments that require close study by organizations intent on benefiting from its anticipated rapid growth.

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Though the current opportunity in India is small and facing the challenges of an economic downturn, limited credit card profitability and high acquisition costs, we see several important trends shaping India's payments industry. Among them are: growing regulatory oversight, increasing electronification (especially of intercompany flows), the emergence of specialist players, and widespread innovation. Given the nature of these trends, the unique structure of India's payments markets and the nation's expanding global presence, we have identified eight strategic plays we expect will be vital to capturing payments revenue. This immense and diverse market will likely present significant growth opportunities for a variety of bank and non-bank participants, whether as solo players or teams.

A rapidly emerging industry

With total payments approaching $9 trillion, India's payments industry has revenues of nearly $14 billion. Payment flows are 7.8 times GDP, comparable to many Western countries and emerging economies, such as Brazil (7.3), Italy (7.2) and the U.S. (7.0). Although sources vary widely by bank, payments contributes about 30 percent of bank revenues. Most of this derives from transaction banking, credit cards and cash and paper transactions (transaction banking includes cash management plus trade and supply-chain financing). The majority of payment flows occur to and within the business sector (Exhibit 1 on page 24).

Meanwhile, electronic payments have grown significantly, from below 5 percent of total value in 2005 to 48 percent in 2008, largely due to electronification of business-to-business payments. Consumer transactions – where electronification is relatively new – are as yet mostly cash and paper-based, with less than 3 percent of consumer-to-business flow value being electronic.

We see significant payments opportunities in such areas as transaction revenue, fee income, and associated float and net interest income on current and savings accounts.

Importantly, the nation's central bank closely regulates interest rates. Interest on savings accounts is currently limited to 3 percent and none is permitted on current accounts. This enables banks to earn high margins on deposits, resulting in a 73 percent share of float and net interest income in the nation's payments revenues.

India's payments industry ranks fifth among Asian countries by revenue. As the payments infrastructure develops, we anticipate greater intermediation by banks to spur revenue growth by about 17 percent CAGR, delivering annual revenues of around $45 billion by 2015. While transaction banking, credit cards and paper transactions will continue to be the industry's main revenue drivers, mobile payments, e-commerce and debit cards will provide the fastest growth opportunities (Exhibit 2).

India's payments industry, like others in Asia, differs markedly from those of other regions. Consumer payment flows are dispersed geographically, with nearly 70 percent occurring among mass and upper-mass segments in centers beyond the top 30 cities. However, revenues and profits have been relatively concentrated geographically, closely paralleling electronification. Affluent consumers in top cities, for example, will generate the greatest share of credit card volume and profits (Exhibit 3 on page 26). Similarly, in business-originated flows, payments revenue pools are greatest among corporations in the top 10 cities, and among small and medium enterprises in the top 30 cities. Especially notable is an emerging paradox in electronic payments: As issuers respond to favorable credit card economics in the top 10 cities and make it the dominant payment form there, debit transactions will likely prevail elsewhere as banks promote debit card use where they already have significant deposit-account customer bases.

Trends foretell strong growth, with challenges

Three trends appear to be shaping India's payments industry: growth in electronification, increasing regulatory oversight and change in industry structure and business models.

We anticipate middle-class growth and an increasingly organized retail industry to

Exhibit 1

Flows to and within the business sector will dominate payments in India

Payments landscape by segments

$U.S. billions

2008 flows / 2015 flows

Payments from: \ Payments to:	Consumer (2008 / 2015)	Business (2008 / 2015)	Government (2008 / 2015)	Total (2008 / 2015)
Consumer	9 / 24	1,001 / 1,805	185 / 293	1,168 / 2,122
Business	268 / 523	6,810 / 15,146	254 / 601	7.332 / 16.270
Government	182 / 288	252 / 596	5 / 7	439 / 891
Total	459 / 834	8,063 / 17,547	417 / 901	8939 / 19,282

Source: McKinsey India payments map

boost consumer electronic transactions from less than 3 percent currently to about 15 percent of total transaction value by 2015. India's emerging, young, affluent and upwardly mobile consumers – for whom payment features have strong appeal – already comprise 34 percent of urban buyers. Expect players to address such demand with a range of electronic solutions that feature enhanced convenience, superior service and lower transaction costs. Today, 48 percent of payments (by value) in India are electronified. We believe this share will increase to 70 percent by 2015.

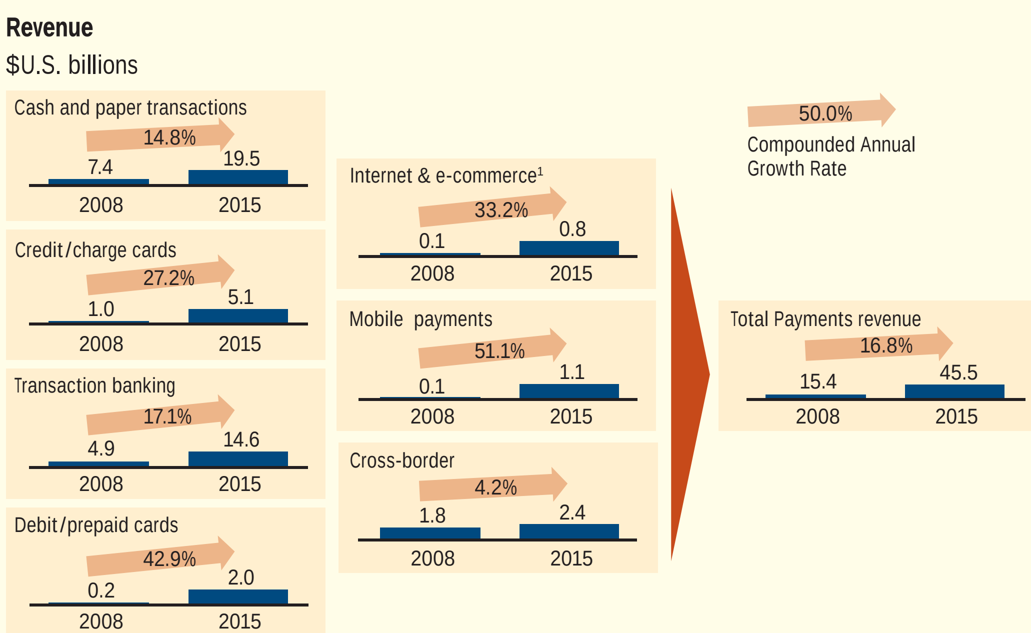
On the regulatory front, oversight is increasing largely in response to electronification-induced changes. For example, the Reserve Bank of India (RBI) established the National Payments Council to lead the development of retail payment and collections systems. The RBI has also defined the broad contours of India's mobile banking – one of the few central banks to do so – and is working aggressively to improve banking convenience and efficiency, reduce intermediation costs and ensure the security of payment flows.

We note, too, a trend toward disaggregating the payments value chain as specialists and non-bank participants emerge – among them, bill pay aggregators, technology providers and transaction processing firms. Also, many banks and non-bank financial institutions are creating alliances to market new products, features and services (often co-branded), thereby improving marketing efficiency.

Lastly, as electronification expands float levels will decline, so bankers will strive to replace lost revenues with fee income. Cash management fees, for example, will likely grow from 6 percent of revenues in 2008 to 9 percent by 2015, consistent with our experience in other economies.

While the above trends portend strong growth, it is also important to keep in mind the challenges of India's payments landscape. The nation's economic growth fell below 6 percent in the last half of financial year 2009, from recent 8 percent highs. Further, structural challenges, such as weak credit histories, collection difficulties and targeting high-risk segments have led to significant losses in credit cards this year. Lim-

Exhibit 2
Mapping revenue growth drivers



[1] Includes credit card, debit card and ACH flows on internet and e-commerce

Source: McKinsey India payments map

ited scale and broad geographic dispersion of consumers means higher upfront distribution costs and longer break-even periods.

Strategy will differentiate winners from losers

The newness of India's payments industry and its potential for rapid development are clearly alluring. But to thrive in this market, strategies will need to focus on building and retaining deposits by capturing both ends of transaction flows and refining business models. We expect most players will adopt a multi-strategy portfolio that targets three types of opportunities: the large and familiar; the small, yet rapidly growing; and those that are less certain, but offer substantial promise.

Within the large opportunity group we see credit cards, government payments and transaction banking. A few industry leaders already use these strategies successfully, and others are likely to learn quickly from them. Here are some examples.

- **Boost card profits through improved segmentation and cross-selling:** Credit card profits have come under pressure mainly due to risky underwriting, high acquisition costs and limited scale (Exhibit 4), with most issuers experiencing losses in 2008. HDFC Bank was among the exceptions; unlike others, it emphasized the cross-selling of cards to existing customers. We think many players will revise their business models to align more closely with customer segments and to leverage cross-selling to build customer loyalty and profits. Business model changes may involve portfolio reassessment, market re-segmentation to reflect shifting buyer behavior and credit markets, and pricing differentiation. Other tactics might include more robust underwriting models and improved collection capabilities. Acquisition models are likely to shift, as well, from direct selling to cross-selling, partnering, and simultaneously pursuing remote and direct distribution channels. These tactics, combined with increases in card spending and scale-driven reductions of fixed costs, should enable the industry to break even by 2011, and to earn about a 2 percent return by 2015. Importantly, this assumes India's economy will grow

Exhibit 3

Credit card volume and profits will remain concentrated in the affluent segment in the top ten cities

Credit card volume and profits

U.S.$ billion

Volume 100 / 100 Profit

	2008 Top 10	2008 Next 20	2008 Other	2015 Top 10	2015 Next 20	2015 Other
Affluent (U.S.$50K+)	8.3 / 26.5	0.5 / (0.8)	0.3 / (2.8)	37.0 / 549.8	3.3 / 20.3	3.3 / (21.0)
Aspiring affluent (U.S.$20-50K)	4.0 / (39.3)	0.2 / (3.3)	0.1 / (3.5)	25.5 / 271.3	1.8 / 5.3	1.0 / (15.8)
Upper mass / mass / others (<U.S.$10K)	2.0 / (141.8)	0.3 / (17.0)	– / (1.8)	10.5 / (107.5)	2.4 / (17.5)	1.3 / (25.8)
Total	14.2 / (154.6)	1.0 / (21.1)	0.3 / (8.1)	73.0 / (713.6)	5.8 / (8.0)	5.5 / (62.5)

2008: Total volume of U.S.$15.7 billion and loss of U.S.$183.8 billion

2015: Total volume of U.S.$84.5 billion and profits of U.S.$659 billion

Source: McKinsey India payments map

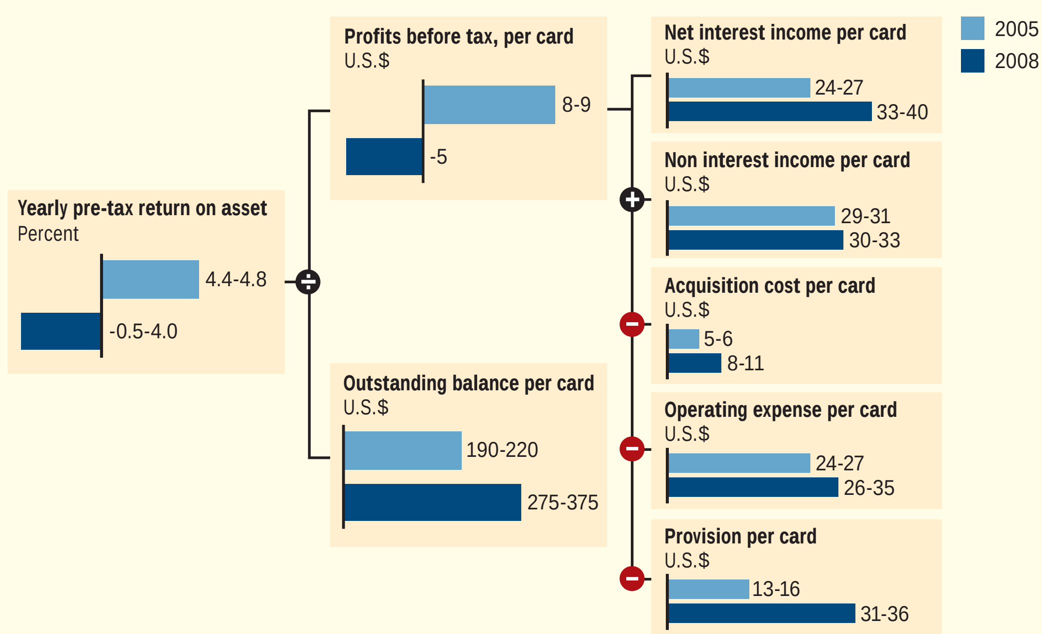
at 7 percent or more and its credit cycle will improve by 2010.

- **Capture and retain government flows through e-solutions:** India's government entities represent a major revenue pool. Derived largely from transaction fees and float, it is projected to reach $1.8 billion by 2015. Notably, RBI is India's central and state government banker, so deposits do not generate interest revenue. Integrated government plays involving tax collection, payments, payroll services, e-procurement and e-payments can be significant revenue sources. Private players, such as Axis Bank, have aggressively developed e-solutions for government entities that enable paying state taxes, duties and utility bills at citizen service centers. Banks could also target the payment needs of local and quasi-government entities by offering customized cash management services, including e-solutions for tax collection, vendor payments and liquidity management.
- **Grow cash management fees:** Cash management generates more than 25 percent of corporate banking revenues, mostly through float. But as noted earlier, electronification will decrease float income, thereby causing bankers to revise their cash management offerings and related fees. Expect this to affect corporate customers for whom institutions have already initiated fixed charges on outstation collections and check processing to offset reduced float income.

Among the small, but rapidly growing, opportunities we include debit cards, prepaid cards and non-resident flows. These commonly require business model innovations – especially in distribution and product portfolios – to capture the anticipated growth. They also demand a willingness to invest for the medium-to-long term. Such approaches include:

- **Promote debit cards:** India has 110 million issued debit cards, of which about 20 percent are active. State-owned banks issued most of these and should be expected to encourage their use. Banks will also strive to minimize branch costs through customer migration and to grow fee income through interchange, thereby enabling debit card revenues to reach $2 billion by

Exhibit 4
Credit card industry economics are under pressure



Source: Financial Services 360; Credit Card Benchmarking Survey 2008; McKinsey analysis

2015. However, POS terminal penetration will need to grow in parallel. We expect the number of terminal-equipped merchants to reach 1.6 million by 2015, a four-fold increase. The entry of specialist acquirers could drive this change. Union Bank, Corporation Bank, and others have already announced partnership plans to aggressively deploy merchant terminals. RBI's recent announcement to allow cash payments and withdrawals at merchant POS terminals will likely spur these efforts even further.

As India's economy gains speed, opportunities will proliferate. Look for banks to pursue revenues and profits across the payments spectrum, including sectors they have yet to tap.

- **Pursue prepaid card and wallet innovations:** While prepaid products produce only $2.5 billion of India's payment flows, product innovation could well cause flows to grow at a 20 percent CAGR through 2015. Offerings could include retail merchant partnerships, online payments, corporate payroll and reimbursements, and foreign travel and remittances. Consumer and merchant convenience along with acquisition-fee avoidance will stimulate growth in prepaid, which still will represent just 5 percent of consumer electronic flows, consistent with other markets.
- **Capture nonresident flows end-to-end:** Inbound international remittances should grow about 10 percent annually, to $95 billion by 2015, despite an anticipated brief decline in 2009. Growth will largely come from non-resident Indians who have substantial homeland interests, but reside in the U.S., the U.K., Canada, Singapore or the Middle East. Success in this arena will require broadening customer acquisition networks at each flow end, offering convenient technology platforms, and enhancing customer service. This opportunity also extends beyond remittances. For example, offering personal financial services, easy transfers and exchanges, and other investment-related services could provide increased appeal to this frequently overlooked, yet lucrative, business segment. (For more on remittances, see "Winning approaches to the cross-border remittance market," *McKinsey on Payments*, June 2009.)

Many market participants will also pursue opportunities that promise high revenue potential, albeit with less certainty of success, such as mobile payments and technology-based financial inclusion. These require willingness to take greater risk, being prepared to endure associated losses, and an ability to innovate continuously.

- **Launch mobile payments:** India's people hold about 27 million credit cards, with approximately half being active. However, they also own 300 million mobile phones, all of which are active. More important, the industry expects the number of mobile phones to double in the next seven years, making the potential for mobile banking and commerce substantial. Mobile banking alone could grow dramatically in phone and direct-to-home time replenishments, as well as in non-proximate transactions. Indeed, mobile payments could become one of India's fastest growing payments opportunities. (For more on mobile payments, see "Mobile payments: Ringing louder," *McKinsey on Payments*, April 2009.)
- **Extend reach with new technologies:** Smart cards and mobile phones provide new channels for reaching unbanked rural and urban households. Several government entities are experimenting with smart cards to route payments of the government's flagship National Rural Employment Guarantee Scheme to rural labor. Meanwhile other players intent on reaching this largely untapped market are testing new products linked to mobile channels.

A wealth of opportunity and risk

As India's economy gains speed, opportunities will proliferate. Look for banks to pursue revenues and profits across the payments spectrum, including sectors they have yet to tap. Publicly held banks will increasingly implement new payment technologies to reach unbanked consumers. And global banks, given their international experience, will find cash management and non-resident Indian flows especially attractive. While the abundance of opportunities is enticing, it is also important to acknowledge that some players will likely struggle and endure the substantial losses that new markets often exact.

Non-bank financial firms, meanwhile, will pursue segments where the regulatory environment allows them to compete, such as credit cards, or areas where banks are less well entrenched, such as prepaid cards. Reliance, Tata and other retailers already leverage their franchises by offering credit cards.

Growth in mobile payments will create numerous opportunities for telcos and device manufacturers to partner with banks, thus creating winning propositions for both. In such partnerships, banks will probably hold the customer franchise given India's regulatory environment, while telcos and device manufacturers serve as the backbone and distribution arm.

Growing pressure to improve stand-alone acquiring economics could create important opportunities for global financial firms to establish beachheads here. ICICI's decision to spin off its acquisition business is a step in that direction. And payments electronification growth will open many doors for firms that develop, market and support related technologies.

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India is an immense and extremely unique market with a nascent payments industry that seems poised for dramatic growth. As opportunities flourish, success will make its usual demands – execution excellence, controlled risk-taking, innovative distribution and careful customer relationship management among them. More importantly, however, it will demand solid understanding of the aspects that truly distinguish this market from others and a genuine openness to innovation and building strategic alliances. The strategies and actions of participants and entrants will together define the contours of this rapidly emerging payments market.

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