SAMI Consulting

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Scenarios for India and China 2015: Implications for the City of London

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Foreword

Michael Snyder
Chairman, Policy and Resources Committee
City of London

The City of London Corporation has long recognised the critical importance of China and India, both to the world economy at large, and to the international financial services industry which raises the capital, provides the advice and facilitates the trading on which that economy so heavily depends. It was for this reason that we funded the establishment of City Representation in Beijing, Shanghai and Shenzen over the past year, and that we are now establishing representation in India. This representation, operating under the "City" brand, is intended to promote UK-based financial services in China and India, to facilitate the business development of City firms by providing support for their visits to these countries, and to support Indian and Chinese companies in working with the City.

This research report represents another part of our contribution to matching the established expertise of UK financial services with the opportunities and challenges of the world's largest and most vibrant emerging markets. The report has a number of unique features.

First, it is built around an exercise in scenario analysis. Three alternative visions of the possible development of each country up to 2015 and how these might produce changes in the relationship of each to the rest of the world were constructed by our consultants, St Andrews Management Institute and Oxford Analytica. Each set of scenarios consists of a base case in which the current pace of growth is maintained, and alternative cases in which change is either retarded or accelerated by the interplay of economic forces and political developments.

Second, the scenarios were explicitly constructed to examine the scale and nature of financial services developments that each would produce and to assess the opportunities and challenges that could arise for the City as a global provider of all of the major types of financial services and products.

Finally, the research was carried out by asking the City itself what it thought of these visions of the future. India and China, although often bracketed together, differ significantly on a range of dimensions arising from their very different political and economic histories and attitudes to the future. Three day-long seminars were held at which a wide range of practitioners discussed the potential rewards and risks that each scenario might produce, and offered informed opinion on how their businesses might be developed or affected.

Given the range and scale of possibilities, and the many uncertainties that attend them, these conclusions are complex. If there is one overriding theme, however, it is that China and India will present significant possibilities for business that the City simply must do everything it can to capitalise upon. Equally, both India and China have much to gain through a closer relationship with the City. I commend the report to all interested parties as an essential contribution to understanding exactly how these possibilities could evolve, and how they might be exploited.

Michael Snyder
London
October 2006

Executive Summary

- India and China are two vast, diverse, economic systems, both containing a number of distinct economic sub-systems. **The countries are often bracketed together but differ significantly on a range of dimensions, arising from their very different political and economic histories and attitudes to the future.** India's democratic heritage makes regulatory systems overt and recognisable; China's communist legacy makes issues of regulation more arcane and harder to discern. Notwithstanding these very different backgrounds, both countries have exhibited strong economic expansion over recent years.

- This report on the impact of India and China on the future of financial services in the City of London is based on specifically developed scenarios for India and China to 2015, which were used as the basis for consultations across the City. The scenarios for each country – which are detailed fully in the report – describe three plausible scenarios for both India and China: the development of existing trends, as a baseline; a revolutionary scenario, in terms of accelerated change; and a scenario of instability and difficult adjustments. While the methodology of scenario development was common to each country, the scenario outcomes are distinctly different.

- **All scenarios see positive rates of economic growth for both countries over the next 10 to 15 years, and at an average annual rate which will probably exceed that of both the US and the EU, but not necessarily a smooth one.**

- **Both societies have embarked on major economic expansion that poses substantial challenges to existing political and social structures.** Thus, careful navigation through the cross currents of societal evolution is required for financial services and other organisations wishing to maximise opportunities and minimise threats during transitional phases. **Throughout the momentous changes in both countries, it should be remembered that the cultures of both India and China seek continuity, pointing to a need to be patient in developing and nurturing links and relationships in India and China.**

- **Both India and China have much to gain from closer relationships with the City, which can provide valuable expertise and expedite necessary financial transactions for the development of both the corporate and personal sectors in the two countries, to the benefit of all parties.**

- **China has been in the headlines for several years as an economic powerhouse; India has had a lower profile but is becoming increasingly recognised as attractive.** Organisations from a range of competitor countries have already taken initiatives and the field is growing. It is vital that the City seizes the fast-emerging opportunities ahead of others if it is to establish a strong competitive position in these two countries.

- In analysing and prioritising the financial services opportunities in India and China, a fundamental point needs to be emphasised: there is an important difference in the financial structure of the two countries. **India has too little capital**; it has a heavily leveraged economy, access to finance is quite costly, and it has a relatively greater need for foreign capital than China – particularly for infrastructure investment. **China's exceptionally high savings rate and positive trade balance provides abundant capital,** and has had the advantage of extensive foreign investment, **but there is inefficiency in capital allocation.**

- **India has a more stable banking system – both in terms of the institutions themselves as well as the regulatory system. The Chinese banking system is burdened by its links to the State-owned Enterprises (SOEs), which continue to be heavily subsidised.** Major banking reform and liberalisation are overdue. They are pre-requisites for longer-term economic progress, and are likely to open up a variety of new opportunities in banking and other financial services, including through joint-venture and use of technology, such as the internet, that can facilitate long-distance communication and interaction. India appears to be taking steps to address some current regulatory concerns, whereas the system in China remains somewhat opaque.

- **There is evidence of Chinese multinational companies (MNCs) moving up the value-chain**, from basic manufacture and assembly. At the same time, **Indian MNCs are also expanding rapidly**, and in this respect India has an advantage in that its current financial services linkages have developed ahead of those of China. International banks are able to offer a bundle of services in both these cases and the City banking sector needs to be aware of the need to ensure it captures a significant share of these opportunities. Such activities include providing corporate banking services, trade financing for Chinese and Indian expansion overseas, and possible listings on AIM or London Stock Exchange (LSE).

- **In China, the state no longer provides a comprehensive lifetime employment and social security system for its citizens**. The change in expectations by Chinese citizens – particularly in the context of China's ageing population – provides huge opportunity in the field of pensions under all scenarios.

- **The non-life insurance business in China finds it difficult to attract capital as the very high rate of Chinese savings is mostly directed at life insurance.** This needs to be monitored closely for any propensity for change and emergence of new opportunities for foreign players, given the shift in state support for citizens and business.

- Further specific opportunities in China are likely to be in capital markets and financing – including debt and equity, and project financing; wealth management for individuals; and consultancy, advisory and regulatory services.

- **The Indian insurance market is still protected by trade barriers**: **when they are reduced or removed**, the result will be a battle for market share, with state and private sector companies possibly going under. This **rationalisation and restructuring may create opportunities for new players** – providing both opportunity as well as competition for the City since Indian insurance companies are already competing with the US on complex products such as litigation, product recall and medical malpractice insurance.

- In India, further specific opportunities are first in FDI, particularly in India's established success stories such as the IT, pharmaceuticals and media sectors, and also possibly in the emerging biotech industry; and secondly in providing retail financial services products for the middle class's banking, insurance, pension and mortgage needs.

- **Both countries – particularly India – are creating a well educated labour force with highly trained graduates**. This represents an opportunity for international financial services institutions to recruit local expertise. Conversely, a threat may come from the use of local expertise to establish a separate rival indigenous financial services industry that shifts the balance of global services towards Asia. This threat is more likely to come in the first instance from China, which under certain scenarios could start to develop as a major Asian financial hub. It cannot, however, be ruled out that Indian expertise in financial services may be the foundation for longer-term success compared to China, particularly given India's growing IT expertise.

- **In principle, both countries are rich with opportunity – but also with risk**. The scenarios contain examples of each in both countries. In fact, the risk profile is different between the two countries, and is driven largely by the risk emanating from the respective governments, in terms of changes in the pace and/or direction of policy. The main opportunities are for the City to capitalise on its strengths: its reputation; the agglomeration of business services including, but not limited to, financial services; its global expertise, reach and quality of management; and above all, its drive for innovation.

- There will also be opportunities in the dislocations that could impede the smooth path of expansion. Such opportunities may include offering a safe haven for funds of indigenous investors and companies; providing expertise in moving money in difficult times; and also being a proven source of probity in a turbulent political world.

- Perhaps the surprise conclusion to emerge from this study is **the strong perception that the attractiveness of India as a business partner has been underestimated by financial services organisations.** While its role as a supplier of back office services, software and call centres is well established, India has a number of significant advantages over China and other countries, such as embedded English language skills; shared legal/commercial culture; democratic government; and a significant Indian business community in the City and other parts of the UK.

- The main threat that has been identified from the explosive growth of China is the potential for disruption of world trade – with competition for raw materials in the short-term and in due course for heightened international trade tensions and strife.

- Hence, a number of the implications and potential action areas that follow are focused on ways in which the City can act as an "honest broker" and provide informal as well as formal links across the cultural divide, to reduce the likelihood of potential disruption threatening global stability.

Implications and Potential Action Areas for the City

(a) India

- There are an estimated one and a half million people of Indian descent living in the UK, including a large number of Indian entrepreneurs who could potentially facilitate trade between the UK and India. India shares a common language and institutions, such as legal and property systems, with the UK. This should provide an invaluable platform for building financial services business in India based on City expertise, also taking advantage of established frameworks such as the Indo-British Partnership, Trade Associations and Alumni networks. Hence, **the City should be more active in seeking to establish links with the Indian business community, and with Indian companies operating internationally, to build financial services links, particularly insurance, banking, legal services and public private partnerships (PPP).** At present, Indian business networks appear to co-exist with those of the City, but are not necessarily as well connected as they should be. Building such links would offer significant business potential for the City.

- India's economy embraces a large internal regional diversity, and these regional differences are likely to persist under all scenarios. In some cases, the particular policy variances among the respective regions of India could have a significant impact on the way in which opportunities and threats play out for specific business initiatives. **It is vital therefore, for financial services organisations to be alert to these regional divergences when developing strategies for India, and not focus narrowly on the traditional financial centres of Mumbai and Bangalore.** Judicious selection of regional – as well as sectoral – investments is crucially important as a means of managing financial risk.

- Each of the scenarios for India, suggest a different strategy for investment. Some opportunities, however, span all scenarios. These are investment in infrastructure; wealth management for individuals; a wide range of consultancy and advisory services; and back office, IT and call centre services. While many of these opportunities present no surprises, it will be important that the early indicators described for each scenario are monitored regularly to prioritise the emerging opportunities and discern potential risks.

- **City institutions need to identify Indian MNCs of high potential and start to form relationships**, given the potential opportunities to offer trade and export finance; merger and acquisition (M&A) services; corporate banking and finance; stock exchange listings; and corporate development services. Such one-to-one relationships might well assist in the broadening of contacts with the Indian business community as a whole, to beneficial effect.

- **The scenarios that have been developed for India all point to** the considerable need for physical infrastructure (power, transport, water and habitation); and yet India suffers from capital shortage, pointing to **significant opportunities ahead for project financing in general.**

- A key infrastructure question is how India will be able to provide sufficient energy to underpin growth, particularly given global pressure on energy supplies and the fact that the country's lack of indigenous finance is one of the major Indian constraints. **Opportunities exist to capitalise on City expertise in areas such as commodities trading, energy futures, carbon trading and, again, project finance.**

- Off-shoring to India has been an important cost-reduction tool for a number of City financial services businesses, assisting them in maintaining overall international cost-competitiveness. There is also the prospect, in one of the Indian scenarios, that India's success will drive local costs to a level where this off-shoring process in turn moves from India to other lower cost, less developed countries (see section 4.3). While at one level this would have significant implications for the recent wave of financial services off-shoring to India, it is also likely to be accompanied **by the emergence of new opportunities further up the value chain – in privatisation, private finance initiatives (PFIs) and foreign exchange markets; and listings on AIM or the LSE.**

- This prospect might offer a way of involving the Indian diaspora in the development of Indian financial services. Such involvement could open the way to greater FDI by the diaspora in onshore financial services.

(b) China

- While China has long been on the UK commercial radar screen (The China-Britain Business Council has been in existence since 1954), **many other countries have been more pro-active in developing links with China** and the wider international Chinese community. The importance of building long-term relationships cannot be over-emphasised. **City financial services organisations should seek to develop direct links with the Chinese community and Chinese organisations, drawing Chinese representatives more closely into their various networking circles.**

- It should be recognised that China's huge economy embraces a large internal regional diversity, which will persist under all scenarios. Policy variances among the respective regions of China could have a significant impact on the way in which opportunities and threats play out for specific business initiatives. **Financial organisations should be alert to these regional divergences when developing strategies, and not be over-influenced by the traditional perspective from the eastern seaboard of China.**

- **Chinese MNCs are moving up the value chain**, towards undertaking product design and development and branding their own products, in part by means of international acquisitions. **It is essential that City businesses identify and establish links with such companies to provide services in export finance; M&A; stock exchange listings; and other corporate services**. Such links might well lead to the development of a wider set of beneficial relationships with this expanding group of companies.

- China's companies have used the Hong Kong Stock Exchange for an "international" listing, but there are increasing numbers of companies coming to London, particularly to the AIM. This trend is important to the City in building ongoing links.

- **China's ageing population is no longer protected by comprehensive state employment and social security provision, and in all scenarios will be looking for savings vehicles allied to personal and company pensions.** The City has undoubted expertise both in designing pensions schemes, and in adjusting investment portfolios to the changing circumstances of scenario evolution. **The City should urgently investigate this huge opportunity and exploit it.**

- As China faces enormous challenges from pollution of air, water and land from coal burning, chemicals and other sources, **opportunities will arise for City institutions to assist in the search for solutions, not only through the provision of finance, but also in the development of turnkey solutions, involving innovative pricing and funding packages, including PFI.** This could provide a model that could be extended to other infrastructure projects.

- Opportunities could arise in privatisations; and in retail services for the middle class. There also needs to be awareness of possible down-stream implications of the opening up of the Chinese securities markets. This could stimulate direct competition, particularly in the Asian arena, from an increasingly strong and sophisticated Chinese financial services sector, whether it be focused exclusively on Shanghai or through a number of financial centres from Beijing to Hong Kong.

- **China is undoubtedly seen as a big opportunity of high growth and high potential; yet one with more inherent risks because of its potentially unstable political culture and the potential for future international trade friction.**

- **Moreover, China does not yet have robust systems of regulation and legal and intellectual property protection – and certainly not of enforcement.** It is vital that financial services organisations be alert to the possibilities of transfer of intellectual capital that might ultimately strengthen potential competitors. Continued strong focus on risk management and strategic and operational flexibility will be paramount.

(c) City Competitiveness

- Nearly half of all skilled worker visas issued annually by the US are granted to Indians, giving an indication of the size of the two-way flow of skilled workers – into the US, and potentially back to India. These skilled workers will be inclined to look to US sources for financial services when they return to India. Similarly, the flow of skilled workers from China to the US is smaller but still about 50,000 per year, with possibly similar results in terms of preferred sources of financial services. Hong Kong and Singapore are also both internationally recognised sources of financial services, with predominantly Chinese staffing. The conclusion from this brief analysis is that the UK is not necessarily the only or even first choice for Indian or Chinese organisations looking for financial services, and that **the small contribution to UK financial services balance of payments from India and China will not increase substantially without focused attention from UK companies.**

- Labour flexibility is an important aspect of the attractiveness for firms to locate in the City and will enhance the City's image as a place where modern firms come to do business. It was suggested by study participants that a number of the large European financial services firms have located major operations in London owing to the greater flexibility of labour and other markets in the UK, and the greater ease of adjusting to structural or cyclical market change. To this end, **the City should continue to lobby the UK government to maintain the UK's advantages of labour flexibility, particularly against the background of developments in EU legislation.**

- **Another important aspect of the City's reputation is that of its pre-eminence in the area of financial regulation. It is vital that this is not weakened** and that the City does not move from principles-based standards and regulation to a rules-based model such as that of the SEC. **The major City financial institutions and regulatory bodies have a key role to play here. They also have a role to play in advising on the development of enlightened regulatory frameworks in India and China.**

- The essential importance of business networks has already been noted for both India and China. Further, given the key role of alumni loyalties, the City should actively support the universities in London in their continuing initiatives to develop relevant and attractive Undergraduate, Masters and Doctoral programmes in financial services topics. There is much scope to develop bi-lateral links with Chinese and Indian universities, and to develop courses not only for Indian and Chinese students wishing to work in the City – or other Western financial centres – but also for those wishing to return home to work, where appropriate skill sets need to take account of local structures and regulatory environments.

- The growth in Islamic banking may become a significant factor in exploiting Indian markets, where Muslims constitute over 13% of India's population. **The potential growth of alternative financial centres such as Dubai could be addressed through such initiatives as the City being more proactive in offering Islamic banking schemes, perhaps also supporting centres such as Dubai.**

- A major strength of the City, as has been emphasised throughout this study, is not so much in the provision of specifically-focused financial services but in the capability to bring together a portfolio of business services – legal, regulatory, IT, large complex projects (such as infrastructure and urban construction) – and in the development of new and innovative products. The City should consider actively developing and marketing this portfolio view.

- Within the scope of this study, it has not been possible to develop a detailed sector by sector analysis of the City's financial services under each scenario for India and for China. **All City organisations need to be alert to the nature of the competitive threat and the opportunities that could arise in their own sub-sectors and local markets**, owing to the overseas activities of Indian and Chinese MNCs and other businesses. **Indian companies have links with the US and Dubai, and Chinese companies have links with the US, Singapore and Hong Kong. To counter this threat, City companies will need to seek out and develop long-term relationships with people at all relevant levels within the Indian and Chinese financial and business communities.**

- **Success in capitalising on opportunities in the Indian and Chinese markets will increasingly require skills in Hindi, Mandarin, as well as other local languages.** In China – where Chinese language penetration of the internet is a harbinger of change – Mandarin speakers are the majority of the population, but 86% of the population also speak regional Chinese dialects. In both India and China, the middle class represents only about one-fifth of the total population; even in the middle classes, skills in the English language are unevenly spread.

- London already has a huge advantage with the Indian and Chinese diaspora, but this does not yet appear to be fully recognised. It needs to be developed and harnessed. The Task Force set up by the Chancellor in March 2006 to "co-ordinate London's development as a financial centre and to promote it overseas" is a very welcome initiative and should be used to develop better cultural understanding and intercommunication.

The City of London Corporation

The City of London is exceptional in many ways, not least in that it has a dedicated local authority committed to enhancing its status on the world stage. The smooth running of the City's business relies on the web of high quality services that the City of London Corporation provides.

Older than Parliament itself, the City of London Corporation has centuries of proven success in protecting the City's interests, whether it be policing and cleaning its streets or in identifying international opportunities for economic growth. It is also able to promote the City in a unique and powerful way through the Lord Mayor of London, a respected ambassador for financial services who takes the City's credentials to a remarkably wide and influential audience.

Alongside its promotion of the business community, the City of London Corporation has a host of responsibilities which extend far beyond the City boundaries. It runs the internationally renowned Barbican Arts Centre; it is the port health authority for the whole of the Thames estuary; it manages a portfolio of property throughout the capital, and it owns and protects 10,000 acres of open space in and around it.

The City of London Corporation, however, never loses sight of its primary role – the sustained and expert promotion of the 'City', a byword for strength and stability, innovation and flexibility – and it seeks to perpetuate the City's position as a global business leader into the new century.

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CITY OF LONDON