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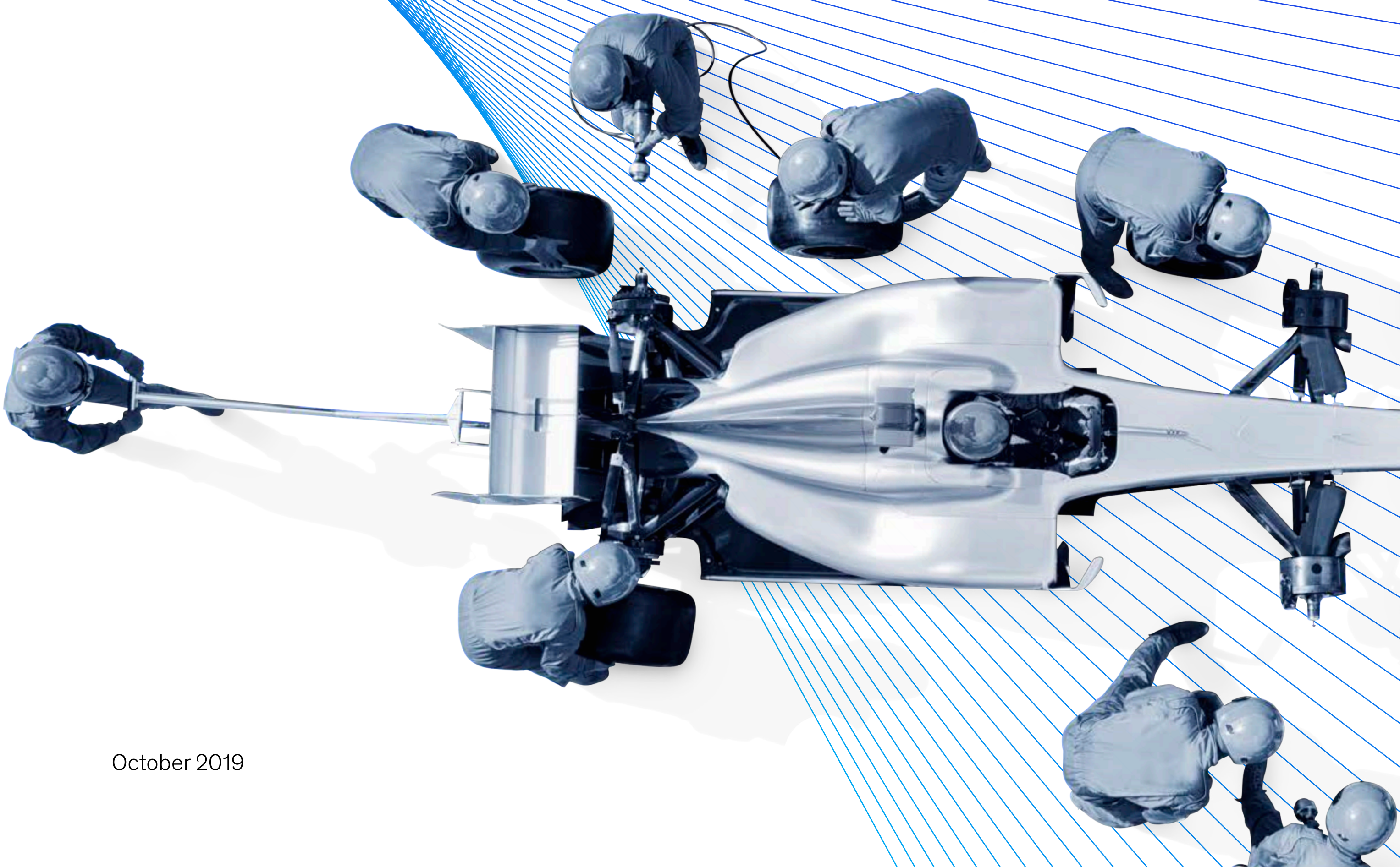
The last pit stop? Time for bold late-cycle moves

McKinsey Global Banking Annual Review 2019



October 2019

Content

Executive summary

What explains the difference between the 40 percent of banks that create value and the 60 percent that destroy it? In short, geography, scale, differentiation, and business model.

A decade on from the global financial crisis, signs that the banking industry has entered the late phase of the economic cycle are clear: growth in volumes and top-line revenues is slowing with loan growth of just four percent in 2018—the lowest in the past five years and a good 150 basis points below nominal GDP growth. Yield curves are also flattening. And, though valuations fluctuate, investor confidence in banks is weakening once again.

Industry veterans have been through a few of these cycles before. But, notwithstanding the academic literature,[1] this one seems different. Global return on tangible equity (ROTE) has flatlined at 10.5 percent, despite a small rise in rates in 2018. Emerging market banks have seen ROTEs decline steeply, from 20 percent in 2013 to 14.1 percent in 2018, due largely to digital disruption that continues unabated. Banks in developed markets have strengthened productivity and managed risk costs, lifting ROTE from 6.8 percent to 8.9 percent. But on balance, the global industry approaches the end of the cycle in less than ideal health with nearly 60 percent of banks printing returns below the cost of equity. A prolonged economic slowdown with low or even negative interest rates could wreak further havoc.

What explains the difference between the 40 percent of banks that create value and the 60 percent that destroy it? In short, geography, scale, differentiation, and business model.

On the first, we find that the domicile of a bank explains nearly 70 percent of underlying valuations. Consider the United States, where banks earn nearly ten percentage points more in returns than European banks do, implying starkly different environments. Then comes scale. Our research confirms that scale in banking, as in most industries, is generally correlated with stronger returns. Be it scale across a country, a region, or a client segment. Having said that, there are still small banks with niche propositions out there generating strong returns, but these are more the exception than the rule. Underlying constraints of a business model also have a significant role to play. Take the case of broker dealers in the securities industry, where margins and volumes have been down sharply in this cycle. A scale leader in the right geography as a broker dealer still doesn't earn cost of capital.

Domicile is mostly out of a bank's control. Scale can be built, though it takes time; attractive acquisitions and partnerships are currently available for most banks. But on their individual performance irrespective of scale or business model, banks can take immediate steps to reinvent themselves and change their destiny, inside the short window of a late cycle. Three universal organic performance levers that all banks should consider are risk management, productivity, and revenue growth. All while building the talent and the advanced data analytics infrastructure required to compete.

[1] Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly,* Princeton, NJ: Princeton University Press, 2009.

Worldwide, risk costs are at an all-time low with developed market impairments at just 12 bps. But just as counter-cyclicality has gained prominence on regulators' agendas, banks also need to renew their focus on risk management, especially the new risks of an increasingly digital world. Advanced analytics (AA) and artificial intelligence (AI) are already producing new and highly effective risk tools; banks should adopt them and build new ones. On productivity, marginal cost-reduction programs have started to lose steam. The need of the hour is to industrialize tasks that don't convey a competitive advantage and transfer them to multi-tenant utilities. Industrializing regulatory and compliance activities alone could lift ROTE by 60 to 100 bps. Finally, on generating elusive revenue growth, now is the time to pick a few areas—client segments or products—and rapidly reallocate top customer-experience talent to attack the most valuable areas of growth and take share as competitors withdraw and customer churn increases late in the cycle.

What's the right next step? Every bank is uniquely bound by both the strength of its franchise and the constraints of its markets or business model. Using these two vectors, we've identified four archetypes that banks around the world can use to identify their starting positions and develop their late-cycle priorities:

Market leaders. Twenty percent of banks globally capture almost 100 percent of the economic value added by the entire industry. These at-scale banks typically serve a large share of a geography, region, or customer segment and operate in favorable market conditions. Their clearest imperative is to reinvest capital and resources intelligently in innovation and further scale for the next cycle.

Resilients. Nearly 25 percent of banks have maintained leadership in challenging markets, including many in Europe. Resilients should focus on expanding beyond their direct set of customers and products through ecosystem plays and differentiating further through innovation.

Followers. About 20 percent of banks have not achieved scale, and are weaker than peers, despite favorable market dynamics. They are at risk from a downturn and must act promptly to build scale in their current businesses, shift business models to differentiate, and radically cut costs.

Challenged banks. About 35 percent of banks globally are both sub-scale and suffer from operating in unfavorable markets. Their business models are flawed, and the sense of urgency is acute. To survive a downturn, merging with similar banks or selling to a stronger buyer with a complementary footprint may be the only options if reinvention is not feasible.

Risk costs are lower than ever, and yet 60 percent of banks destroy value. That's a poor state of affairs in which to enter a downturn and it calls for bold actions. This is likely the last pit stop in this cycle for banks to rapidly reinvent business models and scale up inorganically. Imaginative institutions are likely to come out leaders in the next cycle. Others risk becoming footnotes to history.

This report is based on data and insights from McKinsey Panorama, McKinsey's proprietary banking research arm, as well as the experience of clients and practitioners from all over the world.

“...rather than depend on forecasts of the future, we depend on reading the present. I believe one of the greatest predictors of what the market’s going to do … is where it stands in the cycle.”[1]

Howard Marks, Oaktree Capital Co-founder

The late cycle: Welcome to uncertainty

This time the breadth and depth of the slow-down signal that we have entered the final stages of the economic cycle.

Economic forecasts often miss their target, but Howard Marks reminds us that knowing where we stand today can help us understand the balance of probabilities for the future. As the recovery from the global financial crisis completes its tenth year, the signs of decelerating growth across the world are unmistakable. That, along with declining operating performance and corrections in valuations, points to what many would call "late-cycle" trends. To quote Fidelity's Market Insights report, "the economy looks like it may be approaching its late cycle phase, which is typically when growth slows, inflation rises, […] and the yield curve flattens, meaning the gap between short- and long-term rates shrinks."[2] From the evidence we see, it definitely feels "late cycle" for the banking sector.

To be sure, there have been some downturns during this decade-long recovery, but this time the breadth and depth of the slowdown signal that we have entered the final stages of the economic cycle. To build momentum and power through rising headwinds and uncertain currents, banks must take a hard look at where they stand in the competitive landscape and assess both the constraints and opportunities that arise late in the cycle, with attention to how structural factors affect business lines and geographies differently.

Emerging late-cycle trends increase uncertainty

While growth over the past decade was slower than prior to the global financial crisis, the pace has picked up a bit recently, as banks repaired balance sheets and took advantage of low

1 "Howard Marks, CFA: Getting the Odds on Your Side," CFA Institute, 19 Feb 2019, https://blogs.cfainstitute.org.
2 Fidelity Market Insights report, "Is it getting late for stocks?"

4.4%

2018 growth in global bank lending, the slowest rate over the past five years and well below nominal GDP growth of 5.9 percent.

interest rates to increase lending volumes. Growth in bank assets is no longer keeping up with growth in nominal GDP, however, and this, historically, has been a turning point for banks as the cycle begins to wind down. In 2018, global bank lending grew by 4.4 percent, the slowest rate over the past five years and well below nominal GDP growth of 5.9 percent. Except for the US, where economic growth remains strong, the expansion of lending volumes is slowing in both developed and emerging markets (Exhibit 1).

Another late-cycle development is faster margin compression. Margins have been declining for some time, but the pace of deterioration has quickened recently. Average margins before risk in developed markets declined from 234 bps in 2013 to 225 bps in 2018, despite rising interest rates in markets such as the US and Canada. In emerging markets, margins fell even more sharply from 378 bps in 2013 to 337 bps in 2018 (Exhibit 2).

More inklings of the end of the cycle come from productivity and risk costs. While the two main levers have served well to increase returns for most of the decade, they have become less effective in recent years. Annual gains in productivity have been more modest since 2016 in both developed and emerging markets, with the average ratio of cost to assets (C/A) as of 2018 reaching 144 bps in developed markets and 129 bps in emerging markets. For the first time in a long while, emerging market banks have made bigger productivity gains, lowering their C/A ratio by 38 bps since 2013, compared to just 12 bps among developed market banks (Exhibit 2).

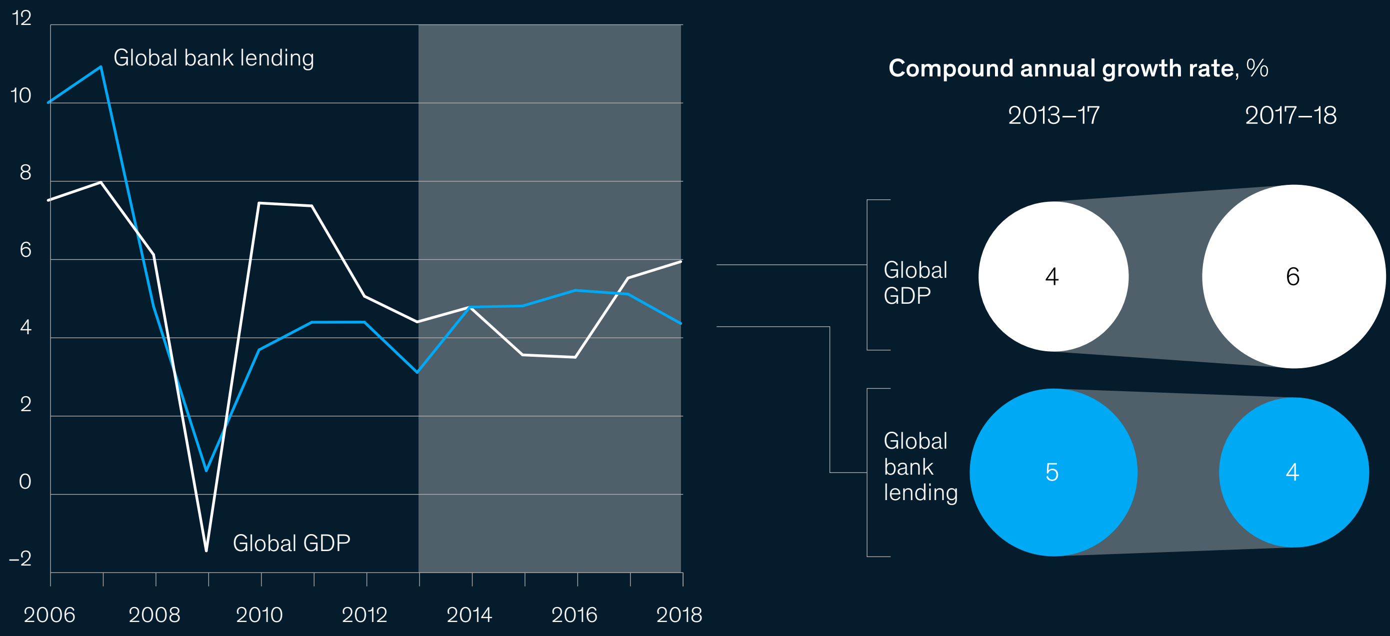
On the risk front, in developed markets the impairment rate of 13 bps is by far the lowest in the past two decades, while the rate of unemployment is also low at 3.5 percent, which suggests that risk costs are unlikely to moderate further. In emerging markets, impairment rates have been hovering around 70 bps since 2015 in line with the long-term average. The deterioration of ten bps in risk cost provisions in 2018 in China—the largest emerging market—is of particular note.

These deteriorating metrics have yet to show up in global ROTE, which has hovered around 10.5 percent for ten years. In the last couple of years, tax cuts and higher base rates in developed markets such as the US have offset the underlying deterioration in operating margins in most other markets. In the meantime, ROTEs in developed and emerging markets continue to converge rapidly, due largely to the erosion of profitability in emerging markets. Thinning margins, declining asset quality, and higher capital needs have pushed the average ROTE for emerging markets down from 20.0 percent in 2013 to 14.1 percent in 2018. Developed market ROTEs, however, have been rising gradually, from an average of 6.8 percent in 2013 to 8.9 percent in 2018. As noted above,

Exhibit 1

The rate of global lending growth has moderated, lagging behind nominal GDP growth in recent years

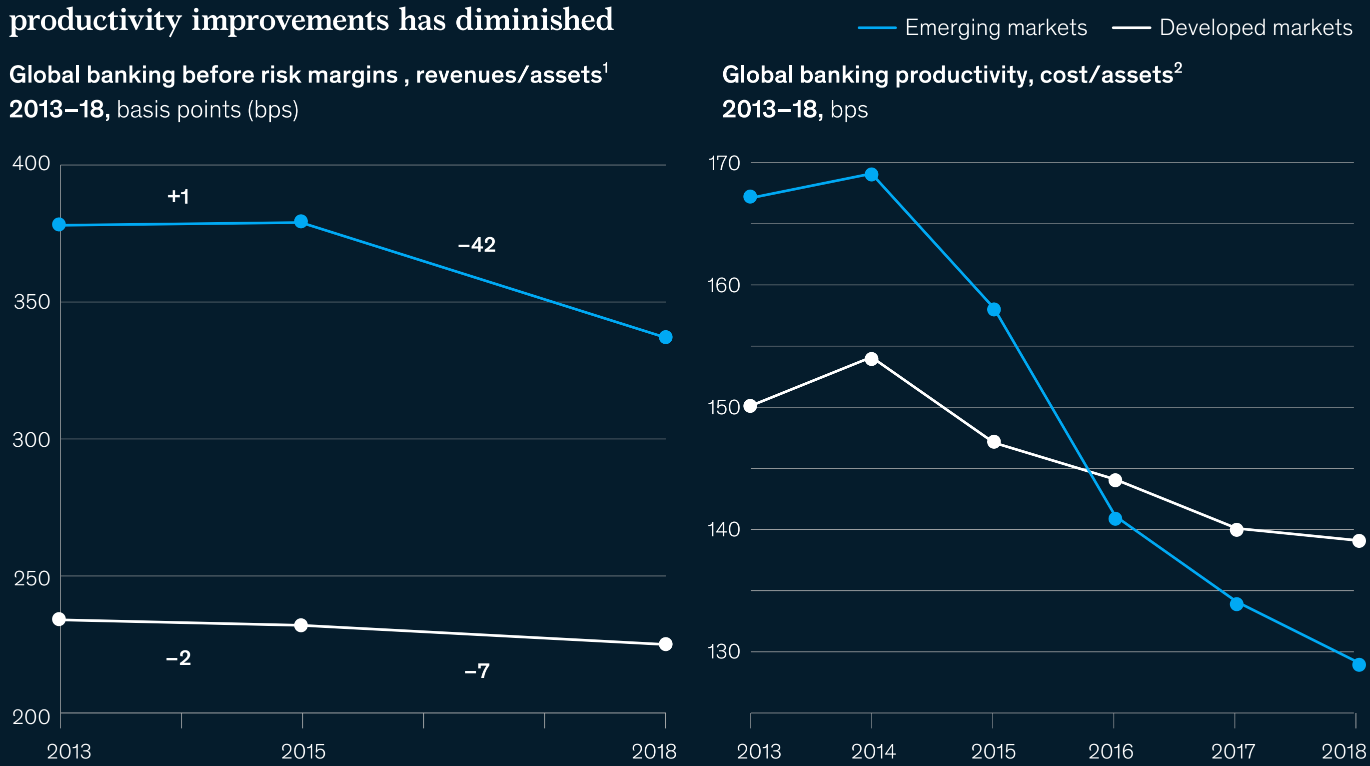
Global bank lending by market and GDP growth rate (2018 constant FX rate), %



Note: Constant foreign-exchange rate (FX) used to remove FX volatility in results. 2018 is an estimate.
Source: McKinsey Panorama, Global Banking Pools.

Exhibit 2

Across all markets, margin contraction has accelerated, while the rate of gains from productivity improvements has diminished

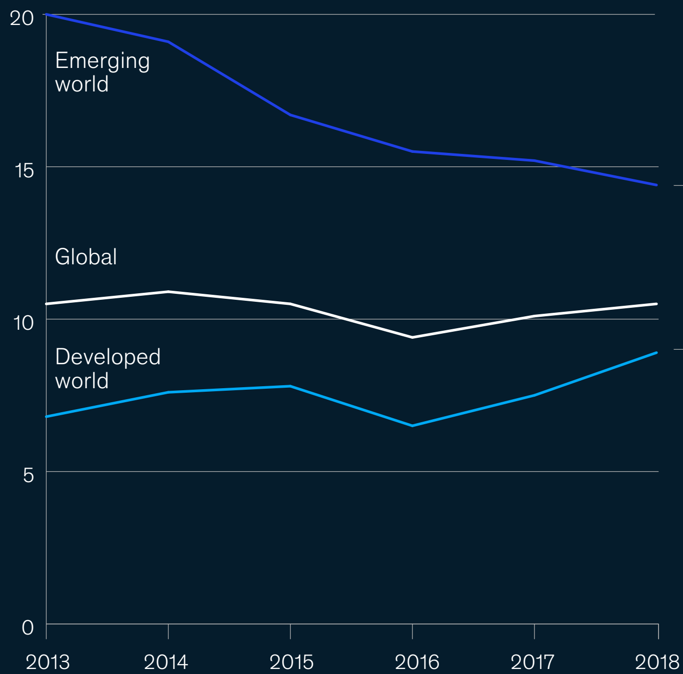


[1]Revenue to average assets, based on a sample of ~1,000 largest banks in terms of assets. [2]Operating expenses over average assets.
Source: S&P Global Market Intelligence; McKinsey Panorama

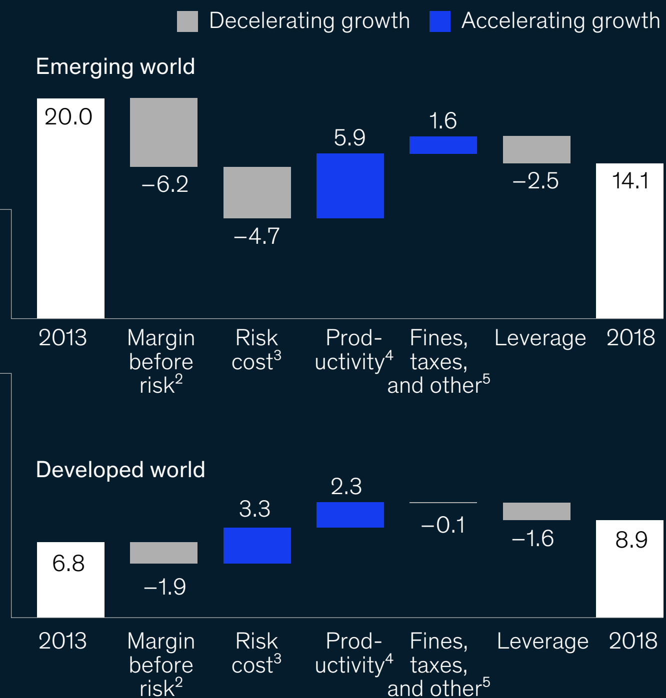
Exhibit 3

Global returns on tangible equity (ROTEs) have flatlined at 10.5 percent since 2013, despite a pickup in yields

ROTE,[1] 2013–18, %



2013–18 ROTE[1] momentum, percentage points

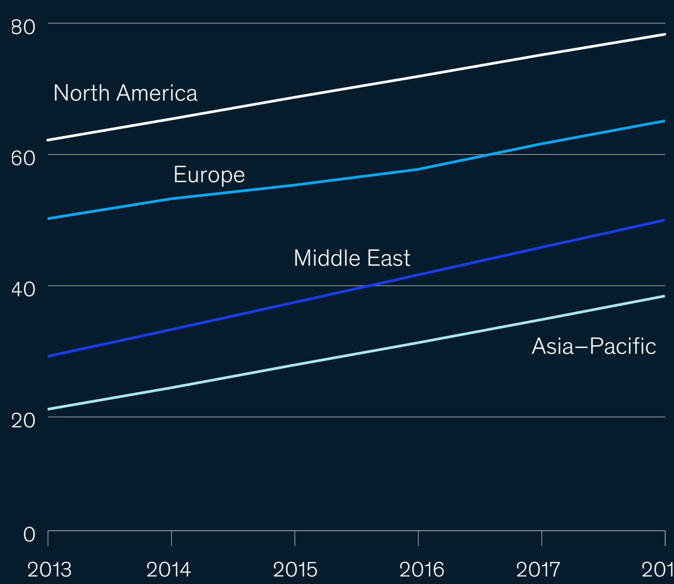


[1]Based on a sample of ~1,000 global largest banks in terms of assets. Profit after tax over tangible equity. [2]Operating income/assets. [3]Impairments/assets. [4]Operating cost/assets. [5]Includes regulator fines, customer redress, impairment of goodwill, gains/losses from discontinued operations, and restructuring charges.

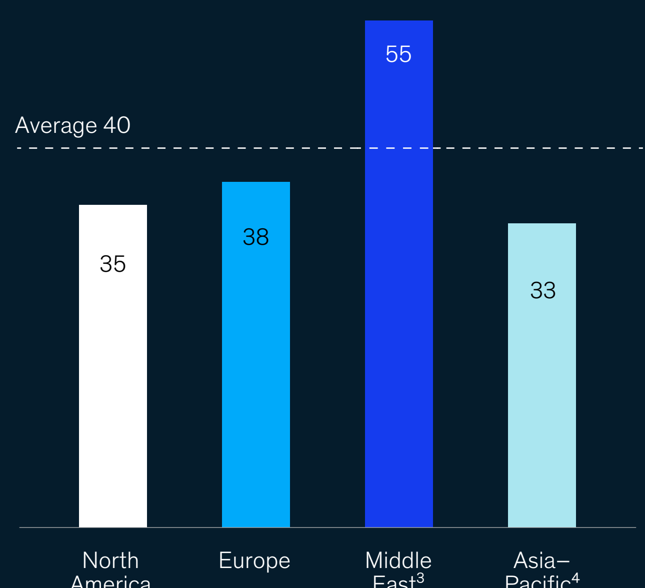
Exhibit 4

Customers increasingly prefer digital channels

Online banking usage rate,[1] 2013–18, % of population



Gap between 'willingness to purchase via digital channels' and 'actual sales behavior' in 2018,[2] %



[1]Share of individuals within bankable population using any internet-enabled device for Internet banking (including desktop, portable or mobile computer, tablets, smartphones, etc.; apps are also included). [2]Consumer survey, responses to question asking: "For the products acquired in the last 2 years, please indicate the main channel you used to buy the product"; % of respondents having bought the product in last 2 years that have done it via a digital channel (selected "Internet Banking", "Tablet Banking" or "Mobile Banking"). [3]Only includes United Arab Emirates. [4]Only includes Australia and New Zealand.
Source: 2018 Retail Banking Consumer Survey (n = 45,000), McKinsey Digital Banking Pools

13pp

average increase across the globe in online banking usage rates between 2013 to 2018

the main factors driving this improvement have been higher productivity and declining risk costs. Within developed markets, however, it has been a tale of two worlds: North America, with ROTEs of 16 percent in 2018, and Western Europe, where even after a 54-bps recovery, banks delivered ROTEs of just 6.5 percent in 2018 (Exhibit 3).

Capital markets are responding to the change in the pace of banks' earnings growth globally with valuations declining between 15 and 20 percent since the start of 2018. The drop in valuation suggests that investors anticipate a sharp deceleration in earnings growth. This outlook is corroborated by earnings forecasts with sell-side analysts modelling in approximately 6.5 percent for the next three years, a far cry from the 13 percent growth seen in the previous four years. In the meantime, with the outlook for interest rates in most markets pointing towards downward revisions, the trajectory of banks' earnings revisions continues downwards.

Late-cycle pressures compounded by ongoing disruption

The digital disruption examined in previous editions of McKinsey's Global Banking Annual Review continues unabated, fueled by structural shifts on both the demand side, through changing consumer behaviors, and supply side, through a growing number of product providers.

The new consumer

Globally, online banking usage rates increased on average by 13 percentage points from 2013 to 2018, and there is room for further growth across all geographies, particularly as consumers' willingness to transact over digital channels exceeds actual digital usage by more than 30 percentage points in many markets (Exhibit 4). Consumers have become accustomed to real-time and personalized services and expect the same of digital banking solutions.

While this behavior is most acutely felt in retail banking and asset management, we are starting to see the same trends emerge in corporate banking as well as in capital markets and investment banking (CMIB). A classic example is a trend within transaction banking where clients increasingly demand a single window and real-time multi-currency multi-asset view of a firm's payments positions with reduced settlement times with each passing year. They also expect banking services to be increasingly linked into their internal finance and treasury functions. Within retail banking, where customer loyalty has traditionally been strong, rates of customer attrition are rising, as digital technology and changing regulations make it relatively painless for customers to change banks. For instance, churn rates for current accounts in the US have risen from 4.2 percent in

2013 to 5.5 percent in 2017, and in France they have risen from 2.0 percent in 2013 to 4.5 percent in 2017.

New standards for propositions

The rise in customer churn rates results not only from changes in customer expectations but also from the superior levels of service offered by new entrants. These new entrants have also benefited from regulatory changes which have lowered barriers to entry, as well as the continued inflow of capital from investors willing to bet on challengers taking a large share of the profit pool traditionally captured by incumbents. These innovative disruptors have been able to offer customer-centric propositions that better meet customers' needs with engaging and intuitive user interfaces, which, in some cases, can connect to other platforms and become part of a broader ecosystem. All the while, bringing pricing down with increasing transparency for the end consumer. For instance, in China, Ping An has built an ecosystem that includes healthcare, automotive, entertainment, and tourism services, while in the US, Amazon offers businesses the traditional banking suite (that is, current accounts, credit cards, unsecured loans), while connecting them to the Amazon ecosystem, which includes non-financial products and services.

A supportive regulatory environment for competition

Regulators in diverse markets are also contributing to disruption in banking, especially as they take steps aimed at increasing transparency and boosting competition by lowering barriers to entry. Among the most disruptive of these initiatives are moves to open access to customer financial data (on consent) to non-bank service providers. These have been a significant catalyst for new competition from technology-oriented entrants. Open banking, one of the most prominent regulatory developments affecting innovation and competition in the banking sector, is at varying stages of adoption in 35 markets (Exhibit 5), relating to products that account for approximately 90 percent of revenue pools in those markets. The UK and parts of Continental Europe already have fully operational open banking regimes; for instance, in the UK, where open banking is being rapidly rolled out, the number of new entrants in the market has increased by 65 percent in the past year alone.

Platform and fintech disruption at pace

The rapid disruption of Asia's banking sector is well known, especially with a swift rise in competition from fintechs and digital platform companies contributing to a sharp deterioration of more than 600 bps in ROTE over the past five years. Developed market banks, wary of the Asian scenario playing out in their home markets, dream of an end to this fintech cycle. However, people's perception of trust towards fintechs and tech companies continues to improve. For example, McKinsey's Future of Banking July 2019 Consumer Survey found that most respondents trust big tech companies to handle their financial needs, including Amazon (65 percent) and Google (58 percent). With this backdrop, it is no surprise that investments in the fintech space grew by 29 percent[3] in 2018, on the heels of 46 percent annual growth since 2014 (Exhibit 6). The challenge for incumbents is intensifying as the fintech landscape also matures, with new rounds of funding shifting towards larger organizations and the number of fintech unicorns globally topping 40 (worth approximately $150 billion).

When we study disruption across industries, there are always clear stages to the lifecycle of a typical attack—from faint signals of experimentation to validated business models to critical mass or at-scale plays. And repeatedly, the reason many incumbents fail, irrespective of their strong ingoing balance sheet and market share, is because of their inability to acknowledge a trend. Conversely, what's the secret of those incumbents that do survive—and sometimes even thrive? One aspect surely relates to the ability to recognize and overcome the typical pattern of response (or lack thereof) that characterizes companies in the incumbent's position. This most often requires acuity of foresight and a willingness to respond boldly before it's too late, which usually means acting before it is obvious you have to do so. The good news is that across many of the banking products highlighted in Exhibit 7, attackers in most markets are still at an early stage. So, if they aren't to go the way of the lodging, travel, or publishing industry, where most incumbents got totally disrupted, those in banking need to act now.

When we study disruption across industries, there are always clear stages to the lifecycle of a typical attack.

[3] Excluding Ant Financial.

Exhibit 5

Regulatory changes continue to lower barriers to entry, with adoption of open banking under way in 35 economies

Economies that have adopted or are adopting open banking

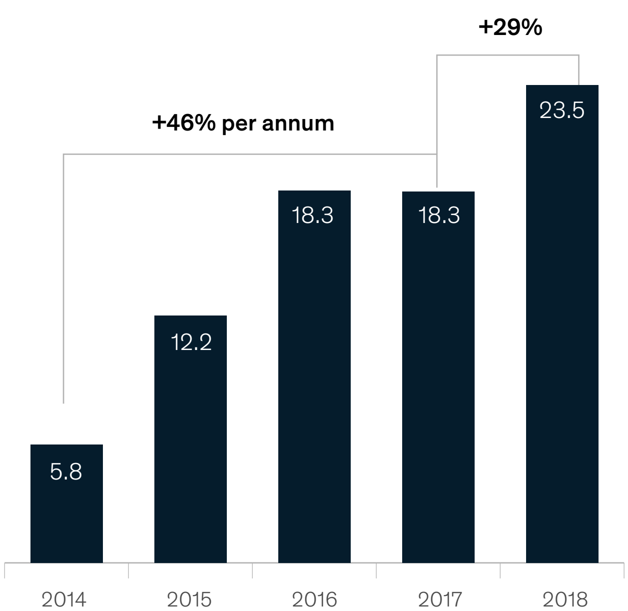
	Stage 1 Initial steps: Industry consultations, draft regulations	**Stage 2** Transpose to national law	**Stage 3** Grant licenses
Regulatory led	Malaysia, United States, Canada, Mexico, Italy, Spain, Netherlands, Norway, Belgium, India, Japan, Australia	Hong Kong SAR China	United Kingdom, Germany, France, Sweden, Finland, Ireland, Czech Republic, Hungary, Denmark
Market led[1]	Mainland China, Thailand, Singapore, Indonesia, South Korea, Switzerland, Turkey, Russia, Taiwan China	Argentina, Brazil, South Africa	United Arab Emirates

[1]Markets in which banks and non-banks lead the move to open banking, with regulators playing a more consultative role.
Source: Press search; expert interviews

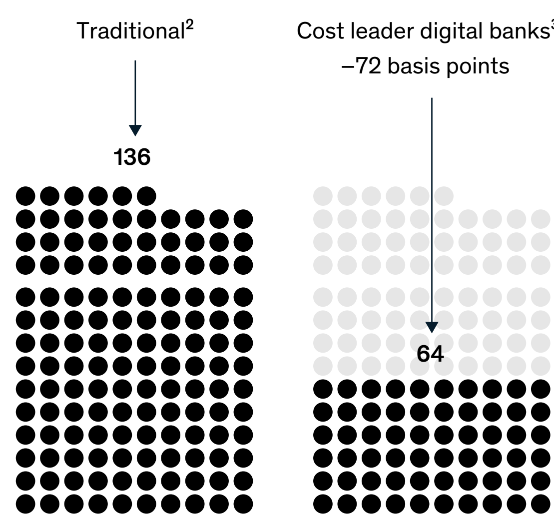
Exhibit 6

Investors continue to fund fintechs globally, while fintechs continue to have a material cost advantage over traditional banks

Global fintech deal funding amount,[1] **2014–18,** $ billion



Operating–expense comparison across banks with different digitization levels, 2018, basis points, operating costs to assets



[1]Excluding Ant Financial. [2]Based on sample of top 1,000 banks' data. [3]Cost leader direct bank peer group includes ING Bank Australia, UmweltBank, Granit Bank, Rakuten Bank, Sumishin SBI Netbank, Sbanken ASA, Gjensidige Bank.
Source: CB Insights; KPMG Pulse of Fintech; McKinsey Panorama Digital Attacker Database & Insights; Reuters; S&P Global Market Intelligence

In developed markets, large technology platform companies have made notable forays into the financial services market. Examples are plenty—from Apple's launch of Apple Card (a credit card albeit issued by a bank) to Facebook's launch of Calibra as a wallet for its proposed cryptocurrency Libra, as well as Amazon's venture into small and medium size enterprise (SME) lending. Exacerbating the situation, fintechs and big tech players are attacking the highest ROTE segments of banking, representing approximately 45 percent of the global banking revenue pool. This will put additional downward pressure on banking ROTEs and cash generation at a time when cash is needed most. Further, as advanced analytics and artificial intelligence continue to improve, digitization of paper-intensive businesses such as mortgages, CMIB, and commercial and transaction banking will increase (Exhibit 7).

The budget challenge to fund innovation and change

The biggest challenge at present for traditional banks is the need to invest in overhauling operating models to compete head-to-head with digital innovators. Both banks and fintechs today spend approximately seven percent of their revenues on IT; but while fintechs devote more than 70 percent of their budget to launching and scaling up innovative solutions, banks end up spending just 35 percent of their budget on innovation with the rest spent on legacy architecture. Another key trend is the sharp variance in IT spending across developed and emerging markets, with developed markets spending approximately three times more as a percentage of revenue. This trend has strengthened over time, with IT spending as a share of revenues in developed markets increasing by 70 bps since 2013, while emerging market spending decreasing by 40 bps of revenues over the same period. It comes as no surprise, therefore, that emerging markets have seen a high degree of fintech disruption, especially from platform companies that have led with significant spending on customer-facing technology. This should serve as a wake-up call to those incumbents in emerging markets that still enjoy superior returns.

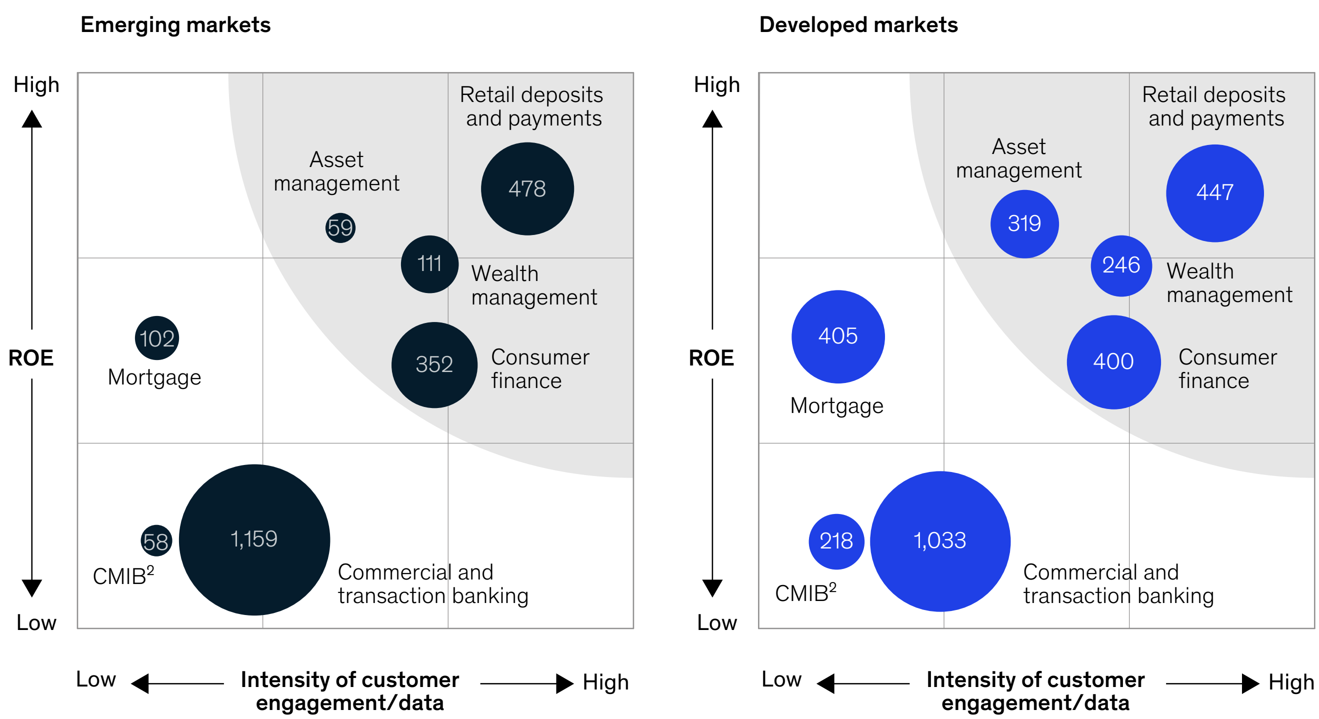
However, the pressures from increased competition and the resulting decline in margins and returns limit the amount of capital that can be put to work on change. With late cycle

Exhibit 7

Fintechs and tech players are aiming at higher ROE segments

Big tech and fintech return on equity (ROE) by engagement, 2018, $ billion (total 2018 global banking revenue pool = $5.4 trillion[1])

Big tech and fintech focus area, ($2.4 trillion revenue = 45% of global revenue pool[1])



[1]Before risk cost.[2] Capital markets and investment banking.
Source: McKinsey Panorama, Global Banking Pools

macroeconomics of slowing growth and lower rates thrown in, these pressures are likely to increase. Continuing regulatory costs don't help either. Further complicating this challenge globally is the wide spread in free cash flow generation between top- and bottom-quartile banks. This spread peaked in 2018, creating completely different playing fields in the capacity to invest for the future. The top-quartile banks, with their healthy cash flows, are in the most privileged position they have been in in the recent past. Bottom-quartile organizations, by contrast, will likely struggle to generate the free cash flow required to keep them in the race for customers' wallets—especially the digital one (Exhibit 8)

This cycle has also felt different

We have seen how the omens of the end of the cycle are mounting. And we have detailed how digital pressures are already influencing some metrics such as profitability in Asia and may soon affect other regions. Yet the impending downturn, if we may call it that, may be the most predicted recession in history. Surely banks are ready for it?

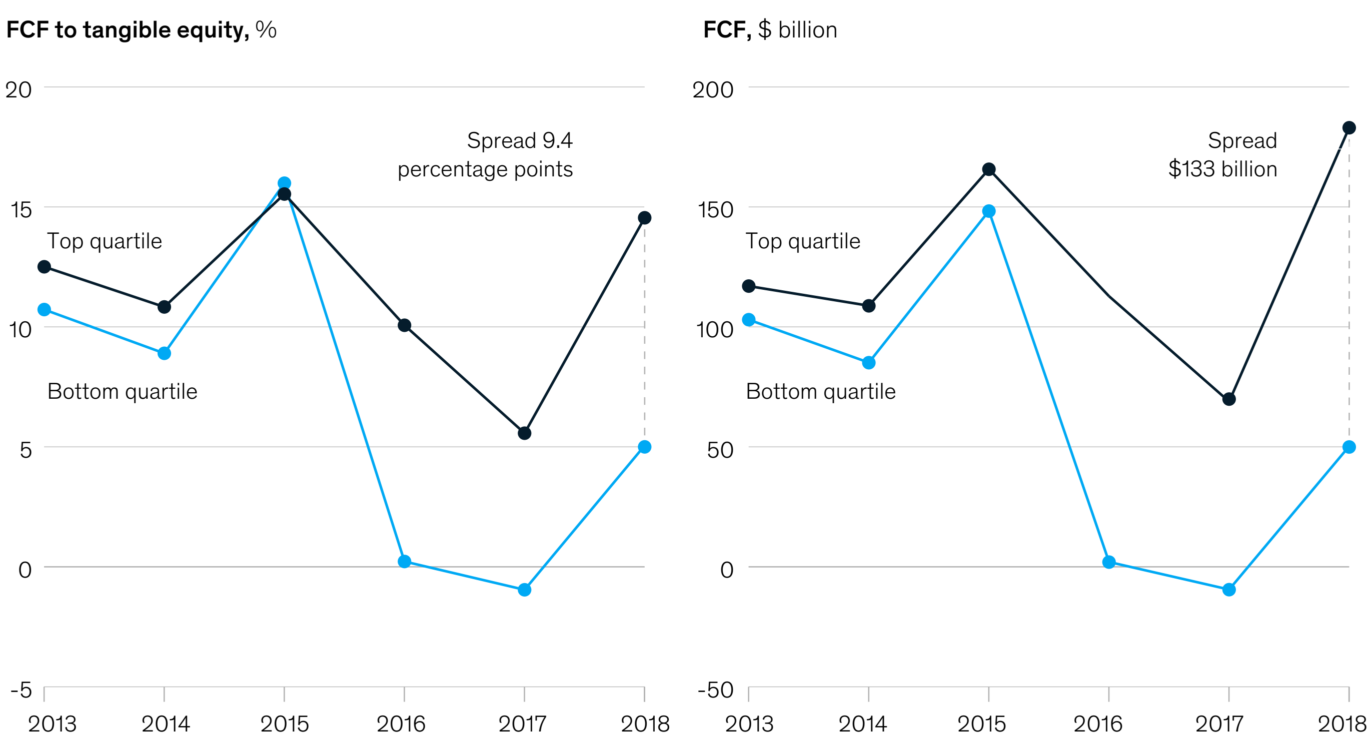
35%

of budget spent on innovation by banks, compared to 70 percent of budget spent by fintechs.

Exhibit 8

As growth has slowed, the gap in free cash flow (FCF) generation between top–quartile banks and bottom–quartile banks has widened

Bank FCF after taxes[1]



[1]Based on a sample of ~100 largest banks in terms of assets, with consistent reporting over timeline. Sample of ~100 largest banks used to account for scale in the FCF generation in dollar terms to avoid skew from small banks. Results on a FCF to tangible equity hold if we use the full bank data set.
Source: S&P Global Market Intelligence; McKinsey Panorama

Unfortunately, not—at least as compared to their financial condition at the end of the previous cycle. Not only has growth over the past decade been slower than the decade preceding the global financial crisis, but most banks have not regained their pre-crisis level of profitability (Exhibit 9).

By several other measures, as well, banks are not nearly as fit as in 2007. In fact, more than 60 percent of banks still do not generate their cost of equity ten years after the crisis (Exhibit 10).

As banks in the 60 percent contemplate how to cross the divide—and those already there seek to secure their footing—they must first reckon with two foundational characteristics that go a long way to determining both their current position and the extent of potential improvements: geography and scale.

First, location matters more now

Banks' opportunities for growth depend on their markets, of course. As an illustration, the current cycle has been marked by considerable disparity in the fortunes of North American and European markets. If North American banks have been a beacon of optimism, with average ROTE hitting 16 percent in 2018, banks in Europe have not achieved even half this rate. What is more, the divergence in returns between these two geographies, which together hold the bulk of the balance sheet for developed markets, widened by more than 450 bps in 2018. Geography can also be seen at work in the consolidation of US strength in global investment banks, at the expense of European peers bogged down by sluggish home markets. More broadly, it is evident that the influence of geography ebbs and flows, and lately seems to have become much more powerful (Exhibit 11).

A wide divergence in monetary, fiscal, and trade policies across the developed and emerging world seems to have been behind the increasing importance of geography as a factor.

Second, scale matters increasingly for most banks

Scale is not simply a matter of size, but the relationship between operating capacity and processing volume. When an organization is operating "at scale," the revenue generated by processing volume covers a) operating costs, b) capital costs, and c) the minimum income or return (as defined by the organization's business strategy). The "scale advantage" is the ability of an organization to increase volume (and revenue) while incurring very low or zero incremental cost, with new revenues going largely (or entirely) to the bottom line.

Our analysis of more than 1,000 banks across developed and emerging markets shows that banks with leading in-country market share enjoy a ROTE premium compared to peers. Also those with the highest shares are the only ones that have shown growth in positive returns in recent years. While the rest

Exhibit 9

This cycle has been different from previous expansions, with most metrics looking much worse

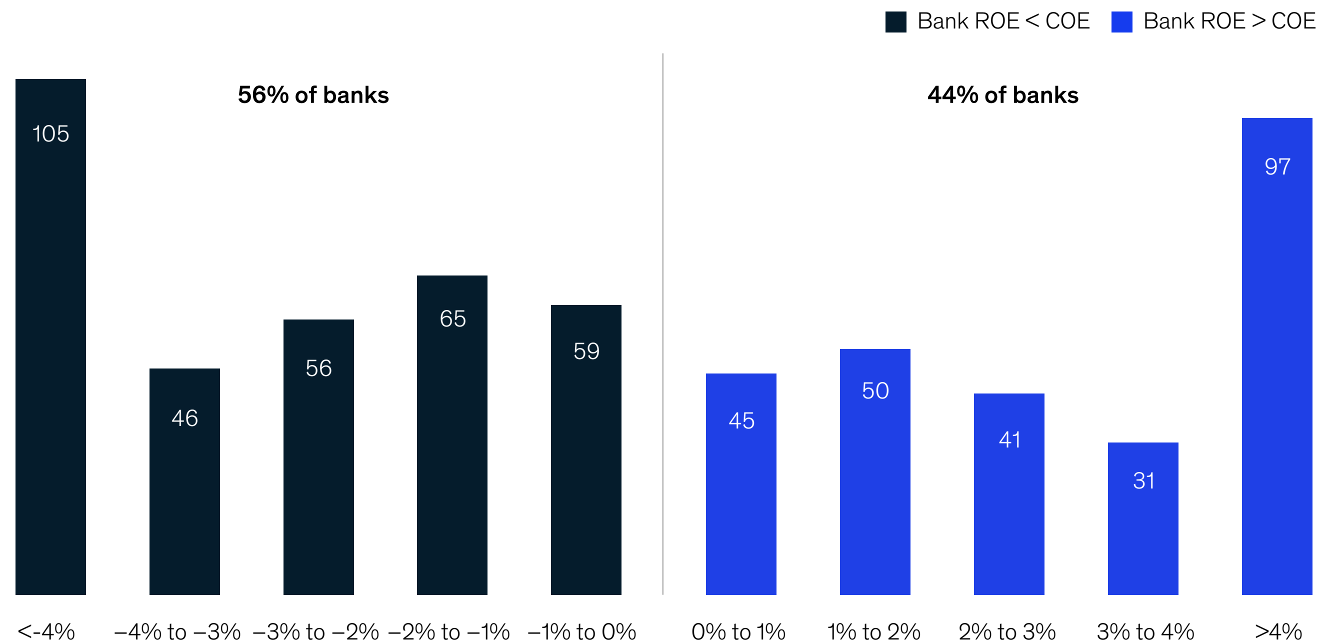
Banking metrics compared		2002–07 Unsustainable expansion		2010–18 New reality
Average returns on tangible equity (ROTE)		16.9%	↓	10.5%
Revenue growth[1]		16.8%	↓	3.6%
Emerging markets' share of revenue growth		26.9%	↑	77.4%
Tier 1 Ratio (average)		8.4%	↑	12.5%
Loan/deposit[2]	Developed	146%	↓	126%
	Emerging	84%	↑	86%
Price/book value	Developed	2.2×	↓	1.00×
	Emerging	2.2×	↓	1.22×
Percent of banks trading below book value	Developed	28.4%	↑	61.2%
	Emerging	19.2%	↑	37.6%
Summary		Robust growth, high ROTE, high multiples		Slow growth, lower ROTE, lower multiples

[1]Revenues before risk cost, compound annual growth rate 2001–10, 2010–18 (client–driven revenues). [2]Customer loans and deposits.
Source: Thomson Reuters; S&P Global Market Intelligence; McKinsey Panorama Global Banking Pools

Exhibit 10

A majority of banks globally may not be economically viable

Global banks return on equity (ROE) – cost of equity (COE) spread 2009–18, number of banks (n=595[1])

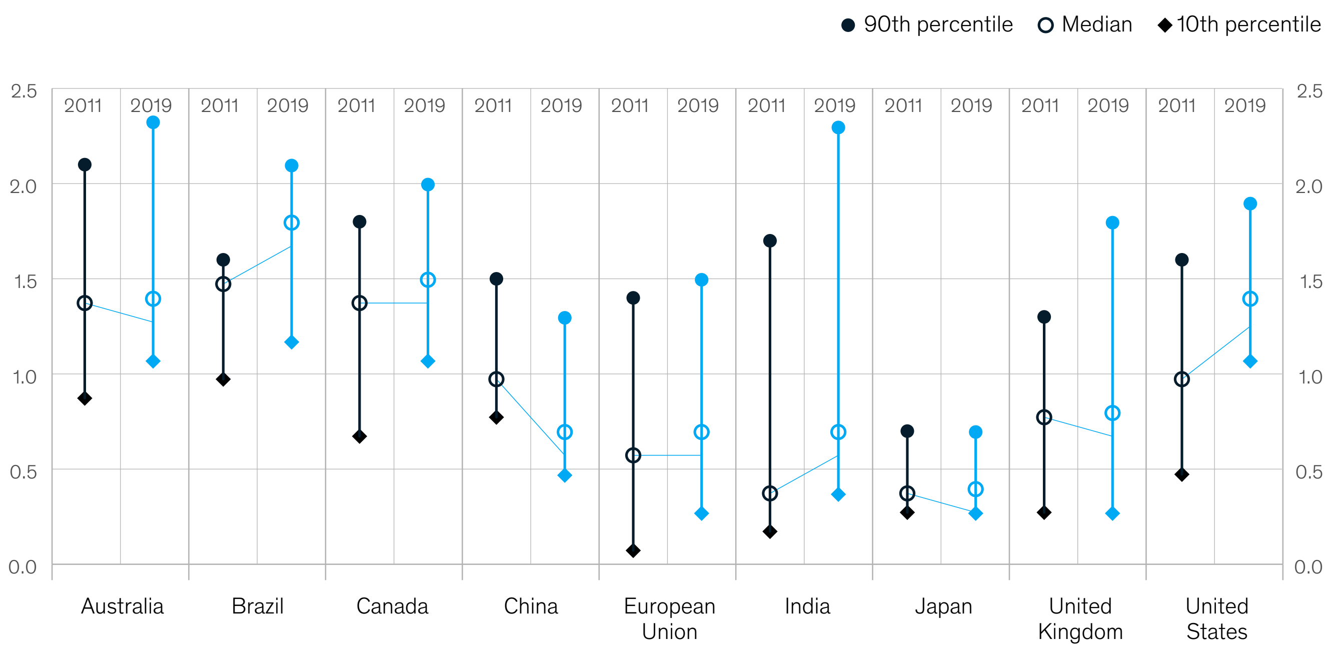


[1]All deposit–taking institutions with available data for 2009–18 (n = 595). ROE based on average net income and average equity including goodwill for 2009–18.
Source: McKinsey Strategy Practice and Corporate Performance Analytics

Exhibit 11

Geography has sprung back as a performance driver, with spread in performance within Europe and North America being most pronounced

Price–to–book (P/B) ratios of large quoted banks[1], 2011 and 2019[2]



[1]Largest 1,000 global banks allocated to country/regions by location of headquarters. [2]As of August 30.
Source: S&P Global Market Intelligence; McKinsey Panorama

of the industry's returns have fallen by approximately 150 bps in the past five years, those with more than a ten percent share of the national or regional market have managed to improve returns by ten bps during the same period (See sidebar, "It's 'in-market' scale that matters"). The scale effect is most pronounced in Asia and Latin America, where market leaders enjoy approximately 400 bps and 430 bps of ROTE premium to average banking returns, respectively.

There are exceptions to the rule. In Europe, for example, there is a C-curve—banks with an in-country market share of either more than ten percent or less than one percent have ROTEs double that of their peers caught in the middle. Across markets, banks serving a niche segment with a specialized product suite and superior customer service have managed to sustain high return premiums through the cycle irrespective of size. More precisely, 17 percent of the smallest banks outperform the average ROTE of the largest banks. Small outperformers fall into one of three categories: (i) community banks with strong ties to the region and tailored localized services, (ii) specialty banks focusing on niche products and services, and (iii) private banks. Specialization and focus have been the basis of their superior performance, as they have been able to keep pre-risk margins flat over the previous five years, even as margins have shrunk by 240 bps for banks globally.

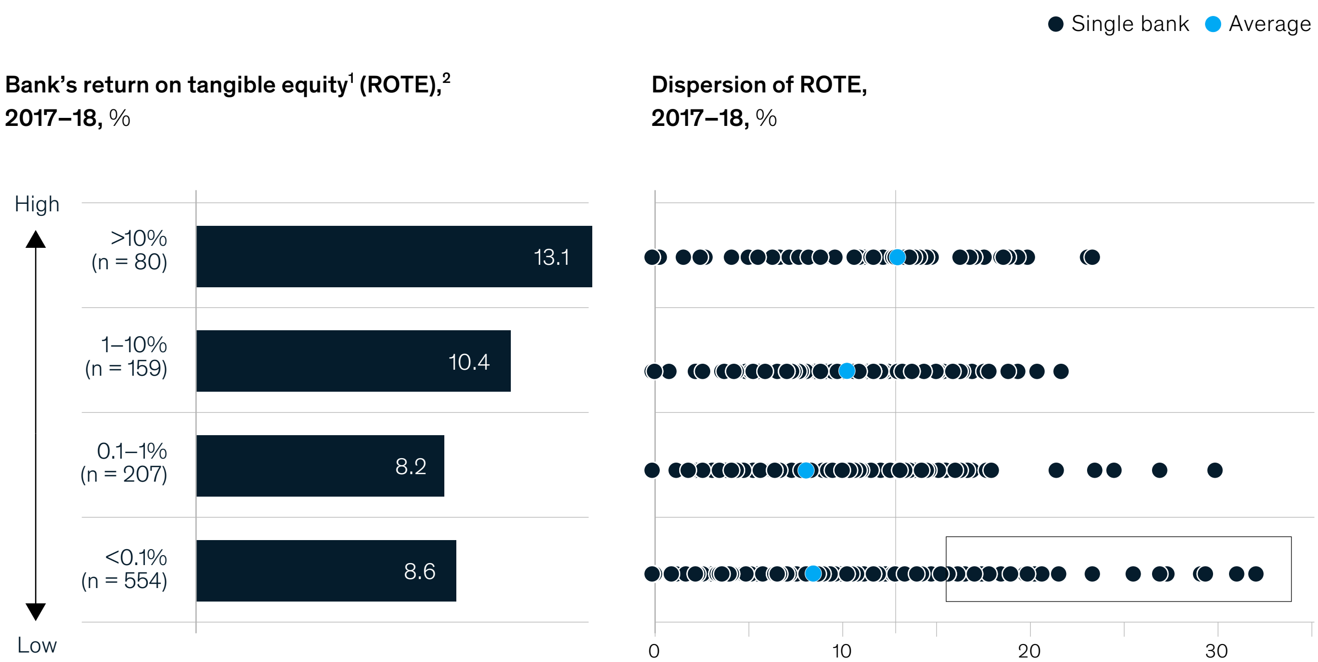
Rigorous specialization and focus pay off. The weakest performers are those banks that are stuck in the middle with returns that are below cost of capital and dwindling. For these banks, a late cycle presents structural warning signals to either gain scale or fundamentally reshape their portfolios and operating models to deliver distinctive value within a carefully defined market segment (Exhibit 12). And finally, there are those with scale deriving relatively higher returns than peers but still struggling to make healthy absolute returns. For these companies, for example, securities companies and broker dealers, it's a call for a fundamental reinvention of the business model. Scale alone won't help.

Going forward, scale will likely matter even more as banks head into an arms race on technology, especially given that most new IT investments, be it for a new technology (for example, blockchain) or a digital build, tend to be absolute in nature and, therefore, much cheaper over a higher asset or revenue base. The effect of scale on ROE has been reflected primarily in a cost advantage—the ability to bring marginal costs down as an organization gains operating leverage with consistent increase in size.

Exhibit 12

Within specific markets, scale is important but not deterministic – if you can sufficiently differentiate

On average, scale helps outperformance but…



[1]Based on a sample of ~100 largest banks in terms of assets, with consistent reporting over timeline. Sample of ~100 largest banks used to account for scale in the free cash flow (FCF) generation in dollar terms to avoid skew from small banks. Results on FCF to tangible equity hold if we use the full bank data set.
Source: S&P Global Market Intelligence, ~1000 top banks by asset size

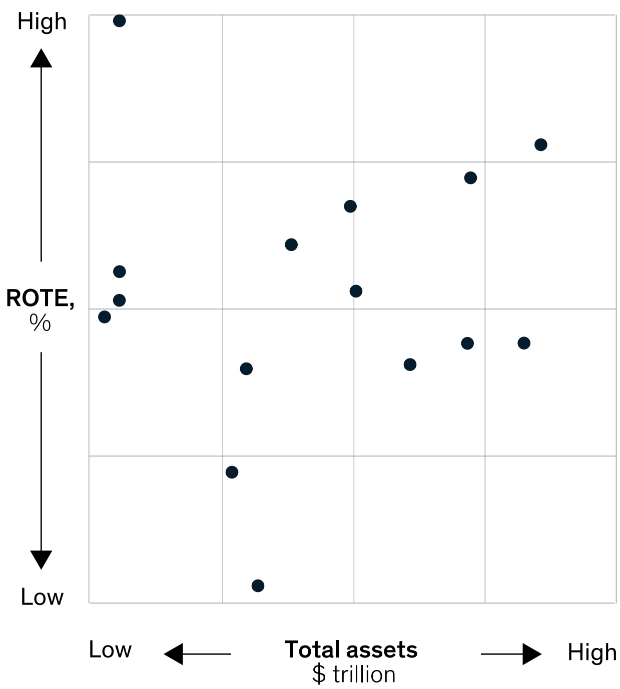
Exhibit 13

In-country scale, rather than global scale, helps lift returns in retail and commercial banking

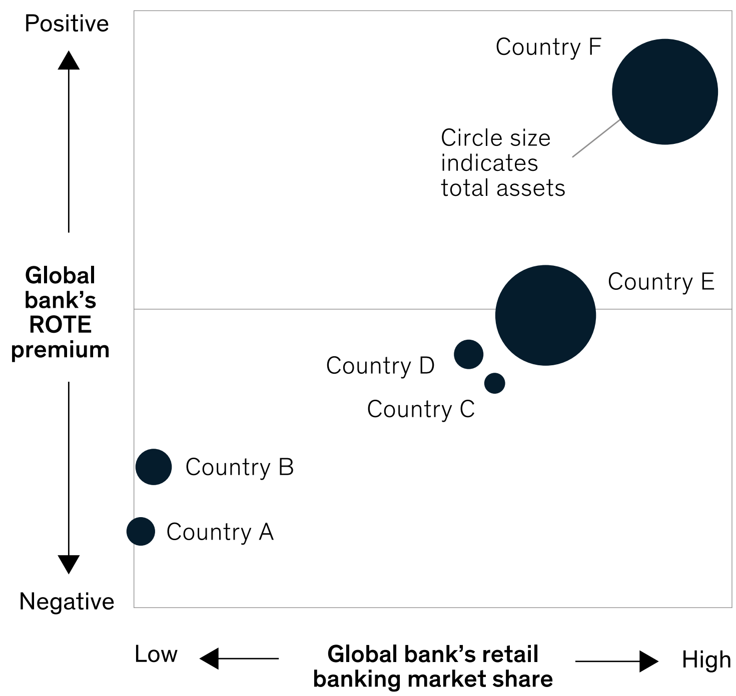
There is no statistically significant relationship between size and ROTE for the top 15 global banks by assets, but …

… broken down by scale in individual markets, the correlation with market share stands out

ROTE for the top 15 global banks and assets



Correlation of bank returns and market share



SOURCE: S&P Global Market Intelligence, 15 top global banks by asset size; WBI tool & McKinsey analysis

It's "in-market" scale that matters

Size in absolute terms s not a reliable metric in banking. Our analysis shows that it is not total size across the diverse markets a bank serves that enables superior performance but optimal scale within a given geography, that is, a local, regional, or national market. We looked at the 15 largest banks that have a global footprint and found that the relationship between scale and returns does not hold for this group (Exhibit 13). While the average ROTE for the 15 largest banks with global operations is 30 bps higher than average banking returns, banks that have more than twice the assets of others do not necessarily have higher ROTEs. Interestingly, our analysis of the local market shares of a large global bank operating across several countries shows that the relationship between domestic market share and outperformance resonates strongly even when the relationship is weak at a global level (Exhibit 13).

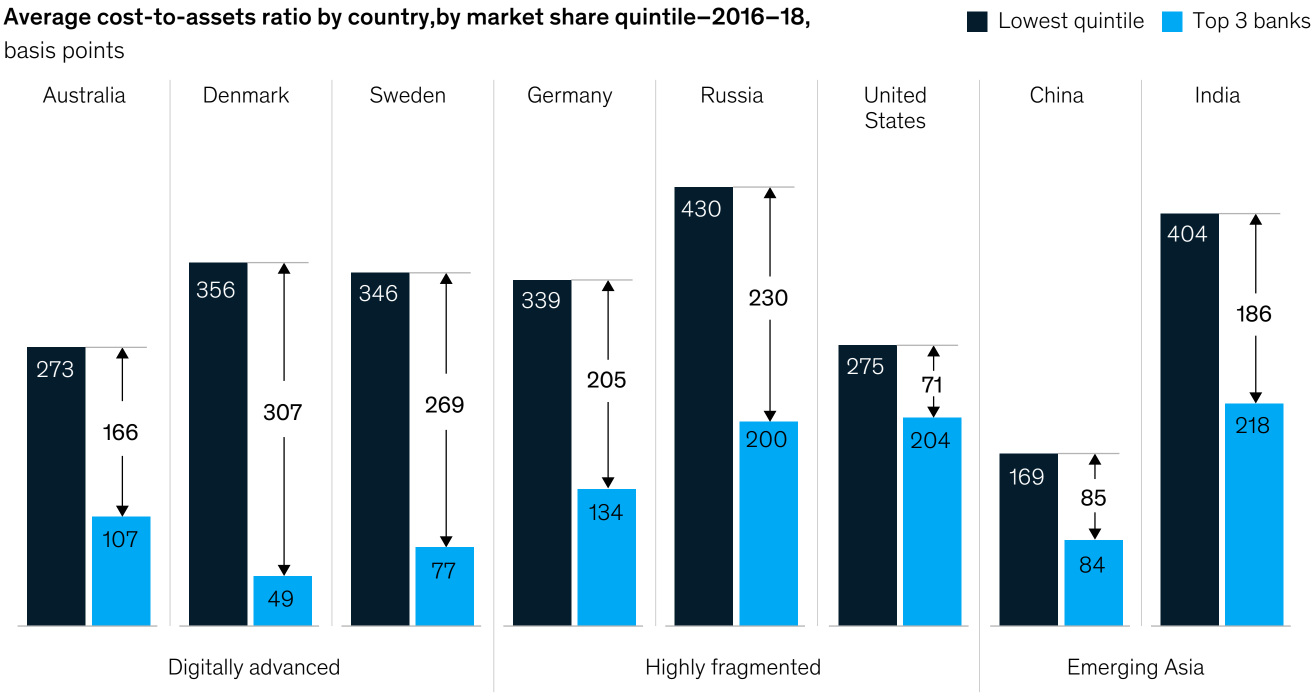
The relationship is also strong at sub-regional or niche levels: A market need not necessarily be an entire population in a country; it can be a homogeneous subset of customers in a region. For instance, in the US, First Hawaiian Bank has approximately 0.1 percent market share in the US but, as Hawaii's largest financial institution, generated a ROTE of 14.6 percent in 2017/18. This compares to the average ROTE of 13.7 percent for US banking over the same period. Similarly, in China, Bank of Gansu has approximately 0.1 percent market share in China, but as the second-largest bank in Gansu generated a ROTE of 16.8 percent in 2017/18, compared to an average of 13.7 percent for all banks in China.[1]

[1] The scale effect also holds within China, where most banks are state backed. Hence Gansu's outperformance can be partly attributed to its regional scale rather than it being state backed.

Exhibit 14

The impact of scale on cost synergies is clear across geographies, though the degree of effect varies by market; highest in markets with high level of digitization

Average cost-to-assets ratio by country,by market share quintile–2016–18, basis points



Source: S&P Global Market Intelligence; McKinsey Panorama

The varying degrees of scale impact by geography

While we found that in-country scale is a significant factor in generating higher ROTEs, the impact of scale varies in magnitude across geographies. To understand this variance, we analyzed the relationship between C/A ratio and in-country market share for banks worldwide.[1] As noted above, we found larger banks to be generally more cost-efficient. For example, tripling a bank's market share typically reduces its C/A ratio by 25 bps. However, the impact of scale varies widely by country (Exhibit 14). We highlight below a few examples:

Digital advanced markets. This includes markets like Australia, Sweden, and Denmark, where banking is rapidly moving online and where the scale impact is pronounced. In Sweden, for example, the top three banks by market share have a C/A ratio of approximately 77 basis points, while the C/A ratio of the bottom quintile exceeds 340 bps. This gap points to the increasingly transformative impact of technology on banking.

Highly fragmented markets. These include markets like Russia, Germany, and the US, where despite highly fragmented markets, we see strikingly different impacts of scale. In Russia, despite the central bank's efforts, its banking system is still highly fragmented, with more than 500 banks. At 200 bps, the average C/A ratio for the top three banks is less than a half that of the lowest quintile (430 bps). By contrast, in the US, another highly fragmented market, the gap between the bottom quartile and top three is only 71 bps.

Emerging Asian markets. In China and India, cost efficiency is associated with scale, but to a very different extent. In China's banking sector, which is dominated by many corporate banks holding large balance sheets, the average C/A ratio for the top three banks by market share is 84 bps, which is half that of the average for the lowest quintile (169 bps). In India, by contrast, while some scale effect is visible, even the largest banks have a C/A ratio higher than 200 bps. Indian banks typically have a higher cost base, in part because many maintain large physical net-works to serve rural customers.

[1] We have chosen costs relative to assets as the primary measure of productivity given its pronounced impact on returns; other metrics, such as risk cost, revenue margin, and leverage, did not yield such a strong statistical relationship.

However, we expect to see even greater benefits of scale from a margin advantage as digital scale really kicks in, including the network effects of mass platforms offering peer-to-peer payments and lending, as well as other scale-led propositions. In fact, ecosystem plays to deliver scale beyond conventional banking market share is one option that we strongly recommend for a set of banks in Chapter 3.

While global banking has enjoyed a prolonged period of growth, the sector still finds itself in a tenuous position, with growth slowing, productivity gains fading, and digital pressures on the rise. Nearly 60 percent of banks still generate returns below their cost of equity. The glass-half-empty view suggests that most banks have missed out on the opportunity to restructure and reprioritize in this cycle. Optimists, however, think there’s still time for banks to find new ways to strengthen profitability and boost returns. In either view, the call to reinvent or scale is imminent. Chapter 2 focuses on critical moves banks should consider to increase revenues and reduce costs while ensuring that risk and capital are managed efficiently, as well as inorganic options that could help strengthen their hand.

“If you look at the American economy, the consumer is in good shape, balance sheets are in good shape, people are going back to the workforce, companies have plenty of capital, it could go on for years, there’s no law that says it has to stop … We do make lists and look at all the other things: geopolitical issues, lower liquidity. There may be a confluence of events that somehow causes a recession, but it may not be in 2019, 2020, 2021.”

Jamie Dimon, CEO of JPMorgan Chase, analyst call, April 2019

Time for bold moves: Levers to improve performance in the late cycle

Introduction

Sticking with the optimist view, one could argue that there is still time for banks to act decisively in a late cycle before we hit a recession. After all, idiosyncratic performance continues to explain a large part of a bank's economic returns—be it through levers to achieve scale or to truly differentiate itself in the markets it serves. As growth slows and average banking valuations decline, pulling these levers becomes ever more crucial. But how can executive leadership take advantage of the late cycle to get a jump on the beginning of the next cycle? The key is to prioritize and deliver on bold and critical moves. Building on the insights and opportunities outlined in Chapter 1, this chapter focuses on a few material interventions that banks should consider—those than can be executed within the short span of two to three years that a late cycle typically offers. In Chapter 3, we discuss additional levers that banks may exercise depending on the overall condition of both the bank and its market.

There are three organic levers that we suggest banks explore:

(1) risk management based on powerful analytical tools to prepare for a downturn; (2) productivity, using modular utilities to materially change cost structures; and (3) revenue growth through an improved customer experience (CX), bringing

Machine-learning models can improve predictive accuracy in identifying the riskiest potential customers by

35%

a larger customer base and/or share of wallet.[1] Essential toexploiting these profitability levers are the critical enablers of advanced data analytics and talent. It is important to note that while these levers are interdependent, our discussion of each lever focuses on the dimension where it will typically have the greatest impact. If banks develop the capabilities required to exercise these levers successfully, they will not only be able to weather the downturn but also to build for the future.

Banks should also consider their options for building scale or competence through inorganic levers, including both mergers and acquisitions (M&A) as well as partnerships. Of course, the choice of inorganic levers depends on a bank's competitive position and the conditions of the markets served. The wide spread in valuations within each market provides healthy ground for building scale through M&A. While banks generally tend to be reactive in their inorganic pursuits (most of which peak in a downturn), carefully chosen proactive investments have the potential to strengthen a bank's performance into the next cycle (Exhibit 15).

Risk management: Building resilience for new-age risks

With most indicators showing that we are in the late cycle, it is time for banks to ramp up planning for resilience, determining how to manage risk and protect returns in a downturn.

Compared to previous waves, banks have relatively lower levels of profitability and have experienced much more muted performance even in the expansionary phase. While banks remain exposed to the same traditional types of risk as in the past—especially in pockets of corporate lending in certain emerging markets and North America—certain risks have changed because of evolving operating models and diverse market circumstances.

Consider funding and liquidity risks. While banks have materially increased their capital and liquidity levels because of new regulations[2] following the global financial crisis, there are less well-identified liquidity risks that deserve scrutiny. These new liquidity risks derive from the changes that have occurred to the banking and payments systems and include, for instance, the risk of faster withdrawals using online applications. These risks are further amplified by the potential of social media to spread negative reports, true or otherwise. For example, a European challenger bank recently suffered from a viral message that incorrectly cast doubt on its liquidity. This contributed to a fall of approximately ten percent in share price before recovery. There is also market risk across certain traded asset classes where a mix of central bank purchasing and the end of proprietary trading by banks have resulted in limited liquidity that could test asset prices in a downturn.

What should banks do to build resilience? Resilient

[1] We focus on profitability levers, as the levers on capital optimization are highly dependent on the country's regulatory system.
[2] For instance, limitations on liquidity coverage ratio or net stable funding ratio.

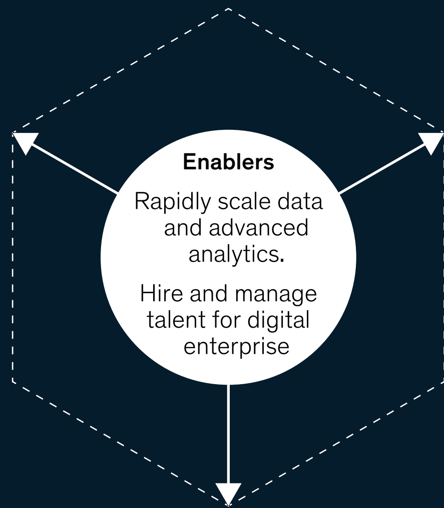
Exhibit 15

Bold moves for the late cycle

ORGANIC

Reduce cost

- Transfer non-differentiating activities to 3rd–party utilities
- Radically restructure cost base using zero-based budgeting



Increase revenue

- Materially improve customer experience
- Develop or tap into ecosystems
- Invest materially in innovation

Build resilience

- Manage risk with a 'leader's mind–set,' advanced analytics, and scenario planning

INORGANIC

- M&A to develop scale or acquire competency in any of the axes above
- Partnerships to leverage the same thesis but in form of joint venture

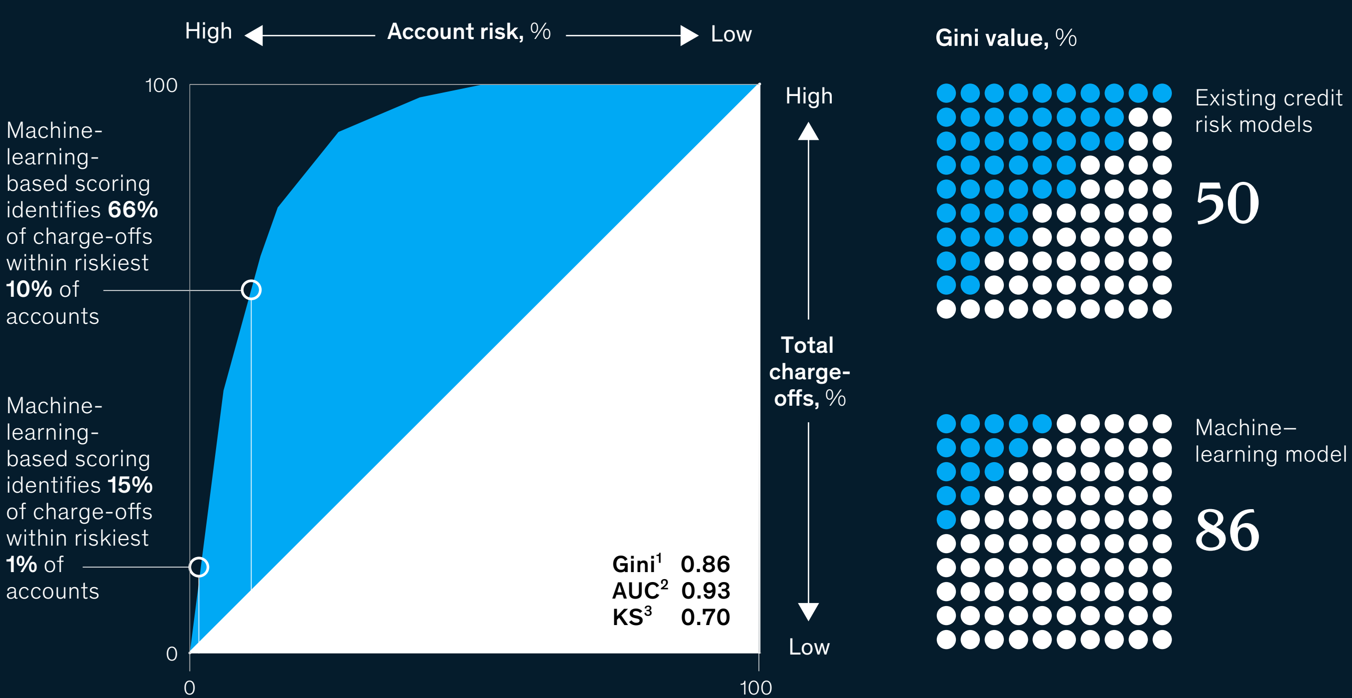
Note: Universal levers addressed in Chapter 2. Archetype-specific levers addressed in Chapter 3.
Source: S&P Global Market Intelligence; McKinsey Panorama

Exhibit 16

Banks can use advanced analytics and machine-learning models to preempt risk; new models potentially identify 66 percent of charge-offs within the riskiest 10 percent of accounts

Cumulative goods-bads curve for machine–learning model

Comparison of current and new model



[1]Gini value (a measure of predictive power, a perfect crystal ball would be 100%). [2]Area Under Curve. [3]Kolmogorov-Smirnov statistics.

organizations have invested in tools and governance mechanisms that allow them to discuss possible deteriorations in the market and implications for the bank, while welcoming alternative views from the mainstream ones. To do this, a good first step is to create "nerve centers" that comprise cross-functional teams to ensure collaboration across business lines, risk management, and operations, thereby increasing transparency and speeding up decision-making during a downturn. Nerve centers not only need a strong leadership mindset but also require superior tools to make effective unbiased decisions that can be executed swiftly, especially as fast response will be of the essence in an increasingly connected and transparent system.

The second lesson is that banks must invest in advanced analytics and artificial intelligence capabilities to support early alerts, enabling banks to monitor emerging trends and distress. A potential case is shown in Exhibit 16, where a machine-learning model can identify the riskiest potential customers with an increase of 35 percentage points in the Gini value (measure of predictive accuracy) compared to traditional models. Banks can also improve their debt collection programs by using AA to help identify accounts with high value-at-risk, segmenting outcomes, and developing digital tools for collections (that is, an orchestrated provision and use of multiple digital channels to both alert customers of their delinquency and provide channels through which they can manage and resolve their debt).

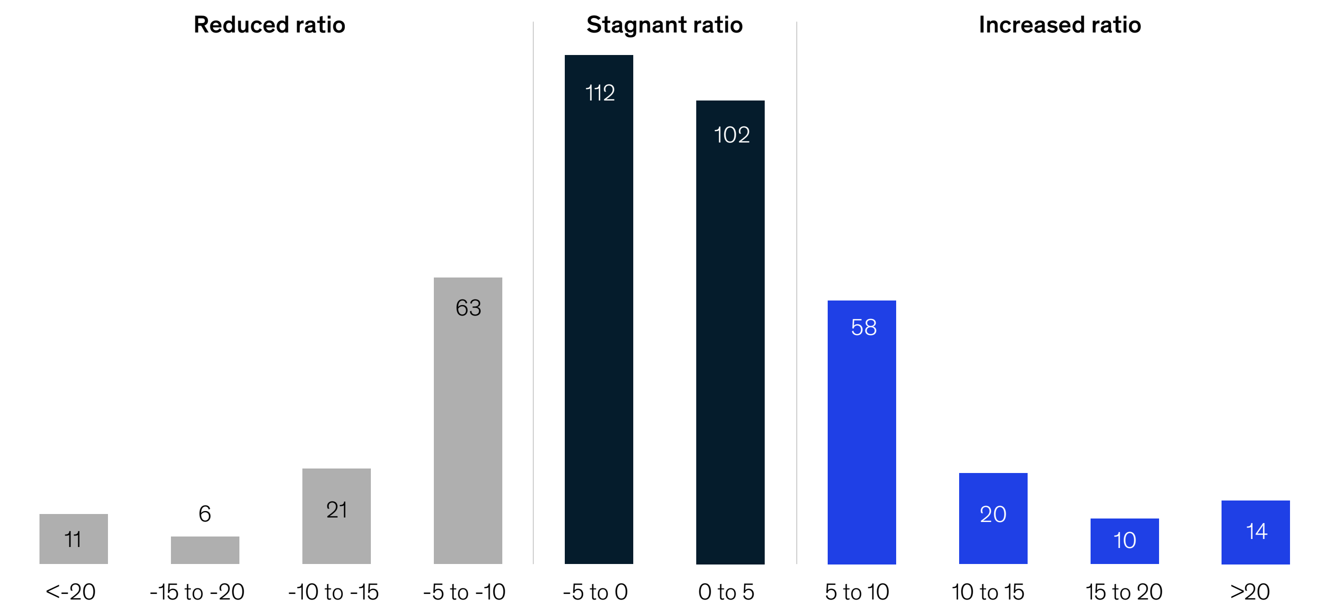
The third key to resilience is to prepare for risks with scenario planning and reinforced infrastructure in security and communications (especially, for example, social media tools). Regulators have increased stress testing for tail risks in recent years and banks should use lessons from those tests to increase resilience. Banks should consider their action sets with respect to: (i) balance-sheet preservation, including liquidity and capital buffers, (ii) preservation of through-the-cycle profit generation, and (iii) strategic positioning. This will allow them to mitigate losses, protect liquidity, secure long-term funding sources through strengthened relationships, and even consider inorganic opportunities (both portfolio sales as well as acquisitions) that tend to present themselves in downturns.

Finally, banks have learned from the previous cycle that socio-political scrutiny peaks during a downturn, particularly as scrutiny of organizations according to environmental, social, and governance (ESG) criteria continues to grow. Now is the time for banks to diagnose any potential ESG risks so they can deal with them before a downturn, and to effectively communicate their ESG strategy, including through social media, with stakeholders.

Exhibit 17

Most banks have failed to deliver significant bottom-line impacts in recent years, despite major cost programs

Banks with given change in cost-to-income ratio (C/I),[1] 2010-15



[1]Based on a sample of 417 banks whose operational expenditure in 2010 or 2015 was >$100 million and assets >$10 billion (n = 417).
Source: S&P Global Market Intelligence

Productivity: Shifting non-differentiating activities to industry utilities

The impact from traditional cost-cutting is rapidly diminishing. Even with years of cost-cutting following the financial crisis, most banks have not made the material improvements in productivity needed to compete effectively with fintechs, neo banks, and digital giants, which operate at nearly half the marginal costs of traditional banks (Exhibits 7 and 17). What is more, the gains generated by most banks' ongoing cost-efficiency efforts are shrinking (Exhibit 2), and all banks, regardless of their performance and the conditions of the markets served, must re-evaluate the impact of productivity on the ability to compete and win in a late-cycle world.

Among the near-term moves available to all banks, the use of third-party "utilities" to handle non-competitive and non-differentiating functions has the potential to produce the swiftest and most radical reduction in costs. We estimate that less than half of bank costs (vested mainly in IT and support functions as well as some operations) is directed towards activities that do not differentiate an organization from competitors (Exhibit 18) and could potentially be outsourced to multi-tenant utilities.[3] The remaining expenses keep the machine running in compliance with regulatory demands but do not add value. For an industry centered on lending, the reliance on external credit bureaus for credit scoring suggests that here are more banks can do to industrialize the cost base.

The experience of German automotive manufacturers in the 1990s holds a powerful lesson in outsourcing modules of non-differentiating activities to common utilities with the volume to reap scale advantages (see sidebar "The auto industry in the 1990s: Lessons for banks in 2019"). We have already seen examples of banks choosing to build their platforms with third-party vendors such as Mambu, Thought Machine, and 10X, and now is the time to push on to other areas of the cost base.

3 This can be through more traditional managed service outsourcing or carve outs and partnerships. We refer to these three options when discussing outsourcing in the utilities section.

Outsourcing a large portion of these activities could create benefits of 200 to 400 bps in an average bank's cost-to-income (C/I) ratio. For example, by moving trading processing volumes for capital markets players to multi-tenant at-scale utilities, the industry can bring down operations spending by approximately 20 percent. Another potential area for industrialization is regulatory and compliance functions such as know your customer and anti-money laundering, which typically represent between 7 and 12 percent of costs. These processes are critical for banks yet entirely non-differentiating.

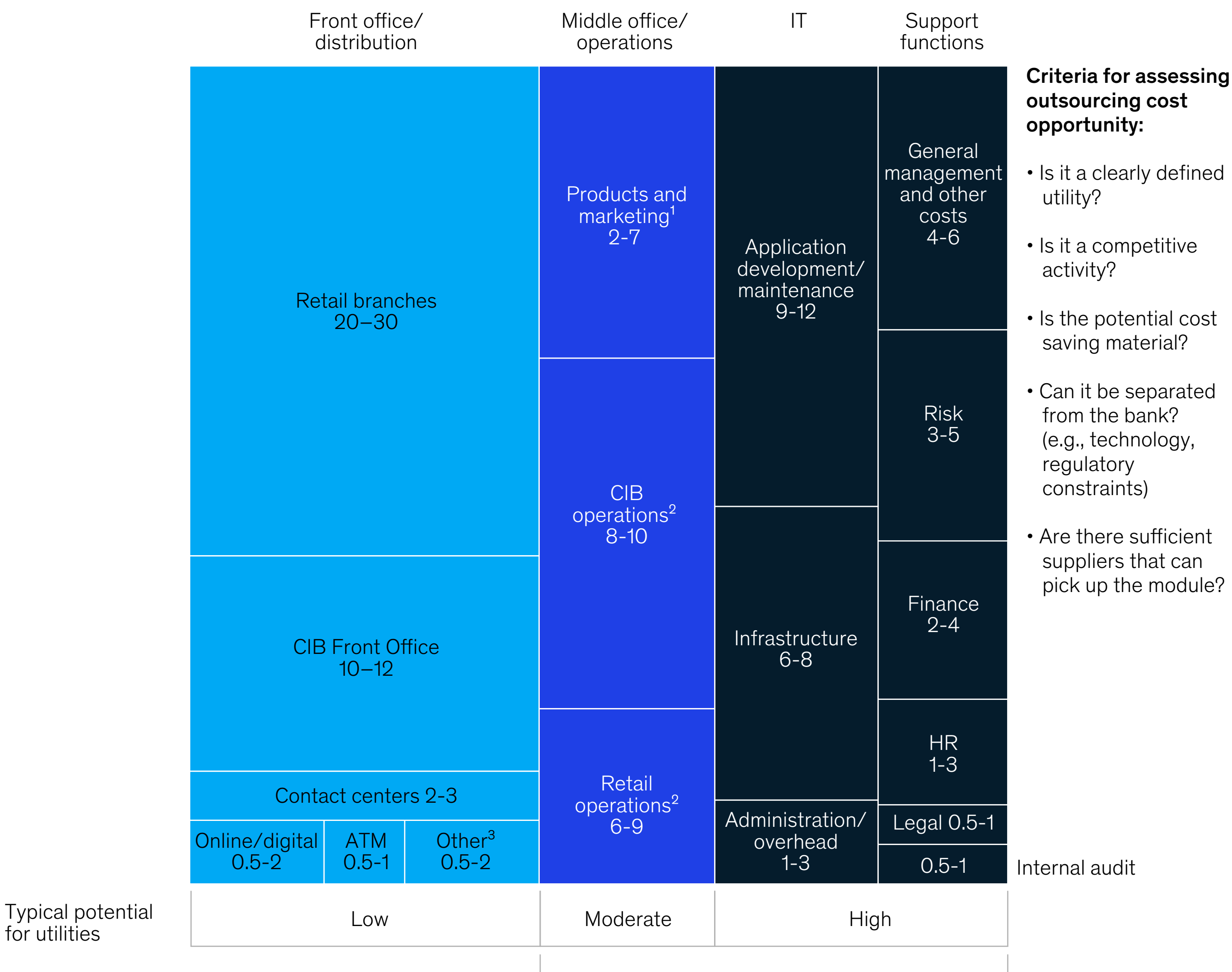
Outsourcing non-differentiated activities could improve banks' C/I ratios by

200 to 400 bps

Exhibit 18

By transferring non-differentiating activities to modular industry utilities, banks could potentially improve return on equity by 60 to 100 basis points

Share of total operating cost, typical universal incumbent bank example, %



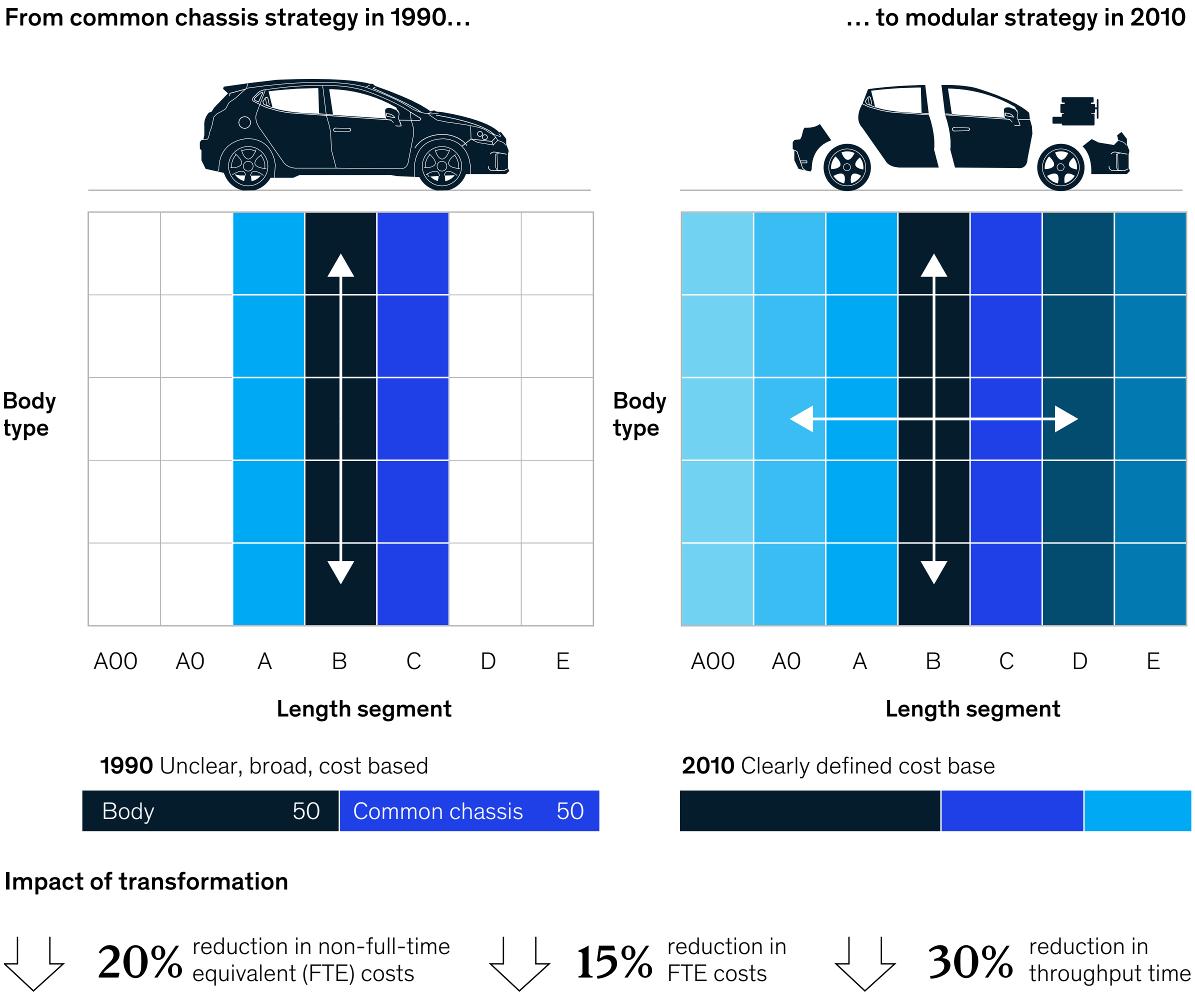
As an example, banks can strip out non-differentiated regulatory and compliance cost modules to more efficient regulatory backed utility; savings in here could yield 60 to 100 bps improvement in return on equity across the average bank.

[1]Includes product management, advertising/promotions, market research, CRM activities, etc. [2]Includes share of collections. [3]Other costs, includes depreciation and amortization.
Source: McKinsey Cost Tool Box Benchmarking and Finalta Retail Cost Benchmark

Further, in countries or functions where third-party providers do not exist, a common, regulatory-backed utility could be created with funding from either private or public capital. Alternatively, specific banks with scale could also provide services within ring-fenced entities. Industry regulators and governments may support such a plan, as it ultimately aims for better customer service and harmonization of customer security across the banking system. In markets struggling with growth and returns, we believe that the creation of industry utilities delivering best-practice services at scale for diverse bank departments, from the front office (for example, the Dutch yellow ATM network, the P27 Nordic payments platform) to the middle and back offices (for example, reconciliation, regulatory compliance), may be the one of the most powerful keys for unlocking value. Shifting the costs of non-differentiating activities to third-party "utilities" could potentially improve ROTEs by more than 100 bps.

Exhibit 19

Automotive manufacturers moved from a platform strategy to a modular tool–kit strategy, significantly improving productivity in face of economic challenges



Source: McKinsey

The auto industry in the 1990s: Lessons for banks in 2019

During the downturn of the 1990s, the German automotive industry faced stagnation in global demand, a high “historical” cost structure, and margin pressure from competitors (in this case, Japanese car makers) with low-cost operating models. Sound familiar? These are precisely the late-cycle trends that we have described for a large swathe of global banking. How did the German automotive industry respond? It replaced incremental innovation with fundamental transformation through a combination of zero-based budgeting (ZBB) and modularization. A winning theme was seamlessly integrating suppliers in the value chain to pivot from a one-off approach to vendor usage, that is, modularization.

Manufacturers achieved modularization by identifying siloed activities that did not add competitive value and could thus be outsourced to an industry-standard utility. As German automobile manufacturers deconstructed their value chains, they discovered several non-differentiated modules of activity, such as car brakes and electronics, and outsourced these to experts with economies of scale. To this day, these components are provided by two or three major suppliers. The change from a platform strategy to a modular one was a huge part of the industry’s successful transformation, reducing the operating cost base by 20 percent and improving productivity via a 30-percent decrease in throughput time (Exhibit 19).

Revenue growth: Improve customer experience to deepen relationships

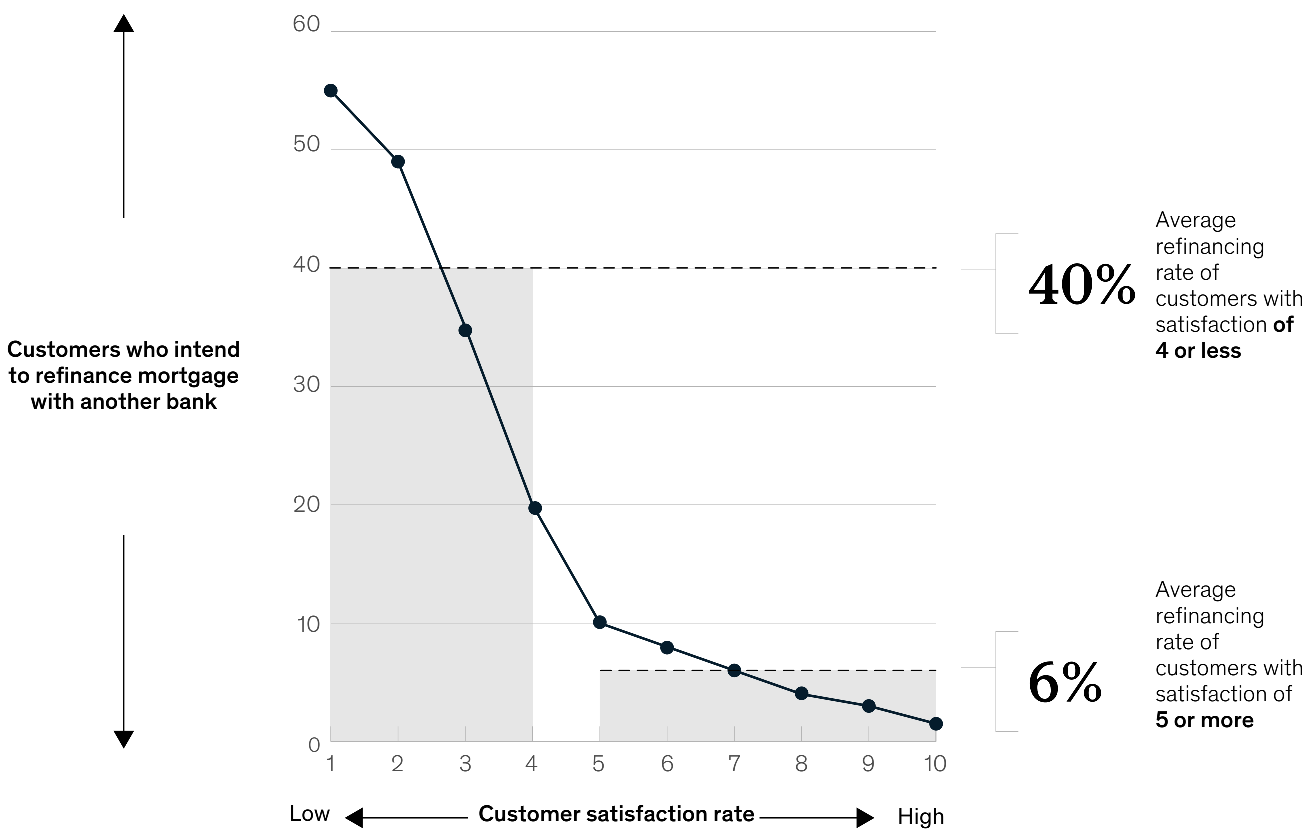
Simply put, when customers are more satisfied, they are more engaged and generate more value for banks. And as customers face increasing economic challenges—as typically happens late in the cycle—they tend to shop around even more, which brings customer experience front and center to a bank's strategic priorities. Cross-functional design teams use recent innovations in data analytics to transform customer relationship management from a high-level concept into a tactical tool to make precise improvements to customer journeys, focusing on decision points that provide the basis for distinction. The redesign of select journeys can produce results (including increased revenue and lower rates of churn) within 12 to 18 months, making CX an attractive lever as banks head into the late cycle. Although the benefits of CX are far-reaching, including growth, productivity, and risk, we focus on its potential for revenue growth, as this is where it has the most material impact. Further, improving CX for growth is not necessarily about being best-in-class, but rather closing the gap from "very unhappy" (the point where customers tend to switch banks) to "good enough." For instance, customers will switch if they've had a very poor experience, but they will not necessarily buy more even if they are highly satisfied. Tactical approaches to enhancing CX, therefore, can benefit all banks—market leaders can use it to widen their competitive advantage, while challenged banks can use it to stop customer outflows.

For banks to improve their products and create a deeper customer relationship, they must be tactical and do it journey by journey, product by product, and customer by customer. Simply trying to move customers as a block from "unhappy" to "okay" to "great" usually fails to lift revenues, due to diminishing returns. With finite CX resources, banks need to make sure they are prioritizing the right ones. For instance, in our research, roughly ten percent of customers who rank their overall mortgage experience a four out of ten or less are approximately seven times as likely to refinance elsewhere as customers who give a five or higher (Exhibit 20).

Exhibit 20

The least satisfied customers are far more likely to refinance their mortgage with another provider

Customers who intend to refinance mortgage with another bank, by satisfaction rate, %



Source: 2018 McKinsey Journey Pulse Benchmarks

Banks should use a value-oriented and analytically informed approach to choose the right CX levers:

— **Integrate the "customer voice" with both operational and financial data** to generate greater insight. A bank can use data from interactions across multiple channels (for example, digital footprints, other channel interactions, product usage, cost-to-serve, revenue data) and use advanced analytical models to connect the dots and build a detailed story of actual customer journeys.

— **Analyze data for two kinds of insight.** First, identify where changes in experience result in changes in customer behavior that increase value. Second, identify the "break points" where a particular element of the experience has a disproportionate effect on the overall outcome.

— **Set up a strong design capability** to ensure the insights are translated into action and to develop new customer journeys as efficiently as possible.

— **Set up strong frontline execution capabilities** to make those designs a reality. For instance, in our research we found that customers wish to be taught how to make the most out of digital channels, and one of the best ways to do that is by investing in branch and contact center capabilities and repurposing tellers for universal roles to match demand efficiently.

Enablers: Advanced data analytics and talent

Advanced data analytics: The case for prioritizing value realization

AA tools are enabling superior performance in organizations willing to make the proper commitment. Across all industries, companies that are more analytically driven grow three times faster than their less analytical competitors.[4] Banking, with access to a broad set of valuable data, starts from a strong position, but has yet to realize the full potential from embedding analytics deep into its culture, decision processes, and business operations.

Unsurprisingly, many of the levers we described earlier depend on a strong set of AA capabilities. What then can banks do to strengthen their analytics capabilities, accelerate performance, and support chosen priorities in the next few years that a late cycle offers?

The answer is two-fold: (i) fully leverage AA end-to-end by balancing an enterprise-wide and business-unit-led approach, and (ii) ensure that advanced diagnostic capabilities are applied in a consistent way and value is extracted quickly from high-priority use cases.

Set up to fully leverage advanced analytics. To build a successful AA program that delivers a return within one to three years, top executives should define the guiding vision for the bank's data transformation and work with business unit executives to develop a detailed roadmap for turning the vision into reality. To develop the roadmap, these executives should identify and prioritize customer journeys and internal use cases that have the greatest impact, either through cost reduction or increased revenue (Exhibit 21). The proper use of data and analytics can potentially increase a bank's cost advantage by ten percent and improve C/I ratios by up to fifteen percent (even in a recession). On the revenue side, for example, the implementation of recommendation engines identifying emerging needs among SMEs has boosted revenue for some banks by between 20 and 30 percent.[5]

Scale capability building to quickly realize value. How can banks rapidly scale AA? First, capability building should be tied to value creation, and banks must prioritize the most valuable levers and the roles most critical for driving those levers. Banks should develop a community where colleagues—across all parts and levels (including the CEO)—learn, engage, and share best practices. Learning content must be customized to reflect day-to-day use cases, with emphasis on high-impact business problems to make learnings stick through iterative cycles of classroom learning and real-world application. Finally, leaders should rigorously track results from capability building initiatives using "hard metrics" as well as qualitative dimensions, linked to business impact across the entire organization.

Talent: The need to win the digital battle

To successfully build their data and AA capabilities, banks need to close the talent gap between their current capabilities and those needed for a predominantly digital enterprise. This poses two fundamental challenges.

Finding talent. Many banks currently find themselves with a significant skills gap widened by two factors. First, digital innovation entails a new balance of skills relative to those banks have traditionally hired for, with diminished reliance on basic cognitive skills and higher demand for socioemotional and technological skills. Second, banks' perceived employee value proposition lags those of technology and other leading sectors, which are also competing for that same talent (Exhibit 22).

Should the late cycle also present a softening in the tech cycle, banks should prioritize hiring as a way to position themselves for success in the next cycle. Further, banks should develop

[4] Carlos Fernandez Naveira et al., "Smarter analytics for banks," McKinsey.com, Sept 2018, https://www.mckinsey.com/industries/financial-services/our-insights/smarter-analytics-for-banks
[5] Ignacio Crespo et al., "Using data to unlock the potential of an SME and mid-corporate franchise," McKinsey.com, October 2018, https://www.mckinsey.com/industries/financial-services/our-insights/using-data-to-unlock-the-potential-of-an-sme-and-midcorporate-franchise

Exhibit 21

In the short term, it is important to outpace competitors in revenue-boosting advanced analytics

Example use cases for using advanced analytics and potential impact

Urgent use cases				High–feasibility use cases		
Micro-segmentation	**Collections**	**Churn**	**Fraud**	**Advanced early-warning systems**	**Smart allocation**	**1-to-1 pricing**
+30%	–20%	–20%	+15%	–25%	+40%	+20
economic value added	bad–debt provisions	churn rate	fraud detection	gross nonperforming–loan inflow	call-center productivity	basis points to deposit margin

What banks should do

Prioritize rapid implementation of microsegmentation cases to avoid competitors gaining market share.

Implement **pricing and call–center optimization** use cases in parallel because of the **strong track record of impact** in other organizations.

What success looks like

In the next three years, advanced **microsegmentation** will give fast-movers a **disproportionate advantage.**

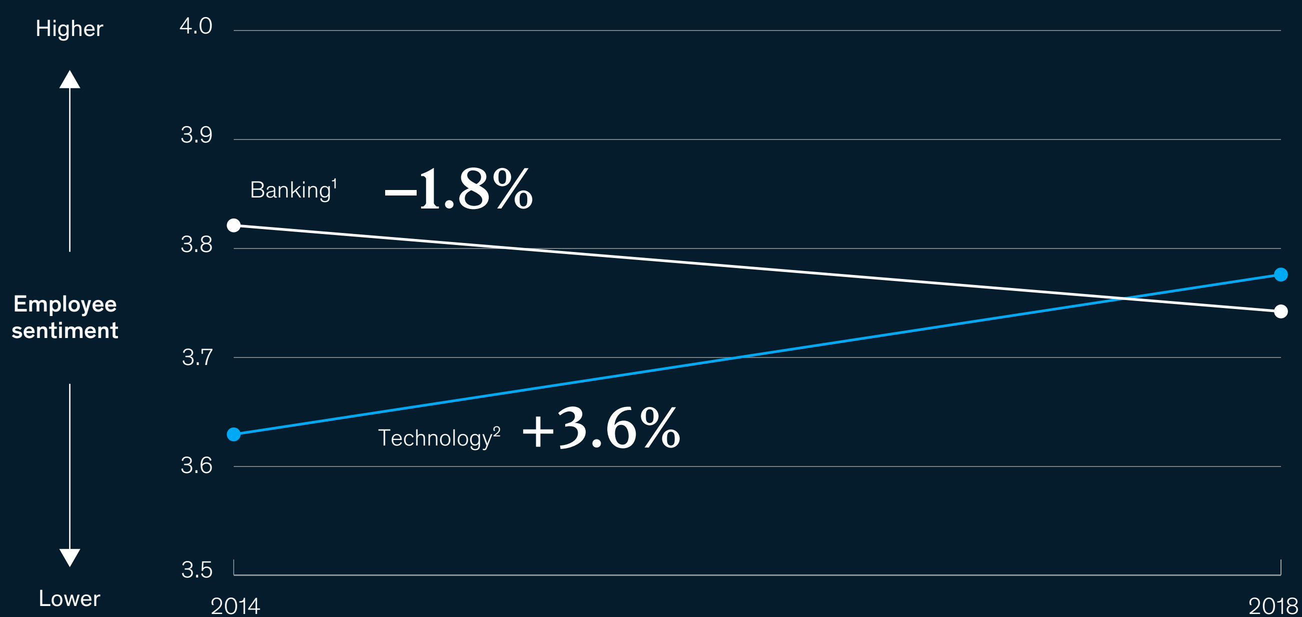
Advanced analytics in **pricing and call centers** is less urgent but has been proven to have low risk, high feasibility, and **high impact.**

Source: McKinsey analysis of publicly available data

Exhibit 22

Banks need to work hard to close the digital–skills gap; technology has overtaken banking in perceived attractiveness of compensation and benefits

Employee sentiment about compensation and benefits



[1]Nine largest US banks by assets, 2017. [2]Ten largest US tech firms by revenue, 2017.
Source: 2018 McKinsey Journey Pulse Benchmarks

79%

of leading banks have partnered with a fintech

reskilling programs to close the gaps in digital talent through their existing work force. We estimate that one-third of existing talent gaps can be addressed by reskilling current employees. Reskilling has economic and social considerations. Eighty percent of CEOs at a recent World Economic Forum meeting pledged that as they adopted AI they would retain and retrain existing staff in 2016.

Managing talent. Banks will need to become faster and flatter to retain the best talent. With the introduction of agile teams, banks must become faster to achieve weekly (versus monthly or annual) digital releases. Not only does this mean that banks will be able to move at the same speed or faster than the competition, but they can also take greater risks with certain projects, as the consequences of failure on smallscale releases are manageable. To enable these faster digital releases, organizations will need to become flatter. This means that they must give more power over decisions to digital talent to pursue these projects at speed without current time-consuming burdens of bureaucracy and build non-hierarchical multidisciplinary teams that are co-located. Banks need to shift from the traditional front- and back-office segmentations to multidisciplinary teams working together on well-defined tasks.

Beyond organic options: Mergers, acquisitions, and alliances

Given the competitive advantages that come with scale, many banks are finding that mergers and acquisitions—along with strategic partnerships—are an efficient way to achieve their scale ambitions or a means to completely reinvent their business models. Indeed, the ground for mergers, acquisitions, and partnerships is fertile, as the current environment provides a favorable combination of capital, regulation, and senior-level interest. First, there is a large dispersion in valuations and capital levels across the banking system, creating an ideal environment for inorganic moves (Exhibit 23).

Second, with systemic risk in banking largely mitigated through capital and liquidity build-ups since the global financial crisis, and fragmented banking sectors in many markets struggling to produce returns (Exhibit 24), regulators are more likely to be supportive of consolidation. Third, the need for large-scale investments in technological transformation, combined with weak organic growth, is pushing M&A up on the board agenda. Banks, however, should be careful as they assess these options, as very few deals have historically created value. Building capabilities in partnerships, joint ventures, and M&A is also essential to maximizing their full potential.

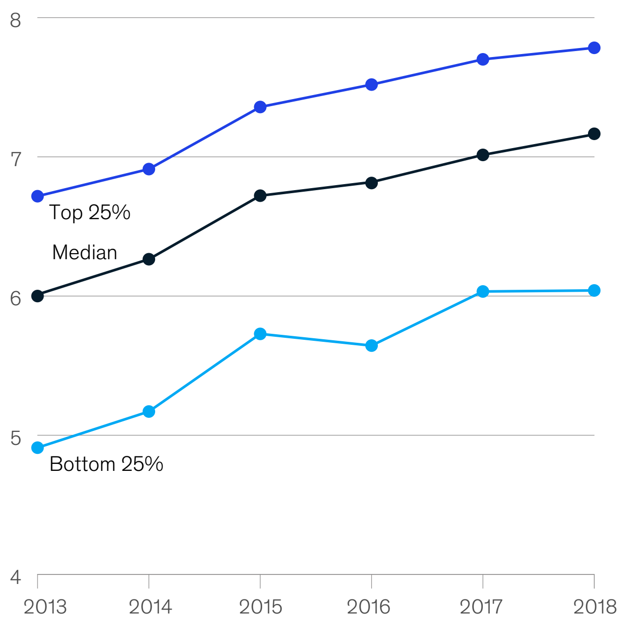
Options to consider. Banks have two options in terms of overall objective and inorganic strategy. The first option is to choose partners/targets that afford them scale. As an example, two challenged mid-market banks serving the same client base in the same geography in a challenged market could consider merging to gain scale. Our analysis shows in-market mergers with overlapping footprints could result in savings of up to 20 percent of the combined cost base in addition to revenue synergies. The ability of a combined entity to then fund differentiating innovation rises significantly as well. A recent announcement from the SABB-Alawwal merger in Saudi Arabia guided to cost synergies of 15 to 20 percent of the combined cost base and revenue synergies of two to three percent. It's hard for banks to realize value to the same quantum organically in a short period of time.

The second option for banks is to merge across capability vectors to complement existing assets and help reinvent their business model. For example, a bank with a strong customer franchise could merge with a digital bank with the primary objective of enhancing operational efficiency (and perhaps realizing a secondary goal of increasing access to customer segments beyond its traditional footprint). This playbook equally applies to large banks that are flush with capital from their superior returns from the last cycle; inorganic options should be considered to acquire and supplement technology, skill sets, and customer groups. A large fintech ecosystem that has been created in this cycle offers plenty of targets in a late cycle; now's the time for banks to sharpen their shopping lists

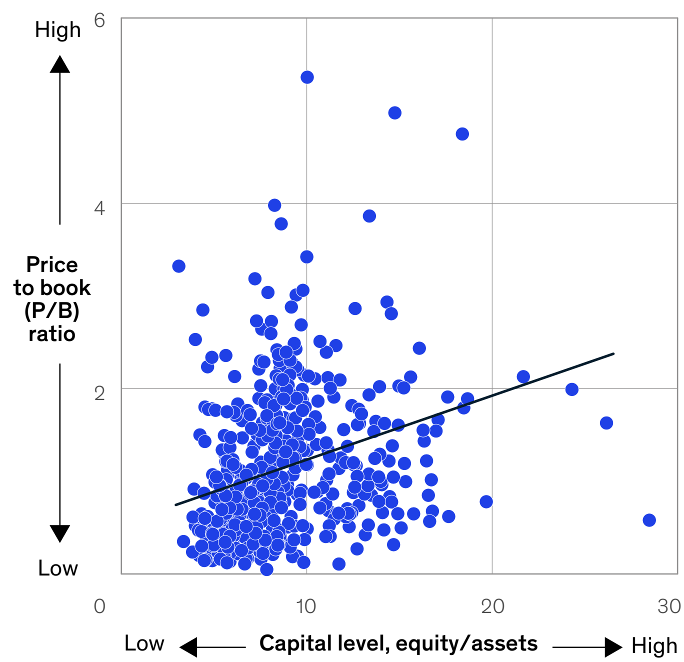
Exhibit 23

The current diversion in capital levels and valuations creates fertile ground for M&A within markets

Capital levels (tangible equity/total assets),[1] 2013–18, %



Correlation between valuation and capital level[2]



[1]Financials of the largest global banks (n = ~1000). [2]Publicly listed largest banks (n = 504).
Source: S&P Global Market Intelligence

as late-cycle valuations become attractive. Lastly, acquisitions can be a critical tool for reinvention where core business models are getting disrupted. For players looking at extending their service proposition beyond their traditional capabilities (which are being disrupted), the fastest way to get there is with tactical acquisitions. The securities value chain, from asset managers to broker dealers to trust banks, is a classic example. With core margins coming down across each business model primarily driven off lower asset management margins, players in each part of the value chain are being forced to ask the fundamental question, What drives value for their customer? Which in turn leads to deliberate choices of where to give away value and where to extract it. And in those new choices of offering value, acquisitions can be a tool to build capabilities faster. We've already seen such plays in the securities industry—for example, State Street acquiring Charles River to boost front-office capabilities to service asset managers even as back- and middle-office margins get competed away. Late-cycle pressures are likely to extend such moves across the securities value chain as players are forced to reinvent.

Further, banks must determine the optimal collaboration model—partner or merge/acquire? This choice should be informed by the scope and depth with which a bank can pursue growth opportunities, as well as its existing capabilities, customer segments served, and the capital available for investment.

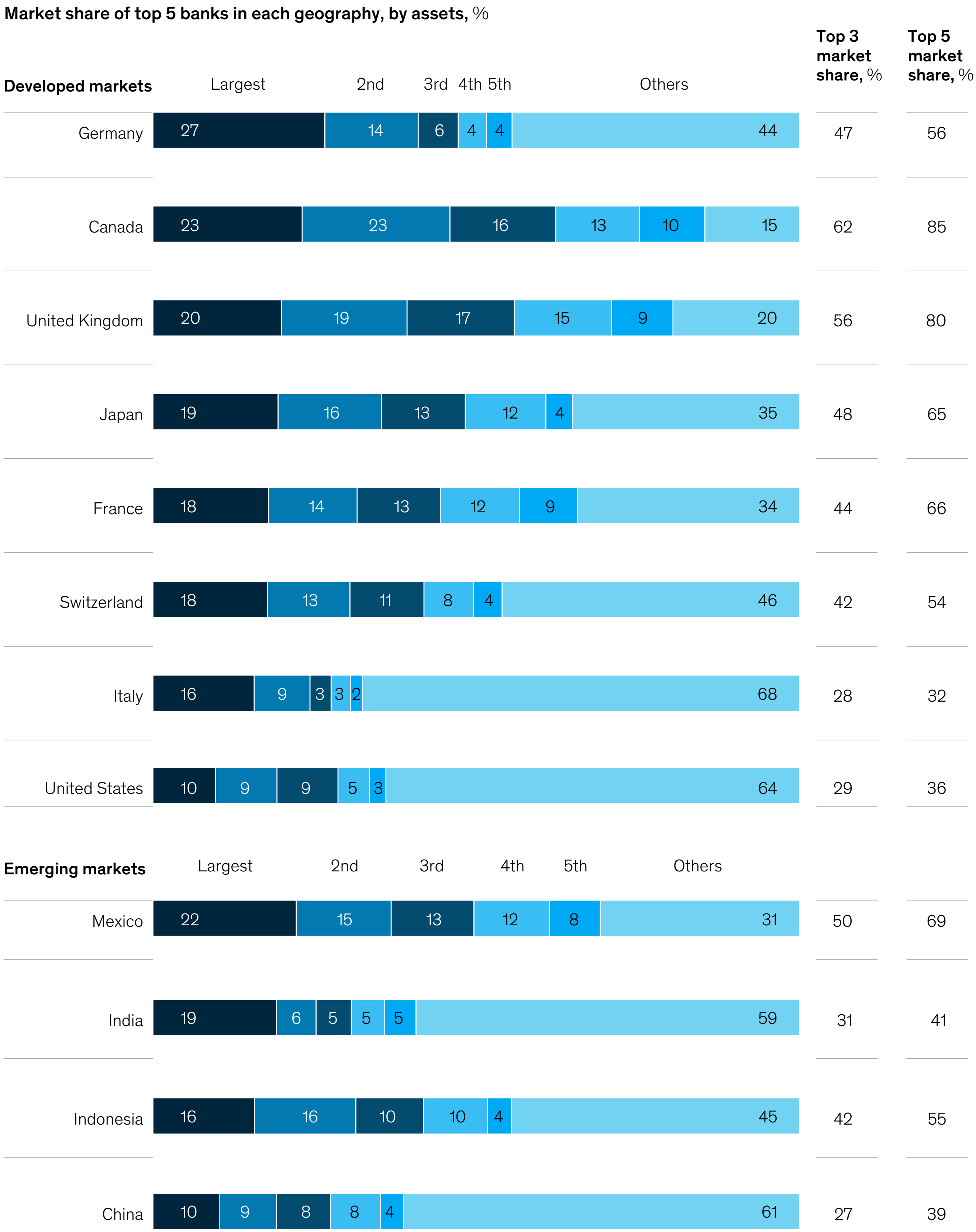
— **Partnerships:** For banks that choose to form partnerships, success will depend on establishing clear terms for combining resources and sharing returns equitably. The process for managing partnerships extends to collaboration in the formation of platform-based marketing ecosystems. Our research shows that 79 percent of leading banks have partnered with a fintech to foster innovation in payments, lending, investment, or other areas.[6]

— **M&A:** For M&A banks must establish a rigorous process for screening potential acquisition targets and prioritizing them according to their relevance to clearly articulated strategic objectives. It is critical to adopt a portfolio approach, coupled with scrutiny, giving a single team responsibility for M&A.[7] Regardless of the structure chosen, significant research and planning is needed as the compatibility of operating models, cultures, technology, and customer relationships are critical to success and value capture.

6 Based on a research covering publicly announced partnerships of the top 100 banks and other digitally advanced banks, from McKinsey Panorama Fintech.
7 Cristina Ferrer et al., "M&A as competitive advantage," McKinsey.com, August 2013, https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/m-and-a-as-competitive-advantage

Exhibit 24

Fragmentation in market sets the stage for the potential of bank M&A

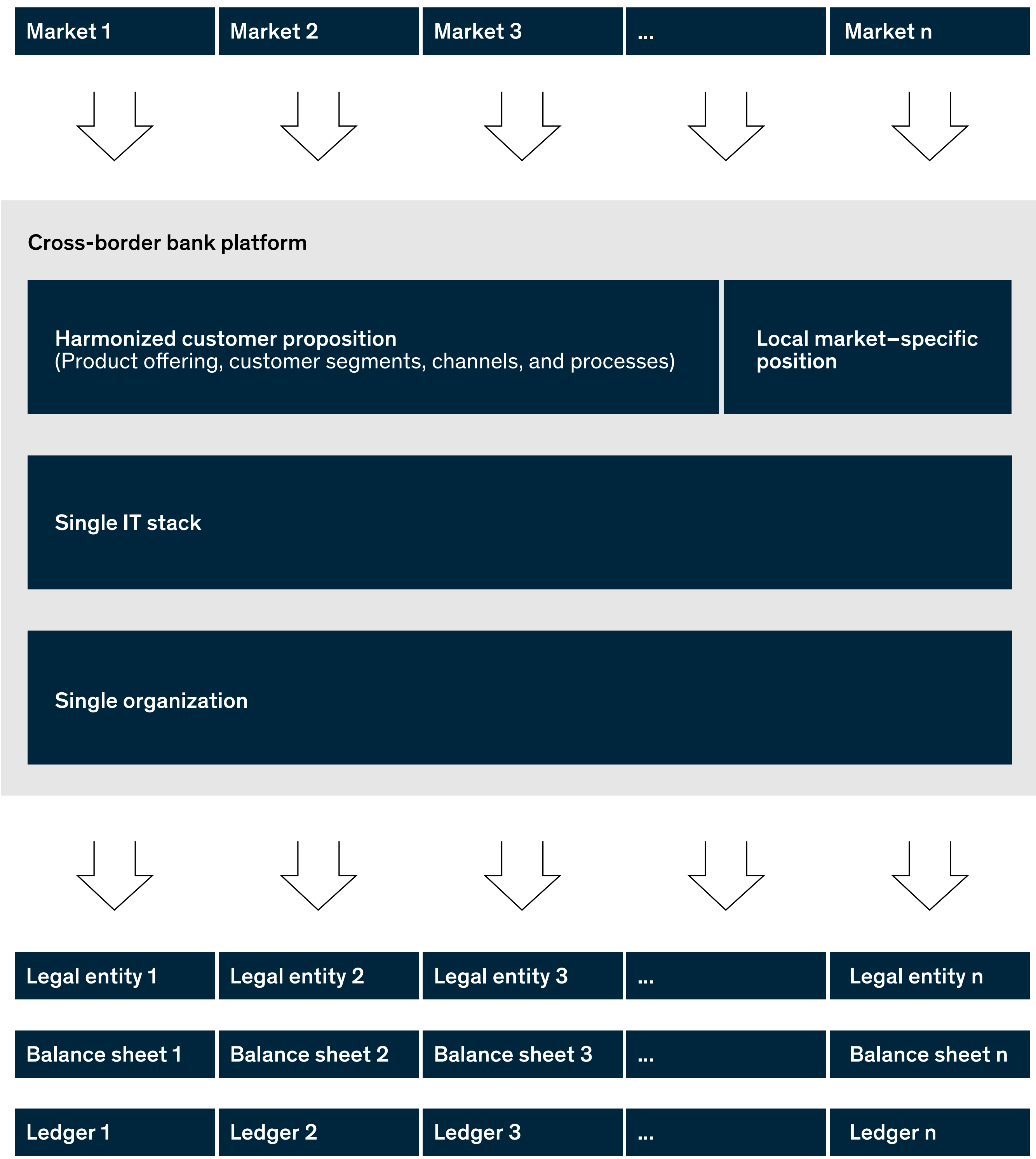


Source: PFIC- World Banking Intelligence

Exhibit 25

Native cross-border platforms have a harmonized cross-border customer proposition delivered through a single IT stack and organization

Countries that have adopted or are adopting open banking



Source: McKinsey analysis

Faced with increased capital and liquidity constraints following the global financial crisis, banks globally have tried a long list of interventions across operative levers to increase returns. Though successful to varying degrees, the marginal return of these initiatives is stalling, and most banks still fail to produce the returns that investors demand. Hence, the urgency of the bold moves highlighted in this chapter. Some are pure defense—for example, managing “new” risks. Some will help banks to go on the attack with material economic impacts—for example, transferring non-differentiating activities to third-party “utilities” and improving CX by redesigning critical customer journeys and decision points. Others, such as advanced data analytics and talent, cut across both. And across all these levers, inorganic options, which most banks have not considered actively for some time, should return to the management table. Are there other levers a bank should consider in light of its starting position and the condition of the markets it serves? We address this question in the concluding chapter.

Can technology help cross-border M&A make a comeback?

Since the global financial crisis, the appetite for cross-border M&A has dropped significantly due to regulators’ efforts to ring-fence certain banking businesses. However, market leaders constrained by share growth in their domestic markets are starting to ask if technology provides a means to scale banking franchises globally. Several European banks are looking to emulate leading technology companies that build once and then scale globally as big tech companies like Uber, Facebook, Tencent, Amazon, and Google have done. These banks have built “one” organization by harmonizing cross-border customer propositions on the basis of a single IT stack. These stacks support separate, country-specific legal entities, balance sheets, and ledgers to satisfy local laws and regulations (Exhibit 25). We estimate that these cross-border platforms can reduce C/I ratios for banks by five to ten percent.[1]

The advantages include the ability to enter new markets much faster—either organically or through an acquisition—with a full product and service line-up; the ability to attract world-class business, product, and engineering talent; and the ability (like big tech companies) to leverage this talent across a global platform. Another advantage is that having one IT stack spreads IT expenditures over a larger revenue and cost base, and the bank can also avoid enormous IT modernization lifecycle costs that would normally have to occur every few years across many local markets. Beyond these benefits, there is an opportunity to change the investor narrative towards valuing the bank as a technology platform company instead of “just” a bank. However, there are two important caveats. First, there has to some level of customer and regulatory homogeneity between the markets that a bank wants to access. It’s easier for a Nordic bank to leverage such an architecture between Sweden and Denmark than for a global bank to use the same to ply similar banking offerings across, for example, the US, India, and China. Secondly, the tech stack offers scale only in technology; to achieve superior returns banks will still need significant in-market banking product scale in each market in which it operates.

On balance, we think there is an opportunity for banks to take a page out of the business models of fintechs and neo banks backed by private equity and venture capital. Most digital lending startups tend to base their business model on the assumption of credit risk in a single market using a new digital stack and completely digitized lending process. Once they scale that model, they monetize it by white-labeling the solution to banks in other geographies without necessarily taking on credit risk. Banks with leading operating models can follow the same game plan and offer solutions to non-competing banks in other markets. A dollar of fee income earned from leveraging their home market operating model is worth four in capital-intensive lending models. This could be a model to scale globally without necessarily assuming credit, market, or liquidity risk across different geographies.

1 Leorizio D’Aversa, Andrea Del Miglio, and Niels Van der Wildt, “The case for cross-border banking platforms,” McKinsey.com, July 2019.

“. . . The best time to plant a tree was 20 years ago. The second-best time is now.”

Chinese Proverb

The right moves for the right bank

The reality is that each bank is unique.

Introduction

The reality is that each bank is unique. The degrees of strategic freedom it enjoys depend on its business model, assets, and capabilities relative to peers as well as on the stability of the market in which it operates. Considering these factors, we narrow the set of levers that bank leaders should consider to boldly yet practically achievable moves to materially improve—or protect—returns within the short period of time afforded by a late cycle. To that end, in this chapter we classify each bank into one of four archetypes, each with a set of levers that management should consider. In combination with the universal levers discussed in Chapter 2, these archetypal levers form a full picture of the degrees of freedom available to a bank.

The four archetypes are defined by two dimensions: (i) the bank's strength relative to peers and (ii) the market stability of the domain within which the bank operates (Exhibit 26; and see sidebar, "Identifying the four bank archetypes," for more details on how the archetypes are derived):

1. **Market leaders** are top-performing financial institutions in attractive markets. They have had the best run economically in this cycle, growing returns faster than the market and earning well above their cost of equity. Their critical challenge is to sustain performance and maintain their leadership position into the next cycle.

2. **Resilients** tend to be top-performing operators that generate economic profit despite challenging market and business conditions. Their strategic priority is to sustain returns in a low-growth, low-interest rate, and highly disruptive environment. For resilient leaders in challenged business models such as broker dealers, reinvention of the traditional operating model itself is the imperative.

3. **Followers** tend to be mid-tier organizations that continue to generate acceptable returns, due largely to the favorable conditions of the markets in which they operate, but whose

Exhibit 26

There are four bank archetypes, based on enterprise strength and market stability

Enterprise strength

The bank's individual state relative to its respective core market[1]:

Performance premium
Return on tangible equity (ROTE) of bank - ROTE of the underlying market in which it operates.

Enterprise health
Assesses the sustainability of the performance premium through qualitative dimensions including (i) culture, and (ii) ability to manage balance sheet risks, operational (including digital) and reputational risk.

Market stability

Level of stability and performance based on underlying key factors:

Market profitability
Average ROTE of the relevant market – cost of equity.

Disruption potential:
Assesses the sustainability of the market's profitability through qualitative dimensions including (i) customer behavior shifts and technology trends (ii) supply-side forces including regulation and private capital investment, and (iii) market concentration.

[1]Market is defined as a homogenous customer base (asset class), i.e. tend to be geography (Retail and commercial) or global asset class market (CMIB, Wealth and Asset management)

4

archetypes, based on enterprise strengh and market stability

overall enterprise strength relative to peers is weak. The key priority for followers is to rapidly improve operating performance to offset market deterioration as the cycle turns by scaling, differentiating or radically cutting costs.

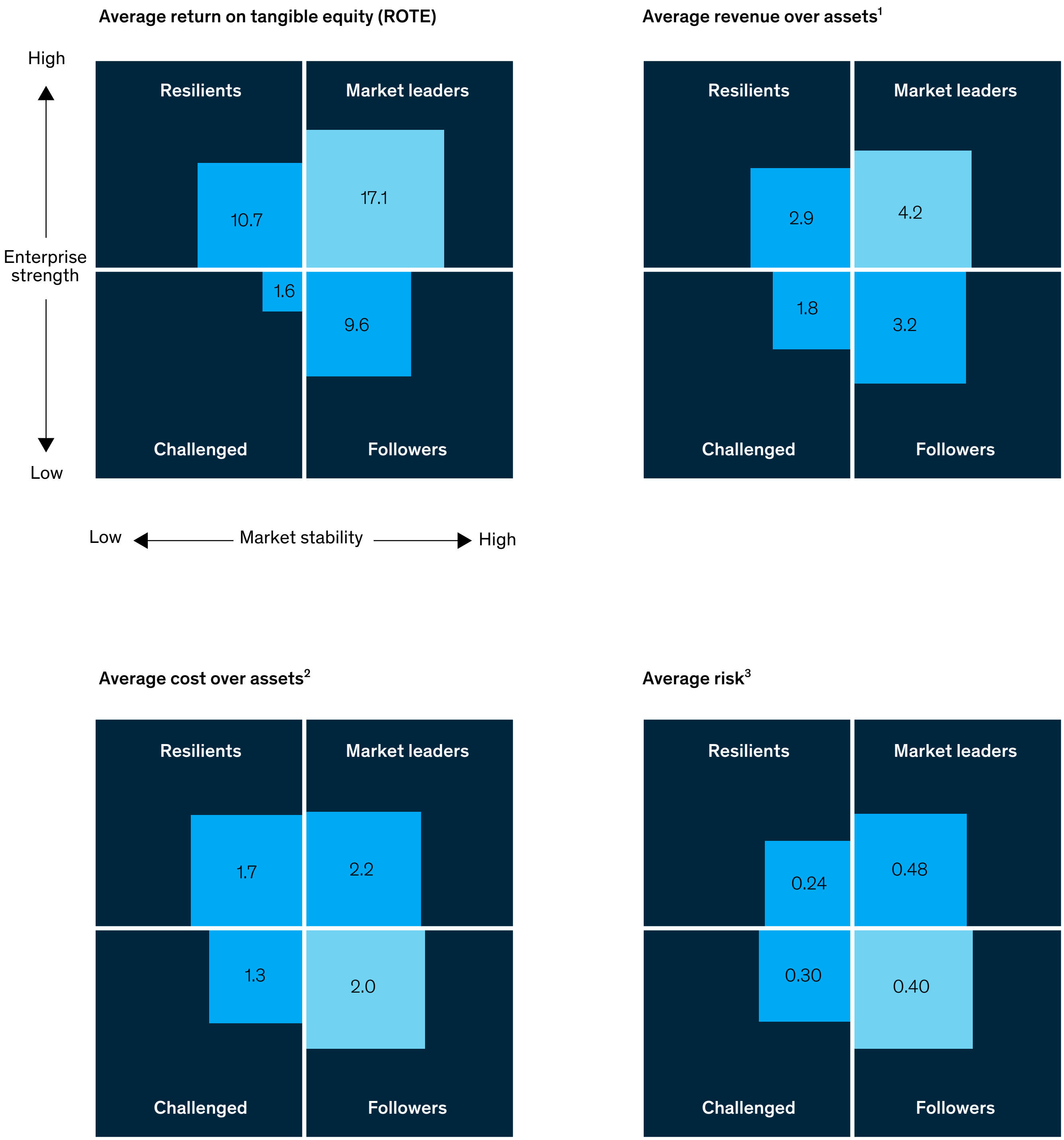
4. Challenged banks generate low returns in unattractive markets and, if public, trade at significant discounts to book value. Their strategic priority is to find scale through inorganic options if full reinvention of their business model is not feasible.

To identify the degrees of freedom relevant for each bank archetype, we assessed: (i) who they are: a description of how banks in each archetype have performed economically in recent years (Exhibit 27) and (ii) where they live: the underlying health of the markets in which they operate (Exhibit 28). These factors point to what they should prioritize, that is, the critical moves banks in each archetype should prioritize during the late cycle.

Exhibit 27

Revenue yield is the key differentiator across the four archetypes

Average performance metrics by archetype, 2016–18, %

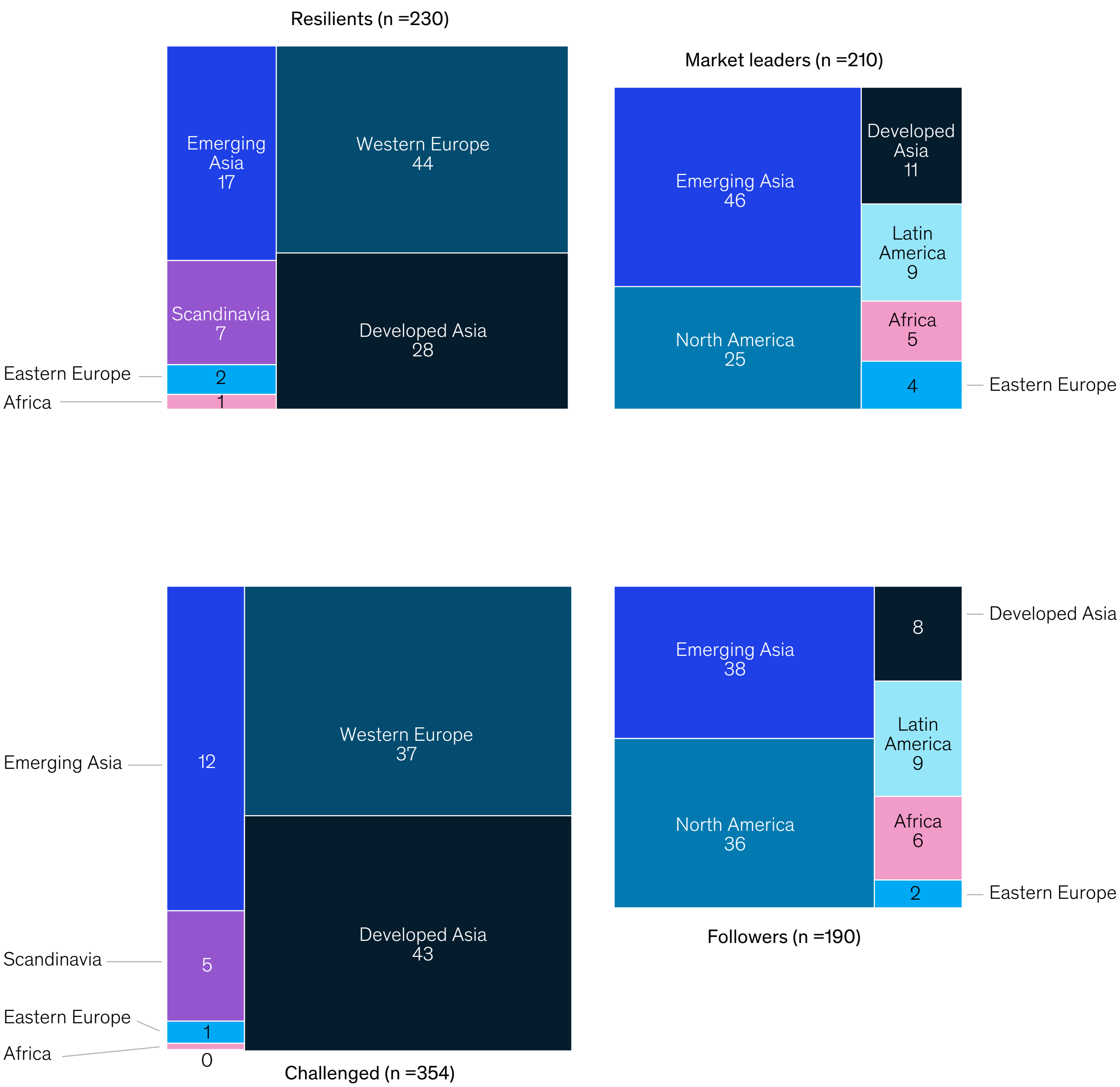


[1]Operating income over assets. [2]Operating expenses over assets. [3]Impairments cost over assets. Metrics are simple averages per bank.
Source: S&P Global Market Intelligence (n = size of 984 banks from different banking segments)

Exhibit 28

Favorable markets are primarily in Asia and North America, while unfavorable markets are found in Europe and developed Asia

Geographical split of archetypes, % of total



Source: S&P Global Market Intelligence (n = 984 banks)

Archetypal levers comprise three critical moves—ecosystems, innovation, zero-based budgeting—in two of the three dimensions discussed in Chapter 2—that is, productivity and revenue growth. Combining the universal and archetypal levers results in the degrees of freedom available to each bank archetype (Exhibit 29). Unsurprisingly, market leaders and resilients should focus primarily on levers that will allow them to gain further scale and grow revenues through ecosystems and innovation, with productivity improvements limited to outsourcing non-differentiated costs to third-party "utilities." By contrast, followers and challenged banks both need to achieve productivity improvements through ZBB, and additional scale within their niche segments with inorganic options as the most credible choice.

A brief look at the archetypal levers

The ecosystem opportunity for driving growth

In previous editions of the *Global Banking Annual Review*, we have examined in detail ecosystems that reach across and beyond banking. What has become particularly important over the past 12 months is the increased significance of scale, the pressure to find new revenue streams, and the threat from innovative big tech challengers (for example, Facebook and Amazon). These trends increase the attractiveness of ecosystems, which offer a unique way to supercharge scale geographically or within a customer segment by leveraging the bank's customer relationships and data. As such, given rapid innovation and the high number of customer touchpoints that allow an institution to "own" the client relationship, payments services have become a key ecosystem battlefield (Exhibit 30). It is no surprise that several large technology enterprises have entered banking through payments (for example, Apple Pay, Alipay, Google Pay). Furthermore, ecosystems are no longer only an "Asian retail consumer" success story, as we now see successful examples across North America, as well as in global wholesale banking.

Identifying the four bank archetypes

The degrees of freedom available to a bank in setting its strategy depend on both (i) enterprise strength relative to peers and (ii) the market stability of the domain within which the bank operates. Each dimension is characterized by both quantitative and qualitative methods that capture the current state as well as the likelihood of change. Based on this framework, each bank falls into one of four archetypes.

Enterprise strength is reflected in a bank's performance premium and health. While the bank's performance premium relative to its peers reflects its strength in its relevant markets, this alone fails to capture the enterprise's overall health, that is, its ability to sustain its performance premium.

Performance premium: Answers the question, "Is the bank a high performer?" This is determined by calculating the bank's three-year average ROTE less the three-year average ROTE of the market(s) in which it operates. "Market" may refer to a homogenous customer base (for example, an asset class), geography (especially for retail and commercial banking), or global asset class market (for example, capital markets and investment banking or wealth and asset management). As discussed in Chapter 1, performance has a high correlation with in-market scale, so this dimension captures in-market size and a bank's true ability to generate scale benefits.

Enterprise health: Answers the question, "How susceptible to risk (relative to peers) is the bank's business model?" We determine this through a combination of quantitative factors (for example, direct risk exposures to market and credit risk in specific sectors or asset classes) and measurable qualitative elements such as non-balance sheet risk (for example, operational risk, including digital and reputational risk) and the enterprise's culture. Market stability combines the market's profitability and its potential for disruption, with market profitability reflecting the current attractiveness of the market and disruption potential indicating the sustainability of that performance.

Market profitability: Answers the question, "Does the underlying market return its cost of capital?" We determine this by calculating the three-year average ROTE of the market minus the cost of equity. Like the performance premium in enterprise strength, returns are considered specific to the relevant customer base (asset class), typically by geography (for retail and commercial banking) or global asset class market (for CMIB, wealth and asset management, and payments).

Disruption potential: Answers the question, "How much disruptive change is the bank's core market experiencing or likely to experience?" This dimension seeks to capture the underlying structural economic health of the domain within which the bank operates. We determine this by assessing: (i) changes in customer behavior (for example, switching inertia) and technology trends (for example, shift from branch to online channels), (ii) supply-side forces, including regulation (for example, open banking) and private capital investments, and (iii) market concentration (degree of fragmentation or consolidation).

Exhibit 29

Late-cycle degrees of freedom vary across archetypes–consisting of archetypal levers and universal levers

Key late–cycle priorities by archetype

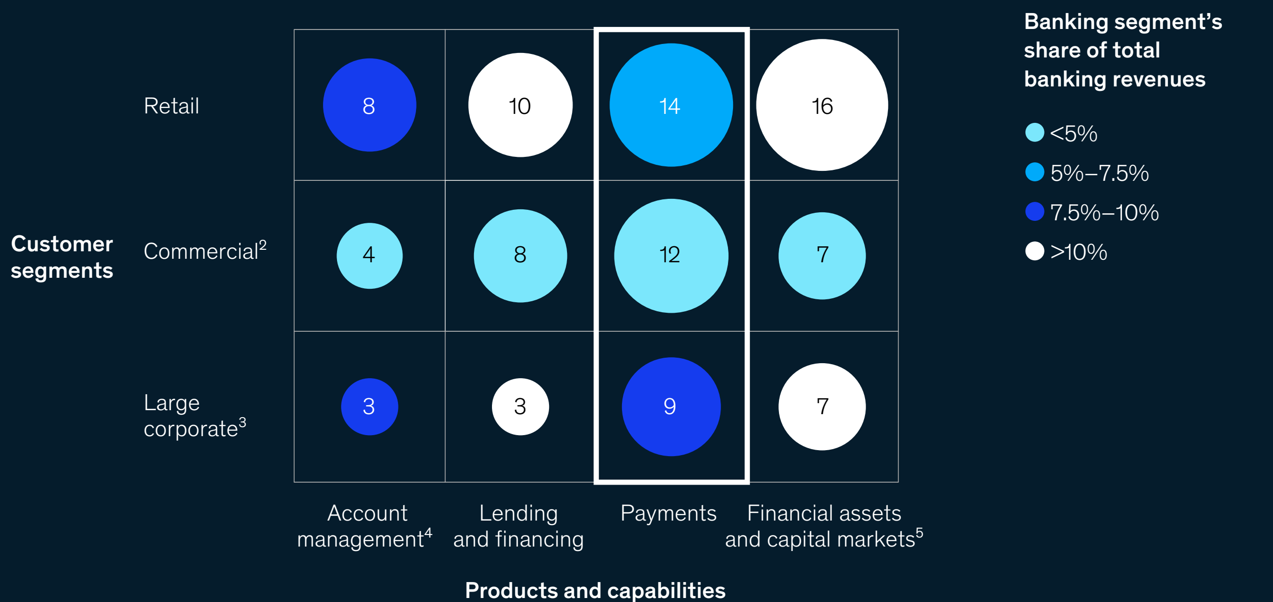
	Archetypal levers			Universal levers					
	Ecosystems	Innovation	ZBB[1]	M&A	Partnerships	Utilities	CX[2]	Risk	Data[3]
Market leaders (21%)	■	■		■		■	■	■	■
Resilients (23%)	■	■	■		■	■	■	■	■
Followers (19%)		■	■	■	■	■	■	■	■
Challenged (36%)			■	■		■	■	■	■

[1]Zero-based budgeting. [2]Customer experience. [3]Data and advanced analytics, and talent.

Exhibit 30

Payments is a key battleground for customer innovation by incumbents and new entrants

Innovating players by customer segment and product focus, 2018, % of total[1]



1,700+ cases registered in the database as of August 2017, might not be fully representative. [2]Includes small, and medium-size enterprises. [3]Includes large corporates, public entities, and non-bank financial institutions. [4]Includes retail current account (CA) deposit revenue and corporate CA and non-CA deposits. [5]Includes investment banking, sales and trading, securities services, retail investment non-CA deposits, and asset management factory.
Source: McKinsey Panorama FinTech database, Panorama Global Banking Pools

43%

of current market leaders will cease to be at the top come the next cycle

How can banks use the ecosystem opportunity to their advantage in the next two to three years? Given the short span of time that a late cycle typically offers, we focus on two ecosystem models: Orchestrators of existing platforms and participants that access other platforms to quickly extend revenue footprint without significant investments (see previous GBARs for detailed definition of ecosystem archetypes).

Ecosystem orchestrators can monetize their platforms by: (i) bundling low- and high-frequency products and services, (ii) cross-selling through partners' channels, and (iii) using multidimensional data for precision marketing. State Bank of India (SBI) is an example of the power of increasing the frequency of client touchpoints. In 2017, it launched YONO, an integrated digital banking platform combining SBI's low- to mid-frequency traditional banking ecosystem with its high-frequency online (non-banking) marketplace, enabling users to bank and shop in a single visit. The platform handled 2.5 million transactions in the first quarter of 2019, up 224 percent from the previous quarter—with over 27,000 banking accounts opened every day.

Ecosystem participants can both acquire new customers and build value by manufacturing key products and services such as payments and credit services for distribution through existing platforms either under their own brand or through a white-labeling opportunity. In either case, the product through which a bank participates in the ecosystem should be chosen by identifying an unmet need or an underserved segment that the bank can address through its best-in-class capabilities or low-cost banking. Participant banks will, of course, need to establish customized and tested APIs that ensure the orchestrator's systems can communicate without glitches. Extending loans to SMEs via Amazon's platform is one example.

What is more, banks need not choose just one ecosystem. In our view, companies that join multiple ecosystems can expect to create more value, as they can achieve economies of scale by sharing customer acquisition costs and improving their cross-selling capabilities. Finally, given the right machine learning and AA capabilities, the new customer data to be captured from value chains spanning multiple ecosystems can yield highly valuable insights, enabling banks to lower risk and other costs while also deepening customer relationships.

Unleashing innovation to fortify and build competitive advantage

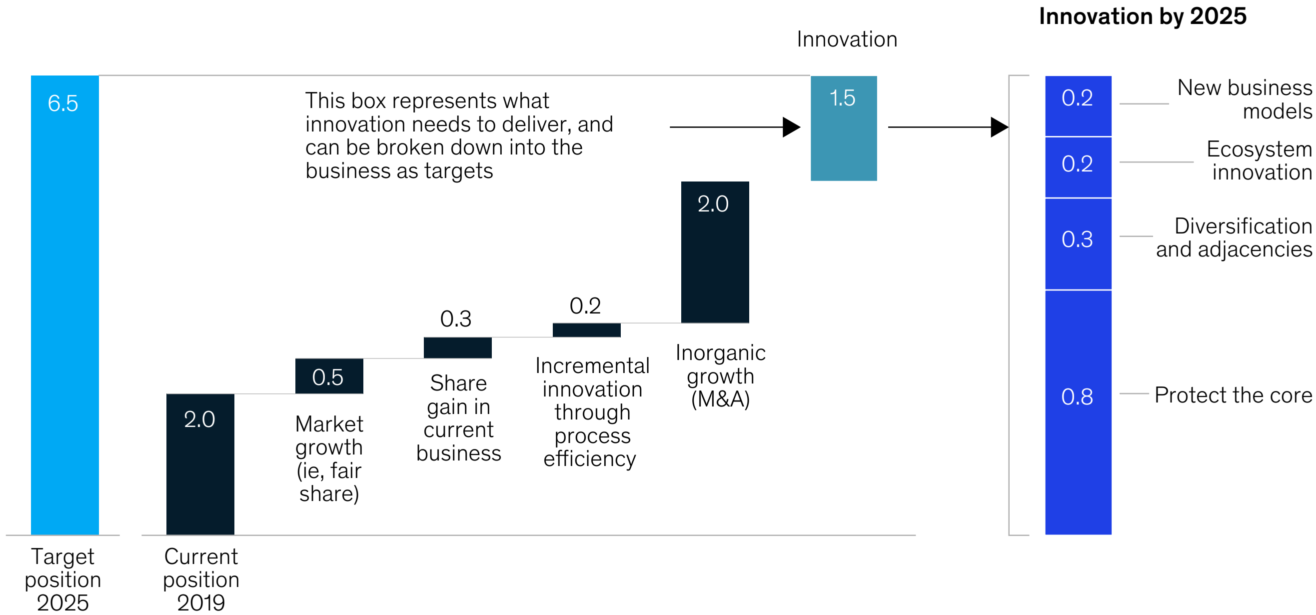
While exploring specific innovations that a bank might pursue lies beyond the scope of this report, we discuss the importance of adopting a portfolio approach for managing the organization's innovation initiatives in a systematic and holistic way to maximize the success of its innovation investments. To develop innovation into a strategic core competency, banks must answer three key questions: (1) What ROI and contribution to revenue and profits do we need from innovation, and how quickly do we need these results? (2) What portfolio of innovation initiatives can attain this ROI and fulfill our strategy? (3) How will we adjust the level of risk in the innovation portfolio as we move through the cycle?

The first step is for top leaders to set goals for the return on innovation (the "green box" in Exhibit 31), define metrics to measure progress, and set time frames for achieving these goals. All these aspirations must be "wired" into annual plans to help leaders measure ROI, understand which initiatives to continue and discontinue, and establish accountability. In our work across industries, we have found that 65 percent of leading innovators set their aspirations in this manner, compared to only 20 percent of all other companies.

Exhibit 31

An organization without clear aspirations and quantified, committed goals for innovation will fail to innovate at scale

Revenues of hypothetical organization, $ billion



Source: McKinsey Innovation Practice

The second step is to manage the organization's innovation efforts and investments as an integrated "innovation portfolio." Banks should manage these initiatives as a portfolio, prioritizing them according to their relevance to strategic priorities, risk, and time to impact. Through this portfolio view, leaders can manage the balance between short-term initiatives that will generate revenue or cost savings relatively quickly, with longer-term investments. Leaders should look for opportunities to reallocate resources, doubling down on initiatives that are succeeding and quickly killing those that are struggling by using metered funding, agile governance, and other mechanisms. Our research shows that 47 percent of leading innovators have strong innovation portfolio management and resource allocation systems, compared to 12 percent of other companies.

Finally, banks should integrate the first two steps within a robust operating model that will allow them to periodically adjust the aspiration (the "green box"), deciding which initiatives to drop and which ones to accelerate as macroeconomic and industry conditions change. The transparency and fast decision-making mechanisms of this model free banks from the need to impose a "universal haircut" on all innovations in a slowdown, only to restart them once conditions improve. Ultimately, innovation is not an "on/off" switch but rather a range of options that can be exercised to optimize returns through the cycle.

Zero-based budgeting: Rethinking the operating model bottom-up

The operating platforms and organizational structures in banks—especially those in developed markets—were built for growth and interest-rate scenarios that are unlikely to materialize in the medium term. This, in addition to increased digitization, calls for an entirely new operating model that is hard to build incrementally. However, lessons from other industries—including automotive manufacturers and telcos—prove that true cost transformation for established players is possible if the operating model is zero-based (Exhibit 32). Further, ZBB embeds a model and culture of continuous improvement, setting banks up to weather late-cycle challenges, especially in constrained markets. In fact, the zero-based model has already been tested in the banking sector, with a leading European bank achieving a reduction of 280 bps in the C/I ratio soon after implementation.

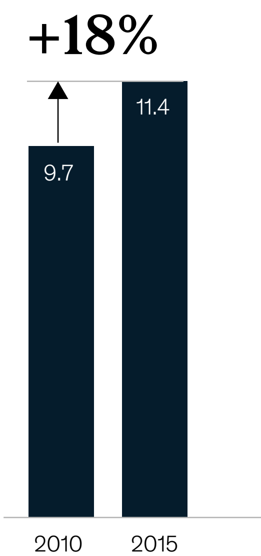
To execute a ZBB program, banks will have to fundamentally rethink the way they look at cost. ZBB is a repeatable process to rigorously review every dollar in the annual budget, manage monthly financial performance, and build a culture of cost management. What makes ZBB unique is not the budgeting methodology but the shift in mindset that upends managers' default assumptions. As one executive who made the transition to ZBB told us, "It was more effective to talk about every dollar

Exhibit 32

Other industries have shown that true cost transformation is possible if the operating model is zero based

Automotive manufacturers

Operating margin, %

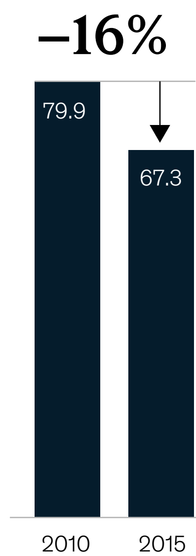


Approach

- Streamlined product portfolio based on a modular approach
- Transferred lean management principles from blue-collar to white–collar working environments
- Used continuous improvement assumptions for budgeting: managers have to constantly look for efficiency improvement opportunities
- Continuous–improvement assumption also transferred to supplier negotiations

Telcos

EU 6[1], Structural costs, € billion



Approach

- Reducing head count continuously
- Shifting large portion of sales to less expensive online channel and facilitating self-service solutions
- Mix of out-offshoring of both non-core and core activities
- Consolidation through in-country and cross-country M&A
- Setting up of shared service center

Efficiency initiatives engaging staff to identify possible cost savings

[1]Top 6 EU markets: UK, Germany, France, Spain, Italy, and Netherlands.
Source: S&P Global Market Intelligence, 15 top global banks by asset size; WBI tool & McKinsey analysis

spent in terms of efficiency, and ask if it was really necessary, rather than to compare it to last year. It resets the discussion.”[1] While ZBB is a powerful lever for material cost reduction, it is a challenge to implement throughout an organization due to the depth and breadth of change it requires. In short, this archetypal lever is best pulled by banks that need critical change.

Who you are you and what are your late-cycle priorities? Game board for the archetypes

Market leaders: Priorities to retain leadership into the next cycle

Who they are. Market leaders have benefited from favorable market dynamics as well as their (generally) large scale, both of which have allowed them to achieve the highest ROTEs of all bank archetypes—approximately 17.0 percent average ROTE over the previous three years. And they have achieved this leadership without having to focus too much on improving productivity, as reflected in their average C/A ratio of approximately 220 bps. Unsurprisingly, most of the market leaders in developed markets are North American banks; however, it is also interesting to note that a significant proportion (approximately 46 percent) of market leaders consists of banks in emerging markets in Asia—mainly China—and the Middle East. These banks, even with declining ROTEs in the previous cycle, still have returns above the cost of capital.

Priorities for the late cycle. For this group, the need for action is clear as we head into the late cycle: These banks must understand their key differentiating assets and invest in innovation using their superior economics, especially when peers cut spending as the late cycle bites. As noted earlier, history shows us that approximately 43 percent of current leaders will cease to be at the top come the next cycle (Exhibit 33). The investments made now—whether organic or inorganic—will decide their place at the top table in the next cycle.

Given the scale advantages that leaders enjoy, banks in this group will be challenged to sustain revenue growth, especially as credit uptake typically slows in the late cycle. The focus now needs to shift toward increasing their share of wallet among current customers by extending their proposition beyond traditional banking products. This should be done through a classic ecosystem move, where they can generate capital-light fees by introducing other products into their platforms. This approach should allow them to expand

1 Matt Fitzpatrick and Kyle Hawke, “The return of zero-base budgeting” McKinsey.com, April 2015.

revenues in a short period of time without spending significant amounts in development or acquisition costs. Meanwhile, improvements to the bank's innovation capabilities as well as capital commitments to innovation should remain in the forefront. Market leaders are also in prime position to explore opportunities to acquire smaller banks that have a customer base that is like their own, or a struggling fintech that has digital capabilities that can supplement the bank, and to pursue a programmatic M&A strategy across a select set of key technologies. In most cycles, a downturn creates the best opportunities, and now is the time to create the wish list. Fundamental to all these is the need to retain a strong capital and management buffer beyond regulatory capital requirements to capitalize on a broad range of opportunities that will likely arise.

Resilients: The challenge of managing returns in sluggish markets

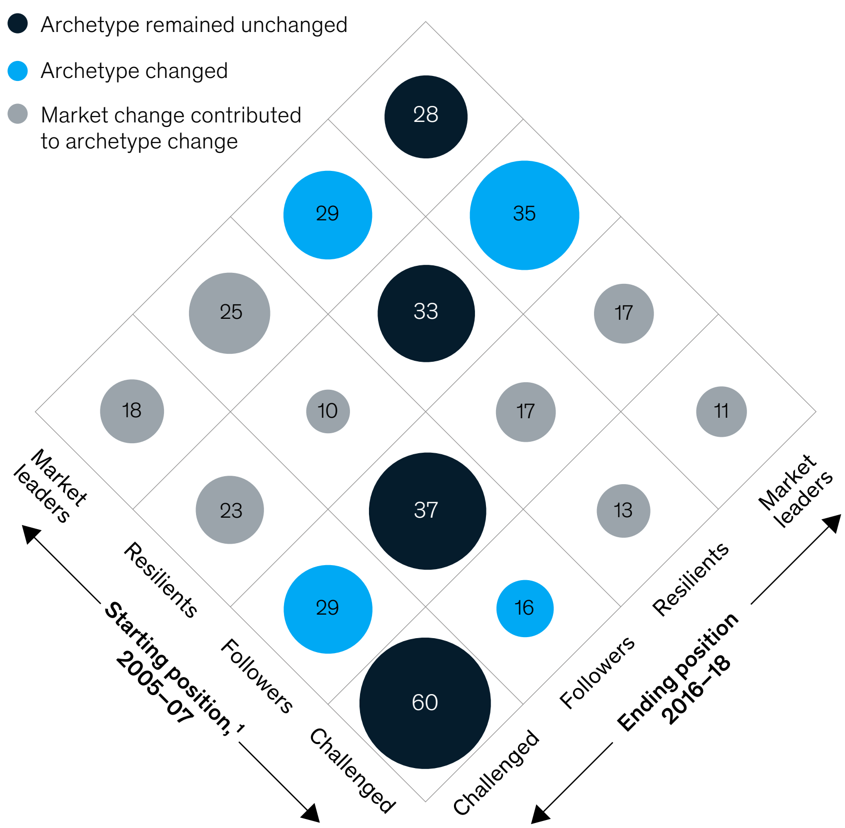
Who they are. Resilients have been strong operators and risk managers that have made the most of their scale in what have been challenging markets due to either macroeconomic conditions and/or disruption. This has allowed them to generate returns just above cost of equity, with average ROTE of 10.7 percent over the previous three years, without taking on undue risk, as reflected in the lowest impairment rates of all archetypes (24 bps). Banks in this archetype have worked hard at costs even as they have struggled to maintain revenues, beating the C/A ratios of market leaders (their peers in buoyant markets) by nearly fifty basis points. However, at 170 bps, there is still significant opportunity for productivity improvements when compared to best-in-class peers. Unsurprisingly, resilients are almost all in Western Europe and developed Asian markets such as Japan, which have been the toughest banking markets over the past three years. Leading broker dealers also feature in this group.

Priorities for the late cycle. Like market leaders, resilients must seek constantly a deeper understanding of which assets set them apart from the competition and take advantage of their superior economics relative to peers to invest in innovation, especially when peers cut spending as the late cycle takes hold. However, unlike market leaders, given that they

Exhibit 33

Leaders must be careful and laggards can be hopeful; archetypes move across cycles

Odds of remaining in same archetype, % of banks



What typically shapes a bank's odds?

Endowment **(who you are)**

- Size
- Regulatory capital levels
- Past investments in product development and technology

Trends **(where you are)**

- Banking profitability in core markets
- GDP growth in core markets

Moves **(what you do)**

- Reinvestment to promote organic growth
- Resource reallocation toward high (ROE), businesses with growth potential
- Improved margins from lower costs, reduced credit losses, and lower deposit rates
- Changing product or pricing mix that supports higher gross interest income and/or greater levels of fee income
- Inorganic moves—acquisitions, disposals, and partnerships

[1]Defining average return on tangible equity (ROTE) of markets as 15%, 2005–07.
Source: S&P Global Market Intelligence (n = 432 banks)

already operate in an unattractive market and barely earn their cost of capital, they have a higher sense of urgency in making their late-cycle moves.

The first item on their agenda, just like market leaders, should be to focus on increasing their share of wallet among their current customers through enhanced CX and by building a value proposition that extends beyond the traditional set of banking products. The most practical path is to expand their ecosystem activities and improve their ability to innovate. Second, those with a large infrastructure asset (for example, securities companies), should innovate by white-labeling their platforms across non-competing peers and other industry participants to find new ways of monetizing their assets. Further on the cost front, resilients need to pay closer attention to opportunities for improving productivity by exploring bank-wide appetite for ZBB. Where the resilients differ from market leaders is in inorganic levers. Due to their lower excess capital reserves, they should explore strategic partnerships to acquire scale or capabilities rather than material acquisitions. However, they should remain alert to the possibility of a compelling distressed asset becoming available.

Within resilients are banks that are less challenged by the macro conditions and more by the declining economics of their own underlying business models. For these, the playbook listed above definitely holds but they need to go beyond. As mentioned earlier in this report, there is an urgent need to find areas where they can actually add value and get rewarded as their core business economics fall. Identifying those areas and ramping up on those capabilities organically or inorganically will be the late cycle priority.

Followers: Preparing for tailwinds turning to headwinds

Who they are. Followers are primarily mid-sized banks that have been able to earn acceptable returns, due largely to favorable market dynamics. However, their returns (on average 9.6 percent ROTE) have been little more than half of those of market leaders, who have also operated with the same favorable market dynamics. The principal driver of their underperformance relative to market leaders is in revenue yields, where they are 100 bps lower. Finally, given their underperformance relative to other banks in similar markets, they have invested in productivity improvements and have C/A ratios 20 bps lower than market leaders but 70 bps higher than similarly underperforming peers in more challenged markets. Approximately 76 percent of followers are North American and Chinese banks.

Priorities for the late cycle. There is a clear need for action with bold moves to ensure that returns do not deteriorate materially during a downturn. Furthermore, if they are to be among the 37 percent of follower banks that become leaders regardless of market environment (Exhibit 31), now is the time to build the foundation as they still have time to benefit from the excess capital that operating in a favorable market gives them.

Given their sub-scale operations and the fact that they are still in a favorable market, they should look for ways to grow scale and revenues within the core markets and customer sets that they serve. This includes both organic and inorganic options. On the latter, followers, which have underperformed their peers in buoyant markets, should also reevaluate their portfolios and dispose of non-strategic assets before the market turns.

Organically, growth priorities for this group are best realized by achieving a high standard of CX and improving the bank's innovation capabilities, with an emphasis on understanding ways to better serve the specific needs of their niche market rather than developing revolutionary new products. They should also explore strategic partnerships that allow them to offer new banking and non-banking products to their core customers as a platform, thereby extending much needed capital-light, income-boosting returns.

Cost is also a significant lever for this group. With an average C/A ratio that is 70 bps higher than peers in more challenged markets (where challenged banks as a group have pulled the cost lever harder than other archetypes), followers have the potential to improve productivity significantly. For the portion of the cost base that cannot be outsourced to third parties, implementing ZBB is a highly effective way to transform the bank's approach to costs.

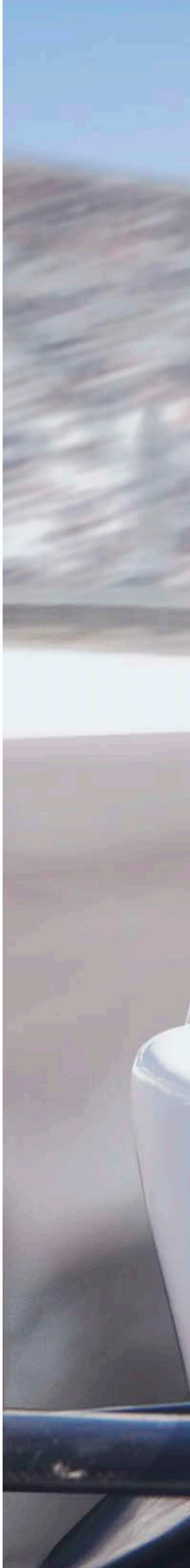
Followers need to make bold moves to ensure that returns do not deteriorate materially during a downturn.

The Challenged: Final call for action

Who they are. Some 35 percent of banks globally have earned a mere average of 1.6 percent ROTE over the past three years. This is the lowest average return of all archetypes and well below the cost of equity of these banks, which we classify as "challenged banks." With an average C/A ratio of 130 bps,

180 bps

average revenue yields for challenged banks, compared to 420 bps for market leaders



they have the best cost performance. The problem, however, is in revenues, where they have the lowest revenue yields, at just 180 bps, as compared to an average revenue yield of 420 bps among market leaders. Further analysis of this category also points to the fact that most operate below scale and are "caught in the middle," with neither high single-digit market share nor any niche propositions. Unsurprisingly, most of these banks are in Western Europe, where they contend with weak macro conditions (for exapmle, slow loan growth and low interest rates).

Priorities for the late cycle. For challenged banks, the sense of urgency is particularly acute given their weak earnings and capital position; banks in this group need to radically rethink their business models. If they are to survive they will need to gain scale quickly within the markets they currently serve. To that end, exploring opportunities to merge with banks in a similar position would be the shortest path to achieve that goal. Potentially high-value mergers within this segment are of two kinds: first are mergers of organizations with completely overlapping franchises where more than 20 to 30 percent of combined costs can be taken out, and second are those where the parties combine complementary assets, for example, a superior customer franchise and a brand on one side and a strong technology platform on the other.

The only other lever at hand is costs, in which this group already leads other banks. However, there should still be further opportunities, including the outsourcing of non-differentiated activities and the adoption of ZBB, both discussed earlier. With an average C/A ratio of 130 bps, challenged banks as a group still have a good 50 bps to cover before they produce the best-in-class cost bases we've seen from Nordic banks. In addition, costs (especially complexity costs) could creep up as the group chases higher revenue yields through product introductions. It is better to launch products off a leaner base, and, should a bank seek an acquirer, a lower cost base would also help strengthen valuations.

Conclusion

While the jury is still out on whether the current market uncertainty will result in an imminent recession or a prolonged period of slow growth, the fact is that growth has slowed. As growth is unlikely to quicken in the medium term, we have, without question, entered the late cycle. Compounding this situation is the continued threat posed by fintechs and big technology companies, as they take stakes in banking businesses. The call to action is urgent: Whether a bank is a leader and seeks to "protect" returns or is one of the underperformers looking to turn the business around and push returns above the cost of equity, the time for bold and critical moves is now.

To this end, banks should urgently consider a suite of radical organic or inorganic moves before we hit a downturn. These universal levers span both defensive moves (for example, improving risk management with advanced analytics and artificial intelligence) and offensive moves (such as dramatically lowering costs by outsourcing non-differentiated cost drivers to industry utilities). And at the same time, making tactical improvements to customer experience to find elusive revenue growth and building advanced data analytics capabilities to support the effort. If executing any of these moves organically turns out to be a challenge, the environment is fertile for mergers, acquisitions, and partnerships. Boards and management teams need to execute fast to create the scale that they need to succeed.

However, all banks are not made equal—be it in their starting economic position or the attractiveness of the markets and business models in which they operate. To reflect these nuances, we divide banks into four archetypes with varying degrees of urgency and action. Leaders in both buoyant and stagnant markets have ridden their scale and differentiated proposition through this economic cycle earning superior returns and generating the luxury of excess capital. What these banks do now with their capital will decide their fate in the next cycle. Investing heavily in innovation where they have the highest competitive conviction will be key; investments should include attempts to reinvent business models to face potential disruption down the line. Leaders should stretch their operating model to look at monetization options beyond banking. Inorganic options should also be considered to add scale or to reinvent business models; especially as certain attractive assets will most certainly come into play. History tells us that 40 percent of those at the top drop to the bottom half of peers in the next cycle—moves made today will have a defining role in hedging the probability of that slide.

Then there are the followers and challenged banks. For many, the urgency now is about finding niches in their business model where they are truly champions and doubling down organically and inorganically to build scale around these customer and product sets. It is clearly an opportunity they have missed in this cycle. However, for the nearly 35 percent of banks classified as challenged, the barely one to two percent ROTE that they generate doesn't leave them with marginal organic options. These banks face a last call for radical inorganic moves to build scale or restructure business models before it's too late.

Postscript

Reinvent, scale, differentiate, or perish: These are the stark choices banks face today. With late-cycle clouds gathering, the call for action is loud and clear.

And lest we forget in our shareholder value-oriented pursuit of scale and returns, we note that banks remain the fundamental pillars of money transmission and the custodians of the wealth of nations. Because of the special role they play in society, they, perhaps more than other industries, benefit from society in areas such as deposit protection and regulation as a means of constraining supply. In return, they are particularly accountable in an era of rising inequality and falling faith in historically trusted institutions; beyond shareholders to society and the sustainability of the environment in which they and their clients operate.

Late cycles spur talks of “bad banks.” Society—including investors and regulators—increasingly wants “good banks,” i.e., banks that have a firm sense of their “why.” As the proverb goes, “If you know your ‘why,’ it is a lot easier to figure out ‘how.’ And as the Business Roundtable noted in its recent statement on a broader stakeholder capitalism, banks especially need to figure out their purpose in society beyond the basic economic role they play. Those banks that look beyond the regulator’s license and central bank protection in grappling with their reason for existing will thrive in the late cycle and into the next.

This annual review of the global banking and securities ("banking") industry is based on data and insights from McKinsey Panorama, McKinsey's proprietary banking research arm, as well as the experience of clients and practitioners from all over the world.

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