



Change is opportunity: Cooperative banks on the cusp of a new era

Profound change is roiling the financial sector, and coops are faced with several strategic questions.

**Pierre-Ignace
Bernard and
Jonathan Tétrault**

After decades of rapid growth that has given the world a much more finance-based economy, the banking sector is now entering a new era. Banks are starting to grapple with comprehensive banking reforms in Europe and the United States, which have begun to impose heavy costs and may force a radical revision of their business models. At the same time, emerging markets are maintaining relatively robust growth rates even as developed markets remain stagnant; new nonbank firms are encroaching on banks' traditional turf; and technological advances and evolving customer preferences are setting the stage for an important revolution in retail banking. Taken together, these changes seem likely to usher in a new phase of slower growth and tougher competition.

For cooperative banks to successfully navigate this new environment, it is essential for their leaders to understand fully the underlying trends and their implications. In particular, cooperative bankers must be aware of the new opportunities that these secular changes will create; the pursuit of these should form the basis of new strategies to help cooperative banks fulfill their mission.

Banking in 2020

We argue that five trends will transform the banking industry over the next decade.

1. Right-sizing the platform

Following the crisis, many countries introduced new regulations in the hope of making their

Exhibit 1

New regulations are lowering European retail-banking ROE.

Regulations' effects on retail-banking ROE,¹ %²

	France	United Kingdom	Germany	Italy	Average ³
Preregulation	13.5	13.6	6.6	5.1	10.1
Basel III	-2.9	-2.8	-2.1	-1.4	-2.4
EU Mortgage Directive	-0.4	-0.4	-0.1	-0.3	-0.3
EU payments regulation (SEPA ⁴)	-0.2	-0.1	-0.1	-0.1	-0.1
EU investment regulation (MIFID ⁵ II)	-0.4	-0.5	-0.4	-0.1	-0.4
National regulation	N/A	-2.8	-0.3	N/A	-1.0
Postregulation	9.5	7.0	3.5	3.1	5.8

¹Return on equity.

²Figures do not sum due to the effects of rounding.

³Weighted average based on the volume of risk-weighted assets (RWAs) held by banks in each country in 2011.

⁴Single Euro Payments Area.

⁵Markets in Financial Instruments Directive.

banking systems sounder and more robust. Although this goal may well be achieved, these new regulations have begun to exert a material negative impact on banks' return on equity (ROE) and will continue to do so: for example, we estimate that the new rules will lower ROE for retail banking in Europe's four largest markets from about 10 to 6 percent on average, before any mitigation action (Exhibit 1). Basel III will affect ROE the most and will require higher capitalization, stronger capital quality, and more funding and liquidity for banks. Its impact will be particularly large for banks' capital market businesses and, in the United States, the Dodd-Frank Act will impose additional capital market restrictions.¹ At the same time, we expect that capital will become scarcer and hence more

expensive—worldwide and in all sectors—due mainly to an investment boom in emerging markets but also to aging populations in many parts of the world and a rebalancing of China's economy toward consumption, reducing its savings rate.²

This combination of lower ROE and higher cost of equity puts banks in a bind. In the past, banks have been able to grow out of their problems; today, some may again be pinning their hopes on a recovery in revenues. However, we think this is unlikely. We expect that the prospect of a long period of unprofitability will force banks to restructure their operations. Primarily, this will mean further cost cuts. We estimate that on average, European and US banks would need to reduce

¹For more, see McKinsey Banking and Securities (Europe) practice, "Day of reckoning for European retail banking," July 2012; and McKinsey Working Papers on Risk, Numbers 25, 26, 27, and 29, all available at mckinsey.com.

²Richard Dobbs et al., "Farewell to cheap capital? The implications of long-term shifts in global investment and saving," McKinsey Global Institute, December 2010 (mckinsey.com).

costs by more than 20 percent over the next five years to return their ROE to 12 percent. Other steps include allocating capital more strategically, maximizing capital efficiency, and limiting capital-intensive operations, especially in capital market businesses.

account for over 60 percent of global banking-revenue growth from 2010 to 2020 and that by 2020, emerging markets will represent about half the world's banking revenue (up from 34 percent in 2010).⁵

The picture is rather different in advanced economies; many are still deleveraging, trying to work off high levels of household and public debt, and most are plagued by high unemployment. After decades of rapid expansion, their banking markets have become saturated and entered a new phase of slower growth. As Exhibit 2 shows, global banking revenue, which increased as a share of GDP from less than 3 percent in 1980 to more than 5.5 percent in 2008, is now expected to grow no faster than GDP and to remain at its post-crisis level of

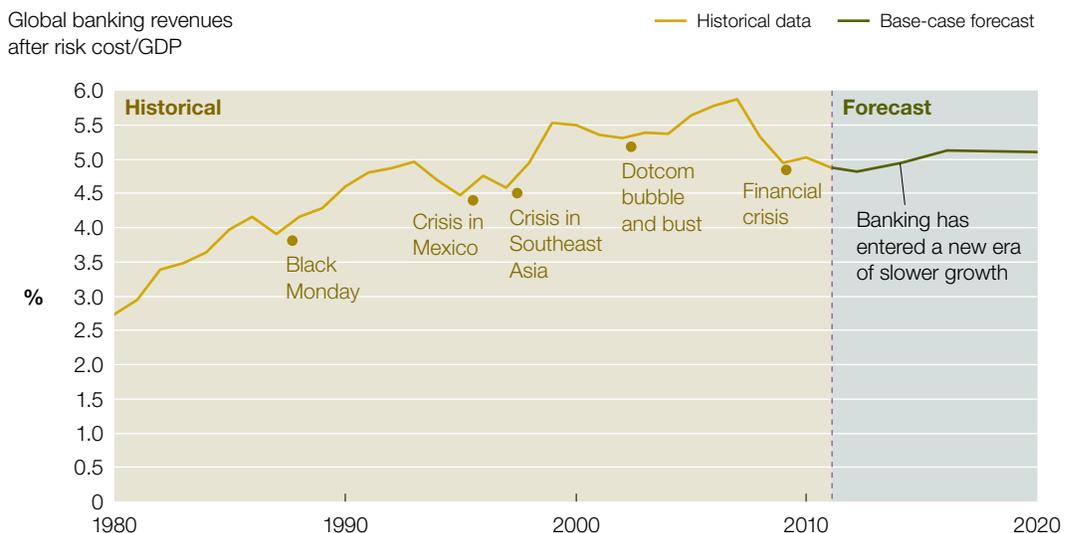
2. Revenues and profits shift to emerging markets

The emerging markets' share of global GDP is rapidly increasing, and their burgeoning middle classes are poised for a massive new wave of consumption of all kinds of goods and services, including financial products.³ Demand is rising and will continue, as 2.5 billion adults still do not use formal financial services and over one billion people have a mobile phone but no bank account.⁴ We estimate that emerging markets will

³For a compendium of McKinsey research drawn from the past ten years of experience with companies in emerging markets and more than 60 proprietary databases and knowledge investments, see Yuval Atsmon et al., "Winning the \$30 trillion decathlon: Going for gold in emerging markets," August 2012 (mckinsey.com).
⁴Alberto Chaia, Tony Goland, and Robert Schiff, "Counting the world's unbanked," mckinseyquarterly.com, March 2010.
⁵McKinsey Global Banking Pools (solutions.mckinsey.com).

Exhibit 2

Banks will be unable to grow as quickly as they have in recent years.



Source: Thomson Reuters; McKinsey Global Financial Initiative

approximately 5 percent of GDP over the next decade.

Although banks from advanced economies will be tempted to seize rapid growth opportunities in emerging markets, they will face high barriers to entry, including limits on foreign control of banks.

3. A seamless multichannel customer experience

The growing use of the Internet, smartphones, and social media is rapidly changing the nature of social and business interactions. As customers become more and more comfortable using the Web and their phones to deal with their banks, they will increasingly expect and demand that other channels (phone and video calls, branches, and banks' presence in social media) match that personalized experience in an integrated way, without exception.

To meet these expectations, even as they are cutting costs, banks must be agile. Most will attempt to build the experience that customers want, redefined as a consistent and seamless offering across all channels. Although the vast majority of transactions will take place on the Internet and on mobile phones, bank branches will still play an important if complementary role, for example, in the handling of complex transactions, and in the provision of high-quality financial advice needed to support complex sales, such as bancassurance products.

But banks' branch networks will be smaller, with fewer and less heavily staffed outlets. In Europe, for example, we expect the average number of full-time equivalents per branch to decrease from ten to fewer than five and the

average branch density to decrease from 475 to 350 per million inhabitants from 2010 to 2015. Formats will also change, with banks deploying a wide variety to accommodate the needs of different customer segments.

4. New competitive threats arise

Over the coming decade, retail banks will face off in a new round of tougher competition. Universal banks' renewed focus on retail will raise the stakes, and saturation and stagnant growth in developed markets will drive more fierce competition for market share. The rise in competitive pressure will be abetted by new digital tools. As customers increasingly use online price and product-comparison tools, they will become more comfortable buying products from several banks, rather than awarding all their business to their main bank. Traditional banking products will become even more commoditized, and pricing will be highly competitive—with few degrees of freedom in a low-interest-rate environment—and banks will have to compete on customer service.

Moreover, many firms, especially some new nonbank players, will use data, innovative technologies, and new business models to threaten lucrative niches currently dominated by banks. For instance, in the payments industry, remote payments, new currencies, business-to-business payments, and e-invoicing are transforming the landscape and will encroach on banks' payments businesses.⁶ Also, integrator tools are increasing the distance between financial institutions and their customers and may threaten banks with partial disintermediation. Direct banks—whose deposits grew more than 20 percent per year

⁶Michael Chui, Robert Mau, and Samantha Test, "The impact of big data on payments," *McKinsey on Payments*, March 2012 (mckinsey.com).

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from 2000 to 2010 and could reach \$500 billion by 2015—will continue to snare business from young, wealthy, Web-savvy consumers.

5. Big data transforms banking products and pricing

By 2020, the world's stored data are expected to have increased by a factor of 30, and computational capacity will continue to expand exponentially.⁷ This will allow new opportunities for banks to improve management, decision making, and operations, provided they can develop the talent and skills that big data requires. For instance, they will fully exploit their customer data to accomplish a range of goals. Data on buying and borrowing patterns in micromarkets can help them build better risk models and allocate capital more strategically and dynamically.⁸ By tracking customers' online behavior and shopping patterns, they will be able to make real-time, customer-specific offers through the customer's channel of choice at point of sale and servicing. They will also be able to assess credit risk in real time and use integrated risk modeling to price products (for example, they will incorporate customer information into home-equity risk models to identify "bad" opportunities and reduce loan losses by an estimated 25 percent).

Similarly, they will launch programs that transform internal and external data to develop

a single, accurate, consistent, and current "golden source" of data, used by every business in the bank.⁹ At one bank, such a single master data repository reduced the cost of data-related problem resolution by about 8 percent.

Implications for cooperative banks

In this section, we ask key questions and offer guiding thoughts that we believe leaders of the world's cooperative banks should consider as they develop strategies to respond to these five trends.

1. How can cooperative banks exploit their focus on customer satisfaction to gain market share?

As public banks face pressure to cut costs to increase ROE, some of their customer satisfaction initiatives may be delayed or suffer. While cooperatives will also need to reduce their costs to remain competitive, we believe that their cooperative mission (as opposed to the imperative to create shareholder value) and their longer-term orientation may give them flexibility to sacrifice some short-term returns. As a result, cooperatives should aim to use that flexibility to deliver best-in-class service to their members at a competitive price.

To that end, cooperatives should, among other things, identify the dimensions of customer satisfaction that are of greatest importance to their members and make corresponding

⁷Brad Brown et al., "Big data: The next frontier for innovation, competition, and productivity," McKinsey Global Institute, May 2011 (mckinsey.com).

⁸Tobias Baer, Tony Goland, and Robert Schiff, "New credit-risk models for the unbanked," McKinsey Working Papers on Risk, Number 30, January 2012 (mckinsey.com).

⁹Institute of International Finance and McKinsey & Company, *Risk IT and Operations: Strengthening Capabilities*, June 17, 2011 (iif.com and mckinsey.com).

long-term investments, especially in areas where competitors are delaying investments. They might ask how they can better leverage their unique cooperative attributes in defining their promise to their members and therefore make them feel like true owners (for example, by giving them the ability to influence the bank's offering, or by providing flawless complaint management). In an environment in which they must be financially disciplined, how should cooperatives prioritize new investments related to customer satisfaction versus their current portfolio of initiatives? Finally, how can cooperatives leverage their often extensive branch network and workforce to provide new and better customer services that will further distinguish them from traditional banks? Winning on customer satisfaction in such a competitive context will be an everyday battle, but one that cooperatives are uniquely positioned to win.

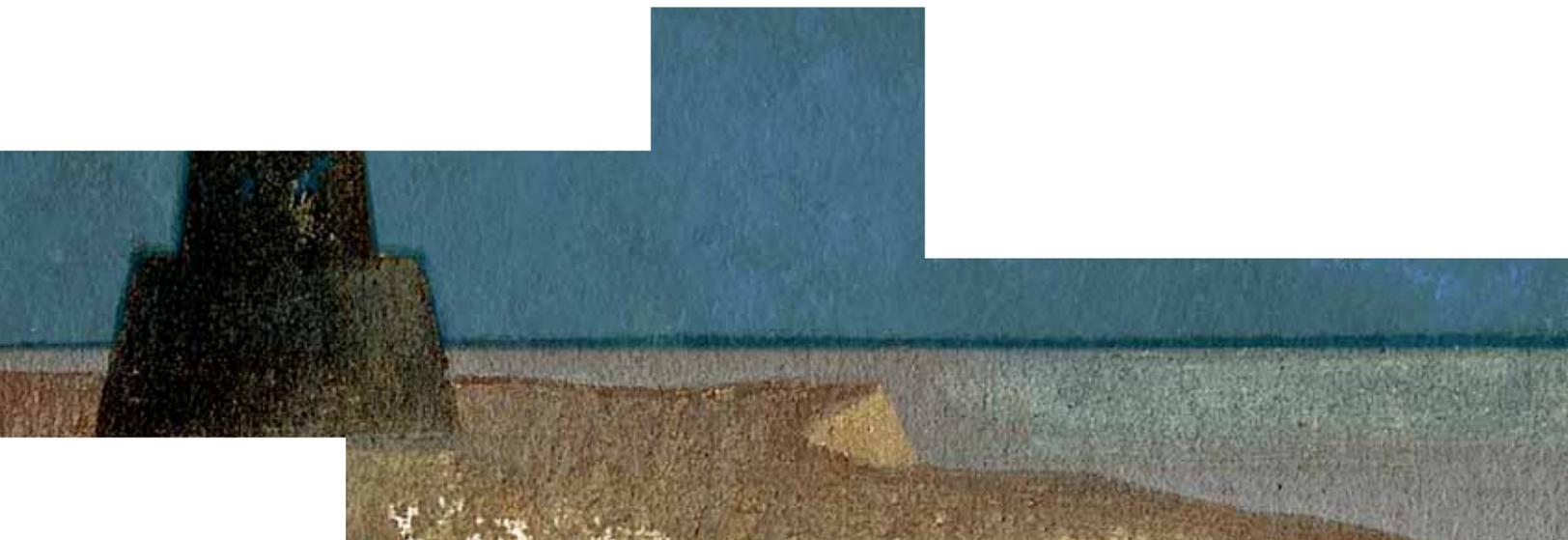
2. Will cooperatives need to look for growth beyond their borders?

Cooperative banks, like their public competitors, must decide whether to expand abroad or focus their resources and management

attention on their potentially saturated home markets. More generally, they should develop a view on how globalization and the shift of economic power toward emerging markets—and competitors' strategies in these markets—will affect their current activities. By staying on the sidelines, some cooperatives might be putting themselves at a strategic disadvantage, at risk of losing high-growth opportunities or additional scale to finance future investments.

Given that cooperatives—in most cases—do not have an explicit mission to seek international growth, they should begin by determining how, and by how much (if at all), their current domestic members stand to benefit from international expansion. Given the nature of these opportunities, cooperatives will, of course, need to assess them on a risk-adjusted basis: opportunities in home markets are typically easier to capture than those in new geographies.¹⁰ In parallel, cooperatives must also assess alternative growth opportunities related to their current member base that could better match members' interests while providing adequate return on capi-

¹⁰ Toby Gibbs, Suzanne Heywood, and Leigh Weiss, "Organizing for an emerging world," *mckinseyquarterly.com*, June 2012.



tal. In short, international expansion is neither a panacea for growth nor a concept that coops should ignore altogether: it may very well suit members' interests at some cooperatives, and not at others. For the former, the next step is to explore all available entry strategies (for example, form an alliance with small local cooperatives, follow corporate members with international activities into new markets, make a targeted push in a new market leveraging a high-performing subsidiary or business unit, and so on). The coop should opt for the one that best matches its competitive advantages to the challenges of international growth.

3. How can the branch network preserve the advantage of proximity while remaining profitable?

As virtualization reduces branch visits and makes the physical network less central to the client relationship, an oversupply of branches will put pressure on coops and their public cousins: they will need either to shrink the network or to find a new role for their branches. Cooperatives are entering a pivotal period in which the branch network could become either a financial liability or a point of differentiation.

For their branches to remain relevant, coops will first have to find compelling reasons for consumers to visit. How can coops take advantage of the changes we expect public competitors to make—reshaping networks to make them leaner and sparser—to develop comparatively stronger relationships with communities and their members? What products or services could be introduced to transform local branches from a fading channel to a competitive advantage?

Coops are decentralized organizations with a good deal of flexibility. Parts of the branch network can readily serve as testing grounds for new concepts and management models. How can coops use this flexibility to unleash creativity?

Coops should consider other questions too. How could branches become knowledge centers that provide truly personalized financial advice and planning? Could branches also expand their offerings to adjacent products and services that their members desire (for example, mobile services and travel services)? The answer to these questions will vary for each cooperative, but it will be critical for all of them to ensure that their branch network remains a key differentiating factor rather than a growing liability.

4. How can cooperative banks use their Web presence and social media to improve relationships with members?

Coops have traditionally relied on their physical presence at the heart of the communities they serve. But they may also have to find new ways to engage members through online and social-media channels as their physical links erode.

Social media and online tools will allow members to communicate with their cooperatives more easily. They will also allow cooperatives to quickly receive member input on a larger scale than previously possible. How can cooperatives best take advantage of these changes to deepen their relationship with their members and better respond to their needs? Could cooperatives reinvent or at least modernize their democratic processes such that they might become as simple as logging in

to a social network? If so, how can cooperatives leverage this new kind of proximity to unleash the bottom-up innovation that has been at the core of the cooperative movement's genesis? While thinking through their response to these social changes, cooperatives will also have to consider how to take advantage of the opportunity while maintaining enough control of the positioning of their brand to limit potential reputation risk.

5. [How can cooperatives retain their privileged relationships with members in the face of new nonbank competition?](#)

The threat from nonbanks (for example, financial integrators, payment-services providers) is elevated for coops, whose unique identity depends primarily on their close relationships with their members. To fight this trend, cooperatives will have to consider alternative ways to engage their members and protect their relationship with them. For example, how can coops put in place powerful loyalty programs, leverage interactions across business lines, and develop new high-frequency services (such as financial budgeting), which might serve as platforms to increase loyalty and create additional opportunities to engage with members on the entire service offering? Should coops develop for themselves the same kind of technology-based products offered by nonbank entrants or even consider acquiring new players? Could they strike alliances with other coops to get the scale needed to be a credible alternative, for example, in the payments business? Cooperatives will have the option of either getting pulled along by this trend—which poses the risk of becoming slowly disintermediated by incumbents—or working to counter it, by shaping and further strengthening their relationships with their members.

6. [How can cooperative banks develop a common voice to better protect their interests during regulatory reform?](#)

As a result of the 2008–09 crisis, all banks are facing a stricter regulatory landscape that will affect their operations and their competitiveness. With their different ownership models, coops may face the risk of some unintended consequences from new rules on capital and should consider whether their interests are sufficiently well represented and defended. How can cooperatives ensure that new regulation will take into account the specificities of their ownership and capital-structure models, and therefore ensure that these reforms will not be detrimental to the cooperative movement? How can cooperatives raise awareness with policy makers and the general public about the particular features of their models in a way that is consistent with cooperative values? Can existing forums or associations carry that responsibility or should new ones be formed and, if so, what are the appropriate mandates and governance structures to ensure their legitimacy? The cooperative movement has too much to lose; coops must ensure that all stakeholders have a sufficient understanding of their distinctive financial and governance features.

7. [Can cooperatives exploit their unique attributes to optimize their balance sheets?](#)

Regulatory changes will make it imperative for banks to optimize their balance sheets and to strengthen their capital base. Given their nature, coops must find innovative ways to do so and take advantage of their specific attributes.

Coops are blessed with direct access to a pool of investors that can help solidify their balance sheets: their members. In a time of low interest

rates, cooperatives need to explore how they can tap into this natural pool of investors, for example, by creating “permanent shares” designed in such a way that they qualify as Tier 1 capital while providing attractive long-term returns for the members. As such, cooperatives also need to explore how they could leverage their relationships with their members to gather more deposits, for example, by creating savings products that could better compete with money-market products. Similarly, cooperatives should explore how they can use future earnings to strengthen their capital structure in the most cost-effective way; these might be distributed to members, converted into some form of permanent shares, or capitalized on the balance sheet. Finally, cooperatives

should also consider options to optimize their balance sheets by tapping into the capital markets under today’s attractive conditions (especially those with strong ratings).



The coming decade will see a radical transformation of the banking sector and will present unprecedented challenges for bank leaders. As they tackle them, cooperatives’ leaders should leverage their organizations’ unique characteristics to ensure their continued relevance for members and the continuous growth of the cooperative model in the long run. ○