This spring, the Bank of England announced the Biennial Exploratory Scenario. Here’s a primer to understand key elements of the stress test and how it can be used for strategic advantage.

The biennial exploratory scenario (BES), announced this spring by the Bank of England, is a stress-testing exercise unlike any other. It seeks to understand how the entire UK banking system might evolve if recent headwinds to profitability persist or intensify. In so doing, it may help banks in the United Kingdom and elsewhere think about how to use stress testing to improve their strategic and financial planning. In this article, we will present the key elements of the BES and explore its strategic relevance beyond mere regulatory compliance.

What the BES is all about: A brief introduction

The BES attempts to put on the table a specific scenario combining two sets of headwinds: sluggish growth with low interest rates, combined with rapid digitization and the rise of fintechs. These topics have been prominent for some time on the agendas of banking conferences, in academic papers, and in high-profile executive-committee war games. However, this is the first time that they form the core of an official regulatory exercise. Unlike other stress tests, the BES does not aim to stress reality in the form of a crisis. It does not aim to address if banks could build sustainable business models in such a difficult environment, but rather how they might do so. To generate answers over the longer term, the BES has a ten-year horizon.

The BES makes some key assumptions about the macroeconomic and industry landscape: global trade stagnates and cross-border banking activity continues to fall. Long-term global GDP growth falls to 1.9 percent, driven largely by deceleration in emerging markets and slower productivity growth. In the United Kingdom, the bank rate is cut to, and remains at, zero. In addition, ten-year gilt yields are 1.25 percent by the end of the ten-year horizon.

Most important, innovations in financial technology in the United Kingdom drive two negative trends: a 40 percent drop in the spread between market retail rates for deposits and lending, and a 21 percent drop in the aggregate stock of corporate loans on banks’ balance sheets. There is no hurdle to pass on the core tier equity ratio; however, banks are required to demonstrate how they will meet, and exceed, the cost of capital over the ten-year horizon.
McKinsey had developed a somewhat similar scenario for our 2016 global banking review, showing that this threshold might be quite a challenge to reach (Exhibit 1).

The environment predicted by the BES is not a far-fetched hypothesis. It is firmly grounded in trends already observed. The low rate environment in Europe has already led banks to adopt innovative responses, such as passing on negative rates to deposits, increasing interest on loans, and shifting deposits into investments. In Germany, for instance, banks introduced negative interest rates on deposits for private clients, along with various current-account charges. Moreover, fintechs are expanding rapidly, and digital nonbank entrants operate with a significant lower cost base than many existing banks. In the United Kingdom, three areas are under the highest threat of digital disruption (Exhibit 2).

The BES takes a stance on two critical unknown factors. The first is the long horizon for the sluggish macroenvironment—ten years. Second is the clear quantification of the impact of...
Exhibit 2

In the United Kingdom, payments, asset management, and consumer finance are under the highest threat of digital disruption.

<table>
<thead>
<tr>
<th>Digital disruption on UK banking revenues by product by 2020, %</th>
<th>Examples of digital attackers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Consumer finance</td>
<td>Zopa, RateSetter, Klarna</td>
</tr>
<tr>
<td>Mortage</td>
<td>Landbay</td>
</tr>
<tr>
<td>CA1 deposits</td>
<td>Monzo, Fidor Bank</td>
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<tr>
<td>Non-CA deposits</td>
<td>Metro Bank</td>
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<tr>
<td>Corporate Cash management</td>
<td>Soldo</td>
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<tr>
<td>Total financing and loans</td>
<td>Funding Circle, PayPal</td>
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<tr>
<td>Payments Payments</td>
<td>TransferWise, PayPal, Klarna, Ripple</td>
</tr>
<tr>
<td>WM3 Asset management</td>
<td>Nutmeg, Saxo Bank</td>
</tr>
</tbody>
</table>

Estimated UK disruption is driven by high level of digital banking adoption and fintech activity in the retail and small-business banking space

1Current account.
2Excludes corporate payments, which is included in payments.
3Wealth management.


Digital disruptors on bank economics—a 40 percent drop in retail margins. This combination of long-standing low rates and sharp margin erosion creates a serious threat to the current banking business model. Spreads are already compressed in the range of 250 basis points (bps) for personal loans in the United Kingdom. A 40 percent drop would strip this down to about 150 bps, to cover for expenses, cost of risk, and return on equity.

Other interrelated challenges are not explicitly highlighted or quantified by the BES. The most important is the evolution of the credit cycle and the cost of risk, both in developed and emerging markets. Today, the cost of risk has hit historically low levels in many markets. However, in the future—and especially in a prolonged low-growth environment—it is unlikely that such a benign condition will persist. In the United Kingdom, the rapid growth of consumer credit in the past year, combined with very low interest rates, has already raised concerns about the future credit performance of consumer portfolios. The Bank of England’s Financial Policy Committee increased the UK countercyclical buffer to 0.5 percent, from 0 percent, in June 2017, and is expected to raise it further, to 1 percent, in November 2017.

On the other hand, there are also undefined opportunities that the BES challenges the banks to explore, quantify, and seize. Digitization and analytics open up new avenues for revenue stimulation, cost streamlining, and business-model redesign. They are just as much a potential transformation catalyst as they are a threat. Moreover, banks can still drive additional value from more traditional engines. These include organizational streamlining, procurement optimization, stronger performance management, and pricing discipline.

**The value and relevance of the BES approach for banks outside the United Kingdom**

While the BES is targeted to UK banks, it can trigger others to think about how to make better use of stress testing in their strategic and financial planning. To be sure, it is an imperfect
approach, as it asks for strategy based on a single scenario only. This limits its value somewhat, creating a disproportionate balance between the amount of effort required and the usability of results.

However, banks could consider an alternative approach, testing multiple scenarios in their strategic-planning cycle and capital-planning process. This could allow them to perform rapid what-if analyses to inform critical strategic decisions. It could also improve the efficiency of capital allocation and budgeting through better balance-sheet usage. And it could increase downside protection by providing analytical insights to redirect resources. It improves the consistency of forecasts and increases confidence in the quality of the budgeting exercise because it uses models as challengers, diminishing the role of expert judgment.

Through such rigorous exercises, global and European banks could create an internal forum to reflect more broadly on the changing environment and create contingency plans across a number of dimensions. This analytical background could form the basis for a more structured and number-driven dialogue on many relevant questions that banks face:

- Which segments, products, and geographies can still deliver adequate return on equity under adverse scenarios? How should banks rethink their focus, portfolio mix, and capital allocation?
- What should be the new target for the cost-to-income ratio in a low-margin environment? How can banks achieve continuous cost improvement and operational excellence?
- If banking is turning into a low-margin commodity, how can banks reinvent their offering and their relationship to customers? How will pricing models evolve? How can the frontiers of banking expand, and what are the ecosystems that banks can dominate?
- How will the footprint of retail banking change? Should banks sustain a branch network, for how long, and under what format?
- What should be banks’ overall strategy regarding fintechs and digitization? Where should they invest? Where should they collaborate, and where should they defend?
- How should banks think about consolidation and scale? What should be their target concentration in the sector, and what are their key inorganic opportunities?
- What are the critical capabilities in which banks must invest to transform and thrive in a less benign environment? What talent will they need to renew and reinforce themselves, and how can they attract it?

It is yet unclear whether other jurisdictions will follow the Bank of England’s exploratory scenario exercise in the near term. The impact and use of the BES has yet to be tested. Meanwhile,
some jurisdictions have begun reducing regulatory pressures, perhaps limiting its uptake. Nonetheless, it will be important to observe how this experiment evolves, in both the United Kingdom and other jurisdictions.

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