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What's next for global banks

Banking giants in emerging markets will probably do well in any likely economic scenario. Other banks face a more challenging future.

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In 2008, as the credit crisis broke, banks underwent near-death experiences on a massive scale. Last year, many enjoyed a recovery that was nearly as abrupt. In the intense uncertainty that ensued, bankers around the world have rightly shifted their focus away from growth and toward survival as they confront ambiguity about markets, risk, regulation, and demand.

Amid such extreme mood swings, long-term structural changes now under way will fundamentally affect banking in the years to come. To understand these changes, we undertook research that combined a historical view of the industry with an analysis of 25 global banks to see how various portfolios of banking businesses and geographic distributions would fare under different macro and regulatory scenarios. Among our findings:

- Under a scenario of lower global economic growth and tough regulatory restrictions, all but emerging-market banking giants will probably destroy value over the next four years. Funding costs will remain high, further hurting profitability.
- Without any management moves, banks of every type will need more capital—as much as \$600 billion over the next five years for the 25 banks we modeled. That suggests a real danger of a capital crunch, further forced asset sales, and the need for additional government help.
- The range of performance by banks using similar business models will widen. Big European banking groups, for example, will see returns on equity (ROE) ranging from 9 to 18 percent.

To arrive at a perspective on these fundamental changes, we turned to scenarios that the McKinsey Global Institute (MGI) developed to help model uncertainty about economic recovery and growth. We adapted these scenarios to include the particular forces that most influence banking returns: inflation and the shape of the yield curve, as well as uncertainties about state intervention, including new capital requirements, consumer protection measures, new rules on risk management, pay caps, and the extension of regulation to the “shadow” banking system.

Two views emerged. The midpoint case foresees prolonged recession followed by subtrend growth, returning within two years to pre-crisis rates. Markets in nearly all asset classes would recover as regulators sought to stabilize the financial system, improve risk-management practices, and increase transparency. Moderate regulation of systemically important banks would include pay caps, new rules on exotic products, and tighter capital requirements.

The extreme case envisions a moderate recession followed by structurally slower global growth. Markets would remain severely dysfunctional, and regulators would see banks as utilities, not independent agents, and accordingly attempt to limit their returns and to suppress volatility. Strict regulation would be applied not only to systemically important banks but to smaller entities as well. In this scenario, banks would face much tighter capital requirements.

When we proposed these two scenarios to about two dozen banking leaders and chief strategy officers, the result surprised us. While the current economic evidence seems to indicate that the midpoint case is more probable, our panel concluded that the extreme one was just as likely.

With both scenarios thus in play, we conducted a “momentum” analysis of 25 global banks, together representing about 40 to 45 percent of global industry assets and all major Western and emerging markets, including Brazil, China, Eastern Europe, India, and Russia. We aggregated these institutions into five archetypes: three kinds of universal banks (European, Japanese, and North American), emerging-market giants, and global investment banks. Then we extrapolated current performance into the future, producing a “run rate” forecast—that is, an estimate of how various portfolios of banking businesses and geographic distributions might fare in either scenario if the banks don’t respond to the forces we see shaping the industry in the next few years (see the interactive exhibit on mckinseyquarterly.com). This estimate establishes the baseline.

Our findings suggest that they will be subject to five substantive forces that will considerably change their fortunes. One key finding is that the capital shortage triggered by the crisis and recently addressed through several rounds of massive capital raising will endure and get worse. Our scenarios model both the demand for capital (the amount needed to finance projected asset growth and meet regulatory requirements) and the supply (earnings, less the amount likely to be paid out as dividends). In every case, demand exceeds supply. Capital needs will range from small (investment banks, which have already raised significant amounts and are holding substantial buffers, anticipating regulatory change) to vast (emerging-market giants, which will need to finance their growth). In-between are the universal banks, which will have modestly challenging capital needs in the midpoint scenario and a very challenging problem in the extreme one.

A second factor weighing on returns will be the high and rising cost of long-term funding. Several factors are at work here, beginning with a shift in demand. As part of balance sheet restructuring, many banks are cutting back on short-term, unsecured funding (such as commercial paper) and seeking instead to issue longer-dated debt. Demand will also rise as the longer-dated funding currently on banks’ books expires and is renewed. On the supply side, government asset-purchase programs—quantitative easing—are already being retired. Finally, the market will see greater competition for funds, not least from

governments that must finance their deficits. All this implies that prices for long-term funding will inexorably rise, shaving as much as several percentage points off ROE, depending on the scenario.

Given these drags on performance, returns will be weak by the standards of the past decade. Worse, they will be highly uncertain—our third finding. In the midpoint case, industry revenues would grow by 5 percent annually through 2014; in the extreme case, the industry would eke out much less attractive annual growth of 1 percent. Under either scenario, the emerging-markets giants come out on top. The story for the other groups of banks is mixed. In the midpoint case, the European and US universals and the investment banks would generate middling ROEs well below their pre-crisis levels. The Japanese universals' returns would suffer from a poor macroeconomic environment. In the extreme scenario, all but the emerging-market giants will find it extraordinarily difficult to return even their cost of equity. In other words, these banks will face a challenging period reminiscent of the early 1980s.

Our estimates may be cautious. We did not include, for example, the effects of a liability levy such as the one the Obama administration recently proposed. Instead we modeled this proposal separately and found that if such a tax were adopted globally and imposed on the banks in our model, the effect would be to reduce their ROEs by 0.7 to 1.2 percentage points.

A fourth finding confirms the economic evidence of the past several months: the crisis affected emerging markets, especially Asia, less severely than Western ones. Parts of Asia were the last areas to enter into recession and the first to emerge from it—indeed, China's economy never stopped growing. Asian banks had less trouble with toxic assets and excess leverage than their counterparts elsewhere did. The crisis served to demonstrate that the balance of power shifts abruptly and powerfully rather than gradually; many Asian banks have vaulted to the top of league tables in one go.

Our research confirms that for the next several years, Asia's economic might will continue to grow, as will the influence and power of its banks. Indeed, in these markets, banking is likely to grow much faster even than the broader economy, because so much of the population is “unbanked.”¹ In both scenarios, all the emerging markets will grow substantially faster than the more mature markets of Europe and North America.

Our last finding stands apart from the rest—and offers a ray of light to many banks. The archetypes constitute a form of destiny: emerging-market giants, riding the back of faster GDP growth, will outperform developed-market universals. In many ways, banking is a leveraged bet on the underlying economy. Yet despite that destiny, banks can do a lot about

¹ See Christopher P. Beshouri and Jon Gravråk, “Capturing the promise of mobile banking in emerging markets,” mckinseyquarterly.com, February 2010.

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their performance. The model suggests that within archetypes, differences in performance will be even greater in the future than they are today. The crisis has considerably ratcheted up economic volatility, putting an end to the period some have dubbed “The Great Moderation.” This volatility will amplify the existing differences in performance. Even banks that have been dealt a challenging hand can do much to outperform their peers and reward stakeholders.

To mitigate these longer-term structural changes, banks can and should take many strategic steps. The necessary moves include reconfiguring and empowering regulatory strategy, placing big bets on the fastest-growing areas, and rethinking liquidity to treat it like other scarce resources the corporate center manages. Such steps, as well as innovations yet unseen, will be important variables in determining the shape of global banking over the long term. 

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