McKinsey&Company

Denis Bugrov,
Miklos Dietz, and
Thomas Poppensieker

A brave new world for global banking

Financial Services January 2017

Our annual global banking review finds that a weak global economy, digitization, and regulation threaten the industry's near-term profitability.

Three formidable forces—a weak global economy, digitization, and regulation—threaten to significantly lower profits for the global banking industry over the next three years. Developed-market banks are most affected, with $90 billion, or 25 percent, of profits at risk, but emerging-market banks are also vulnerable, especially to the credit cycle. Countering these forces will require most banks to undertake a fundamental transformation centered on resilience, reorientation, and renewal.

Our report, *A brave new world for global banking: McKinsey global banking annual review 2016*, finds that of the major developed markets, the US banking industry seems to be best positioned to face these headwinds, and the outcome of the recent presidential election has raised industry hopes of a more benign regulatory environment. Japanese and US banks have between $1 billion and $45 billion in profits at risk by 2020, depending on the extent of digital disruption. Yet after mitigation, their profitability would drop by only one percentage point to 8 percent for US banks and 5 percent in Japan. Banks in Europe and the United Kingdom have $35 billion, or 31 percent, of profits at risk; more severe digital disruption could further cut their profits from $110 billion today to $50 billion in 2020, and slice returns on equity (ROEs) in half to 1 to 2 percent by 2020, even after some mitigation efforts (see exhibit for how digitization may reduce fees and margins across different businesses).

Emerging-market banks face a different challenge. They are structurally more profitable than their developed-market counterparts, with ROEs well above the 10 percent cost of capital in most cases but vulnerable to the credit cycle. Brazil, China, and Russia could have $50 billion in profits at risk, with China comprising $47 billion. A slower growth scenario could result in additional credit losses of up to $250 billion, of which $220 billion would be in China, our report finds, but with their current high profitability of $320 billion, Chinese banks should be able to withstand these losses.

Three formidable challenges

Banks must adapt to the reality of a macroeconomic environment that offers a number of risks and limited upside potential. Along with stagnating growth, banks face enormous challenges to

Exhibit

Fee-based businesses are likely to experience the largest margin reductions.

Fee and margin reduction in revolutionary digitization scenario, %

0–3% | 10–20% | 3–10% | 20%+

	United States	United Kingdom	China	Japan	Eurozone	Other developed	Eastern Europe	Middle East and Africa	Latin America	Other emerging-market Asia
Retail										
Consumer finance	13.9	13.8	7.7	25.1	9.7	10.5	11.3	2.3	11.1	3.4
Mortgage	2.5	5.1	1.0	4.4	3.7	3.2	1.0	0.2	1.6	0.6
Checking deposits	1.0	1.4	0.4	1.4	0.6	0.9	0.3	0.1	0.1	0
Term deposits	3.8	5.1	0	5.1	3.9	3.9	5.5	1.5	8.9	2.3
Corporate										
Cash management	0.5	0.7	0.2	0.7	0.5	0.5	0.2	0.1	0.1	0.1
Corporate lending	0.7	0.9	0.8	0.7	0.7	0.7	0.6	0.1	0.1	0.2
Payments										
Payments	17.3	23.6	8.6	23.6	18.1	18.0	8.6	2.3	3.6	3.6
Wealth management										
Asset/wealth management	16.6	21.7	3.9	21.7	16.6	16.6	3.9	1.1	1.6	1.6

McKinsey&Company | Source: Panorama Global Banking Pools by McKinsey

digest the wave of regulation that followed the financial crisis, despite industry hopes of a more benign regulatory environment in the United States. Control costs in risk, finance, legal, and compliance have shot up in recent years. And additional proposals, termed "Basel IV," are likely to include stricter capital requirements, more stress testing, and new guidelines for conduct and compliance risk.

Meanwhile the pressures of digitization, which boosts competition and compresses margins, are growing. Some emerging-market banks are managing well, offering innovative mobile services to customers. But our report finds that in the largest emerging markets, China and India, banks are losing ground to digital-commerce firms that have moved rapidly into banking.

In developed economies, digitization is affecting banks in three major ways. First, regulators, who were initially more conservative about the entry of nonbanks into financial services, are now gradually opening up. Over time, huge tech companies may be able to insert themselves between banks and their customers, capturing the vital customer relationship and presenting an existential threat. On the positive front, a number of banks are teaming up with fintech and digital firms, using big data and analytics to sharpen risk assessment and drive revenue growth. Last, many banks have been able to digitize processes and dramatically lower costs in their middle and back offices (although digitization can sometimes add costs).

A fundamental transformation

Countering the headwinds now gathering force means most banks will need to embark on a fundamental transformation that exceeds their previous efforts. Tinkering around the edges, as many banks have done for years, is not adequate to the scale of the task and will only exacerbate the sense of fatigue that comes from years of one-off restructurings.

This transformation is centered on three themes:

- Resilience. Banks must ensure the short-term viability of their business through tactical measures to restore revenues, cut costs, and improve the health of the balance sheet. They need to protect revenues through repricing and greater intermediation, reduce short-term costs, manage capital and risk, and protect core business assets. Our report found that digitization is only the start of the answer on costs, with radical reductions in functional costs needed to fundamentally rebase the cost structure.

- Reorientation. While the resilience agenda is defensive in nature, in reorientation, banks go on offense. They must reorient their business models to the customer and the new digital environment by establishing the bank as a platform for data and digital analytics and processes, and by aggressively linking up with fintechs, platform providers, and other banks to share costs through industry utilities. They also need to streamline their operating models and IT structure and move toward a proactive regulatory strategy.

- Renewal. The industry must move beyond traditional restructuring and renew the bank via new technological capabilities, as well as new organizational structures. Any new business model that banks design will likely require new technology and data skills, a different form of organization to support the frenetic pace of innovation, and shared vision and values across the organization to motivate, support, and enable this profound transformation. □

Denis Bugrov is a consultant in McKinsey's Singapore office, **Miklos Dietz** is a senior partner in the Vancouver office, and **Thomas Poppensieker** is a senior partner in the Munich office.

To request a copy of the *McKinsey global banking annual review 2016*, visit McKinsey.com.