Stability in the storm: US banks in the pandemic and the next normal

Banks will be tested. Now is their chance to use their hard-won resilience to preserve the financial system and support their customers and communities.

by Kevin Buehler, Miklos Dietz, Marie-Claude Nadeau, Fritz Nauck, Lorenzo Serino, and Olivia White
The humanitarian and economic fallout of the COVID-19 pandemic has upset the global balance. No person, industry, or aspect of society remains untouched.

The banking industry can uniquely act as a primary source of stability. Banks guard savings and investments, provide sound credit and financing, deliver safe and secure payments and transaction services, and offer trusted advice. They are not simply commercial enterprises but providers of important services to individuals and communities, playing a vital role in the functioning of the economy.

Banks in the United States entered the COVID-19 crisis with the strength of ample capital and liquidity and have moved rapidly to protect their employees and customers. Most have shifted the majority of their workforces to remote work and have closed or reduced capacity at branches while also dedicating hours to serving high-risk customers. Individuals and businesses have received forbearance where needed, and banks have served as critical conduits for the liquidity provided by the Federal Reserve and for the credit and loan forgiveness offered via the Paycheck Protection Program and the Main Street Lending Program. As such, in the early phases of the pandemic, US banks have largely been living up to societal expectations.

Yet the challenge to come is daunting and the path uncertain. Unemployment has hit levels not seen since the aftermath of the Great Depression. More than 25 percent of small businesses anticipate declaring bankruptcy in the next six months. Hard-hit industries, such as oil and gas, travel, and retail, may be forever reshaped. For banks, near-zero interest rates and a flattened yield curve mean diminished net interest income. Credit losses could exceed $1 trillion. Recovery, when it comes, will vary in speed and intensity across industries and regions. The lasting effects will linger for many years—perhaps a decade or more.

As our colleagues have suggested, meeting the challenge will require disciplined thought and bold action. So far, banks have acted swiftly and with resolve to meet the first acute phase of crisis. Now, they must show resilience under great uncertainty, beginning the return from lockdown and reimagining their new postcrisis future. Amid widespread economic struggles and heightened disparities, banks have the opportunity to rediscover their purpose and reform their contract with society, providing stability in the pandemic storm.

Resilience: Strength in uncertainty

Banks will need to plan for the worst among reasonable outcomes while hoping for the best. Our colleagues have developed nine potential macroeconomic scenarios for the economy over the next five years, reflecting a range of virus-containment, public-health, and economic-policy responses (Exhibit 1). They surveyed more than 2,000 executives globally to understand which scenarios they believed to be most likely:

- Scenario A1, a muted recovery, was selected by roughly one-third of surveyed executives. In this scenario, the virus recurs after loosening of physical-distancing measures. US GDP could diminish by 13 percent from peak to trough, with unemployment reaching roughly 20 percent.

- More than one-quarter of surveyed executives are more optimistic, predicting more effective virus-containment or economic-policy response (scenarios A2, A3, and A4). Among these more positive scenarios, the most commonly selected is scenario A3, in which the virus is well contained and economic policy is somewhat effective. This scenario is nevertheless trying. US GDP suffers in 2020, falling 8 percent from peak to trough, with unemployment reaching roughly 20 percent.

Exhibit 1

Executive uncertainty about the COVID-19 crisis.

GDP impact of COVID-19 spread, public-health response, and economic policies

Most likely scenario, % of respondents

<table>
<thead>
<tr>
<th></th>
<th>A1</th>
<th>A2</th>
<th>A3</th>
<th>A4</th>
<th>B1</th>
<th>B2</th>
<th>B3</th>
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</tbody>
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Note: Figures may not sum to 100%, because of rounding.
Source: McKinsey survey of global executives, n = 2,079
Institutions are staring at multiple years of high credit losses while serving a customer base under enormous financial and psychic strain. Only banks that build sufficient resilience will see renewed growth.

However, roughly 40 percent of surveyed executives are less sanguine, predicting that either virus containment or economic policy, or both, will be ineffective. Among these less optimistic scenarios, respondents most commonly selected those in which economic policy is ineffective although the virus is contained, potentially with some recurrence (scenarios B1 and B2).

Financial stability

The safety and soundness of the financial system depend on banks’ financial resilience. In our estimate, the US financial system would withstand scenario A1 or any of the more optimistic scenarios (scenarios A2, A3, and A4). Regardless of scenario, banks need to manage and allocate their capital carefully to sustain the shock while standing by their customers, employees, society, and regulators.

US institutions entered the current crisis with substantially greater capital and liquidity resources than they had at the onset of the global financial crisis. This is seen through the common-equity Tier 1 capital (CET-1) ratio, a core measure of bank financial strength. In 2007, US banks with more than $50 billion in assets had an average CET-1 ratio of roughly 7 percent, which fell to about 5 percent by 2010. During this period, 12 major institutions suffered erosions of 300 basis points or more; half did not survive as independent entities.²

By contrast, at the start of 2020, US banks’ CET-1 ratio was about 12 percent. Over the course of this crisis, that figure might decline by one to four percentage points, resulting in an average CET-1 ratio of about 8 to 11 percent. This is in line with the diminution in capital that US banks prepare to withstand during the annual stress-testing exercise. Most leading US banks today are positioned to weather a capital depletion of this magnitude without falling below regulatory minimums.

We expect that two factors will be most material to banks’ finances over the next several years. Credit losses may range from $400 billion to $1 trillion between 2020 and 2024 (ranges cited here and later depend on the scenario) (Exhibit 2). Net interest income may decrease by up to $200 billion from its 2019 baseline. Overall, we foresee that the credit losses described later in this article will affect bank revenues the most in the next 18 months. And while we see those losses extending beyond the next two years, reduced demand and tightening of credit availability will most likely be major parts of the revenue impact in 2022–23.

Credit losses will come disproportionately from commercial and industrial (C&I) loans to the industries most heavily affected by lockdowns. For example, in retail, transportation, and automotive, more than half of issuers have already been rerated by the credit agencies.³ Oil and gas

borrowers will also struggle: up to 40 percent of producers face insolvency if current prices persist. Correspondingly, we expect C&I loan losses to be significant, with cumulative charge-off rates between 2020 and 2024 ranging roughly from 4 percent to 10 percent, depending on the scenario. Commercial-real-estate loan-loss rates will reach similar levels, with hotels and retail properties most deeply and immediately affected.

Unsecured consumer lending will be even harder hit. In the first seven weeks of the crisis, 33 million Americans have filed initial jobless claims, which is more than in the entire global financial crisis. As people struggle financially, credit cards could see cumulative charge-off rates of 25 to 41 percent. Impact on mortgages and home-equity loans could vary widely—with charge-offs ranging from around 1 to 7 percent—depending on house prices, which are enormously uncertain at present, and governments’ and servicers’ actions, such as forbearance (see sidebar, “Credit-loss projections by asset class”).

**Ongoing resilience**

Resilient institutions not only withstand threat or change but transform for the better. The COVID-19 crisis poses a significant test of financial resilience, as well as banks’ operational, organizational, reputational, and business-model resilience.

Remote-working models and broader environmental factors will challenge operational resilience. For example, remote working has given hackers and state actors more “attack surface,”

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Credit-loss projections by asset class

Commercial- and industrial-loan losses in the COVID-19 crisis will be significant, with cumulative charge-off rates ranging roughly from 4 to 10 percent, depending on the scenario (compared with about 6 percent in the global financial crisis) (Exhibit A). In the pandemic, losses will be driven by industries most affected by the shutdown and surrounding circumstances, including retail, transportation, automotive, and oil and gas, and small- and medium-size-business borrowers.

Exhibit A

Credit losses will vary by product; more than 70 percent will come from corporate lending, commercial real estate, and credit cards.

Source: FDIC; Federal Reserve Board; Federal Reserve Bank of St. Louis; Federal Reserve Bank of New York; McKinsey analysis, in partnership with Oxford Economics
increasing cyberrisk, with new malware campaigns and scammers posing as corporate help-desk teams. External fraud and technology risk have both also grown as more people work from home. Banks have and will need to continue ongoing COVID-19-specific control testing, monitoring, and enhancement while also reinforcing their capabilities to respond quickly to new similarly unforeseen events.

Organizational resilience requires talent development, new measures in people management, and robust succession planning. Building the reskilling capabilities to promote greater agility and scalability helps banks build the organizational capacity to cope with rapid changes like the 80-fold increase in origination volume for small and medium-size bank (SMB) lending experienced recently. Development and succession planning for executive management is equally central for resilience. The COVID-19 pandemic is a grim reminder that no institution can assume its leadership team to be immune from mishap or worse.

Reputational resilience will confront significant tests in the face of COVID-19. Banks are not only the beneficiaries of government support but also major vectors for delivering government aid. As they do so, they must take care to funnel the funds appropriately, which can be a challenge under extreme pressures of time and throughput. At the same time, as loan delinquencies and defaults rise, so, too, will the reputational stakes. Adhering to bank rules and regulations on how to treat delinquent loans and ensuring that those who can pay do pay while also reckoning with new social movements, such as #NoRent, will be a reputational quagmire for which banks must prepare.

Finally, business-model resilience requires institutions to adapt to potentially significant shifts in customer demand, competitive landscape, and regulatory terrain, as we discuss next.

**Return and reimagination: Toward a new future**

Many banks are justifiably focused on returning to “normal” as quickly as possible. However, the halcyon days of 2018—with a more typical yield curve, low credit losses, consistent growth, controlled expenses, and paced evolution toward digital—will not return.

It is already clear that this crisis has accelerated change in the way banks interact with customers...
and undertake remote operations. At the same time, institutions are staring at multiple years of historically high credit losses while serving a customer base itself under enormous financial and psychic strain. Only banks that build sufficient resilience will be able to envisage renewed growth. But in this environment, even resilient banks will need to provide differentiated client relationships and to reduce their cost structures dramatically.

Three characteristics of banks that will succeed in this new future stand out. They will digitize customer interactions to address prolonged public-health risks. They will restructure their workforces and operations to become more agile and productive. And they will increase their pace of innovation to deliver those changes while evolving their value propositions to respond to rapidly changing customer needs.

**Digitization out of necessity**

Over the past two months, banks’ interactions with customers have become almost entirely remote, as people have self-quarantined and branches have closed or reduced their hours. Interestingly, during this time when phone interactions have increased substantially, consumers are using online and mobile banking only slightly more than they did before. In North America, online log-ons increased by 8 percent and mobile log-ons by 1 percent (compared with a 15 percent increase in call volume) since December 2019.⁶

Many organizations have predicted that a tsunami of new customer demand would cause a swift shift to digital banking. In fact, McKinsey surveys suggest that retail–customer preferences are largely unchanged. For example, when asked how they expect their behavior to change after the pandemic, 13 percent expect to use mobile banking services more, while 7 percent expect to use them less (Exhibit 3).⁷ Nevertheless, previous investments in digital offerings are paying off for many banks, and a significant opportunity remains to upgrade digital capabilities so that they become more convenient than a phone call for a broader array of customer interactions.

**Exhibit 3**

**US consumers expect to use digital banking somewhat more after the crisis, but this is not evident in their choices today.**

<table>
<thead>
<tr>
<th>Current US remote-banking use, % change since Dec 2019</th>
<th>Consumers’ expectations for remote-banking use after COVID-19, % of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Digital channel</td>
<td>Use less</td>
</tr>
<tr>
<td>Online log-ins</td>
<td>US</td>
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<td></td>
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<tr>
<td>Mobile log-ins</td>
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<td>Phone calls</td>
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<td>14</td>
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<td>79</td>
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</tbody>
</table>

¹Net intent is calculated by subtracting the % of respondents stating they expect to decrease usage from the % of respondents stating they expect to increase usage.

Source: McKinsey Finalta Remote Banking Pulse Survey, Apr 2020, covering 130 banks globally, including 21 in North America; McKinsey Financial Insights Pulse Survey, Apr 16, 2020, n = 509, sampled to match China general population aged ≥18; survey accuracy is ±3 percentage points.

⁶ McKinsey Finalta Remote Banking Pulse Check Survey, April 2020, covering 130 banks globally, including 21 in North America.
Even in the immediate term, organizations that reimagine processes to help people collaborate more meaningfully will have a leg up on recruiting and keeping the best talent.

While we don’t see evidence yet for a rapid groundswell of digital demand, the digital revolution will come of necessity. Even if customers would prefer to go back to the way things were, those days are likely gone, with public-health risks potentially continuing for months or years, particularly for older generations.

Beyond the immediate impact of the disease, as banks face likely lower revenues and greater pressure on productivity, they may also come to see that their branches are a cost that is not absolutely necessary. US bank branches (which numbered about 88,000 in 2019, roughly 8,000 fewer than in 2013) have been largely vacant for six weeks. Many banks will conclude, based on both branch economics and customer behaviors, that they should not reopen some of those shut branches. In that way, US banking might come to look more like other developed markets. The United States has 35 bank branches per 100,000 adults; by comparison, Canada and the United Kingdom have a density of 20 and 19 branches per 100,000, respectively.8

Similarly, commercial banks will need to rely more heavily on digital channels to serve SMBs, to make it cost effective to serve them and their increased needs. That will mean increasing investment in digital and remote sales capabilities to replace in-person sales approaches. Interestingly, this could improve growth prospects for some smaller commercial banks struggling to cover large geographies, allowing them to access new markets further afield. It may allow some smaller banks to focus on industry niches or specific population segments at a regional or national level.

An agile and productive workforce
Lockdowns throughout the world have pushed companies quickly to remote and more agile ways of working. While the story is evolving, multiple indicators suggest that some remote work will persist even as COVID-19 abates. For example, in one survey, 74 percent of CFOs said they plan to keep at least 5 percent of their workforces remote.9 In another survey, 54 percent of professionals indicate that working from home during the COVID-19 pandemic has had a positive impact on their productivity.10 Those results may not be resounding proof of employee preference, but they do indicate the feasibility of retaining at least some remote work—and the more agile collaboration models that go with it. Banks now face a prolonged period during which co-locating large numbers of employees in small spaces will be inadvisable. In this context, many banks are reorganizing to promote greater agility and scalability.

Remote-work productivity typically increases when an entire team collaborates remotely, as compared with split-team models. Even in the immediate term, for remote employees struggling to work effectively, organizations that reimagine processes to help people collaborate more meaningfully will have a leg up on recruiting and keeping the best talent. For instance, some capital-markets leaders are learning how to

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9 “Gartner CFO survey reveals 74% intend to shift some employees to remote work permanently,” Gartner, April 3, 2020, gartner.com.
10 “Brent Schrotenboer, “Working at home had a positive effect on productivity during the pandemic, survey says,” USA Today, May 4, 2020, usatoday.com.
manage remote teams across the deal flow on a virtual trading floor. Other banks are training relationship managers to engage with customers digitally.

When banks bring some people back to the workplace, they will need to consider the personal details of each team and each employee and their ability to return to the office based on factors such as disease susceptibility, transportation constraints, and local rules. Return plans will need to be highly detailed, spanning new designs for physical infrastructure to protect workers, safe transportation to the office, and childcare for those who need to come to work while schools remain closed.

As banks reimagine work-activity processes from the standpoint of employees, they have the opportunity to radically simplify and digitize each process, yielding welcome productivity benefits. Many tasks that were manually processed a year ago are already being quickly digitized to adapt to the new normal. The potential for automation will shift the role that banks need to fill. As banks rethink their operating models for the next normal, they can take a fresh look at expenses that previously seemed like givens, from third-party spend to unnecessary travel and meetings to their real-estate footprint. Many banks are already actively exploring changes to each of those areas.

Flexible and rapid innovation

The flexibility to address new realities will matter tremendously, with the spoils going to those that can meet the practical demands of the moment with creativity and a commitment to make the most of the inevitable. Flexible innovators that reimagine both customer interactions and underlying operations will be rewarded with customer-share gains and higher productivity in the next normal. Banks that try to wait it out, resist the change by trying to return to a previous normal, or get distracted by novelties are likely to suffer. The following are a few innovation examples:

— For customers forced by branch closings into new interaction models, banks can create innovative experiences that address a wider variety of needs—for example, advice, problem resolution, and loan modification. Our surveys suggest that call-center volumes have spiked since the COVID-19 crisis began. Customers who cannot resolve issues through digital or physical channels are resorting to phone calls, with long hold times. Regardless of channel, banks that can rapidly innovate customer experience and underlying processes will gain superior customer-acquisition and -retention capabilities. The banking equivalent of the one-click purchase—for example, streamlined “one tap” financial-health advice—is not far in our future.

— The most successful banks will shape value propositions as true partners, advisers, and sources of financial stability. Banks can reestablish trust in a context in which customers do not see them as the cause of the crisis but as a potential mitigant. Banks may see value in shifting their product mix and risk appetite—for example, away from subprime credit cards and toward personal loans, or even layaway products, combined with financial-health advice and budgeting.

— Banks that rethink how they use data in risk decisions and personalization will emerge stronger. The pandemic has demonstrated the benefits of both broader data sharing and broader types of data. Because of the crisis’s suddenness and high variance in financial impact, historical traditional financial data will be of limited value in training credit and other risk models or in guiding banks on business decisions during the recovery. The most successful banks will reimagine how to tap their extensive data to understand customers’ risk and potential beyond the traditional markers of creditworthiness. At the same time, increased data availability and sharing will also transform the art of the possible for personalization. We
Today, in the face of massive societal and economic change, banks are well positioned to serve once again as pillars of stability for consumers, companies, and society as a whole.

anticipate that banks will accelerate efforts to use data to inform personalized offerings and interactions that take into account each customer’s unique financial situation rather than using a segmented view that is likely to miss critical nuances.

Another factor in a reimagined future bears mentioning: the potential to reshape a bank’s portfolio. Of today’s 5,177 banks11 and thousands of fintechs, many may not have the resilience to withstand such stress and uncertainty for a long time. As in the years after the financial crisis, stronger institutions will have the chance to acquire many weaker competitors and fintech capabilities at a relative discount, enabling new customer-value propositions, innovation, and productivity gains.

Reform: The new social contract for banks
Almost every economic and epidemiological indicator suggests that this pandemic will be a generational event, with potential to be even worse than the Great Depression. Twelve years ago, a crisis durably damaged the reputation of banks. Some called for banks to be broken up or left to fail. The banking industry has worked hard in the decade since to rebuild its strength and restore its reputation. Today, in the face of massive societal and economic change, such as shrunken global trade, large income disparities, and a potentially lost generation of small businesses, banks are well positioned to serve once again as pillars of stability for consumers, companies, and society as a whole.

Most immediately, banks could consider other means of supporting their communities to highlight their renewed role in a broader social contract. They might expedite financing for medical equipment and manufacturing. They might offer their branches as centers for free COVID-19 testing or, alternatively, for providing free advice on financial budgeting. Banks can also steer their charitable donations toward those hit hardest by COVID-19 and dedicate portions of their owned marketing channels to public-health information.

Many are calling for companies to demonstrate empathy with customers, some of whom have lost their loved ones or their livelihoods. In our view, the only useful form of empathy from banks is one that aligns the incentives of both bank and customer. To do this, banks will need to reform many aspects of their business. For example, metrics and incentives that may have previously emphasized sales would instead encourage a better experience and stronger financial health for customers. Banks would need to modify or eliminate certain financial products that may not align well with that new social contract.

In the bigger picture, the current crisis is a call to action for all businesses—and banks, in particular, given their role in society—to define anew why

they exist and their desired impact on the world. Expectations for business’s role in society are at an all-time high: 73 percent of people say a company could take specific actions that both increase profits and improve the economic and social conditions in the communities in which it operates, up nine percentage points from 2018.12 Expectations for banks are especially high at this particular moment. So far, consumers see banks rising to the challenge. In fact, a McKinsey Consumer Survey indicates that 87 percent trust their banks to “do the right thing” during the crisis, and some two-thirds of consumers trust their banks more now than they did before the pandemic.13 Banks should seize this moment. As credit losses rise sharply in coming months, the challenge will also escalate. Banks need to use the platform provided by the crisis to clarify and communicate their role and assert a compelling purpose.

What exactly the future holds for society, the economy, and banks is deeply uncertain. The moves that banks make today will be critical, not only in safeguarding the lives and livelihoods of their customers and employees but also in reestablishing their role and preserving the trust of society for the years to come.

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