What’s ahead for banking in Eastern Europe

Long-term growth opportunities will emerge when the turmoil subsides.

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Banks in Eastern Europe have had a roller coaster ride over the past decade.1 After dizzying growth between 2000 and 2007, when shares in the region’s top financial institutions performed better than those of their counterparts around the world, asset values slumped by two-thirds as the credit crisis of 2008–09 took hold. More recently, a modest recovery in sentiment—pinned on hopes that the sector could reestablish itself as the engine of regional economic development—has snagged on wider global worries over sovereign debt.

While this volatility will continue and the region will remain vulnerable to external factors, we expect further long-term growth opportunities for the banking industry in Eastern Europe once the current turmoil has subsided. A new McKinsey analysis—based on empirical data, proprietary benchmarking, and interviews with 20 leading bank executives—identifies a number of segments and geographies that look promising over the next decade. It also highlights strategic actions that successful regional players must take to capture these opportunities.

Projections and figures in this article assume a consensus base case built analytically from the midrange of external macroeconomic forecasts and a consensus view on regulatory and market trends. In general, these assumptions are sluggish global growth, a prolonged and painful deleveraging, and high volatility for the next five years. This is not a worst-case scenario, though, and it does not assume, for example, a disorderly breakup of the EU Economic and Monetary Union (EMU) or a fiscal crisis in the United States.

Broadly speaking, the region’s banks must do two things. First, they must acknowledge the lessons of the past, notably by tackling the problems of insufficient scale, inefficient operating models, and relatively weak risk and governance processes that hobbled efforts to create value in the boom years. Second, they must position themselves to confront a number of fresh challenges, including new regulations, higher funding and risk costs, and changing customer behavior.

In the face of these obstacles, some international banks that owned subsidiaries or branch networks in the region have already exited. We expect this trend to continue or even accelerate when capital markets stabilize, as players reassess their long-term commitment. Banks willing to stay the course and able to adjust their operating models, however, can reap considerable benefits as the region’s economies continue to catch up with those of Western Europe.

The years of missed opportunity

The opportunity to reach new banking customers, combined with the prospect of at last closing the historical gap between Eastern Europe’s economic performance and that of

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1 Our study included about 20 countries in the region, notably the Czech Republic, Hungary, Poland, Romania, Russia, and Ukraine.
Western Europe, provided the impetus for growth in the region's banking sector over the past decade.

In 2000, banking penetration in Eastern Europe (as measured by the ratio of lending volumes to GDP) was below that of other emerging markets, such as Latin America or China, in several product categories. Along with low funding and risk costs, this gap created the conditions for a substantial increase in demand for banking services.

Our analysis shows that Eastern European banking revenues from loans and deposits (excluding Russia) grew by more than 14 percent a year on average between 2000 and 2007—more than triple the global average of 4.1 percent and surpassing even China and India during this period. Some products performed particularly well: for example, revenues from mortgages rose between 50 and 100 percent annually, achieving revenue margins of 4 to 5 percent, as well as a return on equity of roughly 100 percent.

Despite the favorable climate and investor optimism, only a few banking groups captured the tangible benefits of expansion. Our analysis shows that between 2004 and 2007, the average level of value creation (defined as returns on equity less cost of capital) at Eastern Europe's top banks was just 0.2 percent, falling to −2.0 percent for the period from 2004 to 2009. These averages concealed considerable variations—the best performers from 2004 to 2009 created 3.5 percent a year of new value; the worst lost 11.2 percent annually.

This performance paradox—phenomenal growth and juicy product margins coupled with low profitability—can be attributed largely to the costly operating models that banks rolled out across the region. The delivery models were mostly the same as those in Western Europe, even though volumes per customer in Eastern Europe are roughly one-fourteenth of Western European levels, according to our estimates, and disposable incomes are one-fifth as big. Most banks pursued country-by-country entry strategies, in many cases creating a patchwork of subscale, fragmented operations. Governance focused mainly on country-level performance, allowing banks to extract only limited synergies from their portfolios. And assumptions about currency and regional economic convergence were often too optimistic. The financial crisis of 2008 and 2009 laid bare the fragility of the banks' business models, exacerbating these inherent performance issues.

A challenging decade ahead
Looking forward, Eastern Europe's fortunes are tied closely to other parts of the world, and the fallout from the sovereign-debt crisis is likely to hit the region hard. That said, the fundamentals for strong economic growth—rising consumption, trade, and investments, as well as the planned accession of more countries to the European Union and monetary association, subject to the euro's future—are in place. The growing concentration of
consumption and wealth in a handful of cities and regions, the need for improved infrastructure, the rise of more affluent consumers, and other important trends will create an impressive economic tailwind to support the growth of banking revenues.

Over the 2010–20 period, we expect those revenues (after loan losses) to increase by an average of 12 percent annually, probably the world’s highest level during these years. Unlike the last decade—when a rising tide lifted all boats—in the future, growth will probably be uneven, concentrated in certain geographic, demographic, and industry pockets.

The banks’ biggest coming challenge, which will be considerably greater than it was in the last decade, is to deliver shareholder returns that exceed the cost of capital. Our market modeling points to a decline in returns on equity from an average of 17 percent (2000–07) to about 13 percent (2010–20). Higher capital requirements, funding costs, and risk costs, as well as new regulations and state interventions and a generally more competitive market, are all likely to weigh heavily on the leading players.

**What winning banks must do**

How can a banking group outperform in such a challenging competitive, regulatory, and funding environment? What will be the major differentiators between good and bad performance in the next decade? And what will be the best ways to capture the opportunities that will create new value? Our analysis and industry survey results suggest that banks in the region must pursue four strategies.

**Reshape business portfolios**

Critical mass allows banks to capture scale advantages and create additional value. In Eastern Europe, where costs are high relative to customer volumes, this is especially important. Only a few top banks have been able to build a consistent, sufficiently large portfolio across major markets. In practical terms, this means about a 10 percent share of all markets where such players operate, Russia apart. Recent experience shows that banks at or above this threshold tend to outperform others in value creation: an average return on capital that’s 5.2 percentage points higher than the rest, according to our survey. Our analysis suggests that further acquisitions or swaps of “stuck in the middle” assets could generate incremental returns on equity of two to four percentage points for a number of regional players. If mergers and acquisitions are not possible, another option would be partnerships in, say, product development or distribution.

**Build stronger regional-governance models**

Successful players must perform a delicate balancing act: on the one hand, to pursue efficiencies by centralizing and standardizing; on the other, to generate value by allowing local units flexibility in managing their business.
One legacy of the past decade has been how most regional groups permit local units to lead stand-alone operations. In the future, finding centralization opportunities and developing standard products or processes through regional operating hubs could drive value, as banks in emerging markets such as Africa have shown. Consolidation is easier in some operations than in others, however. It may be straightforward to centralize international payments, card processing, and custody, for example, but less so the credit processing and IT platforms for deposit and lending products (because of local regulatory requirements).

**Develop a differentiated approach to priority segments**

The region’s banks must position themselves to take advantage of selected product and customer segments that can serve as growth engines for the next decade. This approach might involve developing a distinctive value proposition for a well-defined segment of sufficient size or pursuing a specialized opportunity such as infrastructure finance.

For example, the “emerging affluent” segment—young, educated, and consumption-oriented urban professionals—could account for up to a third of all retail-banking revenues in the coming three to five years: Eastern Europe, with just 7 percent of the total population of emerging markets, already accounts for 41 percent of all middle-class households in such markets around the world. Emerging affluents exhibit similar behavior patterns across the region. They are tech savvy, preferring online-banking and smartphone applications; reluctant users of branches; and price conscious and service oriented.

To capture this potential, banks must learn to better understand the needs of customer subsegments and put in place differentiated value propositions and service models rather than traditional one-size-fits-all approaches. Affluent customers expect a distinctive experience, yet we find they are frequently disappointed because instead they get the service that banks deliver to the mass market.

**Focus on innovation**

In the past decade, most banks in Eastern Europe based their home market models largely on the traditional branch networks in Western Europe. In these years, we observed far more banking innovation elsewhere in the emerging world, where low income levels made traditional models unfeasible. Banks in Eastern Europe must now take their cue from other emerging markets and try to develop business models more compatible with their stage of development. This effort might include focusing on “frugal” innovation—reassessing costs from a zero base—and considering greater centralization and the outsourcing of distribution and support. Eastern European banks also have big
technological opportunities, including the introduction of richer features for automated
teller machines and point-of-sale devices, biometric identification, and mobile payments.

Notwithstanding the industry’s gloomy global outlook, banks in Eastern Europe, including
Russia, can prosper in the next decade if they learn the lessons of the past and prepare for
new challenges ahead. Those that can reshape their portfolios, target priority segments,
build stronger regional-governance models, and innovate successfully are the most likely
to boost market share, efficiency, and profitability.

The authors would like to thank Levente Jánoskuti, Vladimir Kreidl, Georges Massoud, Radek Przybyl, Anthony Radev,
and Cornelius Walter for their contributions to this article.

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