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Future of Asia

Banking

How Asia is reinventing
banking for the digital age



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How Asia is reinventing banking for the digital age

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The West has led much of the development of the world's modern banking industry across all dimensions – from size, to growth, to business models, and innovation. In recent years, however, Asia has tilted the scale, delivering game-changing growth and innovations in banking services. This reflects not only the increasingly central role of diverse Asian economies in global trade and economic growth, but also Asia's renewed leadership in scaling innovative technologies and new business models. Now, as the pace of growth slows, Asia's banks face serious challenges and must reinvent themselves to survive. This paper, in which we summarize the current status of Asia's banking industry and outline one possible plan of action by which banks may reinvent themselves for the digital age, is part of McKinsey's Future of Asia research program.

I. The rebalancing of East and West

It wasn't so long ago that banks in Asia¹ looked to the West as they developed products, services, and business models. The relationship between East and West is changing rapidly, however, as the emerging markets of Asia have become a major engine of growth in global banking. More than 40 of the world's 100 largest banks by assets are Asian and account for approximately 50 percent of the market capitalization of the top 100 banks globally. Asia has been the world's largest regional banking market for a decade, generating pre-tax profits in excess of \$700 billion and accounting for 37 percent of global banking profit pools in 2018 (Exhibit 1). We estimate that as incomes continue to rise and the middle class grows to include two-thirds of Asian households, personal financial assets in the region will total \$69 trillion by 2025, representing approximately three-quarters of the global total.

Not only have Asian banks caught up and begun to surpass their Western peers in scale, but consumers' tech-savviness has created opportunities for banks to deliver new innovations and leap ahead. Asia's best-known fintech innovators, including Alipay and WeChat Pay, lead the world in scaling digital payments. According to McKinsey's Global Payments Map, digital payments in China account for approximately 99 percent of the country's non-cash transaction volume and 45 percent of digital payments worldwide.²

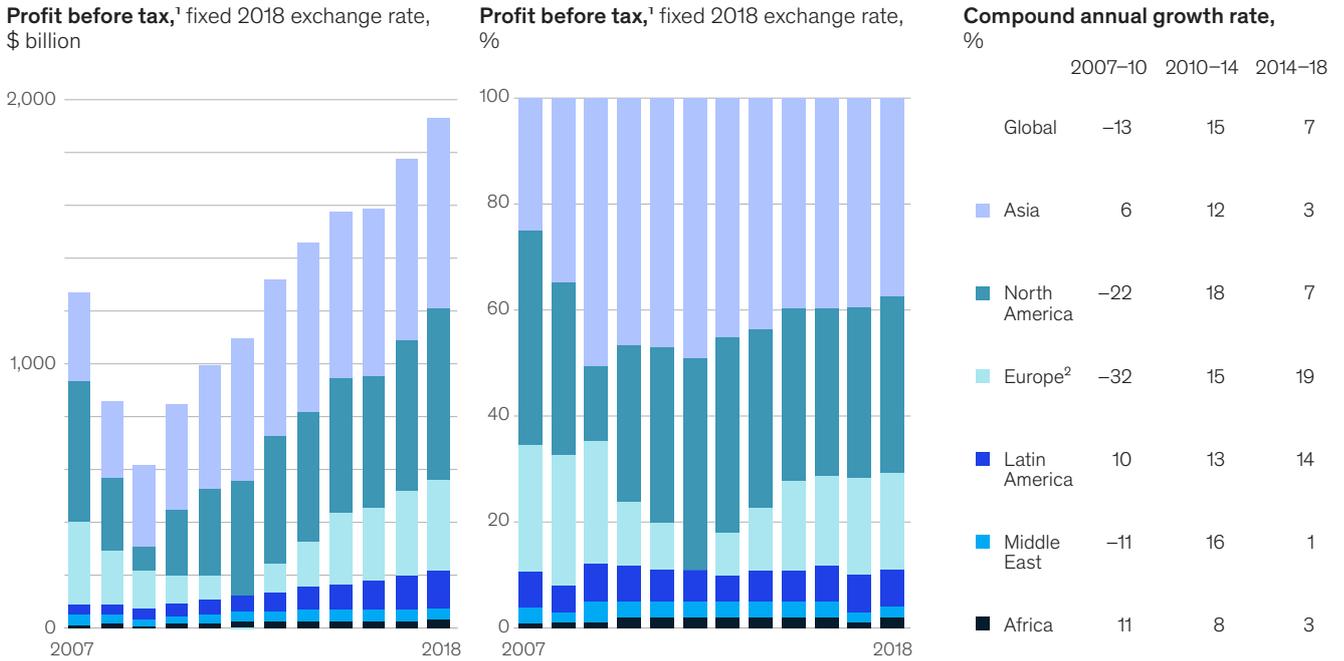
Across Asia, incumbent banks are partnering with fintech start-ups to promote digital payments. In Thailand, Kasikornbank and Grab have teamed up to launch GrabPay by KBank, a mobile wallet. BRI (Bank Rakyat Indonesia) has partnered with Alipay to expand point-of-sale acceptance of mobile payments for Chinese tourists visiting Indonesia.

¹ Including Australia and excluding the Middle East

² McKinsey Global Payments Map. Digital payments include all transactions (cards, bank transfers, digital wallets) initiated by retail customers through digital channels (phone, tablet, or computer).

Exhibit 1

Asia has been the largest regional banking market for more than ten years.



¹Total pretax profit pools of all customer-driven banking activities, including retail and institutional management.
²Includes Eastern and Western Europe.
 Source: Global Banking Pools, from Panorama by McKinsey

Asia has also proven to be fertile ground for the development of digital banking, with numerous companies making the transition from technology platform to digital bank. In China, Tencent's WeChat offers loans through WeBank; in South Korea, Kakao Talk launched a digital bank – Kakao Bank – in 2017; and the Japanese e-commerce group Rakuten has expanded into credit cards, digital banking, investments, and insurance. Not to be outdone by fintech disruptors, traditional banks have launched stand-alone digital banks, (e.g., The State Bank of India's YONO, BTPN's Jenius in Indonesia, and DBS digibank in India and Indonesia) as a way to reach new markets and to acquire new customers at lower cost.

The rise of ecosystems as a new way of organizing economic activity is another area where Asia is leading. For example, a diversified ecosystem for trade, including banking and payments, has emerged from Alibaba's platforms for B2B and B2C commerce. Ping An, one of China's largest financial conglomerates, has reinvented itself as a "tech + fin" ecosystem company, providing loans and investments, as well as insurance, across platforms for healthcare, housing, and more.

Banks in diverse markets are also building digital platforms as a way to integrate financial services into the everyday activities of consumers and small and medium-size enterprises (SMEs), e.g., HDFC Bank has broadened services for small farmers in India; DBS Marketplace enables consumers to search for cars, auto loans, and more in Singapore.

While digitization and advanced data analytics are creating important opportunities for Asian banks, they also render long-standing business models obsolete, as new entrants compete aggressively to steal market share from incumbents. What is more, Asia is facing a tougher macroeconomic environment as growth slows, asset quality declines, and uncertainty about the macroeconomic outlook increases. The storm over Asia is gaining force, and banks must act quickly to counter attackers stealing market share.

II. Asia banking braces for consolidation

For most of the past decade, Asia banking has been the darling of the world, but this is no longer the case, as the industry converges with global averages on margins, returns on equity (ROE), and price-to-book (P/B) multiples. And things are likely to get worse for Asia's banks before they get better.

Banking industry revenue growth in Asia has slowed from double digits in the early years of the decade to five percent per annum for the period from 2014 to 2018. And while Asia today accounts for more than a third of global banking profit pools,

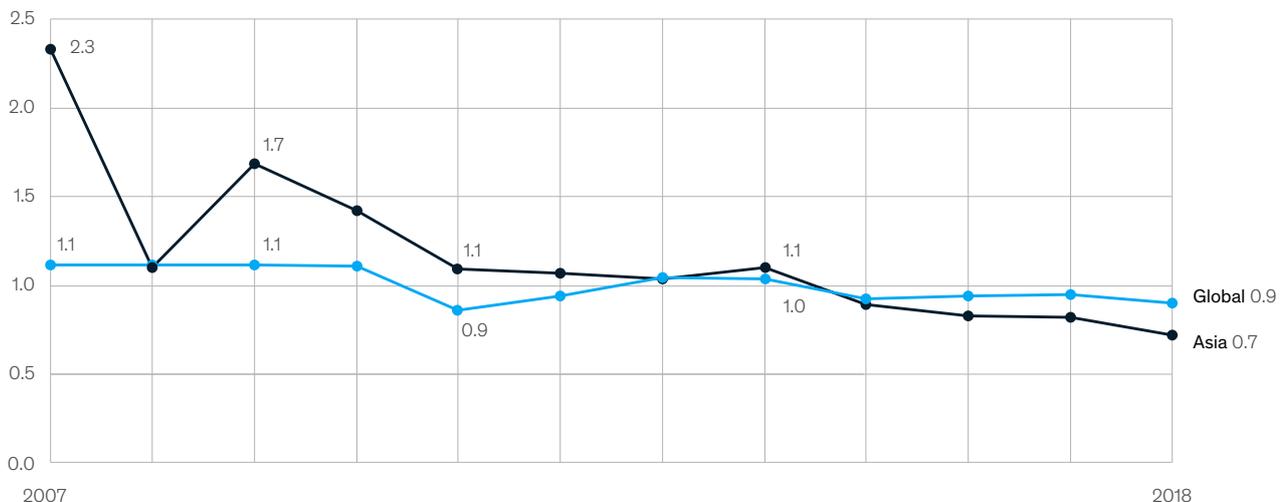
this has shrunk from nearly half in 2010, as banks in developed markets have recovered from the global financial crisis. Margins are also thinning, as banks in both emerging and developed markets contend with fierce competition from digital attackers and peer banks. Average banking ROE for Asia decreased from 12.4 percent in 2010 to 10.1 percent in 2018. In emerging markets, rising capital costs and declining asset quality have also taken their bite out of returns, pushing the average ROE down from 19.5 in 2010 to 11.4 percent in 2018, converging with the global average. Investors have shown strong support for the region's fintech and big tech disruptors, but their outlook for Asia's traditional banks is, on balance, pessimistic, pushing P/B ratios for Asia banking down from 1.4 in 2010 to 0.7 in 2018 – trailing the global average of 0.9 (Exhibit 2).

Not only have growth in revenues and profit slowed and returns weakened for Asia banking, but rising headwinds pose significant challenges for banks at the dawn of the new decade. If, as forecasts suggest, GDP growth continues to lose steam across emerging Asia, banks will be challenged to find new avenues of growth and will likely have to deal with deteriorating asset

Exhibit 2

Banks' price-to-book multiples have declined, reflecting investors' negative expectations.

Price-to-book multiples¹



¹Based on a sample of 2,000 listed banks across markets. Book value does not exclude goodwill as the data are available only for ~60% of covered banks. Source: SNL Banker; Global Banking Pools, from Panorama by McKinsey

quality and rising risk cost. Already in 2018, risk cost provisions for Asia rose to approximately 0.30 percent, the highest level of loan losses for the region since 2002. Slower GDP growth in China – compounded by ongoing trade friction with the US and the rapid increase in real estate prices relative to household income – could weigh heavily on the country's trading partners, as the effect of a correction could potentially destabilize banks in neighboring markets.

In addition to these headwinds, open banking is taking hold, with diverse markets moving toward broader participation in the banking system. India, for example, allows non-bank service providers direct access to the United Payments Interface; Hong Kong and Singapore have recently introduced new procedures for licensing digital-only banks. Australia and Singapore – among others – have adopted open banking rules requiring banks to allow qualified third-party service providers to link to banking systems to access account information and initiate transactions on behalf of customers. We expect that as regulators consider ways to promote lower costs and better products for consumers, as well as improved system efficiencies and controls, open banking will likely become the norm in most Asian markets.

This will undoubtedly increase pressure on the margins and market share of incumbent banks as they go to battle with fintech attackers over payments, lending, and investments. Scale plays a bigger role in this challenging environment, with positive implications for margins, cost efficiency, and productivity, and open banking could prove a boon to forward-looking banks that can leverage their scale and core assets – customer relationships, data reserves, and proven expertise in risk management – to deliver better products, services, and pricing.

Most banks, however, will be challenged to increase their returns adequately to win investors over and execute the transformation required to remain competitive. Well-capitalized institutions generating market-leading returns will likely seek to cement their advantage by acquiring smaller (less-well-capitalized) organizations to increase scale inorganically. Weighing these dynamics, Asia's banks are bracing for consolidation.

III. Reinventing for the future

Just as iron sharpens iron, we believe that the region's banking industry will emerge stronger and leaner than ever. To remain relevant, however, each bank must reinvent itself – a difficult task requiring strong commitment. At the same time, banks must balance short-term goals – in particular strengthening the core and capturing pockets of growth – with priorities for the long term – e.g., articulating anew the bank's purpose for the digital age, redefining its value proposition, and rebuilding the operating model.

Increasingly, banks will both acquire new customers and interact with ongoing customers through digital ecosystems, requiring new approaches to branding and relationship management as well as changes in business model and technology architecture. Top performers must remain vigilant and maintain their lead in products, customer base, and returns by augmenting their data assets and analytical capabilities. Organizations that generate returns below the average cost of capital – approximately two-thirds of Asian banks – will face an existential choice: Either reinvent to stay relevant or lag behind and eventually disappear. Banks must “disrupt themselves,” shifting from old to new models and ways of working, all while increasing revenue and extending market share.

Asia's banking leaders have already taken decisive steps to strengthen the core, focusing on productivity, risk, and capital optimization. Many have reduced operating costs by 30-40 percent across sales and service, support functions, and back-office operations through extensive digitization. The full potential of this opportunity lies in adopting zero-based budgeting to transform mindsets and redesign processes to achieve radical gains in productivity. For risk management, banks are finding that they can reduce loan losses while allowing a broader population to qualify for loans by developing machine learning algorithms to analyze a combination of traditional underwriting data and unstructured data from internal and external sources. Capital allocation is another area where banks can leverage new strengths in data analytics to reduce waste. For example, some banks are able to allocate capital consumption to the level of products and individual accounts, which in turn leads to highly accurate risk weightings at the portfolio level. As a result, these banks have been able to free up between 10 and 20 percent of capital.

To achieve such radical improvements in performance, banks must leverage all the new tools, technologies, and capabilities available today, including digitization, advanced data analytics, robotics, and AI. Banks can deploy these same capabilities in pursuit of strategic growth, focusing on four fast-growing businesses: wealth management, consumer and SME lending, and transaction banking. Together, these businesses hold the potential for US \$100 billion in new revenue for Asia's banks each year.

In **wealth management**, the key is to strike the right balance between self-guided digital tools and high-touch consultation. Within high- and ultra-high-net-worth segments, this means delivering portfolio offerings tailored to individual client needs. Use of voice recognition and AI can support a high degree of personalization at scale for the mass affluent segment. **Consumer and SME lending** are also poised for strong growth. Retail lending in Asia, which totaled \$12.8 trillion in 2018, is on track to reach \$21.2 trillion in 2025

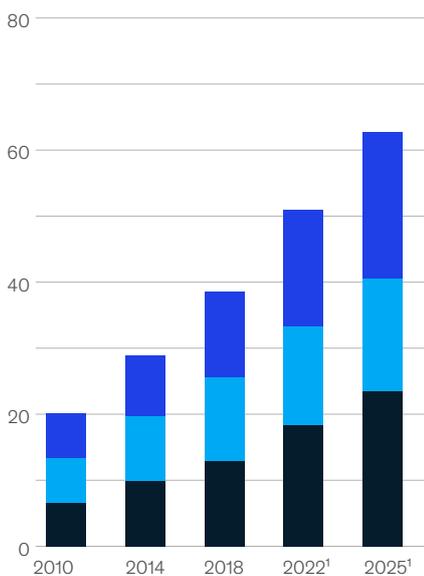
(Exhibit 3). The loan book for SMEs – already bigger than retail and corporate lending – is expected to grow nine percent each year, totaling \$23 trillion in 2025. Banks can use this strong growth as a foundation for developing new value propositions and multiplying revenue streams.

In the consumer lending market, regulators in several countries are wary of mounting consumer debt levels, and banks should use sophisticated risk models to identify the most qualified customers within segments where product penetration is low relative to GDP. Similarly, by combining traditional and non-traditional data, leading banks and fintech attackers have built risk-scoring engines to speed up loan approvals for SME customers, even those with limited or no credit history. One example is HDFC's "Milk-to-Money" program in India, which tracks regular ATM deposits to establish a credit profile for dairy farmers, many of whom have only recently opened bank accounts.

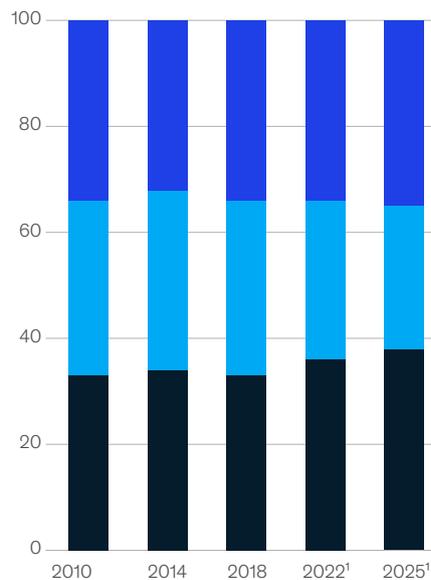
Exhibit 3

Asia's banks can leverage strong growth in retail and in small and medium-size enterprise lending as the foundation for innovation and reinvention.

Asia-Pacific 2018 banking loan balance, fixed 2018 exchange rate, \$ trillion



Asia-Pacific 2018 banking loan balance, fixed 2018 exchange rate, %



Compound annual growth rate, %

	2010–18	2018–25 ¹
Retail	8.0	8.0
Large corporations	8.3	4.2
Small and medium-size enterprises	8.7	9.1

¹Estimated. Source: Global Banking Pools, from Panorama by McKinsey

Finally, **transaction banking**, which already accounts for approximately a third of all banking revenues in Asia and captures more than half of transaction banking revenues globally, holds significant potential for further growth. Banks can potentially increase transaction banking revenue by 10-20 percent across four main business lines: cash management, trade services, securities, and cross-border flows. Competition is fierce and margins are thin, making it crucial for banks to combine scale with sophisticated analytics capabilities to eliminate waste, create new products, and deepen relationships. While it is often assumed that demand for a superior digital experience is higher among retail banking customers, corporate and SME customers expect an equally high level of seamless integration and ease of use. In response, leading banks are using APIs to integrate banking functions more deeply within corporate systems, enabling them to provide a dashboard view, for example, of intraday cash position across multiple currencies, investments, working capital, and payables. What is more, advanced data analytical models are helping banks enhance their liquidity management services, optimize netting arrangements for on-us transactions, and implement dynamic pricing.

In order to succeed in this broad effort to strengthen the core, build new business models, and increase revenue, banks will need to deploy cutting-edge tools, technologies, and capabilities. Succeeding in this requires both new thinking about and reinvention of the way banks operate across four pillars: technology architecture; advanced analytics; talent management; and partnerships, mergers, and acquisitions.

Flexible technology architecture: To compete with big tech companies on speed, productivity, and customer experience requires modular platforms, which allow developers continuous integration and interoperability with core systems. While core systems may be transformed gradually, the modular applications or microservices supporting specific use cases can be updated frequently as the market changes and new innovations become available. Beyond architectural and system changes, banks should also learn to adopt new ways of working. This requires not only flexibility in acquiring, upskilling, and integrating new talent profiles, but also shifting to a new operating model and culture in which

business and technology competencies are more closely intertwined.

Advanced data analytics: Advanced data analytics form the cornerstone of superior customer experience, and many banks now focus on data as a core enterprise asset. This entails the articulation of an enterprise-wide data strategy and investment roadmap so that data-and-analytics projects can be tightly linked to value creation. Banks should focus first on advanced analytics use cases with the greatest impact on customer experience and value to the bank. Commonwealth Bank of Australia (CBA), for example, has built a customer engagement engine that analyzes more than 30 billion data points to generate upwards of 40 million offers each month. Developing a top-notch data-and-analytics program requires vision and commitment, and to earn a good return on the investment, it is crucial to give employees the tools and skills they need to formulate their own data queries for strategic planning and day-to-day management of strategic goals. This requires a combination of strong governance and autonomy to enable individuals across the entire organization – from sales and service to risk management and digital innovation – to excel in a data-driven environment.

Talent management: With automation expected to disrupt up to 40 percent of all banking activity and affecting half of banking jobs by 2030,³ banks are today evaluating how to combine recruiting, reskilling, and redeployment to build the workforce of the future. Malaysia's Maybank (Malayan Banking Berhad) has launched a learning program to help employees acquire relevant skills for the next phase of their careers, with sessions on coding, algorithm programming, artificial intelligence, and machine learning.⁴ Aiming to enhance their appeal to millennials with superior digital skills, many banks are building a reputation for leadership in technological innovation, forging ties with fintech and academic communities, and developing a culture where talented and ambitious employees know they can make a difference. It is critical to understand the shifts required in the bank's composite talent profile, and to succeed in this transition, top leaders must commit not only to recruiting new talent but also to helping existing employees acquire the skills needed to thrive in the new culture.

³ "Skill shift: Automation and the future of the workforce," McKinsey Global Institute, McKinsey.com, May 2018.

⁴ "How Maybank is creating a people-centric workplace of the future," Human Resources, February 25, 2019
<https://www.humanresourcesonline.net/how-maybank-is-creating-a-people-centric-workplace-of-the-future/>

Partnerships, mergers, and acquisitions: In this age of open banking and digital ecosystems, many banks are finding that partnerships are critical to success in extending their footprint, delivering superior products, and gaining access both to new customers and to new types of data (Exhibit 4). As an example, three of Australia's big four banks – ANZ, NAB, and Westpac – have invested in Data Republic, a data hub through which organizations can store, exchange, and collaborate on aggregated data projects in a secure environment. In Thailand, Siam Commercial Bank and Julius Baer have partnered to deliver global investment opportunities to customers. In Indonesia, Bank Central Asia (BCA) has linked with leading e-commerce sites, enabling the bank to expand its lending business while keeping risk costs low. And in Singapore, OCBC Bank (Oversea-Chinese Banking Corporation) offers home mortgages through the personal finance portal MoneySmart.

Mergers and acquisitions (M&A) are another way to acquire crucial capabilities and extend market reach. DBS, for example, has acquired ANZ operations in five countries. Kotak Bank has extended its footprint into southern India by acquiring ING Vysya and entered the lower end of the market with its acquisition of BSS Microfinance. Given the importance of scale in achieving higher returns – and, consequently, higher valuations – carefully executed mergers and acquisitions offer an attractive option for increasing market share and consolidating scale, capabilities, and talent. If they have not done so already, now is the time for banks to establish a dedicated group responsible for planning and managing M&A, as well as partnerships. Banks should remember that 90 percent of the value of a merger is realized within the first two years and establish early on a plan for post-merger integration to ensure that synergies are realized promptly.

Exhibit 4

Partnerships and M&A are effective ways to extend market reach, achieve scale, and consolidate capabilities.



The world is rebalancing, giving rise to challenges and opportunities that are pushing Asian banks to embark on a path of radical transformation. The way forward, however, is fraught with existential challenges for every banking organization, bank and non-bank, incumbent and new entrant: Asia's banks must reinvent themselves or risk disappearing. In order to maintain their status as pre-eminent providers of financial services, banks need to develop best-in-class digital-and-analytics capabilities and achieve new levels of productivity through greater scale, market-leading cost-efficiency, and data-driven models to increase revenue across the franchise, focusing especially on wealth management, retail and SME lending, and transaction banking.

In addition to new business models, banks must define anew their sense of purpose. As stewards of the system of financial intermediation, banks are vital to society. In the years following the global financial crisis, however, many banks seem to have lost their sense of purpose and the perception of the industry has not fully recovered. As they reinvent themselves for the digital age, banks must also be clear about their "why," emphasizing their role as responsible stewards in promoting sustainable growth and building for a stronger tomorrow.

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