

Perspective

German banking returns to the playing field

July 2021

A decorative graphic consisting of numerous thin, light blue lines that originate from the left side of the page and fan out towards the right, creating a sense of motion and depth.



© Getty Images

The next game is always the hardest.

—Sepp Herberger, coach of the 1954 world champion German soccer team

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Introduction: Preseason analysis

If trends continue and German banks take no action, ROEs could fall to 0 percent by 2030.

For generations, Germany's banking industry has played a central role in the country's economy. Banks provide loans to support businesses, help families buy cars and homes, offer secure and nearly instant payments, provide products for investors, and are often considered to be highly prestigious employers in Germany.

Yet, the industry's reputation is mixed at best. As fast-moving, well-funded competitors have emerged, banks are increasingly viewed as reserve-team players who no longer retain a key role in the German financial sector. Yes, banks helped stabilize and reengage the economy during the COVID-19 pandemic, but their public reputation has declined, and the banking sector seems less relevant in the overall game plan for the German economy.

Many banking leaders trust in the resilience of the banking system and believe banks can raise their game to meet new expectations in today's competitive marketplace. They point to sectors such as energy and telecommunications, which have balanced resilience and renewal to overcome significant challenges. Others believe that the sector is facing serious disruptions and that German banks

will become less and less relevant to the German economy and society, and might follow a similar downward path as slow-moving incumbents in other industries.

The vast majority of executives we interact with accept the difficulties banks are facing, and most believe that banking needs a fundamental transformation. However, this transformation may not be destined to materialize. Opinions differ widely on whether it will happen or succeed.

Based on this perspective, we propose a game plan to build a better-performing and healthier industry. We share five main messages:

1. Banks remain at the heart of Germany's economy, providing vital financial services, managing risk, and helping to pull the economy through the pandemic.
2. However, the outlook for incumbent banks is not good. Without any action by banks, they would face continued market share losses and falling profits, and ROE would be on course for 0 percent by 2030. Alternatively, if banks continue to pursue

and amplify current initiatives in the areas of digitization and customer centricity, they could achieve a more acceptable 3 to 4 percent ROE by 2030.

3. Even if they achieve the 3 to 4 percent ROE mark, Germany's banks will still face a shortfall of €30 billion to €40 billion in operating profit, rendering them incapable of making required investments in digitization and addressing environmental, social, and governance (ESG) concerns.
4. German banks can learn from other businesses—both in banking and beyond—that have successfully transformed, even in regulated yet rapidly changing industries.
5. Five improvement themes can boost operating profits: (1) more responsive business strategies; (2) tech-enabled customer engagement; (3) new (digital) business building; (4) truly digital operating models; and (5) a redefinition of banking's purpose to incorporate ESG principles.

We begin with a fact-based analysis of the situation and long-term trends in German banking and then discuss possible aspirations for banks and their stakeholders, including consumers, corporations, and employees. We conclude by identifying the most important changes that will lead to a healthier and better-performing German banking sector.

Throughout the report, we provide insights garnered from successful transformations of the banking sector in Sweden, China, and Japan, as well as from other industries, including energy, media, and telecommunications. Our aim is to foster a clear-eyed, constructive, and perhaps uncomfortable debate on the future of banks and the entire banking sector in Germany across retail and private banking, corporate, and investment banking, asset management, and payments. We base our analyses and recommendations on exclusive primary research from McKinsey & Company and several dozen touchpoints with industry leaders and representatives of the German banking sector and beyond.

We are optimistic that German banking can have a bright future. Through hard-work, courage, and ambition, banks can regain their national and international relevance and the prestige they once enjoyed.

We hope this report provides a valuable perspective for German banking leaders as they consider the path forward for the industry.

2/3

of German banking executives¹ think radical changes are required in the industry

A man is shown from the back, wearing a grey polo shirt. The word "DEUTSCHLAND" is printed in large, bold, black capital letters across the upper back of the shirt. He is holding a black and white soccer ball under his left arm. The background is a blurred stadium with bright lights.

DEUTSCHLAND

1. German banking today: Heading toward relegation?

We have just decided not to disband the club even though we drew.

Jürgen Klopp, football player, coach, and Champions League Winner 2019

Banking services provide financial depth to any economy and are critical to growth. Such services include financing solutions, transaction services, cash handling, and investment opportunities for individuals and corporates. Germany ranks in the top quintile globally with regard to financial depth,² which is strongly associated with overall economic growth.³

In total, about €10 trillion flow through the German financial intermediation system every year. Relative to other players in the German financial system, the country's banks command a larger share of financing: about 65 percent of assets are on banking balance sheets,⁴ compared with less than 50 percent globally;⁵ by contrast, capital markets are weaker.

Banks are reliable on the fundamentals

The German banking industry has reasons to feel a certain level of satisfaction: it is stable and delivers on its core functions, including managing risk and meeting vital financial needs at competitive prices.

High stability

German banks exercise prudent risk management. Nearly all institutions have expanded their risk and compliance capabilities since the financial crisis. Consequently, the sector's capitalization, at a Common Equity Tier 1 (CET1) ratio of 15.6 percent, is slightly higher than the European average of 15.4 percent, while the risk provisioning (loan loss reserves) of 0.9 percent of the total customer loan

book is well below the European average of 2.1 percent. The average rating of German banks in 2021 is A+, with 75 percent better than A-, while the average rating of European banks is A, with 25 percent having a BBB rating or lower.⁶

Meeting financial needs

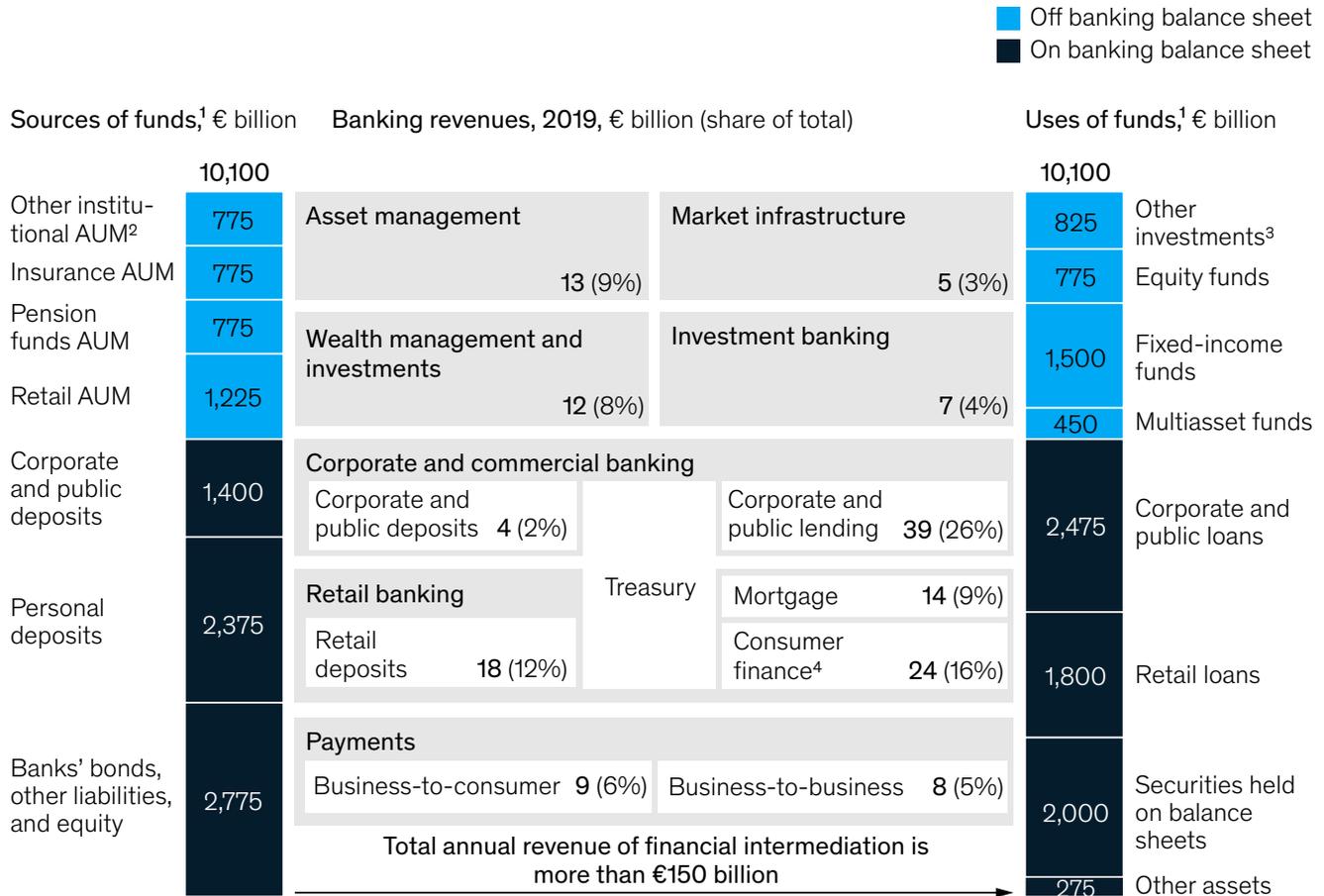
Wholesale lending in Germany totals about €2.4 trillion each year, including about €600 billion to small and medium-size enterprises (SMEs), up more than 30 percent since 2010, as well as some €650 billion to large corporates, up more than 40 percent since 2010. Retail mortgage lending has grown by about 30 percent since 2010 and now tops €1.1 trillion.⁷ Germans rely on banks: 99 percent of adults have an account⁸ and live within five kilometers of an ATM,⁹ and more than 50 percent of German individuals invest for retirement.¹⁰ The industry offers a broad range of products and services to ensure intermediation between sources and uses of funds (Exhibit 1).

Relatively low prices

German banks provide standard products at relatively low cost by international standards. This is especially true for daily banking products in retail and corporate banking, while the costs for corporates are about average in Europe before and after risk costs. Fees for day-to-day banking, such as current accounts, including overdrafts, all types of payments, and online banking, are lower than in other large European countries for individuals, measured as absolute costs, and for corporates,

Exhibit 1

The complex German financial intermediation system generates annual revenues of more than €150 billion.



¹Off-balance-sheet items exclude directly held securities from retail investors, counterpart at use of funds also excluded to be consistent; revenues not affected as revenues from securities reflected within CMIB.

²Institutional assets under management (AUM) include endowments and foundations, corporate investments, etc.

³Includes real estate funds, commodity funds, hedge funds, etc.

⁴Includes revenues from professional loans.

Source: Deutsche Bundesbank; McKinsey Panorama—Global Banking Pools; McKinsey Performance Lens; McKinsey analysis

measured as share of total adjusted corporate turnover (Exhibit 2). Overall revenue in the German financial intermediation system is about 150 basis points (Exhibit 1) compared with the global average of about 180 basis points,¹¹ confirming the highly competitive nature of the German banking market. German banks overall approve more corporations for loans than banks in other European countries—as of 2019, only 5.7 percent of SMEs report access to finance as their most important issue, compared to 8.5 percent in Spain, 7.6 percent in France, and 10.4 percent in Italy.¹²

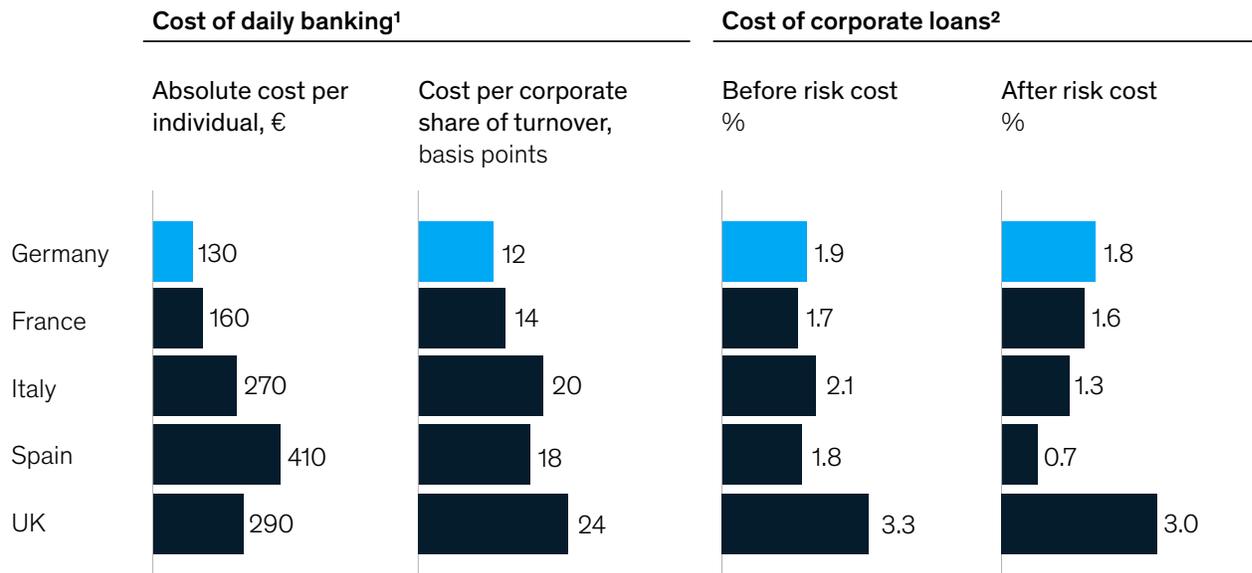
These metrics imply that the industry is in relatively good shape. Indeed, it is partially due to digitization that the industry has weathered the impact of COVID-19 reasonably well. More than 40 percent of German customers interact regularly with their bank digitally, and 79 percent report being at least satisfied with their bank’s digital channels.¹³

A tough business environment demands more of banks

As we have described, German banks have some reasons for satisfaction in their performance—stability, risk management, competitive prices, among them. However, some of the factors that have driven the success of banks in recent years are losing their strength, and fundamental upheavals in areas such as technology and demographics, and emissions and sustainability targets related to ESG, require a transformation of the German banking industry—in fact, from all segments of the German economy—by 2030.¹⁴ Banking leaders in Germany can take comfort and inspiration from transformations by incumbents in other industries, including energy, media, and telecommunications, and from banks in Sweden, China, and Japan. (See sidebars throughout the document.)

Exhibit 2

Daily banking costs in Germany are low by European standards.



¹Includes maintenance fees, interest revenues, incident fees, transactional fees (except cards) for cash, checks, transfers, direct debit, current account, cross-border business, remittances, overdraft, and cards.

²Includes pure customer interest rate before refinancing costs.

Source: Eurostat; McKinsey Panorama—Global Banking Pools; McKinsey analysis

The resilience of Swedish banking

Despite a severe banking crisis in the 1990s and a highly digital consumer and corporate landscape, Swedish banks are a profound example of banking resilience. To emerge stronger from that crisis, they pursued two critical changes:

1. **A digital-first approach to every customer interaction, product, and process.** By 2020, about 85 percent of individuals were using digital channels for banking activities and services.¹⁵ The required investments quickly paid for themselves, as they helped banks control costs: for example, the number of branches per capita in Sweden in 2020 was 58 percent lower than in Germany.¹⁶ Swedish banks now deliver ROE of about 15 percent—one of the highest rates in any market in the world,¹⁷ driven in part by a favorable macroeconomic environment—while maintaining a strong capital base. To sustain that profitability, the next wave of digitization includes the AI-supported automation of mid- and back-office processes and protecting the customer franchise against digital attackers.
2. **A rigorous consolidation process.** Four leading banks emerged from the crisis. All expanded their customer offerings after their mergers and entered a sustained growth mode. Swedbank, for example, has developed into a full commercial bank. With a combined market share of 65 to 70 percent,¹⁸ as well as clear product and pricing strategies, the top four incumbents earn healthy margins even in a low-interest-rate environment.

Of course, this represents a simplified view and does not reflect the complexity of the Swedish banking market: for example, banks also invested in more bespoke advisory services, for instance in wholesale and private banking.

Takeaways: Harnessing the potential of digitization and achieving economies of scale through cooperation and consolidation can significantly improve resilience.

With a successful transformation, German banks can meet the challenges they face—including overbanking and fragmentation, declining revenue pools, falling market share, low efficiency, and low profitability—and turn them into opportunities.

Overbanked and fragmented market

While the number of banking branches has steadily declined by about 4.5 percent annually since 2010, more than 24,000 branches are still open, along with about 68,000 ATMs. This density of 2.9 branches and 8.2 ATMs per 10,000 inhabitants is higher than in most other European markets. The United Kingdom, for example, has a density of 1.3 branches and 9.1 ATMs per 10,000, and Sweden has 1.2 branches and 2.6 ATMs.¹⁹ COVID-19 will likely accelerate this trend as people use less cash, ATMs, and branches in the future.

The industry remains fragmented. The top five banks in Germany have a 31 percent total asset market share, considering savings and cooperative banks as individual institutions. In comparison, the European average is 50 percent.²⁰

Declining revenue pool

Historically, the revenue pool in the German banking market has grown steadily in line with GDP. Between 2010 and 2019, however, it fell by about 8 percent from €129 billion to €119 billion.²¹ That decline is dramatic, considering that the overall economy grew by 35 percent in absolute terms over the same period.²² Most of this decline can be attributed to persistently low interest rates that could be only partly compensated for by higher fees—while German banks' charges for daily banking and credit products are attractive to consumers, low prices lead to substantial challenges on the revenue side.

Falling market share

German banks have lost sizable market share in terms of revenues to foreign banks, including European and US players, specialized players that operate without banking licenses, and digital attackers, including tech companies. The revenue share of German domestic incumbent banks fell from about 70 percent in 2010 to 60 percent in 2019. They still dominate retail banking (including

private banking) with an 80 percent share but have retained only a minority of the market in investment banking and wealth and asset management, with shares of about 20 percent and 45 percent, respectively (Exhibit 3).

German banking executives tell us that they expect direct/online banks and digital attackers, including tech companies and specialist players, to fundamentally drive the competitive landscape in the years ahead. Most are upbeat about their own institutions' prospects but also expect market shares to keep shifting across the board. Quite a

few expect German banks to play only minor roles in investment banking and parts of payments, and they anticipate similar trends in corporate banking, asset management, and other payment areas. (For an example of banks addressing similar challenges elsewhere, see the sidebar "The relegation of Chinese incumbent banks—and their comeback?")

Low efficiency

Despite its focus on costs, the German industry has not been able to translate these efforts into a significantly better cost position. From 2010 to 2019, operating costs rose about 10 percent, from €82 billion to

“Cost”

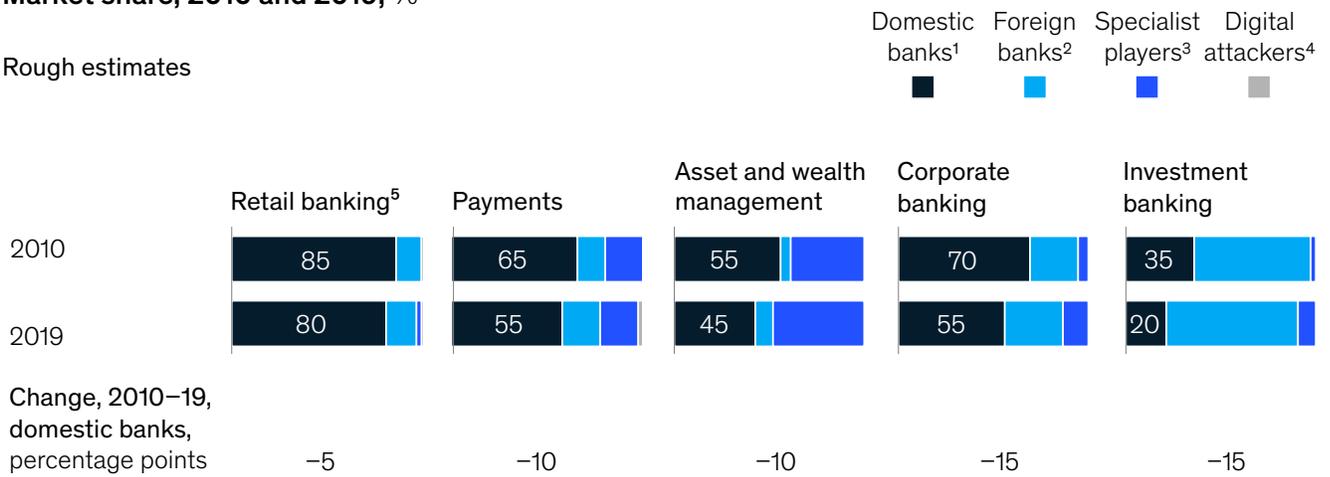
was mentioned twice as often in 2020 bank annual reports as in 2010 reports, while mentions of ‘revenue’ and ‘growth’ stayed level²³

Exhibit 3

Revenues shifted sharply in the last decade, especially for domestic banks.

Market share, 2010 and 2019, %

Rough estimates



¹Incumbent banks and their subsidiaries operating and headquartered in Germany.

²Banks operating in Germany that are majority owned by financial institutions with headquarters abroad.

³Companies operating without a banking license, especially those with focus on payments, asset management, and capital markets infrastructure.

⁴Recently launched companies operating with a digital value proposition, including tech firms, neobanks, and neobrokers.

⁵Includes private banking.

Source: BVI—Bundesverband Investment und Asset Management; Dealogic; Deutsche Bundesbank; McKinsey Panorama—Global Banking Pools; McKinsey Performance Lens; McKinsey analysis

Over the last ten years, German banks have lost five to 15 percentage points market share to specialist players, digital attackers, and foreign banks across all sectors.

€90 billion,²⁴ about 50 percent faster than those of European banks overall.²⁵ While the sector has almost compensated for inflation-driven wage increases by decreasing head count (employees per 10,000 inhabitants declined from 82 in 2010 to 67 today), non-staff costs rose by 17 percent, compared with only 3 percent for staff costs.²⁶

Unsurprisingly, this falls behind European benchmarks, despite a roughly similar regulatory environment. In the context of a genuine transformation mindset, banks in

Italy and Spain, for example, have reduced costs by 1 percent and 7 percent, respectively, since 2010.²⁷

Low profitability

With a declining revenue pool and rising costs, the operating-profit pool has shrunk from €31.2 billion to €21.8 billion, down 30 percent since 2010. German banks' five-year average after-tax return on average equity (ROAE) is only 2.9 percent today, lower than the average of France, Italy, Spain, and

The relegation of Chinese incumbent banks—and their comeback?

In China, digital-ecosystem players such as Alibaba, Pinduoduo, Ping An, and Tencent have built comprehensive platforms that offer consumers digital and e-commerce services and a wide range of financial services, from payments and financing to wealth management. As they collect vast quantities of data, these players gain valuable insights into customers and markets and find opportunities to expand and innovate. When these digital players first emerged, incumbents made few efforts to cooperate—and mostly ended up as mere balance-sheet providers.

Since 2018, many banks in China have worked hard to integrate themselves better into these digital ecosystems, instead of building their own. Examples include the partnership between ICBC and Alibaba and China Construction Bank's establishment of its own fintech. Many banks have also supported government efforts around the DCEP (the local central-bank digital currency), which would tokenize all payments and require banks to act as payment and wallet intermediaries. This in turn could provide partial access to existing closed-loop wallets, such as those provided by Alibaba and Tencent.

Takeaways: German banks should look for meaningful ways to collaborate and cooperate with the new digital and ecosystem players, which are here to stay; fighting them is likely a losing proposition in the long term.

the United Kingdom, which is about 3.7 percent (Exhibit 4). In Sweden, it tops 15 percent.

A tarnished public image?

After a low point during the financial crisis, banking's public image has recovered somewhat, but the sector overall has nevertheless lost relevance in Germany.

Declining economic contribution

Financial and banking services' share of total gross value added has fallen further in Germany than in many other countries: from 3.8 percent in 2005 to 2.3 percent in 2018.²⁸ This downward trend is not expected to end soon. In fact, about 50 percent of leading banking executives in Germany say they

expect the contribution of the sector to fall even further in the years ahead.

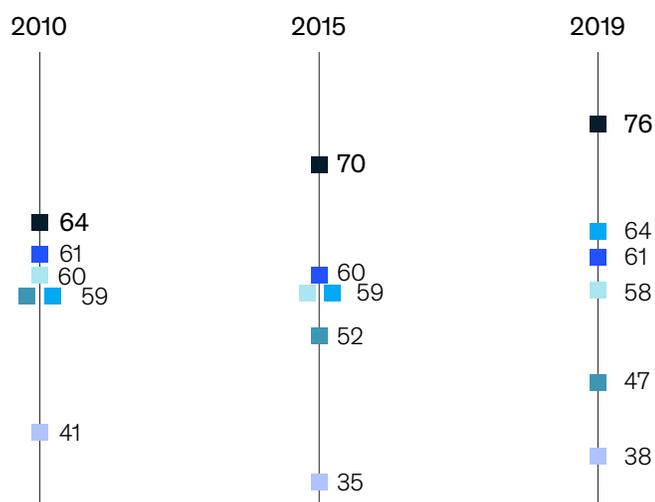
Decreasing market capitalization

In 2005, German banks made up 11.2 percent of the DAX family market cap, but their share has dropped, landing at 1.4 percent in 2020 (Exhibit 5). German banks over the same period delivered annual total shareholder returns of -10.0 percent, compared with +7.3 percent for the entire DAX family. While listed German banks stabilized after the financial crisis, their decline accelerated after 2015, with annual losses for investors of more than 15 percent.²⁹

Exhibit 4

German banks had a high cost-to-income ratio in the last decade.

Cost-to-income ratio, %



After-tax return on average equity, average for 2015–19, %

Germany ¹	2.9 ²
Europe top 4 ³	3.7
Japan	4.2
US	9.9
Sweden	15.2
China	12.2

¹ROE calculated based on profit after tax and before transfers to the fund for general banking risks as a percentage of the average equity (includes the fund for general banking risks, but excludes participation rights capital).

²Includes negative ROE in 2019, much of which arose from high value adjustments at a large German bank.

³France, Italy, Spain, and the United Kingdom.

Source: Deutsche Bundesbank; McKinsey World Banking Intelligence

Declining appeal for new talent

Financial institutions are becoming less attractive to employees and potential recruits, especially graduates and young professionals. In 2010, three German banks were among the 50 most attractive employers for business students. By 2021, only one German bank remained on the list, and its ranking among the top 50 had declined sharply.³⁰

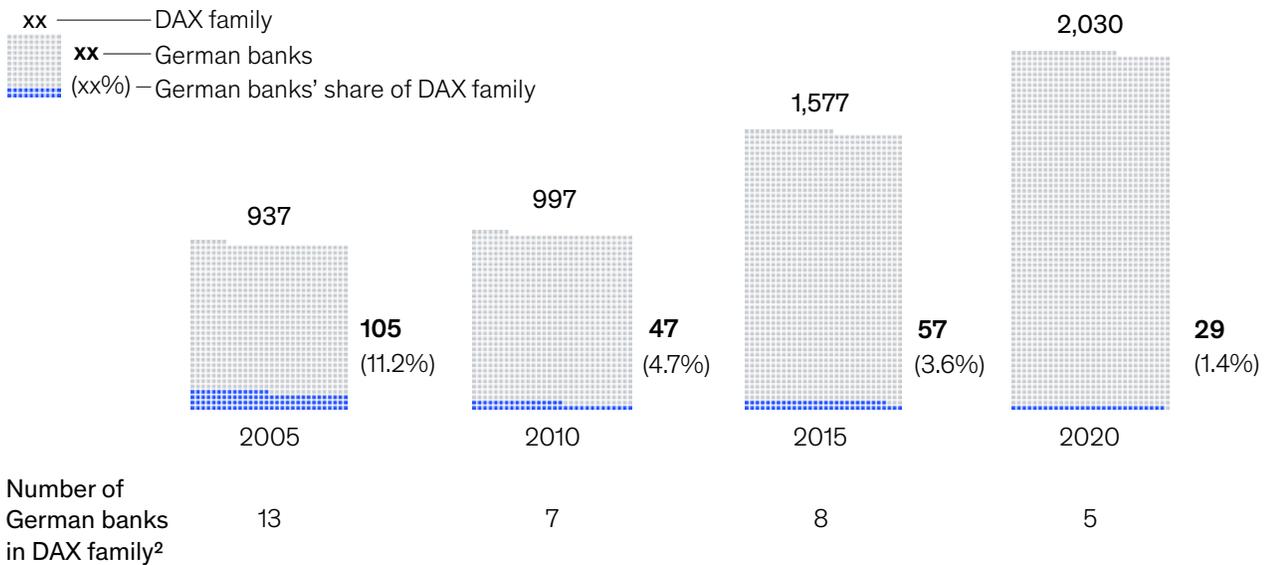
In 2007, 38 percent of German citizens said banking jobs had a very high reputation, but only 23 percent shared that view in 2020.³¹ This is a significant decrease from an already-low level compared with other professions.

The trends and developments we have outlined here are more than just bumps and bruises, but we believe that the banking sector can return to the field of play with renewed energy, perhaps emulating the example of resilience set by the energy industry (see sidebar “How leaders in the German energy sector adapted to new rules”). Banks will need to adopt new mindsets and ambitions, tackle long-term challenges, accelerate digital innovation, and make radical transformative moves toward larger and more sustainable profits, relevance, and prestige. This will require a new level of cooperation among stakeholders but could ultimately help banks regain their position within the German economy and society.

Exhibit 5

German banks’ share of the DAX family market cap has fallen from 11 percent to 1 percent in the last 15 years.

Market capitalization of German banks in DAX family¹ (DAX, MDAX, SDAX, TecDAX), 2005–20 (year-end)
€ billion



¹Includes the top 160 companies by market capitalization.

²Includes financial service companies with a banking license and a main focus on banking and banking-related services. Pure financial sales companies, brokerage platforms, asset and investment managers, and stock exchanges are excluded.

Source: Bloomberg; McKinsey analysis

How leaders in the German energy sector adapted to new rules

Following economic liberalization 20 years ago, the *Energiewende* (energy transition toward renewables) ten years ago, and increasing climate pressure today, many people thought the energy sector was ripe for relegation. Indeed, these changes triggered major shifts in technology, greater consolidation, and the rise of digital attackers.

For many reasons, investments in new and old technology were required. While renewable-energy generation tends to be decentralized, energy companies needed to make significant investments in offshore renewables, networks, and some traditional power plants. The industry reacted with consolidation, funding infrastructure through pension funds and other nontraditional sources, recalibrating their value chains, and spinning off some traditional infrastructure. Overall, the industry rose to the challenge: the top five German energy firms have made €377 billion in capital investments since 2010.³² These investments are now seen more as part of the solution than part of the problem.

Following liberalization, incumbents were also confronted by attackers with new business models, which targeted the customer interface and offered prices low enough to motivate many customers to switch. Many incumbents are responding with “second brand” strategies to compete in this “switcher segment,” focusing on certain target groups and price segments and ultimately assimilating attackers. The more than 900 regional *Stadtwerke* (municipal power providers) still in business in Germany³³ used their local marketing and identities, and their ties with municipalities, to defend their strong footholds.

Takeaways: Banks can accelerate digitization by increasing investment capacity with cooperation, consolidation, and new funding. They can also protect revenue pools against digital attackers by adopting more agile business models, launching secondary brands, engaging in digital marketing, and partnering with fintechs.



2. Time for a new campaign

The toughest opponent is usually oneself.

Joachim Löw, coach of the 2014 world champion German soccer team

In the first chapter, we laid out the challenges we see for Germany's banks. While these challenges are significant, we also believe that there is a pathway to a more sustainable future for the industry. However, the journey will not be easy, and will require a new approach with three broad imperatives: (1) raising the profit ambition; (2) setting a revenue and cost pathway toward an ROE of 7 to 8 percent; and (3) preparing for future challenges and establishing top priorities.

Recognize the profit challenge and raise ambitions

If German banking continues on its current course—assuming slightly declining revenues, a rising cost base, and risk costs below their long-term average—return on equity would fall to 0 percent.³⁴

Breaking the 0 percent ROE trend

Most banking executives recognize the need for change: two-thirds say radical changes are required, and only a third claim that continuous transformation is sufficient. Current initiatives

largely focus on digitization and customer centricity. These mitigating initiatives may lead to a more likely scenario: by accelerating existing efforts and continuing focus on their core business, the sector could maintain its current after-tax ROE of 3 to 4 percent or operating profit before risk of 35 to 40 basis points of average assets.³⁵

However, that level of improvement still would not lead to long-term sustainable growth for the industry, and it could lead to further downsizing, especially in corporate banking, asset management, and payments. This would imply a stronger concentration on retail and SME business, where banks would still have to tackle significant challenges such as digitization, finding funds to adapt to constantly changing customer needs, and developing a sustainable strategy that addresses ESG issues.

Raising ambitions lead to sustainable business growth

Banks need profits to meet their challenges and keep pace with the competition. Exactly how profitable each bank needs to be depends on many factors, including what investors, shareholders,

0% ROE

2030 forecast for German banks on current trajectory

3–4% ROE

2030 forecast in mitigation scenario

and stakeholders expect; what is required to support the German economy with its high export orientation; and what is required to stay relevant in the European and international space. In the end, the sector must earn sufficient profits to satisfy the return and dividend expectations of shareholders and owners and build a capital base large enough to provide stability and room for growth, including resources to invest in transformation and long-term innovation.

The most common profitability metric, at least for traditional banks, is after-tax return on average equity, which can be compared to the cost of equity for investors. The average after-tax ROE of German banks between 2015 and 2019 was just 2.9 percent—too little to meet investor expectations or provide enough funds for dividends, capital accumulation, or required investments. Setting the appropriate ROE or cost-of-equity targets from a shareholder or owner perspective is not straightforward, however, especially for incumbents in demanding regulatory environments and difficult market conditions. Four methods can provide at least rough indications of ambitious but realistic profit targets:

- **Capital asset pricing model (CAPM).** A cost of capital of about 7 to 8 percent seems

appropriate, based on a long-term inflation target of 2 percent as a risk-free rate, an equity beta of 1.0 to 1.2, and a market risk premium of 5 percent.³⁶

- **Analyst estimates.** Listed banks can use a cost-of-equity estimate from sell-side analysts. While only a few German banks are listed, this method points to a cost of equity of 10 to 12 percent.
- **Top German players.** Several German banks have consistently delivered double-digit after-tax ROE in recent years, many of them in specialized businesses such as pure online banking, consumer finance, or wholesale lending, or in asset-light businesses such as private banking or advisory-focused corporate finance services.
- **Other banking markets.** Comparison groups could be other large European banking markets, Japan, Sweden, and the United States (see sidebar “Setting new financial aspirations in the Japanese banking market”). In these markets, we find that average after-tax ROEs between 2015 and 2019 range from 3.7 percent to 15.2 percent.

As capital requirements rose after the financial crisis, some banks began using a hypothetical

An industry-wide 7–8% after-tax ROE is ambitious but achievable—and is required to fund innovation and investments.

capital metric based on about 12.5 to 14 percent of risk-weighted assets instead of real equity capital to reflect this factor.

Considering all this, a realistic target for German banks would be at least 7 to 8 percent after-tax ROE (Exhibit 6). This would translate into healthy profitability levels of operating profit before risk of 70 to 80 basis points of average assets or after-tax profits of €40 billion to €45 billion, which ultimately would attract new investors, transmit a positive signal to top talent, and help the banking sector maintain its relevance. Savings and cooperative banks can

use growing profits also to support stronger regional relationships, local development, and marketing and sponsorship at a grassroots level. This ROE goal is ambitious but achievable, given the returns of banks in other markets and those of some of the top German players.

Choose a revenue and cost pathway toward 7 to 8 percent ROE

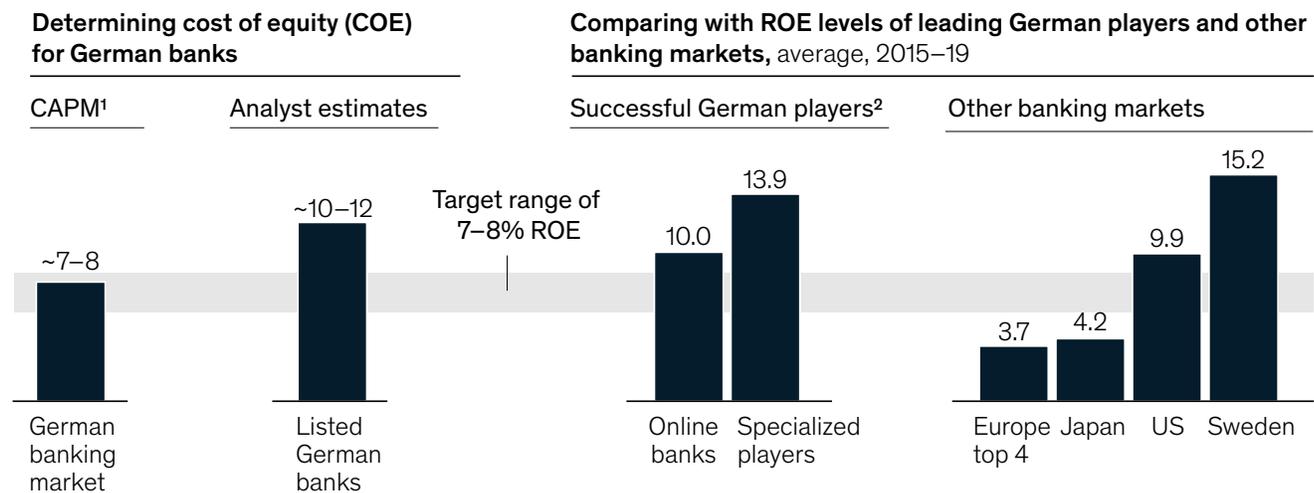
To deliver 7 to 8 percent after-tax return on equity by 2030, banks will need to raise revenues and significantly improve their cost structures (Exhibit 7).

The ROE target translates into 70–80 bps operating income of average assets.

Exhibit 6

An ROE target of 7 to 8 percent seems appropriate, considering different estimation methods.

Derived after-tax return on average equity targets for German banks, %



¹Capital asset pricing model, assuming risk-free rate of 2%, equity beta of 1.0–1.2, and market risk premium of 5%.

²Online banks include DKB and ING; specialized players include Aareal Bank, Deutsche Pfandbriefbank, HSBC Trinkaus & Burkhardt, Mercedes-Benz Bank, Santander Consumer Bank, Targobank, and Volkswagen Bank.

Source: Analyst reports; annual reports; McKinsey World Banking Intelligence; McKinsey analysis

Setting new financial aspirations in the Japanese banking market

The Japanese banking market has now endured almost two decades of near-zero interest rates and very slow GDP growth. This resulted has in specific developments over two phases.

In the first phase of the crisis, banks took various actions to stabilize themselves, given continuously decreasing net interest margins and nonperforming loans. In addition to obvious measures such as restructuring balance sheets, cutting costs, expanding fee business, and building up capital, two developments stood out:

1. **Consolidation.** Over two decades, 16 banks merged into three megabanks which earn about 52 percent of the nation's total banking revenues and 47 percent of ordinary profits in 2019.³⁷ More than 100 regional banks remain, however; most of them purely commercial. With their low profitability, these are facing increasing pressure to consolidate.
2. **International expansion.** Searching for new revenue sources, Japanese banks started to look abroad, initially in investment banking and international lending. Failing to establish strong footholds in attractive fee businesses, they pivoted toward offerings in Japanese and Asian trade and financial flows.

In the second phase, starting around 2014, banks began to focus more on profitability. The three megabanks started to set more ambitious ROE targets to satisfy the needs of investors. Encouraged by the ambitious targets and pulling levers such as capital optimization and new attempts to increase fee business, the megabanks delivered an average ROE of 6.6 percent between 2015 and 2019,³⁸ far higher than the 4.2 percent generated by the Japanese sector as a whole.³⁹

Some takeaways: Ambitious financial targets based on clear strategies can create momentum and are prerequisites for the sector's long-term health.

On average, a bank would need to deliver revenue increases of at least 2 percent annually. This is a significant turnaround, given that revenues have declined by about 0.9 percent annually since 2010. At the same time, costs would need to decrease by 1 to 2 percent per year, which is ambitious considering average cost increases of 1 percent each year since 2010.

These improvements would imply a reduction in the cost-to-income ratio (CIR) from 76 percent in 2019 to 55 percent in 2030, illustrating the magnitude of

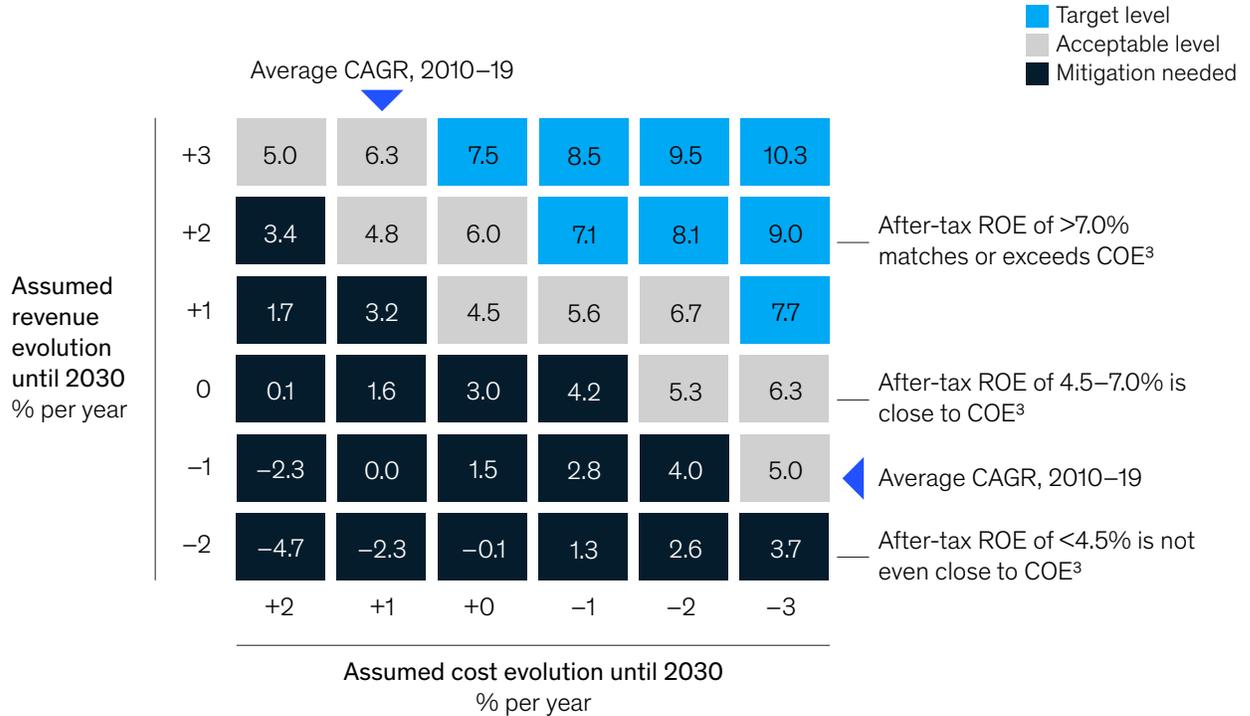
change required, including ambitious improvements on the revenue and cost sides. Nonetheless, about half of German banking executives we spoke with said they expected the CIR of the entire sector to be between 60 and 70 percent in 2030; only about one in four expected it to be below 60 percent.

These directional changes on the revenue and cost sides are more ambitious than the small annual improvement numbers indicate, however. Banks have already reaped the low-hanging fruit, such as tactical price increases and squeezing suppliers, so

ROE varies significantly depending on revenue and cost paths until 2030.

After-tax ROE forecast, 2030^{1,2}

%



¹ROE calculated based on profit after tax and before transfers to the fund for general banking risks as a percentage of the average equity (includes the fund for general banking risks, but excludes participation rights capital).

²Core assumptions for scenarios: (a) risk costs, based on average from 2015 to 2019, grow with 50% of the underlying revenue growth until 2030; (b) average equity grows with 50% of the underlying revenue growth rate until 2030; (c) there are no extraordinary losses and one-off effects for 2030; (d) tax rate stays constant at 31% (average between 2015 and 2018, 2019 rate not representative due to extraordinary losses) and will be 0% in the case of negative pretax profit.

³Cost of equity (COE) is assumed to be 7–8%.

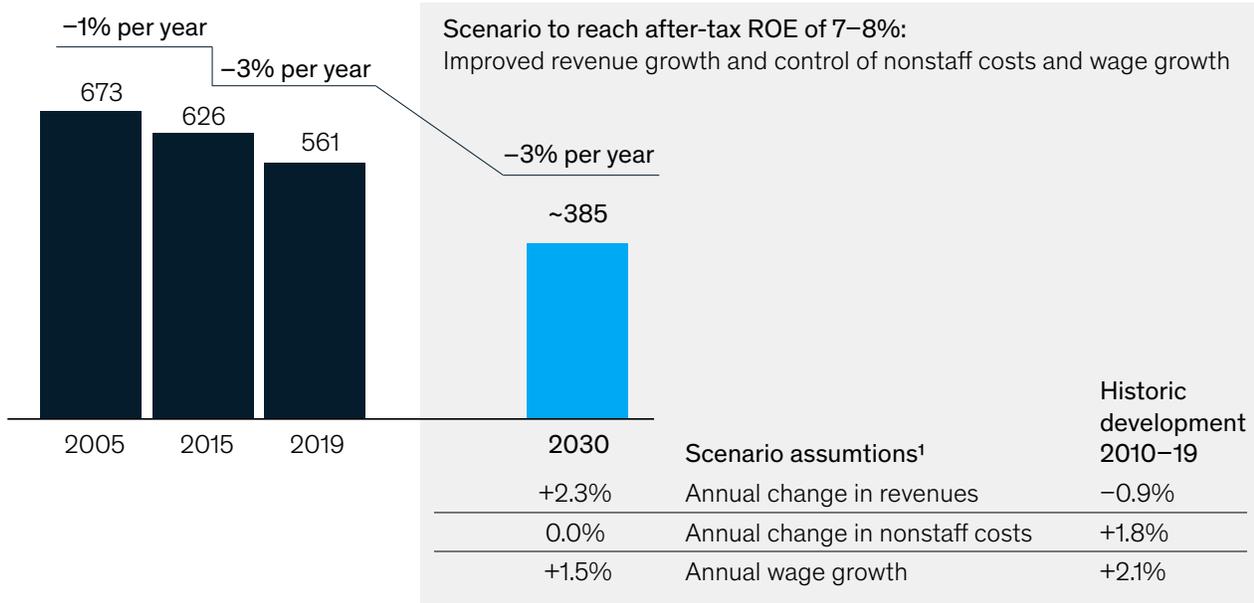
Source: Deutsche Bundesbank; McKinsey analysis

further improvements would require real structural changes. Increasing revenues by 1 to 2 percent would keep pace with inflation and be in line with GDP growth. Meanwhile, the cost ambition for banks is similarly challenging: while workforce size is trending lower (–3 percent per annum since 2015), annual inflation and wage increases of 1 to 2 percent need to be offset as well.

To reach the profit target (Exhibit 8), banks need to set ambitious but achievable targets: grow revenues by about 2 to 2.5 percent per year, continue to focus on workforce optimization, keep non-staff costs flat, and limit annual wage growth to about 1.5 percent. The implied annual 3 to 3.5 percent reduction in banking employees is slightly above historic trend. Banks can take advantage of

To avoid staff reductions above historic trend, revenue improvement and control of nonstaff cost is required.

Number of banking employees, thousands



¹Overarching assumptions: (a) risk costs, based on average from 2015 to 2019, grow with 50% of the underlying revenue growth until 2030; (b) average equity grows with 50% of the underlying revenue growth rate until 2030; (c) there are no extraordinary losses and one-off effects for 2030; and (d) tax rate stays constant at 31% (average between 2015 and 2018, 2019 rate not representative due to extraordinary losses).
Source: Deutsche Bundesbank; McKinsey analysis

the fact that the percentage of employees over 50 years old has increased from 16 to 40 percent since 2004. At the same time, however, they should ensure that sufficient new talent (especially data and digital specialists) is either hired in or developed internally.⁴⁰

Prepare for additional challenges and set holistic priorities

On the demand side, banks should consider not only how customers’ needs are changing, but also how addressing ESG factors can improve organizations’ standing in their communities. Both perspectives can offer insights into which aspirations to prioritize.

Customer at the center—always and everywhere

Banking leaders can begin with the most basic questions, such as whether they’re meeting every customer’s needs today. For each banking segment, options exist for fundamental improvements in products, services, and customer experience (Exhibit 9).

Across industries, true customer centricity offers powerful competitive advantages (see sidebar “Innovating under pressure: The media industry”). It is a tall order for banks, but they can learn from studying the experiences of financial institutions

To achieve sustainable profit levels, German banks must not only accelerate their efforts to improve performance but also deliver an additional 3–4 percent annually in combined revenue and cost improvement, likely with slightly higher contributions from the revenue side.

Exhibit 9

Each customer group seeks unique offerings.



Retail

Simple, fully digital, personalized processes: eg, an account-opening process that takes under 5 minutes without in-person meeting or video call



Multinational corporate

Tech- and partner-enabled solutions across credit, financing, and payments that follow the customer and allow for personal advice



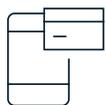
Small and medium-size enterprises

Personalized tech-enabled advice, products, and services: eg, automated invoice generation and submission for fast fund provisioning



Institutional

Comprehensive and tailored investment offerings with ESG¹ at their center, including advisory services, investment products, and regulatory-reporting services



Merchants

Seamless, fully digital customer-checkout solution accepting all digital payment options



Private banking

Personal tech-enabled advice (available 24/7 in any geography) with ESG at the center, and technology, reporting, and tools as needed

¹Environmental, social, and governance.

Innovating under pressure: The media industry

As digital attackers and new technology disrupted traditional media, especially print and broadcasting, incumbents were forced to adopt innovative business models and redefine customer value propositions. Publishers introduced digital newspapers, for example, and broadcasters offered digital apps and video on demand to compete with streaming platforms, such as Netflix and Amazon Prime, that directly reached into people's homes.

Successful transitions were built on big data and artificial intelligence (AI), which help providers offer personalized experiences, such as optimized content and targeted recommendations, to keep users engaged. More than 30 percent of German households now use fee-based streaming services⁴¹ and 61 percent of Germans aged 14 to 29 now prefer watching TV on the internet instead of traditional television.⁴²

Takeaways: Banks could redefine their customer value propositions with new digital offerings and harness big data and AI to provide greater customer satisfaction, broaden the service base, and increase pricing power and revenues.

around the world, as well as organizations facing similar challenges in other industries. The most innovative banking leaders already offer first-rate apps, modern payment methods, and readily available SME loans; create bespoke investment projects; and tap existing capital markets and emerging funding forms, such as platform funding, family offices, pension funds, and so on.

The ESG challenge

The growing relevance of ESG, and climate change in particular, for constituents across the spectrum of European consumers, businesses, broader society, and government, makes it imperative that banks engage seriously and proactively with these pressing issues.

A strong level of engagement with ESG issues will be needed from banks to help finance the economy's efforts to transition towards net-zero emissions, fulfill regulatory demands (for example, possible requirements to systematically assess ESG exposures),

and limit risks from changing customer demands and uncertain outlook for existing assets. According to a 2021 study by the European Banking Authority (EBA) highlighting European banks' exposure to ESG, more than half of exposures to non-SME corporates (58 percent of the total) are in sectors that might be sensitive to transition risk (that is, the risk that a net-zero emission scenario could pose to their existing business model). Another EBA analysis shows that 35 percent of banks' total submitted exposures are towards EU obligors with above-average (median) greenhouse gas (GHG) emissions.⁴³

The business world is taking notice: in a 2020 survey, 42 percent of institutional respondents said they had incorporated ESG into their investment decision-making process.⁴⁴ In light of a recent announcement by the German government that will require solar installation on all new buildings and for major renovations,⁴⁵ it is possible that even products like retail mortgages will use ESG/energy-efficient covenants much more broadly. ESG concerns also

lead to new investment needs: achieving climate neutrality would require redirecting roughly a quarter of current investments—compared with Germany’s long-term average of 20 percent—and increasing capital outlay by 1 percent of GDP (or €40 billion new and €200 billion existing stock⁴⁶).

We estimate that by 2030, 25 to 40 percent of banking revenues in Germany will be affected by ESG, whether through regulation or pressure from stakeholders at large: for example, the ECB published a broad guide on climate-related and environmental risks for banks covering reporting, self-assessment, and banking business models.⁴⁷ In terms of impact on banking sectors, wealth and asset management is likely to be most affected, followed by corporate, retail, and investment banking, with payments least affected.

Of course, the term “ESG” covers a broader range of issues, all of which require the commitment of leading banks, over and beyond climate change and Germany’s commitment to achieve net-zero by 2045, all of which require engagement from banking leaders. Just a sample of potential contributions would include the following:

- Promote the social and governance elements of ESG frameworks by setting a good example and using the bank’s influence as a lender and investor—for instance, by supporting the development of subsidized housing (Sozialer Wohnungsbau). Several NGOs are proposing more than two million additional units by 2030.⁴⁸
- Contribute more meaningfully and strategically to economic development—for example, by offering services such as financing a more digital economy in line with the €750 billion EU recovery plan.⁴⁹
- Serve society better—for instance, by addressing the growing pensions gap, helping consumers save for retirement, and supporting measures such as equal pay and management representation by women and minorities.
- Help accelerate the development of digital infrastructure in Germany and Europe, with support for projects such as digital identity verification and anti-money-laundering assessments.
- Meet the needs of employees and new talent with more attractive careers and social status, job security, personal and professional development, and a healthy work-life balance.

Customer centricity, end-to-end process digitization, and ESG stand out as the top three agenda items for decision makers in German banking.

As banks realign to meet rising and more diverse stakeholder needs, they will face steadily increasing competition. Fintechs and nonbank attackers are targeting attractive fee businesses as ecosystems proliferate and industry borders vanish. Banks therefore must assert themselves to get their fair share of revenues and profits.

Set top priorities

To achieve revenue and cost aspirations and address stakeholders' needs, banks must first clarify their priorities and address their biggest shortcomings.

Germany's telecommunications industry provides an example of what this can involve (see sidebar "Successfully developing the core business in telecommunications").

In discussions with us, German banking leaders cited many topics of great importance to them such as cost reduction, IT, new revenue sources, and people and culture. Three improvement priorities clearly stand out: customer centricity, end-to-end process digitization, and ESG.

Successfully developing the core business in telecommunications

In telecommunications as in banking, customers demand ever-faster, better, cheaper products, rewarding providers that discard diverse and opaque offerings in favor of more intuitive, easy-to-understand product bundles, supported by better digital journeys. Until 2010, telco providers thought they could cover (and monetize) the entire digital service sphere, but they eventually realized they could not compete against true tech players such as Amazon or Google in many digital services. With shifts in the value chain, regulation, competition, and rising pricing pressures, incumbents began to extend offerings more closely related to their core products and existing footprints, seeing themselves as enablers of ecosystem players rather than building entire ecosystems themselves. They understood the value of their key assets—local infrastructure—in meeting customers' demands for data.

To be sure, maintaining and upgrading the telecommunications network, especially the transition from 2G to 3G and now to 4G and 5G, is costly and requires enough scale to justify such investments. As a result, the telco industry in Germany has gradually consolidated into three major players, the "Big Three," which now cover most of the market and in 2019 had a fixed and mobile market share of 85 percent.⁵⁰

Takeaways: The German banking sector, by focusing on its core strengths and building on the trust it has earned from customers, can achieve enough scale to afford the investments required to defend its position against new players.

The next game is always the hardest.

Sepp Herberger, coach of the 1954 world champion German soccer team

We have just decided not to disband the club even though we drew.

Jürgen Klopp, football player, coach, and Champions League Winner 2019

The toughest opponent is usually oneself.

Joachim Löw, coach of the 2014 world champion German soccer team

It is impossible to plant small trees and expect to harvest 100 kilos of fruit in the next year.

Pál Dárdai, Hungarian football player and coach



3. A winning game plan for 2030

It is impossible to plant small trees and expect to harvest 100 kilos of fruit in the next year.

Pál Dárdai, Hungarian football player and coach

The targets set out above for banks—whether monetary, related to employees, or to ESG—are ambitious, and to achieve them, banks will need to grow in a sustainable way through profits: that is, via an after-tax ROE of 7 to 8 percent or 70 to 80 basis

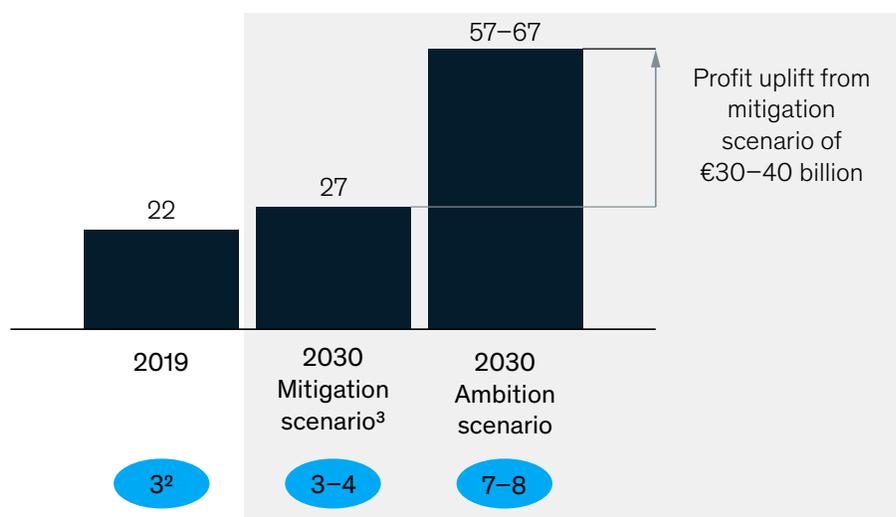
points of average assets by 2030. Based on the mitigation scenario from chapter 2, banks' operating income will likely increase from €22 billion to €27 billion in 2030, leaving a gap of €30 billion to €40 billion⁵¹ (Exhibit 10).

Exhibit 10

To reach the ROE target of 7 to 8 percent by 2030, banks need to uplift operating profit by €30 billion to €40 billion.

Operating profit scenarios for the German banking market
€ billion

... After-tax ROE,¹ %



¹ROE calculated based on profit after tax and before transfers to the fund for general banking risks as a percentage of the average equity (includes the fund for general banking risks, but excludes participation rights capital).

²Excludes other and extraordinary result, otherwise the after-tax ROE would be -0.4% in 2019.

³Assumes slight improvement of historic growth rates with an annual revenue growth of ~0.50%, annual cost growth of ~0.25%, constant risk costs, and annual average equity growth of ~0.25%.

Source: Deutsche Bundesbank, McKinsey analysis

These targets are achievable—with significant changes on the revenue and cost sides and renewed momentum in the competition with both new and foreign players. Indeed, we urge banks to look beyond the traditional borders of their industry, think more broadly, and act more boldly. There's no time to waste: a growing number of nonbank companies are already offering financial services, from accounts to payments to lending, and powerful new competitors are sure to emerge, loaded with talent and capital while at the same time being unburdened by outdated technologies.

As we have seen, customers are voting with their feet. Foreign banks have captured about 30 percent of German corporate banking; as of May 2021, there are five German fintech unicorns;⁵² neobanks already have millions of retail customers in Germany, while ecosystem players are looming on the horizon. A recent study found that 61 percent of Germans would be willing to use certain e-commerce players for financial services,⁵³ while another study found that 15 percent of small business customers are unhappy with their *Hausbank*.⁵⁴

Considering all the developments under way in the sector, it's clear that industry leaders must now decide whether they will redefine banking or let someone else redefine it for them.

Changing the way any game is played is exceptionally challenging. No single solution will suit every institution or situation. But considering successes and failures in other industries and countries, we believe that efforts on multiple fronts will be required: (1) crafting more responsive business strategies that look beyond the obvious, (2) enhancing tech-enabled customer engagement, (3) building new businesses, (4) implementing truly digital business models, and (5) redefining banking's purpose (including embracing ESG) to regain relevance and prestige.

These five improvement themes should be considered over and above existing efforts, which will merely yield a steady-state mitigation scenario overall (with likely additional market-share losses for German banks).

Craft a more responsive business strategy

As change accelerates in the competitive landscape, around customer requirements, and in technology, standing still is not an option. Banks need to update their business strategies: the reopening of the economy post-COVID-19 could be the right moment for reflection. To clarify their individual goals, and their specific advantages and challenges, banks may find it helpful to ask a number of questions across five themes:

- **Customer proposition.** What is our starting position in the customer franchise, and what are our competitive advantages from a customer perspective? Is our payment strategy fit for today, for example, and can we thrive in a more instant, tokenized, and account-to-account-based future? Can our corporate offerings withstand foreign and purely digital players? Is our retail offering truly seamless across the different channels?
- **Scale.** What is the scale and ambition of our customer franchise by sector? Is our investment banking globally competitive or supported by a large corporate customer base? Are the deposit-generating activities of a retail bank used by mortgages and corporate customers at the same bank, or should they be deployed toward partners? Are we considering consolidation enough?
- **Cohesiveness.** Are the aspirations of our customer franchises interlocking? Do asset-management offerings support investment services in retail banking and vice versa? Do payments and investment banking support a corporate franchise, or do they siphon off resources?
- **Responsiveness.** Are our decision and governance processes aligned with customer preferences? Can we react quickly enough to changing customer preferences in retail banking? What is our reaction to digital (crypto) assets in asset management and investment banking, open banking in retail

and corporate banking, or digital currencies for payments? Should we try small pilots over a five-year period or approach potential changes such as digital identity in a truly disruptive manner?

- **Comprehensiveness.** If we pulled every transformation lever, how would the overall business be affected? For example, how would cannibalization affect digital business building and ESG? If ESG changes the underwriting criteria of 50 percent of corporate loans, what needs to happen in asset management and retail banking?

In a rapidly changing market environment where fast-moving new players continue to emerge, most banks will need a focused approach to remain competitive over the long term. We urge them to reevaluate their business mix and decide in which segments and markets they really can win. Examples across Europe include Dutch banks creating challenger banks themselves, British banks reevaluating their international footprint, and cooperative/savings banks in some countries changing their governance structure.

Some may offer banking-as-a-service solutions in the form of bundled offerings, such as through white-labeling or cobranding with nonbanking players. Changes like these would require banks to make digital transformations and carefully consider which products to offer in each market.⁵⁵

300

banking touchpoints per person in a year

In addition to participating in these evolving ecosystems, banks should think broadly about how they might become ecosystem orchestrators—the primary integrators of partnerships. To build its own successful ecosystem platform, a bank would need to rethink its business model and how it interacts with customers, work hard, and take more risks. Those that succeed will open new sources of value creation and build lasting competitive advantages; examples in China (see sidebar “The relegation of Chinese incumbent banks—and their comeback?” in chapter 1) show that banks cannot ignore ecosystem platforms in the long run.

Enhance tech-enabled customer engagement

Three contributors to customer engagement are a customer-centric mindset, intelligent use of data and analytics, and an omnichannel distribution model. Banks that get all three right will have an advantage in achieving growth.

Breathe customer centricity

Banking has more customer interactions than most other industries, with touchpoints as humble as ATM withdrawals and small-business wage payments and as monumental in customers' lives as buying a house or financing a major supply chain. Indeed, after social media and technology companies, banks have the most interactions with retailers, and their wholesale offerings are often directly wired into corporate enterprise-resource-planning (ERP) systems.

Embrace interaction. Changing the industry will require a radical embrace of customer interaction. Compared with their tech brethren and best-practice examples from European banks targeting up to six client contacts daily (over 2,000 annually),⁵⁶ German banks today generate too little value from their roughly 300 touchpoints each year with a typical retail customer—especially in daily banking, lending, savings, and investment. Conversion rates along all touchpoints are still very low.⁵⁷

Similarly, in corporate and investment banking, too many interactions focus on traditional advisory meetings. The future will be more hybrid, particularly in more complex, bespoke businesses, such as private banking or complex structured financing, where the depth of customer interaction can still be increased. Another example is highlighted by COVID-19: delinquencies are primarily seen as credit recovery, not as the point for a great customer experience.

Deepen engagements at touchpoints. Banks can use customer touchpoints to deepen engagement. They can systematically identify and fix pain points in their interaction models to deliver more value and meet customers' rising expectations. Credit provision, for example, still underdelivers on certain use cases such as point-of-sale (POS) lending and micro-corps. We also believe banks can convert more digital interactions into revenue opportunities and that they can provide advice more efficiently. In 2020, over 80 percent of Germans visited a branch or spoke with a representative once a month or less.⁵⁸ Similarly, many more SMEs and corporates now expect to engage primarily remotely, via web portals, APIs, and software.

Leading up to 2030, customer-centric digital campaigns can help banks increase sales and conversion significantly. In the last three years, best-practice banks in Europe have increased their mobile banking app personal loan sales by about 80 percent, while slower banks have remained flat at about one seventh of the sales volumes.⁵⁹ Yet, such campaigns too often remain undervalued and too focused on digital-native segments. In retail, for example, we often see that best-practice campaigns not only

drive digital sales by up to 30 percent but also raise branch traffic and conversion by more than 15 percent.⁶⁰

Potential impact. A recent McKinsey analysis of 23 publicly traded US banks found that the half with high customer-satisfaction scores delivered 55 percent higher returns to shareholders from 2009 to 2019.⁶¹

Unlock data and analytics

Big data and advanced analytics can generate significant value along the entire banking value chain but particularly in customer interactions and sales. While more than 85 percent of large European banks are actively working on big data and advanced analytics,⁶² many of their efforts focus on cost-driven automation and digitization, rather than improving customer centricity or meeting rising customer demands.

Make data-driven decisions. Harness data and advanced analytics to grow revenues, generate leads, and enable a superior, personalized experience for retail and wholesale clients alike. Given the vast quantities of customer information available to banks, banking is intrinsically one of the most attractive sectors for advanced-analytics applications. Teams can use data to increase revenues—for instance, through next-product-to-buy or transactional analytics, such as when to offer buy-now-pay-later products—and to increase client acquisition and retention, such as through predictive churn and customer-experience analytics. Notably, all of this is possible in the context of Europe's strict data-privacy framework. Importantly, data-driven decisions usually improve customer experience, in addition to a bank's P&L, and this should be highlighted when addressing potential concerns about privacy.

>85%

of large European banks are already harnessing big data and advanced analytics

Some industry leaders have started to employ digital and analytics at scale for retail clients, but the promise is equally significant in corporate banking. Here, banks can generate significant value and differentiate themselves by building a truly compelling digital offering that allows for full personalization and provides valuable insights and information about distinct client segments.

Double down on digital. End-to-end banks should double down on automation, digitization, and advanced analytics to achieve continuous productivity gains quickly. Regulatory trends in recent years (such as PSD 2) have already pushed heavily in this direction; future pushes toward open banking, open data, and digital identity will rely even more heavily on data availability. If the data are not easily accessible, implementation costs will be higher. Additionally, doubling down on digital will reduce or eliminate costly human intervention, boost revenue by increasing the use of products per customer, and meet rising customer expectations for a superior, personalized experience across touchpoints and product categories.

Potential impact. Asset managers applying advanced analytics in sales and marketing have delivered revenue increases of 5 to 30 percent with behavioral client segmentation, personalized marketing, predictive sales algorithms, and other advances.⁶³

Live smart-channel distribution

By 2030, customers will expect truly seamless experiences that suit their individual needs at every turn. Banks should provide a channel mix where customers are served via the appropriate channels for their specific need: although all channels may still be in use, consumers will experience a streamlined banking model that greatly reduces cost to serve and steers them to the right channel for each engagement. What remains to be seen in the financial services sector is whether the best experiences will be delivered by banks or by technology firms.

Prioritize smart-channel distribution. A digital channel distribution model must be a priority. New distribution models built for retail customers and corporate clients alike start with digital and online access, including a state-of-the-art API landscape. They are built around customer touchpoints and

advanced analytics up front with a digital-first operating model and high-performing organization in the background. Banks should make personalized recommendations available to everyone, offering personal advice only to margin-rich niches—and stay flexible on remote technology for these segments. Given their larger geographies, many Scandinavian banks have been frontrunners in successfully providing many more services remotely and digitally. Services must be automated as much as possible, eventually reaching more than 99 percent of all interactions. The efficiency and quality of chat and video bots over the coming years will likely be so high that customers will rarely see a difference between automated and human advisory. Customized banking services will be available to retail and corporate customers instantly at any time of day or night.

Consolidate the branch network. Inevitably, banks will consolidate their branch networks into fewer branches and new formats. Banks have reduced the number of branches by about 4 percent every year⁶⁴ with no end or target state in sight. Few customers rely on branches today; 38 percent say they no longer necessarily need one.⁶⁵ Banks should turn the question around and determine how many customer touchpoints they need and how branches can help to deliver them.

The branch of the future will be leaner, and touchpoint driven, a showroom and place for more complex consultations, such as between life phases. Aiming for a branch density similar to that in Sweden—which has 1.2 branches per 10,000 inhabitants, compared to 2.9 branches in Germany—would mean a 58 percent reduction, from about 24,000 branches to 10,000.

Rethink “branches.” Importantly, bank branches will still have a future as showrooms to generate touchpoints, and as mini-call/video-centers. Interchangeable technical infrastructure will allow customers to talk with staff in person or online. In other words, they will primarily be a place of work, and double-hat for remote-advisory and selective inbound-advisory services. By implication, this will shift performance management away from sales in branches and via individual channels, and toward promoting and tracking activities.



~38%

of customers say they no longer need a branch

Some bank branches might pool resources with other organizations to serve as local community and business centers, as they do in Sweden today where they often combine with post offices, insurance companies, and even pharmacies and doctors. In Germany, we are already seeing the first experiments in this space (for example, sharing remote branches), while in the UK, some large banks share physical branches and divide service hours equally among branch partner banks.

Potential impact. A European bank delivered consistent sales growth of up to 20 percent over two to three years by optimizing its omnichannel capabilities.⁶⁶

Engage in new-business building

Building new businesses helps banks address rapidly changing customer needs. Often this will open significant opportunities for new pricing strategies and entry into new markets.

Embrace innovation and digital business building

Innovation and business building are increasingly vital in marketplaces that are changing faster than ever. Banks need to focus on these topics programmatically and systematically. They can learn from telco and media companies, which regularly start new entities and scale them, fold them in, or close them down. In practice, this might mean that a bank should start building a new digital business every three to six months: current examples might cover ESG business opportunities such as carbon markets or payment use cases around digital identity and instant payments. These should be digital first and be run with a sufficient degree of entrepreneurial freedom and the right incentives; they should also be allowed to disrupt or cannibalize the incumbent—before other players do.

Take fresh approaches to digital players, platforms, and ecosystems. Banks should learn from energy and telco players to be much more flexible about branding, marketing, and cooperation. Most telco and energy firms have secondary brands, for example, and regularly buy out growing attackers.

This trend is already under way: about 200 partnerships between banks and fintechs are already in place in Germany. Few of those partnerships may be part of systematic efforts, however. Some banks cooperate and earn income in online comparison platforms, for example, but crucially give up their customer interface; some are not even allowed to contact the clients they gain through these platforms.

Think bigger about revenue sources. Promising avenues do exist, such as the *Allfinanz* approach of cooperative banks, the regional approach of savings banks, and the fintech partnerships of commercial banks. However, they need to be scaled more aggressively. The competition is here to stay, and simple participation will eventually erode banks' positions until they are nothing more than balance-sheet providers across all areas. Globally, the banking industry has a weak record of building or owning its own ecosystems. Smarter engagement will be required to limit pure balance-sheet partnerships, retain customer access where possible, and avoid listing prices in the digital world to prevent crude comparisons. Better goals might include new bank-led, fintech-built platforms, particularly in the emerging field of corporate lending.

Be innovative around ESG. As ESG becomes a business imperative, banks should use this as an opportunity to drive long-term value creation. By developing new ESG-related products, services, and initiatives for retail and corporate clients alike, a bank

can achieve a unique position in the industry. On the retail side, this could entail expanding the ESG product offerings for private clients, such as socially conscious credit cards that donate a percentage of spending to environmental causes or loans and mortgages for environmental purposes. Some banks might offer SMEs social banking platforms or sustainability-focused cash-management solutions such as “green deposits” to help finance social initiatives. ESG advisory also offers enormous room for innovation. Banks could become leaders in this field by launching new IT solutions and software to help private and corporate clients make more sustainable investment choices.

Potential impact. Between 2017 and 2019, banks that prioritized new-business building were 30 percent more likely than other banks to be growing faster than the market.⁶⁸

Agree on a new deal with customers

The media industry offers a useful example of the potential for a new deal with customers. While cable fees have remained mostly stable and in line with inflation, streaming services are now in wide use. In 2000, German households spent an average of €37 per year on home video content; spending jumped to €100 in 2017 and €115 in 2019⁶⁹ mainly as a result of using streaming services.

New pricing models. More revenue could result from the adoption of new pricing models. (It should be noted that, due to a recent decision by Germany’s

Federal Court of Justice [Bundesgerichtshof],⁷⁰ many banks will be required to revise their pricing models.) As noted, German banks offer daily banking and credit products at relatively low cost by European standards. Simply raising daily banking prices for retail and corporate customers to the average of France, Italy, Spain, and the United Kingdom could yield additional annual revenues of about €15 billion.⁷¹ Banks need to use analytics, product bundling, and convenience to increase customers’ willingness to pay.

Expand bespoke service models. In select areas, especially private banking, structured financing and trade, real estate, wealth and asset management, or corporate finance, margins and levels of bespoke advice remain high. While many global players utilize scale, there are in fact many customers who do not fall into the standard grid and can pay for these more bespoke services. German banks should also consider playing more to local expertise: for example, API connectivity with the tax authority.

Potential impact. Fueling pricing excellence in corporate banking could increase revenues by 10 to 15 percent, based on the experience of a leading banking player.⁷²

Follow clients abroad

For more than a decade, German banks have mostly ignored international markets that can offer much higher growth rates and more attractive revenue and profit pools than the domestic market. While German export volumes have grown at an average of 4 percent annually since 2000 to 44 percent of GDP,⁷³ banks have so far not been able to participate in this development, which is reflected in their falling market share.

Cross borders. Banks should follow their clients across borders, focus on the most important trade corridors, and position themselves as trustworthy partners in cross-border activities: for example, allowing for consumers and SME businesses to pay across markets and currencies from a single bank account and currency. This will require rigorous risk management to avoid a repeat of the 1990s and

2000

partnerships already forged by banks and fintechs in Germany

30%

of German households use a fee-based streaming service, such as Netflix

2000s, where overextension in investment banking and real estate, and high costs put a considerable burden on banks. This focus can raise returns and confer competitive advantages. Experience suggests that international expansions should focus on corporate banking, transaction banking, and asset management through loans, project finance, payments, trade finance, and investment expertise. To support German economic growth, banks will need to play a larger role in the international field.

Maintain a strong home base. At the same time, banks must consolidate their positions at home. In asset management and payments, banks will need to take the initiative to regain their fair share in line with existing retail and corporate banking relationships. In retail and corporate banking, banks must strengthen their foothold by developing customer-engaging interaction and distribution models and increase pricing power. In private banking and wholesale banking, they may also need to develop broad, tech-enabled remote advice that is always available.

Many should also consider alliances with other banks much more aggressively—not with natural competitors but to allow for transcontinental partnerships in financing, correspondent banking, asset management, or other areas.

Potential impact. Cross-border platforms can improve cost-to-income ratios for relevant banking businesses by 5 to 10 percent.⁷⁴

Build a truly digital operating model

Banks that thrive in 2030—and even before—will have an operating model that is digital first. Banks also need to consider other aspects of their operating model, including scale, capital spending, and organizational culture.

Digitize for productivity

Banks seeking productivity increases through digitization can learn from the experience of telcos. As with distribution models, the question should be: what would an ideal greenfield solution look like in 2030? We expect it to be purely digital end-to-end technology that can be easily upgraded.

Build digital-first operating models. Banks have made massive investments in technology and infrastructure for many years, but outside of new banks with no legacy tech, most productivity gains have been piecemeal and too often elusive. Even for implementation of cloud solutions, expectations are often not met when based on pure infrastructure cost effects. However, if done correctly, the adoption offers benefits that go well beyond,

4%

annual growth in export volumes since 2000

+5%

performance increase for Tesla vehicles with overnight over-the-air updates⁷⁵

including a higher level of automation and faster time to market in combination with environments that can help the business scale flexibly and integrate new businesses faster.⁷⁶ Such capability will be crucial during a phase of market consolidation. Although these benefits add up to a significant performance increase across the full operating model, only 10 to 15 percent of banks have moved toward using public cloud infrastructure.⁷⁷

Tesla offers an analogy: its cars have far fewer mechanical parts and systems can be upgraded over the air, even for important functions such as battery performance and navigation. Incumbent car makers, particularly those in Germany, are demonstrating how fast they can move toward novel platforms and technologies in response to competitive pressure.⁷⁸

Get agile. Banks rethinking operating models with digital as a foundation and starting point will have to move away from the legacy waterfall approach to work. They will need to embrace data-based, agile ways of working, particularly in operations, risk, and compliance. This implies a radical shift from a frequency-based way of working toward constant supervision and immediate reactions. Lastly, agile also requires discipline around decommissioning legacy technology, channels, and processes to ensure leanness instead of added complexity.

The know-your-customer (KYC) process is a prime example: instead of relying on an annual score, banks should shift to an ongoing scoring mechanism with selective checks. This will reduce the error rate and significantly increase efficiency as demand peaks

are removed from the system. In the end, nearly all processes should be digital.

Potential impact. Banks can see a 30 percent rise in productivity in HR and finance if they standardize and centralize, reduce demand, move to standard software as a service, and digitize common requests and reports.⁷⁹

Consolidate and cooperate to build scale

Each year since 2010, an average of about 40 banking mergers have taken place, including several large-scale deals in the aftermath of the financial crisis. About two-thirds of German banking executives we interacted with expect an increase in the speed of consolidation in the German market in the next few years. Far more consolidation will be required, however, to create a healthier and better-performing industry.

Consolidate further. Engage in meaningful horizontal and vertical consolidation along the value chain. German banking mergers since 2010 have yielded two large private banks, one large mutual bank, and three larger *Landesbanken*, but much more is both possible and needed. Larger institutions should consider measured activity in Europe, while smaller banks should pay more consideration to mergers. Saving banks and cooperatives can gain more benefits from regional consolidation without sacrificing their decentralized nature. By implication, an acceleration from a level of around 40 mergers per year and the 1,650 or so banks we see today is likely.

Embrace the cooperation alternative. In addition to traditional mergers, cooperation, utilities, and infrastructure can deliver the benefits of consolidation. Creating joint operations centers or “utilities” in line with a process redesign can address a significant share of costs. An obvious quick win would be to emulate the joint ATM utilities in many countries and save the €1 billion we estimate to be possible. Simply removing machines that are next to each other might allow for some redeployment toward less well-served areas and still yield significant savings. The rapid fall of cash usage due to COVID-19 likely strengthens the underlying business case.

40

banking mergers have occurred on average each year since 2010⁸⁰

However, German banks should push this further based on market-share trends (Exhibit 3). While they likely have sufficient scale in retail and SME banking, the trend in other sectors is more worrisome. All banks and banking sectors should evaluate whether they have sufficient scale in corporate and investment banking, payments, and asset management. Can they consolidate further, potentially even across sectors? Can they leverage broader trends, such as the confluence of payments, identity, and digital currencies? Are back-office functions, including standard processing and risk and compliance with rules for KYC, fraud, anti-money laundering, and so on, sufficient in scope? Between 2015 and 2019, 21 new utilities went live in Europe, and nine more have been announced for 2020–22.

Potential impact. We estimate that utilities can address 50 to 60 percent of a bank’s cost base. Separate studies have shown that by transferring non-differentiating activities to modular industry utilities, banks might improve ROE by 60 to 100 basis points.⁸²

Optimize for capital usage

German banks rely heavily on their balance sheets today to create income. They must look for meaningful ways to free additional capital—of course without endangering stability—to improve returns on equity and invest.

Consider going smaller to go big. Given their importance to the German economy, banks should reconsider how they fund corporates and particularly the Mittelstand. This would imply a stronger shift toward off-balance-sheet

financing—a system in which banks either directly intermediate funds between lenders and borrowers or develop originate-to-distribute models. These private placements would not only provide funding to companies but also offer attractive investment opportunities for institutional investors and wealthy individuals.⁸³

It would also shrink income in absolute terms and require much leaner, smaller banks—but the fresh capital could be reinvested in areas including digitization and customer centricity. A goal of shifting 15 percent of assets away from bank balance sheets would require more of an originate-to-distribute approach, where credit originated by banks would be passed on to asset managers, pension funds, family offices, and so on.

Potential impact. In addition to the €100 billion capital release, recent McKinsey research shows that many banks can also significantly improve the accuracy of the capital-requirements calculation.⁸⁴ In our experience, regulatory interpretation, data quality, and processes in many banks are leading to inaccurate risk-weighted asset calculations, adding between 2 and 7 percent of conservatism to the calculation; importantly, these inaccuracies can be identified and corrected.⁸⁵

Restructure and refurbish culture

The proverb “Culture eats strategy for breakfast” is now truer than ever. An ambitious performance culture is at the core of every winning team—yet not widely associated with banking today.

Establish a performance culture. Performance culture is a key value generator, not just a soft topic. Culturally healthy companies deliver superior business results and sustainable competitive advantages with a virtuous circle of better employee engagement, motivation, recruitment, and retention.

Our research shows that, across industries, companies with healthy cultures deliver three times more in total returns to shareholders than their less healthy competitors. And within companies, a healthy culture explains as much as half of the variation in performance across units. As for the

€1 billion

in savings possible from a common ATM network

upcoming challenges, healthier companies are much likely to achieve successful transformations.

But what does a great culture look like? Successful banks use their people and know-how at all levels of the organization to outperform competitors through superior execution and continuous improvement. They rely on practices such as knowledge sharing, bottom-up innovation, fostering creative and entrepreneurial environments, and focusing keenly on personal ownership and employee involvement. And, of course, they embody meaningful values that guide employees in their work.⁸⁸

Reevaluate skills and ways of working. Banks are becoming less attractive to current and prospective employees, have an aging workforce, and cannot hope to source all the required new skills externally. German banks need to redouble their efforts in lifelong learning, increase mobility across functions, and balance the age structure as COVID-19 accelerates trends that were already under way. Moving toward a true performance culture also requires changes in the workforce, since new skill sets are necessary.

Potential impact. Up to 50 percent of performance variation across companies can be explained by an organization's health—how it aligns around a shared vision and strategy, executes with excellence, and renews itself to sustainably achieve its aspirations.⁸⁹

Include ESG in banking's purpose

More than ever, people are questioning the purpose of business. Banks and companies in other sectors

will increasingly be evaluated based on their impact on broader society and whether they are forces for good, over and beyond shareholder returns. To their credit, banks in Germany have ESG on their agendas, and many expect ESG regulations to expand. They should get ahead of regulatory demands and provide ESG leadership, reimagining their purpose, to regain their relevance and reputations.

Level up the human capital. To keep up in a marketplace that is changing faster than ever, banks should seek to regain their position as top employers. Two-thirds of millennials now consider a company's social and environmental commitments in their job decisions.⁹⁰ To appeal to top talent, banks will also need to make other improvements, such as reimagining ways of working with updated mobility, flexible work modes, and challenging, more rewarding career paths—thus addressing the “S” or “social” part of ESG for their workforce.

Banks should also train their employees more and hire more experienced people, especially from other industries, to improve cross-fertilization and bring in new ideas. The banking profession enjoys a very positive reputation among only 23 percent of Germans today. To rank among the ten professions with the best reputation in Germany, banking will need to move up to 65 percent,⁹¹ which will mean harnessing all its talent, courage, imagination, and capital.

In summary, the most successful banks in the years ahead will be technology and trust leaders that

€100 billion

capital released by increasing the share of off-balance-sheet

Companies with healthy cultures are

3.8x

more likely to achieve successful transformations⁸⁶

attract, develop, and retain highly sought-after talent year after year.

Seize the ESG opportunity for a positive impact and mean it. Leaders should refocus their organizations on being trustworthy partners in society. Many efforts under way now are steps in the right direction, but some are piecemeal, and others appear to be more about marketing and sponsorship than business models or strategy. Banks should tap into Germany's leading position as the largest European market and a trailblazer in environmental regulation; they have a chance to set market standards and create a positive feedback loop between market, stakeholders, and regulators to leverage their position domestically and across Europe.

Acknowledge the ESG business impact. Banks should be authentic and transparent about economic relevance, long-term financial stability and profitability, their roles as creditor and debtor, and their ability to drive change. The good news is that thinking about more than shareholder returns can actually raise shareholder returns: in a review of more than 2,000 studies, researchers found that

63 percent showed a positive correlation between ESG factors and financial performance.⁹² Companies with higher ESG ratings show better financial and nonfinancial results, including stronger reputations and lower volatility. Research also shows that a company's ethics are three times more important than competence in raising levels of customer trust.⁹³

Potential impact. According to a recent study by the European Banking Authority, the current EU green asset ratio is estimated at only 7.9 percent.⁹⁴ A recent McKinsey global survey on ESG programs revealed that 83 percent of C-suite leaders and investment professionals expect ESG programs to contribute more shareholder value in five years than they do today.⁹⁵

For German banks—where ESG affects 25 to 40 percent of banking revenues—we believe that incremental ESG opportunities could amount to 3 to 4 percent of overall banking revenues (or roughly €5 billion to €7 billion) in areas including transition finance, additional financing of climate infrastructure, or public housing (such as the *sozialer Wohnungsbau*).⁹⁶

2/3

of millennials consider a company's social and environmental commitments in their job decisions

These five improvement themes will not only create a better-performing and healthier industry but will also significantly improve the profitability of the sector. While the financial impact depends on specific business models and the starting positions of individual players, the operating profit uplift through to 2030 could comprise €30 billion to €40 billion for the German banking sector via a combination of revenue and cost measures (Exhibit 11). This profit uplift would also help the sector achieve its core profitability targets of 7 to 8 percent after-tax ROE

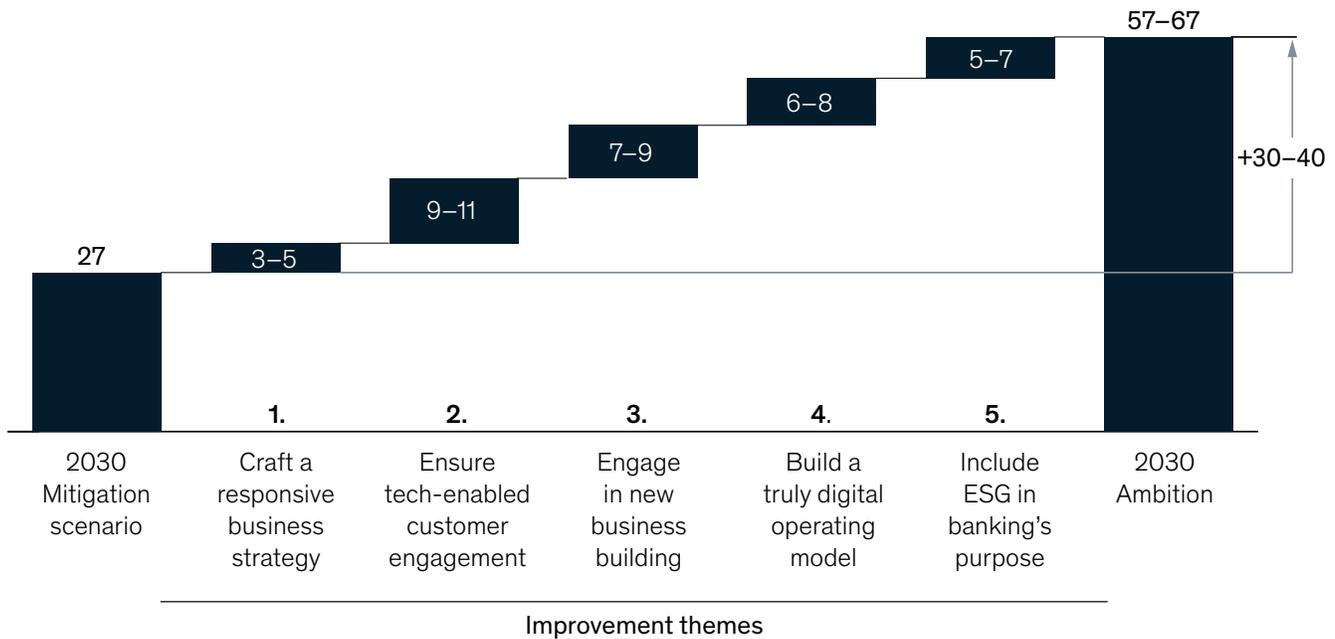
and an operating profit before risk of 70 to 80 basis points of average assets.

Obviously, changing the way the game is played will involve a lot of hard work across functions, from senior leadership to the front line. Some changes may not work equally well for every team, and each sector will require different tactics. However, each change will likely hold some merit for everyone (Exhibit 12). In the long run, these changes will help to build a better-performing and healthier industry.

Exhibit 11

Five improvement themes could generate an operating profit uplift of €30 to €40 billion until 2030.

Operating profit scenario for German banking market
€ billion



€30–40 billion profit uplift translates into €22–27 billion revenue uplift (2% p.a.) and €8–13 billion cost reduction (0.8% p.a.) until 2030.

Source: McKinsey analysis

Exhibit 12:

Five improvement themes emphasize different tactics for each sector.

- Highly relevant
- More relevant
- Relevant

Improvement themes	Sectors				
	Retail banking ¹	Payments	Asset and wealth management	Corporate banking	Investment banking
1. Craft a responsive business strategy	More relevant	More relevant	More relevant	More relevant	Highly relevant
2. Ensure tech-enabled customer engagement	Highly relevant	Highly relevant	More relevant	Highly relevant	More relevant
3. Engage in new-business building	Highly relevant	More relevant	More relevant	Highly relevant	Relevant
4. Build a truly digital operating model	Highly relevant	More relevant	Relevant	More relevant	More relevant
5. Include ESG in banking's purpose	More relevant	More relevant	Highly relevant	Highly relevant	More relevant

¹Includes private banking.
Source: McKinsey analysis



The next season

He who does not give everything gives nothing.

Alfred Kunze, football player, coach, and German Champion 1964

Banks have been playing defensively for some time and are now at risk of sliding toward relegation, but we believe they can make a strong comeback with hard work and fresh strategies. We take heart that many senior executives recognize the need for change and have high ambitions to lead their institutions on new paths.

Not everyone will succeed; the competition will not stand still. Specialist players, foreign banks, digital attackers, and high-tech entrants will find new ways to deliver more value and meet the shifting needs of the most profitable customers, gaining ground on slower-moving incumbents.

Taking inspiration from our five improvement themes and the successes of incumbents in

other banking markets and industries, we believe German banks can deliver some quick wins, particularly in customer centricity and digitization, and that many more transformative efforts will pay off in the medium term. We believe that many key decision makers will rise to the challenge, invigorate their teams to win, and relentlessly pursue longer-term improvements.

It is time to take action. The willingness to change strategy will play a significant part in determining how much banks can improve their position.

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Research team

The authors wish to thank Sarika Chandhok, a knowledge expert, Dominik Termathe, a senior Capabilities & Insights analyst; and Klaus Dommès, a junior Capabilities & Insights analyst, all in the Frankfurt office, for their research contributions.

Acknowledgments

The authors wish to thank Xiyuan Fang (partner, Hong Kong), Helmut Heidegger (senior partner, Vienna), Martin Huber (senior partner, Dusseldorf), Frank Mattern (director emeritus, Frankfurt), Gregor Theisen (senior partner, Dusseldorf), Alexander Weiss (senior partner, Berlin), Eckart Windhagen (senior partner, Frankfurt), Mark Bothorn (partner, Berlin), Simon Kaesler (partner, Frankfurt), Yoichi Kitada (partner, Tokyo), Harald Kube (partner, Frankfurt), Gottfried Leibbrandt (senior adviser, Brussels), Jonathan Michael (partner, Sydney), Albion Murati (partner, Stockholm), Ursula Weigl (partner, Munich), Martin Wrulich (partner, Vienna), and Christian Zahn (partner, Frankfurt), Susanne Maurenbrecher (expert associate partner, Hamburg), Nicolas Reuttner (solution associate partner, Frankfurt), Kristoffer Thoner (associate partner, Oslo), for their contributions to this project.

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Global Banking Practice
July 2021
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