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# A time for reinvention – Challenges and solutions for the Romanian banking system

*by Oana Ionuțiu and Alexandru Filip*

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**The pandemic is the biggest stress test in decades for the global banking system. Romanian banks need to fundamentally rethink their business model in order to overcome this challenge.**

Roughly one year into the COVID-19 crisis, we find ourselves in a place no-one could have anticipated. Individuals, businesses and even government are being forced to constantly reshape their way of working and redefine their strategies in preparation for the “new normal” – the world that will exist once the pandemic finally comes to an end.

The Romanian banking system is by no means exempt from the challenge. The current crisis in the real economy affects banks directly. But banks also play an important role in helping society throughout the crisis as the conduit for state support, supporting businesses both large and small, as well as individual citizens.

## A two-stage challenge

Banks are likely to face a two-stage challenge in the months and years to come. As reported in our latest Global Banking Report, credit losses are expected to peak in the short term, by the end of 2021. After this, amid a muted global recovery in the medium term, Romanian banks could face a profound challenge to their ongoing operations due to increased pressure on revenues and margins. The most likely situation long term is one of slower growth.

If this scenario proves correct, we expect to see banking revenues after risk decline by up to 1/3 in 2021 vs. 2019. This first wave of revenue damage – the short-term impact – will come from both risk costs and margins, driven by a decrease in reference rates and reduced interest due to non-performing loans. The second wave, in the medium term, could lead to volume weakness due to reduced economic activity, as certain sectors in the Romanian economy suffer more lasting damage.

With many businesses hit hard and consumer income slow to recover, demand for both consumer and corporate lending may remain anemic for a while. Without mitigating action, the profitability of banks in Romania is likely to stay below 10% in terms of return on equity after the pandemic, compared to an average of 12.6% in the period 2016-19. The latest research by McKinsey Panorama – Global Banking Pools indicates that the effect of the crisis could be an estimated drop in banking revenues after risk of around RON 58 billion by 2025, compared to the revenues that were expected had the pandemic never happened, due to risk costs and decreased volumes, meaning that it could take at least several years until the banking revenues will get back to 2019 levels.

58bn

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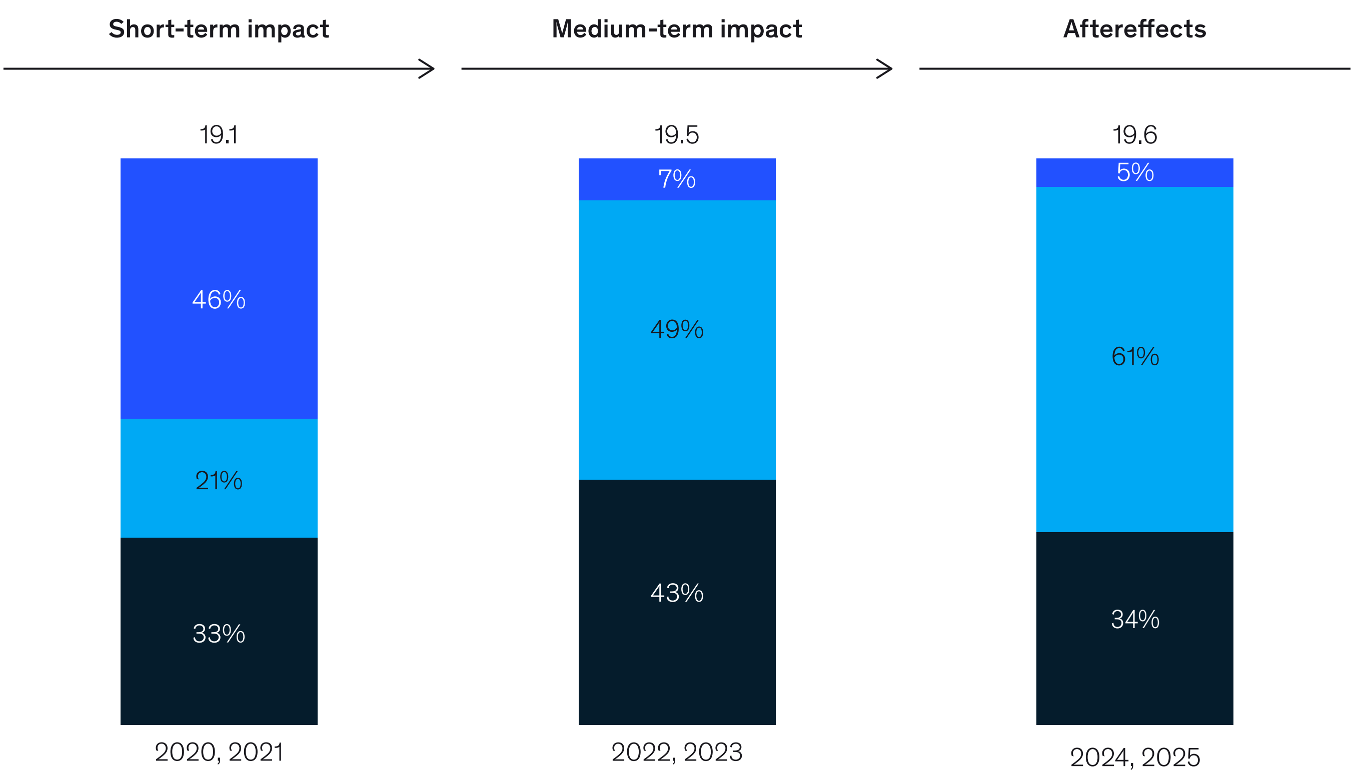
Exhibit

## Potential drop in revenues after risk for Romanian banks – Pre-pandemic forecasts vs. current estimates

**‘Lost’ revenue between Scenario A1 vs. pre-COVID-19 forecasts**[1]
Banking revenues after risk, 2020-55, RON bn, %

Risk costs | Volumes/demand | Margins

↓↓↓ High impact | ↓↓ Medium impact | ↓ Low impact




**Short-term impact (2020, 2021)**

- ↓↓↓ Increased risk costs of lending products
- ↓↓↓ Lower margins as interest rates fall
- ↓↓ Lower lending balances as new issuance slows

**Medium-term impact (2022, 2023)**

- ↓↓ Less demand for consumer lending as incomes/demand fail to recover
- ↓ Risk costs stabilize above their pre-COVID level (companies' risk levels remain higher due to higher leverage/lower income)

**Aftereffects (2024, 2025)**

- ↓↓ Less demand for corporate lending due to weaker economic activity, as the crisis causes long-term damage to certain sectors
- ↓↓ Lower margins due to faster erosion due to digitization

Note: Forecasts assume that interest accrued during loan moratorium/loan holidays is accounted for in the same year
1. Comparison of the decline in revenues vis-à-vis Pre-COVID-19 forecasts i.e., 2023 Pre-COVID-19 forecasts less 2023 forecasts under Scenario A1 ("muted recovery")
Source: McKinsey analysis, in partnership with Oxford Economics, McKinsey Panorama – Global Banking Pools, National Bank of Romania

# Romanian banks need to learn from the crisis and accelerate their transformation

## A way out of the crisis?

The current crisis poses fundamental challenges to the way banks work in Romania. Romanian banks entered the pandemic in a relatively strong financial position. They had enjoyed years of reasonable margins and falling risk costs. Local banks had achieved good levels of operational efficiency and profitability, although they lagged behind their peers in Central and Eastern Europe (CEE) in terms of productivity. The initial stages of sales migration to digital channels could be observed, but sales were still branch-heavy and customer care fragmented across channels.

Romanian banks need to adapt and react accordingly to the challenges posed by the pandemics. We identify two key areas that banks would be well advised to consider: strengthening the risk-management muscle and securing the foundations for further growth.

**1. Strengthening the risk-management muscle**

Romanian banks managed to reduce their risk costs significantly over the last decade. However, decreased job stability and business closures due to COVID-19 now present significant challenges. Banks will need to focus clearly on improving their risk-management skills in the short term in order to keep risk costs under control. In the medium and long term, they will need to excel in digital risk practices, as the key differentiator for new business.

As payment moratoria come to an end, Romanian banks will be confronted with a wave of distressed borrowers. This will be very different from anything they have dealt with in previous crises. For example, they will now need to differentiate between, on the one hand, the usual hardship arising from the economic crisis and, on the other, structural changes in the country's economic model. The role of banks will be to help customers find adequate solutions, potentially with support from government programs.

Rapid action will be needed in order to manage distressed borrowers with minimal impact on provisioning and corresponding capital requirements. Adapting segmentation models and rules to take into account the impact of COVID-19 on customers' needs and finances, and identifying the right resolution strategies for each segment, will be critical to keeping risk costs under control. Our estimates indicate that banks can expect a 10 to 15% avoidance of risk costs by transforming their collections practices. Ensuring an appropriate approach to collections can play a big part in protecting or even improving customer satisfaction in these hard times. It will also help avoid the reputational harm experienced by the banking sector during the previous crisis. Lastly, automating and digitizing collections can deliver a significant productivity upside.

Transforming end-to-end credit processes is also a must for banks. Banks should examine where they stand with regard to future norms, such as machine-led instant decisions for retail and machine-assisted processes supporting conditional approval for new transactions on the corporate business side. Pre-approved, convenient credit terms will be key differentiators for banks once volume challenges hit.

## 2. Securing the foundations for further growth

To strengthen the foundations of their growth, Romanian banks will need to refocus their strategy. Prior to the pandemic, banks concentrated on safeguarding capital and pushing high-yield products (such as consumer loans) and providing financing for the public sector. Data from the National Bank of Romania's Financial Stability Report indicates that more than 20 percent of banking assets covers public debt – one of the highest rates in Europe. This rate has been growing at ten percent a year since 2010, compared to just five percent growth for retail lending and two percent for corporate lending. At the same time, some two-thirds of the banking system's net income is generated by interest, compared to 56 percent in the European Union as a whole (according to the European Central Bank), creating a high level of dependency on lending.

Financial inclusion in the country remains low: According to industry experts, just six out of ten Romanians have a bank account. Despite the fact that monthly incomes have increased by almost ten percent a year over the last decade in local currency terms, the share of banked population has risen by less than two percentage points in the same period, as revealed by the data from the National Institute of Statistics and the World Bank. Ample room to grow remains also in both lending and savings. For the context, our Financial Pulse Survey of summer 2020 found that 60 percent of consumers had less than four months' savings. Those who do save, focus on cash or deposits, neglecting alternative products, for which penetration was just three percent of GDP (compared to 26 percent in Hungary and 42 percent in the Czech Republic, according to the McKinsey Panorama – Global Banking Pools database).

The coronavirus crisis has changed customers' behaviors and needs. Based on our 2020 Digital Sentiment survey of the Romanian market, two out of three Romanians now engage digitally, while the average number of digital services used has doubled during the pandemic. Customers also say that they are likely to increase their use of digital and mobile bank services after the crisis ends. Demand for banking products exists, but is not clearly differentiated by product type. Consumers evidently need more guidance on choosing the right product for their current and future needs.

For banks this could also mean shifting their product portfolio from large-ticket, long-tenor consumer lending to short-term financing or refinancing products and accumulation products. This could be accompanied by non-financial offerings and value-added services, backed up with advisory services. Romanians started showing an appetite for accumulation products as the crisis kicked in. Banks can maintain this with the proper offering and further financial education. For example, across Europe we have seen banks and asset managers releasing regular COVID-related market updates online. Some also offer customers investment advice around innovative trends such as ESG-focused (environmental, social, governance) investments and products with a responsible investment tag.

To facilitate the transition towards a more digital customer journey for investment products, banks in Romania may want to think about stepping up their role in enhancing financial and investment education among customers. According to McKinsey's Affluent Banking Customer Insight survey, more than 60 percent of affluent banking customers in Europe currently prefer multichannel interaction for investment products and advice, while 35 percent would be at ease with fully digital services and remote advice. Remote advice is a win-win proposition for customers and banks: Customers benefit from greater efficiency, availability, personalization and flexibility of services, while banks benefit from greater profitability (35 percent more income per meeting) and effectiveness (40 percent more meetings per advisor, 20 to 40 percent more customers served with enhanced relationship management than in branch). These figures are borne out by our experience with numerous European banks. Rethinking the distribution footprint and re-skilling branch employees towards advisory will also be important for banks hoping to capture the opportunities ahead.

In parallel with the steps described above, Romanian banks will need to reinvent themselves in order to find new revenue sources. Existing fee pools are insufficient. Banks should be looking to innovate with service-related income and new products that lessen their dependency on interest. Around the globe, leading banks are turbo-charging longstanding efforts to offer or expand services that are paid in fees rather than NIM (net interest margins). For retail customers, a focus-based strategy might entail a subscription model for services, reimagining where the customer's relationship with the bank begins and ends.

## Preparing for the "new normal"

To limit the negative impact of the COVID-19 crisis, Romanian banks need to upgrade the way they operate. This requires a new focus on the user experience, agile operations, and IT and digital technology.

- **User experience.** Customers increasingly expect banks to anticipate not only which products and services they need, but also how and when they need them. A large number of customers want to be able to do everything digitally and remotely. During 2020, many banks took action in this area, addressing emerging customer needs such as improving safe digital banking and introducing new, government-backed loans for small businesses. They can now embed this customer focus by ensuring that they generate continuous customer insights and share them with business leaders throughout the organization. Leaders should ask relevant questions about customer feedback and needs at every product-focused meeting. Banks should constantly review their performance, examining the customer experience that they are providing and identifying any areas of weakness. Having a product available digitally will soon become a minimum customer expectation and the drive towards true customer delight and loyalty will be fueled by user experience design.
- **Agility.** Embedding agility will be crucial for banks. Business cycles have shortened from quarters to mere weeks. Banks and other businesses have shifted most decisions from stable but lengthy sequential processes to swift, quasi-instant resolutions passed in group videoconferences. Companies have conjured up new products and new services in a matter of days. This new way of working has some major downsides, of course. For example, the personal connections that spark innovation are often short-circuited. But the pandemic has given business leaders a glimpse of the potential for a very different way of operating. The pandemic has also created a massive experiment in agile: Some companies will embrace it, while others will revert to their old ways. To embed the best of the new ways of working and banish the worst, banks can pursue targeted actions: institutionalize the new decision-making patterns, focus on customers, or re-imagine work for agile, remote teams – as discussed in detail in our Global Banking Annual Report.

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— **IT and digital technology.** Having strong digital foundations will be critical to enable fast product iterations and personalized user experiences. Market-leading digital natives launch new products in a matter of weeks and are able to leverage data to personalize the user experience. In Romania, a significant number of banks are part of regional banking groups. These players can take advantage of the digital and technology capabilities available in their group. However, when using group capabilities and assets, they must take care to preserve their local value generation ability and short times to market. Using commodity banking services from the group while having local control over the digital channels and user experience could offer the best balance. In addition, responding to consumer demand will require investment in technology. Prioritizing investment in modern digital technology in the short term – the next three to six months – will allow banks to streamline their operations and meet customer expectations.

Will Romanian banks survive the stress test? Only time will tell. What is clear is that those that are able to reinvent themselves and prepare for the new normal will significantly reduce their risk of being further casualties of the crisis. In so doing, they will also put themselves in a position to master the many challenges of the post-pandemic era.

## Authors


**Oana Ionuțiu**
Knowledge Consultant
Romania

**Alexandru Filip**
Managing Partner
Romania



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