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For US banks:
A time for transformation

To achieve robust performance and meet market expectations, US banks will need to embark on ambitious and holistic transformations.

Danilo Gargiulo, Tolga Oguz, and Victor Pinto

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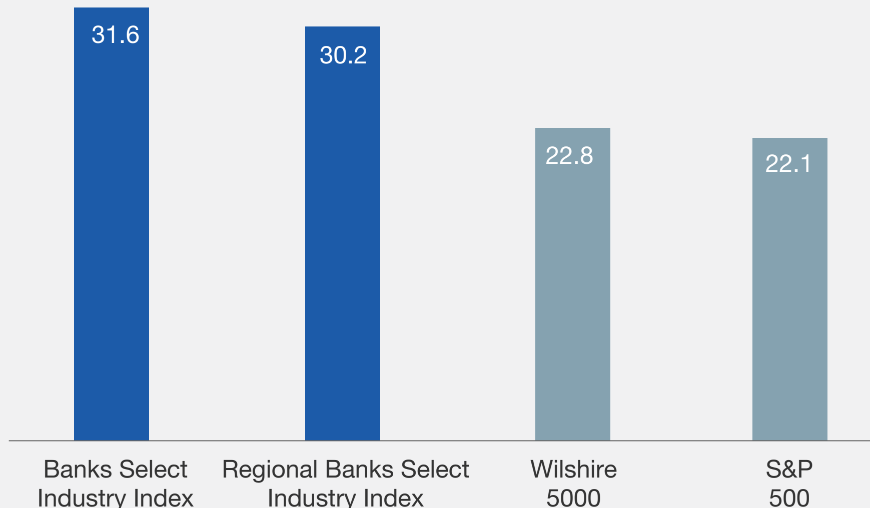
From the perspective of the markets, it appears to be a great time for US banks. The industry's return to shareholders has outperformed the broader market 32 percent versus 22 percent since November of 2016 (Exhibit 1).

This positive outlook is reinforced by the expectation of lower regulatory pressures and higher interest rates in the next five years, which could unlock a new era of high banking returns and growth. The market seems to have accepted this narrative, with the highest market-to-book multiples (in 2016) for US banks since 2007 (Exhibit 2).

However, the market-to-book multiples imply fundamentals—returns on equity (ROE) and revenue growth—that banks have not achieved in over a decade, raising questions about banks' ability to deliver on such high expectations. The valuations imply either a 14 percent ROE (at current growth levels of 2 percent)—a level not reached by banks since before the financial crisis (and a 28 percent increase

Exhibit 1 US banks have outperformed the broader market since November 2016.

Banking industry returns vs the market, between Nov 1, 2016 and Nov 1, 2017, %

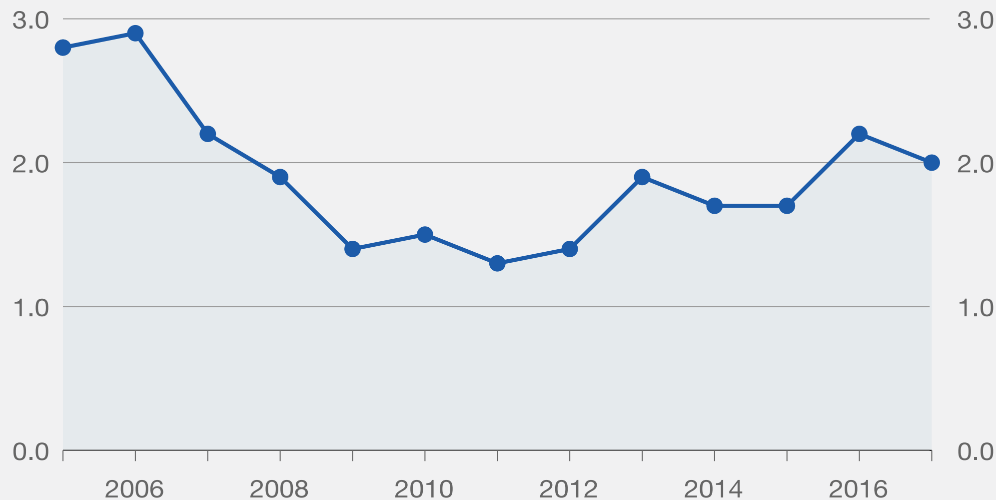


McKinsey&Company | **Source:** Capital IQ

The market-to-book multiples imply fundamentals—returns on equity (ROE) and revenue growth—that banks have not achieved in over a decade, raising questions about banks' ability to deliver on such high expectations.

Exhibit 2 US bank market-to-book multiples are higher than at any point since 2007.

US banks' market-to-book ratio[1]



[1]Median and tangible book value used.

McKinsey&Company | **Source:** Capital IQ

from the 11 percent average of the last three years) (Exhibit 3)—or a growth rate of more than three times the historical average.

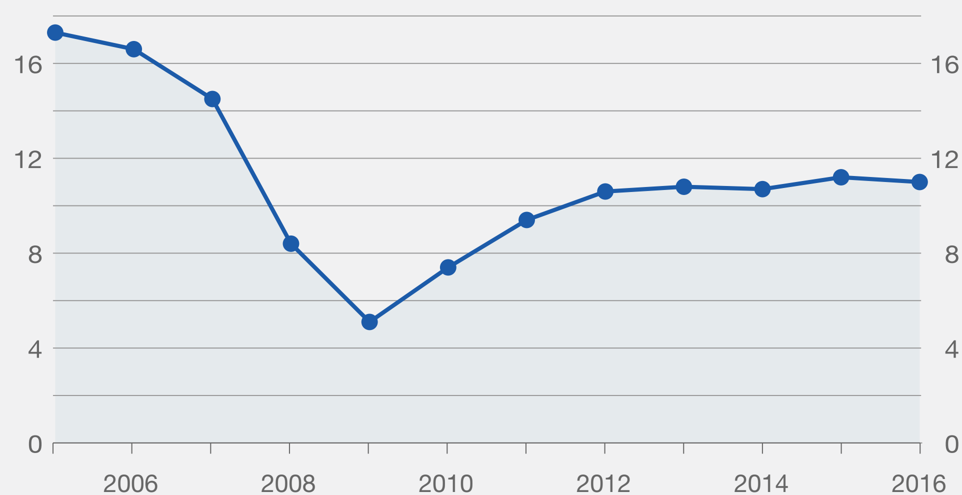
A changing landscape for US banks

The expectations for higher growth and ROE are complicated by three trends that are radically changing the banking landscape: low economic growth, economies of scale through digitization, and the threat of disintermediation:

- Low economic growth. Lower economic growth continues to put pressure on banks. And while major economies are introducing fiscal stimuli to boost growth, the effectiveness of these efforts is not guaranteed. If low economic growth continues, US banks will find it hard to increase revenues organically, especially through deposits and lending.

- Economies of scale through digitization. Banking was once a local scale game: more branches led to higher share of deposits. Digitization is complicating this equation. If banking follows the glide path of similar industries, banks that excel at digital brand building, advanced analytics, and machine learning will see outsize gains in customer experience, revenue, and efficiency. Already, the five largest US banks in terms of assets, which have the largest resources to invest in digital capabilities, have gathered a 40 percent share of total domestic deposits in 2014, up from 20 percent 15 years earlier. In the coming years, digital presence will start to outweigh local scale, and therefore significant digital investment will continue to drive higher growth or ROE.

Exhibit 3 Return on equity for US banks has not reached 14% since 2007.



[1]Median return on equity, net income to shareholders, and tangible book value used.

McKinsey&Company | **Source:** Capital IQ

- The threat of disintermediation. Advances in technology and changing customer expectations are leading to the collapse of the traditional banking value chain and the emergence of an integrated-network economy comprised of "ecosystems." The threat for banks is the loss of the customer relationship—a threat embodied not only by fintechs but also by nonbanking firms playing the role of ecosystem orchestrators. Examples include China's Alibaba, which partners with banks to offer small-business-loan programs and credit systems for merchants and customers, and TransferWise, which uses the banking back end to provide international money transfers at a fraction of incumbents' prices. There are several possible responses for US banks, but they must begin considering their options in the short term, and decide how to allocate resources to enable growth and returns.

The need for scale

For most US banks—particularly regional institutions—meeting the growth expectations implied in current valuations organically will be a stiff challenge, given low economic growth and the increasing concentration of deposits at the top. Compounding the challenge is the fact that some potential pathways to growth—digitization and partnerships with fintechs—demand a scale and ability to invest that only the largest banks possess. Thus, we expect many US banks, especially regional banks, to continue to turn to what may be one of their few options for building scale and creating shareholder value: inorganic growth.

Consolidation is already under way, of course. From 2000 to 2014, there was a 28 percent decrease in the number of small banks, while the number of large banks rose 33 percent. The rise in the number of mergers for small banks indicates that despite a

relatively stable economy banks are still turning to inorganic growth to gain scale and operate more efficiently and competitively. This trend is expected to accelerate over the next five years, especially among small to mid-tier players.

The keys to transformation

To create capacity for digital investment and inorganic growth and develop the execution discipline required to absorb new entities, banks need to go beyond the small-bore, intra-year goals they have targeted in recent years, which may be effective in the short term, but do little to alter the performance culture of the business—or to build the skills that banks need to thrive in a continually changing environment. To improve the major contributors to robust performance, such as revenue growth, cost efficiency, operational effectiveness, customer satisfaction, and sales excellence—and do so on a sustained basis—banks must embark on an ambitious and holistic transformation that affects all aspects of the business. Few, however, currently possess the capabilities and the skills, or the corporate culture, they need to make such radical change stick.

A true transformation delivers significant bottom-line results but also equips an organization to make rapid decisions and operate with rigor. A successful transformation starts with a committed and ambitious leadership team, with the CEO serving as a role model for change. The following five elements are then crucial to success:

High aspirations. In our experience across industries, initial aspirations for transformations are often weakened through compromise and by the tendency for managers to "under-promise and over-deliver." Recent turmoil in the banking system has also contributed to conservative target setting. In our experience, however, companies can achieve goals two or three times greater than those they originally set. It is up to the CEO to demand, from the outset, a fact-based review of all revenue and cost goals, and to take an outsider's view—an active investor mind-set—to pushing the company to stretch for the full potential.

Increase the pace. Just as stretch goals are key to a successful transformation, most successful transformations are achieved through an increase in the cadence of change. This is particularly true in the banking industry, where digital and technological components are at the core of operations, and the technology available is evolving rapidly.

Chief transformation officer. Achieving the full potential in a rapid decision-making environment requires unique capabilities that many organizations lack. Effective transformation is as much about developing the executional capabilities for ongoing change as it is about redesigning business drivers. If this challenge is to be met effectively, there must be a full-time executive—a chief transformation officer (CTO)—to drive it. The CTO's job is to "question, push, praise, prod, cajole, and otherwise irritate an organization that needs to think and act differently."

Too many organizations restrict candidates for the CTO position to internal hires, but it is sometimes a newcomer to the company—someone unafraid of confrontation and without a stake in protecting a legacy—who can bring the required degree of disruption.

Changing mind-sets. When transformations fail, often it is not because they are poorly thought out or lack ambition, but because leadership, culture, capabilities, and incentives are lacking. Because it necessarily stresses an organization, a true transformation will quickly uncover these deficiencies, so it is important to address the issues at the outset. For example, many banks overlook the importance of making the case for change, that is, telling the story of why transformation is necessary. The bare facts are rarely compelling enough to motivate a workforce to embrace significant change.

Incentives—both monetary and nonmonetary—are also crucial for engaging the front line in a transformational effort. They should be simple and significant, acknowledging the stresses and challenges the workforce will be facing. Sometimes recognition from senior executives is enough to make the difference.

Sustainable transformation. When transformations fail, it is generally with a whimper, not a bang. Results will improve—sometimes significantly—for a time, but the lack of continued focus and real capability growth eventually leads the bank back to the old ways. Companies that avoid this fate apply the lessons learned during transformation—the faster cadence, the incentives—to the everyday performance of the company. They continue to challenge orthodoxies, maintain an outsider perspective on change in the organization, and motivate employees to take ownership of change.

US banks face a difficult challenge. The markets expect stronger performance than the underlying fundamentals support, and a number of current trends may increase the headwinds. Consolidation seems likely to continue, but is only a partial solution. To achieve step-change results, banks must set ambitious goals for transformation across the organization. ■

Danilo Gargiulo is a vice president of Recovery & Transformation Services in McKinsey's New Jersey office. **Tolga Oguz** is a partner in the New York office, where **Victor Pinto** is a consultant.

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