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Why banks must make bold late-cycle moves

After a decade of expansion, the banking industry appears to be entering the late phase of the economic cycle.

Growth in volumes and top-line revenue is slowing with late-cycle gaging behind nominal GDP growth in recent years.

Global bank lending by market and GDP growth rate % ATHIS CONSISTS OF

SOURCE Compustat; Bloomberg; Bank Focus; McKinsey Analysis

Compound annual growth rate

Global banking before risk margins (revenue-to-assets)[1] Basis points, YOY

In addition, **margins have been narrowing for some time**—and are now dropping at an even faster rate.

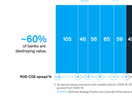
[1] Revenue-to-average-assets, based on a sample of 1,000 banks in 20 countries.
SOURCE S&P; McKinsey Panorama

As another economic downturn approaches, the global banking industry finds itself in less than ideal health. In fact, a majority of banks may not be economically viable.

Global banks return on equity (ROE) — cost of equity (COE) spread, 2009–19

[1] Based on 5,651 banks with available data for 2009–19. ROE based on average, not year-end, equity. Cost of equity based on 2009–19.
SOURCE McKinsey Strategy Practice and Corporate Performance Analytics[1]

In a potentially "lower for longer" rate environment, banks must take bold actions now to succeed in the next economic cycle.



How is value created?

The value that banks create is determined by three primary factors:

1 Geography

The domicile of a bank explains **nearly 70%** *of underlying valuations.*

2019 price-to-book ratio of large quoted banks[1]

[1] Largest 1000 global banks, excluding companies headquartered in Japan and Australia, as of August 30, 2019.
SOURCE S&P Capital IQ; McKinsey Panorama

2 Scale

Scale—whether it's across a country, region, or client segment—is generally correlated with stronger returns.

Correlation of banking returns and market share

Given that geographic reach is mostly out of a bank's control, and scale takes time to build, banks must focus on the third factor: business model.

3 Business model

There are three universal performance levers that all banks can immediately act on to change their destiny.

Risk management

Banks can protect returns in an economic downturn by managing risk.

Identification of a bank's riskiest customers
Gini value, 100% = perfect predictive accuracy

Productivity

To radically reduce costs, banks can transfer non-differentiating activities to third-party "utilities."[1]

This has the potential to increase return on equity by as much as 100 basis points.

[1] Refers to outsourcing, joint ventures, or partnerships.

Share of total operating cost
Typical universal incumbent bank example, %

[1] Includes product management, advertising/promotions, market research, CRM activities etc.
[2] Includes HR, procurement, facilities management.
[3] Other costs, including depreciation and amortization.
SOURCE McKinsey Strategy Practice and Corporate Performance

Revenue growth

When customers are satisfied, they generate more value for banks; the reverse is also true.

Customers who interact with their banks through superior experiences are much more likely to refinance with a different bank.

Customers who intend to refinance their mortgage with another bank, by satisfaction rate, %

SOURCE 2018 McKinsey Journey Pulse Benchmark

By materially improving decision points in the customer experience, banks can increase customer satisfaction ratios within 12–18 months.

The four banking archetypes

Beyond these universal performance levers, a bank should prioritize late-cycle economic decisions based on the archetype it falls under.

Depending on the bank's unique circumstances, different archetypal levers will be available.

Market leaders (top 10 in each country)
Use the scale they have built to deploy large capital base to be used for ecosystem and innovation plays

Resilients (next 30 average returns)
Focus on **niches where they are strong** and have a strong partnership opportunities with market leaders, or have capital base

Followers (next 30 average returns)
Focus on **niches where they are strong** and have a strong partnership opportunities with market leaders, or have capital base

Challenged (ranks below 60 average returns)
Focus on **niches where they are strong** and have a strong partnership opportunities with market leaders, or have capital base

Reinvent, scale, or perish

As the current economic cycle slows down, no bank can afford complacency.

Odds of remaining in the same archetype % of banks

[1] Starting average value on ROAE/ROA/ROTE of resilients or 10%, 2009–2012.
SOURCE S&P; McKinsey Strategy Practice

Banks have stories that **roughly 40%** of market leaders drop to the bottom half of peers in the next cycle.

Now is the time for banks to take bold action through universal and archetypal levers—or risk being left behind.

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