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The Global Banking Annual Review 2023

The Great Banking Transition

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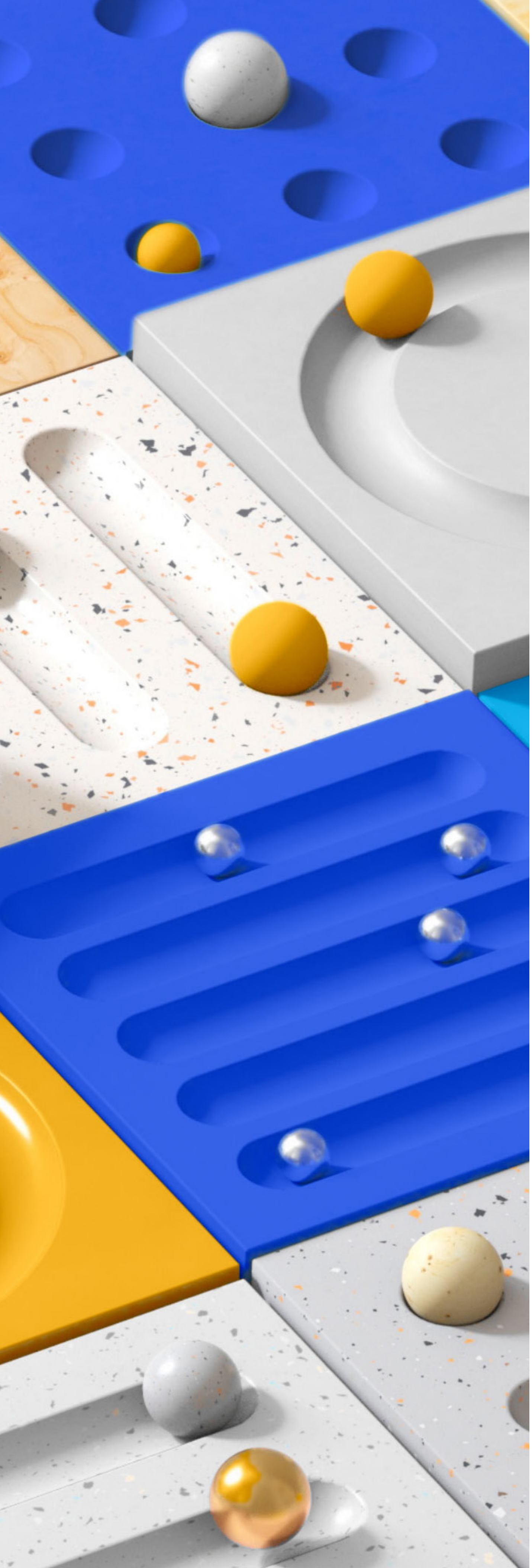

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Executive summary

Banking has had to chart a challenging course over the past few years, in the face of increased oversight, digital innovation, and new competitors, and all at a time when interest rates were at historic lows. The last few months have also brought their share of upsets, including liquidity woes and bank failures. But broadly speaking, a favorable wind now seems to have returned to the industry's sails: viewed as a whole, the past 18 months have been the best period for global banking overall since at least 2007, as rising interest rates have boosted profits in a more benign credit environment.

Below the surface, too, much has changed: balance sheets and transactions have increasingly moved out of traditional banks to nontraditional institutions and to parts of the market that are capital-light and often differently regulated—for example, to digital payment specialists and private markets, including alternative asset management firms. While the growth of assets under management outside of banks' balance sheets is not new, our analysis suggests that the traditional core of the banking sector—the balance sheet—now finds itself at a tipping point. For example, between 2015 and 2022, more than 70 percent of the net increase of financial funds ended up not on banking balance sheets, but held by insurance and pension funds, sovereign wealth funds and public pension funds, private capital, and other alternative investments, as well as retail and institutional investors.[1] Given the size of this movement, we have broadened the scope of this year's Global Banking Annual Review to define banks as including all financial institutions except insurance companies.

In this year's review, we focus on this "Great Banking Transition," analyzing causes and effects and considering whether the improved performance in 2022–23 and the recent rise in interest rates in many economies could change its dynamics. To conclude, we suggest five priorities for financial institutions as they look to reinvent and future-proof themselves. The five are the following: exploiting leading technologies (including AI), flexing and potentially even unbundling the balance sheet, scaling or exiting transaction business, leveling up distribution, and adapting to the evolving risk landscape. All financial institutions will need to examine each of their businesses to assess where their competitive advantages lie across and within each of the three core banking activities of balance sheets, transactions, and distribution. And they will need to do so in a world in which technology and AI will play more prominent roles and against the backdrop of a shifting macroeconomic environment and heightened geopolitical risks.

The recent upturn arises from the 500-basis-point increase in interest rates since the second quarter of 2022 in the United States, echoed in other developed economies. This has brought with it a long-awaited improvement in net interest margins that boosted the sector's profits by about $280 billion in 2022 and lifted return on equity (ROE) to 12 percent in 2022 and an expected 13 percent in 2023, compared with an average of just 9 percent since 2010. Over the past year, the banking sector has continued its journey of continuous cost improvement: the cost-income ratio dropped by seven percentage points from 59 percent in 2012 to about 52 percent in 2022 (partially driven by margin changes), and the trend was also visible in the cost-per-asset ratio (which declined from 1.6 to 1.5).

The ROE growth was accompanied by volatility over the past 18 months. This contributed to the collapse or rescue of high-profile banks in the United States and the government-brokered takeover of one of Switzerland's oldest and biggest banks. The strongest performers of past years, including fintechs and cryptocurrency players, have struggled against this backdrop.

Performance varied widely within categories. While some financial institutions across markets have generated a premium ROE, strong growth in earnings, and above-average price-to-earnings and price-to-book multiples, others have lagged behind. While more than 40 percent of payments providers have an ROE above 14 percent, almost 35 percent have an ROE below 8 percent. Among wealth and asset managers, which typically have margins of about 30 percent, more than one-third have an ROE above 14 percent, while more than 40 percent have an ROE below 8 percent. Bank performance varies significantly, too. These variations indicate the extent to which operational excellence and decisions relating to cost, efficiency, customer retention, and other issues affecting performance are more important than ever for banking. The strongest performers tend to use the balance sheet effectively, are customer centric, and often lead on technology usage.

The geographical divergence we have noted in previous years also continues to widen; banks grouped along the crescent formed by the Indian Ocean, stretching from Singapore to India, Dubai, and parts of eastern Africa, are home to half of the best-performing banks in the world. In other geographies, many banks buoyed by recent

[1] This reflects a long-term trend. For example, investors sometimes find more attractive opportunities to park incremental cash flows into money market funds (rather than bank deposit products). Or borrowers find it more attractive to take credit from nonbanks. This report is not referring to the current US deposit dynamics, which has resulted in outflows for banks as well as shifts within the composition of banks' balance sheet liabilities (for example, deposits and bonds), or between banks.

performance are able to invest again. But in Europe and the United States, as well as in China and Russia, banks overall have struggled to generate their cost of capital.

One aspect of banking hasn't changed, however: the price-to-book ratio, which was at 0.9 in 2022. This measure has remained flat since the 2008 financial crisis and stands at a historic gap to the rest of the economy—a reflection that capital markets expect the return on equity to remain below the cost of equity. While the price-to-book ratio reflects some of the long-term systematic challenges the sector is facing, it also suggests the possible upside: every 0.1-times improvement in the price-to-book ratio would cause the sector's value added to increase by more than $1 trillion.

Looking to the future, the outlook for financial institutions is likely to be shaped by four global trends in particular. First, the macroeconomic environment has shifted substantially, with higher interest rates and inflation figures in many parts of the world, as well as a possible deceleration of Chinese economic growth. An unusually broad range of outcomes is suddenly possible, suggesting we may be on the cusp of a new macroeconomic era. Second, technological progress continues to accelerate, and customers are increasingly comfortable with—and demanding about—technology-driven experiences. In particular, the emergence of generative AI could be a game changer, lifting productivity by 3 to 5 percent and enabling a reduction in operating expenditures of between $200 billion and $300 billion, according to our estimates. Third, governments are broadening and deepening regulatory scrutiny of nontraditional financial institutions and intermediaries as the macroeconomic system comes under stress and new technologies, players, and risks emerge. For example, recently published proposals for a final Basel III "endgame" would result in higher capital requirements for large and medium-size banks. And fourth, systemic risk is shifting in nature as rising geopolitical tensions increase volatility and spur trade and investment restrictions in the real economy.

In this context, the future dynamics of the Great Banking Transition are critical for the banking sector overall. Evidence of the transition and associated unbundling abound. In the United States, 75 percent of the net increase in financial funds ended up off banking balance sheets, while in Europe, the figure is about 55 percent. Private debt, meanwhile, saw its highest inflows in 2022, with growth of 29 percent, driven by direct lending. Beyond the balance sheet, transactions including payments and trading activities are also shifting: consumer digital payment processing conducted by payments specialists grew by more than 50 percent between 2015 and 2022, for example.

The oscillating interest rate environment will affect the Great Banking Transition, but exactly how remains to be seen. The industry may be going through a phase in which a long-term macroeconomic turning point—including a higher-for-longer interest rate scenario and an end to the asset price super cycle—changes the attractiveness of some models that were specifically geared to the old environment, while other structural trends, especially in technology, continue. Fundamentally, the question for banks is to what extent they can offer the products that people are looking for, at a time when risk capacity is broadening and many are searching for the highest deposit yields.

Regardless of the macroeconomic developments, all financial institutions will have to adjust and adapt to the changing environment of the Great Banking Transition, especially the trends of technology, regulation, risk, and scale. Mergers and acquisitions may gain importance.

As financial institutions consider how they want to change, we outline five priorities, which are neither comprehensive nor mutually exclusive, as thought starters. These are the five priorities:

1. *Exploiting technology and AI* to boost productivity, utilize talent better, and improve the delivery of products and services. This includes capturing the AI opportunity, along

with advanced analytics, to deploy process automation, platforms, and ecosystems; operating more like a tech company to scale the delivery of products and services; cultivating a cloud-based, platform-oriented architecture; and improving capabilities to address technology risks. Distinctive technology development and deployment will increasingly become a critical differentiator for banks.

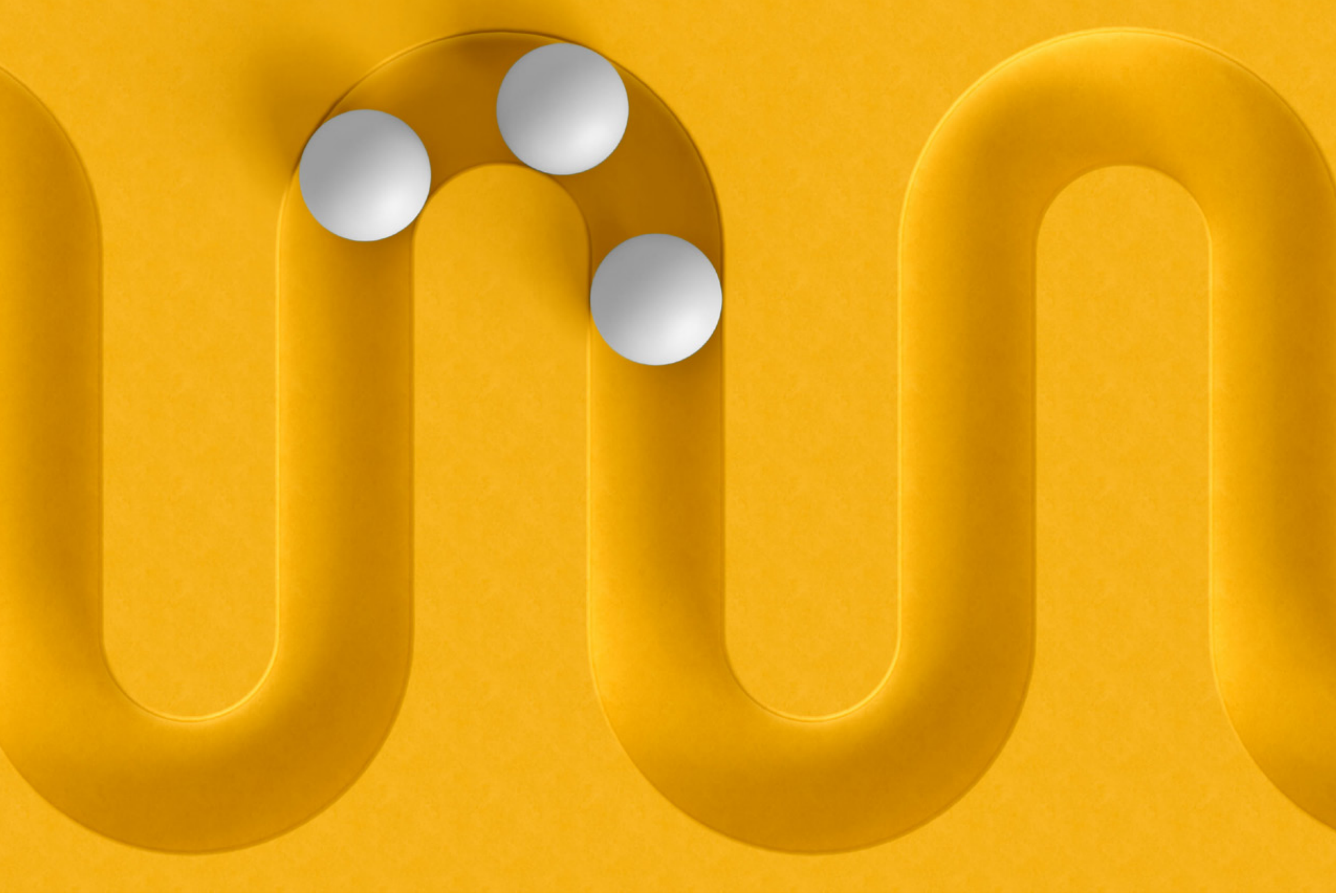
2. *Flexing and even unbundling the balance sheet.* Flexing implies active use of syndication, originate-to-distribute models, third-party balance sheets (for example, as part of banking-as-a-service applications), and a renewed focus on deposits. Unbundling, which can be done to varying degrees and in stages, pushes this concept further and can mean separating out customer-facing businesses from banking-as-a-service businesses and using technology to radically restructure costs.

3. *Scaling or exiting transaction businesses.* Scale in a market or product is a key to success, but it can be multifaceted: institutions can find a niche in which to go deep, or they can look to cover an entire market. Banks can aggressively pursue economies of scale in their transactions business, including through M&A (which has been a major differentiator between traditional banks and specialists) or by leveraging partners to help with exits.

4. *Leveling up distribution* to sell to customers and advise them directly and indirectly, including through embedded finance and marketplaces and by offering digital and AI-based advisories. An integrated omnichannel approach here could make the most of automation and human interaction, for example. Deciding on a strategy for third-party distribution, which could be via partnerships to create embedded finance opportunities or platform-based models, can create opportunities to serve customer needs, including with products outside the institution's immediate business models.

5. *Adapting to changing risks.* Financial institutions everywhere will need to stay on top of the ever-evolving risk environment. In the macroeconomic context, this includes inflation, an unclear growth outlook, and potential credit challenges in specific sectors such as commercial real estate exposure. Other risks are associated with changing regulatory requirements, cyber and fraud, and the integration of advanced analytics and AI into the banking system. To manage these risks, banks could consider elevating the risk function to make it a potential differentiator. For example, in client discussions, product design, and communications, they could highlight the bank's resilience based on its track record of managing systemic risk and liquidity. They could also further strengthen the first line and embed risk in day-to-day activities, including investing in new risk activities driven by the growth of gen AI. Underlying changes in the real economy will continue in unexpected ways, requiring banks to be ever more vigilant.

All these priorities have critical implications for financial institutions' capital plans, including the more active raising and return of capital. As financial institutions reexamine their businesses and identify their relative competitive advantages in each of the balance sheet, transactions, and distribution components, they will need to ensure that they are positioned to generate adequate returns. And they will need to do so in a different macroeconomic and geopolitical environment and at a time when AI and other technologies are potentially changing the game and with a broader set of competitors. Scale and specialization will be determinative, as will value-creating diversification. Minimum economies of scale are also likely to shift, especially where technology and data are the drivers of scale. The years ahead will likely be more dynamic than the immediate past, with the gap between leaders and laggards increasing even more. Now is the time to begin charting the path forward.



1 The highest highs, the lowest lows

A year ago, in our 2022 Global Banking Annual Review, we focused on how the world of banking was entering a period of sudden volatility after years of relative stability. We warned that this could increase the industry's fragility and exacerbate growing divergences between types of banks, business models, and geographies.[2]

Sure enough, the past 18 months have been a time of extremes for the banking industry globally—but the news is far from being all bad. While we have seen the lowest of lows in some financial institutions and in some places, we have also seen the highest of highs. On a global basis, key indicators for the industry, including return on equity (ROE) and capital ratios, have risen after long periods of decline. For some banks in Europe and the United States, 2022 and the first half of 2023 have been the best in more than a decade, as higher interest rates lifted revenue and ended a painful years-long trend of margin compression.

[2] "Global Banking Annual Review 2022: Banking on a sustainable path," McKinsey, December 1, 2022.

Indeed, both traditional and nontraditional banks in any and every geography are proving that it is possible to grow, thrive, and excite customers through reinvention and innovation. For example, one of the most radiant of these spots is in countries forming a crescent around the Indian Ocean, where half the world's best-performing banks are now to be found.

Moreover, new technological developments, including gen AI and faster computer processing power and cloud architecture, are raising hopes and aspirations for massive productivity-enhancing and potentially game-changing solutions to age-old issues.

But the lows cannot be overlooked. One of Europe's oldest banks and some of the highest-profile midsize banks in the United States collapsed or had to be rescued; both the Swiss National Bank and the US federal government needed to step in to backstop consumer deposits. Star performers in previous years, including fintechs, have struggled. Crypto-currencies are sorting through a host of problems after the collapse of key players. And financial institutions as a whole continue to trade below their book value, suggesting that market participants believe they will collectively continue to have an ROE that is below their cost of capital, as is currently the case for more than half of banking institutions, especially those with higher capital intensity and those that are more global in nature and deemed to be systemically important by regulators.[3]

Why can't most of banking, especially the balance-sheet-based part, shake out of its valuation and value creation rut? And to what extent could the big interest rate rises of the past year be a game changer, both for banks with business models that have been under pressure and for those that did well when capital was cheap? In this year's review, we take a closer look at one of the most important underlying factors that can shed light on these questions: the shifts in balance sheets, transactions, and distribution that have been leaving banks to go to nontraditional institutions and other parts of the market, a movement we are calling the Great Banking Transition. While disintermediation has been happening for a nearly a decade, especially in transactions,[4] it has achieved a critical mass for the balance sheet, with distribution potentially to follow. The traditional model of capital-heavy banking still needs to reinvent itself to ensure its own future—and to do so swiftly. And how will the combination of significantly higher interest rates—after an extended period of depressed rates for much of the developed world—and other trends (including regulatory and technology changes) both challenge and accelerate key assumptions about the future?

The Great Banking Transition is the main theme of this year's annual review. In chapter 2, we focus on how balance sheets, transactions, and some distribution channels have been moving away from traditional players, while in chapter 3, we consider strategies for banks seeking to adjust to changing realities and to find new sources for value creation. As we do every year, we start in chapter 1 with an analysis of major developments in the banking sector globally over the past year; these include some of the trends contributing to the Great Transition.

A long-awaited upturn in net interest and profit margins

Banks, especially in Europe and North America, registered gains in net interest margins in 2022 on the back of rising interest rates, leading to a rise in their ROE, and the trend continued into 2023. In the United States and Europe, net interest margins rose by between 15 and 80 basis points, depending on the profile of each financial institution's portfolio, with an average gain of 22 basis points. Many financial institutions across key segments—including payments, wealth and asset management, capital markets, and consumer finance—continue to go from strength to strength.[5] However, wide variations exist within these individual subsectors. A return to ultralow spreads seems unlikely in the short term, but the outlook for net margins remains uncertain.

[3] We define banks in this report to include all financial institutions except insurance companies.
[4] We define transaction in this report to include any asset or trade movement, be it an equity or an electronic payment.
[5] Capital markets refers to the businesses of investment banking, sales and trading, and market infrastructure.

Overall, the best years for ROE in more than a decade

Taken as a whole, 2022 and 2023 have been the best years for banks' ROE in more than a decade, though with considerable variation between institutions. Viewed globally, the ROE for financial institutions rose to 12 percent in 2022 and looks set to reach 13 percent in 2023. That is far above the 13-year ROE average of 9.1 percent (Exhibit 1).

Net income for the sector of $1.4 trillion in 2023 was double the net income posted in 2017. The ROE increase was even accompanied by an increase in capital ratios, with the Tier 1 ratio globally reaching 13.8 percent in 2022–23, the highest in a decade.

The banking sector also continued its journey of continuous cost improvement: the cost-income ratio dropped by seven percentage points (partially

Exhibit 1

Banks globally posted their best return on equity and profits in a decade in 2022–23.

[1]Based on a global sample of ~1,000 largest banks in terms of assets. Profit after tax over tangible equity.
[2]Profit after tax of financial intermediation industry (excludes insurance manufacturing business), not adjusted for unrealized losses.
Source: S&P Global; McKinsey Panorama

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The global figures mask wide variations within individual subsectors. Some financial institutions across markets have created strong shareholder value, premium ROE, strong growth in earnings, and above-average P/E and P/B multiples, while others lag behind.

driven by margin changes), and the trend was also visible in the cost-per-asset ratio (which declined from 1.6 to 1.5).

The financial services sector globally intermediated about $400 trillion in assets and generated $6.8 trillion in revenue in 2022. Those are both records. They compare with about $375 trillion in assets and $6.4 trillion in revenue generated in 2021. Intermediation has been growing faster than the overall economy, with intermediation growth of about 6 percent annually on average since 2017, compared with real GDP growth of about 3 percent.

Looking at these data in a more granular way highlights wide variations that continue to grow across the industry. Intermediation revenues were largely concentrated in corporate, commercial, and retail banking, as has been the usual pattern. The most profitable sectors were wealth and asset management, capital markets infrastructure, and payments (Exhibit 2).

In corporate and commercial banking, where the share of intermediation revenue rose by more than two percentage points in 2022 from the previous year, higher interest rates are improving the margins on transaction banking, despite a slowdown in corporate deal volumes since 2021.

In wealth and asset management, the gap between the best and the rest has been widening since 2019, but overall costs have risen industry-wide. Asset managers, in particular, saw declines in profitability and growth in 2022, mainly due to negative equity and bond performance.

In capital markets, revenue pools continue to grow on the buy side—that is, firms buying financial securities, including pension funds, investment managers, and hedge funds. On the sell side (firms including corporations, advisory firms, and investment banks selling, issuing, or trading in financial securities), revenues remained stagnant. The share of intermediation revenue accordingly declined by one percentage point to $480 billion.

In retail banking, the push to embrace new technologies has seen the emergence of some banks operating with the efficiencies of tech companies. Distribution is moving increasingly from omnichannel to fully mobile channels.

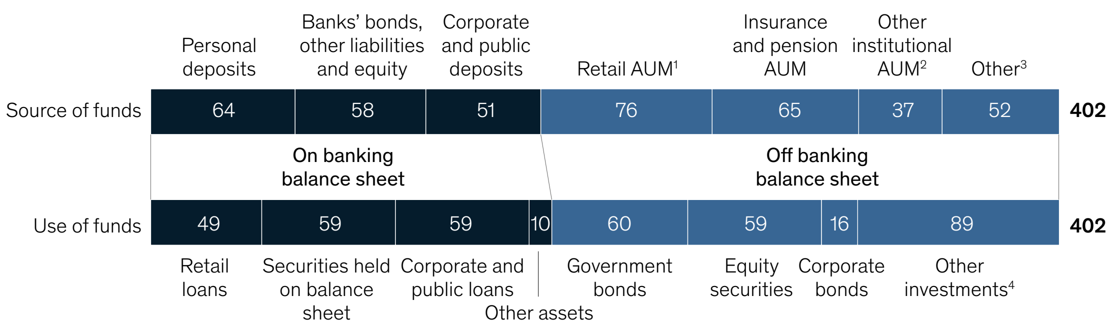
Finally, in payments, global revenues continue to see rapid growth, especially in Asia. The shift to contactless, digital payments is accelerating, and the demand for embedded finance is growing in deposits, payment issuing, and lending.[6]

[6] Embedded finance arises from partnerships between banks, technology providers, and distributors of financial products to embed financial products into nonfinancial platforms. For more, see Andy Dresner, Albion Murati, Brian Pike, and Jonathan Zell, "Embedded finance: Who will lead the next payments revolution?," McKinsey, October 13, 2022.

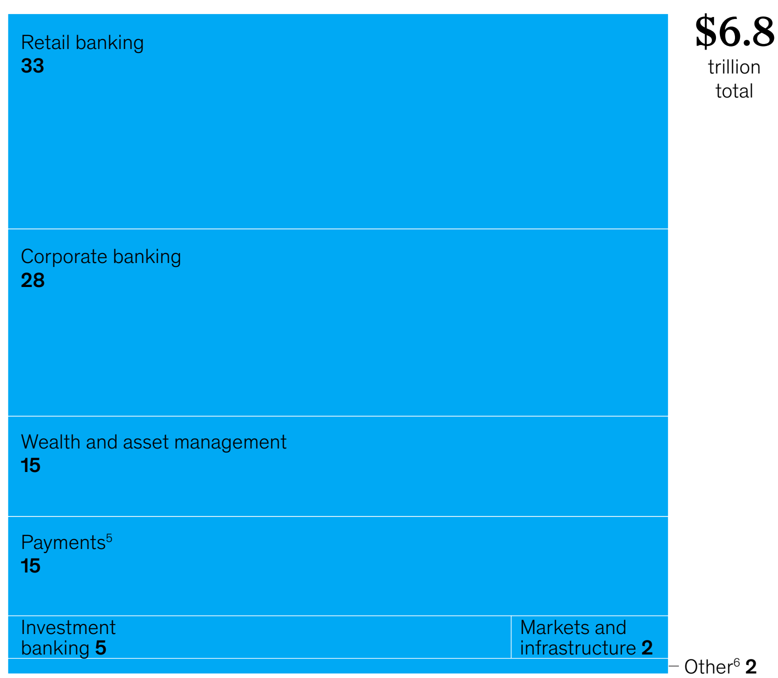
Exhibit 2

The global financial industry intermediates $400 trillion in funds to generate about $7 trillion in revenue.

Global financial intermediation, 2022, $ trillion



Share of total annual revenue from global financial intermediation, by type, 2022, %



[1]Assets under management. [2]Endowments and foundations, corporate investments. [3]Includes sovereign wealth funds and public pension funds; private capital; digital assets; other alternatives. [4]Includes securitized loans; real estate; commodities; derivatives. [5]Net interest income from deposits considered in retail and corporate banking. [6]Includes revenues from real estate funds, infrastructure funds, hedge funds, commodities funds, absolute return, liquid alternatives, and from mining, buying, and selling of digital assets via exchanges, custody, payments, and liquidity providers.
Source: McKinsey Panorama

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The global figures tell only part of the story; they mask wide variations within individual subsectors. Some financial institutions across markets have created strong shareholder value, premium ROE, strong growth in earnings, and above-average price-to-earnings and price-to-book multiples, while others lag behind. For example, while more than 40 percent of payments providers have an ROE above 14 percent, almost 35 percent have an ROE below 8 percent. Among wealth and asset managers, which typically have margins of about 30 percent, more than one-third have ROEs above 14 percent, while more than 40 percent have ROEs below 8 percent (Exhibit 3). Such variations indicate the extent to which operational excellence and decisions relating to cost, efficiency, customer retention, capital allocation, and other issues affecting performance are more important than ever for banking. The strongest performers tend to use the balance sheet effectively, are customer-centric, are effective managers, and often lead on technology usage.

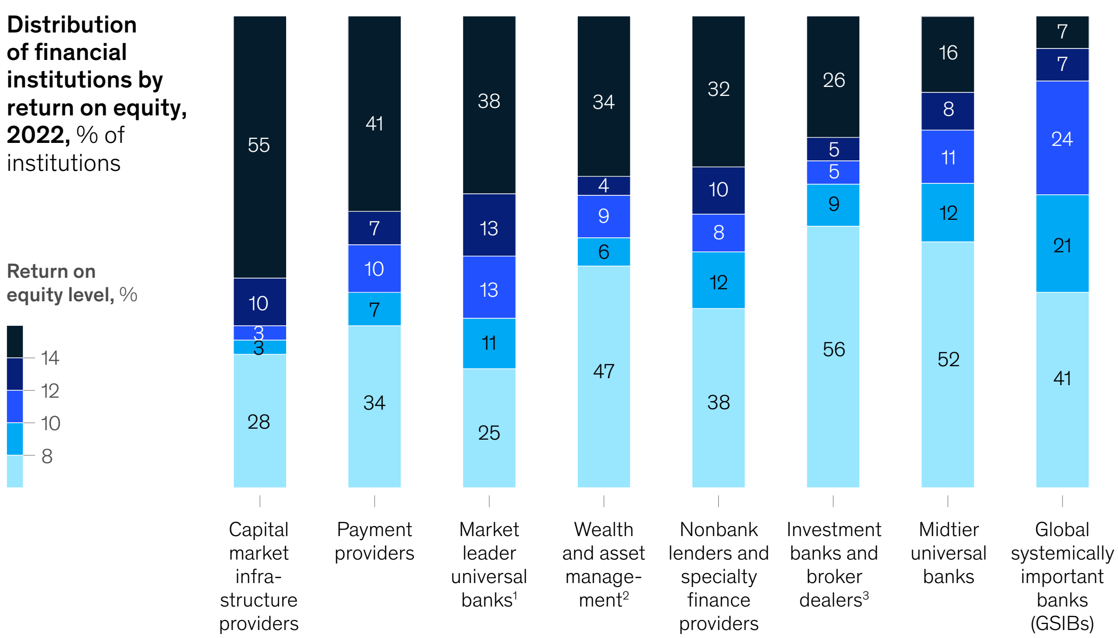
Disruptions kept the sector trading below book value, with exceptions

Banking was affected by disruptions, and the sector as a whole continues to trade below book value. However, there are some notable bright spots.

Several major disruptions in 2022 and 2023 contributed to the high degree of variance in banks' performance. Some of the disruptions related to geopolitical situations; among these, the consequences of Russia's war on Ukraine have included energy supply concerns and sanctions on Russia that

Exhibit 3

Successful institutions exist in every subsector, albeit with much dispersion.



Note: Figures may not sum to 100%, because of rounding.
[1]Domestic market leader with >10% of share in assets, excluding GSIBs.
[2]Includes traditional asset managers, nontraditional intermediaries, and sponsors.
[3]Includes sales and trading.
Source: S&P Global; McKinsey Panorama

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affect Russian banks and non-Russian companies doing business in Russia. In the economic sphere, surging inflation and rapid increases in interest rates caught some banks by surprise and contributed to some US regional banking failures. The crypto-currency market, buoyant in previous years, was shaken by the collapse of several leading players, along with regulatory changes in the United States and elsewhere.[7]

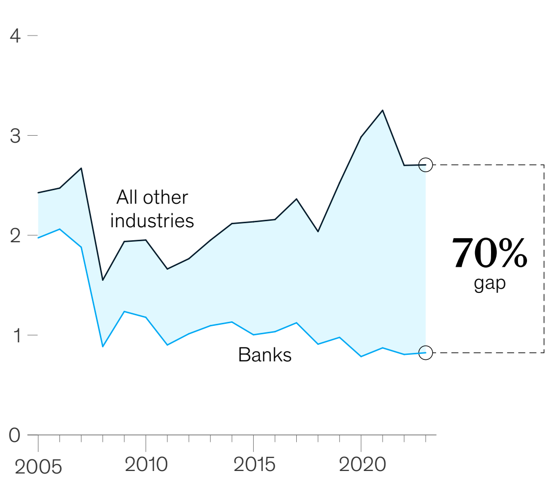
Amid both the upturn in margins and the volatility from these disruptions, one aspect of banking has remained constant: the sector's price-to-book ratio (P/B). At 0.9 in 2022, it has remained largely flat since the 2008 financial crisis (Exhibit 4). Banking is the sector with the lowest market valuation, suggesting that capital markets expect that ROE over time will remain below the cost of equity. But as we describe in more detail in the following chapter, the outlook varies considerably depending on whether the current interest rate environment endures, and for how long, and whether an institution is balance sheet heavy (as traditional universal banks are) or asset light (as, for example, in the case of wealth and asset managers).

Depressed P/Bs and price-to-earnings ratios (P/Es) suggest there may be significant upside: if the sector finds a path to a more future-proof business model, trillions of dollars in shareholder value could be created. This, in turn, could also increase the sector's stability. Still, it is important to note that expectations for value creation in banking should take into account that balance sheet banking is a

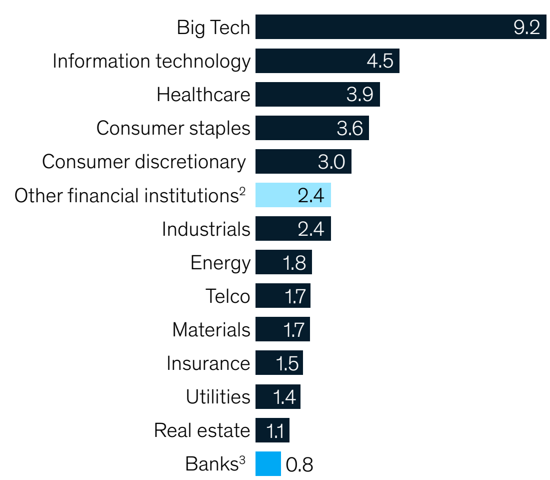
Exhibit 4

The banking valuation gap highlights different regulatory constraints and a need for business models to evolve.

Price-to-book ratio[1]



Price-to-book ratio by industry[1]



[1]Data for 2023 as of Sept 1.
[2]Includes payments, asset management, investment banks (not included under Banks), capital market infrastructure institutions, nonbank lenders, and specialist financing institutions.
[3]Includes global systemically important banks, market leader universal banks, and midtier universal banks.
Source: S&P Global; McKinsey Panorama

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[7] See, for example, David Yaffe-Bellany, "Crypto firms start looking abroad as US cracks down," *New York Times*, June 7, 2023.

leveraged business driven by macroeconomic developments. Any bank's long-term success will predominantly depend on prudent through-cycle steering.

In last year's Global Banking Annual Review, we noted that banks globally fall into three different categories. First were the "North Stars," which performed well in terms of both high returns today and future growth, with high P/Es implying high expectations for long-term growth and high P/Bs reflecting risk-adjusted profitability. Second, about half of the 1,000 largest banks globally had ROEs below their cost of equity and were expected to continue doing so in the future. The remaining 35 percent—banks with high P/Bs but low P/Es—were creating value but not growing sufficiently to ensure they would continue doing so.[8]

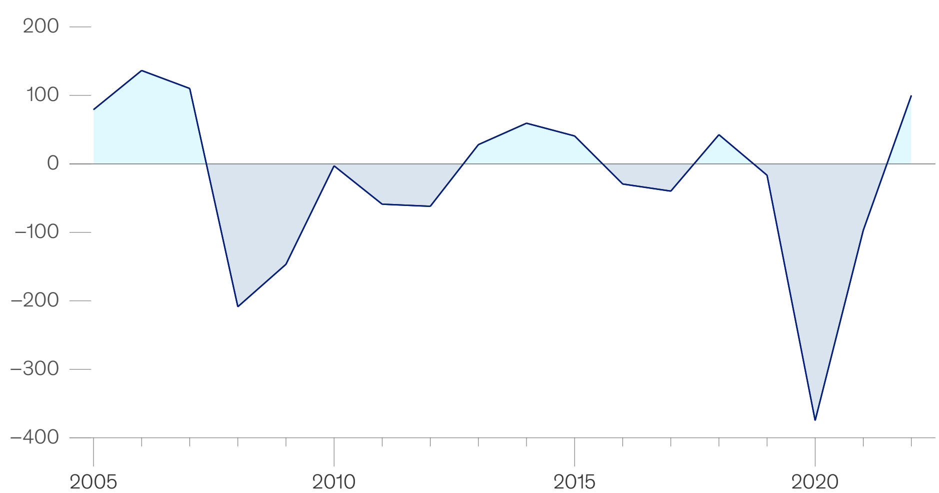
The divergence among the three categories has grown in the past year. In 2022, 15 percent of institutions were North Stars; that share declined to 12 percent in 2023. The share of banks expected to have ROE below the cost of equity rose to 58 percent in 2023 from 50 percent in 2022. And 32 percent of banks fell into the category of those profitable today but with longer-term challenges of value creation, down from 35 percent in 2022.

More broadly, the banking industry continues to face competition from nonincumbents, including specialist players that are less constrained by legacy systems and cost overhang and can move faster than traditional banks. Since the global financial crisis in 2008, the industry's ROE has been below the cost of equity, partly as a consequence of regulatory requirements in many countries (Exhibit 5).

Exhibit 5

The banking industry is evolving in response to economic pressures and new entrants into the market, including specialist players.

Annual global banking industry economic profits,[1] $ billion



[1]Profits minus the cost of capital.
Source: McKinsey Panorama

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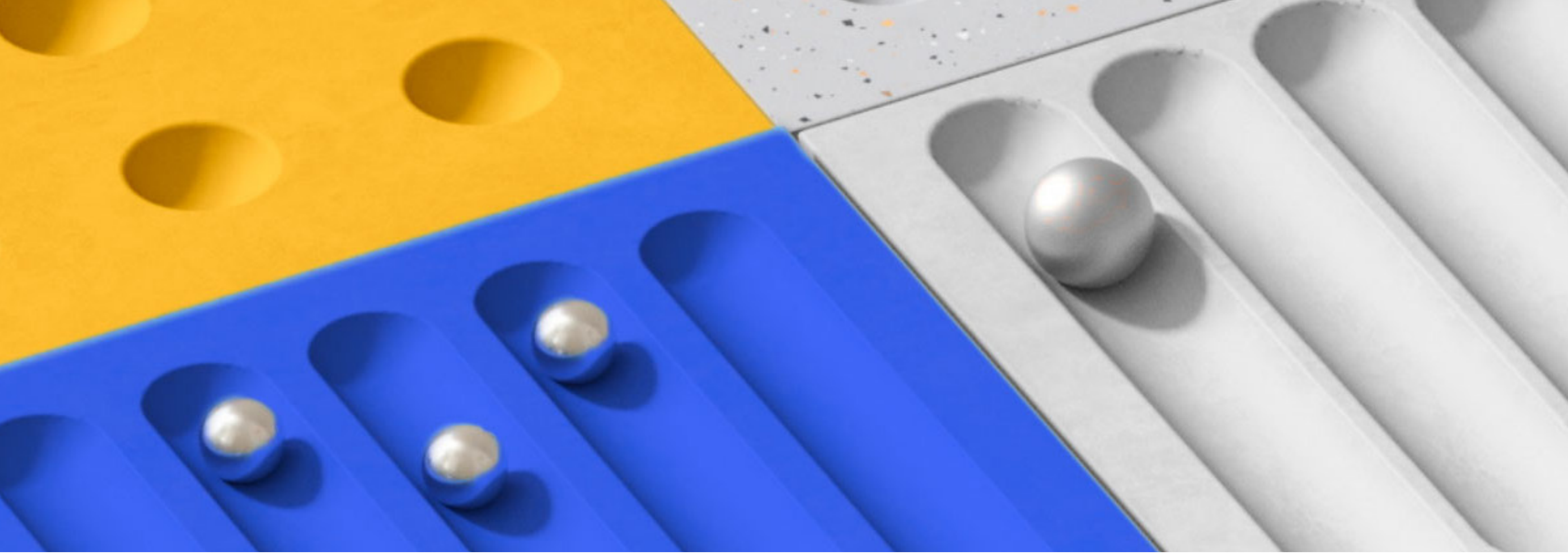
[8] "Global Banking Annual Review 2022," December 1, 2022.



Global trends bring a new outlook for financial institutions

Several global trends contributing to a more volatile world underlie the market highs, many examples of success, and previously described sources of disruption. They are also contributing to the Great Banking Transition we discuss in the next chapter. Four trends in particular contribute and will likely continue contributing to shifting outcomes for financial institutions: the uneven macroeconomic outlook, tighter regulation and government supervision, technology disruption, and systemic risk. Compared to the past, technology and macro-economics in particular have shifted substantially—and likely for the longer term.

These four trends and others are affecting the industry with increased velocity. A high degree of connectivity—propelled by technological innovation and underpinned by economic interdependencies—has increased communication and mobility and the speed of innovation in industry. Today's connectivity can also contribute to disruptions, as when social media acts as a vector for both information and misinformation about the health of banks. The resulting flood of communications contributed to the turbulence that shook US regional banks in the first half of 2023.

Uneven macroeconomic outlook

Growth and inflation expectations vary widely across geographies, and there is continuing concern about volatility and the prospect that the global economy may be entering a new era with widely divergent outcomes.[9] The range of plausible long-term paths remains wide. Much depends on whether the world returns to an era of weak investment and a glut of savings, entailing slow GDP growth, low interest rates, and unabated expansion of the global balance sheet. On another path, stronger consumption and higher investment requirements for the net-zero transition, supply chain reconfiguration, or defense could lead to persistently higher inflation and interest rates.[10]

Over the past 18 months, central banks in areas with high inflation have been raising interest rates faster than in recent history (Exhibit 6). Projections for the medium-term outlook depend fundamentally on what happens to interest rates, with several scenarios possible. While the economy could potentially revert to the low-interest-rate environment of the past two decades, another scenario is for rates to stay at relatively elevated levels for longer amid continued inflation concerns. For banks and the broader economy, the scenario that unfolds will be decisive. A prolonged period of high interest rates would ripple through the entire economy, likely dampening growth and affecting the housing market, consumer spending, job creation, and more. This also implies an increase in the cost of equity across the industry.

For now, there appears to be a sense of stabilization and cautious optimism about the short-term outlook. The International Monetary Fund foresees global

[9] "On the cusp of a new era?," McKinsey Global Institute, October 20, 2022.
[10] "The future of wealth and growth hangs in the balance," McKinsey Global Institute, May 24, 2023.

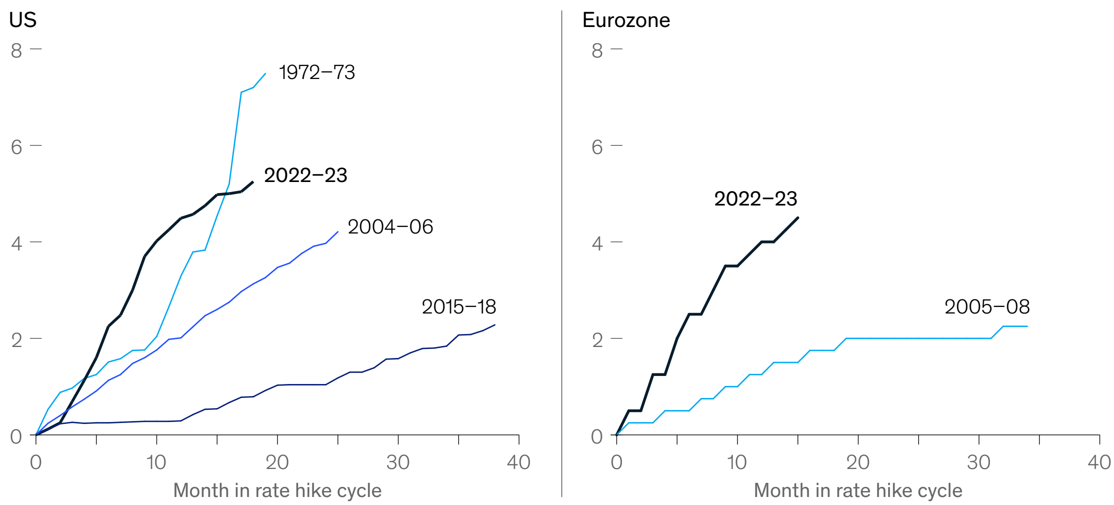
Exhibit 6

The macroeconomic outlook is uneven, with varying growth expectations and rapid increases in interest rates.

Economic outlook measures by economy

	Brazil	China	Eurozone	India	Japan	UK	US
GDP growth, FY 2022–23,[1] %	2.1	5.2	0.8	6.1	1.4	0.4	1.8
Inflation, FY 2023,[1] %	6.3	2.0	5.3	4.9	2.7	6.0	4.5
Policy rate change, FY 2022–23,[2] basis points	+150	–25	+450	+250	0	+450	+500

Historical interest rate hikes,[3] percentage points



[1]Forecast by the International Monetary Fund (IMF), Sept 2023.
[2]Between Mar 2022–Sept 2023.
[3]Calculated as the difference between the policy rate during the cycle and the policy rate at the beginning of the rate hike cycle.
Source: European Central Bank; Federal Reserve; IMF World Economic Outlook report

McKinsey & Company

GDP growth at about 3 percent in 2023 and 2024, in part because of improved sentiment in developing countries, and talk of a deeper recession in the United States and Europe has mostly dissipated. Indeed, for the first time in more than a year, global executives are now more positive than negative about conditions in the global economy. In the latest McKinsey global survey on economic conditions, published in July 2023, respondents overall express an evolving perspective on the interest rate environment, with many saying rate levels may have peaked or could soon do so.[11] The survey nonetheless highlights significant geographic divergence. Respondents in Europe, India, and North America were more optimistic about economic conditions in their home countries than they were six months

[11] "Economic conditions outlook during turbulent times, June 2023," McKinsey, July 7, 2023.

ago, whereas pessimism is growing in the Asia–Pacific region, especially China. In China, which long served as an engine for global growth, the economy has slowed: average annual GDP growth between 2021 and 2023 has been about 4 percent, substantially lower than the average 7 percent growth between 2012 and 2019.[12]

Tighter regulation and government supervision

As the macroeconomic system comes under stress and new technologies, players, and risks emerge, global governments are broadening and deepening regulatory oversight of financial intermediaries. Existing coverage has been tightened in some areas. For example, recently published proposals for a final Basel III "endgame" could change the calculation of risk-weighted assets, potentially leading to significant increases in the capital requirements of large banks. The US Federal Reserve Board estimates that the proposals would result in an aggregate 16 percent increase in common equity Tier 1 capital requirements for affected bank holding companies.[13] The Basel III endgame also proposes new standards to manage credit, market, and operational risk for financial institutions and greater scrutiny of liquidity requirements.[14] The growing adoption of open banking, which enables the sharing of financial data between banks and third-party service providers, has led to more calls for data protection and increased regulation in several geographies.[15] Moreover, a growing swath of environmental, social, and governance (ESG) requirements are being introduced across industries, including banking, and in many countries, notably in Europe.[16] Finally, regulatory coverage is slowly expanding to newer areas, including digital assets such as cryptocurrencies and to nonbanking financial intermediaries such as private capital funds and hedge funds. There also is increasing scrutiny of fast payments.

Regulatory change is unlikely to decelerate and may also begin to encompass new and nontraditional business models. One of the outcomes of these and other regulatory moves has been to accelerate and deepen the Great Banking Transition, as we discuss in chapter 2.

Technology disruption

Technology has increasingly become a competitive advantage in financial institutions, with the most digitally advanced often performing the best. Leading digital banks deploy personalization analytics and digital marketing campaigns to bring relevant offers to (potential) clients. They create an omnichannel experience where branch and contact center professionals have the tools and data to support customers at any stage of the sales journey. They also provide customer approvals in real time using automated credit-risk decisioning. At the back end of the process, they drive client self-servicing through well-designed digital workflows enabled by a modern data architecture.[17] New entrants, including fintechs, have reaped the benefits of their technological edge in recent years, although they have struggled in the past 18 months. Rapid technological advancement in application programming interfaces (APIs), cloud, and tokenization, as well as in data and analytics, has contributed to improved cost structures. As financial institutions roll out new business models that include embedded finance and cross-sectional platforms, the client experience has continued to improve.

With gen AI now emerging on the scene over the past year, a new wave of technological innovation is likely to ensue (see sidebar "Generative AI and banking"). Large language models that underpin this fast-growing technology could provide a significant productivity boost and mark a potentially

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[12] Some commentators are pessimistic about China's economic outlook. See, for example, Adam S. Posen, "The end of China's economic miracle," *Foreign Affairs*, August 2, 2023.
[13] "Agencies request comment on proposed rules to strengthen capital requirements for large banks," Board of Governors of the Federal Reserve System, press release, July 27, 2023.
[14] Alexandra Scaggs, "Basel III: Endgame," *Financial Times*, July 31, 2023.
[15] See, for example, Chandana Asif, Tunde Olanrewaju, Hiro Sayama, and Ahalya Vijayasrinivasan, "Financial services unchained: The ongoing rise of open financial data," McKinsey, July 11, 2021; and Moira O'Neill, "An open door for open banking," *Financial Times*, April 21, 2023.
[16] See, for example, "The Commission adopts the European Sustainability Reporting Standards," European Commission, Directorate-General for Financial Stability, Financial Services, and Capital Markets Union, July 31, 2023.
[17] For further details, see Eric Lamarre, Kate Smaje, and Rodney Zemmel, *Rewired: The McKinsey Guide to Outcompeting in the Age of Digital and AI*, Wiley, June 2023.

Generative AI and banking

Every few years, new technologies emerge that generate excitement in the banking community, though many of them do not become transformational. However, AI—especially its recent iteration, gen AI—has the potential to truly change the shape of banking models.

Gen AI could be different for three main reasons. First, it could bring about a quantum leap not just in productivity but also in customer experience. Second, in its latest forms, it has a relatively low barrier to entry, which can enable even smaller financial institutions and start-ups to quickly test and roll out many different use cases. And third, a significant part of gen AI's impact happens in the back and middle offices, which makes it harder to copy and could enable individual banks to build a competitive edge in use cases. In that sense, it may become possible to rewire a bank in a way that is not easily visible to the outside world—something most new technologies haven't been able to do.

Given its potential uses, gen AI should be viewed not only as a technology issue but also as a deep strategy issue, requiring a CEO-level approach on the where and how to deploy it. Financial institutions seeking to deploy it will need a high metabolism rate coupled with a clearly defined risk appetite and controls. Banks may want to begin this journey with a purpose-built gen AI framework, including considerations on risk and control.

The technology has numerous applications. Through its ability to generate content, possibly while taking context or instructions into account, gen AI can personalize the creation and editing of images, audio, and video. The coherent passages of text it is able to construct can be used in numerous chat-like customer service applications. It can predict or extract information from unstructured data, enabling it to synthesize, answer questions, and reason about text, images, and multimodal data. Finally, it can search and extract key information about topics.

Some caveats are important. Gen AI is still relatively novel and not yet suited for some applications. It remains prone to errors and factual inaccuracy, or invention (known as "hallucinations"), and its value judgments are largely untested. For now, it is not suitable in high-stakes scenarios for which any of these flaws could cause harm or where verification or substantiation is difficult to provide in the moment. That means it still needs to improve before being used in regulatory interactions, among others.

Gen AI nonetheless has the potential to level up the entire end-to-end banking value chain and relieve pressure on the talent pipeline across many functions:

— In marketing and sales, it will be able to automatically create hyper-personalized content tailored to each customer, based on their profile, behavior, and banking history. It may find uses as a frontline assistant, conducting industry research and proposal preparation for commercial and investment banks or playing a role in analysis of wealth portfolios.

— In operations, gen AI can improve existing service chatbots to provide personalized, efficient, and accurate responses to customer queries. It could accelerate and improve tasks such as interpreting or writing technical documents such as loan contracts, requests for proposal, account plans, and third-pillar or environmental, social, and governance reports. A high level of accuracy will be necessary before broader adoption, especially for these sensitive usages.

— In technology, it could accelerate the transition from legacy software and code to more modern systems. One of its compelling features is an ability to improve productivity and accelerate the development of software, through use of gen-AI-based coding assistants such as GitHub Copilot.

— Finally, for legal, risk, and compliance, gen AI can automatically create risk reports such as model documentation, credit memos, or suspicious-activity reports, as well as generating lifelike fraud attempts for proactive testing.

As with all new technologies, challenges are sure to arise on the journey to deployment of gen AI. But if the efforts can lead to higher productivity, more efficient operations, greater innovation, and help change the core relationship between banks and their customers, they may be worthwhile.

significant inflection point. Recent McKinsey research looking at more than 60 use cases of gen AI across sectors has estimated that the technology could potentially reduce between $200 billion and $300 billion in operating expenditures in the banking sector and boost productivity by about 3 to 5 percent. The largest impacts could potentially be felt in marketing and sales, customer operations, investment servicing, software engineering, and risk and legal.[18]

Systemic risk

Although cross-border flows of goods, services, people, and data continue to characterize the global economy, rising geopolitical tensions, the growth of trade restrictions, and black-swan events such as the COVID-19 pandemic have increased volatility and added new and sometimes large-scale risks.[19] Russia's invasion of Ukraine, for example, prompted price volatility on energy markets and concerns in some countries about energy supply and security. The ensuing sanctions imposed by the United States, European countries, and some others on Russian institutions and individuals, in turn, created new pressures for Russia's economy and on international companies doing business there. The Geopolitical Risk Index reached a ten-year high in 2022 as a result of that conflict and remains above its COVID-19 levels.[20] Trade tensions have heightened broadly, not only related to the Russian invasion of Ukraine but also to decoupling between the United States and China and their respective allies. The number of trade restrictions imposed since the global financial crisis has risen fivefold, with a consistent uptick since 2020, and the number of investment restrictions increased in 2022 by the most on a year-to-year basis in the past 15 years.[21]

Other trends

These four trends are not exhaustive. Another shift affecting financial institutions is changing customer preferences, with bank customers increasingly drawn to hybrid and digital service offerings that are personalized and customized for their needs and thus add convenience. In addition, there are structural shifts in lending demands, including rising importance of more lending-light sectors including services, as well as the growth of sustainable finance

The trends are affecting the industry with increased velocity. A high degree of connectivity, propelled by technological innovation and underpinned by economic interdependencies, has increased communication and mobility and the speed of innovation.

[18] "The economic potential of generative AI: The next productivity frontier," McKinsey, June 14, 2023.
[19] "Global flows: The ties that bind in an interconnected world," McKinsey Global Institute, November 15, 2022.
[20] See Dario Caldara and Matteo Iacoviello, "Measuring geopolitical risk," *American Economic Review*, April 2022, Volume 112, Number 4.
[21] See "A rocky recovery," World Economic Outlook, International Monetary Fund, April 2023.

and infrastructure financing, which we discussed at length in last year's Global Banking Annual Review. On the corporate side, as companies get larger and more complex, they have needs that only sophisticated banks are equipped to meet. Lastly, ESG will continue to evolve and drive much change. One example is the issuance of sustainable bonds, including green bonds, sustainability bonds, social bonds, and sustainability-linked bonds, which rose to $1.06 trillion in 2021 from almost zero, five years previously. Issuance declined in 2022 but resumed in 2023 and is forecast to return to $900 billion to $1 trillion.[22]

Impact on the banking sector

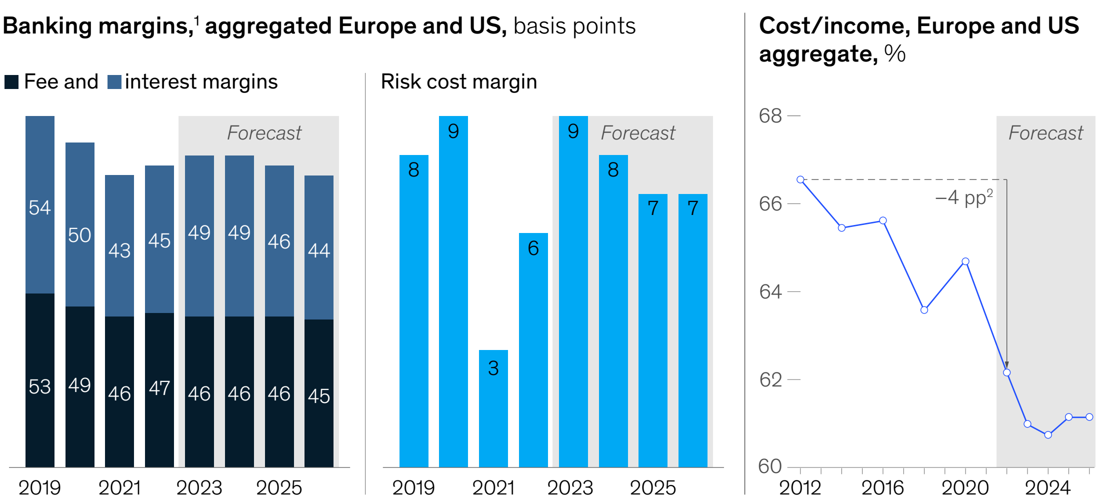
These trends are playing out across the banking sector in different ways. We observe impact on long-term profitability, economic profits, and revenues.

Long-term profitability under pressure

The long-term pressure on profits is primarily affecting balance-sheet-heavy banks. Despite recent positive performance, our analysis suggests that the long-term contraction of global banking margins and ROE may resume, subject to the longer-term outlook for interest rates. Gains in net interest income could be short-lived and interest margins could decline again if and when interest rate hikes slow and ultimately reverse. Fee margins could also decline if the economy softens, and the uncertain economic outlook—despite the first signs of optimism—weighs on risk costs (Exhibit 7). Moreover, the recently published proposals for a Basel III endgame are still under discussion, but the requirements to increase Tier 1 capital could substantially affect banks.[23] We estimate these proposals could have the most pronounced impact on banks that rely on fee-based businesses, such as credit cards and wealth and asset management,

Exhibit 7

Overall banking margins are expected to compress but not as much because cost to income is reducing.



[1]Margins calculated on average exposure volume (assets and liabilities).
[2]Percentage points.
Source: McKinsey Panorama

McKinsey & Company

[22] Dennis Sugrue and Bryan Popoola, "Sustainable bond issuance will return to growth in 2023," S&P Global, March 20, 2023.
[23] "Agencies request comment on proposed rules to strengthen capital requirements for large banks," Board of Governors of the Federal Reserve System, press release, July 27, 2023.

and complex trading products. There could also be major product impacts, including in such areas as trade finance.

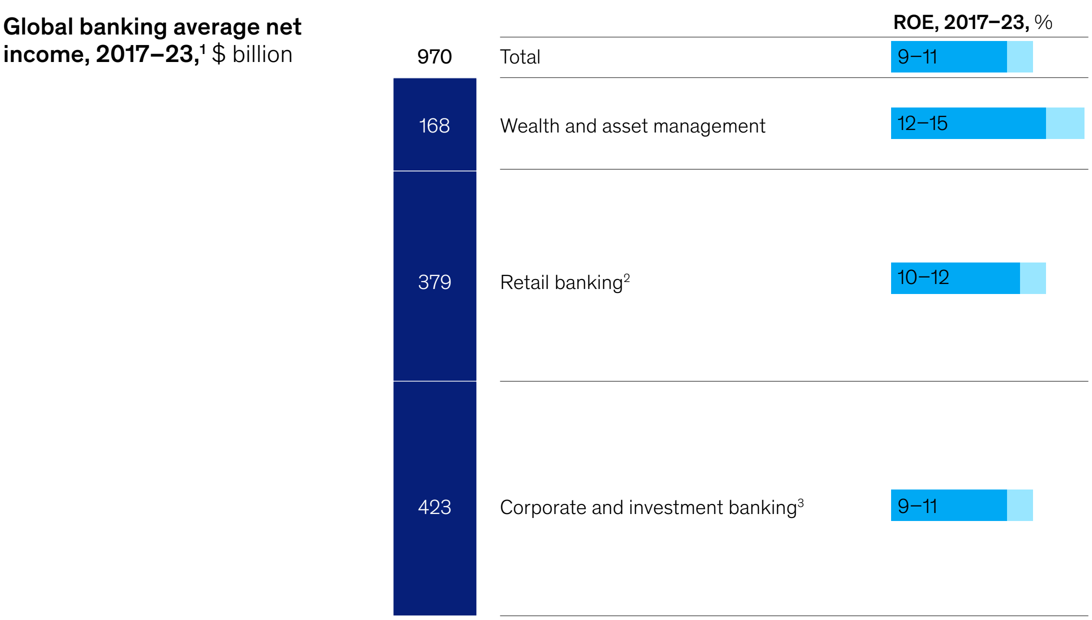
Economic profits are diverging among business models

Banking globally generates about $1 trillion of accounting profit every year, one of the highest figures among industries, with retail and wholesale banking being the latest contributors (Exhibit 8). Banking has generated these after-tax profits even with the turbulence from COVID-19, global supply chain disruptions, and the recent surge in inflation in advanced economies. At the same time, banks have a notional cost of capital that amounts to about $1.2 trillion and exceeds the level of accounting profit.[24]

Among financial institutions, value creation diverges widely among business models and products—for example, corporate banking and wealth asset management—given the impact of economies of scale, regulation and associated capital requirements, and barriers to entry. Markets tend to reward sectors that create value, but with few nuances.

Exhibit 8

Retail and wholesale banking are the largest contributors to the industry's $1 trillion in annual average profits.



[1] Profit after tax of financial intermediation industry (excluding insurance manufacturing), not adjusted for unrealized losses.
[2] Includes retail payments.
[3] Includes lending and transaction banking for corporates, small and medium-size enterprises and public-sector institutions, and investment banking.
Source: S&P Global; McKinsey Panorama

McKinsey & Company

[24] The banking sector employs about $12 trillion in equity for doing business, with a cost of equity of about 10 percent, meaning investors in the sector would expect a minimum of $1.2 trillion in profits in return.

While all subsectors had positive earnings growth on average, subsectors differ widely in their ability to create economic and shareholder value. For example, payments companies have had both strong earnings-per-share (EPS) growth and value creation, whereas the value of mid-tier banks has contracted despite higher EPS growth (Exhibits 9a and 9b).

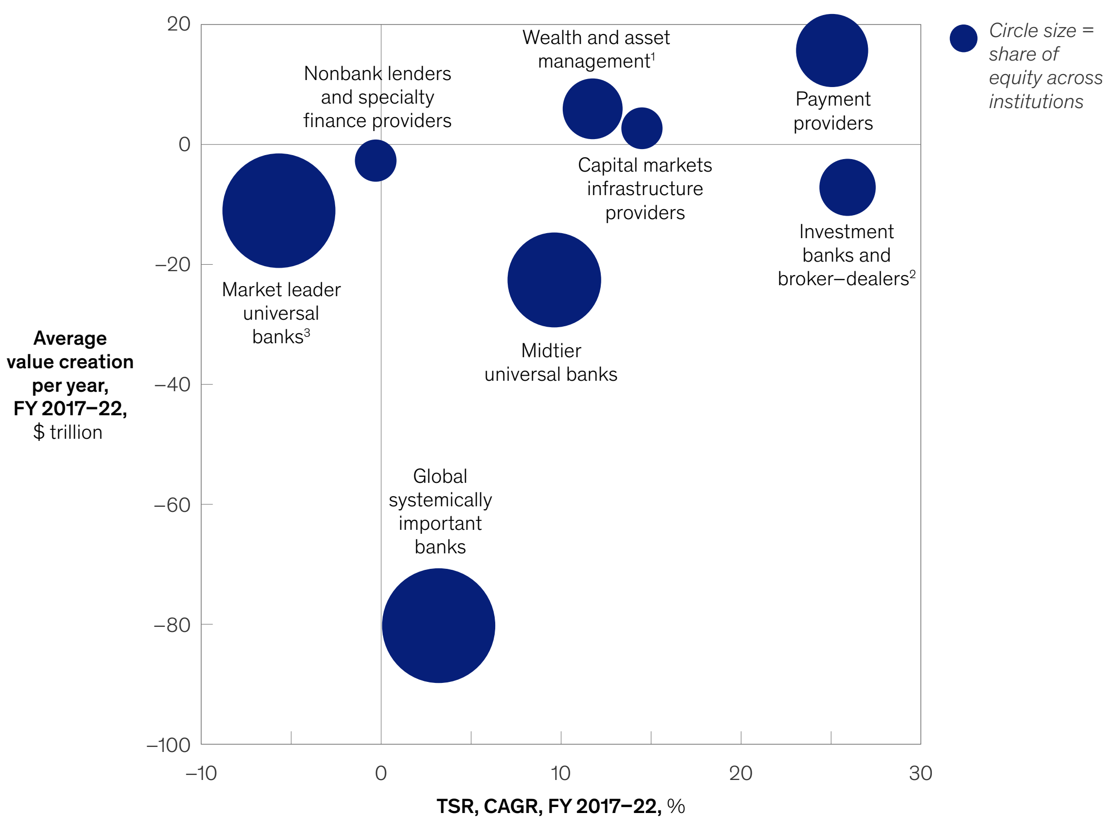
Revenues shifting by geography

Though much ink was spilled in previous years on the ascendance of the so-called BRICS—Brazil, Russia, India, China, and South Africa—the geography of banking continues to shift, but not necessarily to the BRICS. Banking sectors in Asia, Latin America, and the Middle East and Africa are growing revenue faster as a whole than those

Exhibit 9a

There is wide divergence in financial institutions' ability to create economic and shareholder value.

Value creation and TSR for financial institutions



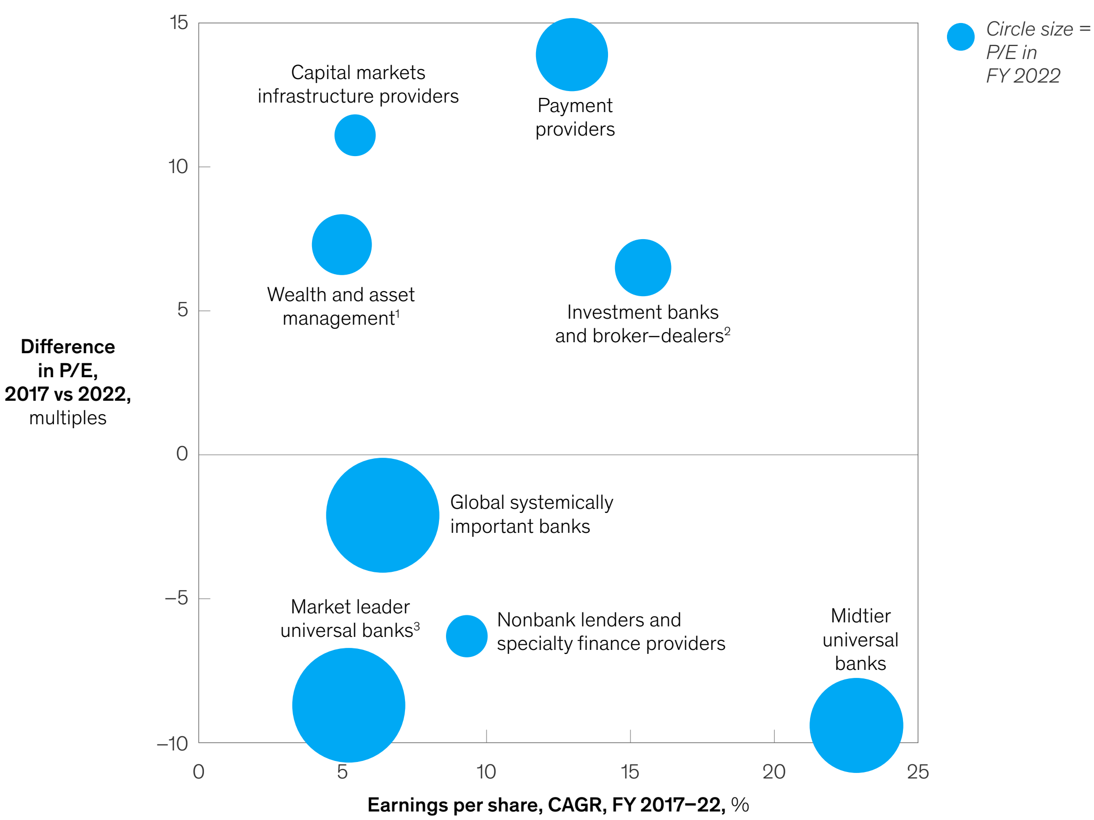
[1]Includes traditional asset managers, nontraditional intermediaries, and sponsors.
[2]Includes sales and trading.
[3]Domestic market leader with >10% of share in assets (excluding global systemically important banks).
Source: S&P Global; McKinsey Panorama

McKinsey & Company

Exhibit 9b

There is wide divergence in financial institutions' ability to create economic and shareholder value.

P/E difference and earnings per share for financial institutions



[1]Includes traditional asset managers, nontraditional intermediaries, and sponsors.
[2]Includes sales and trading.
[3]Domestic market leader with >10% of share in assets (excluding global systemically important banks).
Source: S&P Global; McKinsey Panorama

McKinsey & Company

in developed markets, and this trend is expected to continue over the coming years (Exhibit 10). In 2022–23, for example, the Middle East and Africa saw revenue jump by 11 percent, almost doubling the region's average annual banking revenue growth in 2016–22.

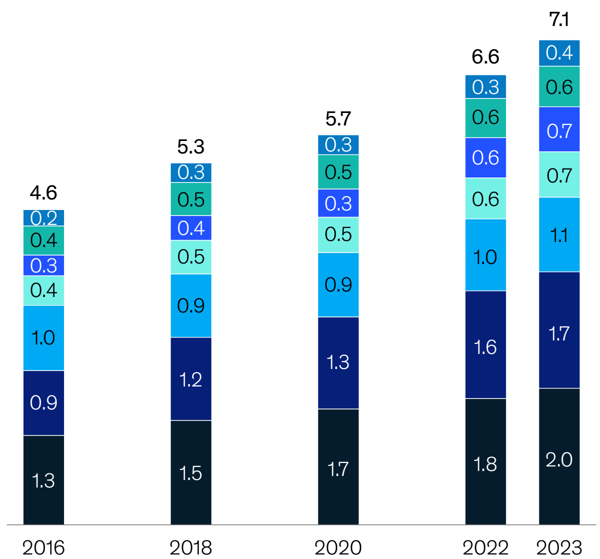
As we noted in last year's annual review, lumping together financial institutions in developing economies under the title of emerging-market banks is misleading, since the performance of banks can diverge substantially (see sidebar "China's banking sector faces tighter times").

A notable aspect of this broader move to a concentration of global banking growth in specific geographic pockets is the dynamism of financial institutions in economies around the Indian

Exhibit 10

Growth of global financial intermediation revenue is likely to be focused on specific markets.

Global financial intermediation revenue by region,[1] $ trillion



	CAGR, % 2016–22	CAGR, % 2022–23
Total	6	8
Emerging Asia[2]	6	11
Developed Asia[3]	5	3
Latin America	12	12
Middle East and Africa	6	11
Europe	2	4
China	9	8
North America	6	8

Assets of largest 100 banks[4] **by region, 2016–22,** %

[1]Does not include revenues from mining, buying and selling of digital assets, real estate funds, infrastructure funds, commodities funds, absolute return or liquid alternatives. Figures may not sum, because of rounding. [2]All Asia–Pacific markets except China and the markets in Developed Asia. [3]Australia, Hong Kong SAR, Japan, Singapore, and South Korea. [4]Largest by book (asset size).
Source: McKinsey Panorama

McKinsey & Company

Ocean region, which we describe here as the Indo Crescent (Exhibit 11). About half of the best-performing banks in the world are now to be found in this region, which is expected to experience accelerated growth across retail and wholesale banking. Innovative institutions here include India's HDFC, which is on track to become one of the world's largest banks by market capitalization once it has completed a merger with HDFC mortgage lender. Others innovative players include StashAway (a digital wealth management platform serving clients in Singapore and Malaysia and charging fees as much as 70 percent below usual managed portfolio costs) and DBS (one of Asia's leading banks that generates about $12.5 billion in annual revenue by providing customers in more than ten countries with end-to-end digital banking capabilities).[25]

[25] Divya Patil and Preeti Singh, "Bank giant bigger than Morgan Stanley arises from Indian merger," Bloomberg, June 29, 2023.

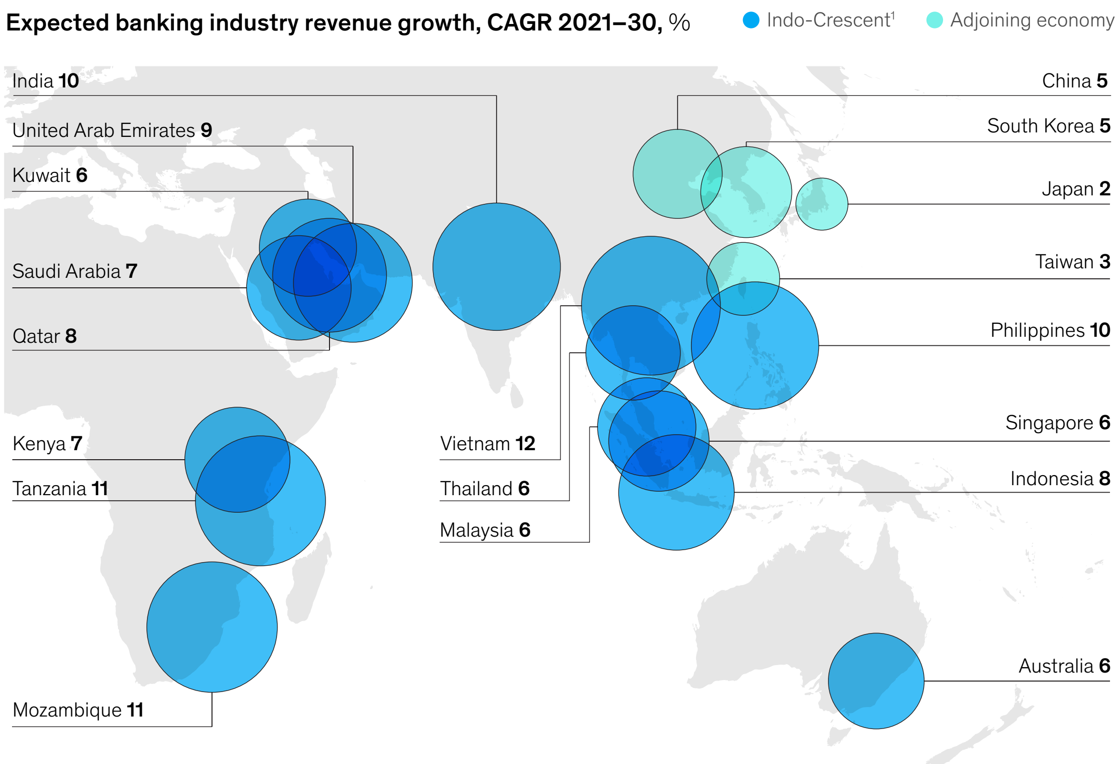
Overall, the Indo Crescent is home to 8 percent of global banking assets and 51 percent of the top-performing financial institutions globally. This superior performance is enabled by several factors, including higher GDP and population growth in some (but not all) of the Indo-Crescent countries.

Note that countries along the crescent include advanced economies, such as Australia and Singapore, but also developing markets, including India, Kenya, and the Middle East. Other enablers of high performance include breakthrough disruptions, ecosystem plays, and cost-efficient

Exhibit 11

The Indo-Crescent region now is home to half of best-performing banks that are achieving breakthrough growth.

Expected banking industry revenue growth, CAGR 2021–30, %



Indo-Crescent share of global assets and banks, 2022, %

[1]Includes countries around the Indian Ocean; nonexhaustive.
[2]Based on valuation: upper-quartile P/E and price-to-book ratio of the top 300 banks by market cap.
Source: S&P Global; McKinsey Panorama

McKinsey & Company

service delivery models; in other words, the area has become a testing ground for a deeper reinvention of banking.

One of the most significant consequences of these global trends is a deep and growing rift in the banking sector between core banking functions that use the traditional balance sheet to maintain customer loyalty and more capital-light parts of the business. While the core banking services struggle to have an ROE above their cost of capital, the latter tend to create the most value. This structural and fundamental shift in the market manifests in the continued move of funds toward nontraditional players and parts of the market. The trend is not new but has gathered pace, moving the banking sector to a tipping point. The following chapter examines this movement of funds—the Great Banking Transition, which could mark the sector's near- and longer-term future, depending on the trajectory of interest rates and the macroeconomic outlook.

China's banking sector faces tighter times

China has the largest banking balance sheet in the world, with unique challenges and opportunities. Many of the global trends identified in this report translate to China differently. For example, while much of the rest of the world has high inflation, China is facing potential deflation.

Traditional universal banks in China are among the world's largest but continue to face challenges with a high level of nonperforming loans. As we noted in last year's Global Banking Annual Review, substantial strain is coming from a real estate overhang. In August 2023, the Evergrande Group, China's biggest real estate company, filed for bankruptcy protection, and some other large real estate companies are facing challenges.[1] Major Chinese banks are currently trading at 0.5 times their book value, with limited prospects for achieving ROE higher than the cost of equity in 2023.

Declines in real estate values are influencing retail consumption as well as provincial debt levels and budget deficits. These challenges require banks to explore cost-saving opportunities, which they are doing with a combination of large-scale sophisticated digitization and, in some cases, salary adjustments. Ultimately government ownership gives these banks an extra layer of protection.

Many issues Western banks are facing now have already been a reality in China for decades. These include the success of large platforms in customer ownership and business model innovation. In the face of the current sectoral and economic corrections, the government is regulating the shadow banking system differently. For example, almost all of China's peer-to-peer lending platforms have been closed.[2]

Attempts to modernize the financial sector continue apace, including the recent creation of a National Administration for Financial Regulation.[3] The government has shown willingness to experiment, including with the digital yuan. But it has also tightened fintech regulations, including rules governing the financial aspects of super apps, such as Ant Financial. Banks themselves continue to play a vital role in promoting overarching growth. Increasing levels of risk management in the sector will remain a priority to maintain customer confidence.

Major opportunities remain. Chinese banks have already shown their capacity to benefit from the rise of digital technologies, which puts them in a strong position to leverage the growth of AI. Chinese banks can continue to play a key role in funding infrastructure and development projects. And as incomes rise and more people gain access to the financial system, including through mobile apps, new opportunities will emerge for wealth management, rural finance, and cross-border banking.

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1 "How bad could China's property crisis get?" *The Economist*, August 16, 2023.
2 See Hui Huang, "The fall of online P2P lending in China: A critique of the central-local co-regulatory regime," Chinese University of Hong Kong Faculty of Law Research Paper Number 2021–33, June 23, 2021; and Qing He and Xiaoyang Li, "The failure of Chinese peer-to-peer lending platforms: Finance and politics," *Journal of Corporate Finance*, February 2021, Volume 66.
3 See "A new super-regulator takes aim at rampant corruption in Chinese finance," *The Economist*, June 15, 2023.

2 The great banking transition

In a story that has been developing for several years, assets and clients have been flowing from traditional financial institutions that are capital heavy, such as universal banks, to nontraditional institutions that are capital-light. The latter include payments systems, financial data, and infrastructure businesses, stand-alone wealth and asset managers, private capital and equity business, and fintechs. While the growth of assets under management outside of banks' balance sheets is not new, it merits attention now because, according to our analysis, the traditional core of the banking sector—the balance sheet—is at a tipping point: the flow has attained a scale that can fundamentally alter the nature of the financial services industry. Besides the impact on the balance sheet, this transition will reshape the other two pillars of banking: transactions and distribution. Underlying these shifts—both enabling and accelerating the transition—is technological innovation, which makes it possible to scale up delivery and reduce costs.

Banks are under pressure from this movement, but everywhere there are opportunities, as we outline in the next chapter. The sharp increases in interest rates over the past year raise key questions about which Great Banking Transition business models will accelerate and which will reverse. Capital-heavy business models that have been losing out over the past years work much better when there are real spreads, as seen in the resurgence of profitability outlined in the previous chapter. But interest rates are just one factor in the Great Banking Transition. Much will depend on the economic scenario that unfolds.

Financial institutions will want to consider each of their businesses to assess where their competitive advantages lie across the three areas of balance sheet, transactions, and distribution. And they will need to do so in a world in which technology and AI will play an even more prominent role, and against the backdrop of a shifting macroeconomic environment and heightened geopolitical risks.

How the transition affects banking

Regardless of what happens next, including changes in the credit environment, the Great Banking Transition is very real, very large, and very tangible. It has been affecting three key pillars of banking: the balance sheet, transactions, and distribution.

From banking balance sheet to off balance sheet

As clients and customers search for higher returns, lower capital funding, or better matching durations of the assets, financial assets have been growing and migrating out of the bank balance sheet—that is, away from corporate and retail deposits, bank bonds, and other liabilities and equity—and into nonbanks, or off-balance-sheet vehicles such as public pension funds, digital assets, private capital, alternative investments, insurance and pension assets under management, and other institutional assets under management. This is most visible in the shift from bank deposits to money market funds.

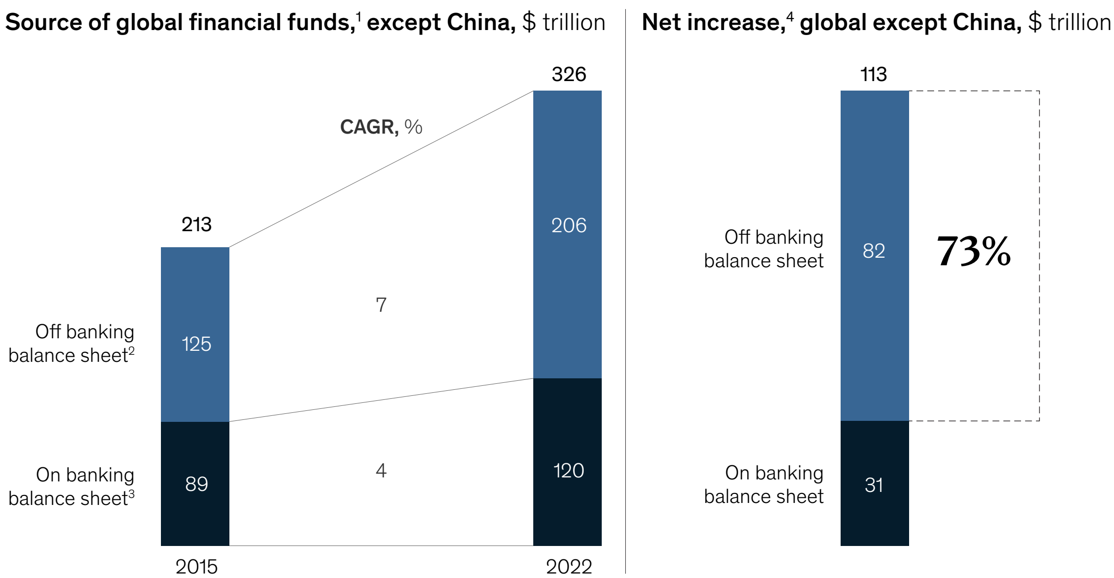
Regardless of what happens next, the Great Banking Transition is very real, very large, and very tangible. It has been affecting three key pillars of banking: the balance sheet, transactions, and distribution.

Bank assets are also leaving banks for reasons related to business models or client service. Customers may find that other institutions can take more risk, better match durations and risk appetite, have lower-cost or stickier funding, are subject to different regulation, or don't have depositors to protect. For example, private credit has been growing rapidly. With regard to service, some institutions are better able to meet client needs, including with technology, products, and services that resonate more with clients and customers.

The shift from balance sheet to off balance sheet has been occurring within and across most geographies. Financial stock that is off balance sheet has been growing at about 7 percent annually, whereas financial stock on the balance sheet has grown at about 4 percent annually.[26] Between 2015 and 2022, more than 70 percent of the net increase in financial funds went into off-banking balance sheet (Exhibit 12).

Exhibit 12

More than 70 percent of the net increase of financial stock happens off-balance-sheet.



Note: Figures may not sum, due to rounding.
[1]Methods of raising capital to fund lending activities, investment initiatives, and operations.
[2]Including sovereign wealth funds, public pension funds, digital assets, private capital, alternatives, retail assets under management (AUM), insurance and pension AUM, and other Institutional AUM.
[3]Including corporate and retail deposits, bank bonds, other liabilities, and equity.
[4]Calculated as the net difference between the 2022 and 2015 positions.
Source: McKinsey Panorama

McKinsey & Company

[26] Retail assets under management include funds and ETFs sold to individual investors through banks, brokers, and wire houses.

This migration has been taking place for two decades.[27] It accelerated after the global financial crisis in 2008 as banks faced higher capital and regulatory responsibilities and, in some places, were looked to for lending that would bolster economic growth. The flow off the balance sheet has now turned into an exodus that challenges the often heavily cross-subsidized nature of the financial services industry (for example, when a loan serves as a loss leader for subsequent advisory transaction business). Once corporate and retail depositors shift, this behavior can prove sticky, with banks having difficulty regaining those deposits. This, in turn, can create a structural deposit shortfall.

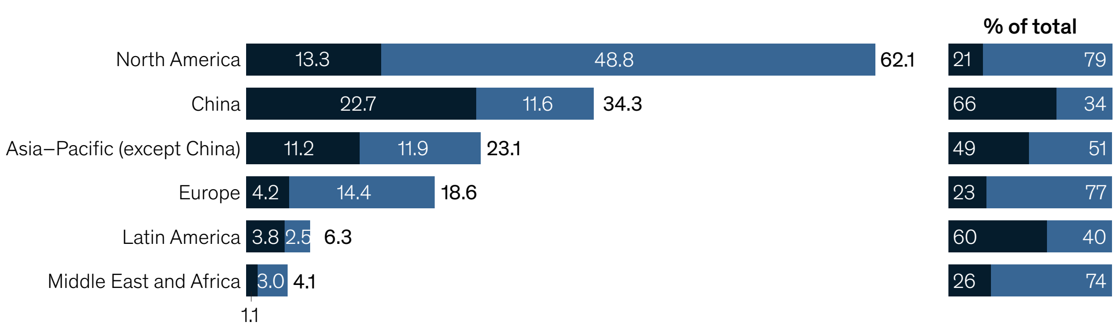
Though assets have been shifting off the balance sheet globally, there are some regional disparities (Exhibit 13). In the United States, more than 75 percent of the net increase in financial funds now go off the banking balance sheet. In Europe, the figure is about 55 percent. In contrast, the proportion of off-balance sheet in China is less than 30 percent and in Latin America is less than 40 percent. Further, there is a marked growth differential between assets off and on balance sheet. For example, in North America, off balance sheet has been growing at 9 percent. Compared with 7 percent growth for on balance sheet. In the Middle East, the difference is larger: 6 percent for off balance sheet and 3 percent

Exhibit 13

The shift toward off-balance-sheet is a global phenomenon.

Net change by source,[1] 2015–22, $ trillion

■ On banking balance sheet[2] ■ Off banking balance sheet[3]



[1]Calculated as the net difference between the 2022 and 2015 positions.
[2]Including corporate and retail deposits, bank bonds, other liabilities, and equity.
[3]Including sovereign wealth funds, public pension funds, digital assets, private capital, alternatives, retail assets under management (AUM), insurance and pension AUM, and other institutional AUM.
Source: McKinsey Panorama

McKinsey & Company

[27] Traditional lending to middle-market and large corporates is increasingly being provided by private capital players, some of which have more than $100 billion in assets, making them equivalent to a formidably sized "bank." As of the second quarter of 2023, these funds had raised more than $90 billion and had more than $400 billion of dry powder to lend. (Loan sizes are also increasing.) Private capital already makes up a significant portion of leveraged finance. Globally, these nonbank financial firms account for 14 percent of all lending.

for on balance sheet. In China, it is 12 percent versus 8 percent. In China and North America, the growth in money market funds (9 percent and 16 percent, respectively) is nearly double that of the growth in deposits (5 percent and 8 percent, respectively).

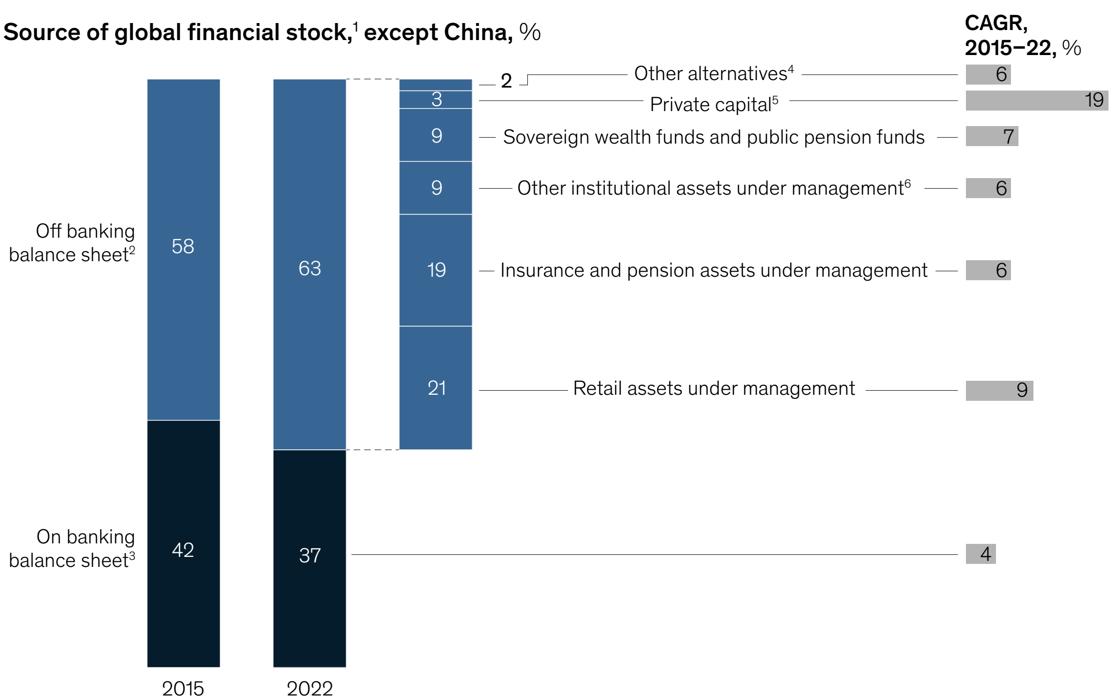
The sources of funds for the growth in off-balance-sheet capital and associated dynamics are noteworthy (Exhibit 14). Private capital—both private debt and private equity—remains a relatively small part of the market, about 3 percent of the total, but it has been growing rapidly, at an average annual rate of almost 20 percent between 2015 and 2022. North America remains the largest market for private capital, followed by Asia. Retail assets under management, which account for 21 percent of total funds, also have grown robustly, at an annual rate of 9 percent since 2015.

Annual growth of both private debt and private equity has been accelerating (Exhibit 15). Private debt saw its highest inflows in 2022, with growth of 29 percent. Still, private debt remains relatively small, compared with total volume of wholesale loans. In North America alone, private debt assets under management amount to about 8 percent of wholesale loans.

Exhibit 14

Funds are increasingly moving off balance sheet across categories.

Source of global financial stock,[1] except China, %



[1]Methods of raising capital to fund lending activities, investment initiatives, and operations. [2]Including sovereign wealth funds, public pension funds, digital assets, private capital, alternatives, retail assets under management (AUM), insurance and pension AUM, and other institutional AUM. [3]Including corporate and retail deposits, bank bonds, other liabilities, and equity. [4]Including hedge funds, real estate funds, commodities, etc. [5]Including private equity and private debt. [6]Including endowments and foundations, corporate investments, etc.
Source: McKinsey Panorama

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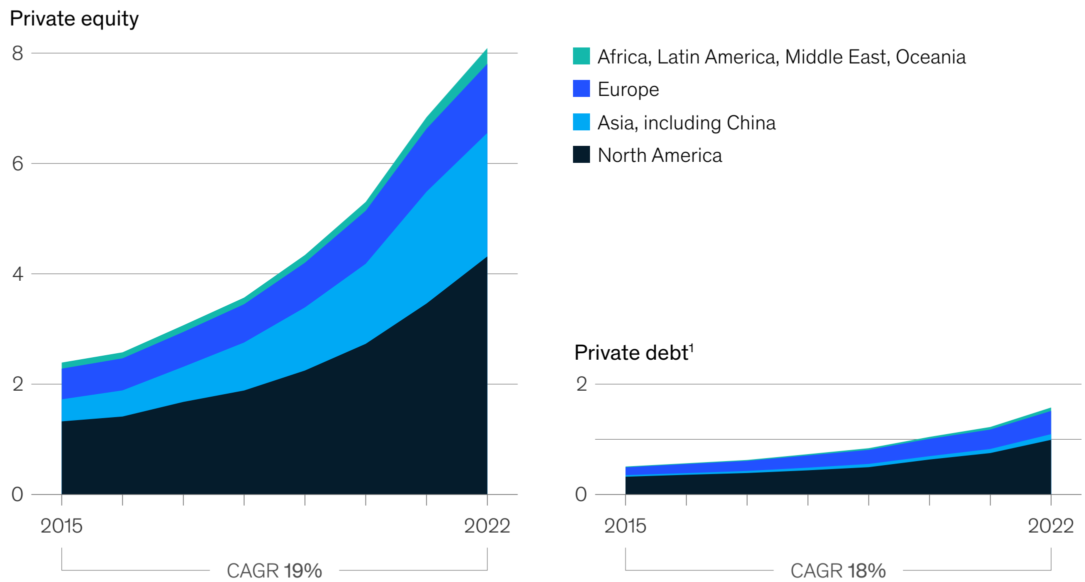
Exhibit 15

Private equity and private debt have both experienced accelerated growth.

Assets under management, $ trillion



[1]Includes corporate and public loans and securitized loans.
Source: Preqin

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Within private debt, direct lending has driven much of this shift. After the global financial crisis, there was a large-scale withdrawal of banks from the leveraged lending market. In addition, private financing channels often have advantages including speed, flexibility, and convenience. Direct lending grew at an average annual clip of 13 percent between 2015 and 2022, and surveys have suggested that limited partners plan to invest more capital in direct lending in the next 12 months.[28]

Shift in transactions from traditional to nontraditional institutions

Transaction volumes have been and are moving to nontraditional, more specialized players. These include capital market infrastructure providers, which have seen robust 7 to 8 percent annual growth in the past few years, even throughout the COVID-19 pandemic and its accompanying supply chain disruptions, as well as open platform models that deliver distribution and sales support or client communication services. Banks have for several years been selling and spinning off operations, or acquiring them to gain scale, including payment-processing companies (for example, RBS's spin-off of Worldpay), wealth and asset managers, and capital market units (for example, the initial public offering of MSCI). Often, the specialist players, whatever their origin, were able to grow faster.

In payments, this shift is evidenced by the increase in consumer digital payment processing conducted by payment specialists. Their share of payment processing grew by more than 50 percent between 2015 and 2022, relative to traditional banks.

[28] Private Debt Investor's LP Perspectives 2023 study.

In capital markets, investment banks and broker–dealers are gaining market share from traditional banks in various products. This includes equity capital, where specialized players raised their market share from 44 percent to 59 percent, in 2015–22, and foreign-exchange transactions, where the specialized players saw their market share increase from less than 1 percent in 2015 to 22 percent in 2022.

In wealth and asset management, independent asset managers not owned by a bank or insurer are gaining market share. Asset managers not owned by a bank had a market share in 2022 of 81 percent of assets under management, up from 77 percent in 2017 (Exhibit 16).

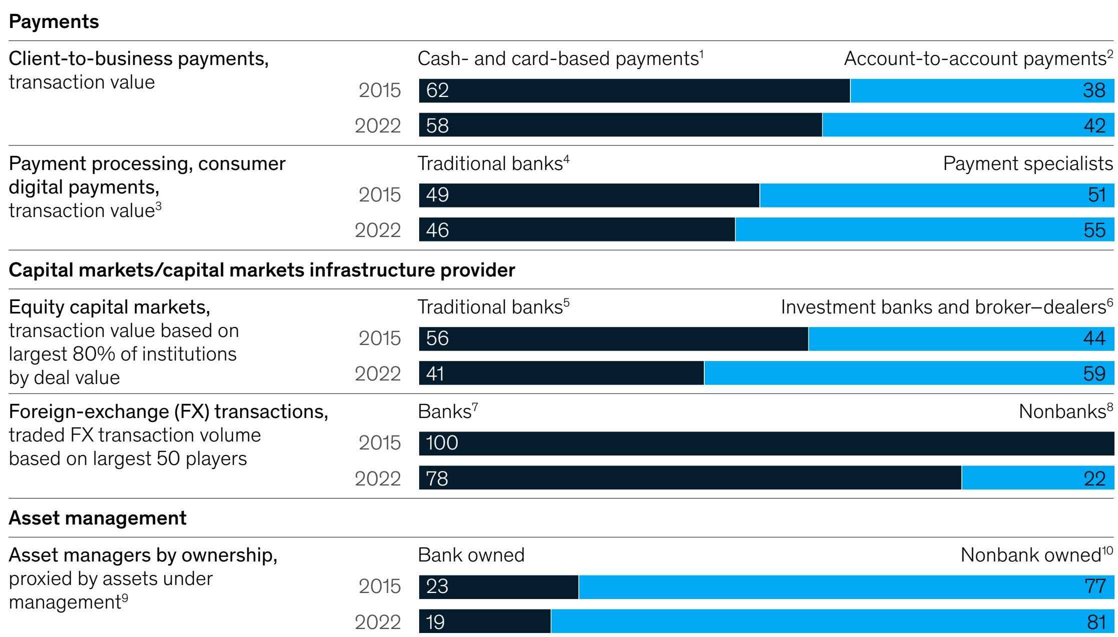
Distribution also is evolving, although the change is still at an early stage

Though this trend is on a more distant horizon than the others, distribution is shifting toward hybrid models, including third-party transactions, which in some cases are not constrained by a balance sheet. For example, in many markets, online comparison platforms now have significant market shares across consumer finance, mortgages, and even deposits

Exhibit 16

Transactions in payments, capital markets, and asset management have shifted from banks to specialized players.

Market share, %



[1]Including cash, debit cards, credit cards, charge cards, prepaid cards, etc. [2]Including credit transfers, debit credits, etc. [3]Figures do not sum to 100%, because of rounding. [4]Including payment specialists that are subsidiaries or joint ventures of traditional banks. [5]Institutions holding banking license but where primary source of revenue is not investment banking. [6]Primary source of revenue is investment banking business. Scope includes securities firms. [7]Liquidity providers holding a banking license. [8]Liquidity providers that do not hold a banking license. [9]Sample based on largest 100 players by assets under management. [10]Including independent and insurance-owned asset managers.
Source: Dealogic; Euromoney Foreign Exchange Survey; *Global Payments Report*, FIS Worldpay; IDC InfoBrief, Oracle

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and loans to small and medium-size businesses. Although it is the last banking pillar to be affected, the shift in distribution has begun in Europe and Asia, where some services have launched and are scaling in multiple countries simultaneously.

The transformation of banking distribution owes much to technological innovation. Technology adoption has focused mostly on retail via comparison platforms for mortgages, consumer finance, and deposits. These have reached more than 40 percent market penetration in many markets—for example, consumer finance in Sweden and mortgages in Germany.

Moreover, embedded finance (defined as the seamless integration of financial products and services into nonbanking products and business models) has continued to take off, especially in some emerging markets. "Traditional" embedded-finance ecosystems such as retail and B2C marketplaces and platforms have further consolidated their value propositions, while emerging ecosystems such as mobility, travel/hospitality, and digital content are rapidly gaining ground. Further growth in ecosystems will be driven by the emergence of B2B marketplaces and platforms. While embedded finance's long-term prospects look increasingly appealing (revenue in the European Economic Area and the United Kingdom could reach €100 billion by 2030), the industry is still scaling and has focused on a select number of tested-and-tried products with potential for rapid scale-up: payments, insurance, and point-of-sale lending.

Banks' reactions have differed: they long have had multiple distribution channels, including call centers for voice, branches for in-person interactions, a sales force for mortgages, relationship managers for the biggest clients, a mobile banking app, and so on. Removing these silos to have a streamlined, seamless approach can lead to huge performance improvements, including a tripling of cross-selling and reduced operating costs in an industry where distribution can amount to as much as 25 percent of operating costs.[29] Yet banks have struggled to consistently connect embedded platforms and capture economic profits when using comparison platforms. As a result, we see a continued transition. The deposit-taking side, for example, is generally more regulated, and thus more protected, but this applies less to many credit aspects.

Variations in impact

A high-level view of banking's three pillars—balance sheet, transactions, and distribution—highlights how the Great Banking Transition has been creating major divergences in terms of value generation and different valuations assigned by capital markets. Thus, the impact of the Great Transition will not be the same for all types of financial institutions. Broadly speaking, it will differ according to business models and depending on the macroeconomic outlook.

Divergent impact by business model

While profits still flow to traditional balance-sheet banks, economic value and positive shareholder returns increasingly have been flowing to institutions that are capital-light (Exhibit 17).[30] Balance sheet activities accounted for 70 percent of the capital but just over half of revenues and profits in 2017–22. The ROE on balance sheet activities was between 5 and 7 percent, far lower than for transactions and distribution, and economic profit was a negative $600 billion, primarily because of low ROE and a high capital base.

Transactions in the five years from 2017 to 2022 accounted for just 12 percent of capital, but 27 percent of revenues and 30 percent of economic profits, defined as return on shareholder capital minus the cost of that capital. With ROE since 2017 ranging between 18 and 23 percent, transactions have posted the highest growth in economic profit, which is up by $115 billion since 2017.

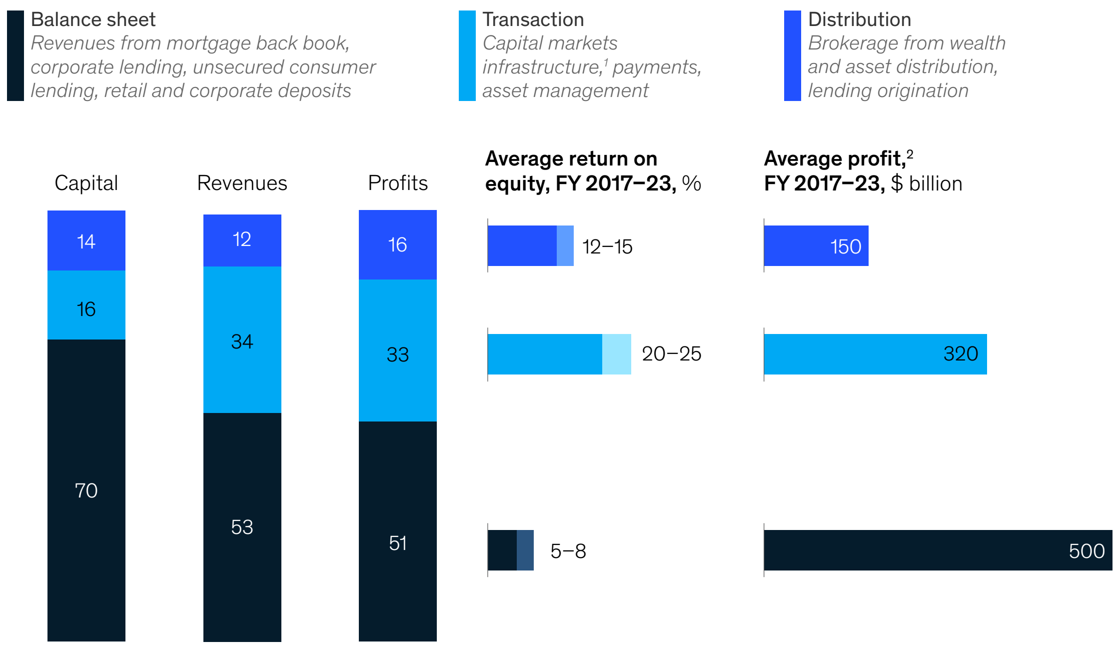
Distribution accounted for just 18 percent of the capital but 20 percent of revenues and 27 percent of profits in 2017–22. Since 2017, the ROE for

[29] See "Integrated channels: The next frontier beyond omnichannel," McKinsey, May 4, 2023.
[30] Economic value is additional profit over and above the cost of capital.

Exhibit 17

The Great Transition is changing the dynamics of banking, with revenues and profits flowing to less capital-intense business models.

Share of employed capital, revenue, and profits by banking business model, FY 2017–23, %



Note: 2023 data estimated. Figures may not sum to 100%, because of rounding. These are not comprehensive examples.
[1]Part of sales and trading is capital-intensive; however, these have been classified under "Transaction" in this chart to simplify.
[2]Net income.
Source: McKinsey Panorama

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distribution has been between 12 and 15 percent, and economic profit has grown by $85 billion.

Payments providers have created the most value in the five years between 2017 and 2022 while accounting for just 2 percent of the capital invested. Capital markets infrastructure providers are not far behind, with about 3 percent of the value created in 2017–22, though they invested just 1 percent of the total capital.

By contrast, traditional universal banks—including global systemically important banks (GSIBs), market leader universal banks, and mid-tier universal banks—are the most capital-intensive institutions. They account for 85 percent of the capital invested in the financial system. They are now benefiting from the general uptick in the sector from higher margins, but once the capital charge is taken into account, they collectively have been losing value at a rate of 1 to 2 percent over the 2018–22 period. Investment banks and broker dealers, along with wealth and asset managers, also have been losing value (Exhibit 18).

Financial markets have been rewarding these shifts with higher valuations for value-generating specialist institutions. Thus, payment providers have a price-to-book ratio that is about seven times the average valuation of traditional banks. Among other subsectors, only capital market infrastructure providers have earned valuations that are substantially higher than traditional banks, about three times as high.

Exhibit 18

Valuation and performance metrics vary widely among different business models.

Metrics by business model

[1]As of Sept 1, 2023. [2]Jan 2018–Sept 2023. [3]Includes traditional asset managers, nontraditional intermediaries, and sponsors. [4]Includes sales and trading.
[5]Domestic market leader with >10% of share in assets, excluding GSIBs.
Source: S&P Global; McKinsey Panorama

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Divergent impact by macroeconomic scenario
Past performance is no guarantee of future results—that classic financial industry disclaimer can equally apply to the Great Banking Transition and the recent trends in the industry. The sudden rise in interest rates could be a game changer for both capital-heavy and capital-light players if it is sustained over the longer term. But if rates were to fall back again quickly to the low levels of the past decade, the bounce in profitability for many capital-heavy financial institutions may be short-lived. The macroeconomic scenario including the credit cycle that unfolds will thus have an impact on the Great Transition in the years ahead.

In a high-interest-rate environment, some of the successful business models of recent years could simply wash out, especially in jurisdictions where banks cannot adjust their equity easily—for example, because of regulation, political pressure, or business model. These include consumer finance players and payment providers, which have been able to move nimbly in a period of ultra-low rates to cherry-pick profitable business. Conversely, for traditional banks based on a balance sheet model, higher rates (and spreads) can potentially bring about a revival in their prospects. And the higher-interest-rate environment may accelerate some business areas that would have languished or

In a high-interest-rate environment, some of the successful business models of recent years could simply wash out, especially in jurisdictions where banks cannot adjust their equity easily—for example, because of regulation, political pressure, or business model. These include consumer finance players and payment providers, which have been able to move nimbly in a period of ultra-low rates to cherry-pick a profitable business. Conversely, for traditional banks based on a balance sheet model, higher rates (and spreads) can potentially bring about a revival in their prospects.

been unprofitable when rates were low, such as building societies and long-term deposits.

Technology as transition enabler and emerging core business

Underlying these shifts—both enabling and accelerating the Great Banking Transition—is technological innovation, which makes it possible to scale up delivery and reduce costs. The net effect is continuous pressure on all activities where scale and capabilities matter. Transactions have been at the forefront due to their more global nature and strong technology base. The pressure is now largely focused on balance-sheet-related activities, which are more local—including in their regulation—and for which technology has been relatively lagging. Distribution often has the most local dimension, and in general is further behind.

Financial players are increasingly competing on the basis of technology to help enable scaled delivery and reduce costs. Digitization was an important spur for change, as is the ongoing cloud transition. With artificial intelligence reaching new levels of sophistication and maturity, especially with the advent of gen AI, tech-fueled competition is likely to become increasingly prevalent and a significant differentiator among banks that determines performance.

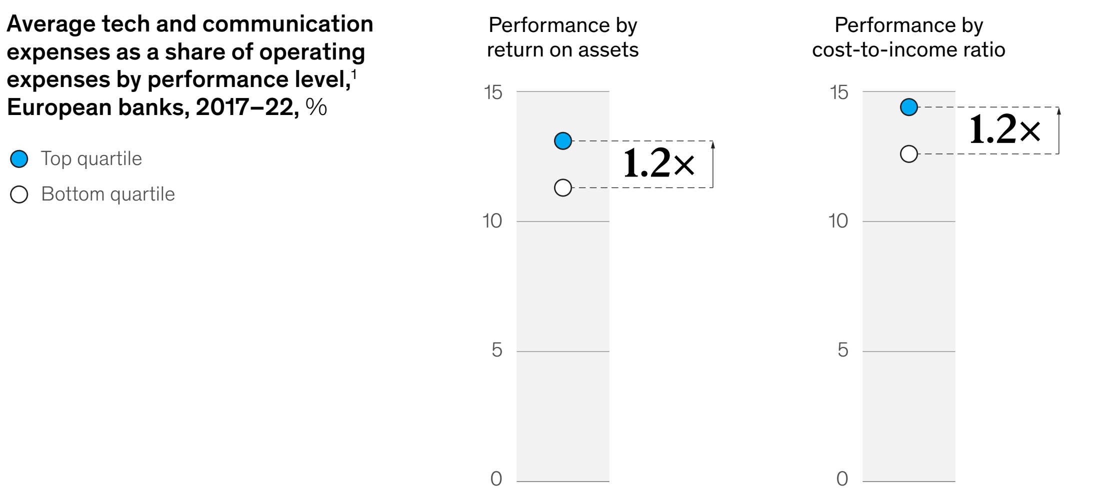
Already, successful banks are deploying tech-backed business strategies with clear value at stake, such as engineering excellence and platform-oriented architecture, to identify technology investments that improve productivity. The transition toward these technology elements has enabled banks to lower their overall costs. This is particularly important, given the existing margin pressure and large share of technology costs being spent on maintaining old legacy systems. We see strong evidence of banks' outperformance if they are leaders in technology investment (Exhibit 19).

In response to the Great Banking Transition, some successful banks are embracing tech-backed

Exhibit 19

High-performing European banks spend significantly more than low performers do on technology.

Average tech and communication expenses as a share of operating expenses by performance level,[1] European banks, 2017–22, %



[1]Analysis based on top 120 banks by assets. Average return on assets was 1.3% for top quartile and 0.2% for bottom quartile; average cost-to-income ratio was 40% for top quartile and 75% for bottom quartile.
Source: S&P Global; McKinsey Panorama

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business strategies with clear value at stake to identify technology investments that improve productivity. This embrace of technology as a core part of business strategy and risk management, which enables banks to lower their technology and overall costs, can take several forms, including the following:

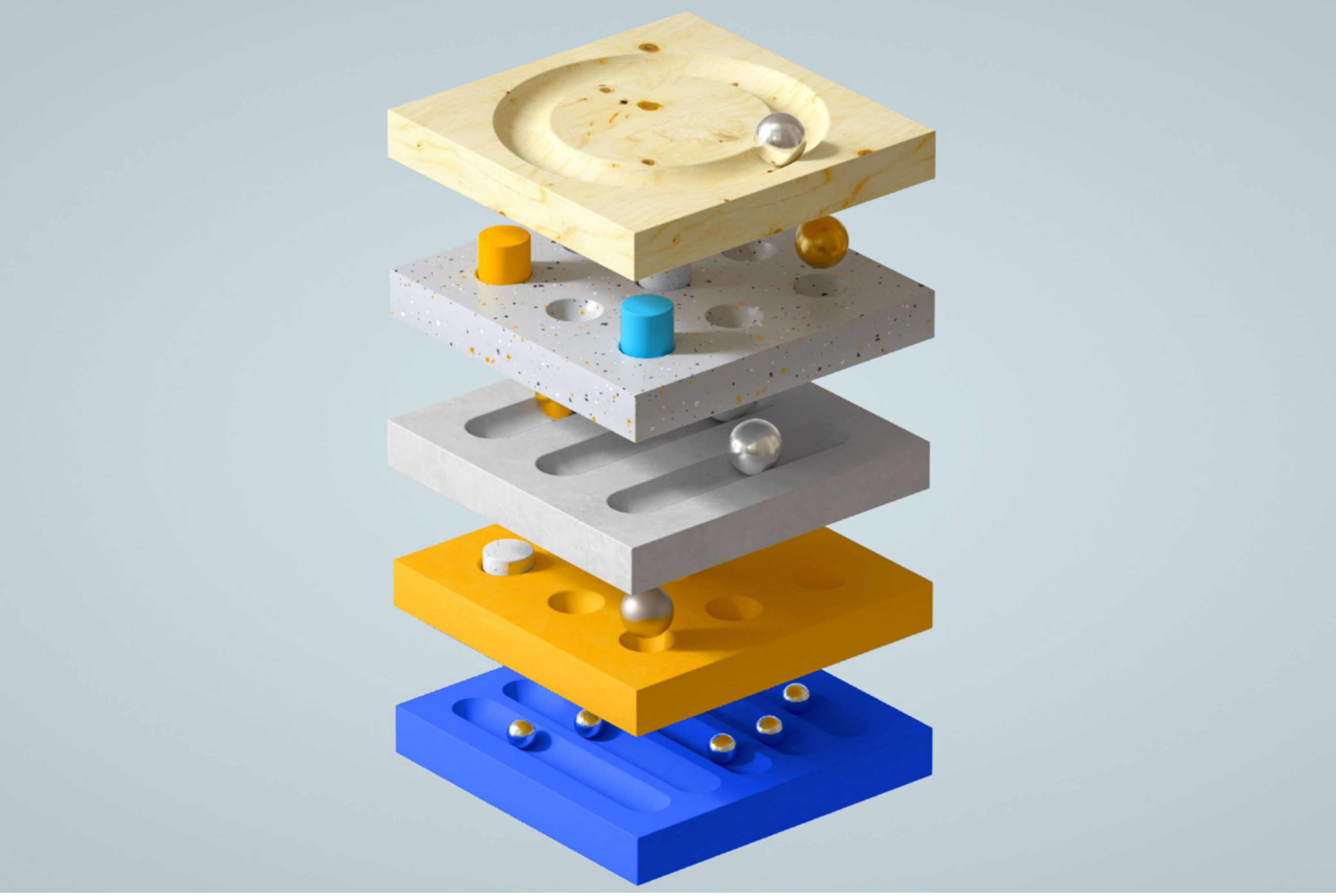
— *A focus on engineering excellence and joint business and IT operating models.* In this case, about 75 percent of the full-time equivalents in technology delivery organizations are engineers, and as much as 95 percent of all IT applications are delivered and operated through automated continuous integration and continuous deployment pipelines.

— *Platform-oriented architecture.* One institution took just nine months to develop a new proposition by building it, based on software-as-a-service (SaaS) banking components.

— *Automated infrastructure and public cloud.* Institutions adopting this approach can host more than half of applications on the public cloud, with 85 percent of infrastructure provisions automated. Gen AI is the next forefront here.

So far, we've seen financial players moving across three horizons. One is the core business transformation. This involves using the technology to reshape the core business and customer-facing operations—for example, collateral appraisal and direct customer interaction. Another horizon is the use of platform-based architecture or behind-the-scenes integration of AI into operations, using applications such as virtual expert or frontline coaching to change the internal operating model. Finally, technology can be used for targeted productivity enhancement. In the gen AI example, this deploys SaaS solutions to improve the efficiency or accuracy of existing tasks, such as coding assistance, copy writing, and customer assistance.

The Great Banking Transition is changing the dynamics of financial institutions in multiple ways, across the balance sheet, payments, and distribution. These are structural shifts and, when combined with the uncertain macroeconomic outlook, pose considerable challenges for all financial institutions, whether traditional banks or the emerging galaxy of nonbanks. How should institutions respond to these changes? In the following chapter, we outline a few priorities.



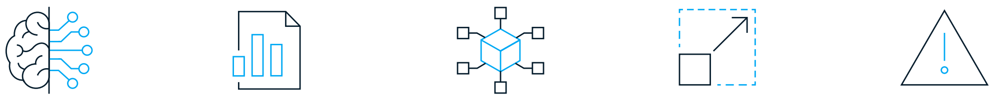
3 Five priorities to capture the moment

Regardless of the macroeconomic developments, all banks will have to find ways to adjust and adapt to the changing environment that the Great Banking Transition will give rise to. The trends of technology, regulation, risk, and scale we highlighted in Chapter 1 are secular ones that will need to be addressed regardless of the outlook for interest rates and economic growth. For balance-sheet-focused banks, the implications of this shifting environment touch all aspects of their business, including overall balance sheet management, such as capital allocation, funding profile, asset mix, and risk capacity. Non-banks, too, will need to keep moving, as new technologies spur ever faster change and innovation. Mergers and acquisitions may gain in importance.

Besides overcoming challenges, banks have a major opportunity to create value if they can reinvent themselves. This concluding chapter lays out five possible and not mutually exclusive priorities that could help institutions survive and thrive: exploiting technology and AI, flexing the balance sheet, scaling or exiting transaction business, leveling up distri-bution and the customer relationship, and adapting to a changed risk environment (Exhibit 20).

Exhibit 20

Banks and nonbanks need to stay relevant across each of the key pillars of banking.



Exploit technology and AI to boost productivity, use talent better, and improve delivery of products and services	Flex and unbundle the balance sheet through syndication, origi-nate-to-syndicate, and 3rd-party balance sheets	Level up distribution to sell to customers and advise them directly and indirectly	Scale or exit transactions business, including through M&A or by leveraging partners to help with exits	Adapt to changing risks, including changing macro context, new regulatory requirements, and risk associated with tech

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Priority 1: Exploiting technology and AI

As we have seen, technology is a game changer for banks when it is used with skill and creativity and is fully integrated into an institution's ecosystem and operating model. The pace of technological innovation is not slowing, and productivity-enhancing innovation is increasingly possible. We have seen leaders in some geographies such as Europe invest 2.5 times more than laggards.

To compete on technology, banks could consider several options:

— *Capture the AI opportunity* to deploy (often together with advanced analytics) process automation, platforms, and ecosystems across customer services to provide better and more efficient services, front to back.

— *Scale the delivery of product and services* to products and platforms to operate like a tech company and prioritize engineering excellence (for example, delivery agility, DevSecOps) by aggressively pursuing top tech talent and partnerships.[31]

— *Future-proof the tech foundation* to cultivate a cloud-based, platform-oriented architecture that allows for continuous innovation and the ability to implement next-generation capabilities.

— *Improve capabilities to address technology risks* to enhance processes to identify continuously evolving next-generation threats, such as remote work security, while mitigating cyber and AI risks, which can include sophisticated ransomware.

Priority 2: Flexing and even unbundling the balance sheet

Financial institutions seeking to follow the broader trend by reducing the balance sheet and moving business off balance sheet can create opportunities to distribute risk to a broader set of investors. The macroeconomic outlook and changes in interest rates over the medium to longer term will likely determine the dynamics of this aspect of the Great Banking Transition. For those making the call that capital-light institutions are the way to go, an option could be unbundling; for others, it will be flexing.

[31] DevSecOps stands for development, security, and operations. It signifies integration of security as a shared responsibility throughout the entire IT life cycle and allows organizations to deploy new code rapidly. See, for example, "What is DevSecOps?," Red Hat, March 10, 2023.

Flexing implies active use of syndication, including for loans; originate-to-distribute (including for ESG project finance, for example); and third-party balance sheets—for example, as part of banking-as-a-service (BaaS) business when using white-labeled revolving credit cards. It may also include the active use of comparison platforms to gain deposits or distribute unused balance-sheet space. At the very least, it will for many institutions include a renewed focus on deposits, especially in North America and Europe, where a whole generation of bankers has never experienced a need to collect deposits and build or reinforce a sustainable funding structure.

Unbundling the balance sheet pushes this concept further. It can mean separating out customer-facing businesses from BaaS businesses and using technology to radically restructure costs.[32] Analogous unbundling has already occurred in the telecom and semiconductor industries in previous decades. For example, when cell phones increased in popularity, telecoms struggled to develop necessary customer-facing strategies within their traditional business models and split into wholesale network providers (capital-intensive, low-ROE business) and retail providers (high-ROE, customer-facing business).

Whether to flex or to fully unbundle depends on the situation. Doing either is especially relevant to capital-heavy banks and can be undertaken to varying degrees and in a number of stages; it's not an all-or-nothing proposition. Often, banks cannot adjust their equity easily or are under obligation to utilize their balance sheet as much as possible—for example, because of regulation, political pressure, or business model. The benefits of both approaches would include the following, to various degrees:

— *Customer service and business capacity.* Banks could originate credit business. For example, the net-zero transition may be an opportunity for more flexible balance-sheet usage by bringing in investors with different time and risk horizons.

— *Capital optimization.* Optimizing capital enables banks to hold on to the assets for which the balance sheet is most efficient (with regard to attractiveness for other banks, nonbanks, and investors).

— *Portfolio and risk optimization.* Banks have an option to choose what they hold, optimize their portfolio mix, and generate additional value by lowering their risk profile.

Flexing or unbundling may also shift the lending business model from being primarily spread income based to one that includes fee income from distributed assets. By separating out the balance sheet and treating it as a pure play, the company may be able to reduce the cost of equity and boost the level at which the core balance sheet trades closer to book value. For customer-facing banking business, unbundling essentially allows financial institutions to double down in prioritized growth products and services that are customer facing—for example, investment advisory and commerce marketplaces. Typically, these have average ROEs between 16 and 18 percent and cost of equity between about 10 and 12 percent.

For BaaS business, this process provides opportunities to be a utility provider or a balance sheet provider. Utility providers may deliver regulatory expertise and back-office services. Balance sheet providers offer access to capital and liability management. BaaS providers typically achieve ROE and cost of equity of 6 to 8 percent, with ROE higher than the cost of equity.

The Great Banking Transition also provides an opportunity for banks to reimagine risk management. They can revamp capabilities to manage credit and liquidity risks with increased efficiency and respond to evolving regulatory changes and emerging risks with increased agility. We discuss this further in relation to the fifth priority, adapting to a changed risk environment.

[32] For a more detailed discussion of unbundling, see "The future of banks: A $20 trillion breakup opportunity," *McKinsey Quarterly*, December 2022.

Priority 3: Scaling or exiting transaction businesses

Although the Great Banking Transition has been happening across payments, asset management, and capital markets and infrastructure for a long time, most customers still need these services (with banks being the distributors). Many banks still hold operations for these services, but many of the benefits have accrued to specialists. From best-practice examples, we can see that scale in a particular market or product is the key to success. But scale can be multifaceted: institutions can find a niche in which to go deep, or they can look to cover an entire market. Following are some points to consider for scale:

— *Decide whether to scale or exit.* Assess the institution's existing and potential products or services on the basis of whether you have sufficient scale. More captive business models might provide benefits, such as in-house card issuing, asset management, and securities services; however, external specialists are often more efficient. As rule of thumb, more regulated and smaller markets need more local developments; in other words, if no fintechs, global asset services, or acquirers have interest to operate locally, you may need to do it yourself.

— *Aggressively pursue economies of scale, examples may be through mergers and acquisitions.* Scale can be used to improve offerings, geographic reach, processes, and cost levels. M&A, along with technology, has been a key differentiator between traditional banks and specialists; consider an M&A strategy (and budget) in order to scale.

— *Leverage partners to help with exits.* The flip side of scaling up in some areas is to reduce in others, to improve focus. Retail banks will likely need card-issuing and asset management services for their customers, for example. Partners can help take care of respective sub-businesses, including payments to security services and asset management.

Across all this, it is important to note that modern tech foundations, especially cloud and APIs, make switching and managing partners easier.

Priority 4: Leveling up distribution

Connecting or reconnecting with customers is an essential element of thriving during the Great Banking Transition. Several paths can help achieve this:

— *Innovate how to interact with clients through hybrid and digital models.* In particular, solve advisory, which many institutions have mastered offline but not usually in hybrid or online form. Conversely, while many private and wealth managers as well as corporate offerings have successfully established advisory services, their digital offerings are often lagging behind.

— *Decide on your strategy toward third-party distribution.* The strategy could involve partnerships to create embedded finance opportunities (for example, buy-now-pay-later applications), platform-based models including build and operate software platforms that directly address customer needs (for example, supply-chain-finance platforms or passive investment opportunities), or establishing the company in marketplaces and ecosystems to create opportunities to serve customer needs with products outside your immediate business models.

— *Stop the leakage where possible.* Ending leakage is especially important with regard to price discovery and comparison platforms by selective engagements, separate products, and technology use.

— *Involve private, corporate, and merchant banking.* Banking leaders often see distribution as a retail issue, but it goes potentially much deeper.

Priority 5: Adapting to a changed risk environment

Chief risk officers in financial organizations are dealing with a plethora of complex issues in the current environment. These include the macroeconomic context, featuring inflation and geopolitical uncertainty; an uncertain growth outlook, and potential credit challenges in specific sectors such as commercial real estate; the regulatory environment, including changing requirements under the Basel III endgame, along with cyber and fraud regulation, and the importance of data; and the exponential integration of advanced analytics into the banking ecosystem—for example, with gen AI—which will have knock-on effects across multiple risk dimensions including credit, cyber, data quality, fraud, market, and model risk among others.

Issues related to the Great Banking Transition are more strategic: the movement raises a set of long-term questions that need to be addressed thoughtfully. Among them: given the migration of funds, transactions, and distribution to nonbank entities, how should the role of the risk function be redefined to be part of the value creation story?

With many activities transitioning outside the perimeter of bank-specific regulation, the risk function will become a significant differentiating factor for banks relative to nonbanks. Trust, confidence, and security will play an increasingly important role in clients' and customers' minds, both retail and corporate, as well as for business partners and regulators.

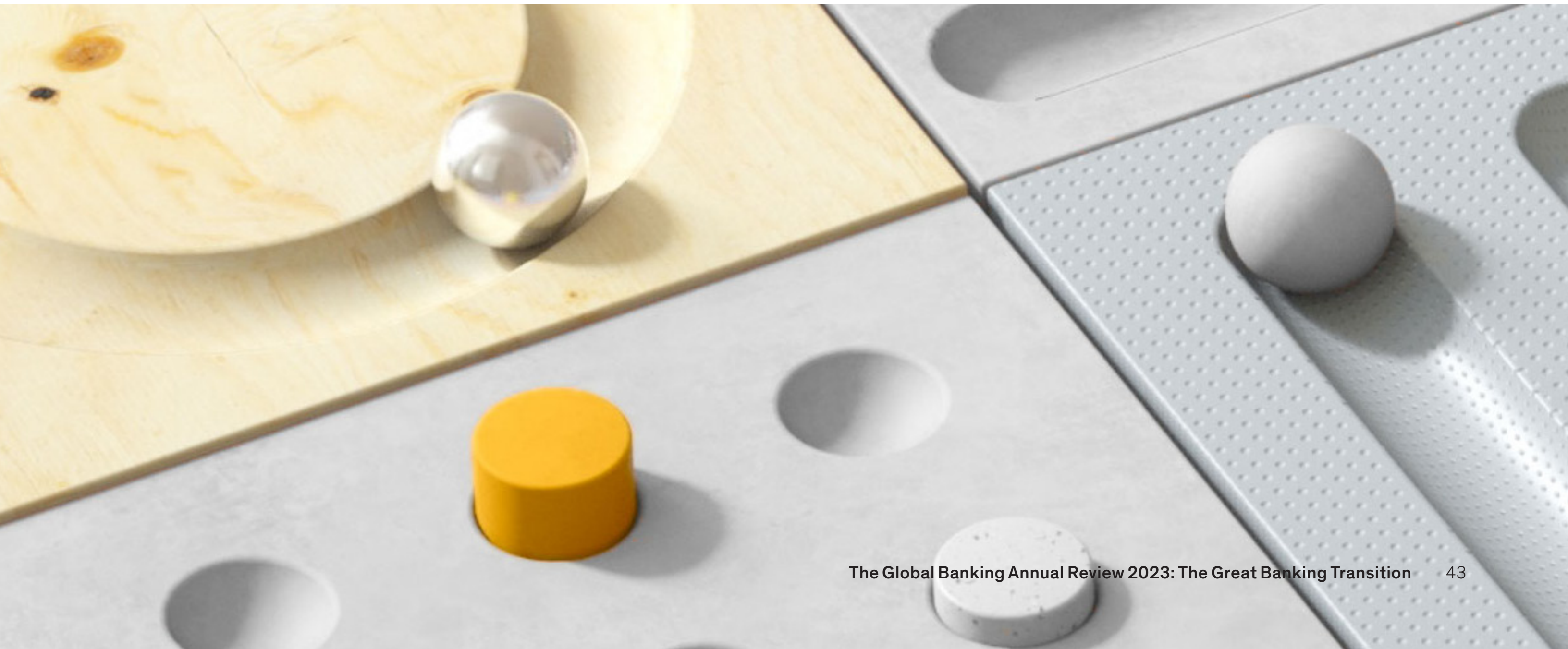
Regardless of the specifics of the future landscape, these trends will further elevate the strategic value of the risk function.

In recognizing this evolving landscape, risk functions can take several no-regret actions, such as these:

— Elevate the risk narrative to make it a true differentiator. For example, in client discussions, product design, and communications, highlight the bank's resilience based on its demonstrated track record of managing systemic risk and liquidity, data protection, cyber, and operational resilience.

— Further strengthen the first line, and embed risk into day-to-day activities, as opposed to conducting after-the-fact oversight.

— Invest in newer risk activity areas, many driven by the growth of gen AI and other advanced analytical techniques, including cyber, fraud, and model risk. This would underscore that risk has moved far beyond credit and market factors.



- Embrace the importance of data as an asset, and treat data risk as an enterprise topic that requires the right governance, operating model, and controls across both providers and consumers of data assets.

- Focus on outcomes and not process. In other words, determine what the bank is actually getting out of its risk and control self-assessment, as opposed to focusing on getting the process right. Rethink committees and governance in light of the trends mentioned earlier.

- Pay close attention to talent implications, linking risk expertise with frontline understanding—for example, spanning integrative skill sets that can look across risk stripes and deep expertise in cyber and fraud groups that speak the language of banking.

- Proactively prepare for increased regulatory scrutiny through increased foresight, scenario planning, and stress testing; improve transparency and depth of reporting at both board and management levels; increase focus on operational resilience; and prepare for faster response times, to both external factors and regulatory inquiry, and increased decision velocity.

The Great Banking Transition has been a dominant underlying theme for the banking sector, and the industry may have reached an inflection point, now that more than half of the global balance sheet has transitioned and technology is likely to induce more change. The recent rise in interest rates will change some dynamics, but regardless of the outlook for interest rates and the economy more broadly, financial institutions should consider how they will set themselves up for success in this fundamentally new environment.

While the degree of change can be disconcerting, banking has a historic opportunity to reinvent itself. If banks—whether they are traditional universal banks, specialists, or new players—can find a business model that reduces the sector's valuation discount to other sectors, the upside in terms of value creation could be enormous. Banks can seize the opportunity if they parse their balance sheet, transaction, and distribution businesses to identify which of them create value or provide a competitive advantage. Where do their competitive advantages lie within each? How will technology and AI impact the market and their advantages? They can identify what it will take to create economic value with new business models in the future macroeconomic environment, amid heightened geopolitical risks, to compete with an ever-broader set of competitors. The effort will be difficult, but for institutions with powerful new technologies and a revised mindset, a new era of value creation is possible.

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