A test of resilience: Banking through the crisis, and beyond

McKinsey Global Banking Annual Review 2020
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Ten months into the COVID-19 crisis, the world has learned a great deal about the disease and the novel coronavirus that causes it. But the knowledge has come at an extraordinary cost: more than 67 million cases worldwide and 1.5 million lives lost. We have also learned more about how to control the disease. But that knowledge too has been hard-won: tens of millions are out of work, a global recession has descended, and trillions in global GDP have already vanished. These extraordinary sacrifices may be starting to pay off. Hopes are growing for COVID-19 vaccines. New therapeutics are also showing promising results. Manufacturing and distributing these products worldwide will be a significant challenge, but there is no mistaking the change in sentiment. People are daring to hope for an end to the pandemic. Almost certainly, however, victory still lies some nine to twelve months in the future. Meantime, second and third waves of infection have arrived in the Northern Hemisphere, and as people crowd indoors in the cold weather ahead, the infection rate may get worse. As a result, the potential for near-term economic recovery is uncertain. The question of the day is, When will the economy return to its 2019 level and trajectory of growth?

“Our latest research indicates that, in almost all COVID-19 scenarios, the vast majority of banks should survive. Further, we expect that most institutions can regain their 2019 ROE within five years, provided they are willing to do the hard work necessary on productivity and capital management”.


In the first half of 2020, global loan-loss provisions exceeded those in all of 2019.

A deep freeze and gradual thaw
As days have shortened in the Northern Hemisphere, banks have been preparing. In the first half of 2020, loan-loss provisions exceeded those in all of 2019. Banks have not yet had to take substantial write-offs; their forbearance programs and significant government support have kept households and companies afloat. But few expect this state of suspended animation to last. The stock market appears to reflect this: industry market cap has declined by about 17 percent in the first nine months of the pandemic, even as broader markets have risen.

We anticipate that, in months and years to come, the pandemic will present a two-stage problem for banks. First will come severe credit losses, likely through late 2021; almost all banks and banking systems are expected to survive. Then, amid a muted global recovery, banks will face a profound challenge to ongoing operations that may persist beyond 2024.

Depending on scenario, from $1.5 trillion to $4.7 trillion in cumulative revenue could be lost between 2020 and 2024. In our base-case scenario, $3.7 trillion of revenue will be forgone—the equivalent of more than a half year of industry revenues that will never come back. In that same scenario, return on equity would continue its decline, from 8.9 percent in 2019 to 5.4 percent in 2020 to 1.5 percent in 2021. At the trough in 2021, ROE would fall to −11 percent in North America, −1.8 percent in Europe, and −0.2 percent in developed Asia. ROE would fall from higher starting levels and bottom out higher in emerging Asia (2.5 percent), the Middle East and Africa (MEA; 3.7 percent), and Latin America (6.2 percent); and it would take a smaller dip to 8.6 percent in China.

Those effects will be felt keenly by an industry that was already stressed. In last year’s edition of this report, we highlighted that nearly 60 percent of banks did not return their cost of capital. By fall 2020, things were worse: the industry was trading at a 50 percent discount to the broader market, a historical low, with 79 percent of banks trading below book value. (Exhibit 1). This is felt differently across regions: North American banks’ price-to-book ratio at midyear was more than 30 points higher than that of European banks and 15 points above that of Asian banks. These regional differences reflect changes over the past 20 years. In 2000, the roster of the world’s 30 most valuable banks included eight American, 14 European, and just 4 Asian institutions. By November 2020, only 4 European banks remained on the list, which now features 15 Asian and 10 North American banks.

Staying warm
People in northern climates know that winter tests our endurance, skills, and patience. Banks will be similarly stretched. Some will need to rebuild capital to fortify themselves for the next crisis, in a far more challenging environment than the decade just past.

Zero percent interest rates are here to stay and will reduce net interest margins, pushing incumbents to rethink their risk-intermediation-based business models. The trade-off between rebuilding capital and paying dividends will be stark, and deteriorating ratings of borrowers will lead to inflation of risk-weighted assets, which will tighten the squeeze.

As this report lays out in detail, solutions are available to each of these problems. Banks responded extraordinarily well to the first phases of the crisis, keeping workers and customers safe and keeping the financial system operating well. Now they need equal determination to deal with what comes next by preserving capital and rebuilding profits. We see opportunities on both the numerator and denominator of ROE: banks can use new ideas to improve productivity significantly and can simultaneously improve capital accuracy.

Those steps should see them through the immediate challenges but will not set them up for long-term success. To get there, banks need to reset their agenda in ways that few expected nine months ago. We see three imperatives that will position banks well against the trends now taking shape. They must embed newfound speed and agility, identifying new directions to growth as the world undergoes a profound transformation. As the economy develops, policies and guidance will shift. The financial system will face new burdens in an ongoing global pandemic, and may need to support new segments of the population and businesses even as the more traditional needs of the financial services industry persist.
the best parts of their response to the crisis and finding ways to preserve them. They must fundamentally reinvent their business model to sustain a long winter of zero percent interest rates and economic challenges, while also adopting the best new ideas from digital challengers. And they must bring purpose to the fore, especially environmental, social, and governance (ESG) issues, and collaborate with the communities they serve to recast their contract with society.

About this report
This is the tenth edition of McKinsey’s Global Banking Annual Review and is based on insights and expertise from McKinsey’s Global Banking Practice. It is structured in three chapters. In the first, we review banks’ pre-COVID-19 context, examine the effects of the crisis to date, and estimate the effects still to come. In the second, we outline the short-term actions needed to adapt. In the third, we trace the trends accelerated by the pandemic and detail the three imperatives banks will need to pursue if they are to thrive in coming years.

Banks can use new ideas to improve productivity and capital accuracy simultaneously.
The COVID-19 pandemic slammed shut a decade-long window of opportunity for banks. Banks had spent the time building capital reserves—a regulatory requirement whose importance is evident in light of the current crisis. However, most industry incumbents did not use the boom to prepare their businesses fully for what is shaping up as a significant bust. Building capital stocks inevitably lowered ROEs, and in many cases, banks did not adapt their business models enough to generate sustainable positive returns. What’s more, few are prepared for zero percent interest rates. Margins and revenues are set to shrink further.

The crisis will play out in two stages. For most banks, the chief concern through 2021 will be credit losses of a magnitude not seen in decades. In 2022–24 and possibly beyond, decreased demand and anemic net interest margins, depressed by a prolonged zero-rate environment, will surpass risk cost as the industry’s primary ailments.

In this chapter, we outline scenarios for the pandemic and the economy, estimate the effects on ROE, and describe how we expect the next four years will play out for the industry.

Scenarios for the pandemic and the economy

Each month since April 2020, McKinsey has surveyed more than 2,000 global executives across industries on the likely path of the pandemic and the economic recovery. We asked them...
to take a view on two critical dimensions that will shape the evolution of the crisis: the potential for rapid and effective control of the virus and the effectiveness of government policy interventions. The three alternatives along each dimension yield nine scenarios, four of which are more positive (the “A” scenarios), and five more negative (the “B” scenarios). In the past three months, the outlook has been steady. Business leaders see a diminishing potential for rapid and effective control of the virus, and they are only moderately optimistic about the effectiveness of government policy interventions.

Exhibit 2

Executives continue to favor A1 as the likeliest global COVID-19 scenario; some see A3 and B2 as more likely.

Most likely scenarios for COVID-19’s impact on global GDP

- A1: Muted recovery
  - Contained health impact; slow long-term growth; time to recovery
  - Strong growth rebound and recovery
  - High levels of health impact; slower near-term growth and recovery
- A2: Fast recovery
  - Contained health impact; strong growth rebound and recovery
  - High levels of health impact; delayed but strong growth rebound and recovery
- B1: Recession
  - Repeating health impact; sector damage and lower long-term growth
  - Strong growth rebound and recovery
- B2: Stalled recovery
  - Repeating health impact; more severe, insufficient to deliver full recovery
  - Strong growth rebound and recovery
- B3: Recession
  - Recurring health impact; slow long-term growth
  - Insufficient to deliver full recovery
- B4: Recession
  - High levels of health impact; prolonged downturn without foreseeable recovery
  - Strong growth rebound and recovery
- B5: Recession
  - High levels of health impact; slower near-term growth and delayed recovery
  - Strong growth rebound and recovery

Most executives anticipate a muted recovery (our scenario A1) (Exhibit 2). Many also expect scenario B2, in which recovery stalls; scenario B1, in which economic interventions are ineffective, is also on the minds of executives. A smaller segment anticipates a faster recovery like that shown in scenario A3. On balance, a narrow majority (55 percent of respondents in our October survey) foresee an epidemiological and economic resolution to the pandemic in 2021. Nearly half expect the crisis to resolve in one of the pessimistic B scenarios.

Regionally, respondents in Asia–Pacific, India, Latin America, North America, and developing markets expect that economic conditions in their country will improve in six months. Two exceptions to the trend are Greater China (Mainland China, Hong Kong, and Taiwan), where expectations have been high for months but dipped slightly in October, and Europe, the only region in which respondents on average expect their countries’ economic conditions to decline rather than to improve.

In this report, we use the muted recovery (A1) as the base case for our projections and the stalled recovery (B2) as the proxy for the range of more challenging scenarios. We also include a view of the faster-recovery scenario (A3), which might be observed in regions with continued solid public-health responses. While A1 is our global base case, it’s of course possible that countries may experience more positive (or negative) scenarios in the coming months and years.

The pandemic’s two-stage impact on global banking

The final tally of economic damage from this crisis won’t be known for some time. What we do know is that the crisis will take a few years to resolve for banks and is likely to play out in two distinct stages.

A few challenging years …

Banks’ returns have trended sideways for a long time. By our calculations, 63 percent of banks did not return their cost of capital in 2019. The current crisis has already started to make this situation much worse. In the first half of this year, that number grew to 77 percent. What’s more, the average bank’s ROE does not cover its cost of equity in 83 percent of countries, up from 71 percent a year ago.

Without management action, in scenario A1, the global average industry ROE could fall to 1.5 percent in 2021 before improving to 8.8 percent by 2024—again, absent management action (Exhibit 3). This would still be lower than the 8.9 percent recorded in 2019.
Absent management action, ROE will fall globally and turn negative in most of the developed world.

For banks, the difficult road ahead will have two stages.

Global revenues in scenario A1, $ trillion

Stage 1
Recession
Forgone revenue
Loan-loss provisions

Stage 2

Total crisis impact, revenues and loan-loss provisions, $ trillion

In most scenarios, banks in North America would see a faster decline in ROE and a more robust recovery than banks in Europe (Exhibit 4). Both regions, along with developed Asia, face negative ROEs in 2021 under scenarios A1 or B2. The impact is smaller in China. Banks in Latin America and the Middle East and Africa face steep falls but reasonably steady recoveries. Emerging Asia is the only region where banks can expect ROEs to be higher post-crisis than before, driven largely by Indian banks writing off higher-risk assets quickly and emerging from the crisis sooner, thus reducing their future capital need.

... in two phases

The painful dynamics just described will unfold in two very different phases (Exhibit 5). One of the first effects of the crisis has been an increase in loan-loss provisions. Despite a better-than-expected set of numbers in third quarter 2020, we expect that credit losses will be the main focus for 2021. In subsequent years, the focus will shift toward revenues, which will continue to come under pressure.

Credit losses and capital cushions: Bend but don’t break

As the crisis began in March 2020, most banks joined the initial rush to secure liquidity and funding. They succeeded, and then some: as the year ends, liquidity levels are at record highs for most banks. For the moment, this is not the industry’s primary concern, unlike in some previous crises. Instead, the immediate concern for the next year is capital.

To curb the spread of the virus, societies around the world have attempted the heretofore unimaginable: they have shut their economies, instantly throwing tens of millions out of work and closing millions of businesses. Those people and businesses are banks’ customers, and their inability to keep up with their obligations would be expected to sharply increase personal and corporate defaults. In anticipation of this, through the third quarter of 2020, global banks had provisioned nearly $1.2 trillion for loan losses, much more than they did through all of 2019 (Exhibit 6). North America and Europe drove that trend, provisioning more than their 2015–19 averages. In the United States, new

2021

will be the year when ROEs bottom out in most parts of the world
Globally, loan-loss provisions in the first three quarters of 2020 surpassed those for all of 2019, and by 2021 they could exceed those of the global financial crisis.

Nominal provisions for loan losses, 2000–20E (fixed 2019), $ billion

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<tr>
<td>Q1</td>
<td>400</td>
<td>500</td>
<td>600</td>
<td>700</td>
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<td>1000</td>
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<td>Q2</td>
<td>400</td>
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<td>Q3</td>
<td>400</td>
<td>500</td>
<td>600</td>
<td>700</td>
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Provisions as a percentage of total loans, by scenario, 2000–24, %

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<tbody>
<tr>
<td>A1 muted recovery</td>
<td>1%</td>
<td>2%</td>
<td>3%</td>
<td>4%</td>
<td>5%</td>
<td>6%</td>
<td>7%</td>
<td>8%</td>
<td>9%</td>
<td>10%</td>
<td>11%</td>
<td>12%</td>
<td>13%</td>
<td>14%</td>
<td>15%</td>
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<tr>
<td>B2 stalled recovery</td>
<td>2%</td>
<td>3%</td>
<td>4%</td>
<td>5%</td>
<td>6%</td>
<td>7%</td>
<td>8%</td>
<td>9%</td>
<td>10%</td>
<td>11%</td>
<td>12%</td>
<td>13%</td>
<td>14%</td>
<td>15%</td>
<td>16%</td>
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<tr>
<td>A3 faster recovery</td>
<td>3%</td>
<td>4%</td>
<td>5%</td>
<td>6%</td>
<td>7%</td>
<td>8%</td>
<td>9%</td>
<td>10%</td>
<td>11%</td>
<td>12%</td>
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<td>14%</td>
<td>15%</td>
<td>16%</td>
<td>17%</td>
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Recession

Source: SNL Financial, McKinsey Panorama Global Banking Pools
Exhibit 6 of 15

As these effects play out, government support expires, and bank programs subside, most banks expect provisions to increase in the next year.

In scenario A1, provisions are likely to rise to levels higher than in the global financial crisis (Exhibit 6). In the more pessimistic scenario B2, provisions would rise to 0 percent of total loans in 2021. In contrast, a handful of countries seem to be on a path toward scenario A3, a relatively rapid recovery by 2021; for them, risk costs would likely remain lower than in 2008–09.

Despite the high level of projected provisions, in our central scenario A1, the industry is sufficiently capitalized to withstand the shock (Exhibit 7). On average globally, under this scenario, common equity tier 1 (CET1) ratios would decrease from 12.5 percent in 2019 to 12.1 percent in 2024, with a low point of 10.9 percent expected in 2021. Regions would follow slightly different paths, but the overall system should be resilient enough. Even in a stalled recovery (scenario B2), we estimate that CET1 ratios would fall only an additional 35 to 85 basis points, depending on region.
Even within a resilient financial system, a subset of banks will face threats to viability.

Banks with given common equity Tier-1 ratios in scenario A1 during trough (2020–24), number of banks

If several banks were to cross that line, especially if a global systemically important bank (GSIB) were among them, the financial system would be on the brink of a different kind of crisis. Notwithstanding the deep liquidity reserves banks have accumulated, the failure of even a relatively small bank could set in motion a broad-based negative spiral. If one or more GSIBs were caught short in such a run, the system could be under pressure, likely from a panic-driven liquidity or funding crisis. Even if liquidity continues to be abundant, sustained confidence in the banking system is critical to its function. Against this backdrop, regulators, governments, and central banks will continue to play a critical role in maintaining confidence in the system, including signaling that they will serve as a backstop, if necessary. These global estimates are just that, estimates, and are subject to factors that are difficult to model. For one, accounting standards differ across regions. For another, financial models cannot accurately predict the behavior of all major actors (banks, governments, and customers) in this system—behavior that has so far muted the impact of the crisis. Banks’ efforts to provide widespread payment deferral and customer assistance may not continue in all cases. Government support and increased unemployment insurance payments have buoyed several sectors and assisted millions who are out of work. However, it’s not yet clear whether these measures will see countries through to the end of the crisis. As temporary programs evolve or wind down, banks will likely reckon with the full force of the crisis. In the United States, unemployment insurance and other assistance programs have ended in some states and been extended in others. A good deal of uncertainty surrounds the future of these programs. Some 10 million Americans are unemployed currently. In our view, given the resulting disruption in cash flow for these households, and Americans’ average savings balances, many households are likely to become delinquent within a few months after job loss and the end of government benefits. Bank charge-offs should follow about 3 to 6 months later. Finally, many retail customers have adapted to the crisis by cutting their spending and reducing debt. But customers’ options are limited, and delinquencies may soon rise. Globally, customer sentiment indicates confidence is still low and missed payments are likely to continue. In the United States at the end of the third quarter, two-thirds of financial decision makers were either pessimistic or unsure about their confidence in the overall economy, believing that the economy would be affected for six to 12 months or longer and would stagnate, slow, or fall into a lengthy recession.  

McKinsey Financial Insights Pulse Survey, N = 2,015, US survey, September 27, 2020. Data were sampled and weighted to match the US general population 18 years and older. The margin of error for wave-over-wave changes is plus or minus three percentage points for all financial decision makers and larger for sub-audiences.

Banks and regulators are rightfully curious: How much more pressure can the system take? In other words, what would it take for capital reserves of the average global bank to fall below regulatory minimums? According to a sensitivity analysis of loan-loss provisions in scenario A1, the depth of the crisis would have to be nearly twice as bad as currently projected to see the global average bank’s CET1 ratio fall below 8 percent, the approximate regulatory capital requirement in many regions. For example, looking at large developed nations, unemployment would need to more than double in North America and Europe or triple in China, and GDP would have to fall roughly 20 percent during the crisis’s worst year in North America or Europe, or nearly 6 percent in China. Economic devastation on that scale would produce a near-two-fold increase in projected provisions for loan losses, to a peak of 3.7 percent of loans globally in 2021, instead of a projected 1.9 percent peak under scenario A1. The base-case scenario will be troubling for banks that were already unhealthy. Under scenario A1, we estimate that 83 percent of the largest 750 global banks are likely to be safe; the other 17 percent have at least modest risk. Seven percent run at least a moderate risk of CET1 ratios falling below 8 percent (Exhibit 8). Three percent of banks, representing about 0.6 percent of banking capital, might suffer capital losses that take their reserves below 4.5 percent, a threshold at which their viability would be jeopardized.

Exhibit 8

83% of banks have a <5% chance of falling below regulatory buffers

7% of banks (0.7% of banking system capital) have a >50% chance of falling below regulatory buffers

3% of banks (0.6% of banking system capital) have a >50% chance of falling below regulatory minimums

Source: SNL Financial.
In 2019, retail and corporate banking were by far the biggest contributors to the top line — but are also sensitive to a zero-rate environment.

Revenues: More than $3 trillion lost

In the second phase, impact will shift from balance sheets to revenues. In some respects, it will only amplify and prolong preexisting trends, such as low interest rates. But it will also reduce demand in some segments and geographies. On the supply side, we expect banks to become more selective in their risk appetite. Of course, there will be offsetting positive effects for the industry, such as a need to refinance existing debt, and some regions and industry segments will still benefit from secular tailwinds. In addition, government support programs are expected to continue to support activity in some places.

However, on balance, the outlook is challenging. Globally, we expect that in scenario A1, revenues could fall by about 14 percent from their precrisis trajectory by 2024 (Exhibit 9). Translating those numbers into absolutes, compared with precrisis growth projections, the industry could face $1.5 trillion to $4.7 trillion in aggregate lost revenue between 2020–2024, depending on scenario ($3.7 trillion in the base-case scenario A1). That represents more than a half-year’s revenues for the global banking industry — activity that will never come back.

To understand how revenues might change in various banking businesses and the world’s major regions, let’s start with a review of financial-intermediation revenues in 2019, earned by banks and others such as hedge funds (Exhibit 10).

The revenues earned by shadow banking, as many call it, grew twice as fast as banks’ balance-sheet businesses between 2017 and 2019. Looking more closely at revenues by lines of business, we see that in 2019, by far the biggest contributors to the sector’s top line were retail and corporate banking, which are also sensitive to a zero-rate environment and increased risk. Fee-based businesses—wealth and asset management, market infrastructure, investment banking, and payments—are a smaller portion of the banking revenue pool. But institutions that have meaningful businesses in these sectors have found themselves more resilient to the crisis so far.

Exhibit 11 lays out our projections for revenue growth from 2019 to 2024 across key regions and business lines in the base-case scenario. (These projections are for banks only.) Retail and commercial banking, which together represented two-thirds of total global industry revenues in 2019, are likely to grow at about the same rate as regional GDP. Payments looks set for the strongest growth, particularly in North America. Looking at each business line, we can find additional insights:

Retail: Deposit revenue for retail has seen a short-term increase, given a surge in volumes in the past year. Looking ahead, it is expected to decline then stagnate as interest rates remain low or fall further, though fee income from deposit accounts is expected to remain. Consumer financing originations are expected to fall with consumption, offset by potentially higher rates to compensate for higher risk. Mortgage rates are likely to continue to be low, which will drive high volumes of refinancing and purchases.

Exhibit 9

Banks’ resilience will be tested; revenues may not recover for two to four years.

Global revenues and profits, $ trillion (fixed 2019)

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue</th>
<th>Profit</th>
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<tr>
<td>2019</td>
<td>8</td>
<td>6</td>
</tr>
<tr>
<td>2020</td>
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<tr>
<td>2021</td>
<td>2</td>
<td>0</td>
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<td>2022</td>
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<td>0</td>
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<tr>
<td>2024</td>
<td>2</td>
<td>0</td>
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</tbody>
</table>

*Profit forecasts assume continuation of cost-reduction trends from previous 5 years. Note: Chart shows year-end data.*

Source: McKinsey Panorama Global Banking Pools
Global financial intermediation is a complex system that generated about $5.5 trillion in annual revenue in 2019.

**Sources of funds, $ trillion**

- SWFs and PEPPs
- Retail assets under management (AUM)
- Insurance and pension funds AUM
- Other AUM
- Personal deposits
- Banks’ bonds, other liabilities and equity
- Corporate and public deposits

**Global banking revenue in 2019, % share of total/$ billion**

- Off banking balance sheet
- On banking balance sheet

**Uses of funds, $ trillion**

- Wealth and asset management
- Wealth management
- Corporate and public deposits
- Retail banking
- Payments

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**Exhibit 10**

Global financial intermediation is a complex system that generated about $5.5 trillion in annual revenue in 2019.

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**Exhibit 11**

Growth in the industry’s largest segments will likely lag GDP growth globally and in most regions.

Global industry revenues, by business line and region, 2019, circle size = $ billion

<table>
<thead>
<tr>
<th>Business line total</th>
<th>North America</th>
<th>Europe</th>
<th>China</th>
<th>Developed Asia</th>
<th>Latin America</th>
<th>Emerging Asia</th>
<th>Middle East and Africa</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ trillion</td>
<td>1,949</td>
<td>1,653</td>
<td>788</td>
<td>739</td>
<td>390</td>
<td>237</td>
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**A test of resilience: Banking through the crisis, and beyond**

- Corporate and commercial: At the outset of the crisis, the corporate and commercial line saw large inflows as corporates began drawing down lines of credit to sustain themselves through shutdowns. Government loan programs also pushed balances up considerably. Looking ahead, supply may be more limited because of credit risk, and repricing to low rates may shrink margins.

- Payments: revenues will see growth driven by recovering consumer spend and by shifts in payments methods in several regions. In emerging markets, consumers will likely continue to shift from cash to both traditional and alternative electronic payments. In developed markets, a shift from credit card to POS credit and other alternative methods is taking off; both are seeing historical growth rates. Payments to vendors and from customers are also digitizing quickly for both large corporates and small businesses. However, given slowing travel patterns, payments networks and others could feel the impact of reduced physical cross-border spend, which is typically a major profitability driver.

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**Banking will grow faster than GDP only in certain businesses and geographies:**

- Retail banking in emerging Asia and MEA
- Corporate banking in MEA
- Payments in North America, China, and Latin America
- Capital markets in North America and Latin America
Leading banks, fintechs, and platform companies have continued to invest during the crisis, particularly in digital channels.

- **Wealth management** revenue growth over the next four years will be mostly driven by market performance, though to be sure that is highly uncertain especially under a muted recovery scenario. The emergence of low-cost models (such as remote advisory) is also likely to put pressure on pricing and fees for traditional service models, which may limit growth. However, wealth management will continue to be an attractive business due to its capital efficiency and growth profile relative to other opportunities, and its increasingly central role in financial advisory as other advisory services such as insurance consolidate. Low interest rates will continue to drive asset owners to look for new sources of yield, and increasing digital adoption is bound to make services more accessible and relevant than ever for mass and mass-affluent clients in many regions.

- **Capital markets, investment banking, and market infrastructure:** The flurry of early-2020 volatility and refinancing that buoyed markets-based businesses at some banks will probably not continue at the same pace. Sales and trading businesses are likely to stabilize at a lower level in the coming years. Origination will lag, with fewer companies issuing debt and equity. Increased M&A activity is likely as the crisis continues, although with valuations low in some sectors and at historical highs in others, there may be fewer motivated buyers and sellers. Market infrastructure—the plumbing of capital markets—is expected to grow as markets overall remain liquid.

It is worth noting that these expectations reflect the average incumbent bank; several banks will outperform. So far through the crisis, some financial-services companies, including large banks, fintech companies, and technology-platform-based financial-services firms have reacted nimbly. They have continued to invest, particularly in digital channels, and remained customer-centric to grow profitably despite difficult conditions.

These projections take into account only the impact of the crisis on revenues and the balance sheet. They don’t account for mitigating actions that most banks’ managements are already taking, especially on cost. Based on what we are able to project, our conclusion is that, in our base-case scenario, the main issue facing the industry will be profitability, not capital-structure resilience.

As we describe next, while the situation will likely become difficult, banks have a full menu of moves that can allay their predicaments and see them safely through the difficult period ahead.
In our base case, most institutions should be able to withstand the recession now gaining force. But no one should confuse survival with success. With capital and revenue greatly diminished, banks could face the risk of a kind of twilight existence. Rebuilding their economics will be a severe test, but the tools are available to make it happen. Those focused on growth should deploy a full range of interventions, including productivity improvements, stronger risk management, and better stewardship of equity capital.

Estimating the work ahead
Banks that reacted to the 2008 crisis quickly and decisively fared much better in the long term than those that did too little or moved too slowly. By and large, many US banks moved quickly and decisively, and many European banks did not. This at least partially explains the difference in performance between the two regions in the past decade.

Thus, a key lesson from that crisis is that banks must move quickly. But where should they direct their energies? And what will it take? Exhibit 12 lays out a sensitivity analysis of the three levers banks can pull: increasing revenues, managing costs, and better managing their equity capital. Getting back to precrisis ROE will require significant but attainable effort.

“Those focused on growth should deploy a full range of interventions, including productivity improvements, stronger risk management, and better stewardship of equity capital.”
Banks can pull three levers to rebuild their economics.

Annual change in individual lever required, holding others consistent with A1 scenario projections, to reach pre-crisis return on equity by 2024, % compared to 2021 trough

<table>
<thead>
<tr>
<th>Region</th>
<th>Revenue</th>
<th>Cost</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>6.1</td>
<td>-4.1</td>
<td>-10.9</td>
</tr>
<tr>
<td>Europe</td>
<td>6.3</td>
<td>-12.4</td>
<td>-10.9</td>
</tr>
<tr>
<td>China</td>
<td>11.3</td>
<td>-11.8</td>
<td>-30.0</td>
</tr>
<tr>
<td>Developed Asia</td>
<td>13.2</td>
<td>-20.9</td>
<td>0</td>
</tr>
<tr>
<td>Latin America</td>
<td>10.0</td>
<td>-3.2</td>
<td>0</td>
</tr>
<tr>
<td>Emerging Asia</td>
<td>6.3</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Middle East and Africa</td>
<td>11.8</td>
<td>0</td>
<td>0</td>
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</tbody>
</table>

Precrisis ROE, 1 %

<table>
<thead>
<tr>
<th>Region</th>
<th>Precrisis ROE</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>11.2</td>
</tr>
<tr>
<td>Europe</td>
<td>6.3</td>
</tr>
<tr>
<td>China</td>
<td>11.4</td>
</tr>
<tr>
<td>Developed Asia</td>
<td>6.1</td>
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<tr>
<td>Latin America</td>
<td>15.9</td>
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<tr>
<td>Emerging Asia</td>
<td>7.3</td>
</tr>
<tr>
<td>Middle East and Africa</td>
<td>11.9</td>
</tr>
</tbody>
</table>

1In 9 regions, precrisis ROEs were below 10%: Europe (6.3%), Developed Asia (6.1%), and Emerging Asia (7.3%). In these regions, we have calculated the change required in revenues, costs, and equity to hit ROEs to 10%.

2Given projected revenue growth in this region, the average bank could in fact increase costs or equity and still return to target ROE.

Source: McKinsey analysis

The level of emphasis on each of these levers will vary by region. Near-term recovery will require even more work in regions such as Europe, which already had fundamental challenges to profitability, depressed margins, and ROEs far below the cost of equity. Banks in developed Asia have already cut costs substantially. For them, the 30 percent cost cut shown in Exhibit 12 may not be realistic; revenue and capital levers are more attractive. European banks have faced a low- or zero-rate environment for years and have made the easiest adjustments. These banks have a steep, slow path to economic recovery and will need the full arsenal of cost and revenue optimizations. The wave of consolidation taking shape in that region indicates that some institutions may not be up to the task.

In Canada and the United States, although the challenge is not as great, regulatory changes and digitization are front-and-center issues; to address them, banks will likely draw on a combination of cost-productivity initiatives and innovative revenue models. Emerging Asian banks face less challenging rate environments and are more focused on disintermediation by technology players. In emerging economies, one of the most formidable challenges will be credit losses. Expanding revenues in a world of zero percent interest rates and technology disintermediation is a broad, strategic, potentially long-term task; we discuss it in Chapter 3. To address costs and capital, banks have at their disposal several tested levers, which can yield significant near-term impact. Approaching these costs in new ways, banks can ensure this impact is not simply "one and done" but continues beyond the crisis. In the short term, we believe every bank should focus on creating what we refer to as a productivity engine, rebuild its risk-management muscle, and improve its capital management.

Build a productivity engine

In recent years, the global industry has made some headway at reducing expenses. The industry's cost-to-income ratio fell from 56.6 percent in 2014 to 54.4 percent in 2019. Every region has made progress. But bank leaders know that more could have been done. Some factor costs have fallen much faster than banks' overall costs: for example, the cost of computing power has decreased by 57 percent since 2014, and the cost of data storage is down 72 percent.

Banks have worked hard at automation to take advantage of these trends but have added complexity in parallel, with the result that the bulk of the cost savings has been eaten away by new functions. They have also, of necessity, added new compliance layers that have increased costs. In the end, cost ratios have fallen but not as much as in less regulated industries that have been completely reshaped by technology and changing customer needs.
In our view, a big part of the problem is that banks conceive of cost savings as one-and-done programs. Instead, they should imagine an ongoing "engine"—a capability and mindset dedicated to continuous improvement—that will see them through the coming years with both greater productivity and better customer experience. The "cylinders" of that engine might be the six parts of the program illustrated in Exhibit 13. We estimate that, at full throttle, such a productivity program can improve efficiency by roughly 20 to 30 percent.

1. Accelerate the shift to digital and reconfigure the branch network. Banks are slowly reopening their branches in markets where the pandemic has eased. Demand has softened in the interim. Over the past year, the use of cash and checks—core transactions for branches—has eased; in most markets, about 20 to 40 percent of consumers report using significantly less cash. In the meantime, customer interest in digital banking has jumped in many markets, although this trend varies widely. In the United States and the United Kingdom, only 10 to 15 percent of consumers are more interested in digital banking than they were before the crisis (and to 10 percent are less interested). In Greece, Indonesia, Mexico, and Singapore, the "more interested" share ranges from 30 to 40 percent. Factors affecting growth in digital banking include the existing digital offerings and capabilities of banks in the market and precrisis levels of digitization.

Trends are going against the branch. But capturing productivity gains is not a matter of bluntly reducing the branch network. Branches still serve a purpose, but customer needs are evolving. In countries where preferences are moving more slowly, banks have an opportunity to shape them. As they reopen their branch network, banks can consider three actions.

Make the new digital behaviors stick. First, consider how to reinforce the new digital behaviors through consumer education about the bank’s attractive value proposition, combined with nudging to make the behaviors easier. Even before the crisis, leading banks in developed markets had achieved 25 percent less branch use per customer. In addition to those who were already digital-only customers previously, another 10 to 15 percent of customers will be unlikely to use a branch after the crisis, further increasing the need for action.

Redesign the bank’s footprint. Banks can also redesign their footprint based on new customer behaviors. Branch networks have expanded and shrunk over the years, but COVID-19 demands that banks move beyond the heuristics that have prompted shifts in recent years. Leading banks are using machine learning to study every node of the network, with particular attention to demographics, ATM proximity, and nearby competitors. One bank developed an algorithm that considered the ways branch customers accessed seven core products. It found that 15 percent of branches could be closed while still maintaining a high bar on serving all customers, retaining 97 percent of network revenue, and raising annual profits $150 million. A/B tests in comparable micromarkets also can help banks make these choices.

Transform contact centers. Banks should also make complementary moves beyond the branch network. During the crisis, contact centers have seen dramatically increased volumes, greater than the increases in digital banking. To respond to these new needs, banks can still make containment rates for interactive voice response (IVR) and chatbots, introducing click-to-call functionality to avoid manual identification and verification steps, and using artificial intelligence (AI) for live coaching of agents and to check script compliance.

2. Systematically deploy the workforce and reskill at scale

In the short term, COVID-19 has changed the workload for specific job families, especially in operational roles, creating much greater demand for a higher-skilled workforce (for example, contact-center agents), and lowering demand for branch bankers and similar process-heavy roles. Chief human resource officers can manage this shift by setting up a reskilling hub that works across business units to act as a single point of talent assessment, retraining, and redeployment. The hub forecasts supply and demand for job families, rebalancing the mismatches banks are now experiencing, and then acts as an academy to reskill and redeploy staff into high-demand areas. This is particularly apt for the big portion (50 to 60 percent) of the talent pool whose work follows standardized, rules-based processes.

Branch banking is a critical focus. Staffing in the retail branch was already a challenge. Now banks need to conceive flexible roles that mix on-site and remote work, such as the customer experience officer. Rules-based workers can be redeployed in different roles, based on assessed skill adjacencies. Branch bankers can perform their traditional teller tasks with some portion of their time. With the remainder, they can get trained on new skills to become contact-center agents. Over time, some people can acquire a full set of skills and become "universal" bankers, able to work well in a variety of roles. Another example addresses the heavy workload of drive-through tellers and contact-center agents, and public cloud. Historically, banks’ chief information officers have kept IT costs flat by achieving modest savings that offset increasing demand.8 Still, today, less than 10 percent of technology spend at an average bank increases value-added business functionality. Now, as some forms of technology demand soar, CIOs will face similarly ballooning costs and decreasing responsiveness, unless they drastically reform the traditional banking IT function. This calls for a radical technology-productivity effort. Leading banks have already shown that this can improve IT productivity by more than 20 percent while also shortening time mindfully about creating real-time data flow across platforms and core banking systems, to speed up critical analytics. They are also devising a strategy to exit or manage legacy core banking systems.

Finally, many top banks are also starting on the journey toward automated infrastructure and public cloud. Some are choosing to shift first to a "cloud-like" operating model for on-prem infrastructure, provisioning their own automated infrastructure and enabling self-service. Many are also considering or shifting to public cloud at scale for major parts of the technology stack, such as digital channels and customer data and analytics, and sometimes using cloud-native applications to let internal customers access the full breadth of services offered.

Although several are already on the technology-transformation journey, many banks have barely left the starting line. In leading banks, as many as

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Many top banks are starting on the journey toward automated infrastructure and public cloud
Many banks see opportunity in permanently adding flexibility to the way people work.

likely than others to emerge with a technology function that is more productive, faster, more responsive, and more resilient.

4. Reset third-party spend through demand re-specification and supplier management

In the crisis, some expense lines have soared, and others have plunged, presenting opportunities to reset the bank’s external spending. Where demand has increased and spurred the onboarding of a flurry of new suppliers (such as telecoms and remote-working tools), banks can establish tiering and rationing policies to ensure the extra spend is justifiable and to seek volume discounts. Where demand has fallen dramatically, as for travel and events, banks can adapt policies to reflect these changing needs.

Leading banks are industrializing this approach by setting up spend control towers to manage demand, “negotiation factory” teams to manage suppliers, and cleansheeting to understand supplier margins. When third-party spending is distributed across the bank, new analytics-based tools can ingest transaction data from banks’ systems and calculate enterprise-wide spending levels that can be benchmarked against peers to suggest the best opportunities. Such analyses often spot contractors whose day rates are out of line with the norm and branches where productivity opportunities: stopping unaffordable services and finding new ways to deliver better-quality support at lower costs.

In HR and finance, many banks are already on a path to achieving up to 30 percent productivity gains through standardizing and centralizing, reducing demand, moving to standard software-as-a-service, and digitizing common requests and reports.

By contrast, control functions like risk and compliance have grown in line with the volume of regulation. Banks that are willing to take a fresh look at these functions find substantial opportunities. For example in anti-money-laundering (AML) processes, the best banks are achieving 15 to 25 percent productivity gains and more effective risk management by creating a simpler, more automated process for low-risk customers, allowing know-your-customer (KYC) information and protocols to be shared across geographic borders, and removing duplication between first- and second-line teams.

6. Find the right hybrid remote/onsite model and shrink the property footprint

With new remote-working models in place, many banks see opportunity in permanently adding flexibility to the way people work. In a recent survey of executives who manage real estate maintenance costs are abnormally high. They can also help identify rogue procurement transactions across different parts of the organization, identifying opportunities to consolidate vendors and costs.

5. Move to minimum viable central functions

Many banks had already started to simplify their support functions (HR, risk, finance, legal, marketing) prior to the crisis. As they consider moving ahead on further cuts, they can reimagine these functions by first designing a no-frills version that fulfills the most basic services and then carefully adding choices to improve service, speed, and quality. The additional functionality can take advantage of automation, digital servicing, and standardization. This approach delivers two

for their companies, about 50 percent of respondents expected at least 25 percent of their workforce to stay permanently remote.

In the short term, the ratio of full-time equivalents (FTEs) per desk will likely fall, as banks seek to maintain social distancing in compliance with local guidelines. When social-distancing measures are eased, retaining a level of remote working could increase a bank’s desk ratio from 1.2 FTEs per desk today to 1.6 or 1.8, freeing up to 20 percent of office capacity and enabling a more flexible lifestyle for a meaningful portion of the employee base that wishes to work from home at least part-time.

Strengthen the risk-management muscle

As credit losses mount, risk teams need to tackle two key challenges: improving customer-assistance effectiveness, especially in serving retail customers and small and medium-size enterprises (SMEs), and addressing portfolio and modeling problems such as sectoral concentration, especially in wholesale.

Customer assistance and mitigating losses

As households fall into delinquency, customer-assistance teams will have more work to do, and they will need to do it diligently and well. In our view, the task has three components.

Reassess portfolio risk of delinquency

Customer-assistance teams will need to reassess the portfolio risk of delinquency by adapting and updating segmentation models to take into account COVID-19 effects—the new variable that should dictate how banks proceed. Customers and areas that have been affected similarly by the pandemic should be identified through new high-frequency data (including public-health data, information on government actions, sector-specific factors such as mobility data, and so on).

Build digital-first customer assistance.

Banks then need to double down on their investment in self-service channels—two-way texting, email, mobile—which will allow for greater self-care for a big portion of customers and will save costs. Leading banks are pioneering an empathetic, frictionless digital service to help customers find the right forbearance program.

Reskill frontline teams.

Digital channels can only do so much; banks need to deploy the necessary capacity in key parts of the credit management cycle. As nonperforming loans rise, banks will need more frontline agents skilled in customer assistance. This will require reskilling the bank’s existing frontline teams.

Portfolio review: Sector concentrations

One key factor affecting ROEs in coming years will be the shape of the lending book. On the wholesale side, exposure to hard-hit sectors in commercial and industrial (C&I) and commercial real estate (CRE) lending poses particular challenges. Those more exposed to higher-risk sectors, such as transportation, energy, and
Banks must also go beyond analyses of sectors and assess individual borrowers.

Manage capital more accurately
Capital management is a challenging discipline: it requires processing millions of data points through a five-part process (business origination, model development, calculation, regulatory response, and capital planning and allocation). Across all of these domains, banks must heed thousands of rules, exceptions, and alternatives. Managing such complexity often means using proxies, finding metrics that better fit with the business context, and giving up on some level of detail in light of time constraints. These small decisions add up and can often put banks in a safe but too conservative capital stance.

Reviewing all the data points, rules, exceptions, and alternatives to calculate the bank’s capital requirements to the last euro or dollar would require considerable time and patience. Our research shows, however, that a subset of these decisions—about 300—can significantly improve the accuracy of capital-requirements calculation; in our experience, the work can save about 2 to 7 percent of risk-weighted assets. These choices offer the most potential with respect to capital accuracy, probability of occurrence, and feasibility of implementation.

In our view, these three steps—productivity improvements, a tuned-up risk muscle, and more accurate capital management—will be important to restoring many banks to their precrisis ROEs in the base-case scenario. For some banks, these measures may not be enough; mergers might be the best way out. Some banks are already pursuing M&A before things get worse. Furthermore, in adverse scenarios, which remain a distinct possibility, almost all banks will need to pursue these same moves more aggressively.

Even as banks work through these short- and midterm considerations, they must also think through the long-term prospects of their core business. For that, most will want to consider the three strategic imperatives we discuss next.

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Our first two chapters focused on the impact of COVID-19 on the global banking industry and how the industry needs to react to survive the crisis. But banks’ operating environment was already changing fast. The pandemic has accelerated six structural trends that will reset operating conditions. Banks must recognize the impact on their customers and businesses, and be prepared to take three actions to mitigate the trends’ downsides and make the most of the upsides. Those that do will not only survive but arrive in style ahead of their rivals.

Six pandemic-accelerated trends
The COVID-19 crisis has accelerated six trends that were already changing the world (Exhibit 14). These trends (and their knock-on effects) are affecting every kind of business, including financial institutions.

“How banks can thrive

“Banks must recognize the impact of six trends on their customers and businesses, and be prepared to take three actions to mitigate the downsides and make the most of the upsides.”
Six trends have upended the banking industry and yesterday’s strategies for success.

**Trends**

1. **Accelerating deglobalization and geopolitical concerns**
   - COVID-19 is a real-economy crisis, with manifold effects. For banks, these include a prolongation of low interest rates, which will accelerate margin compression, and the extent and duration of central-bank support.
   - Deglobalization was already occurring before COVID-19 but is now accelerating, with gaps in global supply and distribution systems.

2. **Radical changes in the macro environment**
   - The crisis has upended traditional ways of working, some of which were already beginning to evolve: working from home, dependence on digital tools, distributed teams, changes in workflow and behavior.

3. **Upheaval in the ways we work**
   - Digital natives’ ability to embed financial services in their platforms has accelerated the drift of customers from their banks. When banks no longer know their customer better than others, they can lose volumes and their feel for customer needs.

4. **Growing challenges from tech players and embedded finance**
   - Customers expect a better, more predictive, and seamless experience than ever before—and better advice—across every channel.

5. **Transformed customer expectations**
   - Interdependence of nations is now more apparent. Climate and sustainability, responsible capitalism, and economic inequality are playing a larger role in conversations among nations and companies.

6. **Increasing urgency of social and environmental sustainability**
   - We are seeing more trade disputes and broader geopolitical uncertainty. Already-tense relations between some large countries have grown more precarious. McKinsey Global Institute recently estimated that as a result, 16 to 26 percent of global supply and distribution patterns, possibly for a long time.

7. **Growing challenges from tech players and embedded finance**
   - Fintechs, small digital banks, and other tech-based competitors have been part of the financial-services ecosystem for several years. Banks have partnered and absorbed many of the most complementary new ideas along some emerging markets seem less affected by this trend.

8. **Upheaval in the ways we work**
   - The crisis has upended traditional ways of working, some of which were already beginning to evolve. Before the pandemic, most banks were barely experimenting with distributed teams, remote work, digital tools, and agile processes. In the months since, these changes in workflow and behavior have taken root, shaping a broad, wholesale change in ways of working. At the time of writing, the majority of bank employees are still working from home. Many banks are setting up new operating models in which a large proportion of their employees will have a permanent option to work from home several days a week. For those still required to perform work in person, work has been transformed to accommodate lower staffing levels and reduced contact with customers.

9. **Growing challenges from tech players and embedded finance**
   - Fintechs, small digital banks, and other tech-based competitors have been part of the financial-services ecosystem for several years. Banks have partnered and absorbed many of the most complementary new ideas along the way. Now the long-anticipated threat from platform companies is accelerating. Look no further than the widespread use of WeChat Pay and Alipay. In other regions, Apple Pay’s growth is accelerating. In commercial lending, fintechs such as Fundbox are embedding lending into major software platforms, while others such as Stripe are creating platforms to simplify access to payments and financial services. As customer trust in platform companies increases, banks are at risk of losing the primary customer relationship—and of becoming providers of commodity products.

10. **Transformed customer expectations**
    - Expectations were on the rise before COVID-19, but this pandemic has ratcheted them to new levels. Many retail and commercial customers will suffer vastly from the pandemic and will expect their financial-services providers to offer loan support or relief. Customers also are increasingly expecting banks to anticipate not only what products and services they need, but also how and when they need them. In particular, many expect to be able to do everything digitally and remotely.

11. **Increasing urgency of social and environmental sustainability**
    - Expectations were on the rise before the pandemic, as the world started to grapple with economic inequality and climate change. The pandemic threatens to wrench income and wealth gaps even wider, as most knowledge workers have kept their jobs and millions of others have become victims of a pandemic that has brought entire industries to a standstill. Carbon emissions have decreased in many regions during the outbreak, but that won’t last, and climate risks will return with a vengeance. In Ho Chi Minh City, direct infrastructure damage from a 100-year flood could more than double from a range of about $200 million to $300 million today to $500 million to $1 billion by 2050, while knock-on costs could soar from a range of $100 million to $400 million to between $1.5 billion and $8.5 billion. In addition, as the US population recognizes the extent and significance of continued racial injustice, this greater consciousness is also spreading to other countries with similar challenges. The world now demands responsible capitalism, not least from the banking industry, which cannot afford to stay on the sidelines.

12. **Growing challenges from tech players and embedded finance**

Embed new found speed and agility

Nine months in, the COVID-19 crisis has changed the way work gets done. Business cycles have shortened from quarters to mere weeks. Banks and other companies have shifted millions of decisions out of stable, long-running processes to group videoconferences for instant resolution. Banks have conjured up new products and new services in a weekend, motivated not only by the instinct for survival, but also by a desire to ensure the right support for customers in a time of dire need.

In this way, the pandemic has given banks a glimpse of the potential for a different way of operating. It’s not dissimilar to the first sub-four-minute mile: running so fast seemed impossible until Roger Bannister achieved it in a 1954 race, but that record was matched within weeks. Likewise, banks’ achievements to date have been made by adrenaline and force of will—and much more is now possible. Banks need to shift to a more sustainable speed by design, with customer-centricity at its core. They can keep the helpful aspects of their new ways of working and embed them in the corporate culture while mitigating the less productive effects of working from home and other new behaviors. Time is of the essence, before people revert to old and still-comfortable behaviors.

To embed the best of the new ways of working and banish the worst, banks can pursue four actions:

- institutionalize the new decision-making patterns
- focus on the customer
- embed the new rules of thumb for data
- reimagine work for agile, remote teams

For more information, see “Embed the speed and agility banks have summoned in the crisis” — fundamentally reinventing the business model — bringing environmental, social, and governance (ESG) considerations to the fore, along with a better sense of corporate purpose

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Institutionalize the new decision-making patterns
Banks have discovered that they can manage well with fewer deciders and more doers. Top teams have focused on essential decisions and delegated the rest. To keep making choices at the same speed, banks can do a few things. Clarifying single-point accountability for key decisions and showing support for those accountable is paramount. Top teams need to make sure that they are retaining the most important choices and delegating the others to the appropriate person lower down in the organization. Accountable parties should have the authority to make decisions without several committee meetings or escalation and without the need for analysis until paralysis. And they should expect that executives will have their back if others disagree. This requires creating the right leadership-development model, ensuring that the right leaders are given the most critical roles at all layers of the organization, and apprenticing leaders to be accountable for making timely, tough decisions.

Meanwhile, the executive team can model these behaviors and focus on the decisions that have potential to reshape the organization. These choices need an executive sponsor to frame the problem, an understanding of their interdependencies, quality debate that moves quickly to solutions, and comfort with imperfect data and “good enough” solutions. To be sure, in this highly regulated industry, more decisions might naturally fall to the top of the house than in other companies. Top teams will need to strike the right balance between decision making and delegation.

The executive team of a midsize European bank took these steps and a few others. They “declared war” on meetings and reports by establishing new norms (no entourage, clearer agendas, short preview memos outlining decision options), moved standing committees to more frequent and shorter interactions, and simplified cross-cutting decision making by reducing process steps and clarifying responsibilities. The team is tracking its effectiveness with a pulse survey, whose results have ticked noticeably higher, with overwhelmingly positive comments from executives.

Focus on the customer
Of the difficult, rapid decisions that banks have made this year, many addressed critical, emerging customer needs. Whether to ramp up safe digital banking capabilities, institute forbearance programs for customers who could not pay, or launch new government-backed small-business loan products, banks suddenly reshaped their priorities to center on their customers. As a result, months into the crisis, over 70 percent of customers in nearly every country reported that their bank was meeting their expectations.


Banks can entrench this new customer focus by ensuring that they have the capabilities to generate continuous customer insights and make them accessible to business leaders across the enterprise. Leaders should also continue to model customer centricty by asking a consistent series of questions about customers’ feedback and needs in every product-focused meeting. They should spend regular time with customers and should require an understanding of customer benefits for any new initiative proposed. As they emerge out of crisis mode, leading customer-centric banks can take a look back at their performance and do a critical diagnostic of the customer experience they provided, which will likely reveal some important points of failure.
Banks may soon face critical decisions such as how to respond to an acquirer’s overtures or how to treat a client’s bankruptcy.

Embed the new rules of thumb for data
One likely failure point involves data: in the crisis, a lot of banks’ data have proved not just imperfect but nearly useless. That’s how much consumer and corporate behaviors have changed. Banks need to distill what they’ve learned about data and apply it broadly.

The need for immediate data and speedy analytics capabilities to apply to them has rarely been so acute. (Scenario planning is a particularly acute need; see sidebar, “Scenario planning for an unruly world.”) Rapid decisions have become almost routine in 2020: how to manage through government health mandates, whether to extend or sectoral disparities. Successful analytical approaches add overlays of human judgment and corporate behaviors have changed. Banks need to distill what they’ve learned about data and apply it broadly.

The need for immediate data and speedy analytics capabilities to apply to them has rarely been so acute. (Scenario planning is a particularly acute need; see sidebar, “Scenario planning for an unruly world.”) Rapid decisions have become almost routine in 2020: how to manage through government health mandates, whether to extend

Reinvent the business model
Two factors are pushing banks to question the foundations of their business models. The first, present before the crisis but now more acute, is the expectation of low or negative interest rates for years to come. With such historical dependence on interest income, how will banks make ends meet? They might begin by thinking big about what business they are in and what business they want to be in. Many might conclude that they want to shift away from business models built on risk intermediation and toward models built on intermediation of services. Investors have recognized the importance of this. Over the past few years, financial-services business models that rely on fees, such as payment networks, have seen their valuations rise steadily faster than risk-intermediation businesses like traditional banks. For the first time, in 2020, the total market capitalization of the largest three payments companies globally surpassed that of the three largest banks.

A second critical factor is the challenge from fintechs and technology platforms that are encroaching on key banking businesses. These challengers do not rely on interest income to succeed in financial services; instead, many do not rely on financial-services products at all. Smaller fintechs often thrive on origination fees or debit interchange, leaving interest-rate risk to

Scenario planning for an unruly world
COVID-19 has shown that disruptions can happen at any time and even the best-prepared institutions are unable to predict them. Preparation does, however, yield greater resilience. For example, the experience of SARS in 2002 caused many Asian countries to invest differently in their public-health systems. These countries mitigated the public-health consequences of COVID-19 much more effectively than Western countries and restored their economies faster.

Banks can do something similar. The novel coronavirus was not a so-called black-swan event. A viral pandemic is a quantifiable risk event at any time and could even be considered likely within a period of several decades. Many epidemiologists and others had noted the possibility. Similarly, there are gray-swan events (known and unlikely possibilities) that banks should begin anticipating, many of which are linked to the pandemic.10 One such event could be another lurch downward in sectors that have already been hard-hit, such as air travel. Another might be rising geopolitical tensions leading to a cataclysmic event.

Geopolitical risks leading to protectionist or isolationist policies were building before COVID-19. The pandemic may accelerate the trend, and as global trade and financial flows taper off, global supply chains and payments infrastructure could break down. Another gray swan might be a significant cyberattack. The pandemic has pushed vastly more business activity online and greatly expanded the potential for a broad-based cyberattack, potentially affecting billions of bank accounts worldwide. Such an event could cause grievous losses and erode public trust in financial institutions.

Perhaps the most likely gray swan is a tech company’s successful launch of a scalable bank offering with a cost base dramatically lower than the current industry average. As we mentioned earlier, disintermediation by tech players is an accelerating trend that banks should be prepared to face. Gray swans intensify the need for constant surveillance. Scenario planning is not a one-off activity. The events of the past decade, culminating in COVID-19, demonstrate that the future often arrives sooner than expected. Banks need to develop a set of scenarios for the resolution of the pandemic, with more than the usual single scenario in the middle of the distribution. Further, they should not be bashful about tweaking these scenarios as events unfold. No planning team is going to get everything exactly right on paper. Adroit scenarists refine their outlooks continually to reflect reality.

In practice, this means developing scenario sets that account for developments along multiple dimensions and then planning steps to take in various cases that combine these outcomes. For example, one dimension might be COVID-19 vaccine effectiveness and the time line to herd immunity; another might be the level of trade tensions; a third might be the extent of supply-chain disruptions. The benefit of such multidimensional scenarios isn’t necessarily the correctness of any one of them; it’s the resulting clarity on what would trigger action on each dimension and what that action would be.

their partner banks. Larger platforms monetize customer data and engagement from financial services to fuel their other businesses. As a result, they are focused on offering customers a seamless customer experience along an end-to-end journey, innovative products, and attractive rates that will drive engagement.

These forces are putting three actions on banks’ agendas:

- Plan to operate in a prolonged low-rate environment
- Create new fee-based income streams
- Adopt the challenger playbook

**Plan to operate in a prolonged low-rate environment**

If there was any lingering doubt, the COVID-19 crisis has made clear that zero or negative interest rates are here to stay. In many parts of the world, central banks are likely to maintain low rates for years to come, further damaging banks’ primary business of earning net interest income. It is a major issue in Europe; in October, the Bank of England indicated as much by requesting details on how well banks’ current business models will operate under zero or negative rates. It’s also a real pressure point in the United States. For much of Asia, where rates remain higher, it’s less of a problem, with the notable exception of Japan, where rates have been low or near zero for decades.

To be sure, low rates have one direct positive effect for banks: they increase customers’ ability to repay and can reduce nonperforming loans. Another, less direct benefit also has helped banks: lower borrowing costs for governments have made possible some huge public-support programs. In many countries, amid the many competing needs, such programs have been feasible only because of these lower costs.

But in the long run, zero and negative rates can have a devastating impact on bank economics. That impact is not immediate; it starts to bite as deposit balances, referenced to central-bank rates as appropriate for the client segment and purpose of deposits. And they might stimulate a shift of unstable deposits with a zero interest-rate floor into alternative investment products, such as deposit platforms, sweep accounts, fund solutions, cash exchange-traded funds, and insurance-based savings plans.

Bank treasurers and asset-liability management (ALM) teams play central roles in shoring up those parts of the balance sheet and the businesses that depend on net interest margin. Three moves are vital:

- **Identify and understand all relevant risks.** Treasurers and ALMs can make technical corrections such as choosing a sufficiently long horizon to capture the impact of negative rates on net-interest margins and the balance sheet. They might also identify the risk inherent in customer behaviors, such as prepayment risk in loans and attrition risk in deposits.

- **Optimize risk/return of funding and liquidity.** Banks need an effective governance model and a clear risk appetite framework for funding and liquidity that will allow the treasurer and risk managers to manage transparent, informed, and effective proposals, including hedges where necessary. For example, they might look for the effect of customer behavior on nonmaturing deposit balances, as those feed into interest-rate risk models and hedging strategies. They might need to revisit assumptions on the size, composition, and funding tenor of the liquidity buffer. And they should think about how to use liquidity in foreign subsidiaries or branches, which can become trapped on local balance sheets because of legal or regulatory requirements.

- **Rewire the commercial approach.** Treasurers and ALMs need a funds-transfer pricing mechanism and limit system that provides business lines with incentives to generate interest-bearing assets, bring down funding costs, increase the stability of deposits, and minimize liquidity-buffer requirements. One idea in this area would be for treasurers and ALMs to provide incentives to underwrite noninterest-bearing currencies with positive interest rates while maintaining consistent risk collateralization to manage implied risk-weighted assets (RWAs).

The exact shape of the yield curve will also play a role.

**Create new, customer-centric fee-based income streams**

With interest income on the wane, banks need to develop new fee-based businesses to counter the loss of interest income. Despite some growth in noninterest income over the last decade, particularly in China, interest income still makes up 50 to 75 percent of total income, depending on region (Exhibit 15).

Existing fee pools aren’t sufficient; banks will need to extend their scope to service-related income and new products that move away from the dependence on interest. Leading banks are turbocharging longstanding efforts to offer or expand services that are paid in fees rather than net interest margin. To get started, a bank can focus on an industry vertical or a customer segment where it already has a foothold and develop new services that extend the relationship.

Similarly, commercial banks that are seeing interest income streams dry up must look for adjacent products to build and offer—for example, products tailored for an industry vertical that provide clients more value-added services.

Rather than thinking about how to serve clients at the lowest rate, banks can aim instead to help them at their economic leverage points to enable their core business. These leverage points are not always financial; some are operational or administrative. Banks need to widen the aperture and consider other services and coordination that would ease them, sometimes even partnering with others to form an ecosystem.

**A test of resilience: Banking through the crisis, and beyond**

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**Note:**

A test of resilience: Banking through the crisis, and beyond

50–75%
growth in noninterest income over the last decade, particularly in China

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**Exhibit 15:**

<table>
<thead>
<tr>
<th>Country</th>
<th>Noninterest Income Growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>50-75%</td>
</tr>
<tr>
<td>Japan</td>
<td>25-50%</td>
</tr>
<tr>
<td>United States</td>
<td>10-20%</td>
</tr>
</tbody>
</table>

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**Note:**

A test of resilience: Banking through the crisis, and beyond
Noninterest income lags interest income in almost every part of the world.

Exhibit 15
Noninterest vs interest income by country, 2006–20¹,

<table>
<thead>
<tr>
<th>Country</th>
<th>Noninterest Income</th>
<th>Interest Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>![Chart]</td>
<td>![Chart]</td>
</tr>
<tr>
<td>North America</td>
<td>![Chart]</td>
<td>![Chart]</td>
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<tr>
<td>Europe</td>
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<td>![Chart]</td>
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<tr>
<td>China</td>
<td>![Chart]</td>
<td>![Chart]</td>
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<tr>
<td>Emerging Asia</td>
<td>![Chart]</td>
<td>![Chart]</td>
</tr>
<tr>
<td>Developed Asia</td>
<td>![Chart]</td>
<td>![Chart]</td>
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<tr>
<td>Latin America</td>
<td>![Chart]</td>
<td>![Chart]</td>
</tr>
<tr>
<td>Middle East and Africa</td>
<td>![Chart]</td>
<td>![Chart]</td>
</tr>
</tbody>
</table>

¹Nominal data represent the top ~700 global banks by market cap. Source: Capital IQ

Adopt the challenger playbook
Adapting to a low-rate world is not the only strategic challenge banks are facing. As the threat of disintermediation by technology platforms becomes more real and customer expectations for a seamless digital experience rise, banks cannot afford to stand still when it comes to digital and analytics, despite all the progress they have made to date. Leading banks will continue to innovate and leverage the playbooks of their attackers.

In the past decade, some banks have dramatically optimized both revenue and cost for a small part of their business by creating a separate digital-only bank within the bank, essentially building the bank’s own disrupter. The digital-only bank can operate at very low cost, up to 90 percent lower in steady state compared with traditional operations. Creating such a separate entity often allows it to be launched faster, with fewer constraints related to legacy technology, and it allows banks to test concepts at lower risk before attempting to transform their entire business. Over time, the bank can move parts of the legacy business to the new system. State Bank of India’s YONO is one example; within 24 months, it has acquired more than 26 million customers and created significant value for the bank, achieving break-even profitability within 18 months. Goldman’s Marcus has enjoyed similar success in the United States. These are strategies centered on customer segments that can easily transition to digital-only sales and service. The dramatically lower cost to serve and acquire customers delivers the added advantage that these banks can expand the potential customer base to mass-affluent customers who are otherwise underserved by incumbents.

Other ideas from the challenger playbook are appealing. As fintechs have done, banks can partner with and embed themselves in the platforms and ecosystems challenging them, thereby gaining the benefits of the platforms’ and ecosystems’ seamless digital experiences, broad customer base, and access to contextual data. For example, fintechs have reduced acquisition costs for SME and commercial loans by embedding lead generation into software flows. Some fintechs, such as Tradeshift and Fundbox, embed invoice factoring into accounting and enterprise-resource-planning (ERP) software. They allow customers to click a button to finance an invoice based on the creditworthiness of both the payer and payee, to receive the cash earlier than net terms might allow.

Payments-technology companies also have integrated lending products and are exploiting data in ways that banks have yet to pursue. PayPal Working Capital and similar products allow small businesses to borrow short-term cash, based on cash-flow data from their core payments-acceptance products. Both the application and the repayment are embedded in PayPal’s account flow. On the consumer side, alternative lenders such as Afterpay, Klarna, and PayPal Credit are increasingly embedding themselves in online-checkout flows to provide credit at the point of sale, in many cases displacing credit cards. On the corporate side, Adyen, a payments company, has developed the ability to serve its customers in a modular fashion to better embed itself. In marketplaces, it can use its data and analytics assets to provide merchants with know-your-business (KYB) services to help them onboard customers to the platform.

Banks do not have to sit on the sidelines: they can also pursue partnerships to embed their own products in these flows. For example, banks could partner with platform companies to provide lending services; underwriting can be made more predictive by the platform company’s unique customer data.

Bring ESG and purpose to the fore
Shifts in values take a long time to develop and then seem to leap all at once from the back pages to the headlines. Environmental, social, and governance issues and the larger question of purpose are at that inflection point. Recent years have supplied plenty of impetus, as extreme weather events multiplied, income inequality widened, the #MeToo movement took hold, and demands for racial justice burst into the open. Broad sections of society are embracing lives more focused on ESG impact; people are increasingly...
Banks will feel the impact of climate change.

From environmental issues, in particular, becomes increasingly apparent, markets will begin to reflect these expectations. Even if the impact is delayed by a decade, pricing and valuation impacts could be immediate; for example, a property located in a likely future flood zone could start being devalued well in advance of the flooding actually begins. The result will be a much more forceful push for banks to act boldly. The final factor is that many governments have indicated they will expect banks to address perceived ESG problems actively.

Banks are responding, of course, but not all at the same pace. Some are ESG leaders, making these issues a core part of their strategy. Banks in this category are creating standards, embedding ESG standards into internal processes, and influencing the threats from a changing climate are urgent. Climate finance is one new business of providing capital to companies to either strengthen their resilience to long-term climate hazards or decarbonize their activities. Banks’ role in climate finance is crucial—it is the logical outcome of their commitments to the Paris climate accord, and it fulfills a critical part of their contract with society.

Building a climate-finance business requires four steps:

1. Think beyond first-level impact. Banks need to consider the whole ecosystem in which they interact, including measuring and accounting for the climate impact of their clients, as their actions can and should help clients on their journey to reduce impact.

2. Shift lending from brown to green. Banks will need to understand the effects of the energy transition in each sector that they serve. This includes emerging technologies that can help incumbent companies decarbonize their activities and competing propositions that could replace legacy approaches, potentially dealing a blow to banks’ borrowers. Banks then need to map these technologies to the products they can provide: equity and debt offerings, trading, supply-chain finance, and others. For example, consider “green” hydrogen, which can be used as a fuel cell by truckers and as a feedstock for steelmakers. Banks have many opportunities to serve those involved with this technology. They can get involved at the first stage of the emerging business system by financing the development of new plants through new debt or equity. Banks could collateralize the loans in any number of ways—through a claim against the asset, participation in an off-take agreement, credit insurance, a pledge of other assets, and so on. More opportunities await. Banks could provide working-capital financing and offer bespoke hydrogen futures to help the client hedge. They also could create a trade-finance product for customers of the plant, to help their purchases.

3. Tweak the operating model. Banks need to build some new capabilities to ensure that expertise in this space is scalable and accessible. Increasingly, leading banks have a climate or sustainability center of excellence (COE), with concentrated expertise and resources across risk and ESG. This COE often can partner with external entities and manage external ESG rating agencies. Most banks also need to put in place a control infrastructure to manage climate risk, including gathering new types of data (e.g., carbon intensity) and methods to assess them. This will also require capabilities in developing or analyzing various climate scenarios and their impact on customer behavior and client economics.

4. Measure and correct. Banks should develop an agreed-upon methodology, regularly evaluate the carbon intensity of their portfolio, and track alignment to goals (e.g., Paris commitment). Banks can be a fast follower in many areas, but ESG is not one of them. It is a societal force that compels banks to get ahead of the curve. For banks that can, it will offer a substantial competitive advantage and a source of new business or defense of an existing one.

Act from a clear purpose.

Beyond climate-transition finance, the ways in which banks can address ESG challenges are many and growing. In the midst of a global pandemic and economic crisis, banks also have a tremendous role to play in the recovery. Contrary to 12 years ago, today’s crisis is not the product of the financial system itself. Like many sectors of the economy, banking and its returns and capital positions are and will continue to be negatively affected by this crisis for some time. But unlike many other sectors, banking is also in a position to help bolster the economy, protect lives and livelihoods, and support communities congressional refusal to act is real and should not be discounted. On current trends, banks will be forced to move much more quickly. More recent studies have established that a strong ESG proposition correlates with higher equity returns. ESG leaders are doing more than responding to the pressures: they are building solid business cases that support the new behaviors. Following is one way that banks can pull it all together, on behalf of their institutional purpose, their clients, their communities, and their bottom line.

An ESG business in focus: Climate finance

A bank’s purpose should guide its most critical choices, including what role it plays in the pandemic recovery, how it approaches ESG issues, and how it supports customers.

Business. It should be a constant reference when making trade-offs in the strategy. To create accountability and drive progress against this purpose, banks should develop a clear set of performance indicators to measure, and they should tie purpose-led actions to incentives across leadership and executive roles.

Banks that do this well will redefine their business portfolio in line with purpose, including trade-offs and priorities in capital investments. These banks might also review the set of products and services they offer customers, analyze data on the impact these offerings have had on customers and society, and make hard decisions where facts indicate that impact is not in line with their purpose—for example, if some products have impaired the financial health of the customers using them.

Banks can also align recruiting, people development, career pathways, and "ways of working" with corporate purpose. For example, a financial-services company that defines its purpose around the ideas of ensuring financial-services accessibility and financial health made choices in line with this purpose when it came to compensation, benefits, and career-path design for its employees at every echelon of the organization.

Banks, like other sectors of the economy, may face a cold winter ahead, but there is the promise of a thaw. The moment is right for banks to affirm their dual role as sources of stability against the pandemic’s upheaval and as beacons to the societies and communities they serve in a post-COVID-19 world. They must act because they have a crucial role to play in the work to restore and sustain livelihoods in their communities.
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