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Financial Services Practice

The Road Back

McKinsey Global Banking Annual Review 2014

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The Road Back

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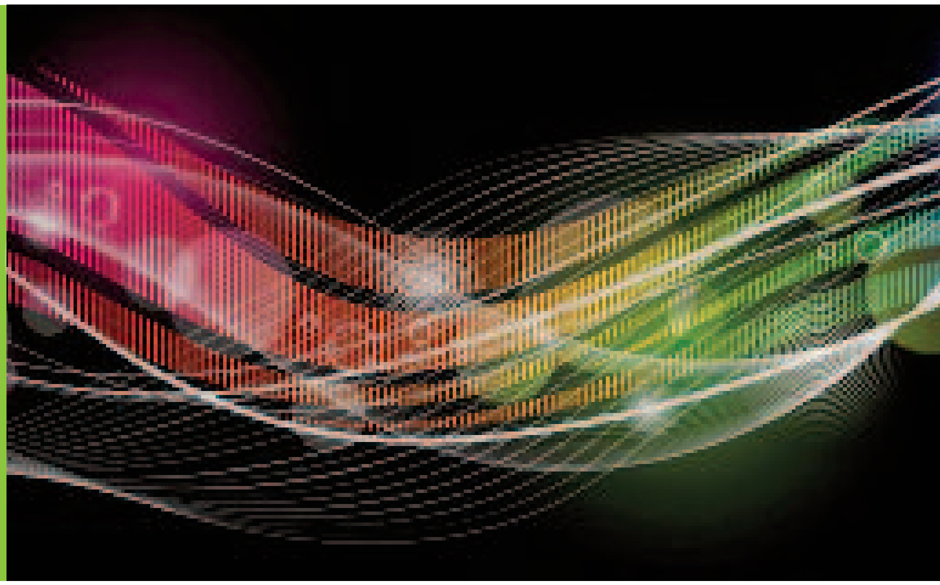


Executive Summary

The global banking industry continues on the road back from the trauma of the financial crisis. In the year just past, economic performance was strong in many parts of the globe. But banking's long-term health is by no means assured. As we suggested in 2012, banks have longstanding issues in relation to culture, compliance, and business-model transformation. Those concerns have become acute as two dynamics—regulatory reform and digitization—accelerated markedly over the past year. To get out in front of these issues, banks must promote four steps to the top of their management agenda. The payoff is worth the effort: our research confirms that those banks that have articulated and executed a regulation-savvy, customer-centric strategy are collecting all the surplus value in the industry.

This report presents our latest research on banking's recent performance and the trends affecting the industry, and ideas about how banks can respond. Our research covering the 500 largest banks in the world revealed five important findings:

- *The industry's return on equity improved again,* to 9.5 percent in 2013 and 9.9 percent in the first half of 2014, nearly regaining the long-term average of 10 percent and close to its long-term cost of equity of 11 to 12 percent. Investors raised their opinion of banks in developed markets, awarding them higher multiples. For the first time in a long while, industry tailwinds and headwinds seem more evenly matched.

Performance remains highly variable among markets. North American banks are leading the way at this stage of the recovery.

- *Performance remains highly variable among markets*. North American banks are leading the way at this stage of the recovery, with an ROE of 9.9 percent in 1H 2014 and the possibility of record yearly profits. In China and many emerging markets, performance has slowed but still remains vigorous. But Western European banks remain mired in a weak economy; their ROE in 2013 was only 2 percent.

- *Regulatory pressure has intensified, and is here to stay.* The growing regulatory agenda in major markets is balkanizing the global banking market, and challenging the strategies and control approaches of most banks, especially those with cross-border businesses. Banks shouldered more than $165 billion in fines and settlements from 2010 to June 2014–including $59 billion in the first half of 2014 alone. That is significant, in a year in which total profits of the 500 largest banks worldwide are likely to be about $650 billion.

- *The digitization of banking* (indeed, most industries) *has accelerated recently.* Banks' bread-and-butter customers (the middle-aged and middle-income) are on the cusp of broad-based uptake of digital services. That makes banks increasingly vulnerable to digitally oriented competitors—a group that includes over 12,000 start-ups, by our count, and is growing quickly.

- *Strategy matters.* Eighty-two percent of industry value lies in its equity capital. The remaining 18 percent (or $1.23 trillion) is attributable to investors' expectations of future value creation. All of that forward value is currently held by the 90 banks that have articulated and executed one of five customer-centric strategies.

▪ ▪ ▪

This year's edition of our annual report is structured in three sections. In the first, we review the performance of the global industry and six major regions in 2013 and the first half of 2014. In the second, we lay out how regulatory pressure and digitization have reached a new pitch. In the third chapter, we present four actions that banks should consider in response to these twin pressures:

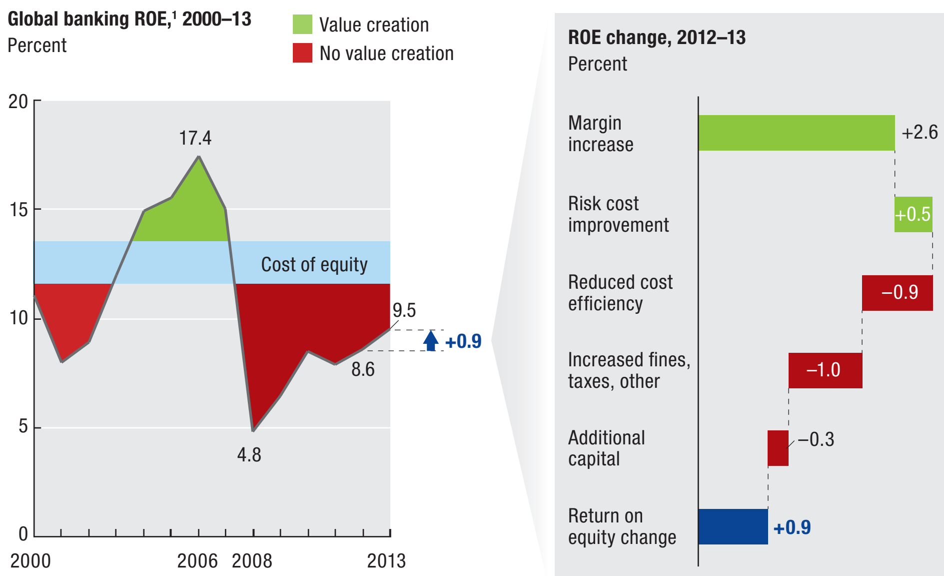
- Improve the mechanisms that govern conduct and control, especially the three lines of defense: the risk owner, an independent control function and internal audit.
- Remake the culture, by using rigorous management practices such as a "cultural scorecard" to develop goals and monitor progress.
- Reassess the portfolio of businesses, optimizing for the most profitable mix of businesses, geographies, and legal structures.
- Decide on their digital posture and priorities: either digitize the existing offer and processes, differentiate through digital, or innovate the business model.

The State of the Industry

In 2013 and the first half of 2014, banks globally continued their recovery from the financial crisis. The industry has nearly returned to its long-term average performance. Within this global average, there are some interesting contrasts. Retail banking is doing better than wholesale. Developed markets, especially the United States and Canada, are performing better than in past years. Performance in some key emerging markets is slipping, however, and their continued strong performance is no longer seen as certain. As a result, investors' expectations for value creation in developed and emerging markets are converging.

Exhibit 1

Global return on equity is improving, but remains below the cost of equity

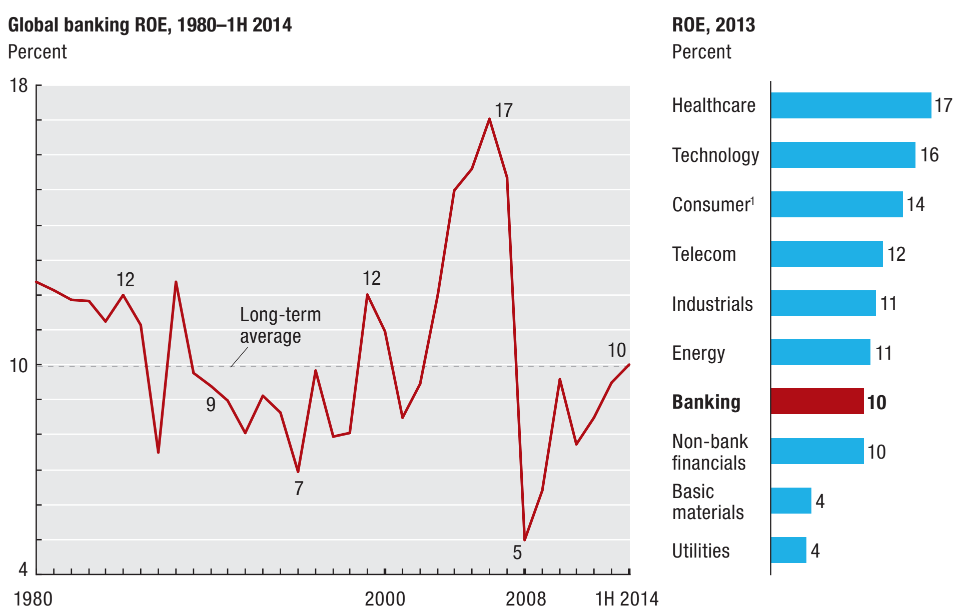


[1] Based on a sample of listed banks with >$10 billion in assets

Source: Thomson Reuters; McKinsey Panorama—Global Banking Pools

Exhibit 2

Global banking's return on equity has returned to its long-term average



[1] Cyclicals and non-cyclicals

Source: Bloomberg; Compustat; Datastream; OECD; Reuters; McKinsey Panorama—Global Banking Pools

Exhibit 3

Deposit taking in China and mortgages in the U.S. grew the most between 2011 and 2013

Global banking revenue growth, 2011–13
$ billion

CAGR, 2011–13
>8% | 3%–8% | <3%

		Retail: $107 billion				Wholesale: $85 billion		
	Total	Consumer finance	Mortgage	Retail deposits	Retail wealth	CMIB[1]	Corporate deposits	Corporate lending
North America	128	5	88	2	5	3	10	15
Western Europe	–74	21	24	–86	–2	1	–45	12
Other developed	–36	–6	–5	–12	–1	–1	–4	–7
China	168	2	–6	80	4	3	112	–27
Emerging Asia[2]	2	3	1	–1	–1	2	–2	1
Latin America[2]	–28	–28	4	1	~0	1	–5	~0
Other emerging	32	8	1	8	~0	2	7	6
Global	192	5	107	–9	4	11	74	~0

[1] Capital markets and investment banking, and security services
[2] Total figure may not match with the sum of sub-products because of rounding
Source: McKinsey Panorama—Global Banking Pools

Industry performance

By most measures, the global banking industry's[1] performance improved in 2013. Return on equity (ROE)[2] rose to 9.5 percent in 2013 from 8.6 percent in 2012 (Exhibit 1). That is a significant positive step, but ROE remains below the cost of equity (COE), which many analysts estimate at around 11 to 12 percent. The global industry is not yet creating value.

This modest underperformance is typical of this fragmented and competitive industry. For much of its modern history, banking has only just returned its cost of equity and for long stretches has not even done that.[3] We analyzed banks' returns globally from 1980 to 2014 and found that, until very recently, returns have been mostly in a band around the long-term average of 10 percent (Exhibit 2). (We also analyzed returns of U.S. and European banks from 1962 to 1980, and came to the same conclusion.) It was not until the early 2000s that returns appeared to move decisively above the cost of equity —only to fall hard after the global financial crisis.

Inside the numbers

If we break down the global averages, we see some critical distinctions. Performance in retail and wholesale divisions varied in 2013; retail revenues grew by $107 billion from 2011 and wholesale by $85 billion (Exhibit 3). Mortgage revenues[4]

[1] In this report, "the banking industry" includes deposit-taking and lending institutions and other banks whose business is concentrated in investment management, servicing, and processing. It does not include pure asset or wealth managers, or insurance companies. Unless otherwise specified, our analysis focuses on the approximately 500 banks with more than $10 billion in assets.

[2] In this report, price/book ratio and ROE do not include intangible assets, unless otherwise specified. See the appendix for definition of terms and more on the databases used in this report.

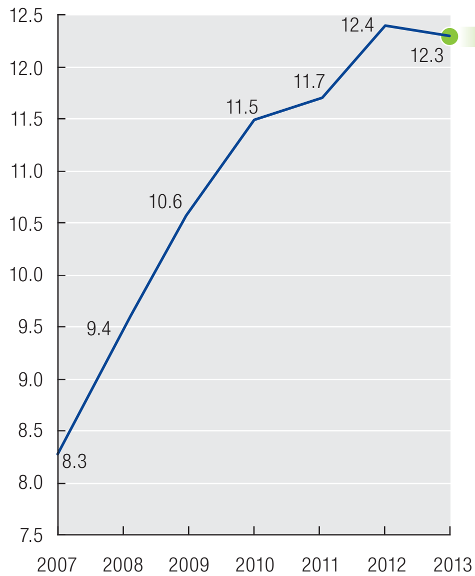
[3] Analysts estimate banks' COE in various ways; the consensus of their estimates is about 11 or 12 percent, depending on the region. In developed markets, consensus estimates are closer to 10 percent; in emerging markets, closer to 12 percent, or more. Global COE has risen over time as emerging markets have assumed greater weight in global averages.

[4] All revenue figures in this chapter are after loan-loss provisions, unless otherwise specified.

Exhibit 4

In 2013, for the first time since the financial crisis, global Tier 1 capital ratio declined

Tier 1 ratio[1]
Percent



	2007		2012		2013
Developed world					
North America	8.2%	▲	13.3%	▼	12.8%
Western Europe	7.9%	▲	13.1%	▲	13.5%
Other developed	7.7%	▲	11.7%	▼	11.3%
Emerging markets					
China	10.2%	►	10.2%	▼	10.0%
Emerging Asia	9.5%	▲	10.8%	▲	11.0%
Eastern Europe	12.7%	►	12.7%	▼	11.8%
Other emerging	13.7%	▼	13.4%	▼	13.2%

[1] Based on a sample of listed banks with >$10 billion in assets
Source: SNL; Thomson Reuters; McKinsey Panorama—Global Banking Pools

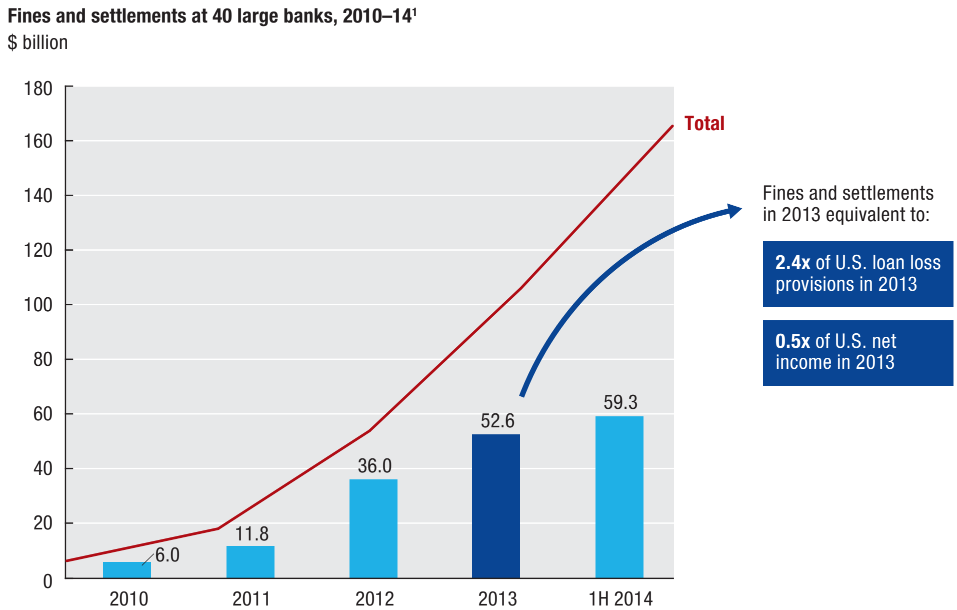
accounted for the entire gain in retail; other products were up or down only slightly. Deposit revenues were down $9 billion; low interest rates meant slimmer margins in the developed world. Deposit volumes in emerging markets grew (especially in China—$80 billion), but margins declined there too.

Corporate and investment banking (CIB) is challenged. In corporate, deposits saw the largest revenue increase, up $74 billion from 2011 to 2013. This was mainly driven by China (the world's largest corporate banking pool), which offset slow growth elsewhere. Within capital markets businesses, regulatory reform has left some businesses profitable, such as foreign exchange and prime services, but has raised the costs of many more, such as commodities and structured credit.

If we look at balance sheets, we see that banks have recapitalized, cleaned up most of their toxic assets, and deleveraged. For example, more than $500 billion of Tier-1 capital has been added to the U.S. banking system in four years by the banks that participated in the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) program. Most banks have now completed their balance-sheet repairs and reached their target capital ratios. For the first time in years, the industry did not increase its Tier-1 ratio in 2013 (Exhibit 4).

Exhibit 5

Banks have taken on $165 billion in fines since 2010 and $59 billion in 1H 2014 alone



[1] Calculated using company annual reports from 2010 to 2H 2014. Coverage includes the top 15 European and top 25 U.S. banks by assets. Amounts include fines only; does not include provisions, such as Payment Protection Insurance in the case of UK banks.

Source: Press; SAS; McKinsey Analysis

However, fines and settlement costs have hurt many banks' businesses, both retail and wholesale, and have had a significant impact on bank profitability, particularly in Europe and North America. Regulators have pursued several claims related to the financial crisis and its aftermath, including actions taken in foreclosures and the creation and marketing of mortgage-backed securities. Many of these claims were resolved in 2013.

Regulators are now also stepping up enforcement in other areas that are not explicitly crisis-related, including consumer protection and conduct regulation, anti-money laundering rules, FX trading, and sanctions violations. Fines and settlements totaled about $165 billion from 2010 to 2014[5]; in 2013 they reached $52 billion (Exhibit 5), a period in which banks' profits were $590 billion. Without such fines, global banking's ROE would have been materially higher in recent years. Reserves for legal costs at the top 10 banks reached $79 billion in 2013 and have been growing at 5 percent.

Some intriguing regional differences also emerge. Exhibit 6 (page 10) lays out the development of ROE for the major regions around the world. However, this picture can be deceptive: one nation's banking market can vary tremendously from its neighbor, due to local differences in macroeconomics and regulation. Even

[5] Calculated using company annual reports from 2010-2H 2014. Includes the top 15 European banks by assets and top 25 U.S. banks; does not include provisions for Payment Protection Insurance in the case of UK banks.

Exhibit 6

Margin and risk costs drive largest change in return on equity

ROE for 7 regions, 2012–13
Percent

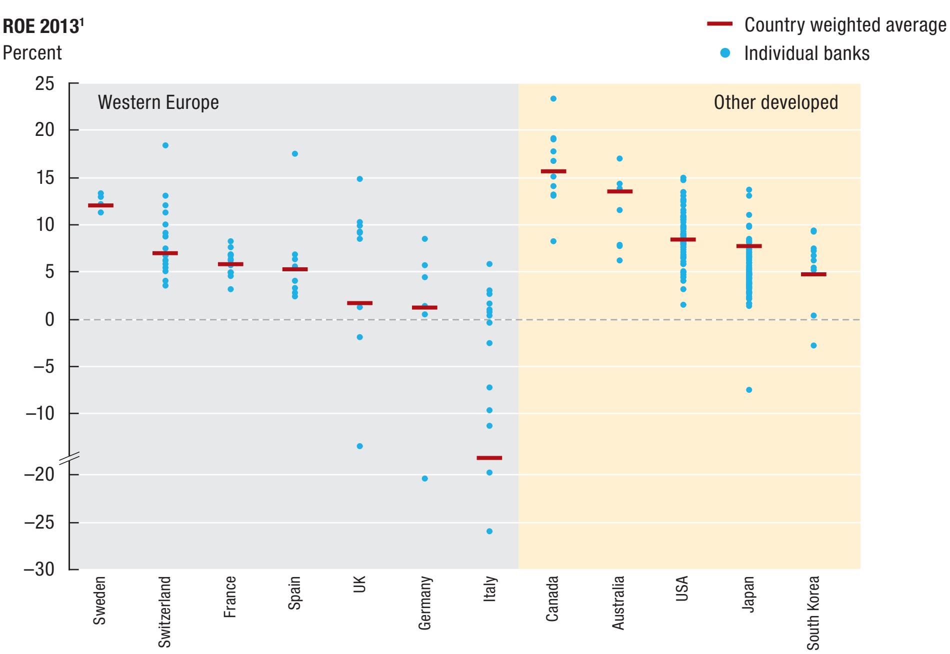
	2012 ROE	+ Margin	+ Loan-loss provisions	+ Operating expenses	+ Other and taxes	+ Leverage	= 2013 ROE
Developed							
North America	8.4%	+0.4%	+1.4%	+0.2%	–1.0%	–0.2%	9.3%
Western Europe	–0.4%	+10.2%	+1.3%	–4.8%	–4.1%	–0.2%	2.0%
Other developed	9.1%	–0.1%	–0.1%	–0.4%	+0.6%	–0.5%	8.6%
Emerging							
China	20.7%	+1.0%	–1.3%	+0.6%	–0.1%	–0.7%	20.2%
Emerging Asia	16.1%	–0.4%	–0.7%	+0.3%	+0.4%	–0.5%	15.2%
Latin America	17.7%	–4.8%	+5.2%	–1.9%	+1.4%	+0.2%	17.8%
Other emerging	15.6%	–0.3%	–0.5%	–0.9%	+0.1%	–0.1%	13.9%

Note: Based on a sample of listed banks with >$10 billion in assets
Source: Thomson Reuters; McKinsey Panorama—Global Banking Pools

Exhibit 7

Individual bank performance varies widely in developed markets

ROE 2013[1]
Percent



[1] Outliers excluded from the exhibit but included in the country averages
Source: Thomson Reuters; McKinsey Panorama—Global Banking Pools

within markets, results can vary considerably. In the following pages, we identify some of the biggest of these regional and national differences.

North American banks lead the recovery

Canadian and U.S. banks continue to lead the global banking resurgence; their ROE improved from 8.4 percent in 2012 to 9.3 percent in 2013. U.S. banking profits in 2013 totaled $114 billion, only slightly behind the record set in 2007, and profits for the first half of 2014 were on track to top $100 billion again. Both revenues and costs improved. Revenues grew 3.2 percent from 2012 to 2013, slightly slower than GDP growth. Including the release of loan-loss provisions (LLPs), revenue growth was 7.4 percent. Cost cuts, such as the 1,300 branches that U.S. banks closed (net of openings) in 2013, have also made a difference. Since 2011 nearly 5 percent of the industry's branch network has been shuttered as transactions shift to online and mobile channels. However, profits are constrained by a conservative regulatory regime now taking shape, as we discuss in the next chapter.

The Canadian industry has emerged stronger than most from the recent financial crisis; its 2013 ROE was 15.5 percent, down slightly from 2012's 16.2 percent. No Canadian bank was in danger of failing or needed a government bailout. But Canada's banks must also cope with regulatory reform; all six of the biggest banks have been designated as domestic systemically important banks, and will be subject to additional capital and reporting requirements starting in 2016.

Western Europe: dragging down the average

Performance at Western European banks improved in 2013. ROE in 2012 was –0.4 percent; in 2013 it increased to 2.0 percent. Almost all banks passed the stress tests for which results were published in October 2014 by the European Central Bank and the European Banking Authority—tests that were widely seen as much more credible than previous exercises. European banks added about €200 billion of new capital in anticipation of the stress testing.

Even with that improvement, however, Western European banks lagged other developed markets. Digging deeper reveals a multi-speed banking system (Exhibit 7). Scandinavia has an ROE of 11 percent, which basically matches its cost of equity. At the other extreme, the GIIPS countries (Greece, Ireland, Italy, Portugal, and Spain) are still recovering from the double-dip crises of 2008 and 2011. Their 2013 ROE is –4 percent, driven by continued high-risk costs and deteriorating cost efficiency. Furthermore, revenues continue to contract (by 3 percent in 2013), though more slowly than in previous years.

UK banks also improved, though ROE actually fell from 1.8 percent in 2012 to 1.7 percent in 1H 2014. While the UK market has strong economics overall, fines and settlement costs and big investments in compliance and control systems have taken their toll. The United Kingdom had one of the most flexible regulatory regimes prior to the financial crisis; now it is at the other end of the spectrum. Plans to separate retail from investment banking through ring-fencing are on track. The UK regulator is leading other supervisors in the scrutiny of all bank behavior through conduct regulation and supervision.

Germany, on the other hand, is another example of a market with rather weak performance. This is not a new development; the market has been a laggard for a long time. While German regulation is not tougher than that in other European markets, the market is very competitive due to its fragmentation, the relatively important role of public sector banks and cooperative banks, and the price sensitivity of German consumers.

On balance, with the European economy still teetering on the brink of recession and regulatory fines continuing to mount, this region's industry has far to go before returning its cost of equity. Fully 45 percent of Western European banks had a 2013 ROE below 5 percent.

Other developed markets are mixed

ROE in other developed markets (including Australia, Hong Kong, Israel, Japan, Singapore, South Korea, and Taiwan) fell to 8.6 percent (from 9.1 percent in 2012), driven by thinner returns (in South Korea), revenue contraction (in Australia), and currency corrections (in Australia and Japan). Overall revenues contracted by nearly 10 percent in dollar terms. There are bright spots, though. Australia is a solid story of improvement, as net income rose and assets jumped. Banks there are preparing for new industry-wide changes on risk and liquidity management. Japan is showing many signs of better health too; for example, 2011–13 total returns to shareholders were 25 percent.

China is slowing

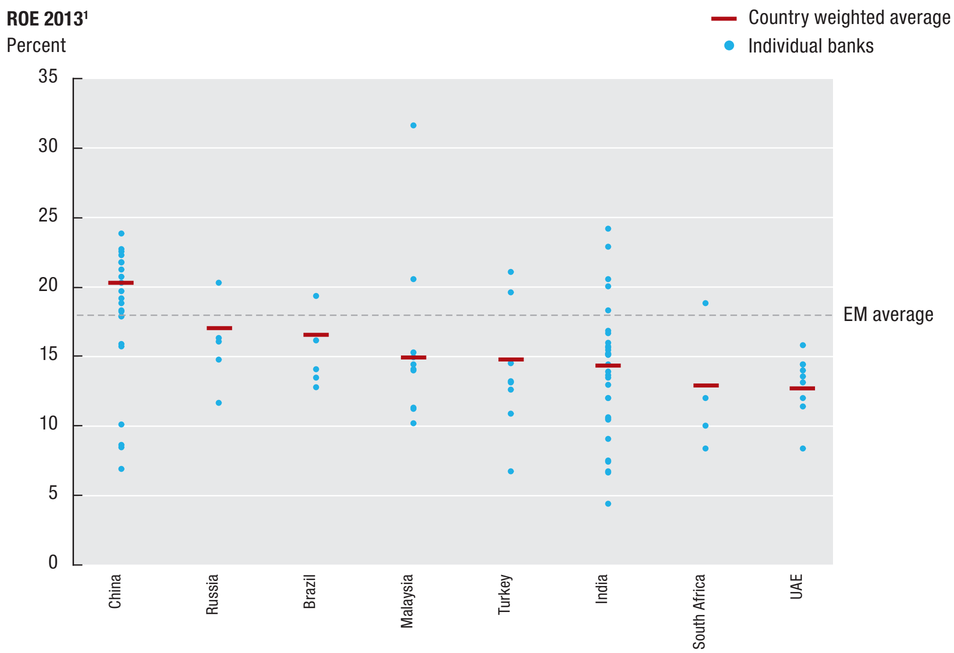
Emerging markets had been an engine of hyper-growth since the mid-2000s, when investors began to award them a higher multiple than developed markets. However, their performance slowed markedly in 2013. China is the largest of the emerging markets, with 64 percent of assets and 41 percent of revenues. It continues to be a top performer, with an average ROE of over 20 percent and revenue growth of 14.0 percent in 2013. But revenue growth slowed noticeably, down from 17.4 percent in 2012.

Beyond this slowdown in performance, the Chinese banking industry is facing three primary risks. First is the changing regulatory environment. Liberalization of interest rates, as happened in late November 2014, will likely lead to increased funding costs and more competition among banks, compressing margins.

A second risk is the quickening pace of growth in non-performing loans (NPL), particularly in the shadow banking system. While China has large government reserves, both loan-loss provisions and NPLs are on the rise; provisions jumped by a third in 2014. Given the country's slowing GDP growth, many analysts expect this to continue, especially in the

Exhibit 8

Emerging nations' return on equity averages show less variability



[1] Outliers excluded from the exhibit but included in the country averages

Source: Thomson Reuters; McKinsey Panorama—Global Banking Pools

property sector. The large and growing shadow banking industry may harbor even greater risks; in 2013, it had around 30 trillion renminbi in assets and accounted for nearly half of new credit issued.

Nonbank attackers pose a third risk to Chinese banks. Though the sector is still dominated by big state-owned banks, nonbanking attackers are gaining ground, particularly in SME lending, payments, and savings. Many of these attackers are using sophisticated data analytics to make inroads in lending and offer near-zero fee payment solutions to merchants; their broad customer bases mean that these tactics can result in an increasing share of industry profits.

Challenges in other emerging markets

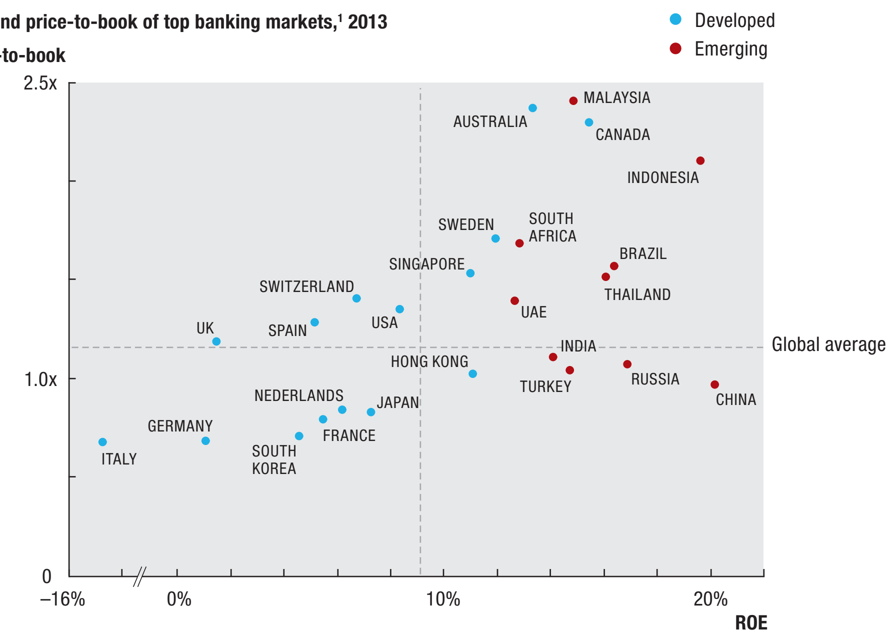
Other emerging markets also dimmed in 2013 after years of strong growth. Emerging Asian countries' ROE fell from 16.1 percent to 15.2 percent. A main culprit was the slowdown in revenue growth: between 2011 and 2013, growth was just 3 percent—down from 17 percent between 2001 and 2011. While ROEs in emerging markets are less variable than those in developed markets, the ROEs of individual banks in most markets differ considerably (Exhibit 8).

In Eastern Europe and Latin America, the main story was margin compression, caused either by competition (as in Russian corporate banking and Brazilian retail banking) and regulation (for example, in

Exhibit 9

Performance is rewarded by investors, with emerging markets leading the way

ROE and price-to-book of top banking markets,[1] 2013



[1] Based on a sample of listed banks with >$10 billion in assets

Source: Thomson Reuters; McKinsey Panorama—Global Banking Pools

retail lending in Croatia and Hungary). Latin America's ROE held up well; Eastern Europe's ROE fell from 19 percent in 2012 to 13 percent in June 2014. Weaker margins threaten to extend last year's ROE and growth declines.

The smaller markets of the Middle East and Africa continue to perform well. But macro and political risks are rising across emerging markets; 2013 was the first year since the crisis in which emerging-market banking stocks had a higher average volatility than developed-world banking stocks. India, Indonesia, Turkey, Brazil, and South Africa have been dubbed the "fragile five" because of the sensitivity of their currencies to the Fed's tapering and a perception of political fragility.

How investors value the sector

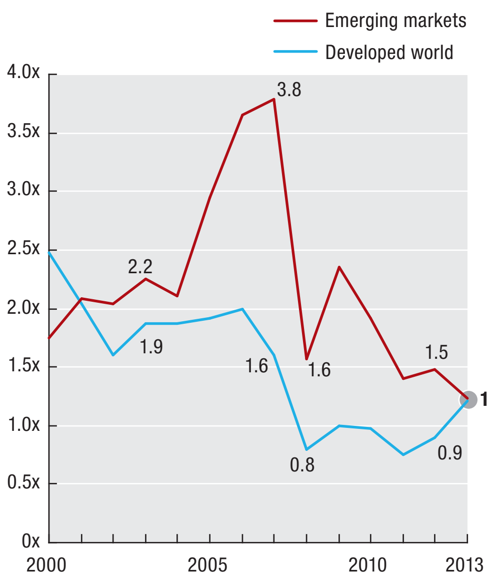
As one would expect, better performance is earning better valuations for banks (Exhibit 9). Price-to-book ratios (P/B) continue to rebound from the depths of the crisis. The global industry P/B rose from 1.1 in 2012 to 1.2 in 2013; the ratio remained at 1.2 through 1H 2014. While this is good news, the industry's P/B is still well below the high of 2.5 reached in 2006. But today's level might be much more stable and realistic over the long term. Market capitalization is now about the same as in 2007, but banks today have nearly twice as much equity as seven years ago.

While emerging markets have attracted higher valuations than developed markets

Exhibit 10

Price-to-book values are converging between developed and emerging markets

Price-to-book multiples,[1] 2000–13



Price-to-book by region

	2013 P/B multiple	Share of banks below 1.0x
Developed world		
North America	1.5x	14%
Western Europe	1.1x	65%
Other developed	1.0x	75%
Emerging markets		
China	1.0x	65%
Emerging Asia	1.6x	40%
Eastern Europe	1.1x	55%
Other emerging	1.5x	29%

[1] Based on a sample of listed banks with >$10 billion in assets

Source: Thomson Reuters; McKinsey Panorama—Global Banking Pools

for more than ten years, that changed in 2013. The P/B of emerging markets' banks fell, and developed markets' P/B rose, such that both groups now have a P/B of 1.2x (Exhibit 10). Recent performance—with North America and many other developed markets improving, while China and many emerging markets were slowing down—cannot on its own explain this convergence. However, investors' perceptions of emerging markets are shifting, driven by a sense of increased geopolitical risk and concerns about an increase in loan losses. LLPs in China rose from 21 bps in 2012 to 28 bps in 2013; in Eastern Europe they rose from 66 bps to 96 bps. In the United States, by comparison, LLPs were 17 bps in 2013; in Germany and Australia provisions were 16 bps. Investors are also worried that many emerging markets may soon follow the path of developed markets and engage in full-scale financial reform.

■ ■ ■

While the economics of the greater industry have improved, Exhibits 7 and 8 (pages 10 and 13) make clear that the performance and health of individual banks in each market differs significantly. The leading banks we identified in our report to you last year continue to break away from the pack. (See "Strategy still matters" on page 16.) For the rest, a significant effort is required to lift performance to the upper echelons—but not before they grapple with the two dominant forces shaping the industry, as we discuss next.

Strategy still matters—an update on the five value-creating strategies

Investors are sanguine about banking—and particularly the 90 banks that are the industry's standard-bearers. As our 2013 report explained, these banks—in contrast to others among the world's 500 largest—have defined and are successfully executing one of five distinguishable, value-creating strategies:

- **Distinctive customer franchises:** Banks using this strategy deliver growth and returns by providing a superior proposition that merits premium pricing. They typically focus on retail and small-business clients; the strategy is more difficult to achieve with corporate and institutional clients. These banks have an after-risk margin that is typically at least 10 percent higher than the market average. They are also readily distinguished by well-designed products, a market-leading digital offering, high share of wallet, and high customer-loyalty scores.
- **Back-to-basics banks:** This strategy delivers steady profit growth through a simple proposition, sustainable cost advantages, and tightly managed risk. Basics banks have a cost-to-assets ratio substantially lower than the market average and typically pay out more than 20 percent of income as dividends.
- **Balance-sheet-light investment specialists:** These banks deliver strong returns by focusing on value-added, technology-intensive, low-risk institutional services while avoiding capital-intensive activities. Revenue/assets ratio for these banks is higher than in other strategies, as is the capital/assets ratio. These banks derive more than half of their group revenue from asset-management activities.
- **Growth-market leaders:** These banks deliver strong top-line growth by outperforming others in fast-growing markets, whether or not it is the bank's home market. These banks have better growth rates and ROEs than the market, and a vigorous growth rate in home markets.
- **Global at-scale universals:** These banks deliver steady profit growth through a relentless quest for global economies of scale and scope. These banks generate a third or more of their revenues from operations outside their home market(s), with substantial contributions from both retail and wholesale banking.

Our 2013 report argued that these five strategies are now synonymous with success in global banking. Share price movements in 2013 confirmed that thesis: it was a good year for the industry and an excellent year for the outperforming 90 (Exhibit A).6 When we examined market capitalization of the global industry, we found that 82 percent of it is already on the balance sheet, as the book value of the industry's equity capital. The remaining 18 percent (or $1.23 trillion) is attributable to investors' expectations of future value creation.

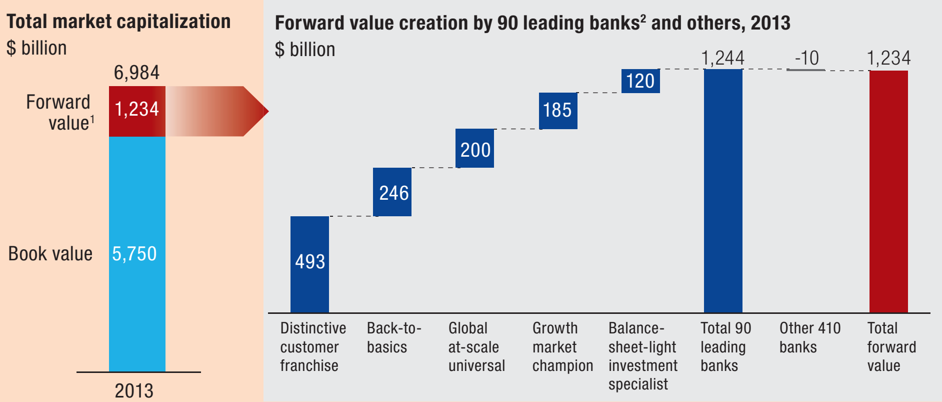
Investors think that all of that value will be created by the outperforming 90—the banks with clear, unified, and well-executed strategies. This is an acceleration of a long-standing trend: from 2007 to 2013, outperforming banks' share of value created (market capitalization less book equity) was 82 percent. Over that same period, they delivered total returns to shareholders of 44 percent, compared with 16 percent for the others. The message is resounding: strategy matters—a lot. Banks with a clear story to tell to investors, and the financial performance to back it up, are breaking away. Exhibit B lays out the various ways in which the five strategies created additional value in 2013.

[6] The 90 banks on our 2012 list remained virtually the same in 2013. We replaced a few banks that merged with others whose improved performance elevated them to the top tier.

Exhibit A

Markets are rewarding 90 banks that have clear, distinctive strategies, assigning all of the industry's forward value to them

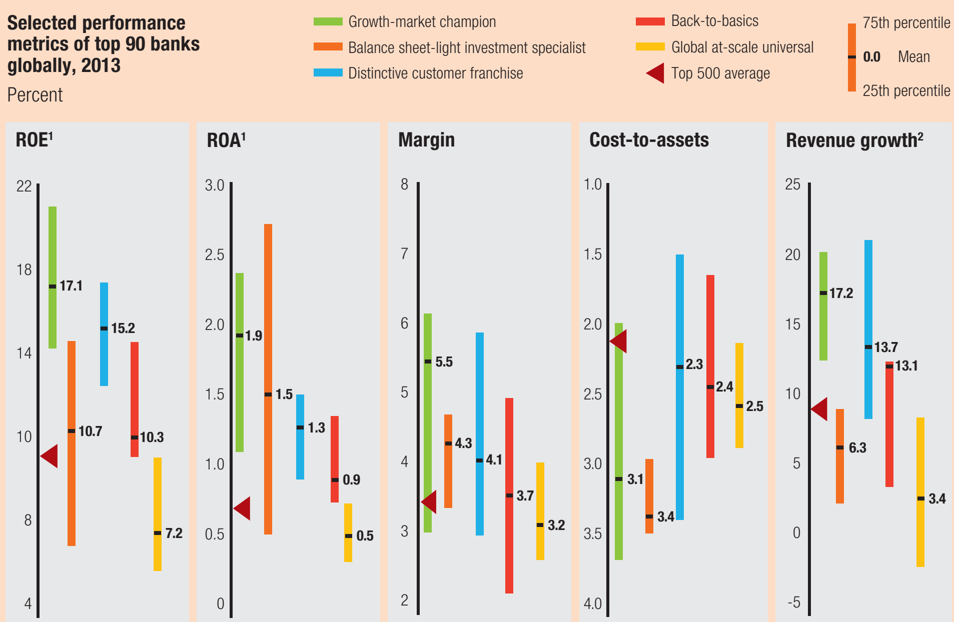
Value creation by top 500 banks worldwide by assets, 2013[1]



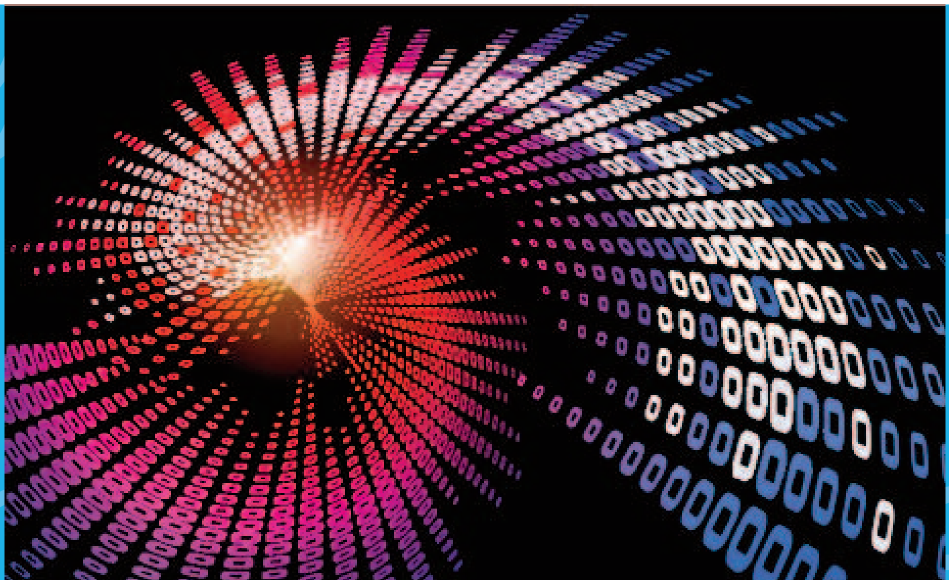
[1] Market capitalization minus equity less goodwill based on sample of listed banks with >$10 billion in assets.
[2] Banks whose successful articulation and execution of a distinct strategy have led to outperformance. See *Breakaway: How Leading Banks Outperform Through Differentiation,* 2013, mckinsey.com, for full explanation of methodology.
Source: Thomson Reuters; McKinsey Panorama—Global Banking Pools

Exhibit B

The winning strategies create value in different ways



[1] Return on average assets and equities
[2] After-risk cost revenues, 2009–13 CAGR
Source: Capital IQ; Thomson Reuters; McKinsey Panorama—Global Banking Pools



Regulation and Digital: Bankers' Twin Concerns

In last year's report, we discussed several challenges facing the industry. We will not revisit all these persistent challenges but will concentrate on two factors: regulatory pressure and the digitization of banking, both of which have intensified during the past 18 months.

Regulation takes hold

Since 2010, banks have been adjusting to reforms designed to safeguard the system. These changes have been planned to take effect over some ten years, a cycle that is not yet halfway complete. Last year, we wrote that banks had made many of the more difficult adjustments, and were coming to grips with some of the remaining uncertainties. Over the past year, however, regulatory reform has gained momentum, and is now clearly the most powerful external dynamic affecting banks; furthermore, it shows no signs of diminishing.

To a significant degree, public opinion is driving the agenda of regulatory change. This is a direct outcome of the financial crisis. As countless editorials have opined, many individuals in countries that bailed out banks are unwilling to do so again.[7] They believe the damage to their countries' economies has been significant, with large increases in public-sector debt and years of sluggish growth. Many members of the public have lost faith in banks,[8] and think that banks' investors and management have not shared sufficiently in this burden.[9]

The result has been a broadening and deepening of the regulatory agenda. To be sure, over the past 12–18 months, the general direction of regulatory reform has been unchanged in many areas, such as capital, liquidity and funding, derivatives regulation, and structural reform. Details are still being released and refined (such as the recent Financial Stability Board consultation on total loss-absorbing capacity), but the fundamental direction is unchanged. However, pressure is increasing in four areas: the supervisory regime, the balkanization of bank regulation, the rising expectations regarding banks' conduct and control mechanisms, and policies in some countries that will reduce the attractiveness of banking.

- In supervision, banks have been increasingly asked to meet new standards of performance; likewise, a broader scope of their activities has come under scrutiny. Major areas of focus include capital estimation (including stress tests), liquidity management, analytics capability, operating cadence, and effective challenge. Banks have been asked to adjust business models to accommodate recovery and resolution regimes; and ensure senior executives and the board play stronger roles with more responsibility for risk management. Regulators around the world are upgrading their expectations. For example, the U.S. Office of the Comptroller of the Currency's Heightened Expectations program is now taking effect. Across the Atlantic, banks in the eurozone expect higher scrutiny from the European Central Bank, which assumed responsibility for banking supervision from national authorities in November 2014.
- The balkanization of bank regulation and supervision has continually increased since the financial crisis. What is different from 18 months ago is that neither regulators nor bankers think that this will reverse any time soon. National regulators and supervisors do not want to be exposed to risk resulting from international banks operating in their markets. For ex-

7 See "No more bailouts: Bank of England chief says banks won't be saved by taxpayers," *Reuters*, November 10, 2014, rt.com.

8 See for example Clive Cookson, "Bankers have tendency to lie for financial gain, say scientists," *Financial Times*, 19 November 2014, ft.com; and Rebecca Riffkin, "In U.S., Confidence in Banks Remains Low," June 26, 2014, gallup.com.

9 See for example "Banks will not pay back bailout until 2015," 4 August 2011, robinhoodtax.org.

ample, it is becoming increasingly difficult for foreign banks to gain new licenses in the United States to operate as branches and the same is true for non-EU banks in the United Kingdom. The United States now requires international banks without proper bank subsidiaries to establish intermediate holding companies. Cross-border intragroup exposures are treated with skepticism and are now subject to exposure limits or collateral requirements in many markets.

Cross-border intragroup exposures are treated with skepticism and are now subject to exposure limits or collateral requirements in many markets.

- Many regulators and supervisors have lost trust that some banks have effective controls in place. The Libor and FX scandals, as well as continued money laundering incidents and sanctions failures, are leading to two reactions. Every aspect of banking activity is becoming regulated. The United Kingdom is leading the charge with its new Regime for Individuals and a broad application of its conduct regime. Around the world, banks are being asked to redesign their control approach through a clearer and more intrusive "three lines of defense" model.

- A few countries have started to introduce policies with an apparent intention to curb bank profits. In Turkey, regulators are curbing consumer finance, capping overdraft interest rates, requiring banks to waive annual membership fees on credit cards, requiring greater provisions for losses, boosting capital adequacy ratios, and raising deposit rates. (Some products are also affected by the government's efforts to limit imports and deal with the current-account deficit). In Hungary, where many consumers borrowed money in foreign currencies before the crisis and unwittingly took on foreign exchange risk, the government has introduced a number of consumer-friendly measures including changes to mortgage laws allowing early repayment, as well as other taxes targeting banks.

  The effect on banks has been radical in some cases. In Turkey, regulatory change is materially reducing revenues and profits. As a result, ROE in Turkey's banks has fallen from 23.0 percent in 2009 to 13.2 percent in the first half of 2014. In Hungary, ROE has declined from 8.9 percent in 2009 to 1.1 percent in 2013.[10]

Across all countries, the new regulatory thrust requires senior executives to spend a significant share of their time on regulatory matters (in our experience, about 20 to 25 percent for most, and for some even more). And the direct costs are even more substantial. For example, two large U.S. banks have added 10,000 employees each to their regulatory and compliance groups since 2011.[11]

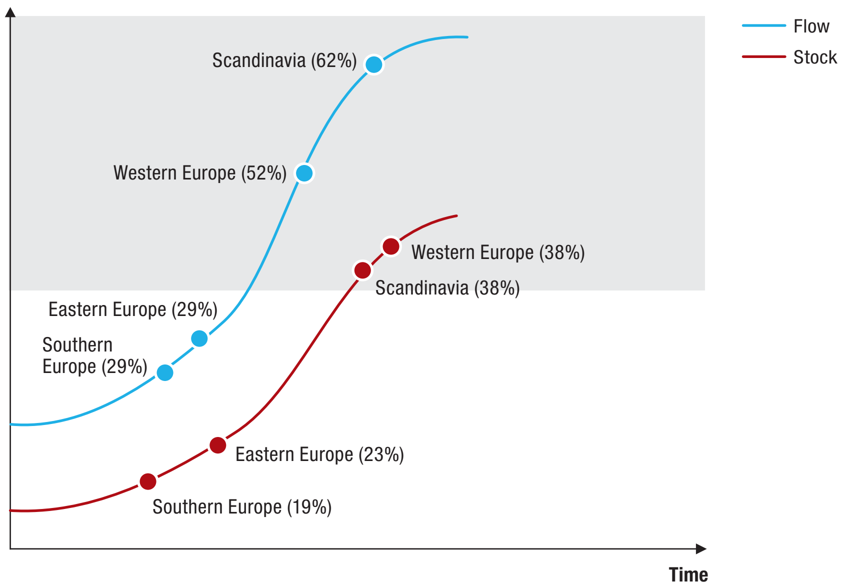
[10] Data from Magyar Nemzeti Bank (Hungarian Central Bank).

[11] Victoria McGrane and Julie Steinberg, "Wall Street adapts to new regulatory regime," *The Wall St. Journal*, July 21, 2014, wsj.com.

Exhibit 11

Digital adoption follows an "S-curve"; disruption occurs near the midpoint[1]

Share of revenue from digital sales, 2013
Percent



[1] Country's revenue base defined as digitally disrupted when digital's share of new revenue (or volume) exceeds 50%
Source: McKinsey Panorama—Global Banking Pools

Digitization shifts gears

The digital revolution has visibly accelerated recently. ("Digital" means different things to many people; for our view, see "What is digital?" on page 22.) In Europe, digital banking products (those purchased online or via mobile) account for 18 percent of the back book (by number) and 22 percent by volume. But in terms of new sales volumes, digital is already propelling 34 percent.

The transformation is also taking new shapes and directions. Three of these changes are especially significant.

First, some emerging markets are leapfrogging the established path. Our research shows that digital banking, like many other technologies, follows an S-curve of adoption. Banks in Northern Europe have had digital solutions for 20 years or so and, accordingly, are well advanced on the adoption curve (Exhibit 11). Digital accounts for over one-third of stock volumes and more than half of new sales in these regions. Other parts of the world are earlier along the adoption path, and are moving towards the inflection point at which disruption drives a rapid uptake of the new technology. Often that point is reached when new functionality is offered to customers, who may not have known what they wanted until it was shown to them.

What's remarkable is that banks in some countries, such as China, Kenya, Poland,

What is digital?

Every bank has questions about digital's impact on the bank—how disruptive will be the change? Which products and which customer segments will be affected most? What is the likely pace of adoption? Is there a benefit to pioneering a given technology, or is it better to be a "fast follower"? And so on.

Banks can start with an understanding of digital that makes sense for their institution. Our work with banks and other companies suggests that "digital" means the four ways that new technologies are changing the bank:

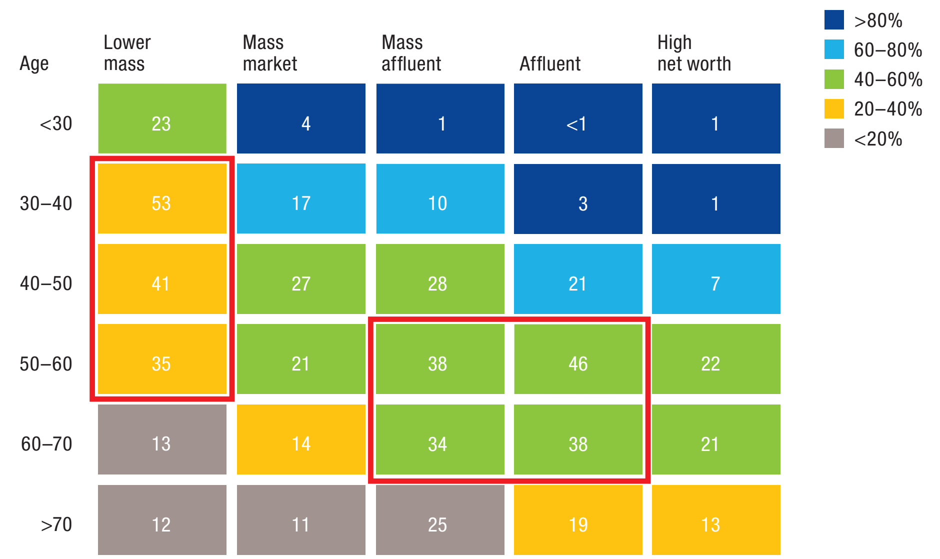
- **Connecting.** This is probably the most familiar instance of digital: the websites, portals, apps, trading platforms, and other sales and execution channels that banks provide to their customers. But there is more here than many banks realize. Digital techniques can bring expertise to more clients; for example, product specialists can connect with clients and relationship managers to deliver real-time thinking. Digital tools can also help RMs sell better to clients by understanding their portfolios, creating custom pitch books, and helping with initial product configuration. Moreover, connecting is not only about customers; some leading banks have been able to drive greater productivity through their in-house social-media networks.
- **Automating.** Straight-through processing (STP) has been an ambition of bank chief operating officers for too many years to count. Today, new digital technologies can help them realize that ambition—both by improving STP for customer processes end-to-end and also by utilizing new technologies (such as applications and portals) to communicate and confirm transactions with customers in areas previously done via spreadsheets and email. For example, in corporate lending, digital can reduce costs and cycle times of key processes through tech-enabling some activities and fully automating others, including many credit decisions.
- **Decision making.** Digital technologies can help banks make personalized offers of high-conversion products to customers; for example, excess cash in corporate accounts can trigger a prompt to corporate treasurers—through the bank's iPad app—to a customized offering of liquidity products. Furthermore, digital capabilities can enable banks to improve the control and management environment—for example, enabling rules-based filters for amendments and exceptions—to truly understand and identify real control issues versus "noise in the system."
- **Innovating.** This is another familiar dimension of digital for incumbent banks—though regrettably for them, it is mostly familiar through the work of digital start-ups. Some high-street banks are also finding success by asking the teams they've built to design modern websites, say, to monetize legacy products, or to advance mobile sales tools well beyond the merely transactional abilities offered by most banks. Cash management, for example, can be delivered on an app with multi-currency investment options.

Exhibit 12

Two U.S. “hotspots” may be vulnerable to digital transformation

U.S. retail banking post-risk revenue pools by wealth[1] and age, 2013
$ billion

Internet banking usage[2]



[1] Based on household financial assets – Lower mass: <$50k; Mass market: $50-200k; Mass affluent: $200k–1M; Affluent: $1M–5M, High net worth: >$5M
[2] TShare of households using the Internet to shop for banking services and transact with their primary bank
Source: Federal Reserve's Survey of Consumer Finances; McKinsey Panorama—Global Banking Pools

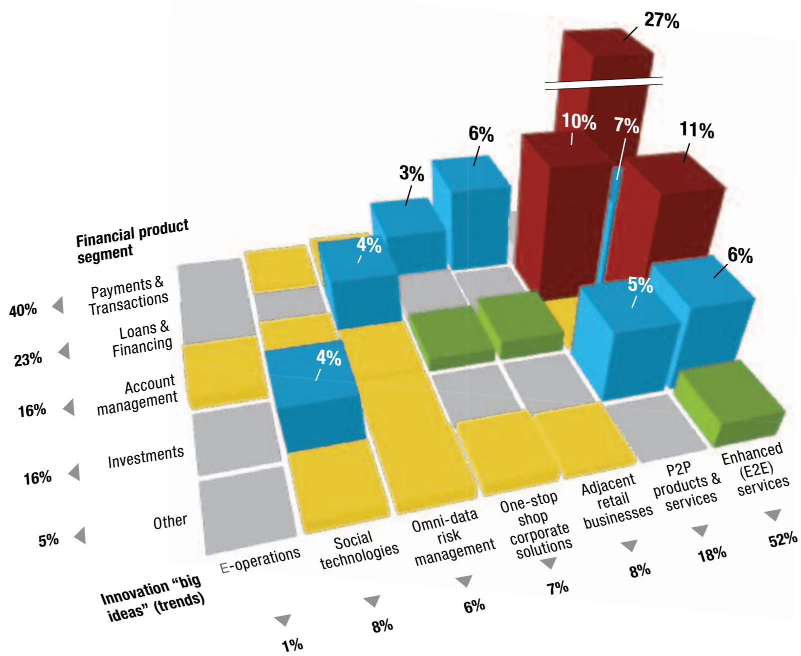
and Turkey, show signs of bypassing the years of low penetration and moving straight to this same point of broad-based adoption. Banks in these countries are less encumbered by legacy systems. They have demographics that are inclined to digital adoption, and in many cases, they have a more supportive regulatory system, such as the rules governing wealth management advisory in China.

Second, we now see a clear trend of digital finding acceptance in new demographic groups. Digital tends to be taken up first by the young and the wealthy. However, increasingly middle-income and middle-aged consumers are adopting digital channels. These new groups taking up digital are banks' bread-and-butter clients, where most banking revenue is generated, and in light of potentially lower margins with digitally-oriented products, revenue growth could be challenged. By contrast, in telecoms and many other industries, the most valuable customers are younger, in their late 20s and early 30s.

What might happen when digital is adopted by the middle-middle demographic group? Consider the United States, where two cohorts make up about 50 percent of revenues (Exhibit 12). These segments have not yet adopted digital in a meaningful way, but as and when they do, a large swath of banks' revenues will shift and could re-

Exhibit 13

Innovation is shifting away from transactions; E2E integration is on the rise



Note: 500+ commercially most well-known cases registered in the database, might not be fully representative

Source: Panorama FinTech database + McKinsey Panorama—Global Banking Pools

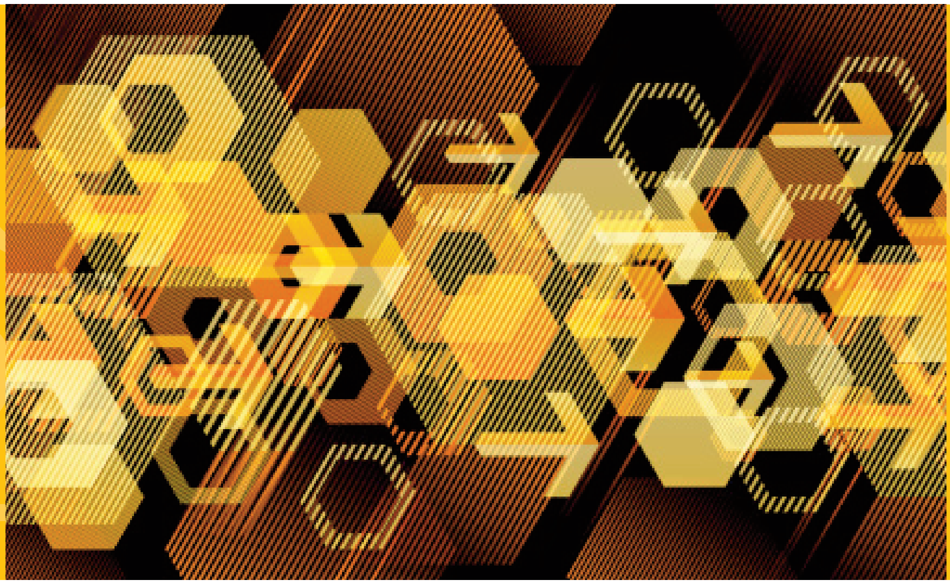
sult in reduced margins. Next up may be small and mid-sized businesses: our research shows that digital services are the second-most-important criteria in their choice of a bank, and nearly two-thirds would be satisfied with a remote relationship manager.

A third shift in the past year has been a rise in the number of "FinTech" startups, and expansion of the pool of established digital attackers. The two groups are moving ever more quickly to capitalize on digital's rapid acceleration. Our research shows that there are now over 12,000 banking startups. Digital innovation is speeding up, and spreading into new parts of the banking business system. FinTechs were first attracted to transactions, but are now moving into other areas (Exhibit 13), particularly social trading sites and apps, and lending, where they are leveraging non-traditional banking data for risk scoring.

While the number of FinTechs is large, most provide more of an opportunity than a threat to global banks, which can build on their ideas, set up joint ventures, and sometimes acquire these firms to deepen or broaden their offerings and capabilities. But some established digital attackers are sophisticated, have built customer bases, and are gaining momentum. These companies have expanded—the aggregated banking revenues of six of the largest attackers would place 20th in a ranking of global retail banks.

In response to these trends, banks are speeding up their own pace of digital change, focusing their digital strategies, and moving to full-scale transformations. Leading banks are beginning to invest some substantial sums. But they expect these investments to pay back quickly as many banks can achieve more than 30 percent cost savings by automating processes while enhancing the customer experience with digitally based offers.

Navigating the accelerating forces of regulation and digitization is critical to success and is reshaping the top management agenda as we discuss next.



Critical Actions for 2015

In the 2012 and 2013 editions of this report,[12] we proposed an agenda for a "triple transformation"—a slate of economic, business-model, and cultural changes—that can lift banks' performance. Today, the triple-transformation agenda is still valid. As we discussed in the first chapter of this report, banks' performance is improving. The economic transformation of cutting costs and boosting revenues, while not yet complete, is proceeding—though with significant variations, between (and even within) countries, and between retail and wholesale businesses.

[12] *The Triple Transformation: Achieving a Sustainable Business Model: 2nd McKinsey Annual Review on the Banking Industry,* October 2012*;* and *Breakaway: How Leading Banks Outperform Through Differentiation: McKinsey Global Banking Annual Review 2013,* November 2013, mckinsey.com.

However, much more work remains to be done on the other transformations that will ensure long-term health: changes to the business model and to banks' culture. The needs here are great, and have been made much more acute by the accelerating dynamics of regulation and digitization. The industry has reached a critical moment, when strategies must adapt to these increasingly powerful forces. Some banks have already taken steps in this direction, of course. But, broadly speaking, banks that have not yet moved must take four actions:

Banks must address heightened expectations for their conduct and control.

- Improve the mechanisms that govern conduct and control, especially the three lines of defense.
- Remake the culture, by using rigorous management practices such as a "cultural scorecard" to develop goals and monitor progress.
- Reassess the portfolio of businesses, optimizing for the most profitable mix of businesses, geographies, and legal structures.
- Decide on digital posture and priorities: either digitize the existing offer and processes, differentiate through digital, or innovate the business model.

Improve conduct and control mechanisms

The shifts in public opinion discussed previously make it unlikely that the current regulatory thrust will slow. Ultimately, it seems probable that in many developed markets almost all banking conduct, both public interactions and behind the scenes, will be regulated. Further, the trends are not confined to developed markets, but are also taking hold in emerging markets. Though they did not have to bail out banks, almost all have borne the effects of a slow recovery and, as Hungary and Turkey have done, may establish new and powerful constraints on banks.

Banks must address heightened expectations for their conduct and control. What's needed is a fundamentally different approach to banks' "three lines of defense." In 2014, working groups at the Bank for International Settlements and the U.S. Office of the Comptroller of the Currency gave guidance on this, outlining certain responsibilities for the first line, the risk owner (that is, the trader, sales rep, or lending officer). Looking over his or her shoulder is an independent control function, the second line. Internal audit provides the third line. Banks are now considering their options within this schema and, in particular, the choices about how to apportion responsibilities between front-line units (and their risk teams) and centralized risk-control functions. Most banks have started to respond to these new requirements by strengthening their three-lines-of-defense model. As it affects all areas of the organization, this is a process that will take many years to be completed.

Remake the culture

Culture is ripe for major change at many banks. Banks globally are re-examining the fundamental way they operate, the way in which their employees behave, and ultimately the culture required to sustain better ways of working.

Ultimately, the goal is to embed the metrics in formal performance-review and compensation processes.

Some banks have taken up the gauntlet and are now attempting a full-scale cultural transformation. To begin, they recognize that culture can be measured in a rigorous way, in fact as rigorously as any hard business metrics. A number of institutions have created "cultural scorecards" in which they describe "what good looks like" through a series of "outcome statements." Those statements cover categories such as customers, people, the communities in which they operate, the way they conduct business, and actual business outcomes. Specific outcome statements might include things like "being a client-focused organization," "being a diverse organization," "contributing to the local community," and "keeping conduct risk under control." For each, banks are establishing hard metrics, such as the percentage of client-driven revenues, the proportion of female managing directors, the amount contributed to local projects, the number of conduct incidents, and so on. The scorecard is reviewed quarterly or more often by senior management, which requests specific follow-up/remediation projects. Ultimately, the goal is to embed the metrics in formal performance-review and compensation processes. The board should also seek regular reports on the state of the culture and the progress of change. This is already a legal requirement in some jurisdictions, with other countries likely to follow.

Review the business portfolio

All banks must cope with rising regulatory requirements. But banks that display one (or several) of five features are particularly affected: big banks, namely the global systemically important banks; those with sizeable capital-markets activities; those with large operations in the EU (especially the United Kingdom), Switzerland, or the United States; banks with large cross-border networks and business models, and banks that either operate in or do business with countries where money laundering and criminal activities are more common and more difficult to control. Each of these characteristics drives additional regulatory costs, such as higher capital requirements, higher exposure to compliance risk, trapped pools of liquidity and funding, the need to apply the most stringent standards globally (for example on compensation practices, especially sales commissions) while domestic competitors are not so encumbered, and more intensive regulatory oversight. These banks will have to be very clear that such additional burdens are worth it. This needs to be a conscious decision and an explicit trade-off.

Finding the optimal solution is a complex strategic exercise. Some leading institutions have come up with an innovative way to manage these and other trade-offs. They have turned to multivariable modeling to optimize their balance sheet. A complex model can optimize for the many regulatory constraints and offer guidance on the most profitable choices within the bank's overarching growth strategy (that is, its choice of the businesses, customers segments, and products it believes offer the greatest organic potential for growth). In our experience, relatively simple optimizations across all the relevant variables can suggest some straightforward changes to the balance sheet mix, which when implemented can boost ROE by about 0.5 to 1.5 percentage points. Some more significant shifts which in turn require business-model shifts can improve ROE by up to 5 percentage points.

Broadly speaking, banks should renegotiate with clients that do not exceed the bank's internal hurdle rate.

A second move is for banks to adjust their corporate structures to better fit the landscape; they can rationalize their legal entities and revisit the structure of their holding companies, subsidiaries, and branches. Another move is relevant for capital-markets divisions. The Fundamental Review of the Trading Book (Basel 3.5), new leverage ratios, and the recent switch to trading on swap execution facilities (SEFs) for a number of liquid products in the United States are driving these groups to once again ruthlessly review their trading activities. For those businesses and countries in which they choose to remain, banks should analyze profitability. Broadly speaking, banks should renegotiate with clients that do not exceed the bank's internal hurdle rate; should that not succeed, these clients can be dropped. Note, however, that there are exceptions; some customers that are only marginally profitable under higher regulatory costs are worth keeping, as part of a larger platform strategy.

Decide on digital

Banking markets occupy very different places on the S-curve of digital adoption. And every bank's circumstances are unique. There is no one "right" set of things to do for all banks. The only principle that seems to hold true across most geographies is that banks cannot underestimate the speed of change. Markets can flip from quiet digital backwaters to paragons of online innovation in just a few years. A strategy of putting off digital as long as possible can be perfectly valid in some markets—until it isn't.

At that point, banks must be ready to move quickly, with a preconceived vision and strategy. Senior managers need to have assimilated technological knowledge, as technology becomes the essence of the business. To prepare, banks should decide on one of three digital ambitions.

While many banks are focused on the new revenues that digital technologies can produce, we find that the short-term cost savings are often more significant.

Digitize the existing offer

Making the current portfolio of products and services available through digital channels is the simplest strategy, with the smallest commitment. Indeed, many banks are already at this stage of digitization. The focus is typically on digitizing sales and service of simple but essential products such as credit lines and savings accounts. In most cases, what's needed is a multichannel interface with consistent offers and functionality across all channels. The information presented to customers should look the same on the ATM, the monthly statement, the web, and the app—and should be consistent with what they hear when speaking with the customer service center. As they build this seamless interface, banks should also devise ways to steer customers toward direct channels for their servicing needs.

At most banks, this work should typically be accompanies by "no-regrets" moves to cut costs, which can produce massive cost savings if banks fully embrace the potential of digital to automate processes. Core processes for mainstay retail and SME products—which are likely to be the first to be disrupted—can be completely digitized, from end to end, resulting in savings of up to 50 percent in some cases. While many banks are focused on the new revenues that digital technologies can produce, we find that the short-term cost savings are often more significant.

To make that automation possible, banks should aspire to a two-speed IT architecture that can deliver digital solutions quickly, while preserving systems that deliver scalable, reliable, and efficient transactions. For customer-facing functions, the approach should be modular and flexible, able to be quickly updated and deployed, while being scalable and offering real-time analytics. IT in the transactional core, however, should be optimized for stability, cost efficiency, and security. And both areas need to evolve in ways consistent with the bank's IT backbone.

Differentiate through digital

Most banks that have digitized their current offering are now moving to the next stage, and seeking to make their digital presence a distinctive part of their value proposition and brand. A deeper commitment, this journey entails a fundamental change to banks' value proposition, operations, and mindset. Banks selecting this option do so to restore their competitiveness with digital start-ups and attackers.

As a first step, many banks should adopt a "mobile first" philosophy, in which products and processes are completely redesigned for mobile, after which they are translated to Internet and branches. That's the reverse of the process used in the earlier growth stage, of digitizing the existing offer. Usually this requires substantial simplification of products and processes.

Clients with a certain profile that already take an invoice financing product are likely to be interested in, say, FX hedges.

This is no small matter—but banks must do more. They need also to invest in new-generation risk management, building on big-data and advanced-analytics skills, to improve their credit-scoring models. Better insight into customer behavior means that banks can also increase their customer base, through traditional consumer lending, or perhaps by providing a peer-to-peer (P2P) lending platform. Capital markets businesses can develop algorithms that predict the next product a given client is likely to want. Clients with a certain profile that already take an invoice financing product are likely to be interested in, say, FX hedges. The technology requires only internal bank data, and the algorithms can be continually refined as clients' history grows.

Managing this is difficult, and likely requires new ways of working, including a cultural change to embrace controlled risk taking. IT teams and others must manage a portfolio of ideas in parallel, seeking the ideal tradeoff between nurturing innovation and execution excellence. IT should be a thought partner to business and other departments in the bank, and work together to deliver solutions jointly within weeks or months.

Innovate the business model

In some markets, banks may decide that the only ways to compete with FinTech startups and established digital players are either to partner with them or to take the lead on orchestrating the emerging digital-banking ecosystem. To truly reinvent their business model, banks must think of themselves first and foremost as data companies, acquiring more data and finding ways to extract value from it. This shift is essential in culture and talent; banks will need to hire on the basis of skills, not experience.

Banks moving in this direction should build on the valuable customer data they already own to broaden their product and service offering. Already, the boundaries between banking, retail, telecoms, and other industries are blurring. Banks have an opportunity to orchestrate an ecosystem of companies that collaborate to win the customer. For example, banks might provide personalized coupons and time- and location-based offers to customers' smartphones, and receive a commission from retailers. They might also provide one-stop shop solutions to SMEs; for a fixed monthly fee, they can provide banking services, accounting help, and so on. In mortgages, banks might build a system of companies to help with property search, legal documentation, and other necessary steps. But they have to act fast, as savvy companies from other consumer industries are already making similar moves.

> Going digital requires large investments and introduces additional complexities in IT infrastructure, data security, and many other areas.

Behind the scenes, banks can also innovate the operating model, and make a step-function change in costs. For too long, banks have persisted in a degree of vertical integration that other industries have long since abandoned. Whole swaths of the operation can be turned over to others. In capital markets, activities such as trade confirm, collateral management, reporting, price verification, and many others can be outsourced, in one of three ways. Some can be turned over to a peer that excels in the activity; banks can pay to use its platform. Banks will have to be cautious about competitive issues; then too, many platforms are "single tenant," so technical problems can be expected. Alternatively, banks could create a utility—a new and flexible platform serviced by third-party providers. Finally, banks could hive off the operations, and create a new "TechCo" or "ServiceCo" to take over the bank's operation and the relevant part of its IT "stack."

This level of transformation will require that banks do the work entailed in the strategies discussed above: creating state-of-the-art front ends, fully automating processes, and redirecting the organization, culture, and mindset. Like their peers that choose to differentiate through digital, banks electing this strategy should build an e-company culture, with an even greater tolerance for controlled risk taking in the pursuit of innovation.

Two design questions

Irrespective of the ambition they choose, banks need to change the way they think about digital investments, and the organizational structure for digital. With the notable exception of the past decade, the industry has traditionally been risk-averse and focused on short-term profitability. Going digital requires large investments and introduces additional complexities, in IT infrastructure, data security, and many other areas. Not all digital initiatives have a crystal-clear NPV—a problem for many banks that are still trying to fully recover from crisis. Moreover, in some cases banks are going up against well-funded startups for which profits are not yet a consideration. Banks need to consider the full range of benefits that digital projects can convey. Not only are there cost savings and new revenues, but digitally enabled processes can improve risk management and regulatory compliance. A comprehensive view of the upside can help banks develop the needed business case—which then must be communicated within the bank and also to investors. Separate reporting on digital investments, using metrics that show the gains in competitiveness as well as returns on investment, can make the bank's work transparent to analysts and investors.

Banks also need to consider the best structure for their teams. Some organizational models, including external partnerships, joint ventures, and investment in startups, can deliver the needed expertise, scale, and infrastructure. Banks should also consider ring-fencing their digital operations. Keeping the digital bank separate from other banking functions allows it to move faster and experiment more. Appointing a board-level sponsor is an essential step; without a visible champion, the digital bank can be seen as unimportant by the rest of the organization. Finally, acquiring and developing digital skills will go a long way toward creating a true "e-company" culture; a few new costly front-end innovations will not make a bank "digital."

■ ■ ■

The industry's performance is mending, but its health is vulnerable, and thus it is not yet in control of its destiny. Many banks still need to make significant changes in culture, compliance, and business model. Further, all banks need to make the transition to digital; the only question is when. Getting these decisions right has enormous value. Strategy matters more than ever, and banks that articulate one of five strategies designed to meet a specific set of customer needs are enjoying disproportionate returns and stronger growth.

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McKinsey Panorama—Global Banking Pools: Balazs Peter Bok, Jay Datesh, Attila Kincses, Valeria Laszlo

Appendix

Definition of metrics

1. Return on equity (ROE). Total accounting net income after taxes divided by average total equity.

2. Revenues. Total customer-driven revenue pools after risk costs.

3. (Revenue) margin. Revenues before risk cost divided by average total assets.

4. Risk cost (margin). Loan loss provisions divided by average assets.

5. Price to book value (P/B). Market capitalization divided by average total equity less goodwill.

6. (Revenue) margin. Revenues before risk cost/total assets.

7. Credit-default-swap (CDS) spreads. Used as a measure of perceived risk of the banking sector (in basis points).

8. Market multiples. Measured as the weighted average of individual banks' price-to-book (P/B) and price-to-earnings (P/E) ratios within a specified country or region.

Databases used in this study

We used two primary databases to derive the data aggregates presented within.

Panorama—Global Banking Pools (GBP). A proprietary McKinsey asset, Global Banking Pools is a global banking database, capturing the size of banking markets in 90+ countries from Kazakhstan to the United States, across 56 banking products (with 7 additional regional models covering rest of the world). The database includes all key items of a balance sheet and income statement, such as volumes, margins, revenues, credit losses, costs, and profits. It is developed and continually updated by more than 100 McKinsey experts around the world who collect and aggregate banking data from the bottom up. The database covers the client-driven business of banks, while some treasury activities such as asset/liability management or proprietary trading are excluded. It captures an extended banking landscape as opposed to simply summing up existing bank revenues, including not only activities of traditional banks but also of specialist finance players (for example, broker/dealers, leasing companies, and asset managers). Insurance companies, hedge funds, and private-equity firms are excluded. The data covered for each country refer to banking business conducted within that region (for example, revenues from all loans extended, deposits raised, trading conducted, or assets managed in the specific country). The data cover 14 years in the past (2000–13) and 7 years of forecasts (2014E–20).

Thomson Reuters banking. A database of the key profit-and-loss, balance-sheet, and other financial metrics of the top 500 banks by assets, sourced from Thomson Reuters. All banks are clustered individually into countries (based on their domicile), regions, and specific bank types (based on a classification of 14 different bank types). The data cover 14 years (2000–13), with a varying number of banks available in different years.

Additionally, we used data from a range of other sources (including the Organization for Economic Co-operation and Development, the European Central Bank, and Bloomberg) to populate various indicators.

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