McKinsey&Company

Financial Institutions Group

The triple transformation

Achieving a sustainable business model

2nd McKinsey Annual Review on the banking industry
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Contents

Executive summary

Welcome to the second edition of the McKinsey Annual Review on the banking industry.

The global banking sector has made some progress over the past year towards stabilizing after the financial crisis. Banks have launched numerous initiatives to improve capital efficiency, revenues, and costs. However, the impact was not reflected in 2011 earnings, due to the combined impact of low interest rates and tightening capital requirements. Further, the sector faces some difficult choices going forward as it strives to improve performance and regain the confidence of investors and society. Amid tighter regulation, shifting customer dynamics and macrovolatility, the search for a sustainable model goes on. In this report we examine the current state of the sector, and present our view of the changes necessary to restore banks to the health and vigor they are capable of achieving.

The report is presented in three chapters:

- Chapter 1 presents our view of the status of the sector five years after the beginning of the financial crisis. While progress has been made, challenges remain.
- Chapter 2 examines the outlook for banking. We expect the tough environment to persist, with medium-term risks to performance outweighing positives.
- Chapter 3 presents our vision of the way forward. A focus on return on equity (ROE) is necessary, but not sufficient, and we suggest a "triple transformation" may be required, around banking economics, business models, and culture.

1. More capital, but not yet a sustainable model

- **Substantial increase in capital base.** Banks have made significant efforts in the recent period to stabilize their balance sheets, lifting average Tier 1 ratios to 11.7 percent in 2011, compared with 11.4 percent in 2010 and 8.2 percent in 2007.
  - Since 2007, the Tier 1 capital of the sector increased by $2.0 trillion, a rise of 57 percent. In the same period, assets grew by 25 percent ($17 trillion) leading to lower levels of leverage. In 2011 those trends continued, but at a slower pace.
  - Portfolio risk positions and management of risk-weighted assets (RWAs) improved. RWAs increased less than total assets.
  - Banks have since 2007 increased deposits by an impressive $17 trillion (32 percent), driving a four-year trend of declining loan-to-deposit ratios, which averaged 85 percent in 2011, compared with 97 percent in 2007.

- **Despite efforts, performance has deteriorated.** In last year's global banking sector report[1], we discussed the need to improve along three vectors – capital efficiency, revenues, and costs. While banks made efforts across all three vectors over the past year, the changes were not reflected in profitability. That is partly because of the challenging macroeconomic environment, which offset the positive effect of banks' initiatives. A full performance transformation may take several years.
  - Capital efficiency deteriorated slightly. Notably, the ratio of off-balance-sheet to on-balance-sheet financing decreased, as the ratio of securitized loans and nonfinancial corporate bonds dropped by 1 percentage point to 29 percent.

1 McKinsey Annual Review on the banking industry, September 2011

- Revenue growth lost momentum. Global revenues grew by just 3 percent last year to $3.4 trillion, compared with 9 percent from 2009 to 2010, as recovery of risk costs declined and revenue margins deteriorated on average by 11 basis points.
- Cost-to-income ratios rose while cost-to-asset ratios were stable. The sector's cost base in 2011 jumped 5 percent to $2.5 trillion.

- **Many banks did not earn their cost of equity.** Global banking ROE fell by 0.8 percentage points to 7.6 percent in 2011, well below the 10 to 12 percent average cost of equity. Average earnings fell by 2 percent.

- **Three regional variations on a theme – little progress towards a sustainable model in the US and Europe, while Asian growth will be more volatile.**
  - **US: a tough road ahead**
    - US banks improved balance sheet positions, largely driven by regulation. Average Tier 1 ratios were 12.7 percent in 2011, compared with 7.5 percent in 2007, while RWAs fell by 2 percent.
    - Still, moderate revenue growth, declining margins and increased costs (cost-to-income ratio of 68 percent versus 60 percent in 2010) suggest US banks face significant challenges to long-term profitability. US banks earned an average ROE of 7 percent in 2011.
  - **Europe: significant risks and distortions**
    - Despite an increase in average Tier 1 capital of 0.4 percentage points to 11.7 percent last year, risk in the European banking system has increased. Leverage remains high, and many European banks have yet to realize loan book risks. Southern European banks remain reliant on the drip feed of ECB and emergency funding.
    - There was little progress on earnings. In Western Europe, revenues declined by 1 percent, and remain 16 percent below precrisis levels. Costs meanwhile rose. European banks on average earned a ROE of zero percent (5 percent excluding the troubled peripheral countries).
  - **Emerging Asia[2]: continued growth – though slower and more volatile**
    - Emerging Asian banks have maintained sound capital and stability ratios and will to account for more than 39 percent of global revenue growth. However, average ROE may drop by 3 to 4 percentage points from the current 17 percent because of increased regulatory demands in some markets, as well as declines in asset quality and shifts in consumer dynamics.
    - Emerging Asian banks in the past year lifted Tier 1 ratios by 0.2 percentage points to 10 percent (slightly below the global average). However, this may not be sufficient in the medium term given the need for growth capital, with emerging Asian banks estimated to require more than $1 trillion in new capital through the coming decade. With downward pressure on ROE and over 75 percent government ownership (and governments likely to limit capital injections in this environment), attracting private capital will become a priority within two to three years. This could necessitate another round of business model innovation to bolster ROEs and policy action in some markets.

2 Excluding Japan and Australia

- China faces some specific challenges. Increased bad loans (mainly to local governments and SME) and slower economic growth expectations of about 8 percent give rise to concerns. In addition, China needs to manage the smooth transition from a heavily directed growth model to a more market-driven economy.

- **Investor confidence remains low – reduced expectations of a quick recovery.** Although regional differences are significant, investor confidence in the banking sector fell globally, suggesting doubts over the sustainability of business models.
  - The average price of insurance against default in the credit default swap market of 124 banks sampled exceeded 370 basis points in the past year, the highest level on record.
  - At mid-2012, bank stock market valuations were at very low levels, with an average price-to-book ratio of 0.8 in developed markets and 1.5 in emerging markets, compared with 1.0 and 1.9 respectively in 2010. Some two-thirds of banks in developed markets and over 40 percent in emerging markets traded below book value.
  - Price-to-earnings ratios averaged 11 last year, compared with 15 in 2007.

2. Earnings headwinds may increase

- **Challenges more daunting than expected**
  - **Regulation has become more complex and burdensome.** At the heart of the reforms are new rules for capital, liquidity, funding, and OTC derivatives. In retail banking, a wave of consumer protection rules is being implemented globally. In addition, the pendulum is swinging towards more regulation, driven by recent events such as the LIBOR fixing scandal and the widespread loss of faith in the sector's conduct.
    The impact of regulation on bank profitability will be significant. In retail banking in Europe's largest economies we estimate that 2010 ROE would have been 6 percent instead of 10 percent if all the regulation in the pipeline was already applied. In capital markets globally, we estimate that 2010 ROE would have been 7 percent instead of 20 percent under the same circumstances. The risk of overregulation has increased. It will become more challenging for banks to raise capital and funding which is sufficient to meet both new regulatory requirements and support lending growth.
  - **Customer and technology revolutions have accelerated.** Innovative technologies are changing the way customers interact and businesses operate. They fundamentally challenge traditional business models and open entry points for technology-based competitors. New technologies means switching banks has never been easier for customers – a dangerous proposition given current high levels of distrust. On the other hand, smart incumbents will understand how to leverage technology to increase customer loyalty.
  - **Macroeconomic volatility adds to gloom.** Global deleveraging will persist for years, and may be exacerbated by medium-term macroeconomic risks.

- **A trend-break in sector growth.** For the past three decades, the regulated global banking sector grew faster than underlying national economies. This trend has come to a halt. Banking penetration[3] in North America fell to 6.3 percent in 2011, from a high of 7.8 percent in 2007, and is not expected to reach precrisis levels before 2020. In Western Europe and emerging markets, banking penetration is expected to remain flat around the current rates of 4.5 percent and 4.9 percent respectively.
  Still, fundamental demand trends remain intact, fueled by the natural financing needs of expanding economies. Rising global infrastructure investment, growing international trade and the needs of ageing populations may constitute a base on which to build profitability in the longer term.

- **What is the size of the performance challenge?** We simulated an unmanaged scenario for Europe and the United States: in order to achieve 12 percent ROE, cost-to-income ratios would be required to drop to 46 percent in Europe, from an average of 68 percent in 2011 and to 51 percent in the United States, from 68 percent. Banks have already initiated various mitigating actions. The magnitude of this challenge, however, highlights the need for a fundamental transformation.

- **What might boost earnings?** In the medium term, two potential developments could give earnings a boost: interest rate recovery and sector repricing. Still, those changes by themselves are unlikely to return ROE to acceptable levels.
  - **Interest rate recovery – a call option for deposit-rich or transaction-heavy banks.** Interest rate recovery could boost margins. Our simulations show that a 100 basis point increase in underlying rates would boost ROE by 1 percentage point in the US and 0.6 percentage points in Europe. The benefit is greater in the United States because interest rates and loan-to-deposit ratios are currently lower than in Europe, creating a relative advantage in any rise.
  - **Structural repricing** – if banks continue to earn returns below their cost of equity, investors will be reluctant to commit significantly more capital. Lending capacity will grow more slowly than demand and result in structural repricing, if not delayed by market structure interventions.

- **State aid postponing a shake-out.** One key reason why many underperforming businesses have remained in the market is the $1.7 trillion in direct support (capital injections, assets purchases and state lending) injected into the global banking system.

3. The triple transformation

For many banks in crisis hotspots such as peripheral Europe, immediate survival will remain the predominant focus – with the priority being to secure funding, replenish capital and restructure assets. The sector as a whole, however, must look beyond survival and plan for the future.
In light of the challenges we have discussed, waiting for cyclical change may not be sufficient. Banks should aim high, fundamentally transforming their economics, business models, and culture – what we call a “triple transformation.”

3 Defined as revenue after risk cost to nominal GDP

- **Accelerate economic transformation.** Executives must make a determined effort to improve financial metrics.
  - **Capital efficiency – significant room for improvement.** Banks must review loan books, enhance risk models and improve collateral management. In addition, they must implement structural changes, for example by shifting financing off balance sheet. This is particularly true for European banks, which in 2011 had far lower ratios of securitized loans and corporate bonds to total financing volumes (19 percent) than US players (64 percent).
  - **Revenues – finding pockets of growth.** Banks must go beyond traditional levers and search for drivers of structural growth. Growth is becoming more granular (significant variations between similar countries on a product-by-product basis; select macrotrends, such as urbanization, affecting certain regions disproportionally) and banks must identify and mine individual areas of expertise. Smarter pricing and transformation are key levers for revenue growth.
  - **Costs – an irrefutable case for industrialization.** Banks need to embrace the changes already seen in other industries, such as automotive, including business simplification, streamlined operating models, and lean process optimization.

- **Drive business model transformation as basis for future growth.** Many banks require a fundamental transformation of business models.
  - **Retail and private banking – game-changing moves expected**
    - Revenues from private clients (including wealth management) grew by 6 percent to $1.8 trillion in 2011, accounting for 53 percent of the global sector revenue pool, compared with 52 percent in 2010.
    - In developed markets, the main challenges in retail banking are widely recognized: decreasing customer loyalty, technology-based nonbank competition, regulation, and a tough macroeconomic situation. However, most banks have opted to pursue a defensive adjustment path.
    - Payments are serving as the entry point for technology-based new players. The ecosystem of alternative financial services is expanding fast and game-changing moves are increasingly possible, exploiting the gap between customer satisfaction and incumbent's performance. Alibaba and Rakuten in Asia, or Mint and Simple in the US are examples of new models for financial services players.
  - **Corporate banking – finding growth amid tighter lending**
    - Corporate banking revenues after risk costs grew by 2 percent to $580 billion in 2011, representing a share of total revenues of 17 percent.
    - Corporate banking has been less impacted by regulation and has seen some repricing. However, the focus of corporate lending is shifting because banks no longer enjoy structurally lower funding costs than many of their large corporate clients. Leading banks are responding by expanding their product range and cross-selling.
  - **Capital markets – walking the line**
    - Revenues from capital markets decreased by 17 percent last year, accounting for just 7 percent of revenues, well below the 2009 peak of 12 percent. Capital markets is the most challenged segment, due to regulatory pressure, higher funding costs, and shrinking revenues.

- Massive cost cutting is necessary, alongside a review of product offerings and trading activities. Leading banks are already making substantial progress on a range of metrics.
- Fundamental cultural change has begun, for example through the redefinition of customer value and adjustment of compensation models.
- Undifferentiated business models will be reconfigured based on three core capabilities – risk-driven, customer-centric and infrastructure-driven; each of these have specific regulatory exposures, operating models, and economics.

— **Adjustment to institutional models.** Three priorities emerge: taking advantage of growth markets, reassessing the benefits and challenges of size, and cleaning up portfolios.

- **Embrace cultural transformation to support and enhance value creation.** Banks, rightly or wrongly, are widely viewed as primarily responsible for the troubled state of many economies. Recent scandals have pushed their reputations to new lows[4] and caused some stakeholders to question the underlying culture and values of banks. Banks should view cultural transformation as a strategic issue, not a public relations problem. They should examine their cultures carefully across four dimensions to ensure they are fostering value creation: balancing the interests of shareholders and society as a whole, creating value for customers, ensuring the soundness of internal processes, and influencing the mindset of employees. This will not only increase safety and soundness, but will restore public trust, spur customer-oriented innovation, and form a strong foundation for long-term sustainable growth.

Introduction

Nearly half a decade after the start of the global financial crisis, the banking system remains under pressure, amid a combination of regulation, technological change, and macrovolatility. While banks have improved the health of their balance sheets, they are still some way from achieving a model capable of producing robust and sustainable returns. Banks face a multitude of structural challenges, many of which are unlikely to dissipate any time soon, while revenues are still below precrisis levels. Banks in developed markets are failing on average to earn their cost of equity. On the key metrics of capital efficiency, revenues, and costs, much work remains to be done.

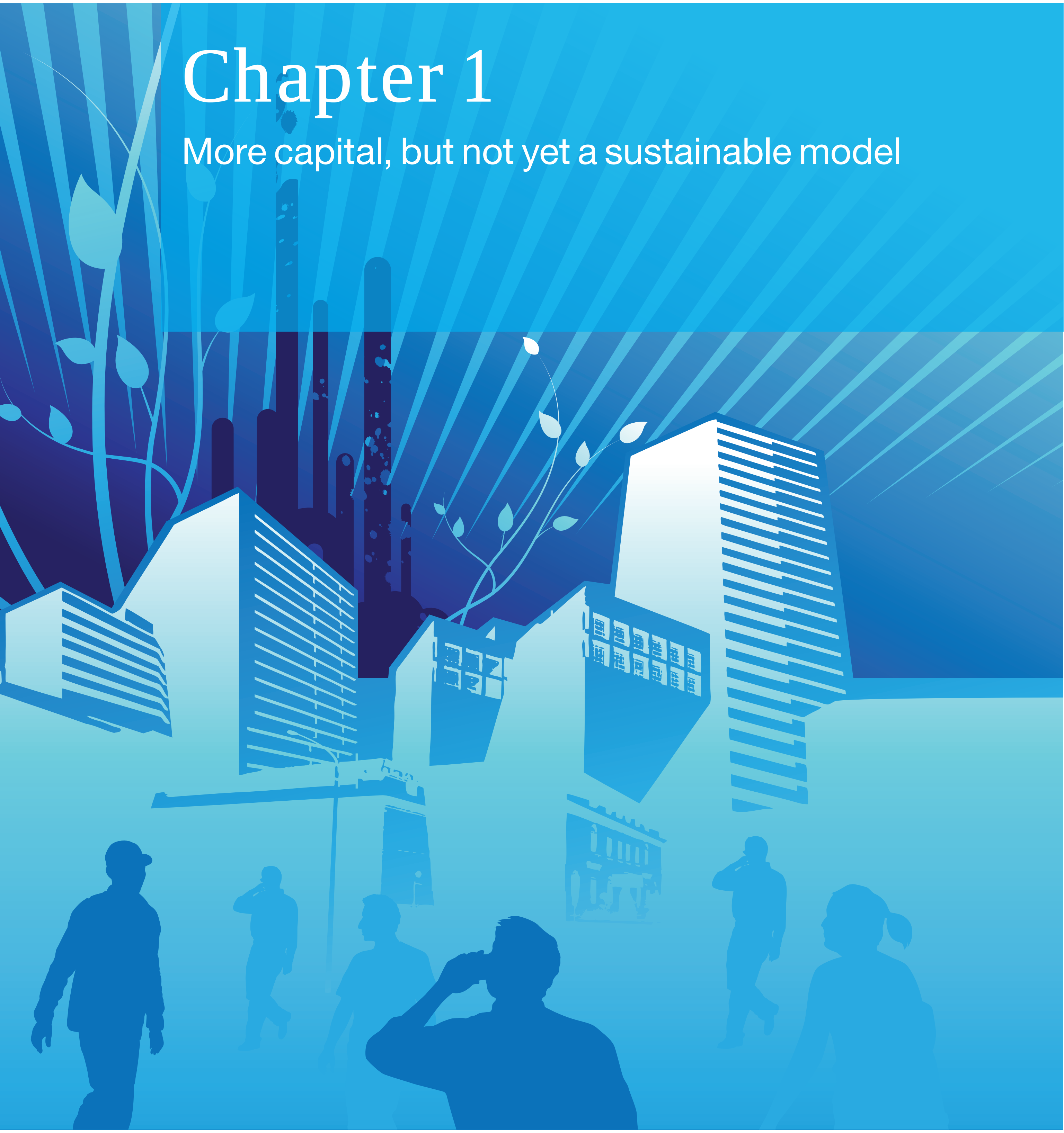
More than two-thirds of the listed banking sector in developed markets now trades significantly below book value – a sign of investor concern that the challenges faced by banks may be larger than expected. However, there are also some reasons for optimism, and in this report we hope to provide a compass that may help banking institutions chart a course away from the damage of the recent past, and towards a new future. We build our case on the need for a “triple transformation” of economics, business models, and culture. As we consider how the shape of the banking sector may evolve, we take time to examine the individual parts of the business, from retail to corporate banking and capital markets.

For those executives interested in sharing their thoughts on the future of banking, we welcome your feedback and comments.

Finally, we hope this second edition of our annual banking report provides readers with the insight and inspiration that we gained in producing it.

Chapter 1

More capital, but not yet a sustainable model



1. More capital, but not yet a sustainable model

Substantial increase in capital base

Banks around the world have made significant efforts in the recent period to stabilize their balance sheets. On a global basis, banks lifted Tier 1 ratios to 11.7 percent in 2011, compared with 11.4 percent in 2010 and 8.2 percent in 2007.

Since 2007, Tier 1 capital of the industry has grown by $2.0 trillion, or 57 percent (Exhibit 1). In the same period, assets grew by 25 percent ($17 trillion). The leverage of the global banking system has also dropped (asset-to-equity ratios declined to 17, in 2011 from 21 in 2007) (Exhibit 2). Over the past year these trends continued, but at a reduced pace.

Between 2007 and 2011, the proportion of RWAs to total assets on bank balance sheets declined by 1 percentage point.

Banks have since 2007 grown deposits by $17 trillion (32 percent), driving a four-year trend of declining loan-to-deposit ratios, which averaged 85 percent in 2011, compared with 86 percent in 2010 and 97 percent in 2007.

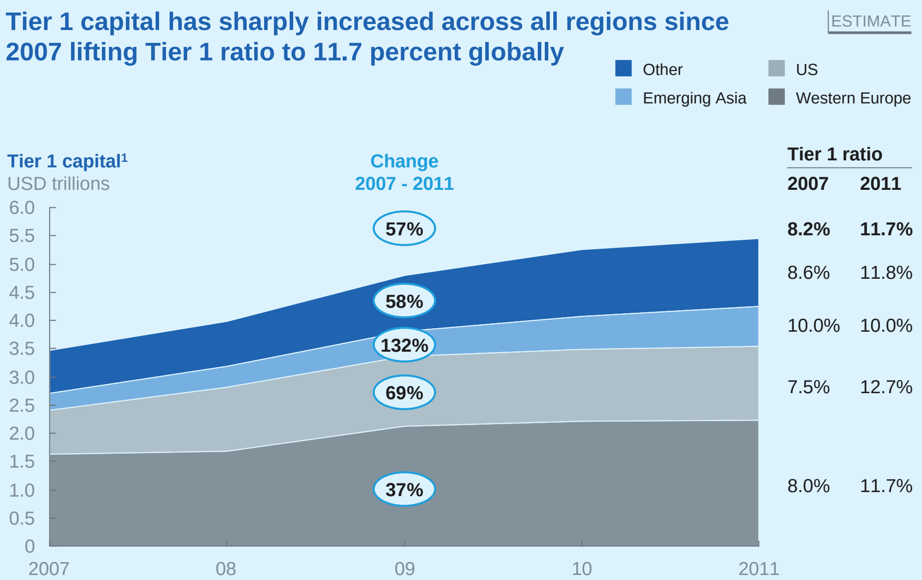
Stronger average balance sheet positions would seem to suggest the banking sector is on a more robust footing. While this is the case on a sector level, with many banks posting higher levels of Tier 1 capital in 2011, a large number posted Tier 1 declines, and some of these were as much as 300 basis points.

Despite efforts, performance has deteriorated

In last year's global banking sector report, we discussed the need to improve along three vectors – capital efficiency, revenues, and costs. Despite efforts over the past year, 2011 profit-

Exhibit 1

Tier 1 capital has sharply increased across all regions since 2007 lifting Tier 1 ratio to 11.7 percent globally



1 Upscale estimate, aggregation of all listed banks with available data in Reuters plus a 10% buffer for nonlisted banks

SOURCE: Thomson Reuters; McKinsey Global Banking Pools

ability did not evidence significant progress against those metrics, suggesting the performance transformation will take several years (Exhibit 3).

- **Capital efficiency: slight deterioration.** Capital efficiency deteriorated slightly. Notably, the ratio of off-balance-sheet to on-balance-sheet financing decreased, as ratio of securitized loans and nonfinancial corporate bonds dropped by 1 percentage point to 29 percent.

- **Revenues: no convincing growth story.** Amid signs of the post-crisis rebound running out of steam, there was no convincing revenue growth story. Recovery of risk costs slowed down, removing a key driver of profitability in 2010. Revenues after risk costs last year reached $3.4 trillion (Exhibit 4). However, revenue growth in 2011 was just 3 percent (in constant exchange rate terms), compared with 9 percent in 2010.

  Revenue margins deteriorated on average by 11 basis points to 3.1 percent from 2010 to 2011. Only Asian banks were able to improve margins, by 16 basis points on average, whereas US and Western European banks saw average margin declines of 48 basis points and 12 basis points respectively.

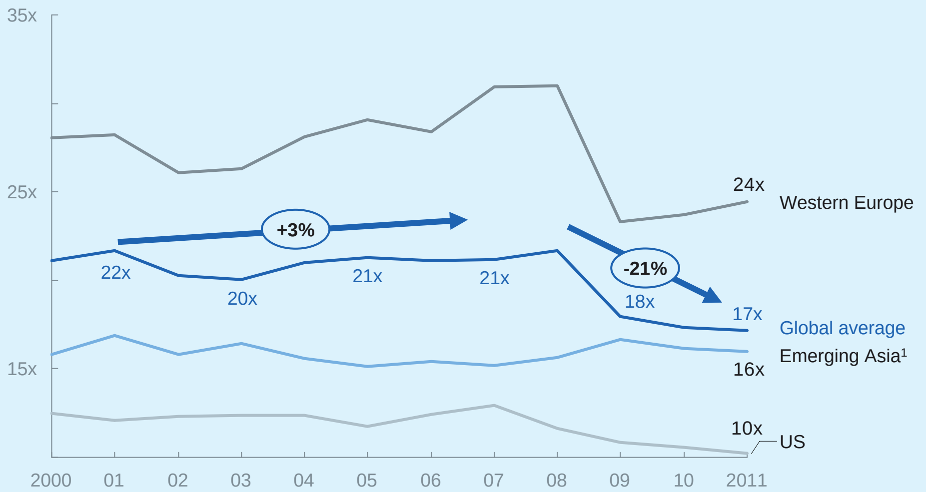
- **Costs: few efficiency improvements.** For the sector as a whole, there was no average operating cost improvement last year, with cost-to-income ratios increasing (60 percent in 2011 versus 58 percent in 2010 and 60 percent in 2007), while cost-to-asset ratios improved slightly (1.8 percent in 2011 versus 1.9 percent in 2010 and 1.8 percent in 2007) (Exhibit 5).

Exhibit 2

Since the start of the financial crisis banks have focused on balance sheet management and have achieved significant deleveraging

ESTIMATE

Total banking assets to equity, multiple



1 Without Japan and Australia

SOURCE: Thomson Reuters; McKinsey Global Banking Pools

The sector's cost base increased by 5 percent to $2.5 trillion last year. Before the financial crisis it was $2.3 trillion.

Many banks did not earn their cost of equity

The lack of performance improvement and increased capital ratios translated into declining ROE, which prevented a considerable number of banks from earning their cost of equity.

Profits decreased by 2 percent from 2010 to 2011 (and dropped by as much as 15 percent from 2007). In parallel, common equity increased by 47 percent from 2007 to 2011.

Global average ROE fell to 7.6 percent in 2011, after improving by 1.7 percentage points to 8.4 percent in 2010, down from as much as 13.6 percent in 2007. Average ROE is now only half of its peak value before the financial crisis (Exhibit 6).

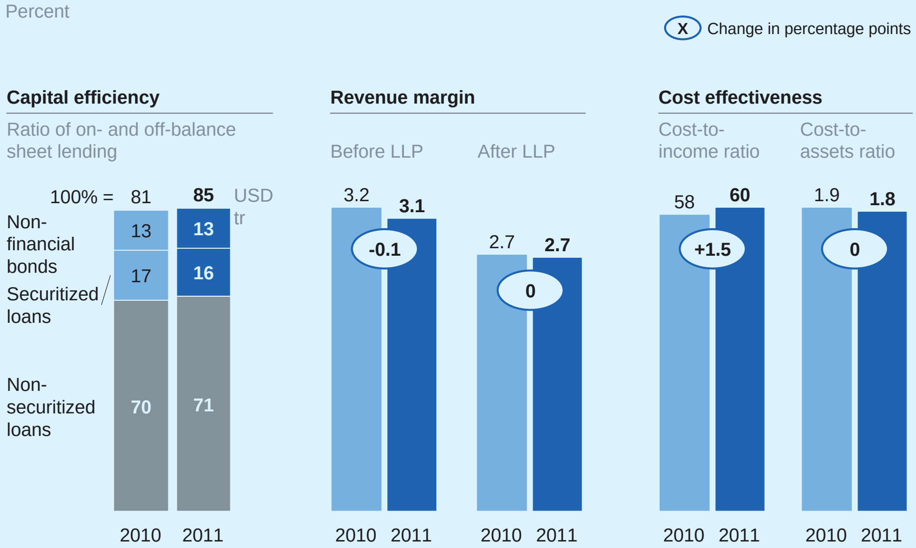
A turnaround is not in sight, with recent profit growth achieved largely on recovering loan loss provisions, an engine that is fast running out of steam. In 2010 loan loss provision recoveries accounted for 26 percent of annual profits. In 2011 they accounted for 12 percent.

Widening gap between best- and worst-performing banks

Notably, across all regions, the banks that managed to improve profitability in the past year were the ones in least difficulty. Half of those with a positive change along the three vectors were already in a strong position, while those with the greatest need made little progress. Only 6 percent of banks were able to improve

Exhibit 3

There is little sign of true banking transformation
Percent



Note: Cost ratios and margins (calculated over assets) are based on a sample of 193 banks with eligible data out of top 300 banks by market capitalization

SOURCE: Thomson Reuters; McKinsey Global Institute; McKinsey Global Banking Pools both cost efficiency and margins over the past year, while close to 30 percent of banks saw a weakening of both cost and margin ratios. The gap between best- and worst-performing banks will likely widen further in the coming years (Exhibit 7).

Three regional variations on a theme – little progress towards a sustainable model in the US and Europe, while Asian growth will be more volatile.

- **US: a tough road ahead.** American banks became more stable as they successfully cleaned up balance sheets through significant write-downs and the creation of good-bank/bad-bank structures to sequester and remove troubled assets. Further, regulatory pressure led to a significant improvement in capital bases. US banks lifted Tier 1 ratios to 12.7 percent in 2011, from 12.2 percent in 2010, and 7.5 percent in 2007. They reduced RWAs by 2 percent from 2010, reaching nearly the same absolute level as in 2007.

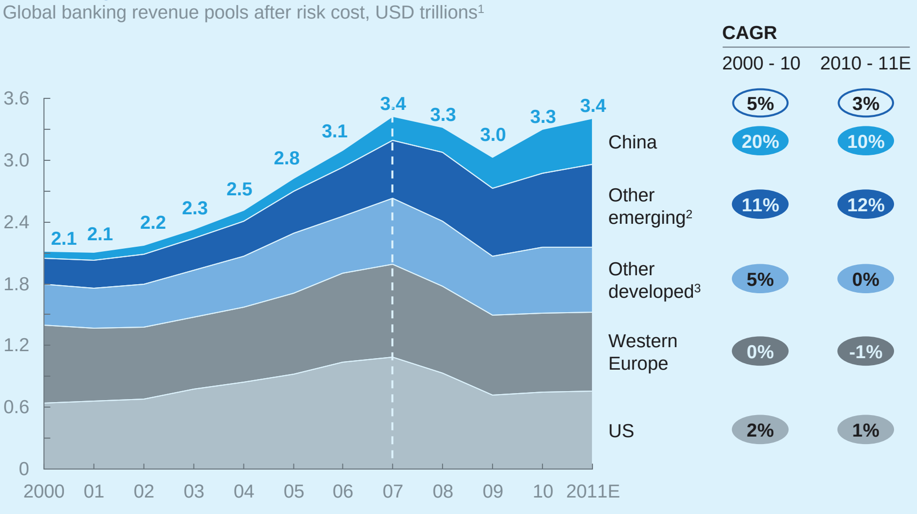
  However, the sector still faces significant challenges, as illustrated by slowly recovering revenues (only 1 percent growth over 2010, -30 percent compared with 2007), volatile margins (-48 basis points versus 2010, but +22 basis points versus 2007) and increased costs (cost-to-income ratio of 68 percent, versus 60 percent in 2010 and 62 percent in 2007, and cost-to-asset ratio of 3.2 in 2011, 3.1 in 2010, and 2.8 in 2007).

  US banks had an average ROE of 7 percent in 2011, a rise of 0.8 percentage points from 2010 (due to declining write-offs), and they are still far from earning their cost of equity.

Exhibit 4

The rebound has lost momentum – Western European banks post declining revenues

Global banking revenue pools after risk cost, USD trillions[1]



1 Constant 2011 exchange rates
2 Includes CEE, CIS, India, South East Asia, South Asia, Northern Africa, Sub-Saharan Africa, Latin America, and Middle East
3 Includes Australia, Canada, Hong Kong, Korea, New Zealand, Singapore, Taiwan, Japan

SOURCE: McKinsey Global Banking Pools

- **Europe: significant risks and distortions.** Despite significant efforts to stabilize the banking system, risk among European banks has increased. Although Tier 1 capital levels rose by 0.4 percentage points from 2010, the additional risk buffer would be insufficient if one of the looming macroeconomic risks materializes. Leverage remains high, with asset to equity ratios averaging 24.

  In addition, European banks have yet to realize all of the bad loans in their portfolios.

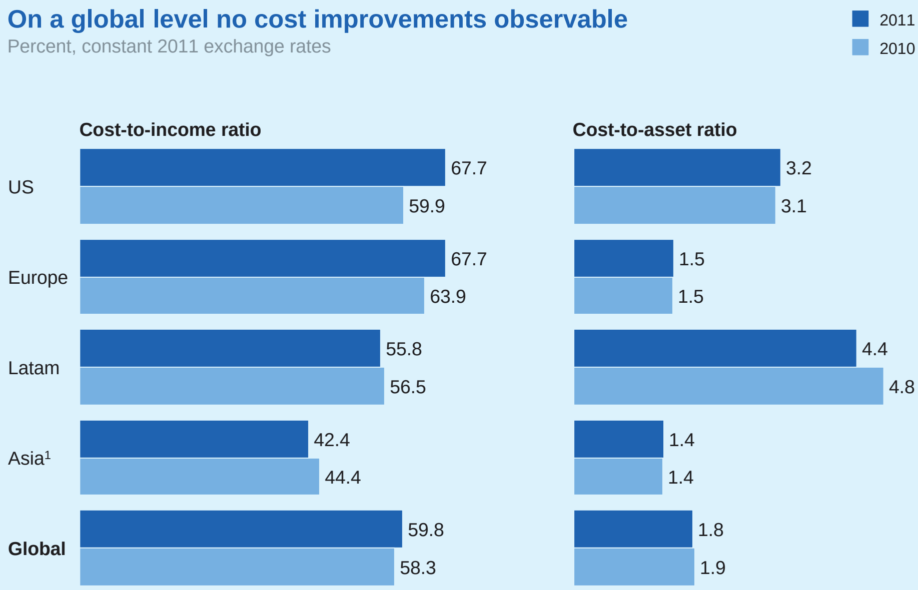
  Meanwhile, funding issues in the eurozone have made firms increasingly dependent on central banks. The European Central Bank (ECB) has stepped in as a provider of long-term liquidity with tender programs at the end of 2011 and beginning of 2012. Additionally, the ECB has softened collateral requirements and, in coordination with the Federal Reserve, has provided dollars to European banks. Recourse to the ECB increased significantly for both refinancing and deposits: while approximately €1.4 billion of liquidity were provided to the banking system, some €340 billion of deposits were placed with the ECB and national banks as of August 2012 (which was a near 50 percent decline compared with May 2012). Spanish, Italian, and Greek banks were heavily dependent on ECB operations, highlighting wide disparities across the region.

  In addition to further stabilizing their capital and funding sources, and cleaning up balance sheets, European banks must improve their revenue and cost bases. In Western Europe, revenues after risk costs were flat, reaching $761 billion in 2011. Revenues are down 16 percent from 2007. In line with the United States, European banks did not show any improve-

Exhibit 5

On a global level no cost improvements observable

Percent, constant 2011 exchange rates



1 Excl. Japan and Australia

SOURCE: Thomson Reuters; McKinsey Global Banking Pools

ment along the cost vector, with cost-to-income ratios increasing 4 percentage points, while cost-to-asset ratios remained unchanged. This led to an ROE of 0 percent – or 5 percent if the peripheral countries – Greece, Italy, Ireland, Portugal, and Spain – are excluded.

- **Emerging Asia[5]: continued growth – though slower and more volatile.** Emerging Asia banks managed to keep their sound capital and stability ratios intact and will continue to drive over 39 percent of global banking revenue growth.

  However, while banks increased Tier 1 ratios by 0.2 percentage points to 10 percent (slightly below the global average), there was a decline in revenue growth over the past year, largely driven by a drop in China, where growth was 10 percent, compared with 41 percent in 2010. In other Asian markets, revenue growth was stable at 8 percent.

  Emerging Asia banks cut cost-to-income ratios to 42 percent in 2011 from 44 percent the previous year but did not cut cost-to-asset ratios.

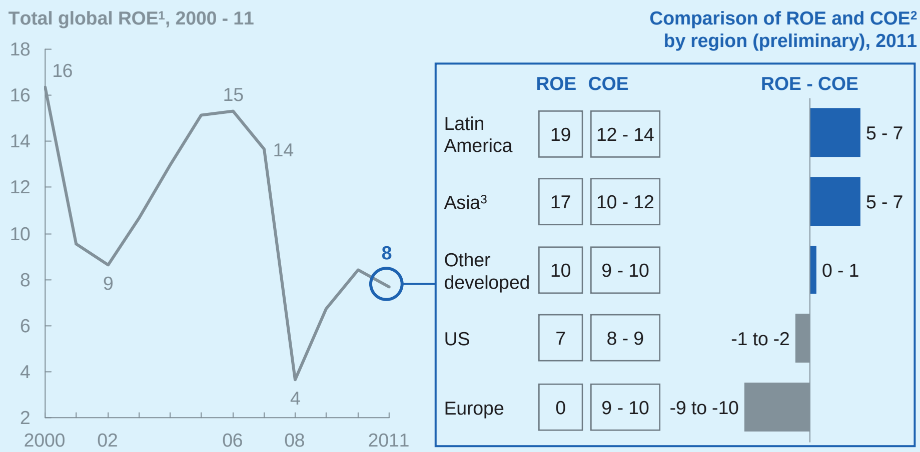
  On average, Emerging Asia banks earned an ROE of 17 percent in 2011, compared with 15 percent in 2010. Still, increasing risk costs (+10 percent from 2010 to 2011), highlighted the fact that they are not isolated from the global macroeconomic environment. Further, capital requirements in some markets are even tougher than required under the Basel III framework.

5 Excluding Japan and Australia

Exhibit 6

Industry profitability remains significantly below precrisis levels – cost of equity not earned in developed markets

Percent



1 Based on a sample of 906 – 1961 quoted banks with eligible data
2 Calculated with a CAPM-based model, but includes liquidity adjustment to reflect current market situation
3 Without Japan and Australia

SOURCE: Thomson Reuters; McKinsey Global Banking Pools

Finally sharp drops in customer loyalty are beginning to fragment customer wallets, again impacting profitability. Overall, these forces, unmitigated, will reduce ROE by 3 to 4 percent; a level that for some banks is below the cost of equity.

Given the growth expected in Asia, banks will need more than $1 trillion of largely growth capital (over and above retained earnings) through the coming decade. Against a back-drop of declining ROE, banks must innovate to attract private sector funding. Further, in some Asian markets, policy action may be necessary to manage industry structure and support efforts to raise capital.

Within emerging Asia, China faces specific challenges. Regulators and banks acknowledge a rise in bad debt, especially from loans to local governments and SMEs. Whereas local government bad debt is estimated at $400 billion[6], the potential impact of bad SME loans remains difficult to evaluate, partly because a reasonable proportion has been financed through the shadow banking system. Also, the Chinese government set growth expectations of only around 7.5 percent in 2012 – below the 8 percent previously targeted and thought to be necessary to maintain a harmonious social society.[7] Lastly, there is a significant risk in the transition from a heavily directed economic growth model to a market-driven economy, which

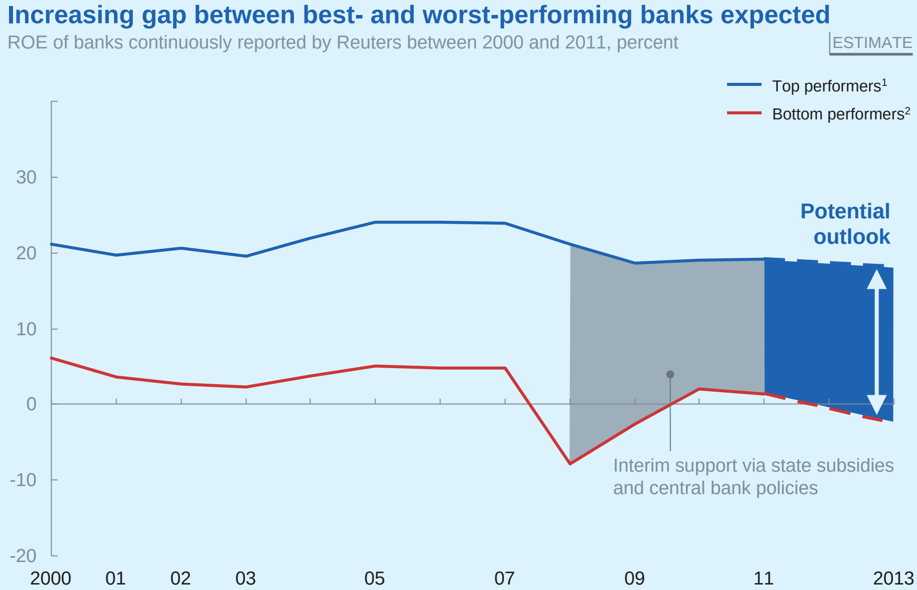
6 Reuters: “Special report - China’s debt pileup raises risk of hard landing”, October 10, 2011

7 Chinese Government Work Report 2010 on Mar 5, 2010

Exhibit 7

Increasing gap between best- and worst-performing banks expected

ROE of banks continuously reported by Reuters between 2000 and 2011, percent



1 Top decile
2 Bottom decile

SOURCE: Thomson Reuters; McKinsey Global Banking Pools

requires a difficult balancing of reforms and safeguards. The ongoing interest rate liberalization is an example of the many difficult transitions ahead.

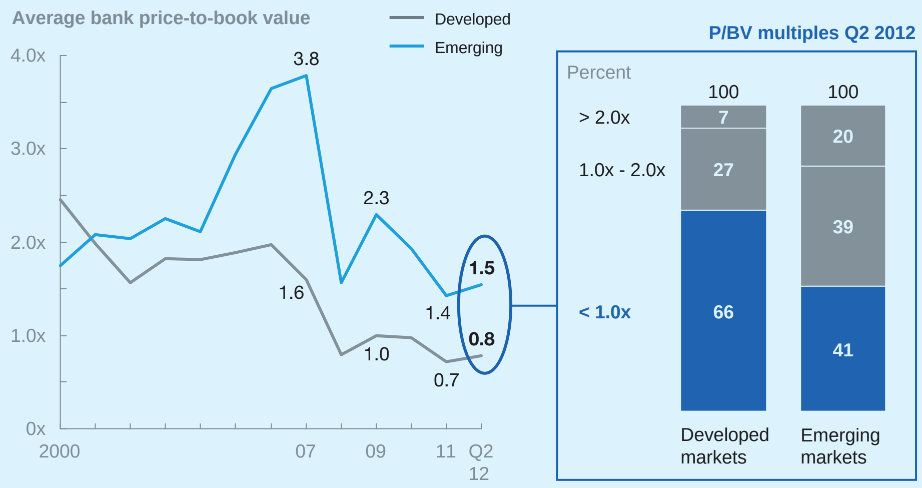
- **Other emerging markets: high growth, but increasing challenges.** Latin American and Eastern European banking markets continued growing in the recent period. Latin American banking revenues grew by 15 percent in 2011 and Eastern European revenues expanded by 14 percent. Uncertainty caused by rebellions in North Africa and Bahrain reduced revenue growth in Middle East/Africa to 3 percent. While at different stages of development, these markets are all subject to increased risk costs and growing profitability challenges. Risk costs rose 7 percent in Latin America and 14 percent in Middle East/Africa, whereas Eastern European risk costs were stable in 2011, due to improved performance in Russia and Poland. While the challenges are somewhat different in Latin America (e.g., rapid margin declines), Eastern Europe (e.g., contagion to EU) and Africa/Middle East (e.g., commodity price risks), there was a remarkable uniformity of P/B declines over the last 12 months. Average P/B ratios declined to 1.7 in Latin America and 1.4 in Eastern Europe and Middle East/Africa.

Investor confidence remains low – reduced expectations of a quick recovery

Although regional differences are significant, one common denominator is that investor confidence in the banking sector has declined globally, and capital markets have wasted no time in punishing banks for their lackluster performance.

Exhibit 8

Capital markets question the sustainability of the business model



SOURCE: Thomson Reuters; McKinsey Global Banking Pools

Banks' costs of borrowing have risen substantially. The average price of insurance against default in the credit default swap market of 124 banks sampled rose above 370 basis points in the past year, the highest level on record.

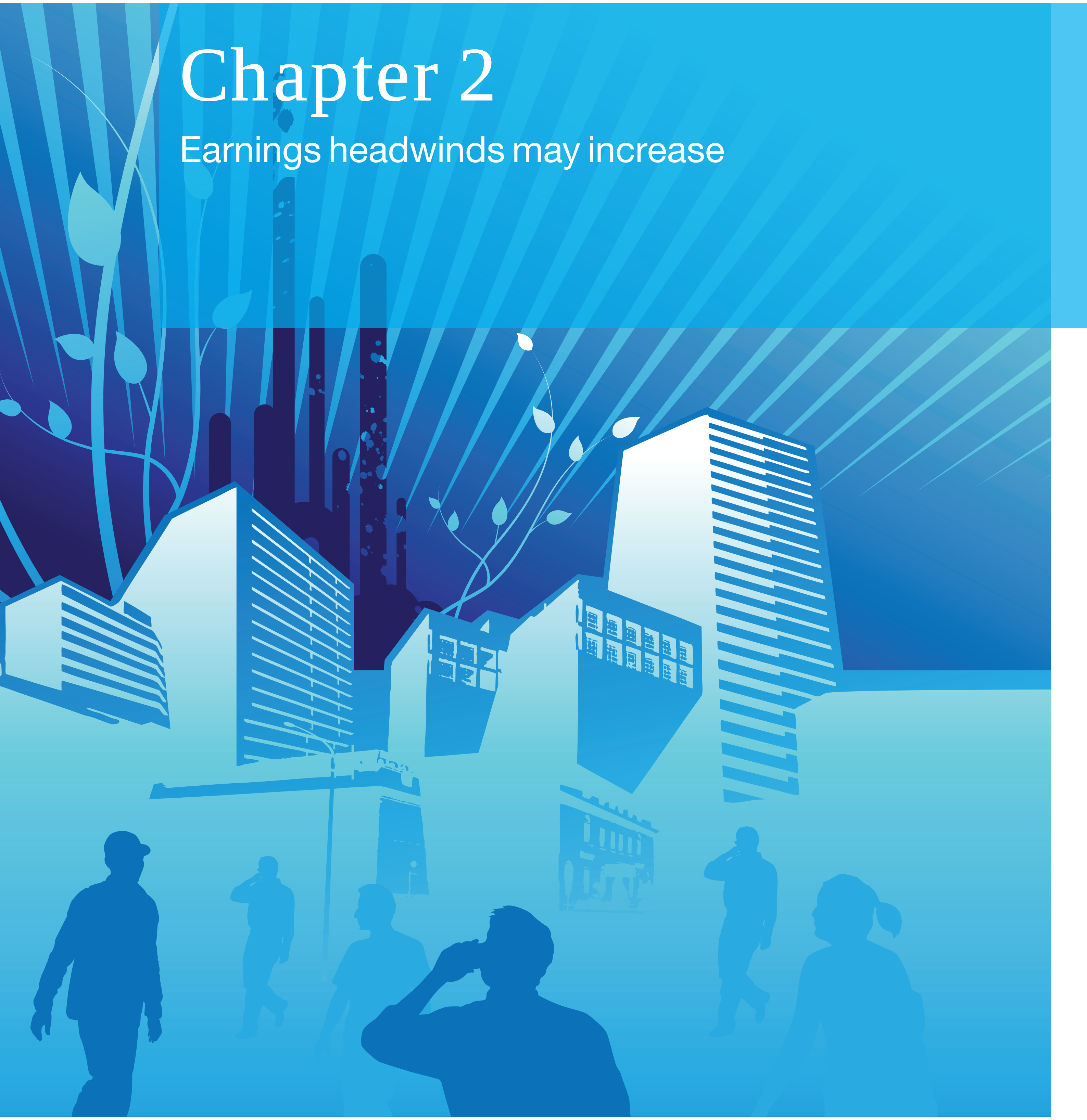
At mid-2012, bank stock market valuations were relatively low, with average price-to-book ratios of 0.8 in developed markets and 1.5 in emerging markets. That was a decrease of 20 percent and 21 percent respectively over 2010 year-end multiples, and a drop of 51 percent and 59 percent against 2007 figures. Some two-thirds of banks in developed markets traded below book value – amid concern over dilutions from further capital take-ups, additional write-offs, low earnings, and medium-term macroeconomic shocks. In developing markets, over 40 percent of banks traded at price-to-book ratios of less than one, reflecting investor uncertainty over short-term prospects (Exhibit 8).

Average price-to-earnings ratios were around 11 in 2011, compared with 15 in 2007. Although total equity has risen by 5 percent since 2010, and 47 percent since 2007, average market capitalizations remain significantly below precrisis levels.

These messages from the market reflect fundamental skepticism over the future of the banking sector.

Chapter 2

Earnings headwinds may increase



2. Earnings headwinds may increase

The regulatory, technological, and macroeconomic challenges banks are facing are likely to increase rather than diminish over the coming years, restraining earnings growth. Further, many institutions recognize that increased profits alone may not be sufficient to renew investor trust and improve market valuations. Sustainable growth is the key. Meanwhile, the difficulties banks are facing have been exacerbated by recent scandals, which have fueled mistrust among customers and society at large.

Challenges more daunting than expected

Regulation has become more complex and burdensome. The banking sector faces unprecedented regulatory change, led by the new frameworks to which the G20 leaders have committed themselves. These include new rules for capital, liquidity, and funding under the Basel 2.5 and Basel III frameworks, and a shift to standardization, transparency, and clearing through central clearing houses for OTC derivatives. The G20 has also mandated an additional capital surcharge for globally systemically important financial institutions (G-SIFIs) and has required G-SIFIs to develop recovery and resolution plans for times of stress.

In addition, there is ample regulation on a regional and national level. In the United States, the Dodd-Frank Act mandates more than 200 new regulations, and 67 studies and reports to be conducted by regulators. The United Kingdom may "ring-fence" retail banking operations in 2015, following the recommendations of the Independent Commission on Banking.

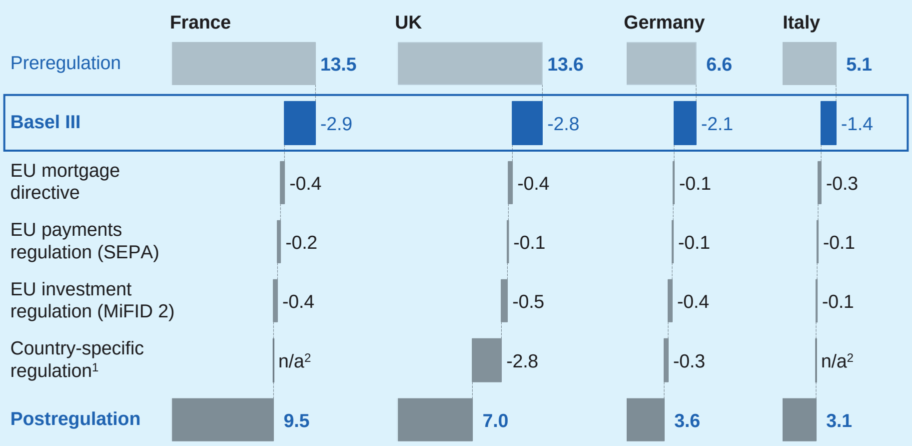
In the retail sector, a wave of consumer protection has been rolled out, with a potentially significant effect on profitability. The changes range from

Exhibit 9

Regulation will strongly affect retail banking profitability – Basel III as main driver

2010 ROE, percent

INACCURACIES ARE DUE TO ROUNDING



1 Germany: taxes and levies; establishment of a fee-based advisory model; UK: ICB ring-fencing, FSA on PPI, living wills, account switching/portability, taxes, and levies

2 Country-specific regulation in France and Italy has either been implemented already in 2010 or has only low impact and therefore has not been modeled

SOURCE: Day of Reckoning for European Retail Banking (McKinsey, July 2012) needing to keep meticulous records of customer consultations and providing extensive product information to fee caps and the complete prohibition of certain products. The European Union has further directives in the pipeline that regulate mortgages, payments, and investment products. Several countries have imposed levies on banks to recover some of the damage of the crisis, and have moved to protect consumers through higher levels of transparency.

The combined impact of these regulatory changes could be dramatic. For example, if all regulations in the pipeline were applied with immediate effect, and assuming banks took no mitigating actions, 2010 ROE for retail banking in Europe's four largest markets (Germany, France, Italy, and the UK) would fall on average by 4 percentage points to 6 percent[8] (Exhibit 9).

The impact of regulation on the global capital markets business is even more significant, and under a similar analysis of top 13 global players ROE would fall from 20 percent to 7 percent[9] (Exhibit 10).

Regulation will also lead to a reassessment of the benefits and challenges of size. The pressure is likely to be particularly felt by those universal banks that are regarded as G-SIFIs (see above), due to their significant investment banking activities and strong retail and corporate banking presence.

8 See McKinsey White Paper "Day of Reckoning for European retail banking", July 2012 (mckinsey.com)

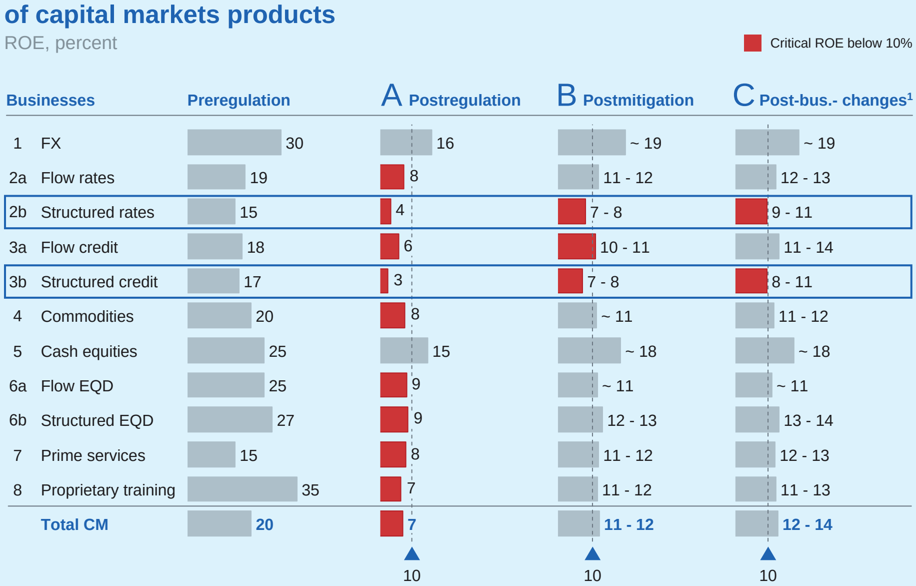
9 See McKinsey Working Paper on Risk, Number 29 "Day of Reckoning? New regulation and its impact on capital-markets businesses", September 2011 (mckinsey.com)

Exhibit 10

Regulation will fundamentally deteriorate economics of capital markets products

ESTIMATE

ROE, percent



1 Very rough estimate

SOURCE: Day of Reckoning? New regulation and its impact on capital-markets businesses" (McKinsey, September 2011)

Those institutions will face the challenge of demonstrating superior profitability to compensate for forthcoming G-SIFI capital surcharges and additional regulatory burdens. For example, European retail banks face a potential ROE decline under G–SIFI legislation of 40 to 120 basis points[10] (Exhibit 11).

In the recent period, public sentiment toward the banking sector has deteriorated[11], and further regulation cannot be ruled out. Continued high levels of compensation, perceived credit crunches in segments such as lending to small and medium-sized enterprises, as well as sizeable trading losses and the LIBOR fixing scandal have had a negative impact on public opinion, giving rise to discussions over whether the sector needs to be more tightly regulated. Also, the debate on the need for structural changes, for example the separation of some businesses and the prohibition of certain activities, which seemed to be settled with the US Volcker rule and the "ring-fencing" recommendations of the Independent Commission on Banking in the UK, has recently returned in many Western markets.

A side effect of tighter regulation is the growth of the shadow banking system.[12] Shadow banking already accounts for 15 to 18 percent of the global capital market and investment banking revenue pool, and is set to grow by 5 to 10 percent a year,

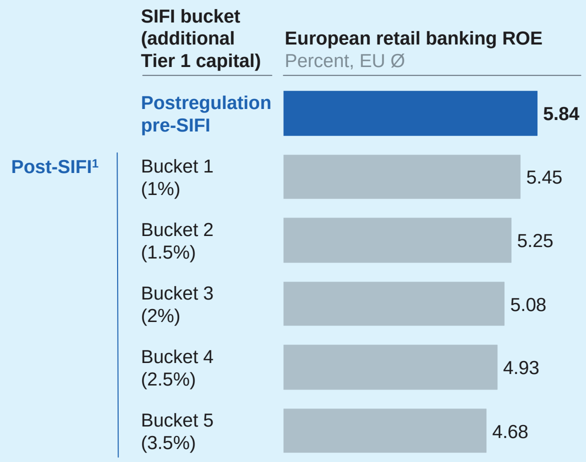
10 See McKinsey White Paper "Day of Reckoning for European retail banking", July 2012 (mckinsey.com)

11 2012 Edelman Trust Barometer

12 Shadow banking, as defined here, includes the following banking activities: advisory, issuances, underwriting, market making and prop trading by nonbank players

Exhibit 11

SIFI status lowers European retail banking ROE by additional 40 to 120 bp



1 Impact estimated as average based on 4 countries average impact

SOURCE: Day of Reckoning for European Retail Banking (McKinsey, July 2012) although there is a possibility that regulation and responses from incumbents could temper this.

Customer and technology revolutions have accelerated. Technological changes and higher levels of customer mobility will influence the way banking players operate over the coming decade, and may fundamentally transform the banking value chain. In particular, the accelerated dissemination of smart phones and tablets, offering convenient mobile Internet access, will drive new customer behaviors, which we will further explore in the retail section of Chapter 3.

The financial services "ecosystem" is becoming more diverse, with nonbank entrants gaining market share in customer-facing areas, and down-streaming parts of the value chain. Banking customers now have real alternatives to traditional banks, a critical situation for incumbents when taken with the very serious reputational issues across the sector.

Still, technology does not need to be a competitive threat, and may be a benefit. For example, incumbents may boost loyalty if a customer can personalize his banking service platform.

In retail, some regions are several years ahead in terms of technology uptake. For example, Internet banking penetration in northern Europe is 76 percent, an increase of 19 percentage points in the past five years, while the number of branches in the region has declined by 24 percent since 2001.[13] Mobile online interactions, meanwhile, have soared by 100 percent in the past year, overtaking "stationary" online interactions.[14] Mass migration to online and mobile banking give banks the opportunity to book significant efficiency gains in branch networks.

Technology is also playing an increasingly critical role in corporate and investment banking. In the front office, the penetration of electronic trading across equities and fixed income is growing (up to 55 to 65 percent of notional volumes in FX), and continues to transform interactions with clients. For the middle and back office, having scalable, robust technology platforms can help leading firms derive ~ 80 percent lower unit costs per trade. Finally, robust technology platforms – including strong data management capabilities – are necessary to meet increasing regulatory demand (e.g., the move to central clearing for OTC derivatives).

In the longer term, different technology-driven scenarios are possible. In the best-case scenario for banks, they will become multiservice digital giants, capturing new wallets through finance and digital services. Already there are examples of banks acting as one-stop access points for digital services, offering an ecosystem of solutions, including e-commerce, travel, and portals, in addition to traditional banking services.

Macroeconomic volatility adds to gloom. The pace of global deleveraging seems to be increasing, driven by regulatory restraints and the increased cost of funding in developed markets. In Asia, overheating pressures may cause liquidity to dry up. The level of outstanding private sector loans and corporate debt (bonds) relative to GDP increased 10 percentage points to 110 percent in the 10 years to 2010. It is likely to decline to 109 percent by 2020 (Exhibit 12).

13 Eurostat

14 EFMA and McKinsey Mobile Banking survey

The effects of deleveraging may be exacerbated by medium-term macroeconomic risks.

The state of the global economy has become even more fragile. The eurozone is, for all practical purposes, in recession, with the remaining risk of a breakup, while US growth is far from robust. Further, governments in advanced economies have their hands tied, with budgetary or political roadblocks constraining fiscal expansion and historically low interest rates limiting monetary policy firepower.

The weakness in advanced economies has rippled through emerging markets in the form of weaker exports, which could presage a harder-than-expected landing for some countries as they struggle to counter the retreat in domestic and external demand. China, India, Brazil, and Russia are all showing signs of pressure, with the latter three facing concerns over accelerating inflation. The decline in external demand comes on top of cross-cutting slowdowns in both consumer and investment activity. As a result, government authorities are attempting to support growth through pro-business regulatory measures (India), investment-focused stimulus (China), and large-scale infrastructure programs (Brazil).

A trend-break in sector growth

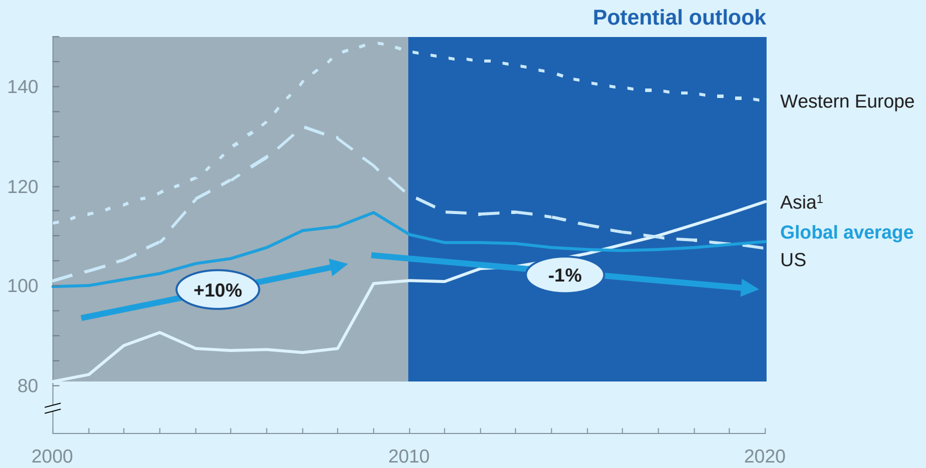
The fundamental performance challenges described above suggest the 30-year trend of banking revenue growth exceeding GDP growth (leading to banking accounting for a growing share of GDP) is likely now being broken. The year 2007 might remain the high-water mark for banking revenues as a share of GDP until as late as 2020. In both emerging and developed markets, banking revenues are expected to flatline

Exhibit 12

The end of "leveraging" in the developed markets is slowing drive for loans

Total private sector loans to GDP, percent

BASE CASE



1 Excluding Japan and Australia

SOURCE: Thomson Reuters; McKinsey Global Banking Pools

at around 5 percent of GDP for the foreseeable future (Exhibit 13).

In North America, banking penetration fell to 6.3 percent in 2011, from a high of 7.8 percent in 2007, and is not expected to return to precrisis levels until after 2020, given that banking revenues are projected to increase at 4 percent a year, near the same level as forecasted annual GDP growth. In Western Europe, banking penetration is expected to remain flat around the current rate of 4.5 percent, with banking revenues set to grow in line with GDP at between 4 and 5 percent a year.

In emerging markets, we expect banking revenues as a percentage of GDP to stay steady at around 5 percent, but with high annual GDP and banking growth rates of approximately 11 percent. Looking at individual countries, however, we find a much more heterogeneous picture. While banking penetration in Brazil is more than 10 percent of GDP, countries at the other end of the spectrum, including Russia, India, Nigeria, and Mexico, have rates below 4 percent of GDP.

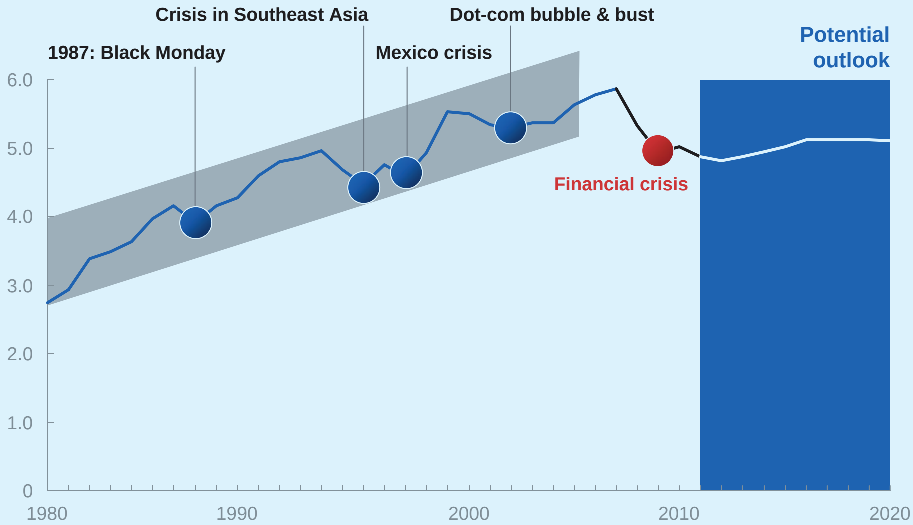
In China, the current penetration rate is 6.2 percent of GDP, but is expected to decline to 5.3 percent by 2020. Here, as in some other emerging markets, strong growth in customer volumes is likely to be outweighed by declines in revenue margins towards levels seen in developed countries, combined with falls in risk costs.

The reason why banking revenues may at least keep the pace are the natural financing needs of expanding market economies. Up to 2020, global credit stock is expected to grow at an annual rate of 7 percent, in line with consensus nominal GDP growth, with emerging markets achieving 11 percent growth, while developed

Exhibit 13

It is likely that there is a trend-break in relative growth of banking industry after ~ 30 years of steady increase in banking penetration

Relative size of banking revenues after risk cost to nominal GDP, world, percent



SOURCE: OECD; McKinsey Global Banking Pools market credit expands annually by 5 percent. Over the same period global infrastructure investment is expected to rise by 60 percent, and foreign trade flows as a proportion of real GDP could grow from 27 percent to 37 percent. Further, the emergence of a new customer class in emerging markets, with some 2.5 billion adults currently without access to banking (plus the needs of an ageing population in developed economies) may constitute a base on which to build profitability in the longer term.

What is the size of the performance challenge?

Based on our analysis of the impact of capital regulation and estimate of the size of the global banking revenue pool, we simulated an unmanaged scenario for Europe and the United States, which does not include the various mitigating actions the sector has already announced or initiated. Under this scenario, the ROE of the sector will stay considerably below the cost of equity in Europe (5 percent) and the United States (approximately 6 percent) until 2015. In order to achieve a 12 percent ROE (a level that would generate a reasonable return over the cost of equity), cost-to-income ratios would be required to drop to 46 percent in Europe, from an average 68 percent in 2011 and to 51 percent in the United States, from 68 percent in 2011. The magnitude of this challenge highlights the need for the triple transformation we describe in Chapter 3.

What might boost earnings?

In the medium term, two potential market-driven developments could give banks a boost: interest rate recovery and sector repricing. Still, these changes would only ease the banking sector's current ROE challenge, rather than overcome it.

- **Interest rate recovery – a call option for deposit-rich or transaction-heavy banks.** As discussed above, persistently low interest rates reduce margins on financial products. Interest rate recovery would boost margins for deposit-rich banks and help increase ROE. Our simulations show that a 100 basis point increase in underlying interest rates would increase ROE by 1 percentage point in the United States and 0.6 percentage point in Europe. The benefit is greater in the United States because interest rates and loan-to-deposit ratios are currently lower than in Europe, creating a relative advantage in any rise.

- **Structural repricing.** If banks continue to earn returns below their cost of equity, investors may be unwilling to commit significantly more capital. As a result, lending capacity will grow more slowly than demand and result in structural repricing. In some areas, such as asset finance, this effect is already visible. This is a fundamental positive for the banking sector compared with other industries – for example semiconductor manufacturing. There, overcapacities and low pricing can only be overcome by a painful restructuring process, with players exiting the market. Since the adjustment process in banking will take time, we will probably see the emergence of repricing until the cost of equity is reached. However, if markets are highly fragmented and a significant proportion of players are not publicly listed, or have access to equity from shareholders with different return expectations, such as the state, the repricing mechanism may not function.

State aid postponing a shake-out

As we have highlighted above, progress along the three performance vectors was very limited in 2011. When we analyze the performance of individual banks, we find only a handful of “new shapers:” only 6 percent of banks improved across the vectors of costs and revenues over the past year. On the other hand, the performance of 30 percent of banks has worsened, and emerging market banks are not excluded. In fact, recent success in emerging markets could become a distraction if banks fail to seize the opportunity to transform in the face of the challenges presented by regulation and technology.

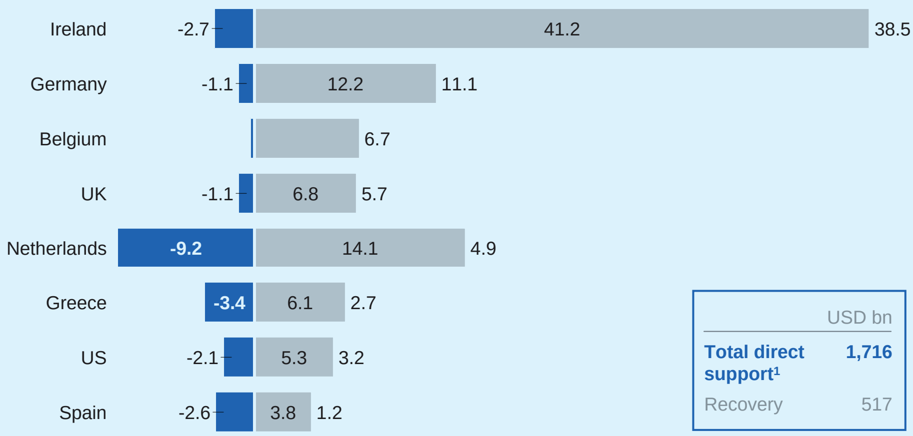
Given uneven levels of performance across the sector, one would normally expect sector consolidation. However, healthy banks are reluctant to buy weak banks because of a low level of trust in balance sheets and the risk that a major crisis may hit during the postacquisition integration process. Further, while forced restructuring was widespread during the financial crisis, when a number of banks disappeared from the landscape, state aid and central bank policies have significantly alleviated consolidation pressure and impeded a major shake-out. There have been only 30 bank failures in the United States year-to-date, compared with a high of 157 in 2010. Globally, some $1.7 trillion of direct support has been injected into the banking system, with no clear visibility as to when this support will be withdrawn or when the sector will be required to fend for itself (Exhibit 14). Transformation momentum will only accelerate when state interventions subside.

Exhibit 14

Total direct support to the financial sector amounts to more than USD 1.7 trillion

Direct financial sector support of selected advanced economies[1], percent of 2011 GDP

Recovery   Direct support

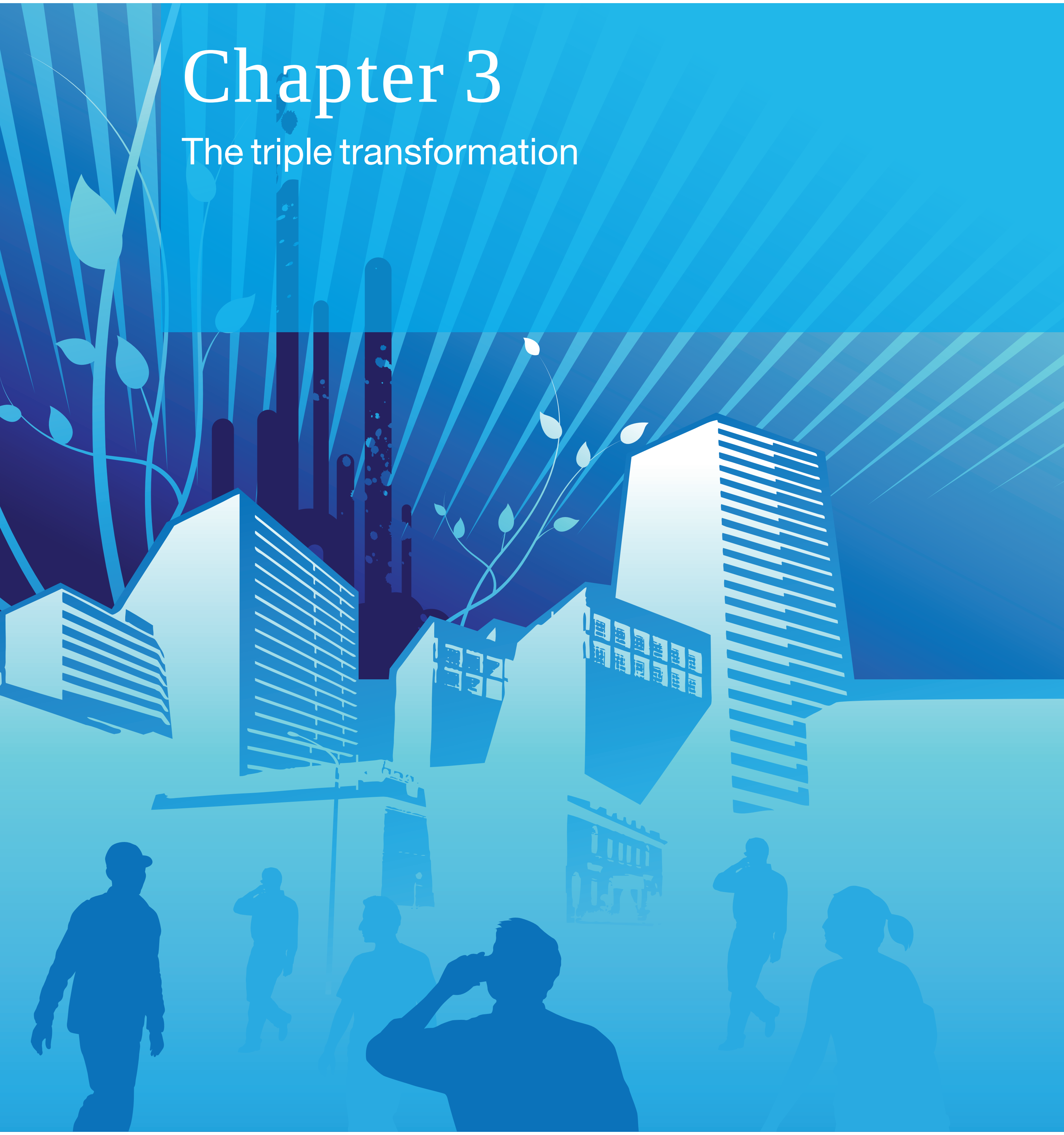


1 Cumulative direct support (utilized capital injection and purchase of assets and lending by treasury, including bad banks) since the beginning of the financial crisis until Feb 2012, for some countries latest available data is as of Dec 2011

SOURCE: IMF Fiscal Monitor 4/2012

Chapter 3

The triple transformation



3. The triple transformation

For many banks in crisis hotspots such as peripheral Europe, immediate survival will remain the predominant focus – with the priority being to secure funding, replenish capital, and restructure assets. The sector as a whole, however, must look beyond survival and plan for the future.

In light of the challenges we have discussed, waiting for cyclical change may not be sufficient. Banks should aim high, fundamentally transforming their economics, business models, and culture – what we call a "triple transformation."

Accelerate economic transformation

The magnitude of the challenges that financial institutions face cannot be resolved through tactical adjustments to the business model or simply waiting for cyclical change. Rather, a fundamental transformation along all three performance vectors is necessary.

- **Capital efficiency – significant room for improvement.** Banks have been successful in trimming their balance sheets to improve capital ratios. In order to improve profitability, however, they need to redouble their efforts in respect of capital efficiency, specifically by reviewing loan books, enhancing risk models and improving collateral management. In addition, they must implement structural changes, for example by shifting financing off balance sheet. This is particularly true for European banks, which in 2011 had far lower ratios of securitized loans and corporate bonds to total financing volumes (19 percent) than US players (64 percent).

- **Revenues – finding pockets of growth.** Banks must go beyond traditional levers and search for drivers of structural growth. Growth is becoming more granular and banks must identify and mine individual areas of expertise. Significant variations exist between similar countries on a product-by-product basis, while macrotrends, such as urbanization, affect certain regions disproportionally and may constitute a key driver for revenue growth. Tailored offerings for specific customer groups, such as small entrepreneurs, offer additional growth potential.

One key lever is **smarter pricing.** Capacity reduction in the sector is proceeding at a slow pace as high levels of financial support keep institutions afloat. Shrinking asset volumes over a fixed cost base have made negative profit margins on corporate loan portfolios more common. Taking a systematic approach, banks can reprice or exit a large proportion of underpriced portfolios and employ the freed-up resources for new issuance on improved terms, including more flexibility for further repricing and higher margins. In less than two years, a bank in central Europe repriced more than 40 percent of its portfolio, selling or terminating nonnegotiable credit items with a loss of up to 10 percent and increasing the margin on its SME portfolio by around 80 basis points.

Another critical avenue is monetizing the **transformation to digital.** "One click" processes will allow clients to get information, order products, and pay with smart phones and tablets. As a result, 99 percent of transactions and service requests could be handled digitally, as well as the majority of sales leads (Exhibit 15). When customers want to speak with someone at the bank, they will interact via telephone or video conferences, and the bank will link to premium clients at home. The branch network will be more tailored to client needs than at present, with a range of different formats to match customer profiles and needs in each location. These changes, which will create a radically different distribution profile, could increase sales by up to 20 percent.[15]

- **Costs – an irrefutable case for industrialization.** To achieve sector-wide productivity improvement, banks need to embrace the changes already seen in other industries, such as automotive, starting with simplified businesses – reflecting customers' needs – streamlined operating models with strategic sourcing and digitized processes. An entirely new culture of full process transparency and control needs to be established. The time is right for a giant leap forward, with economic pressure and technological potential creating the conditions for change.

Drive business model transformation as basis for future growth

Each market segment must address the fundamental changes we have discussed according to its own set of priorities.

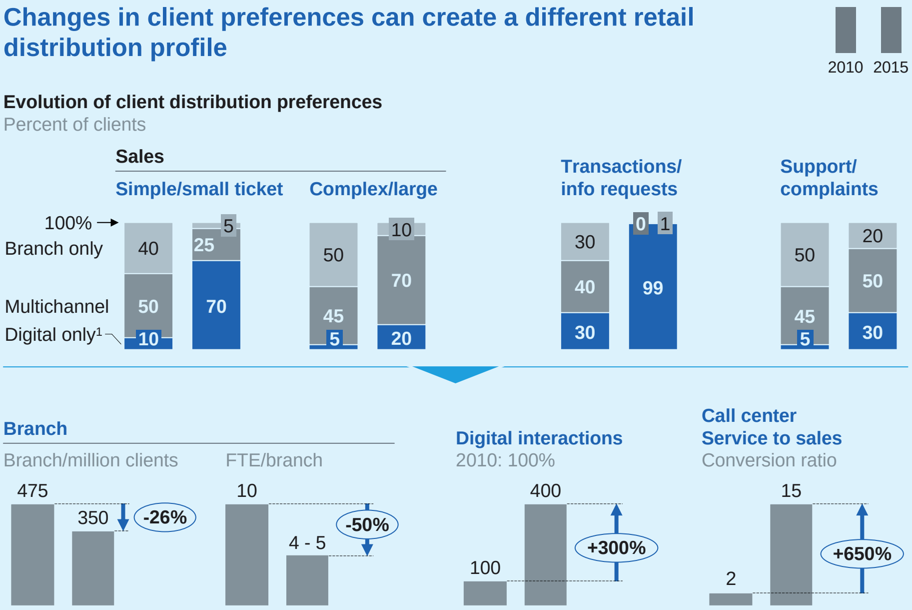
A detailed discussion of each segment model would exceed the scope of this report. However, as a high-level point of reference we have described current segment economics and the main areas of future change.

Revenue mix adjustments reflect post-crisis transformation towards retail-driven business.

As a source of revenue, the relative importance of capital markets has declined by 3 percentage points since 2007 to 7 percent of global revenues,

15 McKinsey multichannel survey

Exhibit 15



1 Including call center

SOURCE: McKinsey Banking Practice

as retail and private banking rose by 1 percentage point to 53 percent and corporate banking rose by 1 percentage point to 17 percent (Exhibit 16).

Retail and private banking – game-changing moves expected. Revenues from private clients (including wealth management) grew by 6 percent to $1.8 trillion in 2011, accounting for 53 percent of the global sector revenue pool, compared with 52 percent in 2010 (Exhibit 16). Costs increased by 4 percent leading to a cost-to-income ratio of 54 percent, a 1 percentage point decrease from 2010.

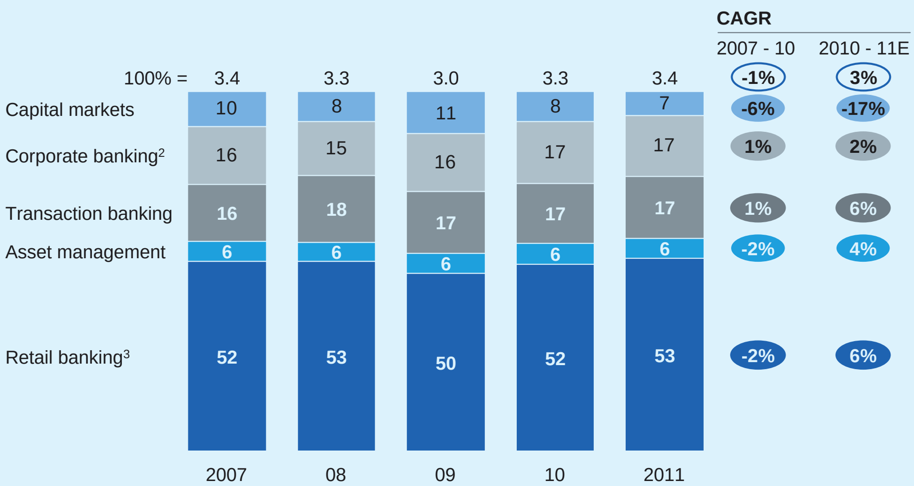
In developed markets, the main challenges in retail banking are widely recognized: decreasing loyalty, technology-based nonbank competitors gaining market share (initially focused on payments), the greater-than-expected impact of regulation and a tough macroeconomic situation (including low interest rates and household deleveraging in some countries). However, most banks have opted to pursue a defensive adjustment path, relying on the relative stability of their business.

With transactions shifting away from branches, banks have the opportunity to book efficiency gains of about 50 percent, allowing them to focus on sales and advice rather than on administration and operations (Exhibit 17). Further capacity reductions in the network will come in different forms, depending on market structure and customer behavior. In the United States, we expect that by 2020 there will be only two-thirds of today's branches. Last year in Asia, the high

Exhibit 16

Customer-driven segments gaining importance in bank revenue mix – capital markets suffering

Global banking revenue pools after risk cost, USD trillions[1], percent



1 Constant 2011 exchange rates
2 Excluding transaction banking
3 Including wealth management

SOURCE: McKinsey Global Banking Pools

rate of uptake in online banking led to the first drop in branch visits since 1998.[16]

As already mentioned above, new entrants can be a game changer. The elements of an alternative financial services model for private customers and small businesses are already in place: customer facing entry points (especially in the payments arena or online), aggregators, and product and service innovators. The gap between customer expectations and incumbent performance provides a classic opportunity for ambitious banks and/or technology-based competitors to fundamentally change the model. These new shapers will eventually overcome trust issues and regulatory barriers and fully leverage technological innovation to deliver existing and new financial services at much lower cost, following in the footsteps of retailing and other industries.

There are already examples of the emergence of new superstars. In Asia, fast-growing companies such as Alibaba and Rakuten have developed entirely new ecosystems, extending the traditional scope of banking. Rakuten is currently the fastest growing bank in Japan. Formed as e-bank in 2000 it offers "one-stop" access to a wide range of services that touch all aspects of everyday life via digital: e-commerce, travel, portals, and finance – all under the Rakuten brand.

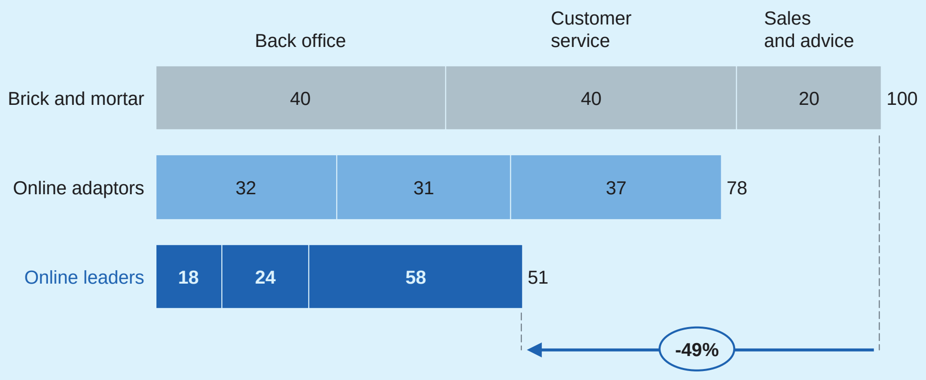
Each incumbent bank must consider how far it can rely on the intrinsic stability of its balance-sheet revenues and customer franchises and how to manage the transition towards a new model.

16 Personal Financial Services Survey Asia (McKinsey, 2011)

Exhibit 17

Online adaption will lead to significant efficiency gains and allows banks to focus their capacities more on sales and advice

Indexed capacity need by function, percent



SOURCE: EFMA; McKinsey Multichannel Survey 2010; McKinsey

In wealth management, leading banks need to follow shifts in wealth creation, especially towards Asia Pacific. These regions will disproportionately contribute to the global wealth management profit pool (Exhibit 18).

Corporate banking – finding growth amid tighter lending. Corporate banking revenues after risk costs grew by 2 percent to $580 billion in 2011, representing a share of total revenues of 17 percent (Exhibit 16). Costs increased by 3 percent, leading to an average cost-to-income ratio of 46 percent, a 0.4 percentage point decrease compared with 2010.

Corporate banking has been less impacted by regulation than most other businesses (with the exception of products such as structured credit), and has seen some repricing. However, the relative value of corporate lending is declining because banks no longer enjoy structurally lower funding costs than many of their large corporate clients. Leading banks are responding by pushing cross- and up-selling, transforming front-office processes, applying lean solutions and adopting e-solutions.

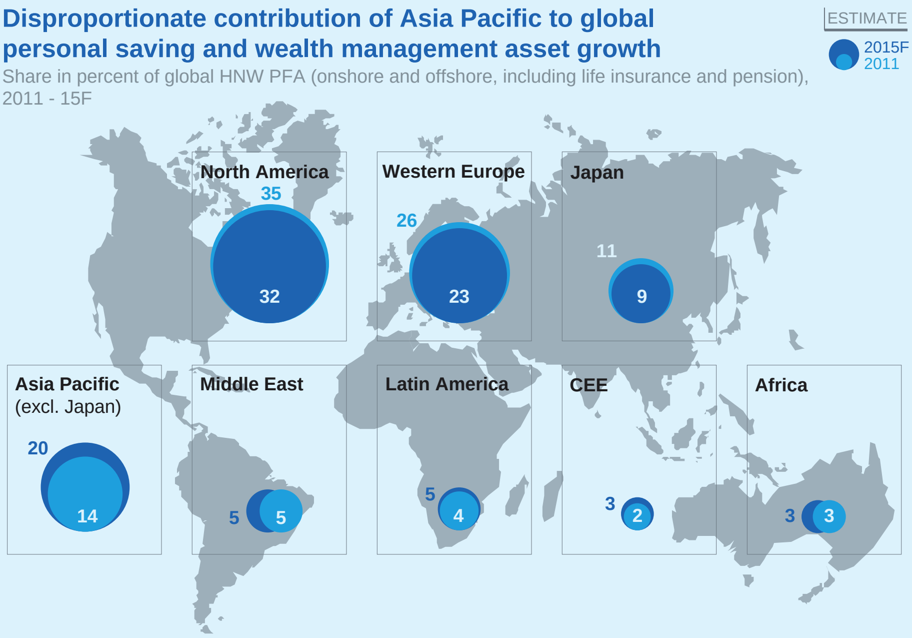
Capital markets – walking the line. Revenues from capital markets decreased by 17 percent to $200 billion in 2011, equaling 7 percent of the global sector revenue pool (8 percent in 2010) (Exhibit 16). Costs fell by 17 percent, leading to a cost-to-income ratio of 60, the same as it was in 2010.

The capital markets business is the most challenged segment, due to regulatory pressure, higher funding costs, and shrinking revenues. However, capital markets have responded faster and more radically than some other segments, in particular over the past year.

Exhibit 18

Disproportionate contribution of Asia Pacific to global personal saving and wealth management asset growth

Share in percent of global HNW PFA (onshore and offshore, including life insurance and pension), 2011 - 15F



SOURCE: McKinsey Wealth Pools; McKinsey Private Banking Survey 2011

Notable improvements include portfolio reviews, RWA reduction programs, fundamental business reviews, and cost cutting. Risk models have been enhanced, data improved and collateral management upgraded. Most banks now focus in an industrialized manner on mid- and back-office costs, as evidenced by cost-per-trade curves that we compile annually for the leading capital markets players (Exhibit 19). In addition, repricing is occurring in several product markets. Many players are now reasonably confident that they can earn returns above the cost of equity in the future.

Still, the adjustment challenge should not be underestimated. Lower revenues and higher capital needs mean the cost base must be cut radically. Further, some fundamental questions need to be answered, for example how the capital markets business will be funded going forward (a particular concern for banks without a solid deposit base).

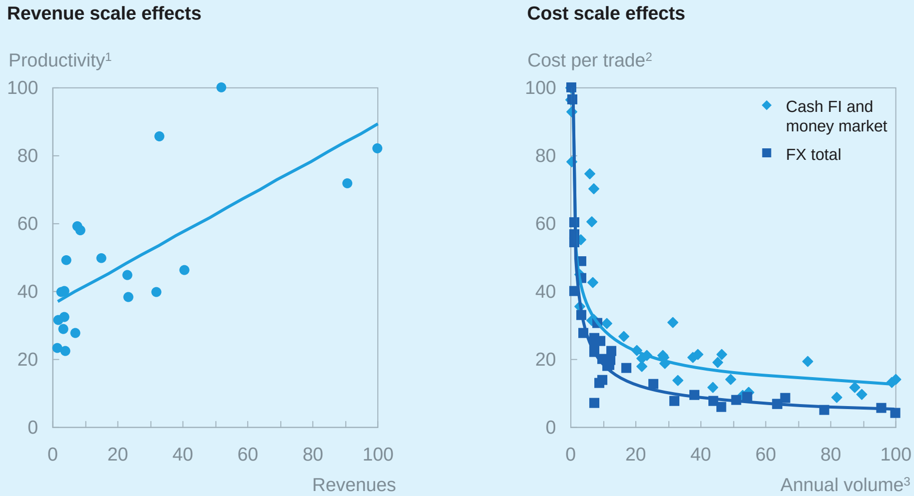
In no other banking segment is the need for cultural change more pressing, in order to restore the trust of shareholders, customers, and society. That also requires a redefinition of client relationships across the whole business. Some banks have launched front-office lean programs that are nothing short of revolutionary, with sales and trading no longer viewed as an "art," but as a process that can be largely standardized and must meet performance imperatives like any other part of the business.

We have observed discussions at leading banks over how compensation levels and structure can dramatically change. It is likely that a significant shift in compensation practices will soon occur.

Exhibit 19

Scale is key for costs as well as revenues

Example: FICC, indexed



1 Revenues per FTE
2 Middle office, back office, IT, third-party costs
3 Number of front-office trades per year

SOURCE: McKinsey Capital Markets Practice

Business models will become more differentiated, with an increasingly important role for specialist players. The "multitalent" approach, with a largely undifferentiated product-client mix based on proprietary infrastructure, is likely to disappear. We see four distinct winning models emerging: new investment banks, flow-driven universals, new corporate banks and franchise banks (Exhibit 20). These players have been joined by a variety of nonbank specialists, which will compete for business in traditional areas of banking activities; this trend is likely to continue.

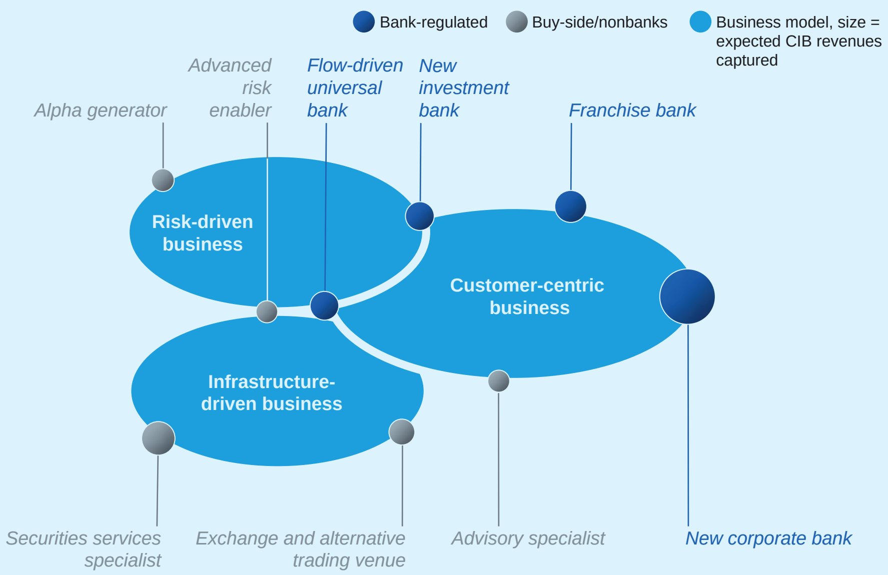
Adjustments to institutional models. In addition to changes to individual segments, banks must adjust their institutional models. Three priorities emerge: taking advantage of growth markets, reassessing the benefits and challenges of size and clearing portfolios of underperforming assets. Banks have a poor track record in active capital reallocation. Those institutions that develop advanced portfolio reallocation capabilities will be able to react quickly to new opportunities across segments and regions.

One priority is to orient businesses to take advantage of growth markets, where performance over the past 10 years has far exceeded that in developed markets. The natural momentum of growth markets has emerged as the key driver of profit growth over recent years (Exhibit 21).

Regulation will lead to a reassessment of the benefits and challenges of size. Institutions classified as SIFIs and G-SIFIs will face the challenge of demonstrating superior profitability to compensate for forthcoming SIFI capital surcharges and additional regulatory burdens. Still, size can offer substantial benefits, such as economies of scale, provided that any additional complexity is properly managed. Generally, we do not observe a positive correlation

Exhibit 20

CIB business model will likely become more differentiated performing in different competitive arenas – 4 banking models emerging



SOURCE: Future of CIB (McKinsey, January 2011) between size and profitability. However, larger banking groups usually deliver a more consistent performance (Exhibit 22).

Embrace cultural transformation to support and enhance value creation

Successful economic and business model transformation will depend in large part on a corresponding cultural transformation at a number of banks.

As industry leaders are acutely aware, banks, rightly or wrongly, are widely viewed as primarily responsible for the troubled state of many economies. Recent scandals have further tarnished the banking industry's reputation and caused stakeholders to question the underlying culture and values of banks. Various interest groups differ on what should or should not be done to change the culture of the banking industry. Not all of their demands are reasonable, and banks will not be able to satisfy all of them.

Nonetheless, as a critical component of the triple transformation now facing them, banks should take the time to examine their cultures carefully across four dimensions to ensure they are fostering value creation: balancing the interests of shareholders and society as a whole, creating value for customers, ensuring the soundness of internal processes, and influencing the mindset of employees. Directors and senior managers should view cultural transformation as a strategic issue, not a public relations problem.

- Banks must not lose sight of the need to balance their duty to maximize profits against the potential cost to society of losses caused by excessive risk-taking. Any risks that could require taxpayers to provide funds to the

Exhibit 21

Natural momentum of growth market as key driver of profitable growth

Drivers of pretax profit growth, 2002 - 10[1]

SIMPLIFIED OUTSIDE-IN SIMULATION

□ < 2x □ 2 - 4x □ > 4x

Developed players

	Profit growth	= Market size	× Market share	× Productivity[2]
Santander	3.4	1.9	0.9	1.9
JPMorgan[3]	2.5	1.7	1.8	0.8
Société Générale	2.5	2.1	0.9	1.4
Barclays	1.9	2.2	1.3	0.7
UBS	1.6	2.5	0.4	1.8
Deutsche Bank	1.1	1.6	0.7	1.0

Emerging market players

	Profit growth	= Market size	× Market share	× Productivity[2]
ICBC	14.4	4.6	0.9	3.5
GarantiBank[3]	9.4	5.2	0.8	2.3
ICICI Bank	8.7	5.0	0.7	2.5
Sberbank	8.2	5.6	1.0	1.5
VTB	5.9	5.0	2.1	0.6
Itaú	4.9	2.6	3.0	0.6

1 Relative changes, i.e. 100% means no growth in market size, constant market share or unchanging productivity
2 C/I and risk; productivity is defined as the ratio of profits over revenues, i.e. represents the ability to translate its revenues to profits in a cost effective way
3 2003 numbers have been used

SOURCE: Annual reports; McKinsey Global Banking Pools bank, whether due to internal or external events (however unlikely), must be avoided.

- Banks need to redouble their commitment to creating value for their customers, ensuring transparency and meeting best-practice standards for products and services. This includes treating all customers and counterparties fairly with regard to pricing, execution, and middle-and back-office services.

- Internal processes in areas such as risk management and compliance must support the core values of safeguarding customer interests and meeting the bank's legitimate responsibilities to society as a whole. Risk policies and procedures and controls must be rigorous and consistently enforced across the organization.

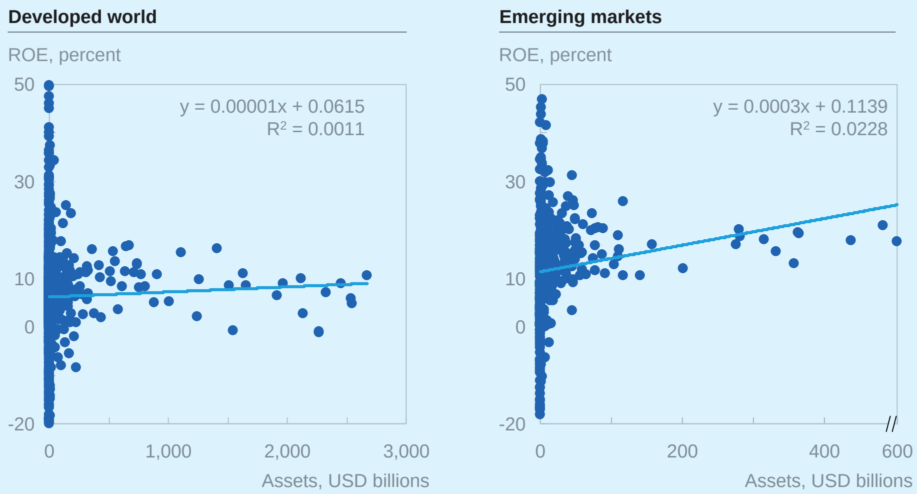
- Executives should be rewarded not only on the basis of producing strong financial results, but also based on high ethical and business standards. Customer focus should be a key component of performance evaluation. Bank executives should also be aware of their role in the broader economy and make the case for the industry by proactively promoting the benefits of a healthy banking system.

In today's challenging economic and political environment, bank directors and executives must address the concerns of a variety of stakeholders: regulators, investors, customers, politicians, and the general public. If they fail to take the initiative on cultural transformation, change is likely to be imposed by outside forces – potentially endangering business models. Healthy cultural transformation will not only increase the safety and soundness of banks, it will restore public trust, spur customer-oriented innovation, and form a strong foundation for long-term sustainable growth.

Exhibit 22

No correlation between size and profitability on a group level – but large banks deliver a more consistent performance

2011



SOURCE: Thomson Reuters; McKinsey Global Banking Pools; Bloomberg; BankExplorer

Summary and reflection

After decades of consistent success, global banking faces a period of historic change. Many of the profitable mechanisms developed in the years leading up to the financial crisis are now obsolete and unlikely to be revived anytime soon.

The banking business model is under pressure from a combination of regulation, technological change, and macrovolatility. While banks have strengthened their balance sheets in the recent period, there has been little progress towards sustainable growth, with revenues still below precrisis levels. Capital and costs must be better managed and the trust of investors, regulators, and wider society regained.

In this report we have set out our view that in order to thrive over the coming decade banks must act to implement a "triple transformation," in respect of economics, business models, and culture. Those that succeed will emerge stronger and ready to reap the rewards of the next sustained period of global economic growth.

Appendix

Technical appendix

1. **Revenues.** Total bank sector revenue pools after risk costs, which includes all customer-driven revenues in a given country or region

2. **Cost-to-income ratio.** Operating expenses/ total revenue pools before annual provisions for loan losses

3. **Return on equity (ROE).** Total accounting net income after taxes/average common equity

4. **Capital ratio.** Tier 1 ratio: calculated as Tier 1 capital/risk-weighted assets

5. **Loan-to-deposit ratio.** Total nonsecuritized customer lending volumes/total customer deposit volumes

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 capitalization.** Total market capitalization of all (listed) banks, measured as a percentage of total global market capitalization

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

We used data from a range of sources[17] to populate indicators across multiple years for individual countries, for each major region, and at a global level.

17 Including OECD, ECB, the McKinsey Global Banking Pools, Reuters, and Bloomberg

Databases used in this study

Global Banking Pools (GBP) Database. A proprietary McKinsey asset, the Global Banking Pools is a global banking database, capturing the size of banking markets in 69 countries from Angola to the United States across 56 banking products (with five additional regional models covering rest of the world). The database includes all key items of a profit and loss/income statement, such as volumes, margins, revenues, credit losses, costs, and profits. It is developed and continually updated by 50+ McKinsey experts around the world who collect and aggregate banking data bottom-up. The database covers client-driven business of banks, while some treasury activities such as ALM 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 (e.g., broker-dealers, leasing companies, 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 (e.g., revenues from all loans extended, deposits raised, trading conducted or assets managed in the specific country). The data covers 12 years in the past (2000 to 2011E) and nine years of forecasts (2012 to 2020).

Individual Bank Database. A database of the key profit and loss, balance sheet, and other financial metrics of the top 300 banks by market capitalization, 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 covers 12 years (2000 to 2011) with a varying number of banks available in different years. For price-to-earning (P/E), price-to-book (P/BV) and return-on-equity (ROE) aggregations, we used an extended sample of over 2,400 banks worldwide, sourced from Thomson Reuters.

Country financial statistics

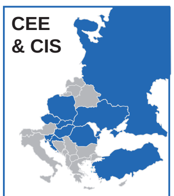
$ billions, 2011

Region	Country	Stock values and volumes: Financial depth/GDP	Stock values and volumes: Market capitalization	Stock values and volumes: Government debt securities	Stock values and volumes: Private debt[1]	Stock values and volumes: Non-securitized loans	Cross-border capital flows: Inflows	Cross-border capital flows: Outflows
Western Europe 	Austria	279%	82	244	452	391	39	49
	Belgium	321%	230	451	808	159	108	100
	Denmark	532%	180	159	657	775	-7	10
	Finland	241%	144	104	144	252	137	125
	France	362%	1,569	1,807	3,701	2,967	25	-70
	Germany	293%	1,184	2,065	3,420	3,815	104	284
	Greece	388%	34	357	362	423	11	-15
	Ireland	548%	35	111	758	288	-5	-17
	Italy	340%	431	2,197	2,499	2,344	155	74
	Netherlands	533%	595	421	2,414	1,051	137	195
	Norway	268%	219	84	388	606	20	117
	Portugal	410%	62	171	446	300	-11	-24
	Spain	516%	1,031	871	2,866	2,941	99	54
	Sweden	371%	470	163	709	652	57	99
	Switzerland	477%	932	123	658	1,321	25	129
	United Kingdom	463%	2,903	1,613	4,018	2,668	389	370
Americas 	Argentina	34%	44	91	16	61	19	12
	Brazil	156%	1,229	1,009	680	968	133	81
	Canada	351%	1,907	1,218	1,033	1,939	160	108
	Colombia	128%	201	98	12	108	27	17
	Mexico	96%	409	316	261	126	58	29
	Peru	116%	79	34	13	74	12	7
	United States	455%	15,641	12,875	31,316	8,790	784	380
Asia Pacific 	Australia	318%	1,198	432	1,275	1,832	143	98
	China	220%	3,389	1,516	1,902	9,241	528	694
	Hong Kong	572%	890	90	125	287	173	187
	India	163%	1,015	512	149	1,057	73	32
	Indonesia	92%	390	110	112	165	30	28
	Japan	450%	3,541	12,791	2,702	7,354	421	551
	Korea	324%	994	506	847	1,267	33	60
	Malaysia	369%	395	155	199	281	4	53
	Philippines	155%	165	93	16	55	7	13
	Singapore	333%	308	106	85	365	47	84
	Taiwan	306%	623	156	116	532	-33	64
	Thailand	223%	268	167	54	282	25	30
	Vietnam	141%	18	3	0	152	14	7
CEE & CIS 	Croatia	170%	22	20	2	65	1	0
	Czech Republic	125%	38	65	42	123	10	3
	Hungary	154%	19	80	21	96	22	22
	Poland	142%	138	241	19	332	35	15
	Romania	71%	21	6	n/a	108	8	2
	Russia	99%	796	119	141	780	86	172
	Slovakia	99%	5	31	5	54	8	4
	Slovenia	182%	6	20	9	54	2	2
	Turkey	111%	202	240	27	395	52	-13
	Ukraine	101%	26	12	9	120	17	8
Middle East and Africa 	Angola	10%	n/a	n/a	n/a	10	4	6
	Egypt	53%	49	4	3	71	-17	-22
	Kuwait	111%	101	n/a	3	92	-5	33
	Morocco	182%	60	2	n/a	118	5	0
	Nigeria	38%	39	1	2	50	10	7
	Saudi Arabia	106%	339	n/a	13	261	12	104
	South Africa	333%	856	136	118	249	17	11
	United Arab Emirates	138%	94	11	85	306	7	36

1 Includes all corporate and financial bonds, as well as securitized loans; excludes nonsecuritized loans

Note: Numbers enclosed here are preliminary as of July 2012. Due to revisions in source data and methodological improvements, our 2010 base data may have changed since our 2011 report. For further details please feel free to contact us at gbp@mckinsey.com

Banking markets
$ billions, 2011

Region	Country	Banking revenues and profitability[1]: Revenue margin[2]	Revenue pools[3]	Cost-to-income ratio	Profit pools[4]	Risk-to cost ratio[5]	Loan-to-deposit ratio[6]
Western Europe 	Austria	1.4%	17.7	50%	5.2	0.7%	95%
	Belgium	1.2%	23.2	68%	4.0	0.4%	81%
	Denmark	1.3%	19.3	42%	8.0	0.2%	293%
	Finland	0.9%	8.9	55%	2.7	0.2%	138%
	France	1.0%	100.3	61%	20.0	0.5%	128%
	Germany	1.2%	152.4	66%	30.6	0.3%	90%
	Greece	2.0%	(1.0)	58%	(7.5)	4.0%	163%
	Ireland	1.3%	4.8	47%	(2.3)	2.4%	127%
	Italy	1.7%	97.8	58%	17.5	1.0%	98%
	Netherlands	0.8%	37.0	50%	11.9	0.4%	96%
	Norway	1.3%	14.5	49%	5.0	0.1%	210%
	Portugal	2.0%	15.5	43%	5.4	0.9%	99%
	Spain	1.6%	72.4	41%	20.7	1.1%	117%
	Sweden	1.1%	22.0	47%	8.2	0.2%	193%
	Switzerland	0.8%	43.1	56%	13.5	0.2%	137%
	United Kingdom	1.1%	128.8	49%	25.2	1.4%	68%
Americas 	Argentina	7.6%	14.2	57%	3.3	2.8%	57%
	Brazil	7.9%	240.6	54%	62.0	3.5%	119%
	Canada	2.1%	174.6	59%	52.4	0.4%	79%
	Colombia	4.7%	14.0	46%	4.3	2.5%	119%
	Mexico	3.9%	28.5	50%	8.6	2.2%	69%
	Peru	5.0%	9.9	55%	2.9	1.6%	63%
	United States	1.4%	873.2	55%	149.6	1.7%	70%
Asia Pacific 	Australia	1.3%	70.0	49%	20.7	0.6%	104%
	China	2.1%	446.4	49%	146.6	0.8%	71%
	Hong Kong	1.1%	23.1	41%	10.7	0.6%	29%
	India	2.0%	60.4	48%	18.9	0.6%	75%
	Indonesia	3.7%	24.9	54%	7.7	1.0%	87%
	Japan	0.9%	260.1	55%	72.5	0.4%	55%
	Korea	1.9%	64.2	44%	23.4	0.9%	100%
	Malaysia	1.5%	13.6	49%	4.4	1.3%	108%
	Philippines	2.1%	4.8	57%	1.2	1.3%	51%
	Singapore	1.1%	19.6	48%	7.3	0.5%	75%
	Taiwan	1.2%	22.2	67%	4.1	0.7%	78%
	Thailand	2.7%	21.5	48%	6.9	0.9%	108%
	Vietnam	3.6%	7.6	34%	2.9	2.2%	103%
CEE & CIS 	Croatia	2.5%	3.0	42%	1.4	0.4%	148%
	Czech Republic	2.7%	9.1	47%	3.4	1.0%	78%
	Hungary	3.4%	2.9	52%	(1.6)	6.1%	138%
	Poland	2.5%	17.7	52%	5.9	0.9%	125%
	Romania	3.0%	1.6	65%	(1.9)	4.7%	149%
	Russia	3.7%	46.7	46%	12.6	2.7%	92%
	Slovakia	2.7%	3.4	52%	1.1	1.2%	103%
	Slovenia	2.1%	1.6	44%	0.2	2.9%	156%
	Turkey	4.6%	30.1	38%	13.6	1.4%	111%
	Ukraine	7.2%	3.5	47%	(1.9)	9.6%	186%
Middle East and Africa 	Angola	5.4%	1.6	42%	0.5	2.3%	39%
	Egypt	2.1%	3.9	71%	(0.2)	2.7%	42%
	Kuwait	1.3%	9.1	36%	5.3	1.6%	77%
	Morocco	0.9%	7.3	60%	1.7	1.2%	86%
	Nigeria	6.9%	7.8	74%	1.0	1.8%	65%
	Saudi Arabia	1.8%	9.8	32%	5.7	1.1%	88%
	South Africa	2.9%	19.7	53%	4.9	1.4%	154%
	United Arab Emirates	2.1%	11.0	32%	5.8	1.4%	95%

1 All figures sourced from GBP database, representing customer-driven banking figures. Different from reported results, noncustomer-related results (such as ALM, prop. trading) are excluded
2 Calculated as total customer-driven revenue pools before provisions for loan losses/total customer-driven volumes (at average of period) as it is available in global banking pools
3 Revenue pools after provisions for loan losses
4 Profit pools after tax
5 Loan loss provisions/total retail and wholesale loan volumes (at average of period)
6 Calculated as nonsecuritized loans/deposits (at end of period)

Note: Numbers enclosed here are preliminary as of July 2012. Due to revisions in source data and methodological improvements, our 2010 base data may have changed since our 2011 report. For further details please feel free to contact us at gbp@mckinsey.com

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