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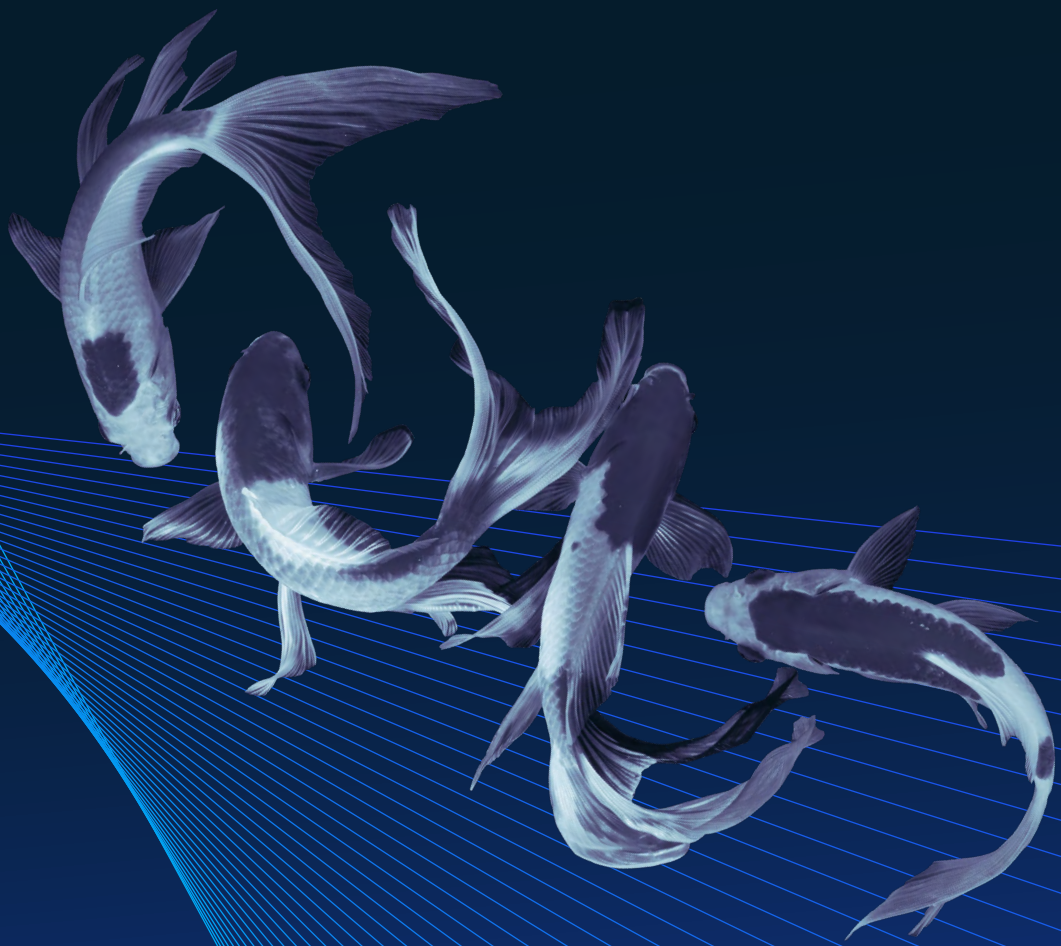
The great divergence

McKinsey Global Banking Annual Review 2021



December 2021

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Executive summary

"Tipping point" may be the most overused metaphor in business; it gets broadly applied to all kinds of ho-hum changes. But once in a great while, it's more than appropriate. The COVID-19 pandemic is truly a tipping point: Everything has changed. Malcolm Gladwell's 2000 book popularized the idea that the best way to understand trends in business and society is to think of them as epidemics. Little did he know that 20 years later, the world would grapple with a true epidemic that would not just devastate lives, but move markets, bring global industries to their knees, and transform others forever.

The effects on society are still startling, no matter how many times we see the statistics: nearly 256 million cases, more than five million deaths, and 7.3 billion doses of vaccine administered.[1] The ways that buying and selling have changed are no less incredible: every business, from the corner grocery to any of the world's largest companies, has been profoundly altered.

For banks, COVID-19 marks the end of an era. After the 2008 global financial crisis, a conflagration that started in banks and ended many of them in spectacular fashion, the survivors went to work. They rebuilt capital, mended fences with regulators, and invested in digitization to build relationships with customers and wrest more efficiencies from their back-office processes. The gambit worked. Banks withstood the pressures of 2020, and capital reserves rose last year. But it came at a cost: the global industry's return on equity (ROE) fell from 8 percent in 2011 to 6 percent in 2020. The industry became safer, more predictable, more commoditized.

At the same time, a slow-motion investment trend went viral. For years, investors had been gravitating toward a new generation of financial-services firms with new ways of applying technology to serve customers better. In 2020, on the back of a broad rally in share prices, the trend took off. Payments specialists, exchanges, and some securities firms captured more than 50 percent of the $1.9 trillion in market cap that the industry added. Most retail banks—those in the less exalted business of taking deposits and making loans—were left on the outside, looking in.

That's only the most outward manifestation of what we call the "great divergence" between the industry's top performers and its utility-like laggards. Welcome to the 11th edition of this report, in which we document the ways the industry is splitting into haves and have-nots, explain how to tell them apart, and show how banks with ambition and determination can join the leaders. We will discuss the following key findings from our research this year:

- Banks have thus far endured the pandemic with losses averted but profitability depressed. In North America, ROE fell from 12 percent in 2019 to 8 percent in 2020. European banks' ROE was halved, from 6 percent to 3 percent. ROEs in Asia fell by a percentage point.
- The global financial-services industry still trades lower than other industries. Banks trade at book value, versus companies in all other sectors at three times book value. Half of banking institutions trade for less than the equity value on their balance sheets and generate profits below shareholders' cost of equity.

1 WHO Coronavirus (COVID-19) Dashboard, as of 4:27 p.m. CET, November 18, 2021; covid19.who.int.

— Creating value for shareholders is not for the fainthearted. Most banks' economics are modest at best, with ROEs under 10 percent and income growing 3 to 7 percent annually. The traditional bank's balance sheet is overly liquid, too capital-intense, and less relevant for revenue monetization, even as a digital disruption accelerated by the pandemic tilts the action away from the balance sheet and toward fee-based services.

— The banking industry now faces a great divergence. The gap in market-to-book ratio between top and bottom performers has widened. Today the spectrum runs from seven to well below 0.5 times.

— The divergence is based in part on the geographies in which financial institutions operate, their relative scale, and their segment focus.

— But the biggest factor is a bank's ability to deploy a future-proof business model that displays three characteristics that make them attractive to investors (and customers):

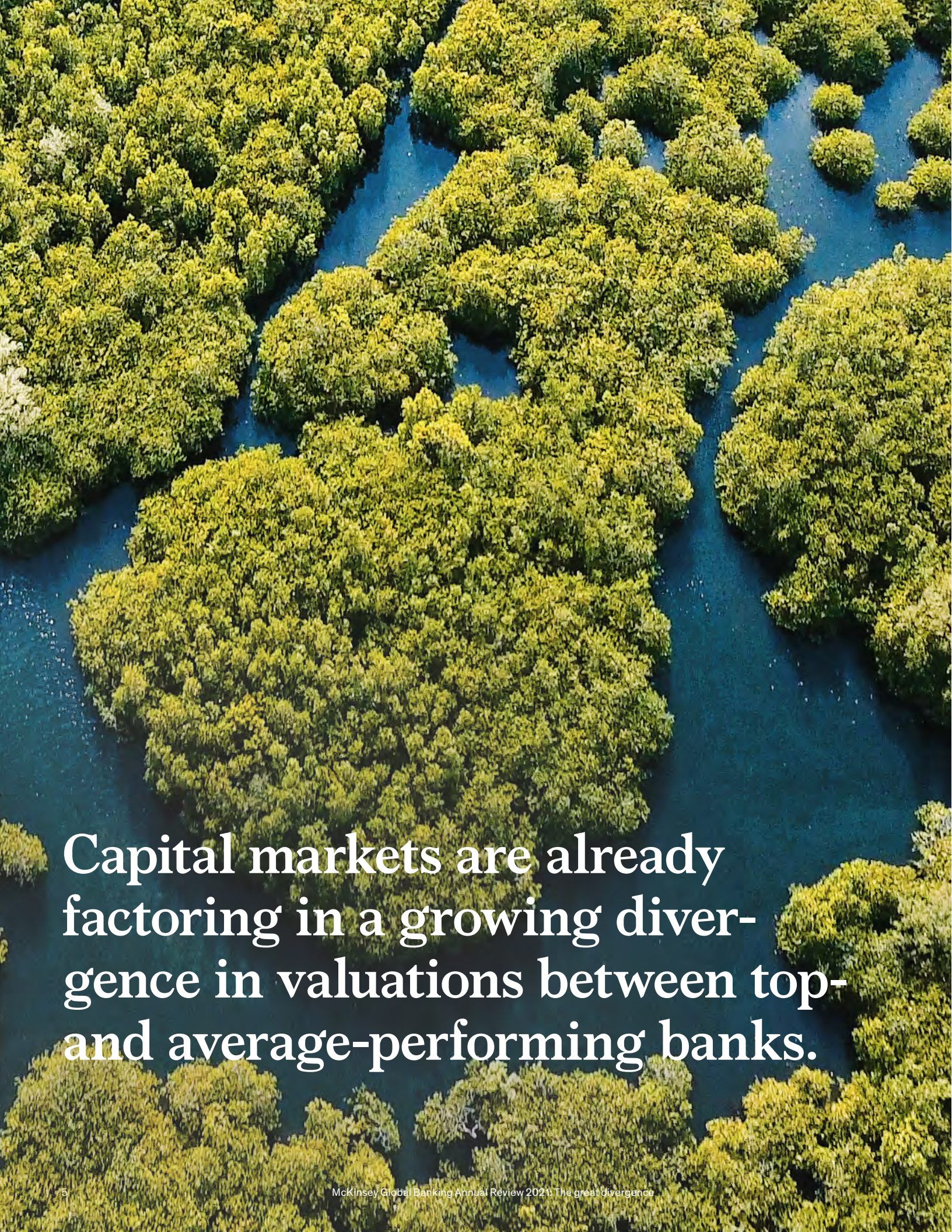
  • They are embedded in customers' lives (with more touchpoints and greater ownership and engagement), using digital channels and ecosystems to solve specific customer needs with distinctive and personalized experience—and they use the insights they gain to develop even better ways to keep customers engaged.

  • They have a sustainable economic model that is less capital-intensive and more focused on growth and customer monetization through services/commissions rather than just financial intermediation.

  • They are faster and more flexible, and they invest—both organically and through acquisitions or partnerships, and by attracting the best talent—in delivering multiple releases that delight customers.

— Traditional banks that wish to join this elite group have only a limited window. About two-thirds of the value generated during an entire economic recovery cycle is created during the first two years after a crisis.

McKinsey's Global Banking Annual Review is based on insights and expertise from McKinsey's Global Banking Practice. This edition is structured in three chapters. In the first, we review how banks fared in the whirlwind of 2020 and what forces will likely influence their economic fate in the next few years. In the second, we look in detail at the great divergence—the factors such as geography, customer base, scale, and business model that are lifting one set of banks above the rest. We conclude with some business-model questions for CEOs and strategists to consider, along with examples of what is possible for banks seeking the on-ramp to growth and prosperity.



Capital markets are already factoring in a growing divergence in valuations between top- and average-performing banks.

1. Banking in the pandemic: An industry crisis averted

The global economy has surprised to the upside, and banks have escaped the worst. But the outlook for the industry is clouded by the fact that half of banks do not cover their cost of equity. In coming years, banks have a chance at decent but not spectacular performance. Three macro factors—interest rates, government support for economic recovery, and the way banks manage excess liquidity—will tell much of the tale. But regardless of the macro scenario, banks' business models remain overly liquid and capital-intense, with balance sheets that are less attractive and less relevant for revenue monetization than those of institutions focused on origination. Finally, digital disruption has been accelerated by the pandemic, giving fintechs and other digital players an opportunity to consolidate their considerable progress in financial services.

World economy: Better than expected

Over the past several months, in many parts of the world, businesses, governments, and societies have heaved a huge collective sigh of relief. Eighteen months ago, disaster seemed to be on the doorstep. Effective vaccines for SARS-CoV-2 were a distant dream; new cases and deaths were spiraling out of control. Many businesses were shut, others were struggling, and all were facing a climate of extreme uncertainty.

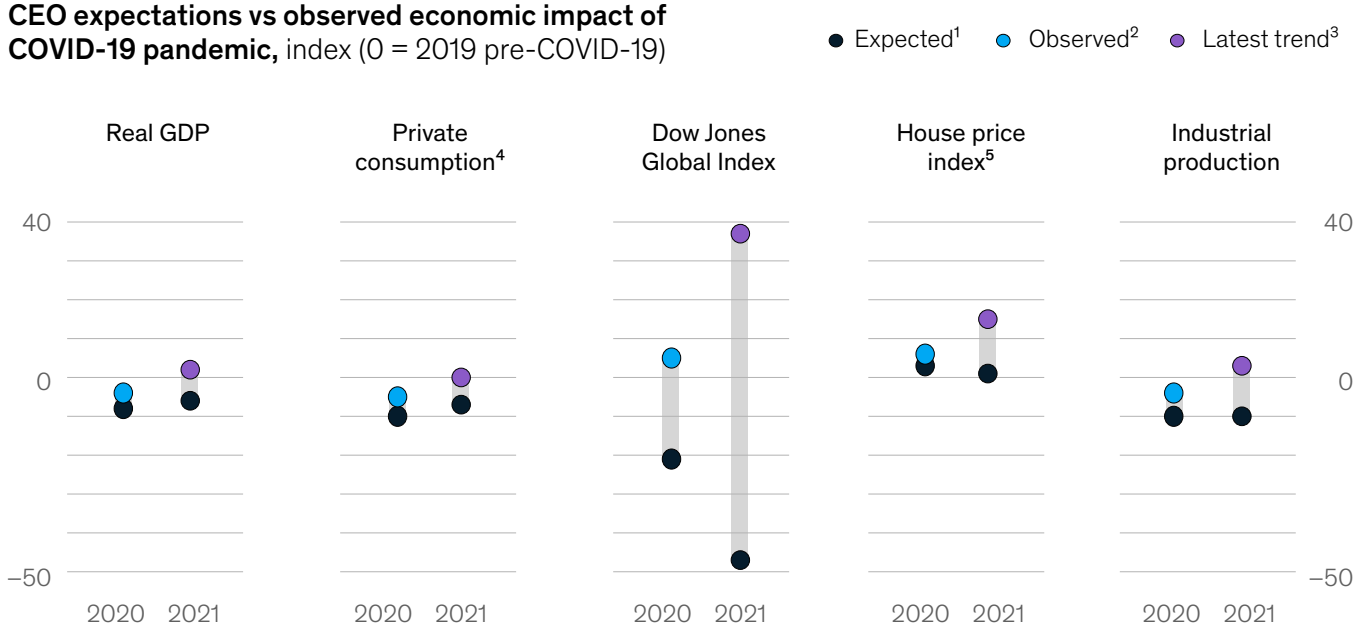
Today, many countries are on a path back to a form of normalcy, thanks to effective government support and the success of many vaccines. However, some regions are confronting third and fourth waves of the disease, many of them triggered by the Delta variant, and by struggles with vaccination rates. In late November, the World Health Organization designated a new variant of concern: Omicron. As we publish this report, it is too early to say how effective current vaccines will be against the new variant. However, the emergence of a new variant underscores a simple fact: in an interconnected world, none of us are safe until we're all safe.

The economic reality is a bit brighter, surpassing expectations on almost all dimensions globally. Both analysts' forecasts and executive sentiment (as reflected by our panel of more than 1,000 global executives) were caught by a positive surprise. The world economy is recovering to—or even surpassing—pre-COVID-19 levels (Exhibit 1).

Exhibit 1

The global economy is weathering the pandemic better than CEOs had expected.

CEO expectations vs observed economic impact of COVID-19 pandemic, index (0 = 2019 pre-COVID-19)



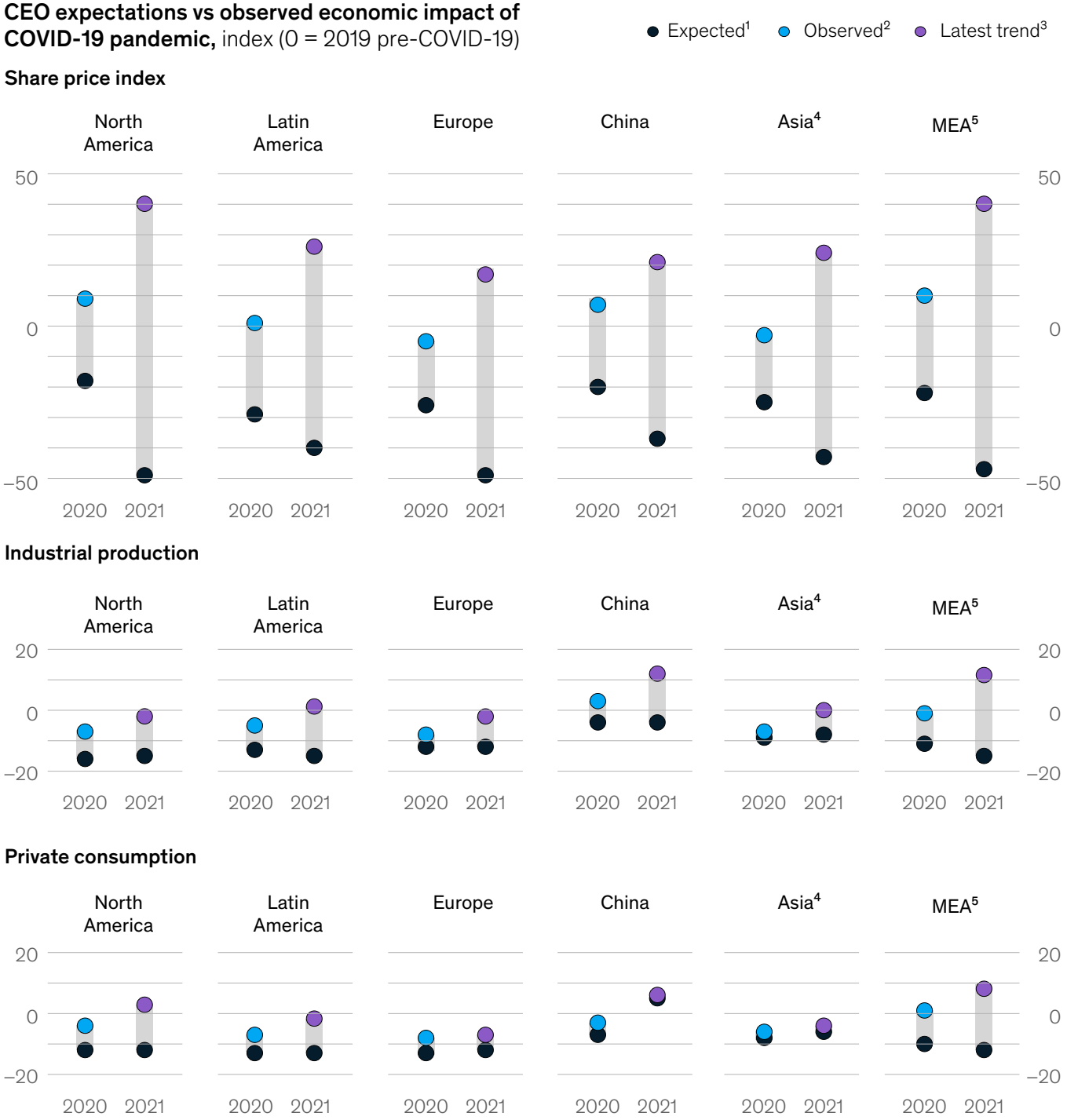
[1]Most likely scenario as of June 2020, based on global weighted average survey response of ~1,000 global executives. [2]Factual values for FY 2020. [3]FY 2021 forecasts based on most recent expectation of ~1,000 global executives. [4]Weighted average value of 31 countries. [5]Weighted average value of 32 countries.
Source: McKinsey analysis in partnership with Oxford Economics

The pace of recovery varies by region, with China and the United States leading the way, while Europe is still below pre-COVID-19 levels in GDP, industrial production, and private consumption. But if we consider financial markets' performance as a leading indicator, these are above, and often well above, 2019 levels across the world (Exhibit 2).

Exhibit 2

Capital markets, businesses, and consumers are showing resilience in all regions.

CEO expectations vs observed economic impact of COVID-19 pandemic, index (0 = 2019 pre-COVID-19)



[1]Most likely scenario as of June 2020, based on global weighted average survey response of ~1,000 global executives. [2]Factual values for FY 2020. [3]FY 2021 forecasts based on most recent expectation of ~1,000 global executives. [4]Not including China. [5]Middle East and Africa.
Source: McKinsey analysis in partnership with Oxford Economics

Success has many parents. When the pandemic emerged globally in early 2020, few expected government measures of the magnitude that was delivered. All told, governments supplied economic stimulus worth about 29 percent of GDP, a far cry from the 3.3 percent they provided after the 2008 global financial crisis. Nor was the world ready for the unprecedented speed of vaccine delivery by the scientific community, which developed several vaccines in less than a year—a process that usually takes decades. The resilience of businesses that radically reinvented their offerings also surprised; e-commerce vaulted from 18 percent of all retail sales in 2019 to 29 percent in 2020. In the United States, e-commerce grew almost three times as quickly from 2019 to 2020 as it had during the previous five years, and many Americans even proved willing to buy cars without literally kicking the tires. The diligence of the world population confined at home was also remarkable. And the selflessness of tens of millions of frontline workers, from nurses and doctors to retail clerks and bus drivers, inspired many around the world.

But just as the economic impact of COVID-19 was not as bad as first feared, the recovery now under way might prove slower and less vigorous than it now appears. First and foremost, as mentioned, this pandemic, though well managed in many places, is far from being over.[1]

More recently, supply-chain bottlenecks and rising inflation in some regions, such as the United States, have introduced significant obstacles to recovery, slowing industrial growth, suppressing consumer sentiment, and causing hardships. Inflation expectations, for example, rose in October, to 2.9 percent, a level still within the inflation targets of most central banks.[2]

A big chunk of government support was injected through credit moratoriums; in the European Union, this has reached €900 billion, and in countries including Ireland, Italy, and Portugal, more than 10 percent of all loans had payments and interest suspended. These moratoriums have been gradually withdrawn, and it is unclear how many borrowers will resume payments without restructuring or default.

Finally, some economic sectors will take longer to recover, leaving companies with limited growth opportunities in an unfavorable interest-rate environment.

The effects of the struggle for growth amid these disruptions has become evident in the lower GDP expansion of the third quarter. During this quarter, China grew at an annualized rate of 4.9 percent, short of expectations for 5.2 percent growth and slower than the 7.9 percent pace set in the second quarter. Meanwhile, the US economy grew at an annualized rate of 2 percent, below expectations of 2.7 percent and well below the 6.7 percent pace set in the second quarter. Analysts attribute the slower US growth to the resurgence of COVID-19 in the summer of 2021, supply-chain issues, and the fall-off in consumer spending on durable goods after government stimulus checks were spent (Exhibit 3).[3]

Governments supplied economic stimulus worth about

29%

of GDP

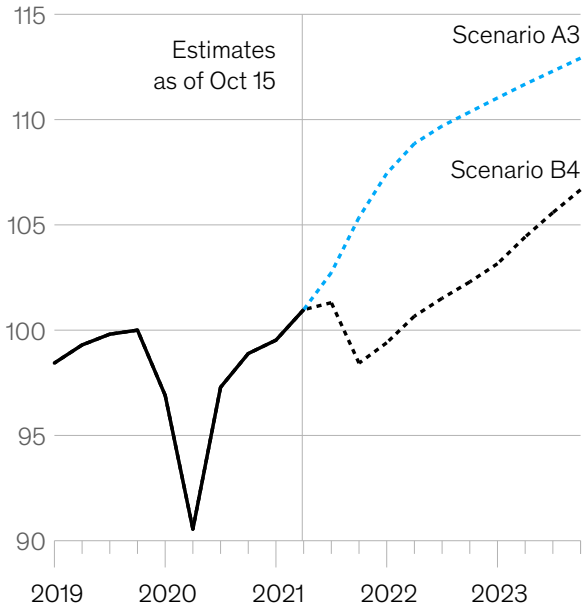
[1] Sarun Charumilind, Matt Craven, Jessica Lamb, Shubham Singhal, and Matt Wilson, "Pandemic to endemic: How the world can learn to live with COVID-19," October 28, 2021, McKinsey.com.
[2] Inflation expectations as implied in the yields US Treasury bills versus Treasury Inflation-Protected Securities of the same maturity.
[3] Alan Fitzgerald, Krzysztof Kwiatkowski, Vivien Singer, and Sven Smit, "Global Economics Intelligence executive summary, October 2021," November 2021, McKinsey.com.

Exhibit 3

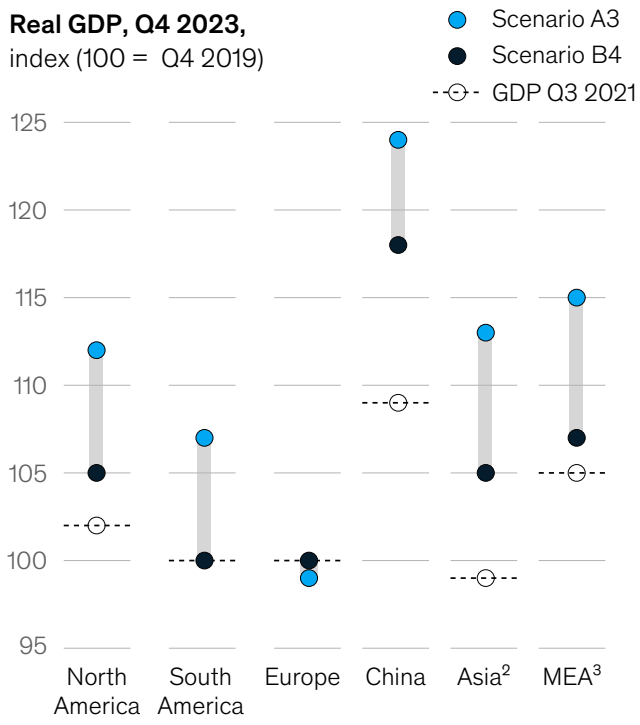
The global economy recovered to pre-COVID-19 levels in Q2 2021, but ongoing recovery will be nuanced by region.

COVID-19 exit pathways, scenarios A3 and B4[1]

Real GDP, constant prices and $ exchange rates, index (100 = Q4 2019)



Real GDP, Q4 2023, index (100 = Q4 2019)



When Q4 2019 GDP levels will be reached by scenario, recovery quarter

	North America	South America	Europe	China	Asia[2]	MEA[3]
Scenario A3	Q2 2021	Q3 2021	Q4 2021	Q2 2020	Q4 2021	Q3 2020
Scenario B4	Q2 2021	Q4 2023	Q4 2023	Q2 2020	Q1 2023	Q3 2020

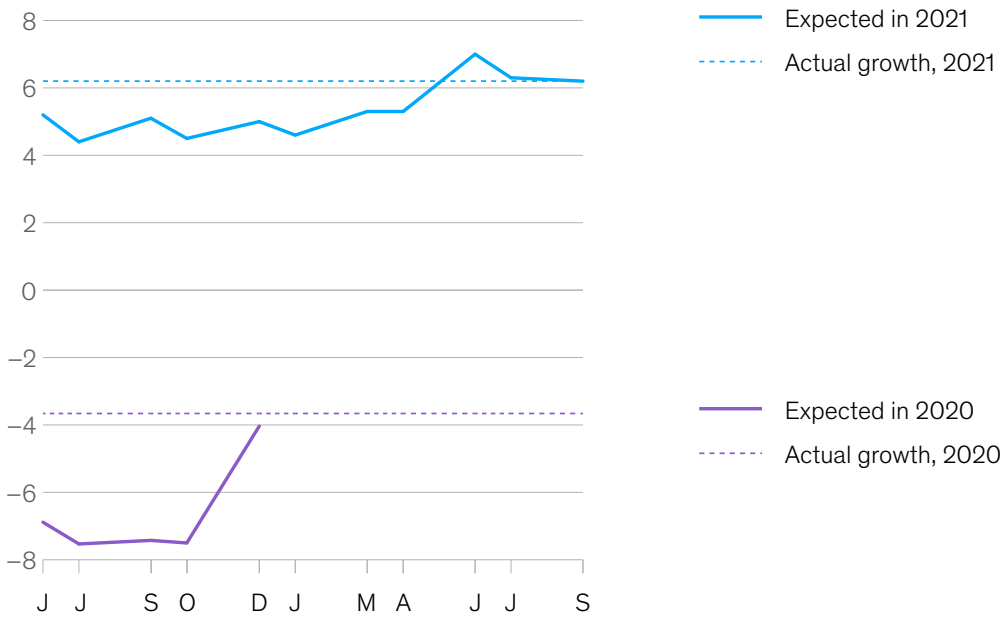
[1]McKinsey COVID-19 economic scenarios. A3 scenario described as "contained health impact; strong growth rebound and recovery"; B4 described as "high levels of health impact; slower near-term growth and delayed recovery."
[2]Not including China.
[3]Middle East and Africa.
Source: National statistics agencies; McKinsey analysis in partnership with Oxford Economics

Despite these headwinds, the economic future looks much brighter than most imagined a year ago. Our survey panel of more than 2,000 executives worldwide is factoring in a recovery across the board (Exhibit 4). Global GDP is expected to be 10 percent above 2019 levels in 2024, led by China (30 percent), Emerging Asia (28 percent), the Middle East and Africa (13 percent), and the United States (11 percent). Europe (6 percent), Latin America (9 percent), and Japan (3 percent) are the large economies expected to show more modest growth.

Exhibit 4

Macroeconomic expectations have been gradually becoming more optimistic during the past 12 months.

CEO expectations for yearly global real GDP growth by survey date,[1] %



[1]Weighted average GDP growth rate based on executive expectations of various economic scenarios as projected at different time periods of 2020–21.
Source: McKinsey Global Institute; McKinsey analysis in partnership with Oxford Economics

How banks fared in 2020–21

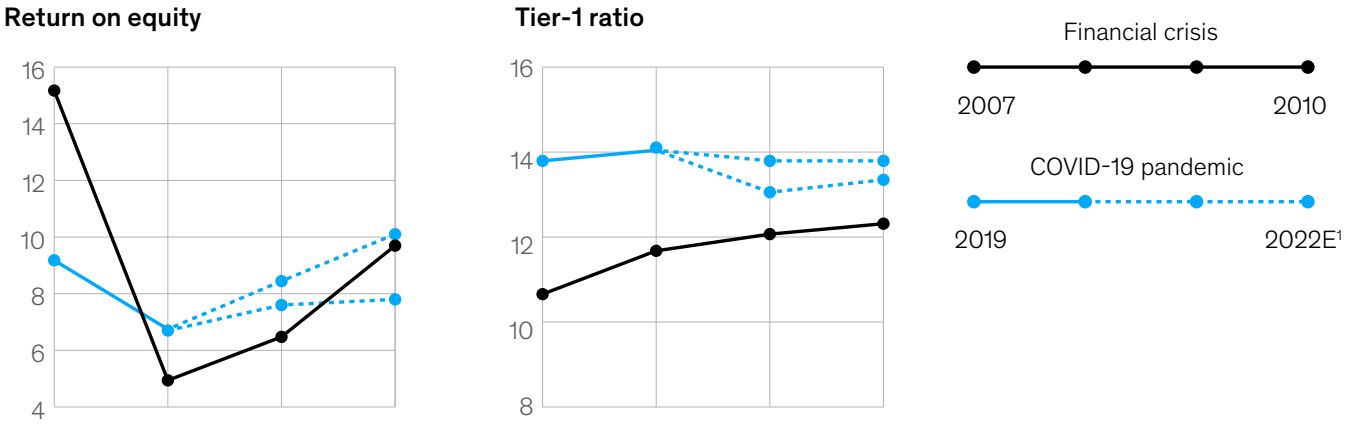
Banks and bankers are playing a big role in this recovery. Not only were banks instrumental in delivering government aid and ensuring financial stability through their continuous daily operations, they also opened their balance sheets to lend: loans grew at 11 percent last year, five times more than the consensus prediction, boosted by China (20 percent) and Europe (9 percent). And they achieved this at a time when most branches were closed.

Unlike the previous economic crisis, this time banks did not witness any abnormal losses, material capital calls, or "white knight" acquisitions. In fact, bank profitability held up better than most analysts expected. ROE in 2020 was 6.7 percent—less than the cost of equity but still a better showing than expected and above the 4.9 percent observed in 2008 in the aftermath of the financial crisis (Exhibit 5). The pandemic depressed ROE in all regions. In North America, ROE fell from 12 percent in 2019 to 8 percent in 2020. European banks' ROE was halved, declining from 6 percent to 3 percent. ROEs in Asia fell by a percentage point (Exhibit 6).

Exhibit 5

The COVID-19 pandemic's impact on banking profitability and capital has been mild compared with that of the 2007–10 financial crisis.

Comparison of ROE and Tier-1 ratios, global banks, 2007–10 and 2019–22 (estimated), %

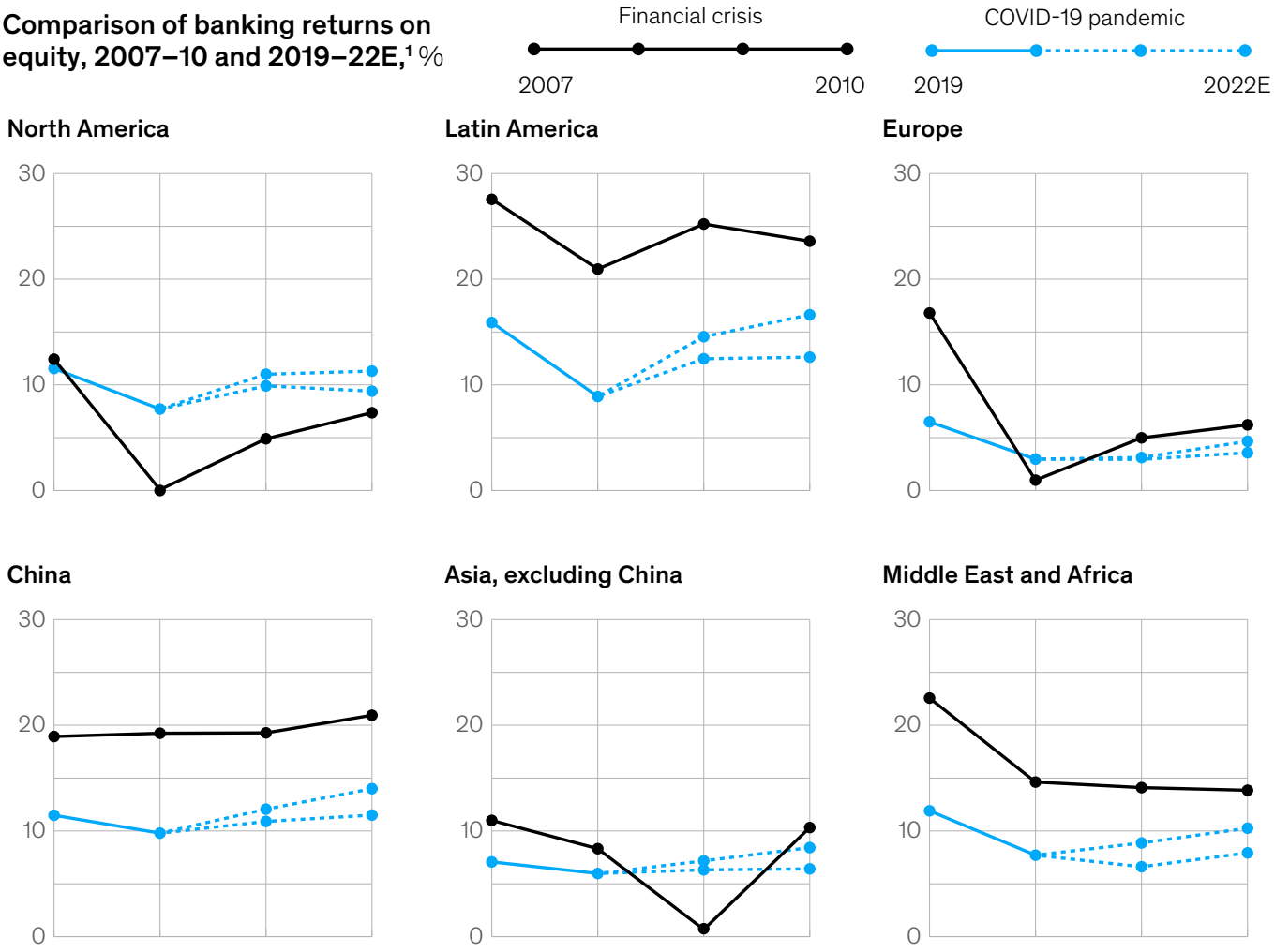


[1]Estimated.
Source: S&P Global; Panorama by McKinsey

Exhibit 6

Europe and Latin America banking profitability has been halved during the pandemic, with other regions more moderately affected.

Comparison of banking returns on equity, 2007–10 and 2019–22E,[1] %



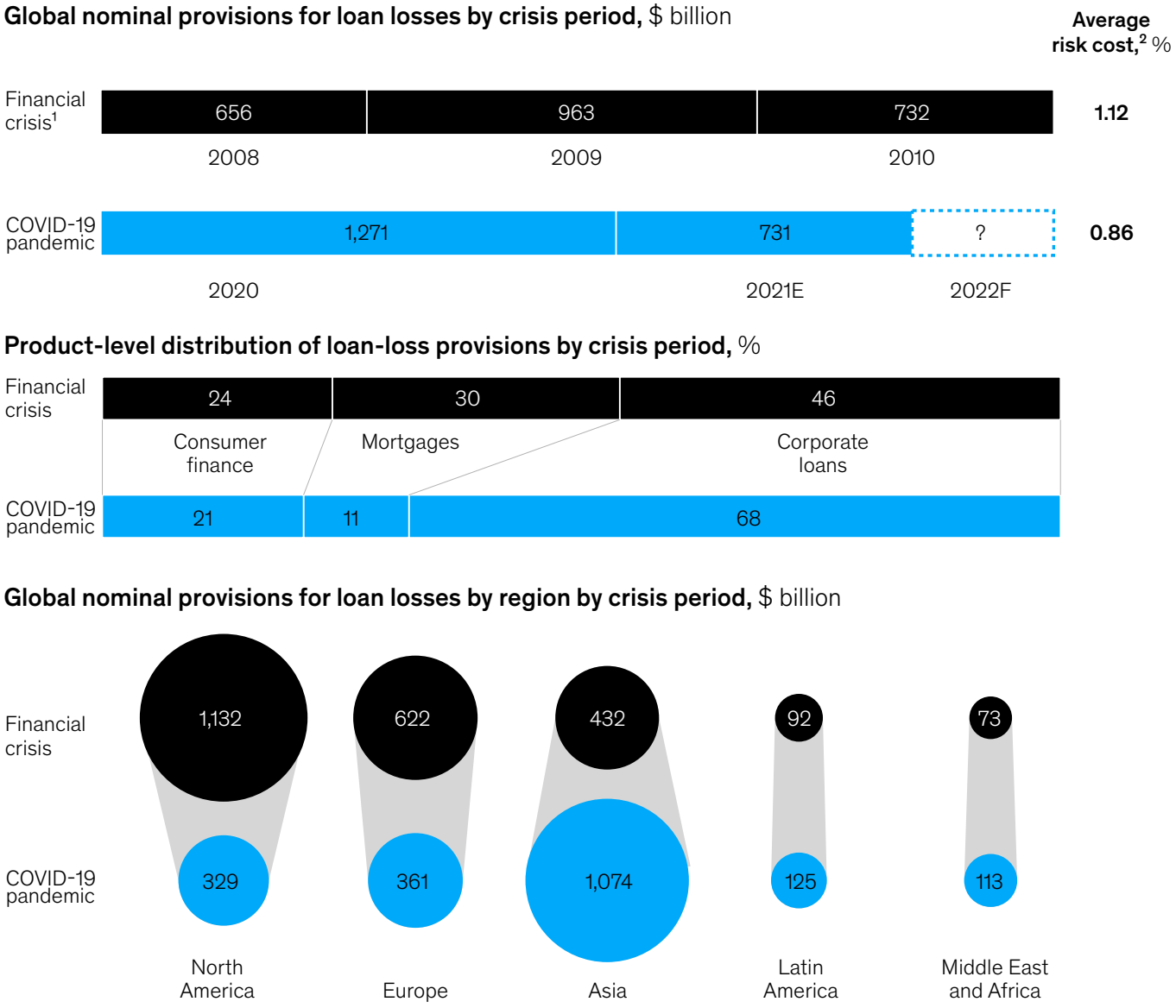
[1]Estimated.
Source: S&P Global; Panorama by McKinsey

Banks not only proved to be resilient in many ways but also positioned themselves as part of the solution to this crisis, leveraging the fortress of capital they had built during the dozen years after the 2008 crisis. Globally, core equity Tier 1 ratios rose in 2020, from 12.4 percent to 12.7 percent. The reasons? Strong asset prices and economic recovery meant that banks' provisions for nonperforming loans (NPLs) were lower than expected. In the last edition of this report,[4] we estimated that banks would take $1.5 trillion in NPL provisions in 2020; the actual number turned out to be $1.3 trillion. That's still a startling figure—about $400 billion higher than in 2009, after the last crisis—but less than expected. It should be noted, however, that some losses will certainly be deferred, as more than two-thirds of the risk costs are expected to be in corporate loans, compared with less than 50 percent in the 2008–10 financial crisis (Exhibit 7).

[4] Kevin Buehler, Roger Burkhardt, Miklos Dietz, Somesh Khanna, Matthieu Lemerle, Asheet Mehta, Marie-Claude Nadeau, Kausik Rajgopal, Joydeep Sengupta, Marcus Sieberer, and Olivia White, ***Global Banking Annual Review 2020: A test of resilience***, December 2020, McKinsey.com.

Exhibit 7

Compared with the previous crisis, the pandemic is expected to generate lower credit-risk costs, with provisions more concentrated in corporate lending.



[1]Between 2008 and 2010 large North American and European commercial and investment banks provisioned an additional ~$150 billion for securities and other financial assets.
[2]Total loan loss provisions for the period/average loan balances of the period.
Source: S&P Global; Panorama by McKinsey

More proof of banks' resilience came with the most recent stress tests run by the European Banking Authority. In the adverse scenario, banks' CET-1 ratio would fall by 485 basis points to above 10 percent levels. The tests suggest that the system can bend but not break.

But if the pandemic did not have the expected harmful financial effects on the global banking industry, it certainly had plenty of others. Digital banking accelerated, cash use fell, savings expanded, remote became a way of working, and environment and sustainability are now top of mind for customers and regulators.

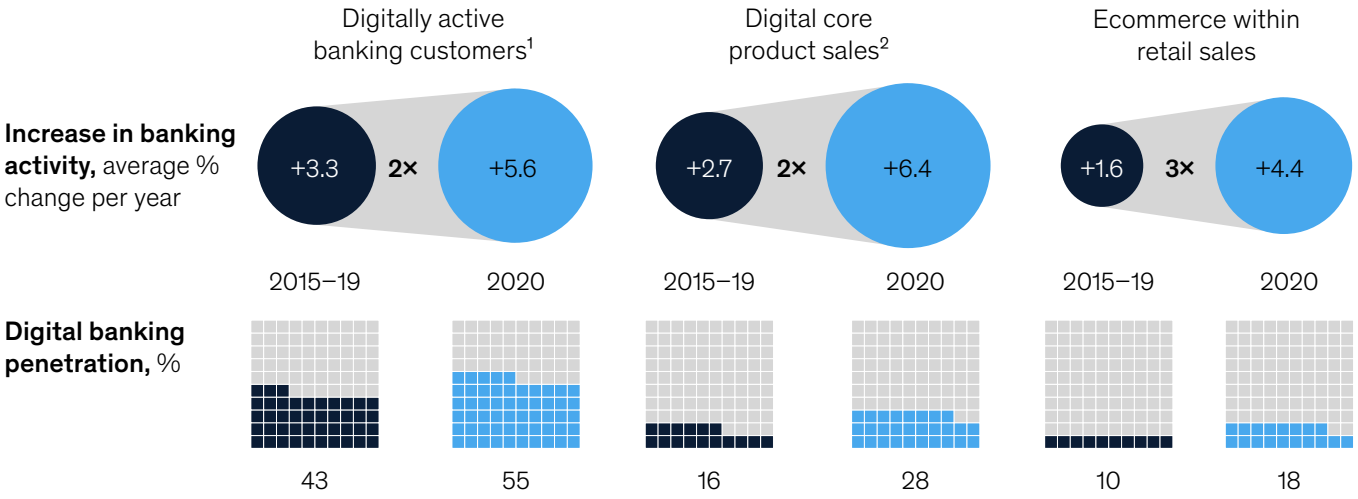
Digital banking is at an all-time high. But this was already true before the pandemic in most developed markets, where digital usage had already surpassed physical interactions with the bank. The latest surge in growth is a result of two trends. First was the digital adoption by the least digitally savvy customers, such as rural and elderly populations. Second, digital-laggard banks deployed new offerings to ensure services and transactions could be performed even with branches closed.

COVID-19 has also reinforced the digital trend in payments and retail commerce across payment types, demographics, and geographies (Exhibit 8). In the United States, the share of consumers using two or more digital payments methods jumped from 45 percent in 2019 to 58 percent in 2020. African governments are using digital payments to disseminate stimulus funds and to extend financial inclusion beyond the traditional bank establishment. For example, the government in Togo launched Novissi, a cash transfer program that disburses social-welfare payments through mobile channels.

Exhibit 8

The rate of digital banking adoption has doubled during the pandemic.

Comparison of digital banking metrics from 2015–19 and 2020



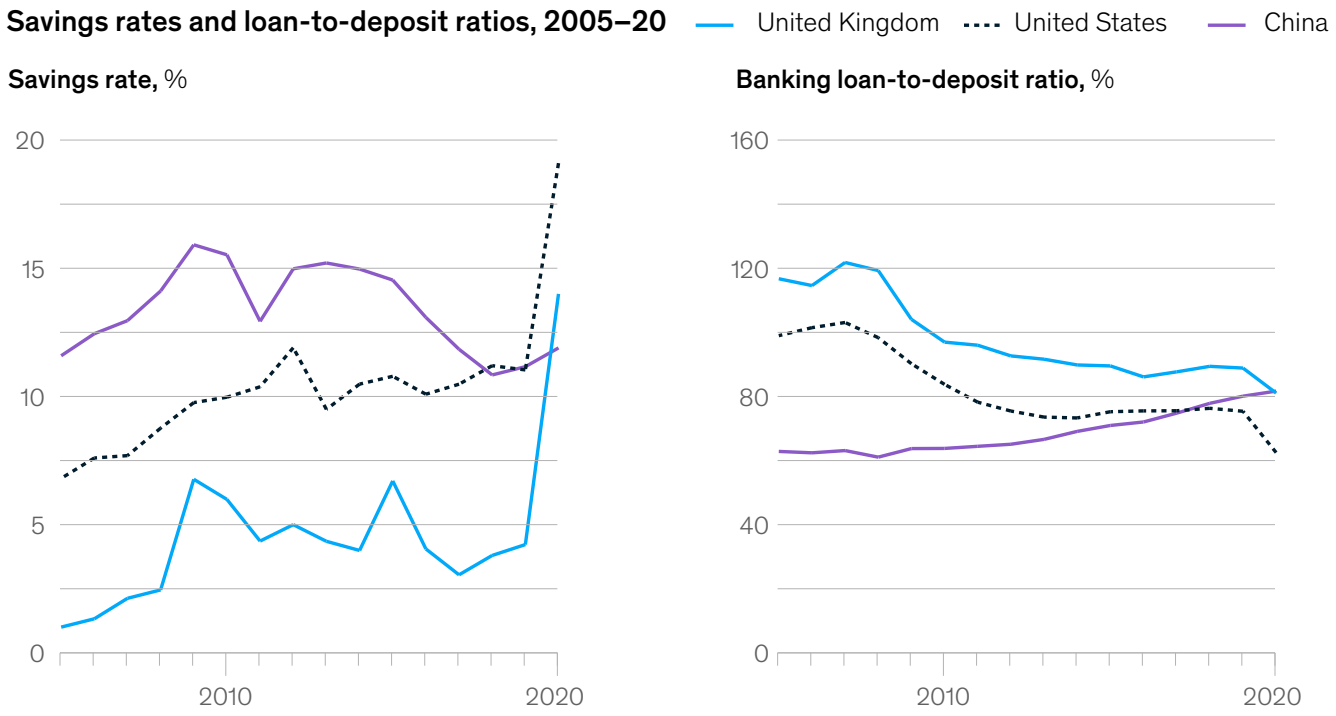
[1]Day active digital (online plus mobile) users over total active customers.
[2]Digital product sales over total product sales. Sales data reflect product units.
Source: Finalta; Statista

Another trend that predated COVID-19 but solidified with the pandemic is balance-sheet liquidity. Despite the loan growth in 2020 and the first half of 2021, loan-to-deposit (LTD) ratios remain at historical lows across the world. Personal savings in the United States spiked in April 2020 to 33.7 percent, the highest rate ever recorded,[5] and US household savings have more than doubled, to $3 trillion, since 2019. In the United States and the United Kingdom, savings increased, and LTD ratios declined (Exhibit 9). The reopening of economies might bring some "revenge consumption" and deplete savings rates, but banks will likely manage the eventual aftermath of this crisis with an overliquid (and overcapitalized) balance sheet—particularly when compared with the previous crisis.

[5] FRED, Federal Reserve Bank of St. Louis, July 2021, fred.stlouisfed.org.

Exhibit 9

Increased savings rates have further depressed loan-to-deposit ratios.



Source: Economist Intelligence Unit; S&P Global; Panorama by McKinsey

The year 2021 also saw increasing pressure from governments, investors, regulators, and consumers to address climate risk issues (Exhibit 10). Many governments are now committed to net-zero targets, and interest from investors in environmental and climate topics is growing. In this context, the European Central Bank announced a Climate Risk Stress Test for 2022. Regulators in other regions are preparing similar tests. For banks, financing a green agenda will be a regulatory requirement, a commercial imperative, and a social responsibility.

Exhibit 10

The pandemic has increased the focus on sustainability.

A range of heightened expectations and pressures related to sustainability

Significant near-term value

$3–5

trillion in sustainability investment by 2030

Bolder environmental regulation

30–50%

corporate profits at stake from external engagement (eg, with carbon pricing)

Increasing investor requirements

2–5×

Multiple uplift possible for companies with sustainability focus

Shifting customer expectations

15–30%

price premium for sustainably produced products and services

Talent prefers sustainable companies

80%

of millennials want to work for a company strong on ESG[1]

First movers capturing value

50%

faster growth in sustainable brands

[1] Environmental, social, and governance criteria.
Source: CDP Climate Change Report 2019; McKinsey analysis

Industry outlook: Uncertain and disrupted

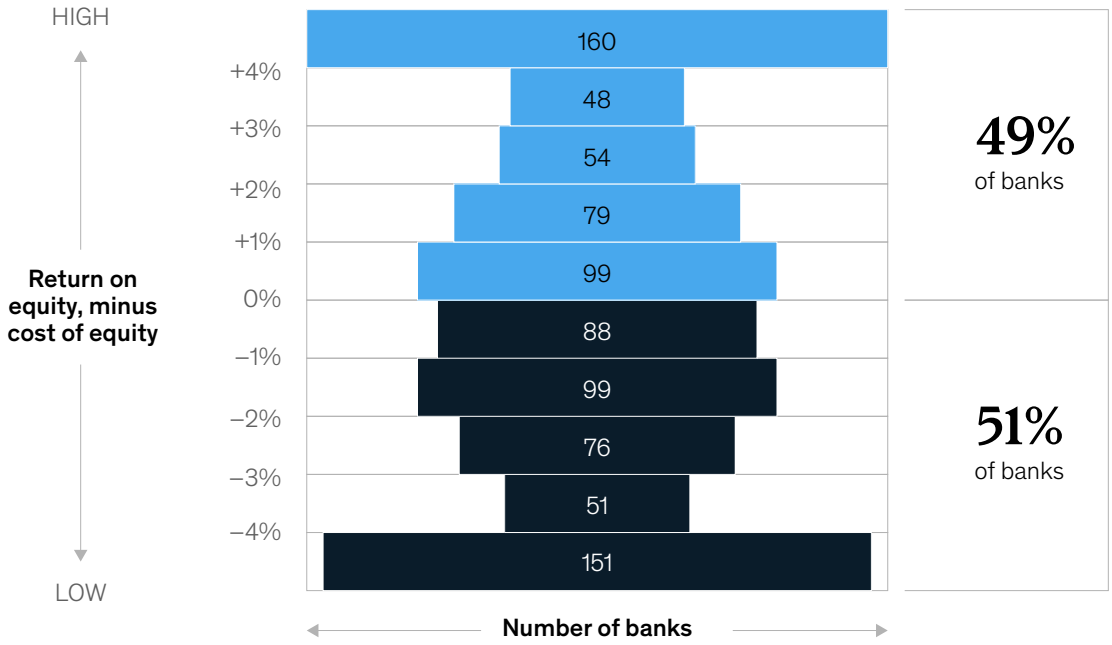
The world economy appears to be weathering the current crisis better than expected, and the banking system is at least as solid as it was before the pandemic—and much healthier than after the last crisis. But can we say a bright and smooth future lies ahead for banks and their shareholders? Not really. Cause for concern is evident in banks' performance on two yardsticks: ROE, a measure of current profitability, and market-to-book value, a leading indicator of how capital markets value banking.

Fifty-one percent of banks operate with an ROE below cost of equity (COE), and 17 percent are below COE by more than four percentage points (Exhibit 11). In an industry that has high capital requirements and is operating amid low interest rates, creating value for shareholders is structurally challenging. In fact, the almost $2.8 trillion of capital that was injected by shareholders and governments into banking over the past 13 years eroded three to four percentage points of ROE. That cohort of 17 percent of banks would not be creating value even at previous capitalization levels. The remaining 34 percent managed to comply with regulatory capital ratios but still struggle to comply with the imperative to create value for shareholders.

Exhibit 11

Half of banks generate returns on equity below the cost of equity.

Average return on equity—cost of equity spread 2011–20, number of banks (n = 905[1])



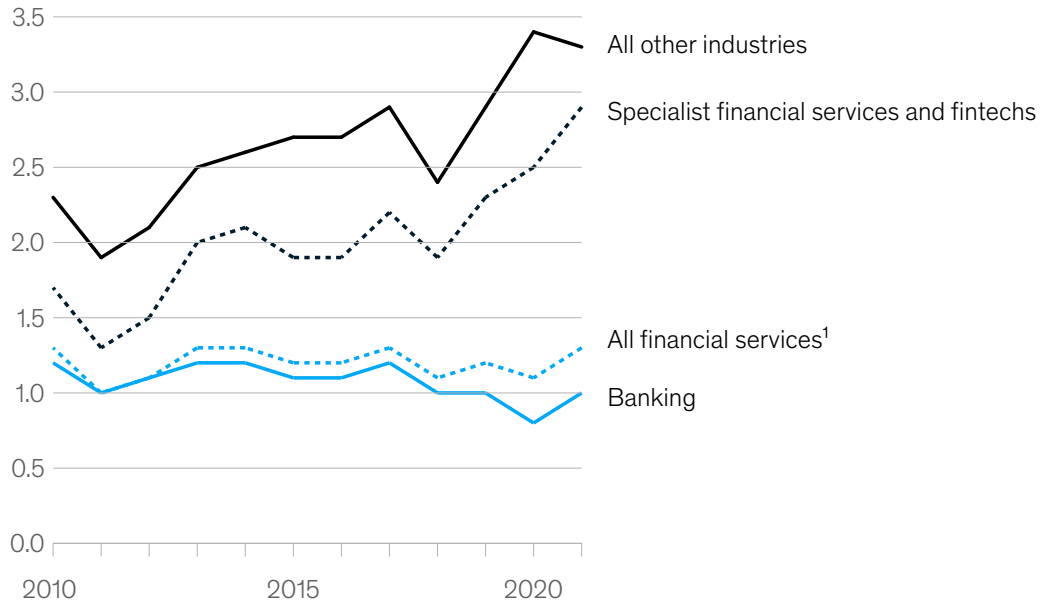
[1]All deposit-taking institutions with available data for 2011–20 (n = 905).
Source: S&P Global; Panorama by McKinsey; McKinsey corporate performance analytics

The challenges facing a capital-intensive industry in a low-price environment also show up in valuations. Banks are trading at about 1.0 times book value, versus 3.0 times for all other industries and 1.3 times for financial institutions excluding banks (Exhibit 12), with 47 percent of banks trading for less than the equity on their books. And these undervaluations persist even after a period in which the financial system as a whole gained about $1.9 trillion (more than 20 percent) in market cap from February 2020 to October 2021.

Exhibit 12

Banking continues to trade at a significant discount to the broader economy.

Banking price-to-book ratio, %



Banking return on equity, %

2005–07	2008–12	2013–17	2018–20
15	7	9	8

Impact of excess capital,[2] percentage points

2008–12	2013–17	2018–20
–1	–3	–4

[1]Includes banks, specialized financial institutions, and fintechs.
[2]Difference between average ROE in the period and ROE at (lower) preglobal financial crisis Common Equity Tier 1 levels for respective periods.
Source: Economist Intelligence Unit; S&P Global; Panorama by McKinsey

How could this apparent paradox happen? Because simple averages hide the devilish details: out of 599 financial institutions analyzed, just 65 accrued all the gains thus far over the course of the pandemic (Exhibit 13). More than 50 percent of the market cap gains went to specialists: payments companies, financial exchanges, securities and investment banks, and others (Exhibit 14). A few universal banks also gained, but the vast majority either realized small gains in their share price or lost value.

Exhibit 13

Market cap gains are concentrated in a few players.

Change in market capitalization during the pandemic[1]

599 financial services players by performance group

65

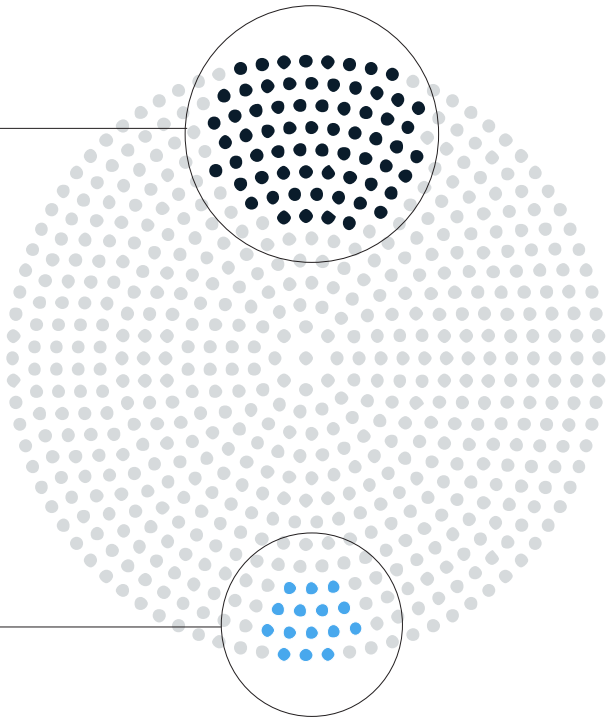
financial services players are **outperformers** with **>$8 billion gain** in market capitalization

519

financial services players are **stuck in the middle** and **gained or lost up to $8 billion** in market capitalization

15

financial services players are **underperformers** with **>$8 billion lost** in market capitalization



Total market cap added during pandemic:

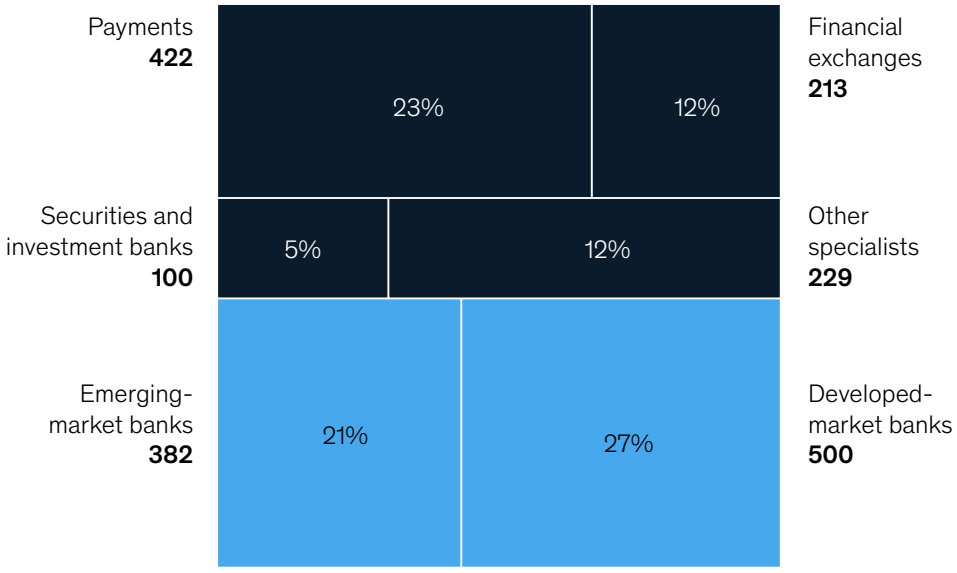
$1.9 trillion[1]

[1]From February 2020 to October 2021.
Source: Panorama by McKinsey

Exhibit 14

Specialists have accounted for more than 50 percent of market cap gains during the COVID-19 pandemic.

Market capitalization added from February 2020 to October 2021, $ billion ■ Specialists ■ Universal banks

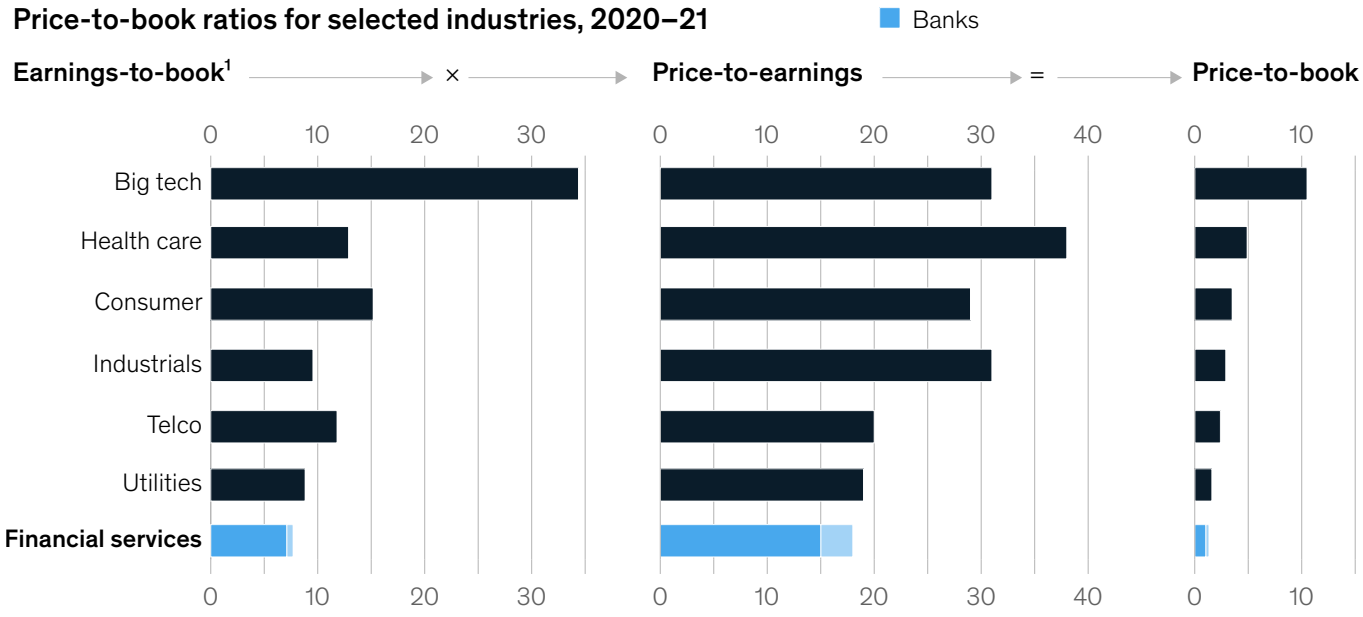


Source: S&P Global; Panorama by McKinsey

Banking valuations suggest that capital markets are discounting an industry whose baseline for profitability and growth is decent and resilient but not attractive—and that is undergoing disruption from specialized and capital-light financial services players. This is reflected in the market multiples, where banking is currently valued more in line with an average utility, with a price-to-earnings ratio (P/E) of 15 times (Exhibit 15).

Exhibit 15

Market expectations for growth and profitability of banking remain low.



[1]Calculated based on latest publicly available data which varied from end of year 2020 to Q3 2021.
Source: S&P Global; Panorama by McKinsey

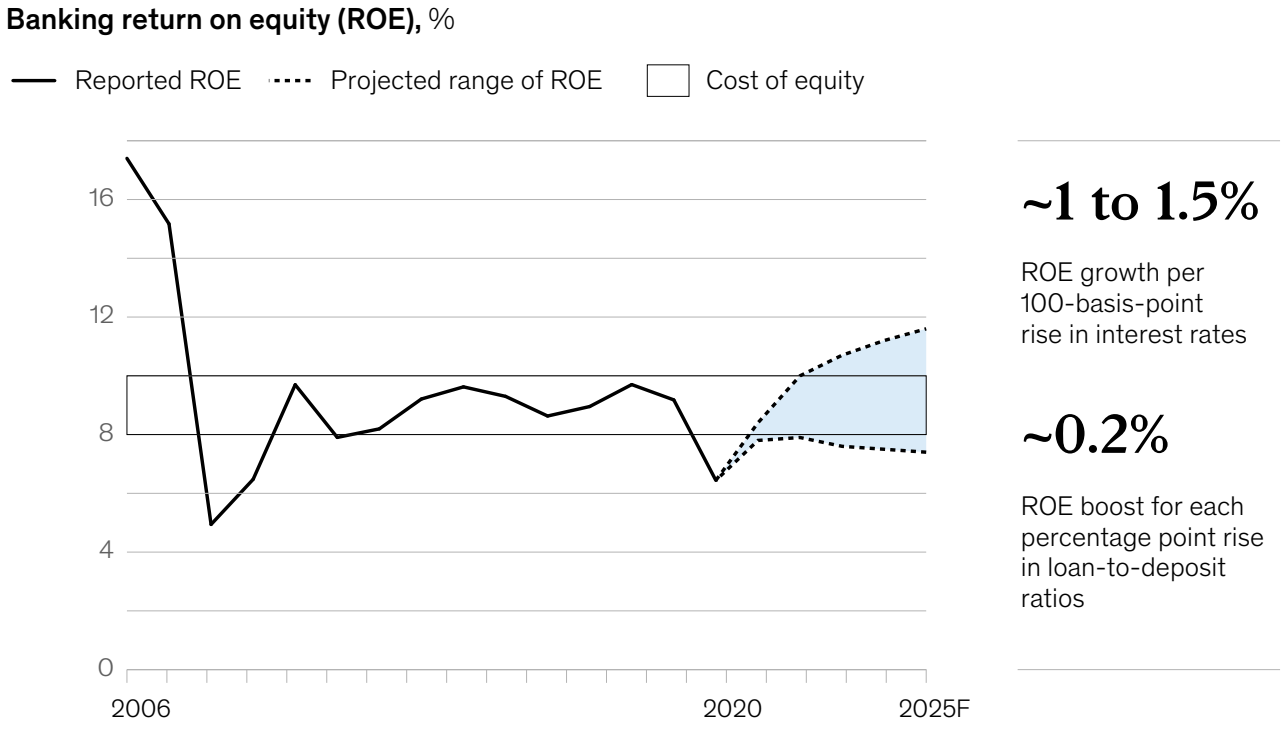
Banking valuations suggest that capital markets are discounting an industry whose baseline for profitability and growth is decent and resilient but not attractive.

Baseline for 2022–25: Decent, but not attractive

Taking into account the likely macroeconomic and pandemic scenarios and factoring in the highly varied starting position of banks worldwide, we see the global industry set for a recovery that could put ROE at between 7 and 12 percent by 2025 (Exhibit 16)—which is somewhat aligned with what happened in the last decade (2010–20), when the average ROE was 7 to 8 percent.

Exhibit 16

The banking industry outlook is decent but not attractive.



Source: S&P Global; Panorama by McKinsey

This baseline is nuanced by region and will be shaped by three macro and interconnected factors beyond banks' control: inflation and ultimately interest rates, government support for the recovery, and liquidity. These variables will determine whether the industry will operate in the upper (12 percent) or lower (7 percent) range of profitability.

Inflation and interest rates. During the pandemic, central banks in major regions have lowered benchmark rates and supported bond markets; prevailing rates fell sharply. US Treasury three-month bills averaged 2.1 percent in 2019 and 0.4 percent in 2020. This year, in the early stages of the recovery, product shortages and supply-chain woes have caused consumer and producer inflation indexes to rise sharply. Should an inflationary trend take hold, banks could expect

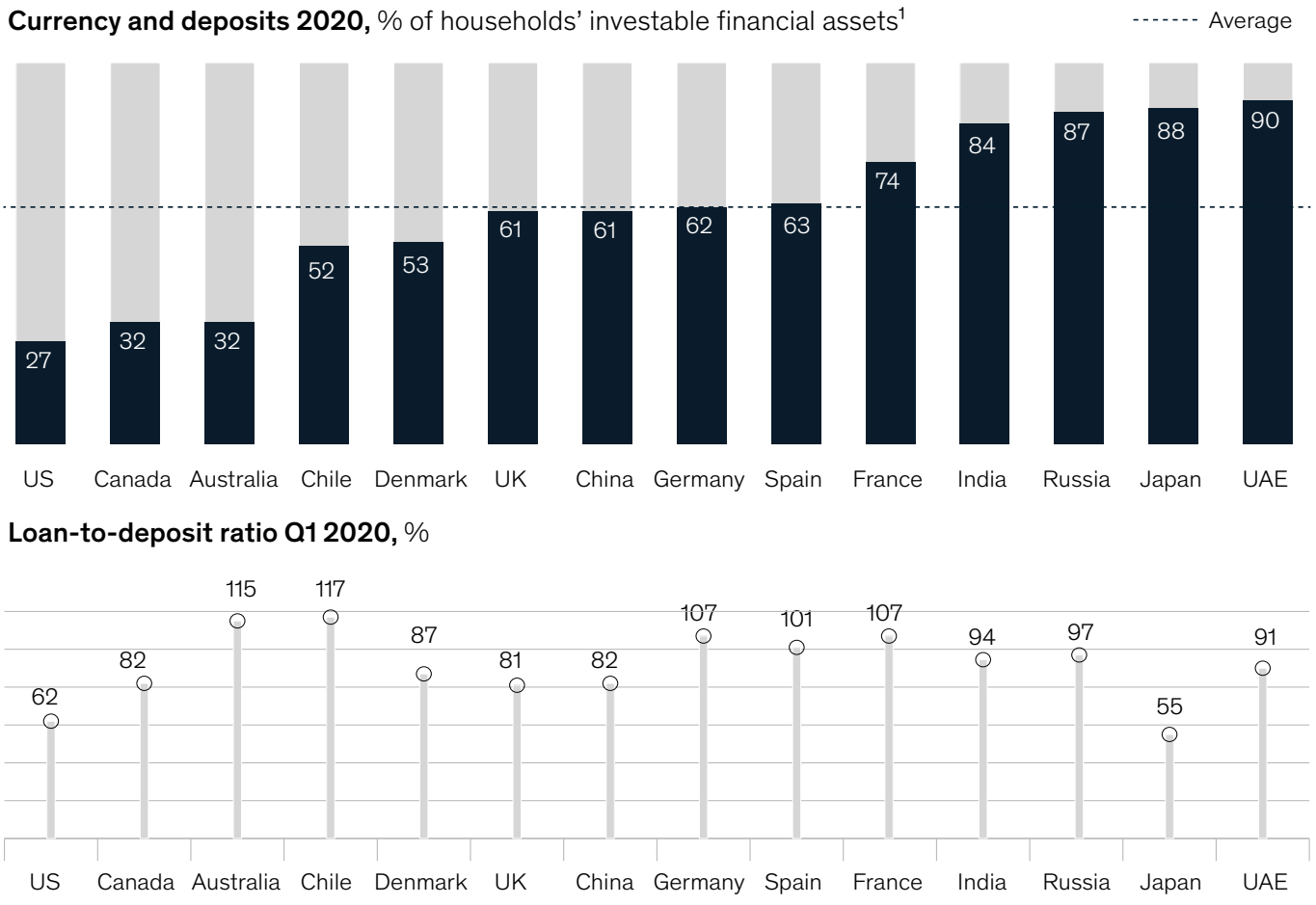
some improvement in net interest margin—but also higher credit delinquency and early redemptions. We estimate a 1.0 to 1.5 percent ROE increase for each 100-basis-point increase in interest rates. This can be seen as a windfall but depends on the starting point of each region, is far from assured, and would not have a material impact on banking intrinsics other than the nominal value of the balance sheet.

Government support. Countries provided trillions of dollars of economic support in 2020–21. But the next rounds of government stimulus will also be massive. In Europe, the Next Generation EU funds 2021–23 are worth €750 billion (half in loans), which is equivalent to about 15 percent of total current outstanding credit on European banks' balance sheets. These programs will be crucial for the economic recovery, and banks will play a central role in ensuring these funds reach the right economic agents. This can represent a tremendous opportunity not only to directly increase loans (though at lower margins) but also to cross-sell with other types of financing and banking solutions, such as payments.

Liquidity. As the economy recovers, we should expect private consumption to increase. A McKinsey survey published in May 2021 found that about half of US consumers wanted to indulge themselves—cautiously. If that happens, saving rates should come back to "normal" levels. But if nothing else changes, LTD ratios will remain below 100 percent. Banks can move this ratio upward by shifting deposits into off-balance-sheet products. In most European countries, cash and deposits represent more than 50 percent of the total household savings (Exhibit 17), a figure that is high compared with the United States (27 percent) or with what many financial advisors consider a healthy proportion of assets (10 to 30 percent).

Exhibit 17

Over-liquidity can be seen as an opportunity for disintermediation.



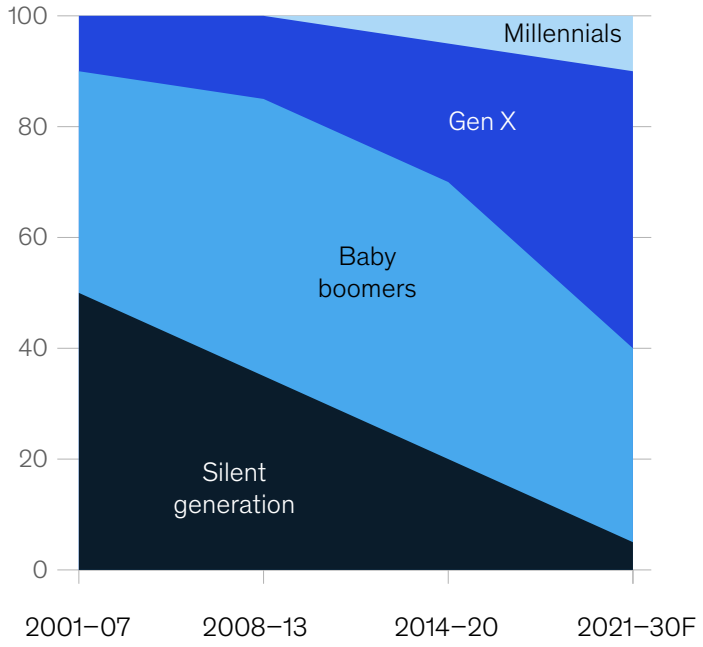
[1]Currency, deposits, mutual funds, and securities.
Source: S&P Global; Panorama by McKinsey

A big part of these savings is in the hands of baby boomers (people born between 1945 and 1964). As an example, in the United States, we estimate that 50 percent of total personal financial assets are held by baby boomers; but in the next ten years, up to $9.4 trillion will change hands as boomers and members of the "silent generation" (born between 1928 and 1945) pass their wealth on to spouses and children (Exhibit 18). This gigantic transfer can offer banks an opportunity to

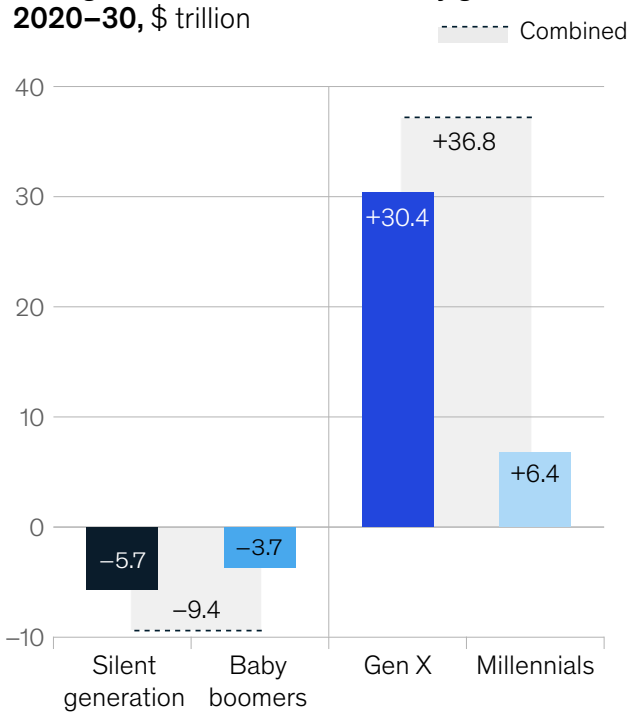
Exhibit 18

Wealth is shifting to Gen Xers and millennials, who have different expectations than baby boomers and the silent generation.

Distribution of investable financial assets[1] in the US by generation, %



Change in financial asset value by generation 2020–30, $ trillion



[1]Inheritance and divestiture.
[2]Investment yield and additional inflows.
Source: Federal Reserve Board survey; Panorama by McKinsey

convert cash into investment products. At the same time, it can represent a threat, considering that the younger generation who will receive this wealth have different expectations in terms of both capital allocations and service channels.

If banks can successfully make the conversion, the rewards would be considerable. A marginal rise of five percentage points in LTD can yield a gain of up to 1.5 points in ROE. The question is, Who is going to capture this opportunity—traditional banks that are perceived as trusted balance-sheet managers or specialists and fintechs, whom investors see as more innovative and faster moving?

All things considered and if stars align, ROE in its upper range would compare favorably with the levels achieved in 2017–19. But that's still far from being attractive to investors, who have many rapidly growing, more profitable opportunities to consider.

Digital disruption from platform companies

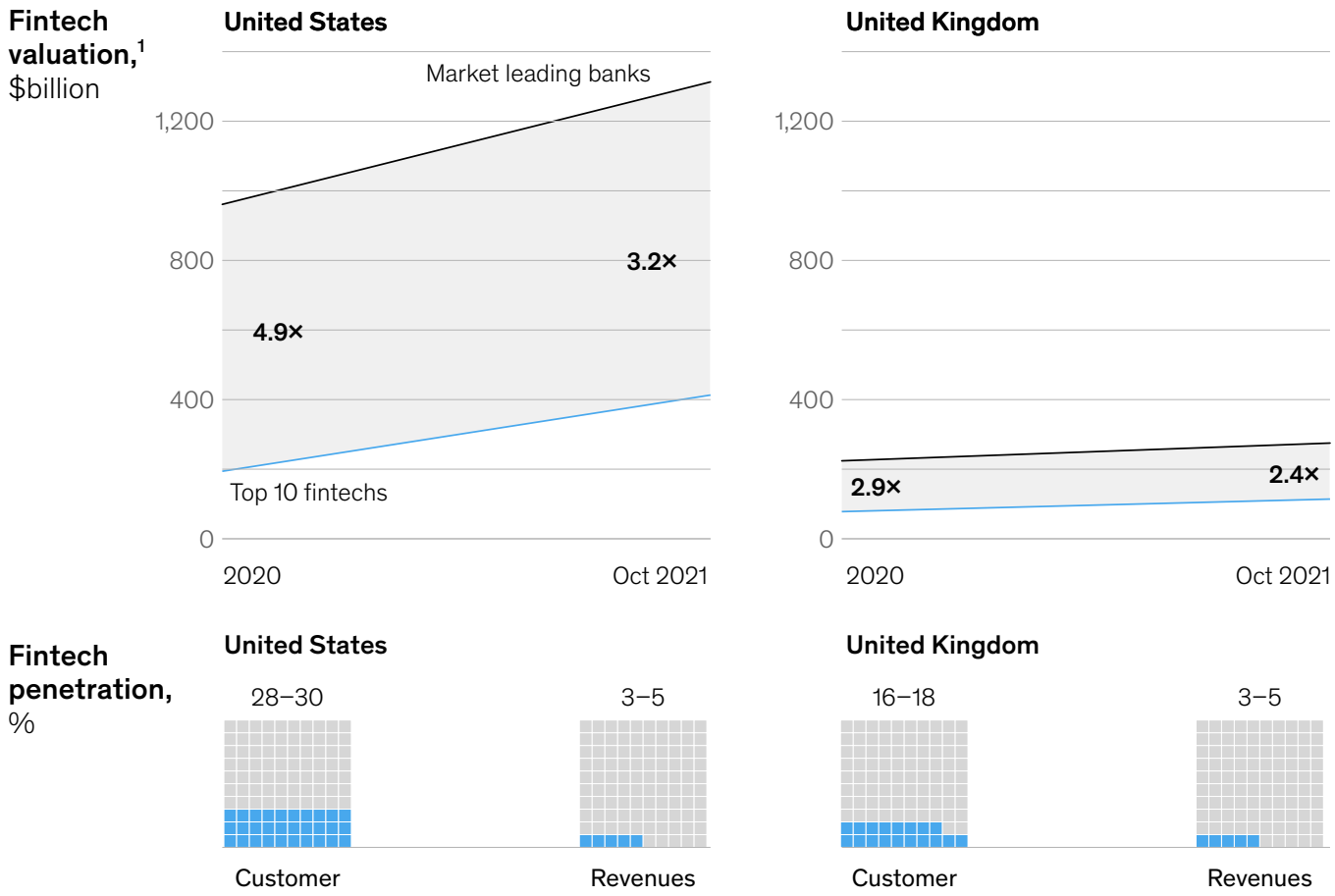
We first wrote about the disruptive threat of fintechs and platform companies in the 2015 edition of this report. Since then, these companies have grown from a sideshow to the elephant in the room for banks. By engaging customers in their daily lives to solve specific financial needs with a distinctive experience while delivering back useful customer insights with advanced analytics, these digital companies have gained customers by the millions and a rapt audience of investors attracted to their compelling growth story.

Our 2021 global retail banking consumer survey shows that in the United States, roughly 40 percent of retail clients are already banking with a fintech or a big tech. In Western Europe, this penetration is at 30 percent. The main reasons to bank with fintechs are price and customer experience—more precisely easy access, speed of service, and app features.

In the United States and the United Kingdom, these providers represent 3 to 5 percent of banking revenues (Exhibit 19).

Exhibit 19

Fintechs are catching up with banks in valuation, and already capture 3 to 5 percent of banking revenues in the US and the UK.



[1]Fintech valuation includes both market capitalization data and valuation of unicorns; 2021 October or latest available valuation.
Source: S&P Global; McKinsey Retail Banking Survey

This might be a small fraction, but traditional specialized financial-services players also started small and now represent more than one-third of global banking revenues. In Sweden or Portugal, for example, consumer-finance specialists capture more than 50 percent of the market.

The inroads into banking from fintechs and big techs are no longer just a threat. They are real. Amazon, Apple, Facebook, and Google have consumer payments offerings; some offer credit cards, and most have point-of-sale (POS) consumer-finance options. In China, Alibaba and Tencent have even more extensive suites of offerings. Two years ago, 65 percent of consumers told us they trust Amazon to handle their financial needs; Google and Apple received similar scores.[6]

This reality is visible not only among retail customers. The Coronavirus Business Interruption Loan Scheme (CBILS) launched by the UK government in March 2020 attracted more than 100 accredited lenders. Two-thirds were fintechs like Assetz Capital, Funding Circle, Iwoca, and ThinCats. Funding Circle, a peer-to-peer marketplace, issued loans worth £2.3 billion, making it CBILS's third-largest lender after Natwest and HSBC. In the United States, Cross River Bank provides banking services to several fintechs, and originated more than $11 billion in small-business loans through the Paycheck Protection Program.

Whether platform companies will confirm Bill Gates's 1994 view that "banking is necessary but banks are not" may be beside the point, at least for the next three to five years. What matters is that they are redefining banking customer expectations in a way similar to how Spotify redefined music listeners' expectations and Booking.com changed travel planning.

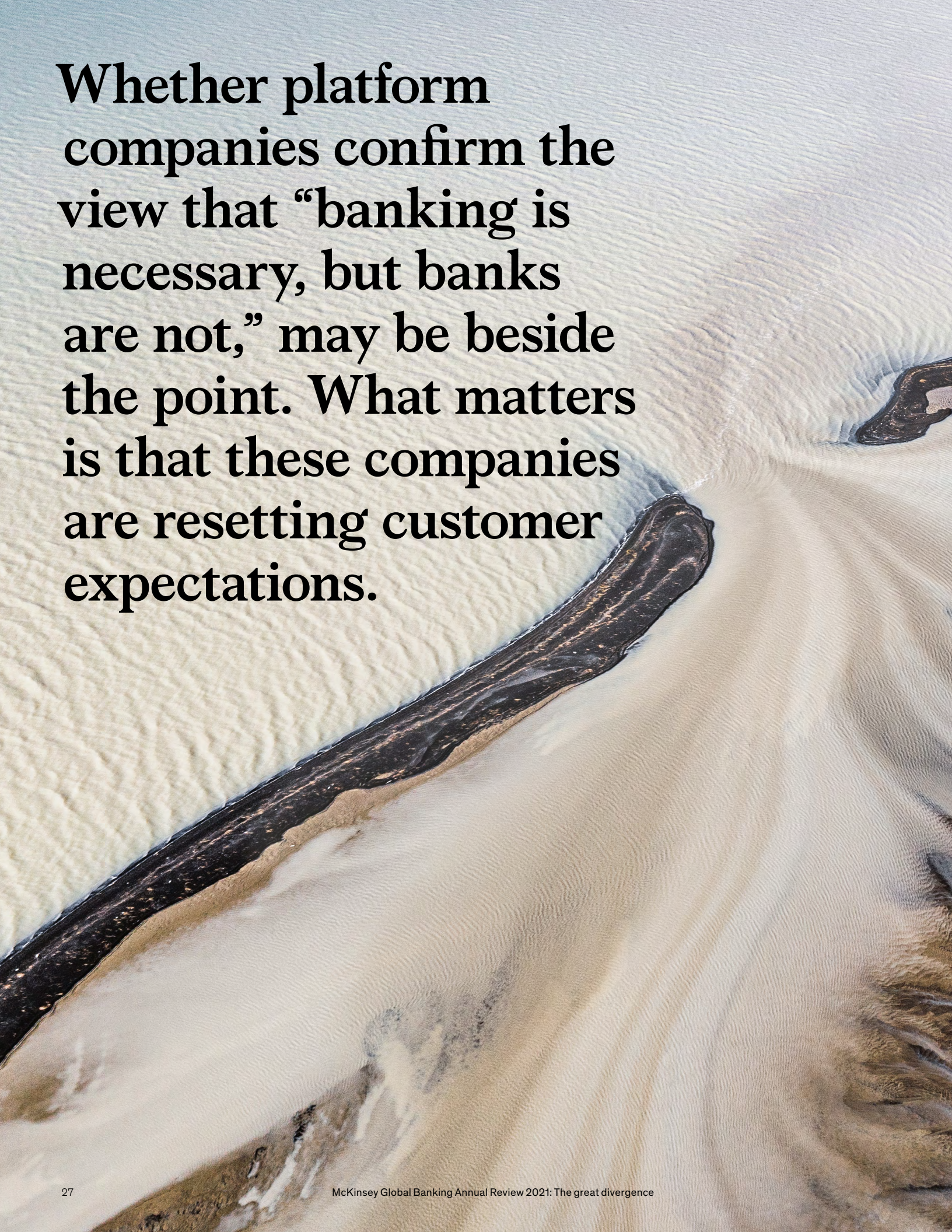
Investors are putting their money where customer preferences are. In 2020, total investment in fintechs reached about $40 billion globally. In the first half of 2021, fintechs raised $52 billion. These might be considered small-ticket investments compared with global banks' market cap of $8 trillion. However, the threat for banks is not how relevant fintechs and big techs are today but how fast they will grow and how relevant they will become to customers in the most profitable parts of the financial-services business.

———

The shift in investor sentiment is a preview of what we expect to be a broader, secular divergence between banking's haves and have-nots, as we discuss next.

In some markets, fintechs are serving 30 percent of customers and generating 3 to 5 percent of banking revenues.

[6] McKinsey 2019 Future of Banking Consumer Survey; n = 2,036.



Whether platform companies confirm the view that "banking is necessary, but banks are not," may be beside the point. What matters is that these companies are resetting customer expectations.

2. The great divergence in financial services

As we near the end of 2021, some financial institutions—and not necessarily banks—are gaining ground, while others are slipping. In this chapter, we look at four sources of divergent shareholder value: *geography* (where are the bank's main markets?), *scale* (how big is the bank compared with its rivals?), *customer base* (which segments does the bank focus on?), and *business model* (how does the bank design and deliver its services?). The first three are supremely relevant but inherited and difficult to control. The last is firmly within banks' grasp and gaining more relevance; here, we abstract the characteristics of leaders that others can emulate.

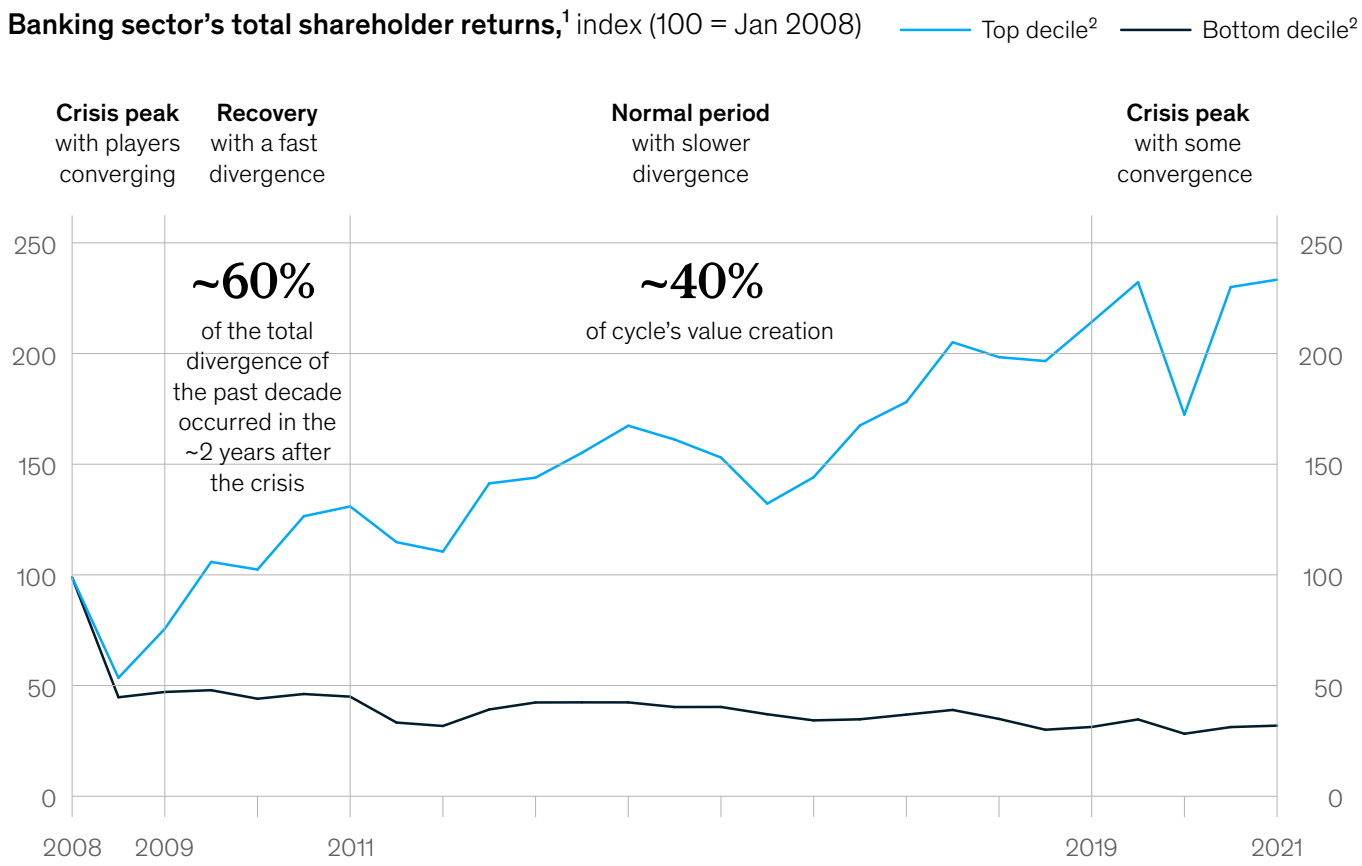
From convergent resilience to divergent growth

In any race, some runners lead the pack, most are middling, and a few bring up the rear. Also, there is a defining moment where the leaders diverge from the rest. That's the nature of competition. The same holds true for business. Indeed, that's what we've observed over many years in our analyses of the distribution of profit within industries, including banking.

Since 2008, the gap between the banking industry's leaders and laggards, as measured by total returns to shareholders, has steadily widened. By 2019, top-decile performers were delivering about five times more value to their shareholders than the bottom decile (and 3 times more than the average bank). Now we've arrived at another defining moment in this shareholder value race: the aftermath of a crisis. As an example, after the last crisis (2007–09), about 60 percent of the performance gap over the next decade occurred during the first two years of recovery (2010 and 2011) . During the remainder of the decade, the gap continued to widen, but more slowly (Exhibit 20).

Exhibit 20

Two-thirds of the value created by banks in a postcrisis recovery is generated in the first 18 to 24 months.



[1]Analysis based on a sample of ~600 publicly listed banks.
[2]Top/bottom decile refers to top/bottom 10% of banks based on past 5 years' total return to shareholders.
Source: S&P Global; Panorama by McKinsey

If we are fortunate with regard to COVID-19, 2022 will be about navigating the aftermath of a crisis. Critically, this period will also mark the beginning of a new era in global banking, in which the industry will move from a decade of convergent resilience (2011–20) to a period of divergent growth (2022–27).

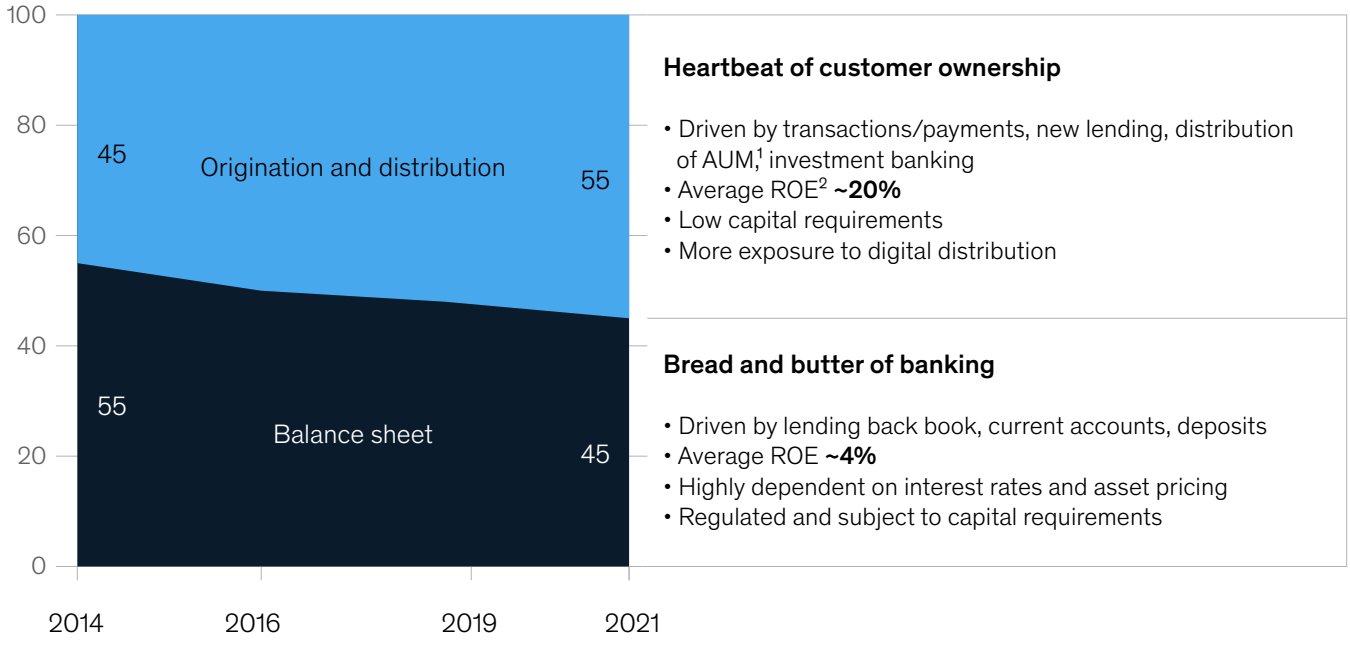
Over the past decade, banks mainly focused on the same activities: rebuilding regulatory capital, mending regulatory fences, investing in digitization, and achieving productivity and efficiency gains. The result was a convergence of profitability to levels below cost of equity as average global ROE fell from 8 percent in 2010 to 6 percent in 2015. The gap between the industry's top 10 percent and average ROE performers narrowed from 17 percentage points to 14. Valuation followed the same pattern, with market-to-book premiums moving from 250 percent to 234 percent over the same period.

This convergent resilience was an outcome of necessary actions taken by banks, especially in the early years. But as banks moved in lockstep, their offerings became commoditized, and customer expectations skyrocketed. In a low-interest-rate world, a commoditized business model based on the balance sheet yields less income and brings no differentiation to the customer. (Disruption from decentralized finance and central-bank digital currencies are even more recent sources of pressure for banks; see sidebar "Cryptocurrencies.") If we split revenues between those generated by the balance sheet and those that come from origination and sales (for example, mutual funds distribution, payments, consumer finance), the trend is clear: growth and profitability are shifting to the latter category, which has an ROE of 20 percent—five times higher than the 4 percent for balance-sheet-driven business—and now contributes more than half of banks' revenues (Exhibit 21).

Exhibit 21

Revenue pools are moving from the balance sheet business model toward origination.

Global banking revenues by activity, 2014–21, %



[1]Assets under management.
[2]Return on equity.
Source: S&P Global; Panorama by McKinsey

Not coincidentally, origination and sales are where specialists and platform companies are extending their tentacles to offer innovative, fee-based services that are challenging traditional banks' business models. At launch, Revolut offered payment services with no fees and an app with spending insights. Recently, the UK-founded fintech entered the wealth management business by facilitating investments in fractional shares or cryptocurrency. The result: growth from 2 million to 15 million customers worldwide in three years. Mercado Libre, an established Latin America e-marketplace with about 400 million customers, is setting up its own payments solution, Mercado Pago. Square, founded 12 years ago to enter the merchant acquiring business, is valued at almost $100 billion and trades at a price-to-book of roughly 33 times (as of November 30, 2021). The firm's shareholders recently approved the acquisition of Afterpay for $29 billion.[7] The objective? Strengthen their value proposition by adding "buy now, pay later" service to a joint customer base of 50 million users.[8]

Capital markets are already factoring in this growing divergence. In 2020, the premium from top to bottom performers widened to 470 percent (8.5 times market to book versus 1.5 times). In October 2021, this gap widened further to 518 percent (Exhibit 22). This divergence is more evident if we separate traditional banks, which are more reliant on balance-sheet-driven business, from the specialists and platform companies, which are more focused on origination and sales. The reason is that banks are valued similarly to utilities (that is, with low valuations and a narrow though widening gap between top and bottom performers), while specialists and platform companies are valued more like tech companies in other industries, with high valuations and wide gaps (Exhibit 23).

Sources of divergence

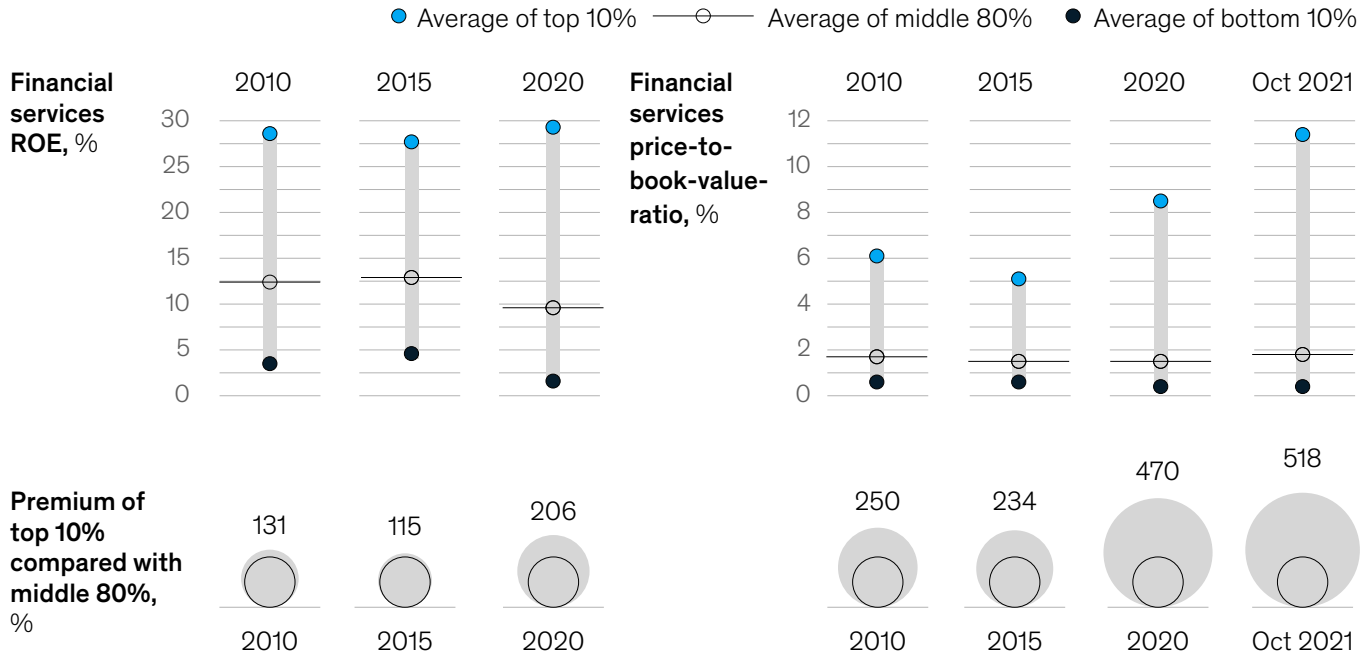
Decisive strategic commitments made today will separate the leaders from the also-rans in the race for shareholder value over the next five years and will position them to flourish in the future of banking. What are today's leaders doing differently? What can banks emulate? What factors lie beyond their control?

[7] "Square investors approve $29 bln buyout of Afterpay," November 3, 2021, reuters.com.
[8] "Square, Inc. Announces Plans to Acquire Afterpay, Strengthening and Enabling Further Integration Between its Seller and Cash App Ecosystems," August 1, 2021, squareup.com.

Exhibit 22

Capital markets are already anticipating a divergence in financial services valuations.

Return on equity (ROE) and price-to-book comparison between banking performance tiers

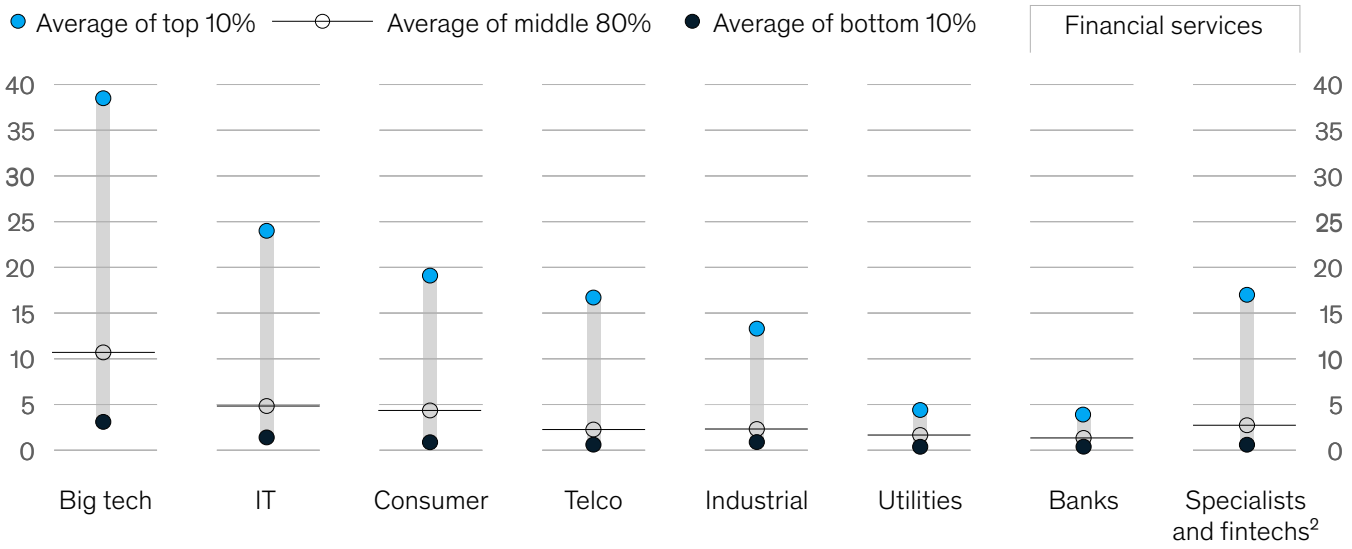


Source: S&P Global; Panorama by McKinsey

Exhibit 23

Specialized financial services are leading the divergence.

Price-to-book ratios of large companies[1] across industries, Oct 2021



[1]Listed companies with a market cap over $1 bilion; (300–800 companies considered for each industry).
[2]Specialists include payments providers, wealth managers, and others.
Source: S&P Global; Panorama by McKinsey

Cryptocurrencies

Cryptocurrency has been touted for its potential to usher in a new era of financial inclusion and simplified financial-services infrastructure globally. To date, however, its high profile has derived more from its status as a potential store of value than as a means of financial exchange. That disconnect is now evolving rapidly with both monetary authorities and private institutions issuing stabilized cryptocurrencies as viable, mainstream payments vehicles.

The European Central Bank announced earlier this year that it was progressing its “digital euro” project into a more detailed investigation phase. More than four-fifths of the world’s central banks are similarly engaged in pilots or other central-bank digital currency (CBDC) activities. Concurrently, multiple private, stabilized cryptocurrencies—commonly known as stablecoins—have emerged outside of state-sponsored channels, as part of efforts designed to enhance liquidity and simplify settlement across the growing crypto ecosystem. Although the endgame of this extensive activity that spans agile fintechs, deep-pocketed incumbents, and (mostly government-appointed) central banks remains far from certain, the potential for significant disruption of established financial processes is clear.

The impact of CBDCs on private-sector banks likely depends on the speed of their adoption. Specifically, if adoption of CBDCs were to happen relatively quickly, the flow of funds into bank deposits would be diverted, at least temporarily, into digital cash, thereby limiting the ability of banks to lend and generate income with such deposits. Accordingly, it would seem in the interest of private-sector banks for the introduction of CBDCs to be slower and more carefully orchestrated, potentially with initial transaction limits.

Chief risk and financial officers will benefit from evaluating the broad impact of digital currencies on bank liquidity and capital requirements, given potential policy changes. They could monitor potential increases in funding costs, the possibility of further erosion of payments profit margins (for example, given CBDC’s potential as a frictionless “free” cash replacement), and even safeguards against potential digital bank runs. Many of the existing circuit breakers that afford some protection for traders and investors do not exist in the 24/7 cryptocurrency markets, although such limits are being built into some CBDC designs.

We analyzed more than 150 financial institutions globally—including banks, specialists, and fintechs—and found four sources for divergence: the geographies in which financial institutions operate, their relative scale, their segment focus, and the business models they deploy.

As we stated in the 2019 edition of this report, "Domicile is mostly out of banks' control. Scale can be built, although it takes time; attractive acquisitions and partnerships are currently available for most banks. But on their individual performance . . . banks can take immediate steps to reinvent themselves and change their destiny, inside the short window of a late cycle."[9] At that time, no one knew that a pandemic was coming. But we were already anticipating the end of a cycle that turned out to be shockingly abrupt.

Strategic choices banks are making today are determining their fate. Who takes advantage of this era of divergent growth and who fades away will depend on their capacity to build a future-proof business model. But one thing is for sure: at the end of the day, the biggest winner will be the customer.

Geography

In 2010, a bank's core geographic market accounted for 73 percent of the standard deviation in price-to-book (P/B). For the first half of the decade preceding that moment, emerging economies had been the global growth engine; logically, banks that focused on serving these regions could count on their markets' growth to boost investors' confidence in their strategy.

Then, five years ago, there was an inflection point: growth returned to the developed world after the financial and European sovereign-debt crises, and the contributors to value were reversed. In 2017, the region a bank operated in accounted for only 41 percent of its P/B standard deviation.

Now location is again the biggest factor, accounting for about 65 percent of P/B standard deviation, according to our analysis (Exhibit 24). The primary cause is the economic slowdown in developed markets, which is primarily related to concerns over the US trade conflict with China and an increase in Federal Reserve rates.

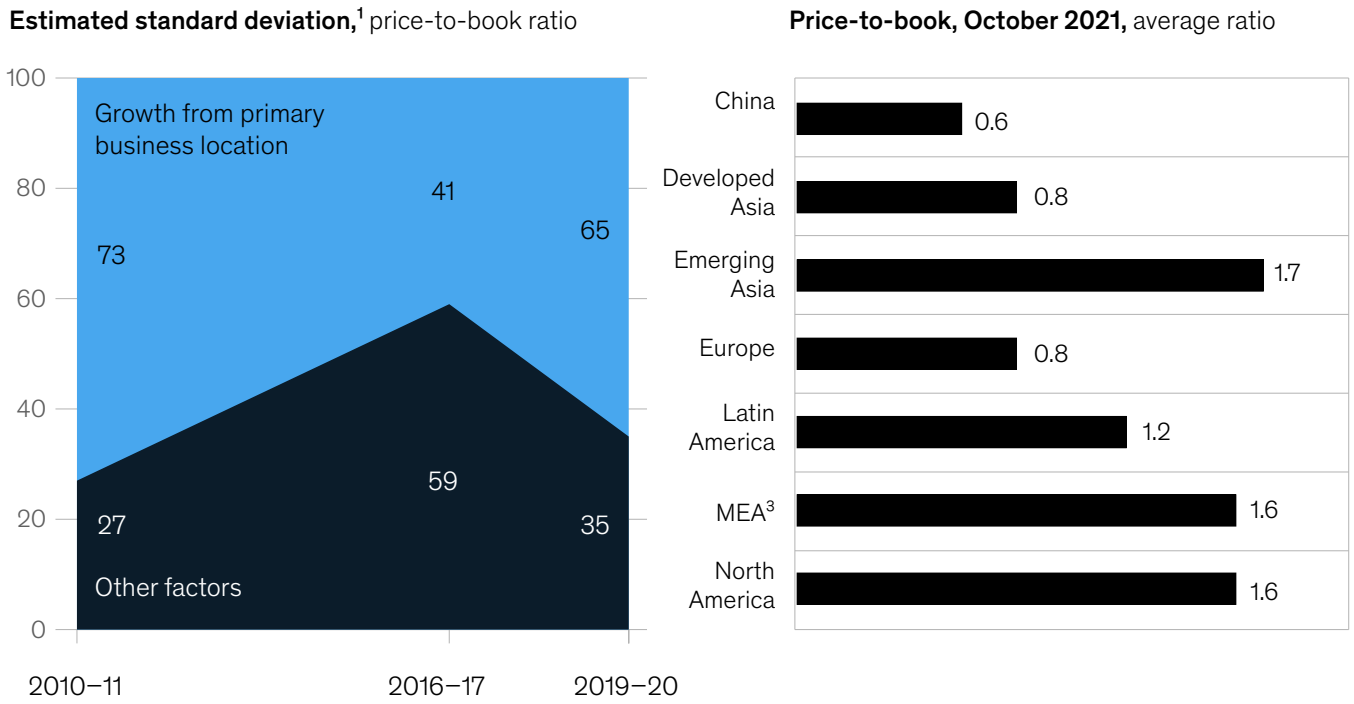
After the pandemic, we expect that emerging markets will again grow faster. In one likely scenario for the recovery, China's GDP would grow at 5.4 percent annually from 2019 to 2024; Emerging Asia would see growth of 4.8 percent annually. That's considerably faster growth than Eastern Europe (2.4 percent) could expect in this scenario. North America (2.5 percent),

[9] "The last pit stop? Time for bold late-cycle moves," Global Banking Annual Review 2019, October 2019, McKinsey.com.

Exhibit 24

Geography is back as a major driver of banks' valuations.

Impact of location on price-to-book ratio



[1]We analyzed the deviation in banks' price-to-book ratio across the past decade, using a standard regression model, to estimate key drivers behind variation in price-to-book, from either primary business location for banks or other factors, including management, operations, and all the other levers that banks command.
[2]Total shareholder returns.
[3]Middle East and Africa.
Source: S&P Global

Developed Asia (1.5 percent), and Western Europe (1.4 percent) would be even further behind. According to our estimates, emerging markets' share in global banking revenue pools will exceed 50 percent by 2025—a striking figure, considering that at the start of the millennium, these countries represented 20 percent of revenues.

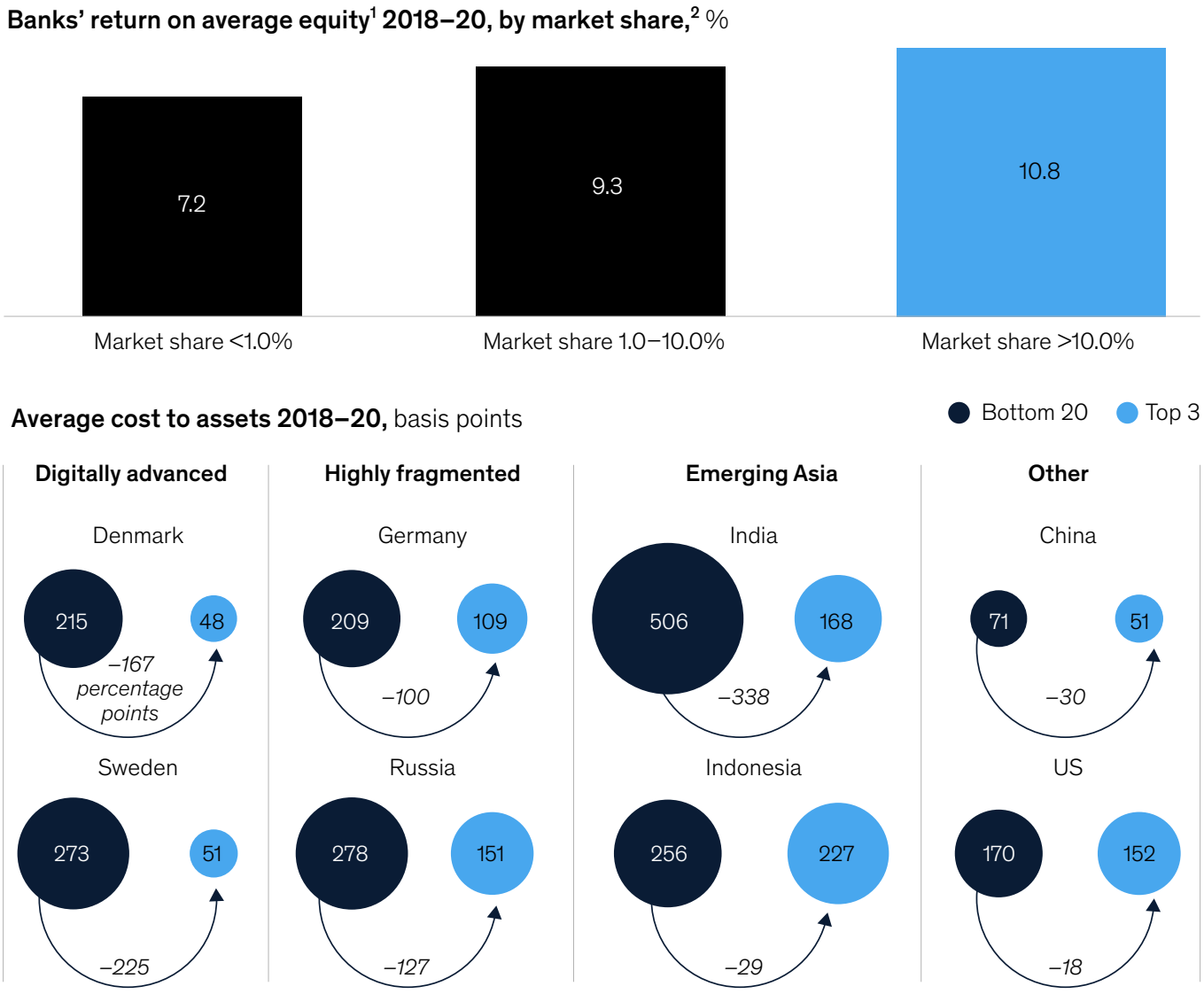
Banks with the good fortune to have sizable and fast-growing economies as their core market—for example, a Chinese payments firm or an Indonesian asset manager catering to the wealthy—will naturally benefit. Others, such as a European universal bank, will have to work harder to achieve similar results. Investors are already pricing in some of these geographic distinctions.

Scale

Our analysis of about 150 financial institutions across the world shows that banks with leading in-country market shares display an ROE premium compared with peers. This scale effect is more pronounced in Asia and Latin America, where leaders

Exhibit 25

Bigger banks are outperforming smaller players in profitability, mostly in digitally advanced countries.



[1]Calculated using simple average of post-tax ROAE.
[2]>10% (n = 352), 1–10% (n = 429), 0.1–1% (n = 534), <0.1% (n = 1,229).
Source: S&P Global, ~2,000 top banks by asset size

enjoy approximately 400 and 450 basis points of ROE premium, respectively. In Europe, both large banks and small specialized players outperform midsize banks.

Larger banks are generally more cost-efficient, although the magnitude of the difference varies. In Sweden, Denmark, Germany, or Russia, the top three banks by assets are noticeably more efficient than the bottom 20 percent, with a cost-to-assets gap of 200 to 300 basis points. In the United States or China, the difference is lower—less than a 50-point gap (Exhibit 25).

We expect scale to matter even more as banks compete on technology, a view we expressed in our 2019 report. One reason for its importance continues to be that most IT investments tend to involve a fixed cost that makes them cheaper over a higher asset or revenue base. The initial impact of scale is this ability to bring marginal costs down as an organization gains operating leverage with consistent increase in size. But we continue to expect greater benefits than cost cutting as digital scale begins to deliver the network effects of mass platforms offering peer-to-peer payments and lending, among other applications.

Segments

Another contributor to the great divergence is differences in banks' capabilities to serve the fastest-growing and more profitable customer segments. Consider what's happening in US retail banking. Over the past 15 years, the revenues from middle- and low-income households have shrunk considerably. According to our analysis and proprietary data, an average US household generates roughly $2,700 in banking revenues annually after risk costs, while a self-employed customer between the ages of 35 and 55 with a bachelor's degree and an annual income above $100,000 generates four times more ($11,500). If the same customer lives in New York and banks digitally, he or she generates five times more revenue ($13,500) (Exhibit 26). In emerging markets, the disparity is even greater: in India, for example, 40 percent of retail banking revenues is concentrated in male customers younger than 40.

The divergence in segment profitability is growing and not only in retail banking. Small and medium-size enterprises (SMEs) represent one-fifth (about $850 billion) of annual global banking revenues, a figure that is expected to grow by 7 to 10 percent annually over the next five years. However, the profits of banks in this segment varies significantly, partly because of highly varied credit quality in the portfolio. Finding the optimal balance between providing a great customer experience and managing the cost to serve has also proven to be difficult. As a result, many banks have not prioritized SMEs—forsaking the vast potential value and leaving many SMEs feeling that their needs are ignored.

Future-proof business models

In a world that continually surprises, we hesitate to talk about a "future-proof" business. Many companies that thought they were ready for anything in 2019 are frantically reinventing themselves—or disappearing. Nonetheless, the concept is useful: What does it take to build a bank that is impervious to disruption as we understand it today?

Payments can serve as an example. Fiserv, Global Payments, Klarna, and Square are very different and operate in different parts of the payments value chain, but they all have thrived in a business in which most banks have been struggling to create value. Their business model is capital-light, focused on sales growth in the most relevant and attractive revenue pools and with a strong investment in technology and scalable and integrated systems. Banks, on the other end, have focused on the debtor-side interfaces where value creation has been limited and revenue sources are under pressure—for example, current accounts and cross-border payments.

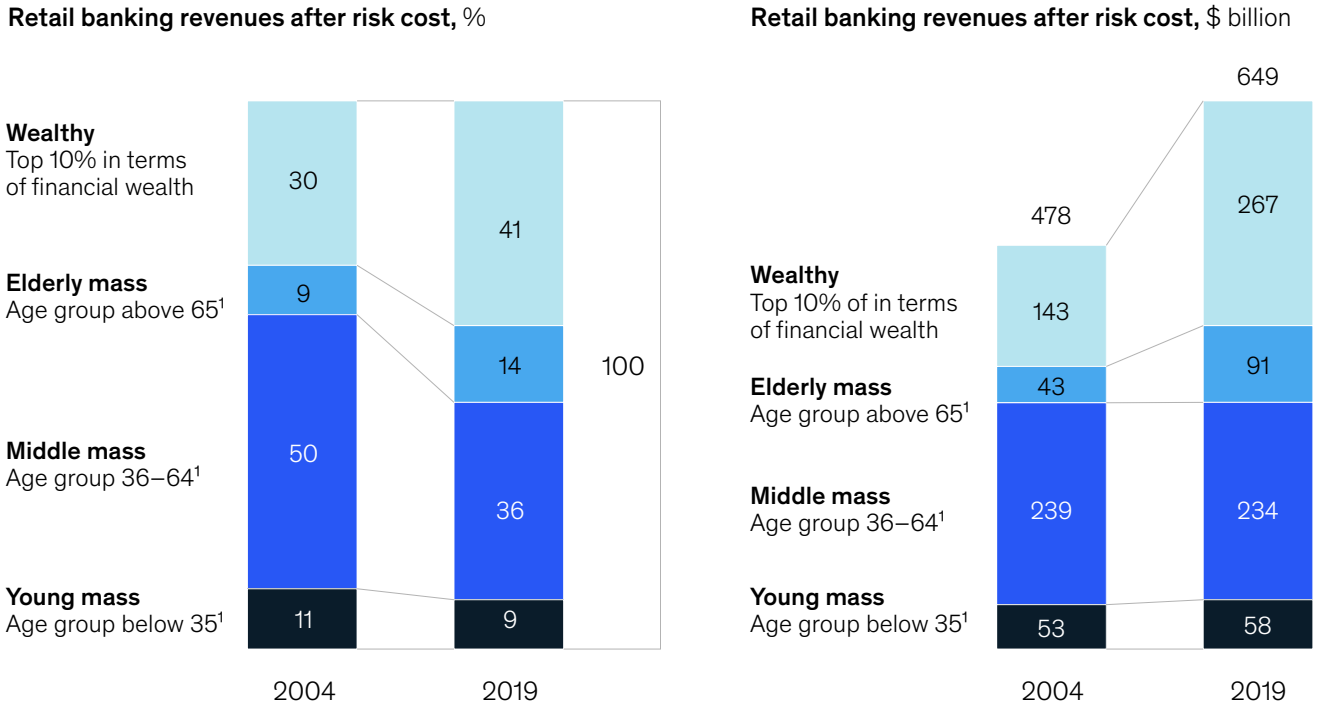
Overall, specialized financial-services providers—in payments, consumer finance, or wealth management—are generating higher ROEs and valuation multiples than most global universal banks. Some fintechs are going from a rough sketch to billion-dollar valuation in a few years. And there are indeed some banks among the institutions diverging from the pack (Exhibit 27, page 37). What do these top performers have that others can build, acquire, or access through partnerships to deliver a higher shareholder value? Our analysis of top-performing financial institutions points to three common elements that make a future-proof business model: (1) customer ownership with embedded digital financial services; (2) an efficient economic model that fosters growth beyond the balance sheet; and (3) tech-enabled innovation and fast go-to-market.

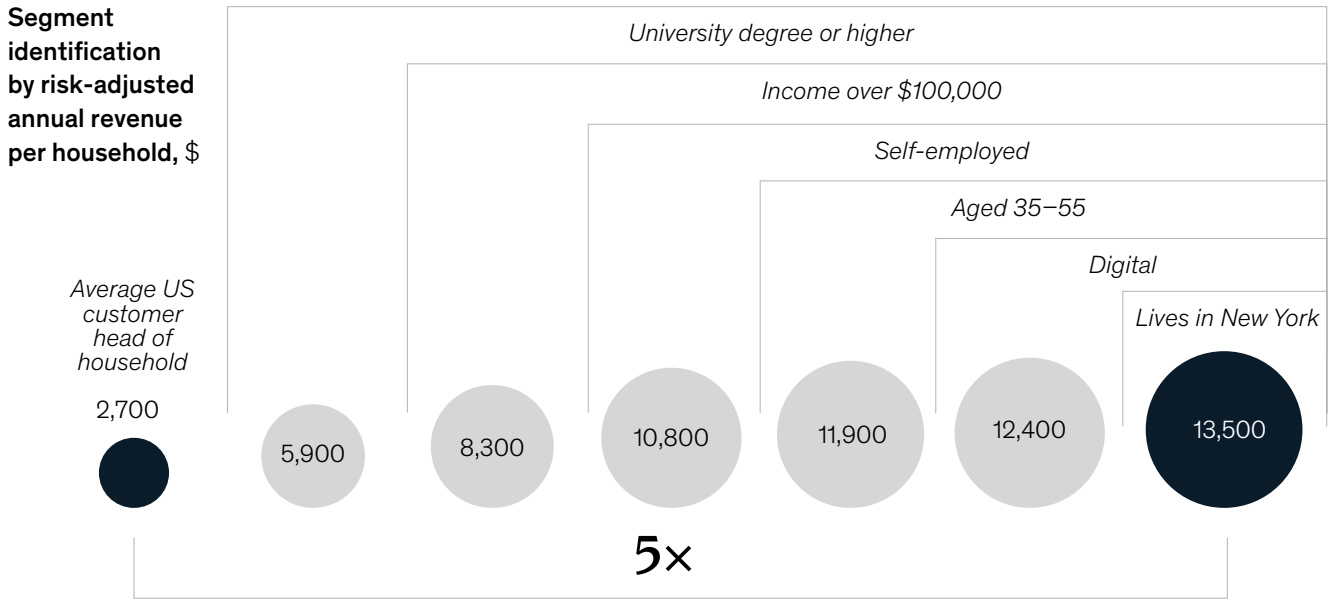
In a future-proof business model, the customer, not the product, is the focus.

Exhibit 26

As value pools shift away from middle mass market, granular segment insights are critical to find revenue hotspots.

Comparing retail banking revenues by segment, US



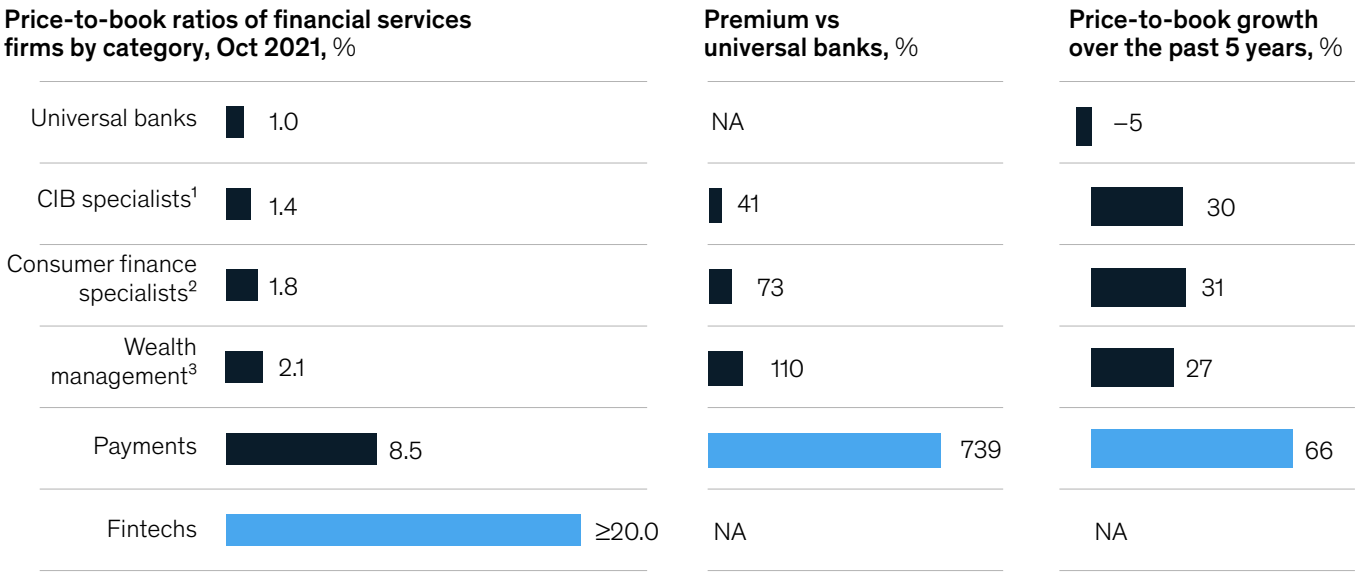


[1]Excluding top 10% in terms of wealth.
Source: Panorama by McKinsey

Exhibit 27

Payments have outperformed other business models in shareholder value creation over the past five years.

Comparison of price-to-book ratios for banking sectors, %



[1]Corporate and investment banks. This includes investment banks, niche corporate banks, and commercial focused nonbank financial institutions.
[2]Nonbank consumer finance focused specialists.
[3]Wealth management focused banks and nonbanks, brokers' houses, and asset managers. Estimates: last valuation compared with equity of unicorn fintechs (sample of ~15 fintechs).
Source: S&P Global

Customer ownership with embedded digital financial services

Companies like Amazon, Apple, Google, Netflix, and Spotify have taken existing services and transformed them into digital experiences that are now embedded in customers' daily lives. Leading fintechs, specialists, and banks are replicating this model in financial services, turning products into features to meet customer needs and keep them engaged. The existing, underlying elements are still there—the checking account, the personal loan, or the POS terminal—but they are less visible, a seamless part of a digital experience that goes beyond banking. In a future-proof business model, the customer, not the product, is the focus.

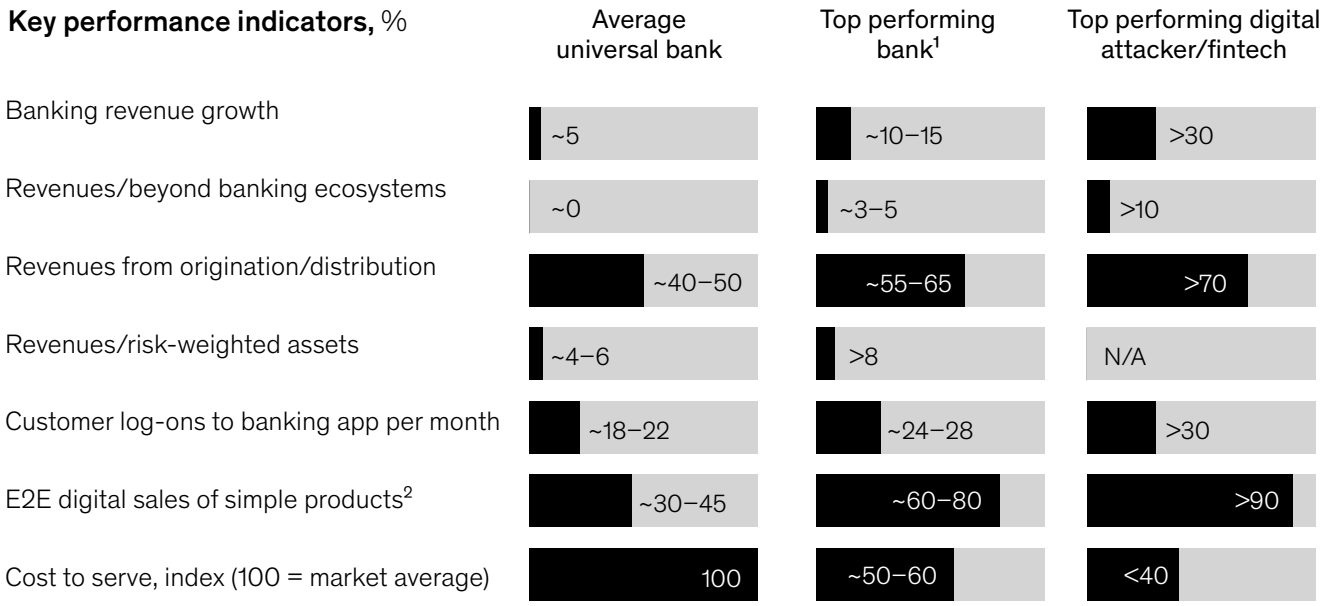
Successful financial-services providers take three discrete steps to position their business for this shift. First, they attract customers by solving very specific yet relevant needs. Examples include Alipay, Klarna, and Square, which make shopping and cash management easier and convenient for small businesses through quick and simple onboarding, transparent pricing, new POS terminal features, and buy-now-pay-later checkout solutions. NuBank and WeBank are furthering financial inclusion by reaching out to unbanked clients. Nutmeg, Robinhood, and Vivid serve young and digital-savvy customers, charging low (or no) investment fees while offering the possibility of investing small amounts in fractional shares, robo-advisory, or IPOs and to participate in financial tutorials.

Second, top performers bring customers into an ecosystem, connecting them with other services and building a dynamic and distinctive experience. For example, Square's core offering is a payments service, but from there it developed comprehensive value-added services for sectors such as restaurants, where its POS services include digital ordering, kitchen display, and customer insights.

The third step is providing customers with personalized analytical insights. This increases customer engagement and, eventually, advocacy through word of mouth and social media. And in a virtuous cycle, it tells the bank or fintech more about customer behaviors and needs. The Canadian bank RBC is

Exhibit 28

Economic model of top-performing digital attackers and fintechs more attractive than banks.



[1]Top performers evaluated separately within each metric.
[2]Savings, credit cards, unsecured lending.
Source: Finalta; S&P Global; McKinsey Ecosystem Strategy Hub

constantly upgrading its AI-powered financial assistant app NOMI. On top of the app's convenience, analytical insights on spending, and saving features, NOMI provides users with cash flow forecasts that take into account loan installments and subscription services, and applies deep learning techniques to customer transaction behaviors.

Efficient economic model that fosters growth beyond the balance sheet

Financial institutions with higher valuations tend to have a 40 to 60 percent lower cost to serve than the average universal bank and four times greater revenue growth (Exhibit 28). Higher revenues and low costs lead to more value, of course, but a deeper analysis of these leading financial institutions also shows that 55 to 70 percent of their revenues come from origination and distribution, compared with 40 to 50 percent for an average universal bank, and they leverage digital channels to interact with customers two to three times as frequently as the average bank.

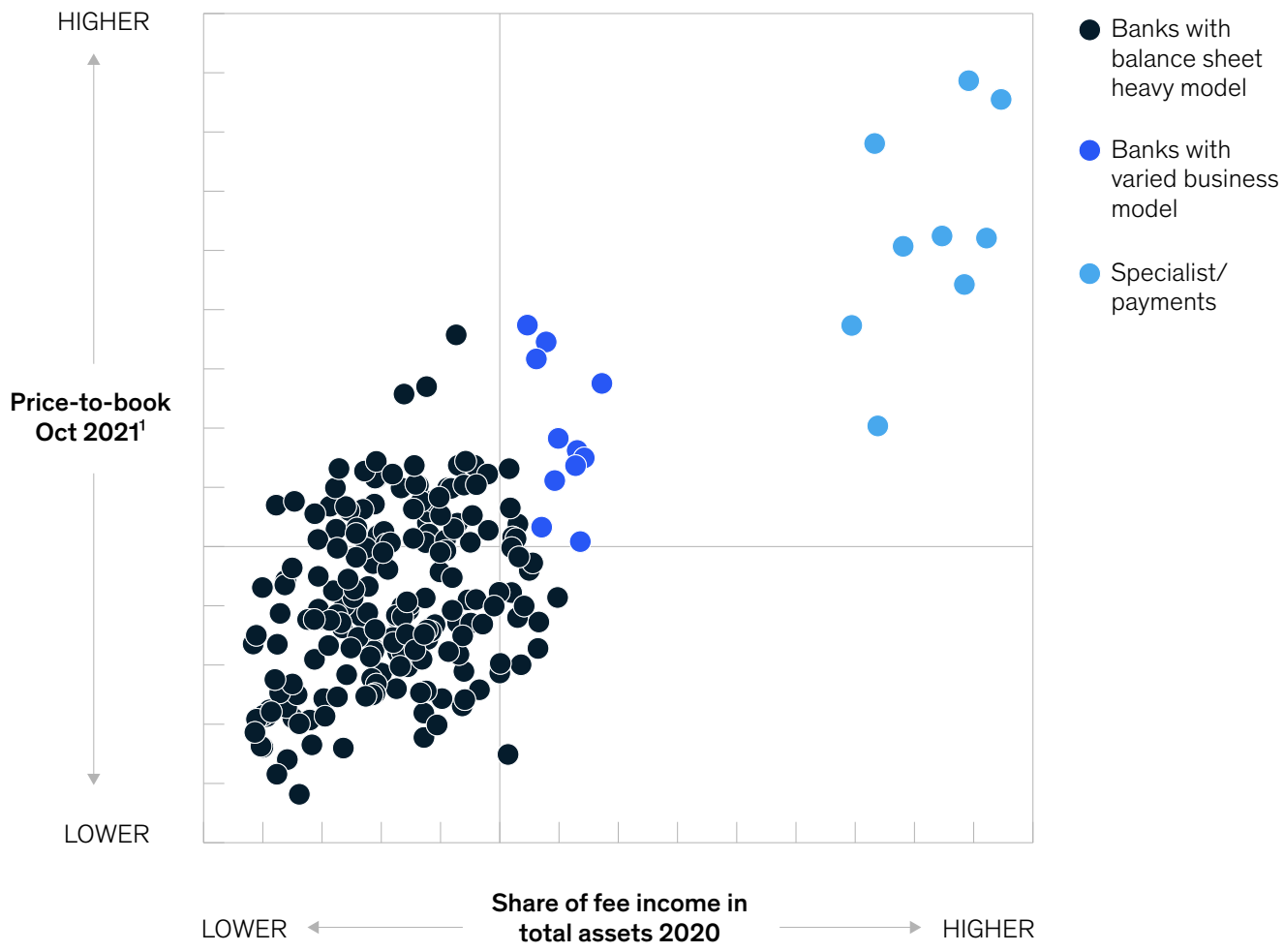
China's WeBank, for example, was launched in 2014 and today serves more than 200 million individual customers and 1.3 million SMEs. This growth was achieved without a single branch and with only 2,000 employees. Profitability is above 25 percent, sustained by a cost to serve of 50 cents per customer—one-thirtieth that of an average bank. While the WeBank model might not be replicable for most banks, it illustrates how the combination of shifting to digital channels, zero-basing support functions, radically transforming technology productivity (for example, by automating provisioning and testing, and using highly standardized cloud infrastructure), and shrinking property footprint can drastically reduce cost to serve.

Future-proof business models are less dependent on financial intermediation (and its correlation with interest rates) and more focused on value-added services that generate greater customer involvement and sustainable fees (Exhibit 29). Businesses like payments or wealth management have a natural advantage, because they gather fees without involving the balance sheet. For banks, the challenge—and opportunity—is to leverage their massive customer base, go beyond traditional banking offerings, and increase revenue by providing value-added services.

Exhibit 29

Business models with higher fee income tend to have higher valuation.

Correlation between valuations and fee income



[1]Logarithmic scale.
Source: S&P Global; Panorama by McKinsey

Pioneers are already moving. Several banks around the globe—including Commonwealth Bank (Australia), DBS (Singapore), Itaú (Brazil), RBC (Canada), Sber (Russia), and SBI (India)—are pursuing an ecosystem model of some kind[10] (Exhibit 30).

In 2020, CBA created x15, a wholly owned subsidiary with the mandate to build, buy, or back at least 25 concrete solutions for CBA customers by 2024. Although this start-up venture is separate from the bank's core systems, all the solutions will operate under the same security standards. As of this writing, the bank has nine digital ventures in areas such as home search, property management, hospitality, and small business.[11]

It also has investments in Little Birdie, an AI-powered retail price tracker, and Amber Energy, a subscription-based energy retailer.

Sber is scaling up a non-financial-services ecosystem that in the first six months of 2021 accounted for 4 percent of its overall revenues.[12] Itaú started its ecosystem efforts in 2015, through the creation of Cubo Itaú, a community to connect start-ups and corporates. In 2021, the bank partnered with cloud software start-up Omie to launch Itáu Meu Negócio, a platform offering nonbanking business management services for SMEs.

[10] Miklós Dietz, Matthieu Lemerle, Asheet Mehta, Joydeep Sengupta, and Nicole Zhou, "Remaking the bank for an ecosystem world," Global Banking Annual Review 2017, October 2017, McKinsey.com.
[11] Brendan Coyne, "'We're just getting started,' says CommBank's x15 ventures chief; plots massive walled garden of services for 15m customers to take on global tech giants," Mi3, October 13, 2021, mi-3.com.au.
[12] Adrien Henni, "Sberbank accelerates ecosystem investment," *Moscow Times*, August 4, 2021, themoscowtimes.com.

Exhibit 30

Several banks have already started establishing their footprint in relevant ecosystems.

Overview of select banking ecosystems

1	2	3	4	5	6	7
Commonwealth Bank Australia	**Itaú** Brazil	**RBC** Canada	**SBI** India	**Sberbank** Russia	**DBS** Singapore	**NatWest** UK
Suite of non-banking SME[1] services including smart POS, ecommerce, and business data and analytics	Initiatives include P2P payments, open insurance platform, car buying, and lifestyle marketplace services	15+ ventures targeting niche, high-value customer segments	Digital marketplace focused on increasing engagement	Ecosystems spanning mobility, housing, health, commerce, and more	Marketplaces for travel, mobility, and property; payments and APIs for institutional clients	Suite of tools for SMEs covering payments, accounting, and more

[1]Small and medium-size enterprises.
Source: McKinsey analysis

Continuous innovation and fast go-to-market, leveraging technology and talent

Today's top performers in providing banking services are valued more like tech firms than banks—a clear sign that banks need to increase their innovation metabolic rate. Saying that tech companies with banking licenses will one day take the place of banks as the primary providers of financial services does not seem far-fetched anymore.

WeBank launches up to 1,000 updates per month and takes only ten to 11 days to go from ideation to production. Meanwhile, an average bank launches 50 to 100 updates per month and takes one to two months to bring new ideas to customers. WeBank's heightened metabolic rate is also reflected in customer service: it processes more than 550 million transactions per day, takes only five seconds to deliver a fully mobile credit decision, and uses chatbots to answer 98 percent of the million customer inquiries it receives each day. More than 60 percent of WeBank's employees are fully dedicated to technology—coding, programming, architecture design, and data science.

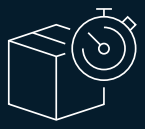
Brazil's digital NuBank is fostering financial inclusion by providing credit cards and personal loans to 50 million customers, most of whom lacked a credit history and thus were not served by traditional banks. NuBank uses behavioral data sets and proprietary algorithms to overcome this obstacle, and thus provide credit to those who qualify.

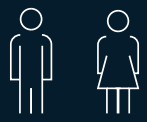
For traditional banks faced with more agile and digitally advanced competitors like these two firms, the challenge can seem daunting (Exhibit 31). And the clock is ticking. As technology and digital adoption evolve, these competitors—as well as the big tech firms—appear to be positioned to continue their upward divergence.

Exhibit 31

Agile is critical to success in a digital environment, delivering productivity and lead-time improvements.

Comparing average and top-performing banks on a range of agility metrics



	Release frequency, releases per month	**Time to market,** weeks	**Productivity,** function points per person per month	**Employees focused on analytics and digital**
Average universal bank	25–50	8–26	3–20	5–20%
Top performing bank	500–1,000	2–4	20–40	>40%

Source: McKinsey analysis

A "future proof" business model is embedded in customers' lives, and has an economic model that fosters growth and innovation.

Banks can develop digital capabilities, as we have seen, or access them through partnerships. A third path is acquisition. As an example, JPMorgan has completed more than 30 acquisitions thus far in 2021, including cxLoyalty, a credit-card reward business and technological platform; C6, a Brazilian digital bank; and 55ip, a provider of automated tools to reduce customers' tax liabilities. The bank has also acquired businesses outside of banking, such as The Infatuation (a restaurant guide JPMorgan offers as a service for its customers) and Campbell Global (a forest and timberland investment company intended to support the bank's transition to a low-carbon economy).

A future-proof business model has three elements in common: customer ownership with embedded digital financial services, an efficient economic model that fosters growth, and tech-enabled innovation and speed. At the same time, financial institutions are far from uniform. Because they are at different starting points with different strengths, we foresee many ways forward in applying this model. A useful starting point is to establish the organization's readiness, as discussed in the next section.


The next few years are crucial for any bank with aspirations to land on the right side of the divergence.

3. Is your bank ready to diverge?

Thus far, we have described a banking industry in which a set of outperformers is diverging significantly from the rest of the pack. Traditional business models are becoming more commoditized and less profitable. New competitors and some banks are taking advantage of digital and fast execution skills to fulfill customer expectations and deliver higher shareholder value. This scenario, which we first outlined in the 2015 edition of this report, has moved much more quickly toward reality as a result of the COVID-19 pandemic's impact.

An optimist would note banks' strong and sizable balance sheets and capital positions, coupled with high levels of trust backed up by decades of customer relationships. Such organizations would seem able to resist any attacker, navigate the upcoming divergence, and wind up on the right side of the divide. A pessimist, however, would claim that it's a matter of time until fintechs and big techs replace banks as customer owners and financial-services providers, relegating the banks we know today to the role of balance-sheet operators. A realistic view would be somewhere in the middle. In any case, time is of the essence, given that the first two years of an economic recovery cycle are typically when more than two-thirds of the next decade's growth occurs. As a wise man once said, "The best time to plant a tree was 20 years ago. The second-best time is now."

To guide banks in crafting a strategy for today's changing environment, this chapter poses nine questions about the divergence. Each bank should consider these questions to assess how the ongoing digital disruption and economic recovery will affect its businesses in specific segments and geographies, as well as the nature of competition it will face. Then it will be important to make bold choices about the bank's positioning and portfolio. In almost all cases, banks will need to rethink their business model to defend against new competition and seize new opportunities.

1. Do we have highly differentiated customer relationships? In which cross-industry journey can we claim true customer ownership?

A successful digital strategy is no longer just a matter of migrating sales and servicing from branches to an app. As customers move toward life goals such as buying a home, planning for retirement, or opening a new business, banks need to move from a product-centric perspective to an end-to-end view of customer journeys, both within and outside of banking (say, housing or SME short-term financing). This broader view can build deep relationships and unique access to target segments. For example, some of the banks mentioned in this report are on the road to making banking "invisible" by embedding financial services within customer journeys on online marketplaces for property, travel, cars, and utilities. In these cases, the bank leads the front end and owns the customer relationship, while partners facilitate the back end, such as listing management and software.

2. Do we have privileged data and insights on customers, beyond what our banking and nonbanking competitors have?

The coin of the realm in today's financial-services environment is proprietary data on customers. Leveraging data and insights with real-time, continuously updated A/B testing supported by artificial intelligence will allow banks to build nano-segmentation models and provide significant advantages. It is no longer enough to isolate broad segments such as "affluent" or "SME" customers; financial institutions must identify the needs of so-called segments of one.

3. Do we make substantial and clear bets when allocating resources and capital to the segments, businesses, and geographies in which we are distinctive?

Having the flexibility and resources to make bold moves through sizable investments (and divestments) will be critical in the coming years. Achieving this will require a constant rebalancing of budget, staffing, and capital to uncover and capture true opportunities while actively looking for partnerships to build new businesses or acquire new capabilities. Already, some banks regularly reallocate incremental capital across the portfolio, both among existing businesses and for new business builds.

4. Do we have a steady stream of new revenue sources, such as third-party commissions and subscription fees, to replace lost revenues in core banking?

Pioneer banks are continuously searching for and expanding into new revenue pools, monetizing relationships, and orchestrating new cross-industry journeys. They also share willingness to "cannibalize" core businesses in the effort to broaden their reach. An ecosystem should be a means to add new forms of value, not just a vehicle for customer acquisition and retention. Ecosystems can, for example, deliver platform revenues in the form of lead generation; recurring fees for services such as registration, listing, or subscriptions; and data monetization. In some cases, these beyond-banking entities have surpassed the valuation of the institution that created them.

5. Do we have a strategy for the impact of environmental and social transformations?

Do our customers see us as a leader in ESG or economic development? We expect global climate-related banking revenues to exceed €100 billion by 2025, with opportunities particularly in transition finance within specific industries. For banks, ESG concerns must go well beyond compliance: banks could, for example, orchestrate national and global economic-development conversations with distinctive research, enabling customers to directly contribute to society via smart marketplaces.

6. Do we have a clear vision for how to build economies of scale or offset diseconomies of scale?

In a digital world, the competition for productivity will be won at a marginal cost that is near zero. Achieving this implies operating at a scale where the revenue generated by processing volume and sales not only covers operating and

capital costs, but also delivers the returns set out in the bank's strategy. This doesn't mean that all banks need to become large global institutions, but they will need scale in the products and business lines where they choose to compete and will need to leverage solutions to dilute and share costs more efficiently. Cloud computing, for example, provides tangible benefits and productivity for banking IT as a whole, and particularly in areas like risk management or cash management. Another way to achieve productivity and scale gains is to build industry utilities in non-differentiating activities (for example, trading processing, KYC, AML) or networks like ATMs, or even branches.[13]

7. Do we have superior insights into and solutions for current risks (market, credit) and emerging exposures (cyber, geopolitics)? If so, are they enabling us to tap new sources of growth?

Pricing risk is a fundamental capability for banks. This has been true from the industry's inception; but today, banks have access to far more granular data on which to build risk insights. Those institutions with more data and more advanced algorithms will gain advantage on risk pricing and generate better returns. If a bank does not have the access or analytical capabilities to create an integrated strategic view on all risk categories (including credit, market, climate, and cyber) and a clear map of "return on risk," they will need to invest in building them or acquiring them, or seek partnerships to gain access to them.

8. Do we have an attractive investor story about how our unique value proposition enables us to exceed traditional banking valuation ranges?

In terms of valuation, universal banks often suffer from a "conglomerate discount"—meaning that due to a lack of reporting transparency, investors have trouble understanding value drivers. It is challenging to value a bank's many business lines—acquiring, issuing, factoring, mortgage, securities, and so on—as parts contributing to a whole. Being able to report stand-alone businesses as if they were ready to spin off will allow investors to better value and track the banking business as a sum of many different smaller business units with a premium on top. As ecosystems begin to represent a significant fraction of financial services value creation—with both direct revenues and synergies with core lending and saving businesses—it will be even more important for banks to be able to tell a clear story about that value.

Investors have clearly shown their preference for tech companies—or financial-services firms that act like tech companies. Clearly, banks trying to catch the right side of the continuing divergence need to undertake real operational and strategic shifts, but positioning also is important. The bank's new story could be about rebirth as a tech company that provides banking services or about changing corporate holding structure by ring-fencing the balance-sheet business from high-value-creating entities (for example, those focused on technology, distribution, or growth). Still, it is a difficult challenge for a bank to rebrand as a tech firm.

9. Do we have a high metabolism rate and an innovation flywheel with a truly entrepreneurial culture and talent to enable our strategic ambition?

Perhaps the most difficult challenge for banks facing the great divergence has more to do with style or culture. Big techs and fintechs often succeed based on their ability and willingness to constantly "ideate, try, fail, repeat and try again to win." In an industry like banking where failures are punished and prevented, this approach feels alien. But successful incumbent financial institutions are paving the way by deploying an entrepreneurial mindset and adopting some of the cultural and organizational levers that make some fintechs powerful innovation engines—for example, a balanced long-term portfolio of initiatives, unique value-creation approaches, steady streams of acquisitions and IPOs, and world-class talent.

These questions cover a lot of ground; few banks will be able to tackle all of them. The important thing, in our view, is to pick the right challenges and confront them without reservation. Customers and shareholders will reward the right choices, while the wrong bets might be punished. But in an era of divergence, doing nothing is probably the riskiest approach.

———————

Global banking has proven its resilience thus far in the face of COVID-19's economic impact. But questions remain about the viability of the traditional banking model. The market clearly favors new operating models and innovative businesses, creating an industry divergence in which the leaders are breaking away from the rest of the pack in terms of their valuation.

The next few years are crucial for any bank with aspirations to land on the right side of the divergence described in this report. Not only is there simply no value to waiting, but also history shows a pattern in which institutions that take bold steps toward growth in the first years after a crisis generally hold on to those gains for the longer term. The coming years will be disruptive in banking, but this can be a sort of "golden era" for strategic decision making. In the current moment, banks and their many stakeholders can justifiably enjoy some brief satisfaction for having weathered a storm. Then banks must quickly return to forward-thinking action.

[13] Nicholas Megaw, "UK banks extend pilot scheme for sharing branches," *Financial Times*, August 17, 2021, ft.com.


The coming years will be disruptive in banking, but they can also be a “golden era” for strategic decision-making.

4. Appendix

The following pages provide snapshots of banking performance and five-year forecasts for the global banking industry and for six major regions. The data is from McKinsey's Panorama, with additional data from S&P Global.

Exhibit 32

Global baseline 2021–25: Muted profitability and anemic growth from an overliquid balance sheet.

Global

	2015–20 Average/growth, %	2020 Absolute value	2021–25 Average/growth, %E
Return on equity	8.7	6.7%	7—10
Total banking revenue	4.9	$5,739 bn	5.1
Retail banking	4.9	$1,934 bn	5.0
Commercial and corporate banking	3.5	$2,140 bn	4.2
Payments	6.4	$868 bn	5.4
Wealth and asset management	6.7	$796 bn	6.3
Risk costs as a % of credit	0.6	0.8%	0.5—0.7
Loan/deposit ratio	94	85%	80—85

~25%

of revenue growth will be driven by loans underwritten after 2021

~40%

of revenue growth from China as growth moves toward retail lending

~10%

growth from Europe; lending growth remains muted in low-interest-rate environment

Exhibit 33

North America baseline 2021–25: ROEs just above cost of capital; revenue growth driven by fee revenues and slight pickup in retail lending.

North America

	2015–20 Average/growth, %	2020 Absolute value	2021–25 Average/growth, %E
Return on equity	9.9	7.7%	10—12
Total banking revenue	4.0	$1,647 bn	4.5
Retail banking	4.0	$604 bn	3.8
Commercial and corporate banking	2.7	$450 bn	2.9
Payments	4.2	$245 bn	4.6
Wealth and asset management	5.3	$348 bn	5.4
Risk costs as a % of credit	0.6	1.2%	0.3—0.8
Loan/deposit ratio	76	65%	~60

~4% p.a.

consumer finance and mortgage volume growth (vs 3% 2015–20)

~45%

of revenue growth will come from fee revenues

Source: McKinsey Panorama, S&P Global

Exhibit 34

Europe baseline for 2021–25: Muted profitability and anemic growth as lending grows slowly in a low-interest-rate environment.

Europe

	2015–20 Average/growth, %	2020 Absolute value	2021–25 Average/growth, %E
Return on equity	5.9	3.0%	3—7
Total banking revenue	2.8	$1,252 bn	3.0
Retail banking	2.4	$378 bn	2.9
Commercial and corporate banking	2.6	$529 bn	1.9
Payments	3.3	$171 bn	3.3
Wealth and asset management	4.6	$174 bn	4.5
Risk costs as a % of credit	0.5	0.9%	0.3—0.8
Loan/deposit ratio	114	107%	~98

~2% p.a.

loan volume growth from 2021–25; despite low interest rates

Low interest rates

European Central Bank (Bank of England and other central banks) policy rates continue to be low resulting in anemic NIMs across region

Exhibit 35

Asia excluding China baseline for 2021–25: Muted profitability, but growth picks up as emerging Asian markets recover from crisis.

Asia excluding China

	2015–20 Average/growth, %	2020 Absolute value	2021–25 Average/growth, %E
Return on equity	8.5	6.1%	7—10
Total banking revenue	2.0	$890 bn	4.7
Retail banking	2.8	$340 bn	3.9
Commercial and corporate banking	1.0	$358 bn	3.6
Payments	1.0	$94 bn	5.4
Wealth and asset management	4.1	$99 bn	5.2
Risk costs as a % of credit	0.7	1.3%	0.5—1
Loan/deposit ratio	80	79%	~84

~4% p.a.

loan volume growth 2021–25; driven by rapid growth of South Asia and SE Asian banking markets

~35%

revenue growth to come from fee-based revenues

Source: McKinsey Panorama, S&P Global

Exhibit 36

China baseline for 2021–25: Retail banking becomes engine of growth as corporate lending slows.

China

	2015–20 Average/growth, %	2020 Absolute value	2021–25 Average/growth, %E
Return on equity	12.7	9.8%	11—14
Total banking revenue	10.0	$1,371 bn	8.3
Retail banking	10.7	$337 bn	11.3
Commercial and corporate banking	6.4	$596 bn	6.0
Payments	14.1	$292 bn	8.8
Wealth and asset management	13.9	$146 bn	9.4
Risk costs as a % of credit	1.2	1.2%	0.6—1.1
Loan/deposit ratio	76	82%	~86

~30%

of growth will be driven by loans underwritten after 2021

~40%

of global revenue growth will come from China

Exhibit 37

Latin America baseline for 2021–25: ROEs continue above cost of capital; slower revenue growth due to low interest rates.

Latin America

	2015–20 Average/growth, %	2020 Absolute value	2021–25 Average/growth, %E
Return on equity	14.7	8.9%	12—17
Total banking revenue	5.2	$358 bn	3.4
Retail banking	5.3	$196 bn	3.9
Commercial and corporate banking	5.5	$97 bn	2.1
Payments	3.5	$45 bn	5.0
Wealth and asset management	9.7	$21 bn	6.1
Risk costs as a % of credit	2.6	2.8%	1.7—2.3
Loan/deposit ratio	101	99%	~95

~60%

of region's banking revenues come from Brazil and Mexico

Low interest rates

in recent years curtailing net interest margins and revenue growth

Source: McKinsey Panorama, S&P Global

Exhibit 38

Middle East and Africa baseline for 2021–25: Revenue growth picks up as lending and fee-income penetration increases.

Middle East and Africa

	2015–20 Average/growth, %	2020 Absolute value	2021–25 Average/growth, %E
Return on equity	11.8	8.1%	7—11
Total banking revenue	5.1	$222 bn	8.3
Retail banking	7.4	$81 bn	9.0
Commercial and corporate banking	4.1	$112 bn	7.1
Payments	3.8	$21 bn	4.5
Wealth and asset management	3.2	$8 bn	6.5
Risk costs as a % of credit	1.0	1.4%	0.9—1.3
Loan/deposit ratio	91	87%	~87—92

~10% p.a.

loan volume growth 2021–25 vs 7% p.a. 2015–20

~6% p.a.

growth in fee revenue as payments and wealth management penetration increases

Source: McKinsey Panorama, S&P Global

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