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PRESS RELEASE

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Return on equity for German banks could more than double by 2030

- McKinsey study: with an ambitious push for renewal, banks could see operating profit increase by EUR 30 to 40 billion and generate a 7 to 8 percent return on equity – while 0 to 4 percent is likely if current trends continue
- Two out of three decision makers think radical change is necessary
- The need for action on ESG issues is especially urgent

DÜSSELDORF. The fundamental disruptions of recent years make transformation imperative in all segments of Germany's economy – and to support this transformation, banks must change too. With an ambitious push for renewal, the German banking sector could boost its operating profit by an additional EUR 30 to 40 billion and catapult return on equity to at least 7 to 8 percent – more than double the average after-tax rate of 2.9 percent for the last five years. These findings emerge from the analysis in "German banking returns to the playing field" a report released today by the McKinsey & Company consulting firm.

Strong starting position, poor performance

"Germany's banks remain key to the country's economy," says the report's co-author Max Flötotto, Senior Partner at McKinsey and head of the firm's Banking Practice in Germany. "Upheavals in terms of technology, demographics, and the climate mean that German business will be undergoing a fundamental transformation across segments. To remain a strong player on the economy's future 'team roster,' banks will need to renew themselves, too."

The picture is very different if German banks continue doing business as usual. According to McKinsey's analysis, classical banks would permanently lose market share, earnings would fall, and after-tax return on equity (RoE) would be on course for 0 percent by 2030. (For 2015 to 2019, average after-tax RoE for German banks was 2.9 percent.) If banks further focus and intensify their existing initiatives, especially those advancing digitization and customer orientation, after-tax RoE could reach at least 3 to 4 percent. But these gains are far short of those McKinsey foresees from an ambitious renewal effort, including EUR 30 to 40 billion in additional operating profit by 2030 – which would in turn enable German banks to make required investments in further digitization and addressing environmental, social, and governance (ESG) concerns. At the same time, banks pursuing such an ambitious agenda could increase their after-tax RoE to at least 7 to 8 percent during the same period. This level of profitability would translate into an operating profit before risk of 70 to 80 basis points of average assets, or after-tax profits of EUR 40 to 45 billion.

“After-tax RoE of 7 to 8 percent is an ambitious goal, but the financial performance of banks in other markets and the top players in Germany show that it’s thoroughly achievable,“ says Max Flötotto. “Performing at this level would transmit a positive signal to top talent, help the banking sector to maintain its relevance, and attract new investors.”

Relatedly, a survey conducted by McKinsey in January and February 2021 reveals that two out of three bank decision makers believe radical change is needed in the German banking landscape.

To do so, the financial industry can build on a strong starting position: its annual revenues are EUR 150 billion. In total, about EUR 10 trillion flow through the German financial intermediation system every year. Relative to other players in the German financial system, the country’s banks command a larger share of financing: about 65 percent of assets are on banking balance sheets, compared with less than 50 percent globally. The banking landscape is attractive for German customers, too: fees for everyday banking services are more than double for customers in the United Kingdom and France (EUR 130 p.a. on average) than in Germany, while customers in Italy and Spain pay nearly three times more. At 2.9 bank branches per 10,000 inhabitants, branch density is also above average (United Kingdom: 1.3, Sweden: 1.2). German banks also proved stable after the financial crisis: their average rating in 2021 is A+, with 75 percent better than A-. In contrast, European banks overall achieve an average rating of A, with 25 percent having a BBB rating or lower. Likewise, German banks withstood the COVID-19 pandemic well, as 79 percent of private customers were satisfied with their bank’s digital channels.

But study co-author Reinhard Höll, Partner in McKinsey’s Düsseldorf office, warns, “Despite this strength in the basics, some of the factors that have driven the success of German banks in recent years are losing their strength.”

Historically, the revenue pool in the German banking market has grown steadily in line with GDP. Since 2010, however, it fell by 8 percent – to EUR 119 billion – while GDP rose by 35 percent. Operating costs increased in the same period by nearly 10 percent, about 50 percent faster than the rate for European banks overall. As a result, the operating profit pool has shrunk by 30 percent since 2010. German banks’ five-year average after-tax return on average equity (ROAE) is only 2.9 percent today, lower than the average of France, Italy, Spain, and the UK, which is about 3.7 percent. This has consequences: financial and banking services’ share of total gross value added has fallen further in Germany than in many other countries: from 3.8 percent (2005) to 2.3 percent (2018). German banks’ contribution to the market capitalization of the DAX family of companies plummeted from 11.2 percent (2005) to 1.4 percent (2020). And foreign banks, specialists without a banking license, and digital attackers have captured 5 to 15 percentage points of market share from Germany’s banks over the past decade.

“With hard work and fresh strategies, banks can make a strong comeback,” says Philipp Koch, Senior Partner in McKinsey’s Munich office and another study co-author. “We take heart that many of the industry’s senior executives recognize the need for change and have high ambitions to lead their institutions on new paths.”

Five strategic priorities for ambitious growth

To reach an after-tax RoE of 7 to 8 percent by 2030, banks must achieve a challenging but feasible twofold goal: grow revenues by 2 to 2.5 percent per year and decrease costs by 1 to 2 percent per year.

Five strategic priorities can help banks reach this goal:

- **More responsive business strategies**: The competitive environment, customer demands, and technology are all changing faster and faster, so banks should re-evaluate their business mix and focus on the business areas with the greatest promise. “For one bank, this could be offers bundled to create banking-as-a-service solutions; for others it could be a central position in this new ecosystem,” says Höll. “A bank that wants to build its own ecosystem platform will need to rethink its business model and interactions with customers – and be prepared to invest a lot of resources and take more risks.”
- **Technology-supported customer engagement**: Each year, banks and their customers have contact at 300 touch points. This intensity is unmatched outside of social media and the tech industry. However, banks should put these contacts to stronger use. With modern data analysis, campaigns could increase customer frequency at banks and raise conversion rates by 15 percent. And it’s important to note that data-supported decisions don’t only help improve a bank’s bottom line – they generally have a positive impact on customer experience as well. This point is a key argument to highlight in discussions about protecting personal data.
- **New business areas**: German banks and fintechs have already created more than 200 partnerships. Few of those partnerships may be part of systematic efforts, however. Some banks cooperate and earn income in online comparison platforms, for example, but crucially give up their customer interface. Better goals might include new bank-led, fintech-built platforms, particularly in the emerging field of corporate lending. Between 2017 and 2019, banks that prioritized new-business building were 30 percent more likely to grow above market levels than those that did not.
- **Genuinely digital operating models**: Banks’ fundamental rule should be “digital first”: in the future, processes should be completely digital to avoid the need for breakpoints. What’s more, digital interfaces make it easier to flexibly incorporate new providers into the value chain. This ability is especially useful for raising capital: German banks can involve other lenders much more strongly through digital interfaces and optimize utilization of their own capital. Furthermore, banks can see a 30 percent rise in productivity in HR and finance if they standardize and centralize, reduce demand in these areas, move to standard software as a service, and digitize common requests and reports.
- **Purpose redefined with ESG**: McKinsey anticipates that the shift to a sustainable economy will be key to increasing bank earnings. By 2030, 25 to 40 percent of banking revenues in Germany will be affected by ESG – from environmentally friendly investment options to loans for companies based on ESG criteria or ESG-compliant asset management. According to McKinsey’s analysis, for German banks with such a ESG high revenue share, additional earnings of 3 to 4 percent (about EUR 5 to 7 billion) are possible from financing climate infrastructure or public (social) housing. In addition, a recent McKinsey global survey on ESG programs revealed that 83 percent of C-suite leaders and investment professionals expect ESG programs to contribute more shareholder value in five years than they do today. Flötotto says, “Banks can and should become the financers of climate neutrality.”

The complete “German banking returns to the playing field” report is available in German at https://www.mckinsey.de/publikationen/german-banking-report.

About McKinsey

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If you have any questions, please contact:

Marion Nagl, telephone: (0) 89 5594 8870
E-mail: marion_nagl@mckinsey.com
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