What better place than here, what better time than now? German banking in 2023

On the back of a great year, banks have an opportunity to build on growth and ensure profitability

Sep 11, 2023

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Introduction: A new dawn?

After a prolonged period of low profitability, 2022 marked the highest income for banks in Germany in over a decade. While the end of the low interest rate era has been a major driver of rising profitability, we have observed additional trends changing the underlying dynamics of the banking business.

The competitive landscape has been growing more diverse and complex. Banks are being redefined, as German incumbents now face competition not only from each other, but also from an expanding cohort of specialists, foreign institutions, and fintech companies that often bring more innovative products and services to the market, raising customer expectations and setting new standards for banking practices.[1]

Together, these fundamental shifts urge all market participants to reevaluate their strategy, reconsider their operating model, and invest in their future competitiveness. Banks in Germany are now in a unique position to be able to improve and fortify their operating model, given the boost in earnings. Amid these changes, it becomes crucial to address the following questions:

- What are the implications of the 2022 macro-shifts on the profitability of German banks?
- How will the competitiveness of German banks evolve in the upcoming years?
- What are the essential future moves and investments necessary to enhance competitiveness?

In our attempt to answer the above questions, we arrived at three key findings, which will be explained in more detail in the following three chapters:

- **Return of elevated profitability.** In 2022, German banks had their strongest performance in over a decade. Previously, the low interest rate environment had made achieving high profitability challenging for the sector. However, the global shocks of 2022—which led to significantly higher interest rates—marked a veritable reshuffling and significantly increased net interest income (a 15 percent increase from 2021 to 2022).
- **Future profitability at risk.** Despite the profitability uplift in 2022, secular trends persist. Specialists generate the highest profitability in the sector, new (fintech) competitors and foreign institutions are being established, and customers are demanding more hybrid and digital service offerings. In parallel, domestic incumbents face pressure to increase the efficiency of their operating model through technology and to address the talent cliff. These persistent trends are accompanied by macroeconomic uncertainties, such as high inflation and a likely reduction in regulatory protection. Thus, while average profit levels have risen, many institutions must evolve toward a sustainable business model.
- **Call to action for German banking.** To ensure growth, enable the continuation of elevated profitability, and adapt to the changing risk environment, banks in Germany should act now and use their higher earnings to invest in five areas: a fully digital operating model; a differentiated client proposition; transformational real-economy opportunities (for example, financing the transition to a more sustainable economy); talent development, recruitment, and retention; and balance-sheet resilience.

[1] Please note: this report uses a broad definition for banking, covering any regulated bank operating in Germany. Thus, it includes traditional German banks, such as German private banks, savings and cooperative banks, and building societies; nontraditional institutions, such as specialists and fintechs; and foreign institutions. Specialists include payment and consumer finance specialists, auto banks, and direct banks.

I. 2022 marked the return of elevated profitability

We looked at the most recent developments within the context of the sector's performance and influencing factors over the past decade and identified three key findings.

1) For more than a decade, low interest rates corresponded with low balance-sheet income for banks

Over the past decade, the ultralow interest rate environment has had a significant impact on Germany's banking sector in the form of lower balance-sheet income. For example, in 2021, banks held more than €250.0 billion in excess reserves, for which they had to pay €1.5 billion in negative interest to the European Central Bank (ECB) in that year alone. Since this put additional pressure on banks' profitability, traditional banking institutions, which primarily focus on lending and deposit taking, saw their net interest income shrink by 13 percent between 2011 and 2021.

The difficult interest rate environment further exacerbated several challenges that Germany's banks have also been facing for quite some time now. From 2011 to 2021, for example, return on equity (RoE) decreased from 6.7 percent to 3.2 percent, according to Deutsche Bundesbank. As a result of the challenging environment, consolidation in the German banking sector has accelerated, with the number of credit institutions falling by 30 percent from 2,080 to 1,458 between 2011 and 2022.

2) Several global shocks in 2022 triggered severe economic consequences

2022 was marked by a series of interrelated global shocks:

- The Russian invasion of Ukraine led to a substantial increase in energy and commodity prices as gas supply to Germany was reduced (down to 40 percent of its maximum capacity), sanctions were imposed, and ports in the Black Sea were closed.
- Asset valuation experienced a shock, marked by the sharp devaluation of fintechs and cryptocurrencies, the bankruptcy of high-profile crypto organizations, and the severance of Russia from the global financial system.
- Supply chains remained constrained in the aftermath of COVID-19 lockdowns, and labor costs, ways of working, and talent availability have changed significantly and permanently since the pandemic.
- Overarching geopolitical tensions have increased.

Collectively, these shocks triggered substantial consequences—the most significant of which were inflationary pressures and shifts in interest rates—which are giving rise to a new environment in the German banking sector.

The main characteristic of this new environment is record-high inflation, which reached 7.9 percent in Germany and 9.2 percent across the eurozone in 2022. In response to rising inflation, the ECB started to tighten its monetary policy in 2022, instigating a shift away from the ultralow interest rate environment that persisted over the past decade. This resulted in a rise of the ECB deposit facility rate to 3.5 percent in July 2023, compared to a negative rate between 2014 and 2022.

3) Interest rate increases have resulted in the highest operating income for banks in Germany in a decade

The ECB's decision to raise interest rates has meant that banks in Germany are seeing increased income from interest-bearing assets. The net interest income of banks in Germany rose by

an estimated 15 percent in 2022 (Exhibit 1), the largest annual increase over the last decade. Also, banks have achieved the highest operating income in over a decade after a 9 percent annual increase in 2022.

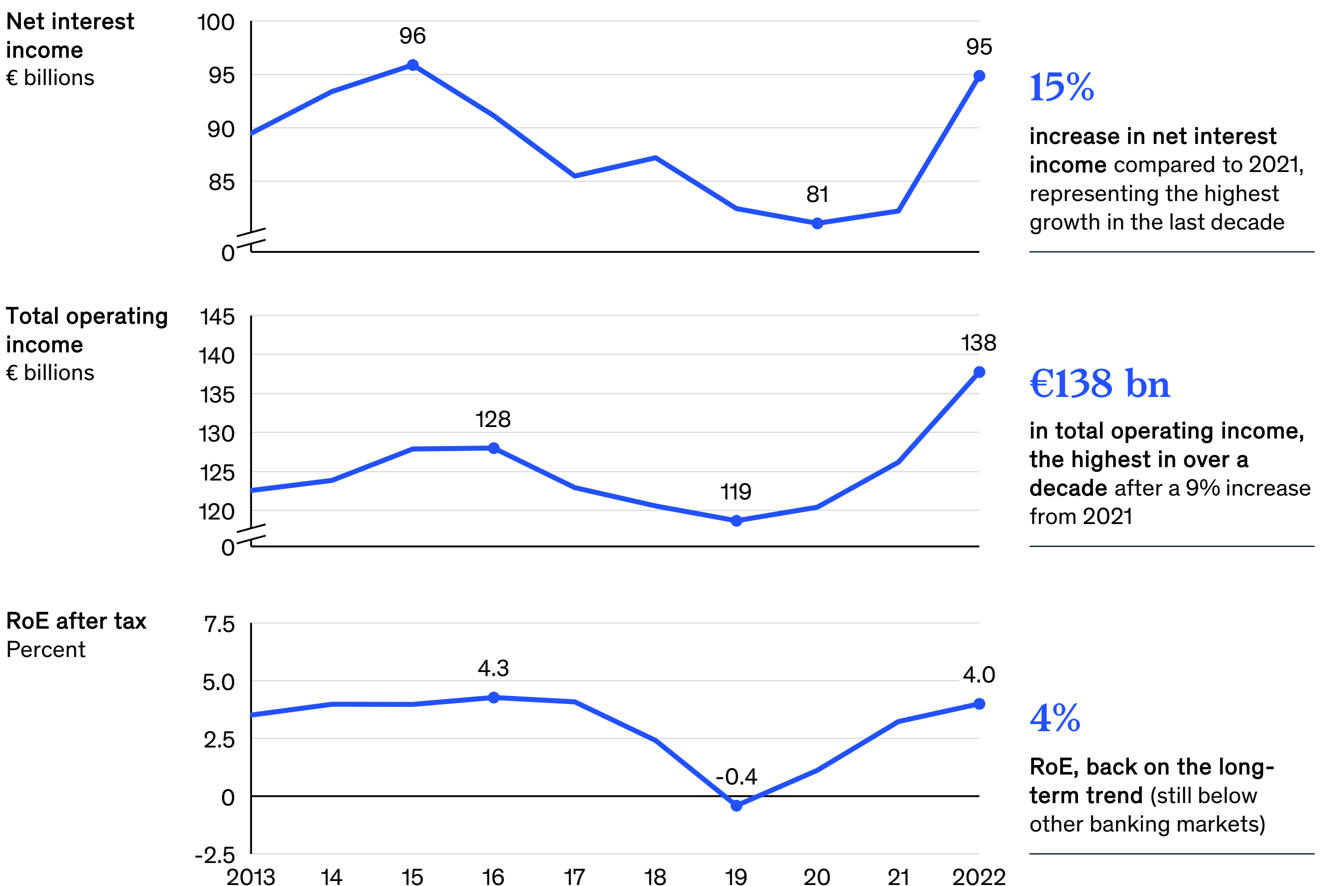
While this rise in income may increase the risk of recession and higher inflation, we have so far not seen a substantial increase in nonperforming loans or other shocks that preceded recent bank failures in the United States and Switzerland.

As a result of this boost in net interest income, the profitability of banks in Germany, as measured by RoE, has increased significantly after several years of lower profitability. The average RoE for banks in Germany increased to 4.0 percent in 2022, up from 3.2 percent in 2021, despite the challenges that banks continue to face.

Exhibit 1: Performance of the German banking sector

Performance of the German banking sector shows the highest operating income for banks in a decade

2013-21 actual, 2022 estimated



Source: German Central Bank; annual reports; McKinsey analysis

II. Five trends are affecting the dynamics in German banking

We have identified five trends that banking institutions in Germany will need to navigate going forward, each of which offers opportunities but also presents challenges.

1) Rising customer expectations and the emergence of new banking solutions put pressure on banks to innovate

Across retail, small and medium-size enterprises (SMEs), and large and international corporates, customers' expectations continue to grow. For example, they expect banks to offer digital connectivity and a range of new products. They also expect to be able to conduct banking business in nonbanking spaces, such as financing a big purchase while shopping on a retail website.

Digital banking's momentum in the German banking market continues. Digital offerings, such as online business banking, banking apps; and online wealth advisory, have become the most important banking features for customers (79 percent of respondents mentioned this in a recent survey on digital finance by Bitkom).[2] Moreover, online banking is becoming synonymous with mobile banking, as the use of smartphones for online banking services has nearly doubled from 34 percent in 2015 to 67 percent in 2022. Customers of leading banks are almost 50 percent more active on mobile apps than customers of late movers. End-to-end availability is the main driver of satisfaction with digital solutions, whereas the main reasons for not trusting digital channels are cybersecurity and data handling. In contrast, personal in-branch advisory and a dense branch network have become less important to customers (even private banking customers).[3]

The change in customers' preferences is not limited to mass retail customers, as private banking, SME and corporate client expectations continued to shift as well. Companies, influenced by experiences as private individuals and with digital-native firms in other industries, are seeking similar experiences in their banking relationships. They expect seamless, real-time, and tailored services to meet their unique business needs through customer-centric advisory portals, omnichannel coverage, and digital products.

Underlying one of the biggest innovations in banking is a shift toward third-party distribution solutions, which seamlessly integrate financial services into nonfinancial platforms (embedded finance). Financial institutions provide access to their services to other institutions through a banking-as-a-service (BaaS) offering. These solutions allow nonbanking institutions to provide services that their own platforms cannot provide (covering anything from cross-border payments in large corporates to "buy now, pay later" for merchant and retail customers). The revenue generated by third-party distribution services in Europe alone is expected to provide a €100 billion opportunity by 2030.[4] Clients can integrate the banking solutions into their existing infrastructure through standardized APIs. This emerging segment presents a significant opportunity (especially for smaller or nimbler players). For example, in one case, embedded finance for SME lending in a major European market increased the conversion rate by three times at a significantly lower customer acquisition cost, offsetting the apparent downside of revenue sharing with a partner. Data-driven, analytical preselection of business customers helped reduce risk (the loan–loss ratio for embedded finance was about 80 percent lower compared to traditional channels in this case).

[2] Achim Berg, *Digital Finance – Wie digital ist die deutsche Finanzbranche?* Bitkom, May 2022.
[3] Eric Lamarre, Kate Smaje, and Rodney Zemmel, *Rewired: The McKinsey Guide to Outcompeting in the Age of Digital and AI,* first edition, Hoboken, NJ: John Wiley & Sons, Inc., 2023.
[4] "Banking-as-a-service—the €100 billion opportunity in Europe," McKinsey, September 28, 2022.

2) Diverging business models are emerging, with nontraditional and foreign institutions often leading the way

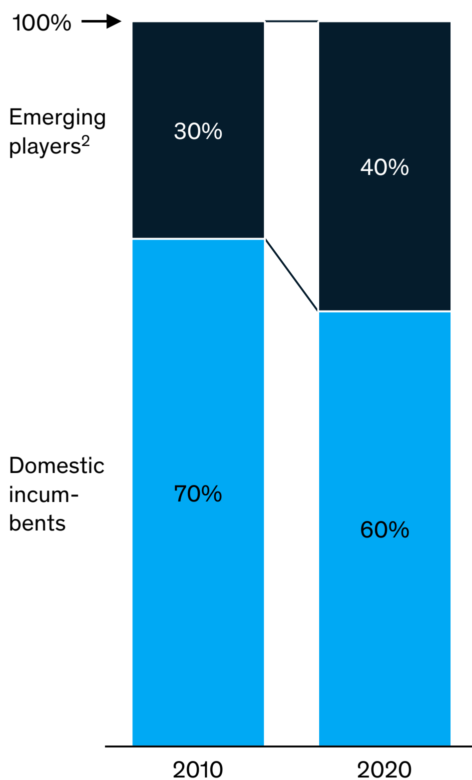
In the German banking sector, domestic incumbents continue to hold the largest market share (around 60 percent in 2020). However, nontraditional and foreign institutions have gained market share over the past decade (from 30 percent in 2010 to 40 percent in 2020) (Exhibit 2).

The recent earnings boost is driven by interest rates affecting areas where incumbents are strongest, particularly in retail deposits. German incumbent banks held around 80 percent of deposit volume in 2020, and this share grew until 2022. Also, in terms of revenue, domestic incumbents captured approximately 77 percent of retail banking revenue in Germany in 2022 despite lower

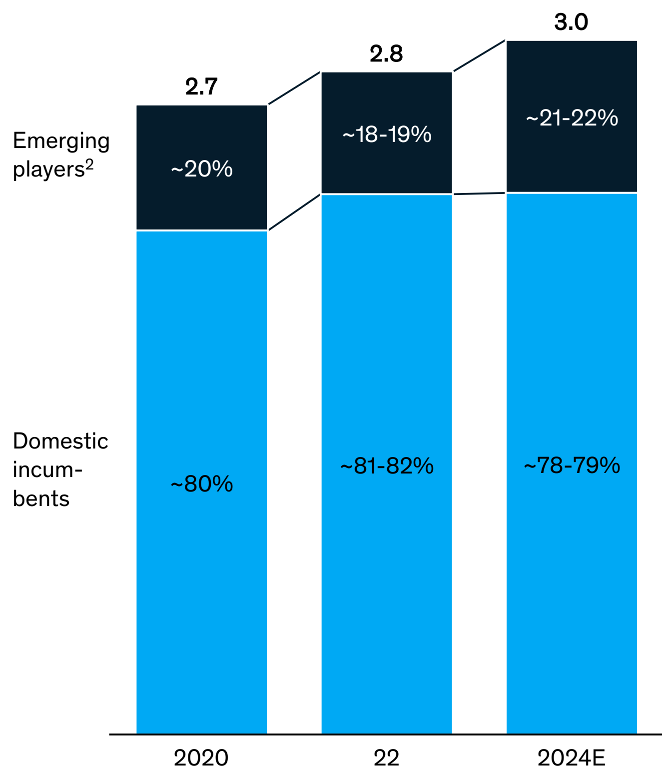
Exhibit 2: Market share in German banking

Domestic incumbents' market share is declining; recent positive development driven by interest-rate development will probably only last for a short time

Overall market share in German banking[1]



Volume in retail deposits,[3] an area with a high market share of domestic incumbents, € trillions



Domestic incumbents lost market share against nontraditional and foreign institutions in the past decade

Recent success of domestic incumbents is driven by changing interest rates affecting areas where incumbents are strongest (80 % market share in retail deposits and mortgages)

Pressure is increasing as volumes are expected to stagnate, while competition from nontraditional and foreign institutions increases and the uptake of platforms drives down revenues

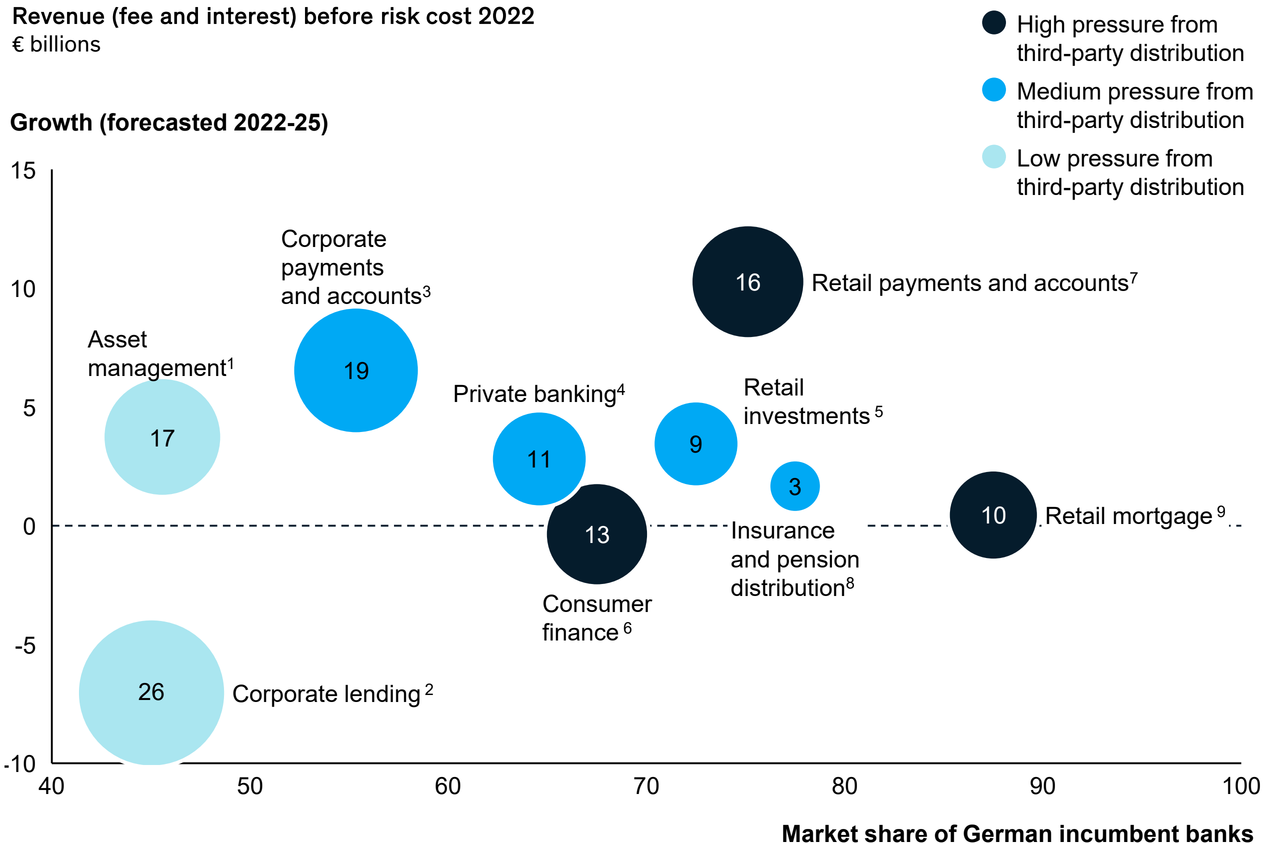
1. By revenue, consisting of 4 segments: retail banking, payments, corporate banking, and asset management
2. Specialists, foreign institutions, direct banks, fintechs
3. Rough estimates

Source: German Central Bank; McKinsey Global Banking Pools; McKinsey analysis

profitability compared to nontraditional and foreign institutions.[5] Driven by rising rates, incumbents are overbiased toward areas with expected positive growth, including retail payments and accounts, retail investments, and private banking. However, this landscape is changing. Nontraditional institutions have established themselves as strong competitors, chipping away at the domestic incumbents' market share. In particular, they have made significant inroads in highly specialized segments, such as asset management and corporate lending (Exhibit 3). In theses segments, nontraditional and foreign institutions already hold over 50 percent of the market share.

Exhibit 3: Market share of German incumbent banks

Nontraditional and foreign institutions already cover substantial market share in several high-growth areas



Nontraditional and foreign institutions have significant market share in high-revenue and high-growth areas such as asset management and corporate lending

Increase in third-party distribution puts additional pressure on domestic incumbents, particularly for mortgages, deposits, and consumer finance

1. Asset management incl. active and passive asset management, alternatives, and money market business
2. Corporate lending incl. financing (straight loans, structured loans) and specialized finance (leasing and factoring)
3. Corporate payments and accounts incl. acquisitions, cross-border payments, cash management, corporate cards, corporate overdrafts, and corporate deposits
4. Private banking incl. all revenues generated by clients with wealth of €1 mn+ Retail investments incl. securities and derivatives brokerage and mutual fund distribution
5. Retail investments incl. securities and derivatives brokerage and mutual fund distribution
6. Consumer finance incl. personal loans, credit cards (lending), and overdrafts
7. Retail payments and accounts incl. current account deposits, domestic payments, remittances, and noncurrent account deposits
8. Insurance and pension distribution incl. discretionary pensions, life insurance, and property and casualty insurance
9. Retail mortgages incl. housing loans, home equity loans, and other mortgages (e.g., home equity lines of credit)

Source: McKinsey Global Banking Pools; McKinsey Growth Cube; McKinsey analysis

[5] German Bundesbank

Moreover, the underlying market share is misleading in areas with strong third-party distribution, especially in retail mortgage, retail payments and accounts, and consumer finance, where comparison websites and embedded finance often capture a significant share of the economic profit and put pressure on prices more broadly. For example, in retail, domestic incumbents feel increasing pressure as volumes are expected to stagnate while competition from nontraditional and foreign institutions increases and the uptake of platforms drives down revenue. What is more, incumbent banks had a retail banking market share that was between 7 and 9 percentage points lower in 2022 than in 2010, both for new retail banking business and existing banking products. Market share is being lost to direct and digital banks that differentiate themselves, mainly through a clear and distinct value proposition, a simple and convincing user interface, an immersive digital experience (for example, mobile first), and free-of-charge services (for example, accounts).

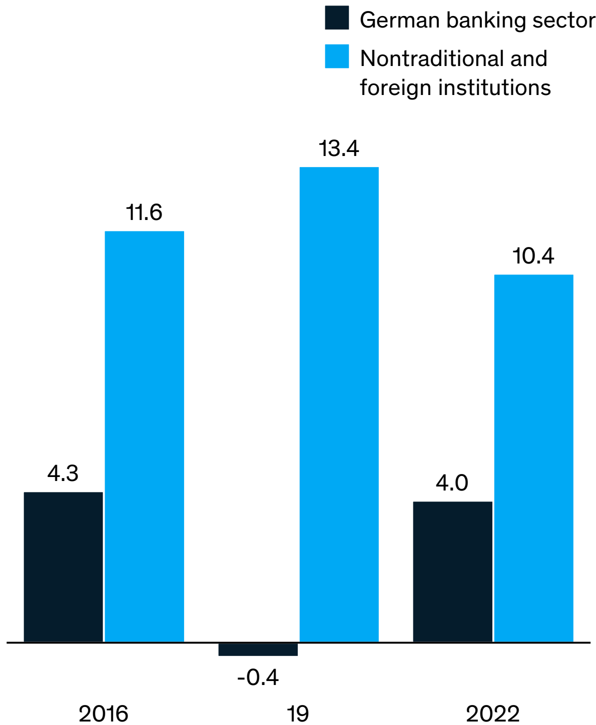
Additionally, we are globally observing higher growth of "off banking balance sheet" funds (for example, funds of asset managers) compared to "on banking balance sheet" funds (for example, deposits) as well as higher growth of intermediation revenue for nontraditional and foreign institutions. We also notice this trend in Germany. However, the overall pace of this development is slower in Germany due to the more traditional and risk-averse financial culture.

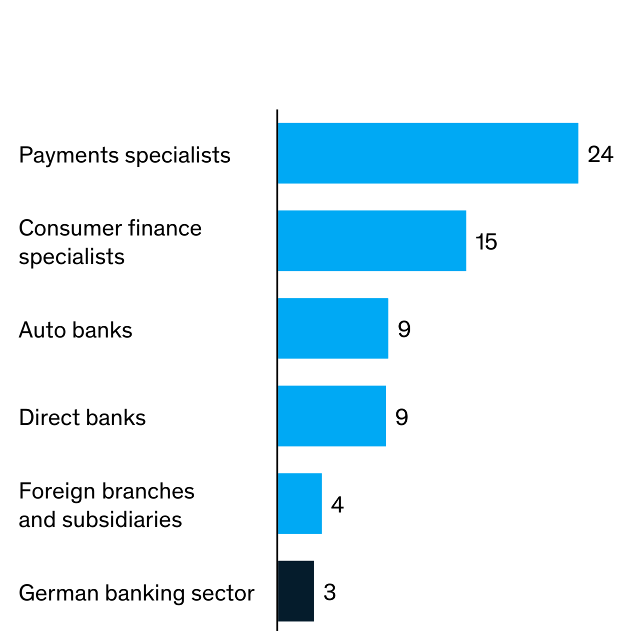
3) Customer centricity, technology adaption, and efficiency underlie high profitability for nontraditional institutions

Despite the recent uptick in profitability for incumbent banks in Germany, nontraditional and foreign institutions continue to generate the highest returns in the sector (Exhibit 4). Their average RoE consistently outperforms that of traditional banks. For instance, in 2022, the average RoE of nontraditional and foreign institutions was estimated at 10.4 percent, significantly higher than the 4.0 percent average for the German banking sector as a whole. In addition, the profitability of specialists appears to be less volatile than average sector profitability. Among specialists, payment and consumer finance specialists have had the highest profitability. Importantly, the fintech subsegment has grown significantly in areas such as deposit gathering, cross-border payments, and BaaS, despite recent funding challenges.

Exhibit 4: Profitability in the German banking sector

Nontraditional and foreign institutions generate the highest profitability in the German banking sector





Up to ~20% RoE difference
in 2022 shows outperformance of nontraditional and foreign institutions vs. the overall sector

Sustained higher profitability
of nontraditional and foreign institutions than the overall sector; payment and consumer finance specialists have the highest profitability among nontraditional institutions

1. RoE after taxes (without profit participation capital) of payment specialists, consumer finance specialists, auto banks, direct banks, foreign branches, and subsidiaries

Source: Bundesbank; annual reports; McKinsey analysis

Specialists typically have advantages over incumbent banks in three areas that result in higher profitability:

— **Distinct, customer-centric offerings.** Specialists, as the name suggests, often serve a more selective customer and product segment compared to traditional banks. Their proposition is often distinct and clearly communicated to customers. In addition, nontraditional and foreign institutions are generally more agile and customer focused within their niche, allowing them to create more innovative products and services. Customer satisfaction rates for specialists are, on average, 15 percent higher than for traditional banks.

- **Technology adoption.** Specialists, fintechs, and foreign institutions tend to have more modern core technology and have generally leveraged technologies such as the cloud, artificial intelligence (AI), and advanced data analytics. For instance, they are investing into using AI more extensively than traditional banks. This enables them to streamline processes, enhance customer experiences, and capitalize on new market opportunities. For instance, the use of AI in risk management processes has allowed specialists to reduce their risk-related costs by an average of 15 percent.

- **Operational efficiency.** Specialists, fintechs, and foreign institutions often operate with leaner cost structures, enabled by more focused offerings and more modern end-to-end technology, which reduce their overhead costs and increase operational efficiency. Legacy players often rely on organically grown and difficult-to-adjust legacy IT systems. In contrast, digital-first specialists have an average cost-to-income ratio that is about 20 percent lower than traditional banks.

4) The benefits of the new interest rate environment will level off, and new challenges will emerge

Despite its positive impact on banks' profitability, the new interest rate environment is also creating new challenges that may jeopardize the continuation of profitability at current levels. There are several indications that the current level of profitability may not be permanent.

Decreasing interest rate margin. There are two main rationales for a reduction of net interest margins and, consequently, lower profitability for banks. First, banks are facing an increase in the cost of funds due to higher interest rates. The higher rates have already opened up a fight for retail customers as banks are competing to offer customers more attractive interest rates. While higher interest rates increase income from lending activities, they also mean that the cost of funds, including deposits and borrowings, will increase, thus reducing net interest margins. Second, after a period of high inflation rates in 2022, inflation rates have stabilized and begun to decrease. The lower inflation could lead to a decrease in interest rates that would reduce net interest income (albeit likely to a higher level than during the late 2010s), as the analysis of macroeconomic scenarios in the next paragraph shows.

A prolonged period of uncertainty. 2022 was marked by an increase in uncertainty caused by the global shocks described earlier. One indication of high uncertainty is the increase in DAX volatility,[6] which was still higher than prepandemic levels after some smoothing at the end of 2022 that was followed by a decline in volatility in 2023. The elevated uncertainty in the financial markets is also evident from the reversed yield curve[7] for German government bonds, which raises concerns about future economic performance. Historically, a reversed yield curve has been an early indicator of economic downturns. This trend can hurt banks' profitability, as they rely on short-term borrowing and long-term lending. Additionally, the probability of a recession in the coming years remains high due to the combined effects of inflation, geopolitical risks, and structural challenges on the German economy. This could further depress the profitability of banks in Germany, while the likely reduction in regulatory protection and the resulting changes (for example, the digital euro) could increase risk.

Stagnating lending volume. The environment of higher interest rates, market uncertainty, and elevated inflation have led to a stagnating lending volume. German banks have seen a decline in credit demand from SMEs and large corporates as well as from retail customers since mid-2022, according to the Bundesbank Lending Survey. Long-term corporate credits and retail mortgages are especially affected. For instance, the new business volume of mortgage finance to households in Germany decreased by more than 40 percent year over year in December 2022. The main reasons for this stagnation are the increased interest rates and the higher investment costs, which often result in the delay of larger investments. Banks expect

[6] Measured by VDAX-NEW.
[7] Long-term interest rates are lower than short-term rates.

that this stagnation in credit volumes will continue in 2023, even though the sentiment is less pessimistic than it was at the end of 2022. In addition to stagnating credit demand, macroeconomic trends may also limit banks' lending capacity. The liquidity of financial institutions could decrease due to shifts from liquid toward illiquid assets and the shift of customer funds from deposits into "off banking balance sheet" funds as a result of more attractive interest rate spreads. This could ultimately limit banks' ability to issue new loans. Both lower lending demand and supply could reduce the net interest income of banks and, consequently, their profitability.

5) Macroeconomic scenarios show a future that looks much different than the previous decade

As highlighted throughout, the macroeconomic outlook is uncertain. To illustrate potential outcomes, we took four macroeconomic scenarios from our recent McKinsey Global Institute (MGI) report.[8] Three out of the four scenarios over the next decade predict a very different landscape compared to the previous one, potentially characterized by lower profitability and a different set of opportunities for banks (Exhibit 5).

In scenario 1, akin to Germany in the early 2000s, the global economy could return to the characteristics of the previous era of high savings, weak investment, low inflation, low interest rates, and modest productivity growth. This would put pressure on banks' profitability and limit their ability to invest in innovation and growth initiatives. In turn, net interest income could decline by about 2 percent per annum, with a net interest margin decline of approximately 20 to 25 basis points until 2030.

Another scenario of concern, which is similar to the United States after the oil shock in the 1970s, envisions prolonged elevated inflation and short-term interest rates of around 4 percent, which would further increase the cost of borrowing for banks and their customers, depress the real value of assets, including equity and real estate, and negatively affect profitability. This could result in an average net interest income growth of about 1 percent per annum until 2030 (but the net interest margin is not expected to improve as financial assets increase).

The worst-case scenario, which is similar to Japan in the 1990s after the real estate bubble, describes a recession due to a sharp correction of asset values as a result of forceful monetary and fiscal tightening in response to persistently high inflation. Contracting asset prices would lead to high stress and potential failures in the financial system. This scenario could result in an average net interest income reduction of around 5 percent and a decline of the net interest margin by about 40 basis points until 2030.

The fourth scenario, which is similar to post–World War II in the United States and Europe (late 1940s to 1950s), is the only one that envisions long-term growth of both income and wealth, anticipating strong demand and an abundance of attractive investment opportunities, which would extend banks' season of high profitability. The economy would be stable and strong, and productivity would increase. Net interest income would grow by about 4.5 percent per annum, and the net interest margin could improve by around 25 to 30 basis points.

[8] For the full MGI report, see "McKinsey Global Institute sees 4 possible scenarios for the economy by 2030," MGI, June 8, 2023.

Exhibit 5: Macroeconomic scenarios

Macroeconomic scenarios show a future that looks different than the previous decade

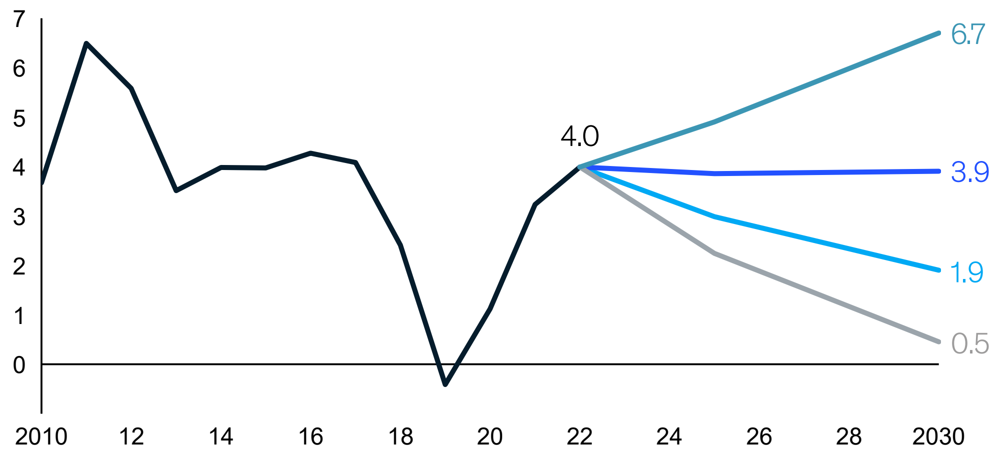
Scenario 1
Decreasing interest rate environment resulting in average NII[1] reduction of ~2% p.a.; NIM[2] can be improved by ~20-25 bps[3]

Scenario 2
Stagnating interest rate environment resulting in average NII growth of ~1% p.a.; however, NIM cannot be improved[4]

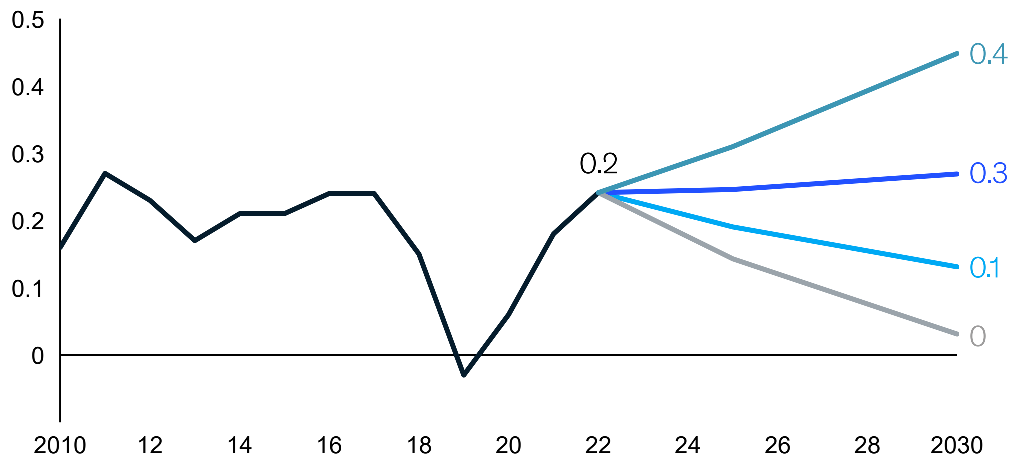
Scenario 3
Strongly decreasing interest rate environment resulting in average NII reduction of ~5% p.a.; NIM falls by ~40 bps until 2030

Scenario 4
Increasing interest rate environment resulting in average NII growth of ~4.5% p.a.; NIM can be improved by ~25-30 bps

RoE – post-tax
Percent



RoA – post-tax
Percent,[5]



1. Net interest income
2. Net interest margin
3. Basis points
4. Given the steady assumed growth of financial assets of ~1% p.a.
5. Return on assets

Source: "McKinsey Global Institute sees 4 possible scenarios for the economy by 2030," McKinsey Global Institute, June 8, 2023

III. Banks in Germany need to leverage this moment

Given these emerging challenges and the potential future scenarios, banking institutions in Germany must take action in order to build a strong foundation for future growth and competitiveness. As we have shown previously, the market is price sensitive and, in many respects, undifferentiated. The current high earning levels mean that the time to act is now.

German banks have undoubtedly already made efforts toward transformation, but the low earnings environment of the past decade constrained their capacity for substantial investments in transformation, such as digitization and innovation. Today, banks have an opportunity to turn their relatively modest efforts into ambitious, comprehensive, organization-wide programs.

To ensure growth and profitability in the new era, banking institutions in Germany should commit to and invest in action in five areas (Exhibit 6). Large, traditional banking institutions can gain a particularly large advantage if they seize these opportunities.

Exhibit 6: Investment areas

Five investment areas for banking institutions in Germany

1) Rewire technology for a fully digital operating model

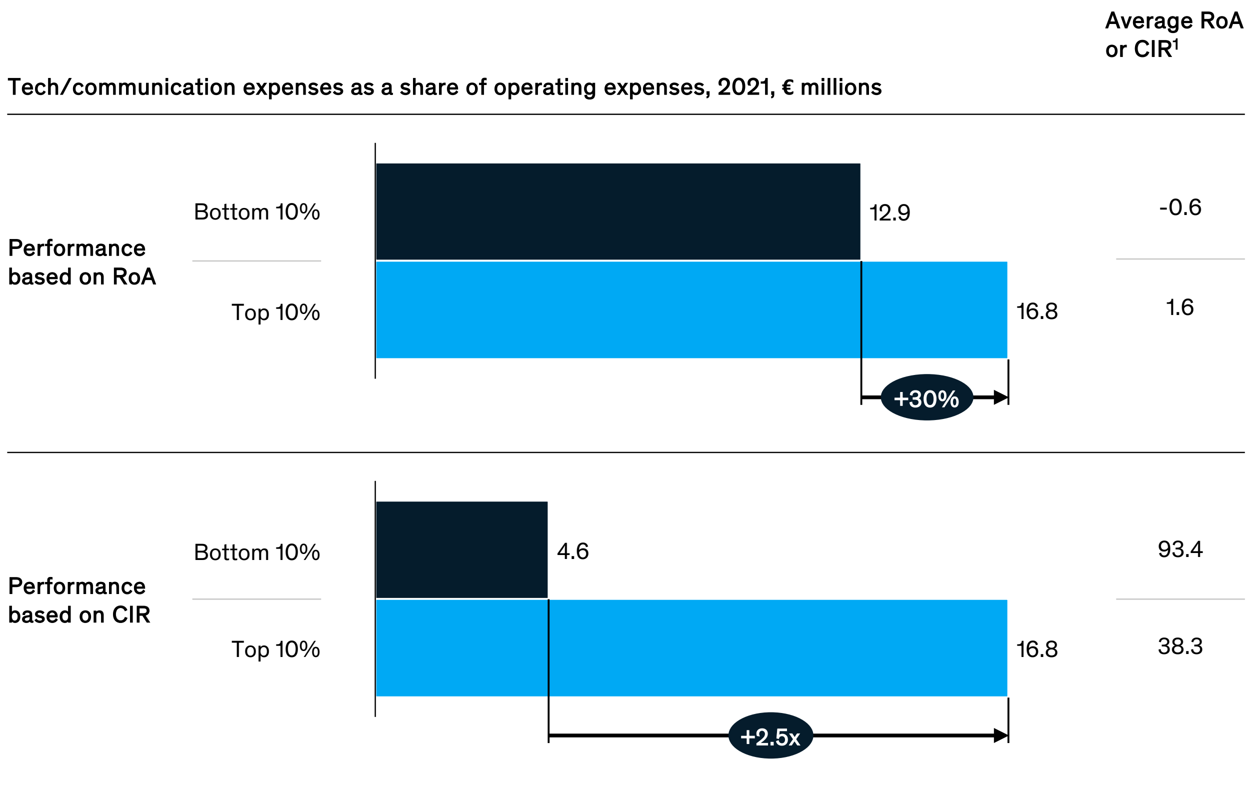
By modernizing operating models, supporting infrastructure, and business approaches in ways that take advantage of emergent technology, banks can improve time and work efficiencies and reduce costs. Overall, we find that leading banks (in the top 10 percent of cost-to-income ratio) spent up to 2.5 times more on technology in 2021 than the lowest-performing banks (in the bottom 10 percent of cost-to-income ratio) (Exhibit 7). This trend is also evident prior to 2021. In addition, banks with high profitability in 2021 had already invested significantly more in technology in 2016 (compared to banks with low profitability).

There are four technology measures that are critical for banks. Large banks can benefit the most if they implement these effectively.

Increase efficiency and customer services through AI. AI has the potential to transform many processes, for example, in call centers, programming, or industry-specific content generation.

Exhibit 7: Technology spending of high- versus low-performing banks

High-performing European banks spend significantly more on technology than low performers



Leading banks invest 2.5x more in technology (performance measured by CIR)

1. Average performance among the bottom 10% and top 10% performers, respectively, which are defined based on performance measured as RoA and CIR in 2021

Note: Sample includes 115 European banks that reported technology and communication expenses over the respective period (Developed Europe); top and bottom 10% value based on median with base year 2021

Source: Capital IQ

The technology has the potential to improve efficiency and enhance the customer experience because it can be used to automate routine tasks, improve risk management, and provide personalized services to customers. In particular, generative AI (GenAI) is experiencing significant momentum in the banking sector in 2023, as it enables the creation of new, unstructured content (such as text or images) while taking context or instructions into account, and it is able to predict or extract information from unstructured data (for example, to summarize or answer questions). The potential productivity lift from GenAI is thus expected to be 3 to 5 percent, resulting in $200 billion to $340 billion in additional revenue for banks globally. What is more, GenAI can drive impact across the banking value chain and customer segments, for example, through:

— Revolutionizing the entire customer operations function, and improving the customer experience and agent productivity through digital self-service.

— Changing the anatomy of work by augmenting the capabilities of individual workers through automating some of their individual activities.

— Improving on efficiencies already delivered by AI by taking on lower-value tasks in risk management (for example, required reporting and monitoring regulatory developments).

Exhibit 8: Effects of GenAI

GenAI can positively impact banks' entire value chain

Not-exhaustive

Marketing and sales

Automatically create hyperpersonalized marketing and sales content tailored to each customer, based on their profile, behavior, and history

Deploy frontline AI assistants, e.g., for conducting industry research, preparing proposals, or managing wealth portfolios

Operations

Improve service chatbots by providing personalized, efficient, and accurate responses to customer queries

Automate tasks currently performed by subject-matter experts, e.g., interpreting or writing technical documents (loan contracts, RfPs, account plans, Pillar 3 reports, or environmental, social, and governance reports)

IT

Accelerate the transition from legacy software/code (e.g., banks still use systems written in COBOL) to modern systems

Improve productivity of software development using GenAI-based coding assistants (e.g., GitHub Copilot)

Legal, risk, and compliance

Automatically create risk reports such as model documentation, credit memos, or suspicious activity reports
Generate life-like fraud attempts for proactive testing

GenAI can therefore be expected to positively impact the entire banking value chain, as the examples in Exhibit 8 indicate.

To prepare the ground for this, banks are required to enable AI innovation and scale up its implementation through capability building and change management. On the other hand, banks need to consider a wide range of AI-related risks such as algorithmic bias, intellectual property infringement, privacy concerns, and security threats, and implementation of controls to mitigate such risks.

Align IT and business. Transform IT organizations into platform organizations with cross-functional teams, which can decrease duplicate efforts by 80 percent. Streamline and standardize processes and deploy automation tools along the software development life cycle. This can reduce the time to market of service delivery by up to 90 percent and increase productivity.

Invest now in IT architecture, the cloud, and cybersecurity. Many banks still run on legacy banking systems that are more than 20 years old. The cost of building and implementing more robust IT architecture has been a deterrent, but the recent high profits make now the right time to invest. Compared to a complex legacy architecture, a modernized architecture could reduce the number of applications and related maintenance costs by 40 percent. To also reduce the number of interfaces, move from point-to-point technology integration to a holistic API program. Complement the strength of this new IT architecture with a cyber-risk management program, using clear key performance indicators and risk-reduction metrics tailored to the risk profile of assets. This approach can reduce the risk of cyberattacks by 7.5 times compared to a control- or maturity-based approach. This is also the time for banks to implement a cloud

strategy that is aligned with the business strategy. Better alignment can typically reduce costs by 20 percent and provide access to innovation. Moreover, higher standardization of the tech stack and improved utilization of servers can further reduce related costs by 20 to 30 percent.

Implement a fully digital operating model that utilizes BaaS, where beneficial. Consider implementing a fully digital operating model that, where beneficial, leverages BaaS. This approach allows banks to be more agile and scalable while reducing costs. Banks utilizing BaaS can reduce operating costs by up to 40 percent and improve time to market for new products and services by 50 percent. To support this shift, banks can take a more aggressive approach to outsourcing certain front-to-back product processes, such as trade finance, leasing, or foreign exchange, to optimize operational efficiency and focus on core competencies.

2) Create a differentiated client proposition

Implementing a set of initiatives to create a clear corporate identity and deliver a customized and convenient customer experience can help banks hold on to customers, improve RoE, and drive down operating expenditures.

Make "where to play" a strategic choice. Adopt competitive positioning for clear differentiation from competitors, such as becoming a cost leader, ecosystem player, premium provider, corporate-sector specialist, or green finance leader. Banks with a differentiated competitive position achieve an RoE that is 2 to 16 percentage points higher compared to those with a commoditized revenue strategy. Banks can better meet the specific needs of their clients and build long-term customer relationships by making an active, strategic choice on where to play, committing clearly to where they can make a difference, and tailoring their offerings to volume and margin evolution in each product type.

Leverage advanced analytics. Continue to use advanced analytics to gain valuable insights into customer behavior, preferences, and needs. While most banks in Germany have started, few have fully scaled up analytics. These insights enable more personalized and relevant service delivery. Banks that successfully utilize advanced analytics can increase revenue by up to 10 percent and reduce operational costs by up to 15 percent. Additionally, advanced analytics can help banks identify new growth opportunities, optimize pricing strategies, and manage risks more effectively.

Enhance customer touchpoints and implement a smart-channel sales strategy. Improve customer touchpoints across digital and physical channels to offer seamless, convenient, and engaging experiences. Banks with superior customer experience can achieve up to a 20 percent higher customer satisfaction rating and a 15 to 20 percent higher sales conversion rate compared to their competitors. Investing in user-friendly interfaces, mobile applications, and innovative in-branch experiences can strengthen customer relationships and attract new clients. To complement touchpoints, develop smart-channel sales strategies that align with customers' preferred channels, whether digital or physical. An effective omnichannel strategy can increase sales productivity by up to 30 percent and increase customer satisfaction by 25 to 35 percent. The integration of digital channels with a traditional sales approach can reach more customers, deliver tailored products and services, and drive growth in an increasingly competitive market.

3) Embrace transformational real-economy opportunities

To capture fundamental real-economy opportunities for unlocking growth, true winners will take three actions:

Build aspirational transformation finance businesses (products, people, and tech) to finance the transition to a more sustainable economy. The transformation of the global economy that is needed to achieve net-zero emissions by 2050 would require $9.2 trillion in annual average spending on physical assets, which is $3.5 trillion more than today. That is

equivalent to half of global corporate profits in 2020.[9] New approaches to products, people, and tech are required to realize the biggest real-economy demand case in 50 years. Given the scale, complexity, and internationality of the challenge, large banking institutions are well-positioned to capture their share of the opportunity.

Channel private capital into the real economy. Fostering a true capital markets culture, including firm fundraising through capital markets and retail investment in securities, would allow new capital to be channeled into the real economy.

Create a profitable position with SMEs. Offering a digital or hybrid business model specifically targeting SMEs could present an opportunity for banks.

4) Increase balance-sheet resilience

A focus on strategy, capability building, and alternative revenue that can help banks improve the resilience of their balance sheet, can be implemented through the following steps:

Prepare for an increase in the cost of funds. After almost 15 years of low interest rates, many banks lost their institutional memory of the challenge of competing for deposits. As the race for retail deposits begins, competition intensifies, and refinancing costs rise due to several European liquidity facilities coming to an end (for example, ECB asset purchase programs have been substantially reduced), German banks should be prepared to adjust their deposit strategies accordingly.

Improve balance sheet and capital positions to capture revenue opportunities. To respond to the changing interest rate environment, German banks should work to improve their balance sheet and capital positions and ensure that they have sufficient originate-to-distribute capabilities. By doing so, they can increase their risk-taking capabilities and invest in their own business transformation efforts to ultimately improve revenue potential. To relieve capital constraints and increase funding margins, many banks should consider enabling originate-to-distribute models. Originate-to-distribute capabilities help banks avoid hitting the internal ratings-based output floor set by the Basel III Finalization Package.

Strengthen business models that are less reliant on an abundance of liquidity. German banks should explore opportunities to strengthen business models that generate fee-based income, such as transaction banking, private banking, bancassurance, and other noninterest income sources. By focusing on fee-based income sources, German banks can build resilience against future interest rate fluctuations and create more diversified and stable revenue streams.

5) Address the talent cliff

Coming to terms with the realities of a challenging employee pipeline can help banks attract, develop, and hold on to the talent they need to thrive in a new era of banking, be it in advisory or in leveraging AI effectively. Banks can do this in several ways.

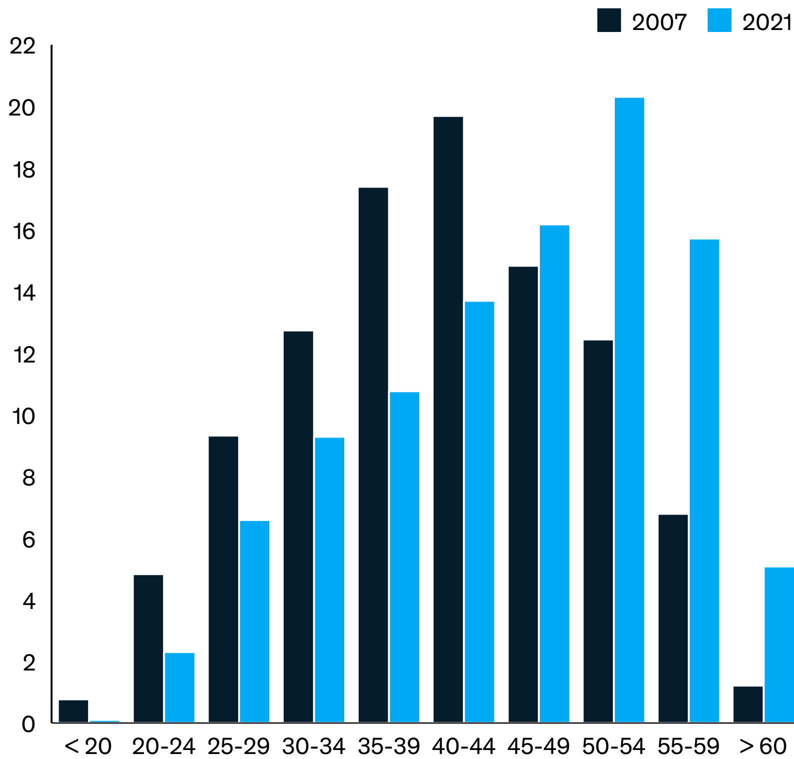
Prepare for high retirement rates and increase attractiveness for new talent. Prepare for the retirement of up to 30 percent of current employees by 2030. The age distribution of banking employees has shifted over the last 15 years, resulting in more than 40 percent of employees being older than 50 and an average age of over 45 years. 72 percent of banking employees consider quitting, in comparison to the overall average of 40 percent (Exhibit 9).[10] Thus, banks will need to explore ways to become the industry of choice for younger talent.

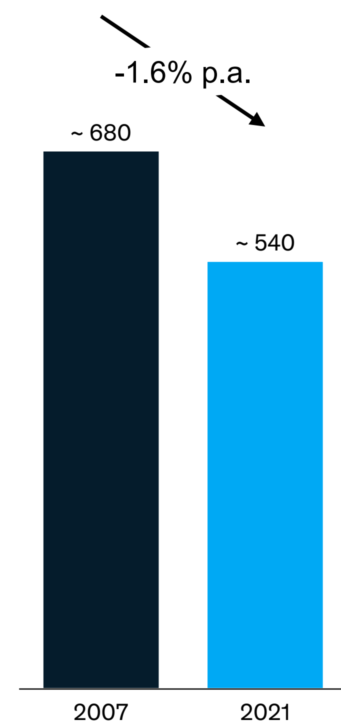
Leverage opportunities to attract professionals. Attract experienced professionals from across industries, with a preference for customer and technology skills. Since more than 80 percent of Gen-Z employees consider purpose when picking a place to work, banks need to better communicate their purpose as the lifeblood of the economy and how they offer interesting careers in addition to competitive compensation.

9 For the full MGI report, see "The net-zero transition: What it would cost, what it could bring," MGI, January 2022.
10 "Great attrition, great attraction," McKinsey survey, 2021/22.

Exhibit 9: Attractiveness of banking for talent

Aging employees and low attractiveness for tech graduates present a challenge for banks





> 40%
of bank employees are more than 50 years old, compared to 20% in 2007

Up to 30%
of bank employees will retire by 2030[1]

Limited appeal
of banks—none are within the top 40 of the 100 most attractive employers for computer science graduates

1. Assumption: employees retire at the age of 65

Source: AGV Banken; Arbeitgeber-Ranking.de

Invest in training and development. More than 60 percent of banks see a significant risk of running out of skilled workers. Thus, banks need to invest in training and development programs to ensure employees have the necessary skills to thrive in the digital age, including technological, digital, classical, and transformative competencies. Transformative competencies are becoming increasingly important since they are fundamental to shaping social change, developing visionary solutions, and uniting employees behind a common goal.[11] Investing in workforce upskilling can achieve up to a 40 percent improvement in productivity while significantly increasing employee engagement.

Become the industry of choice for talent again. In 26th place, the Bundesbank is the only German bank on the top 50 list of most attractive employers.[12] By prioritizing talent development, banks can enhance their digital capabilities, foster a culture ofw innovation, and become more attractive again. This includes competitive compensation packages, career development opportunities, new work and career models to fulfill work–life balance, and enthusiastic adoption of hybrid working practices.

[11] *Future Skills 2021,* Stifterverband and McKinsey discussion paper number 3, 2021.
[12] “Das sind die besten Arbeitgeber Deutschlands,” Stern, 2022.

IV. Onwards and upwards

Exciting times are ahead for the banking industry, especially if institutions take the time now, while they have a little breathing room, to craft an enhanced future value proposition. In 2030, we could be looking back at how institutions have done the following:

— Reinvented advisory for retail, private banking, and corporate clients.

— Became much stronger financial partners for firms' foreign operations, building on Germany's strength of being the third-largest exporter worldwide.

— Established profitable hybrid digital service models in SME banking.

— Built at-scale transformation finance businesses for the green economy.

— Fostered a capital markets culture across corporate fundraising through capital markets and retail investment in securities.

There's no better time than now, and no better place than here.

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Acknowledgements

The authors wish to thank Sven Blumberg (senior partner, Düsseldorf), Sarina Deuble (associate partner, Frankfurt), Thorsten Ehinger (associate partner, Stuttgart), Denis Francis (partner, Cologne), Julian Kirchherr (partner, Berlin), Susanne Maurenbrecher (partner, Hamburg), Timo Mauerhoefer (partner, Frankfurt), Nicolas Reuttner (partner, Frankfurt), Henning Soller (partner, Frankfurt), and Uwe Stegemann (senior partner, Cologne) for their contributions to this article.

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McKinsey & Company
Sep 11, 2023
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