McKinsey & Company

The road to success

Perspectives on German banking

Contents

Executive summary 5

01 German banking in the slow lane 8

Slower growth and declining RoE 10

Performance gaps between segments 11

The income pool continued to shrink 13

Cost-to-income ratios rose 14

Consolidation lost momentum 16

An interview with Dr. Andreas Dombret 18

02 Global banking – turning a corner 22

Most markets remained under pressure 24

Operational productivity improvements through structural changes 25

Tapping into new sources of revenue 30

03 A twin speed industry – leaders and laggards 32

Local cooperative banks and Sparkassen – operational efficiency required to sustain success 36

Private banks – universal banks must reinvent their business models 38

04 Accelerating reinvention of business models 40

Cost cutting is a must, but not a panacea 42

FinTechs – blessing or curse? 45

Two transformation enablers and strong foundations 48

Final remarks 53

Thank you 54

Contact 55

Executive summary

In the previous version of this report, published in 2016, we outlined three significant trends – the low-interest-rate environment, regulatory pressure, and digitalization.[1] We discussed how the trends were shaping the German banking landscape and impeding performance. Our analysis suggested the industry urgently needed to find strategic levers to offset the headwinds it faced.

Now, three years later, this report revisits the banking industry and assesses its progress. The good news is that there have been positive changes. Some banks have grown and seen higher earnings. However, others have achieved less, and the country's banking titans have tended to underperform.

Across the board, there is work to do. The banking industry must take control of the challenges it faces, some of which are structural. This report offers a new look at the key challenges and opportunities. It also offers strategies that may help banks unlock value and move forward.

German banking in the slow lane

German banks continued to struggle between 2014 and 2017, despite efforts to transform and lift levels of performance. Competitive pressure and low interest rates meant they were generally unable to raise prices, and retail customers remained averse to fee-based products. The result was declining income across the industry. At the same time, operating costs rose, adding to pressure on performance. Moreover, consolidation continued to slow – a trend that has been in place since the financial crisis. In addition, employee numbers remained relatively stable (declining less than 1 percent annually), and German banking failed to make the efficiency gains seen in other countries.

However, not all banks struggled. Sparkassen and local cooperative banks continued to outperform and build momentum in terms of profit share. Their success was driven by several factors, including strong retail and corporate loan growth, low risk costs, and the resilience of the German economy. This mirrors the trends highlighted in our previous report. However, it is unsure whether these banks can sustain their performance as the macro environment evolves, given their strong focus on low-margin mortgage products, exposure to a potentially overheated property market in some regions, and a potential spike in defaults given higher refinancing costs for corporates when interest rates rise. Private banks, by contrast, were still some way from achieving the profitability levels seen before the crisis.

Global banking – turning a corner

Comparing like with like in an international context is challenging and conclusions should be treated with caution. Nonetheless, there may be interesting findings. International markets that performed best over the past three years have tended to lead on structural changes, including consolidation, branch closures, and productivity increases while also showing growth.

Across the eight banking markets in the scope of this report, the average number of banks as a proportion of population declined.[2] Germany, on the other hand, continued to have the highest number of banks relative to the size of its population.

Furthermore, most banking markets saw productivity improvements from 2014 to 2017, primarily due to declining numbers of branches and employees. By contrast, the ratio of total staff costs to total income in Germany was higher than in any other country, driven by the higher numbers of employees.

We also saw some countries outperforming on revenue generation. Banks in Sweden and the US were among those to successfully tap into new sources of growth. In fact, many European countries (Germany included) also saw fee income increases. However, the gains were often offset by declines in net interest income.

A twin-speed industry – leaders and laggards

Some banks led, while others trailed. Local cooperative banks had the highest share of relatively successful banks in terms of asset growth and RoE.[3] Similarly, Sparkassen generated stronger-than-average RoEs. Both segments profited from their ability to navigate the low interest rate environment. However, there are questions over whether they can sustain their success (see below).[4]

Private banks saw higher levels of performance variability. By count, barely a quarter of private banks were somewhat successful. By assets, the picture was even less positive. A mere 13 percent of private bank assets were able to generate an RoE of more than 2 percent. Private banks with the highest growth and profitability included foreign banks, direct banks, and banks specializing in consumer finance. Large universal banks, which often operate in a more complex wholesale environment, struggled to manage complexity.

Accelerating reinvention of business models

Most German banks have faced a structural cost problem. The performance of leading banks, however, suggests that those focusing on growth and managing costs effectively have been more successful than those focusing on cost cutting alone.

We believe that to return to higher levels of profitability, banks should consider business model transformations based on three pillars.

— **Develop a laser-sharp customer focus.** There is strong evidence that banks that deliver a superior customer experience see higher levels of loyalty and more growth. As a result, there should be a key strategic shift away from products and towards putting customers first. At the same time, banks should trim noncore businesses, which will help reduce complexity and costs.

— **Embrace analytics.** Banks have access to significant amounts of transaction and personal data. They should use advanced analytics and artificial intelligence to reduce costs in operations, risk, and compliance. Meanwhile, functionalities such as next-product-to-buy and sharper pricing can drive significant revenue growth.

— **Move to digital distribution.** Digitalization can help banks move away from a bricks-and-mortar distribution model and significantly improve productivity. Digital fuels growth by allowing banks to create and test new products and solutions much faster. On the cost side, digital is the key to optimizing the sales process and it enables banks to innovate on interactions with customers.

The three pillars provide a basic structure for boosting efficiency, managing costs and fueling growth. However, they will be most effective if backed by new ways of working, dedicated talent strategies, and strong foundations in technology, capital management, and risk.

German banking requires fundamental transformation and lower costs. Consolidation may be part of the equation. However, banks must also think in terms of business model renewal, encompassing the customer proposition, data and analytics, and digital. Finally, speed is of the essence; in an era of increasing competition and fast change, only the most decisive are likely to succeed. The best place to start is a full-blown strategic review and dedicated innovation agenda.

01 German banking in the slow lane

German banking is in the slow lane, amid persistently low interest rates, a demanding regulatory environment, and the numerous impacts of digitalization.[5] These are the same trends highlighted in the previous version of this report, published in 2016. Their persistence suggests there is an urgent need for reconsideration of business models and rising pressure on banks to find new ways to boost revenue.

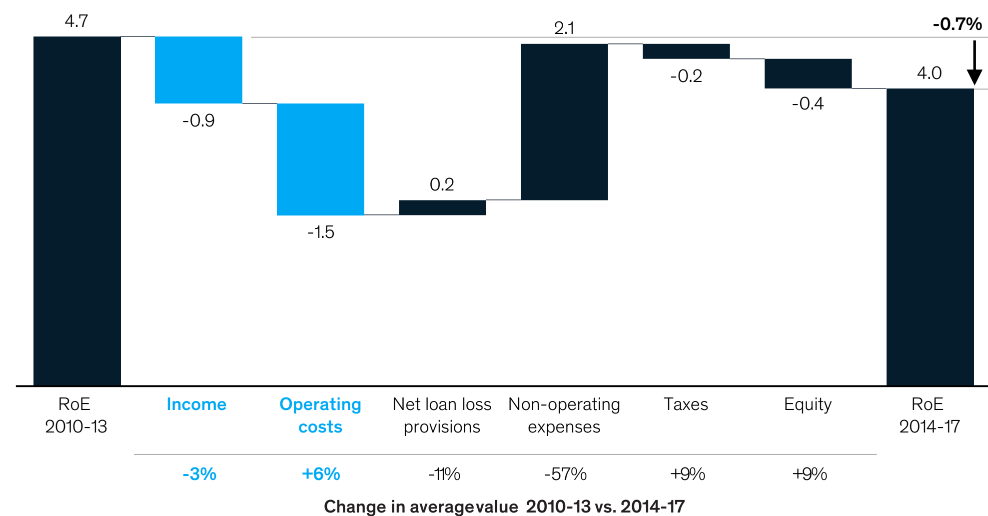
Slower growth and declining RoE

German banks have struggled to grow RoE in recent years, despite strategic and tactical efforts to improve performance. The average annual after-tax RoE was 4.0 percent from 2014 to 2017, compared with 4.7 percent from 2010 to 2013. Income fell and operating costs rose (Exhibit 1). Average total income fell by 3 percent, contributing to a 0.9 percentage point decline in RoE. Operating costs rose by 6 percent, reducing RoE by 1.5 percentage points. The RoE declines were offset by a significant reduction in nonoperating expenses, primarily because of lower extraordinary costs (for example, restructuring charges) and one-off effects.[6] Risk costs were low and, in some cases, improved RoE due to the release of loan loss provisions. The combined impact of these factors prevented a collapse in profitability.

Exhibit 1

German banking RoE deteriorated in the 2014-17 period

Change in average RoE 2010-13 vs. 2014-17
Percentage points



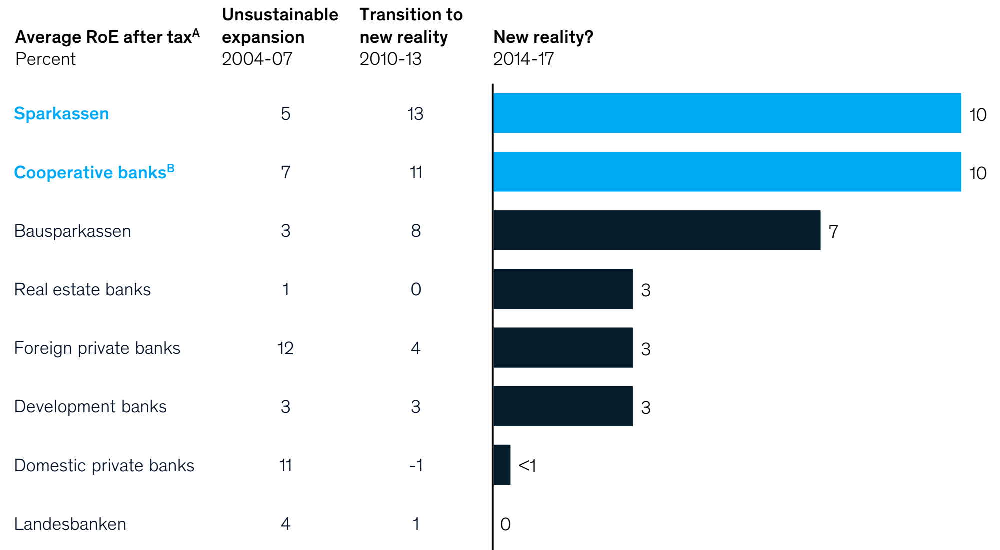
Source: Deutsche Bundesbank; McKinsey analysis

Performance gaps between segments[7]

Sparkassen and local cooperative banks saw strong performance from 2014 to 2017, posting an average after-tax RoE of 10 percent, almost double the precrisis levels (Exhibit 2). Following a similar result in the 2010 to 2013 period, the segment built momentum in terms of profit share.[8]

Exhibit 2

Sparkassen and cooperative banks led the field



A RoE calculated based on profit after tax and before transfers to the fund for general banking risks as a percentage of the average equity

B Average RoE 2014-17 of cooperative banks: 10% cooperative banks only, 9% incl. DZ Bank/(former) WGZ

Source: Deutsche Bundesbank; McKinsey analysis

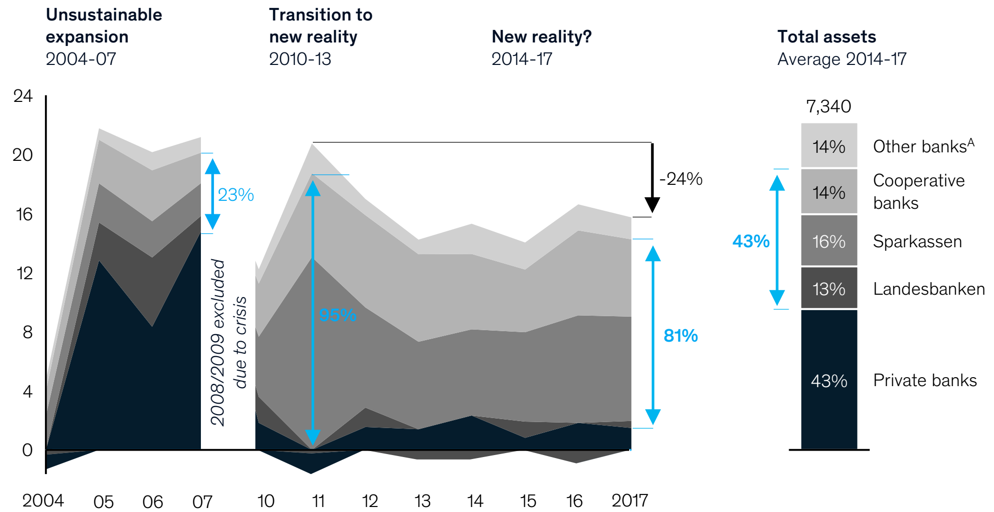
Private banks, by contrast, struggled to return to the profitability levels seen before the crisis, at least in their domestic business activities (which form the basis of our analysis).[9] Average domestic private bank RoE was just below 1 percent from 2014 to 2017, compared with -1 percent from 2010 to 2013, while average foreign private bank RoE was 3 percent, compared with 4 percent previously.

The German banking after-tax profit pool shrank to EUR 15.7 billion in 2017, compared with EUR 20.7 billion in 2011 (Exhibit 3). Sparkassen, Landesbanken, and cooperative banks accounted for the lion's share of profits, despite holding just 43 percent of banking assets. Together they generated 81 percent of profits in 2017, slightly less than the 95 percent seen in 2011. The decline was due to a partial recovery in the private sector.

Exhibit 3

The savings and cooperative sectors dominated the profit pool

Net profit after tax and total assets in the German banking market by bank segment
EUR billions



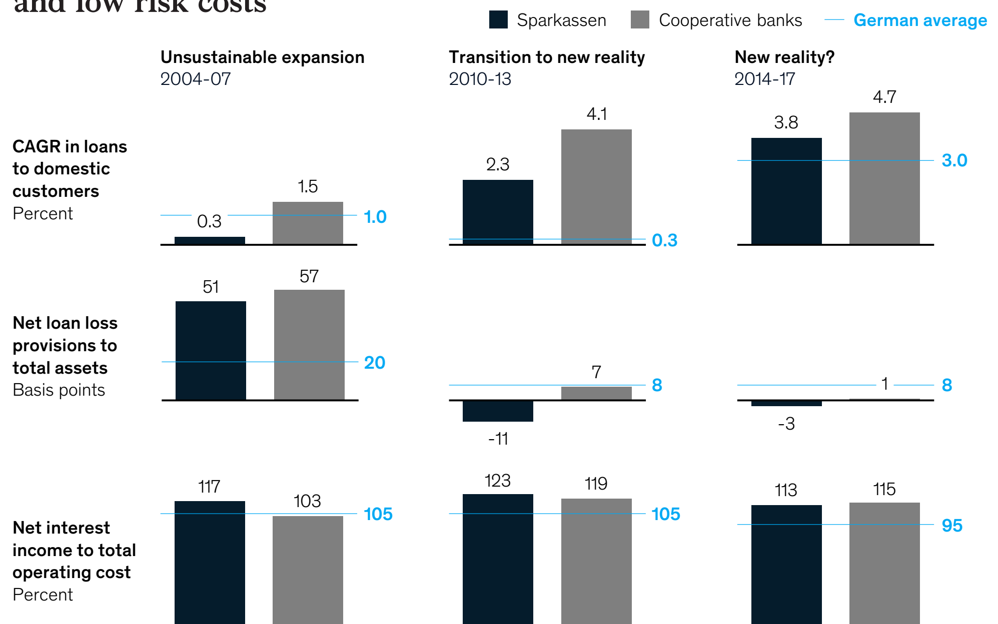
A Bausparkassen, RE banks, development banks

Source: Deutsche Bundesbank; McKinsey analysis

Sparkassen and cooperative bank success was driven by three factors: strong retail and corporate loan growth, low risk costs, and the resilience of the German economy, mirroring the trends highlighted in our previous report (Exhibit 4).

Exhibit 4

Sparkassen and cooperative banks' profits fueled by lending growth and low risk costs



Source: Deutsche Bundesbank; McKinsey analysis

Both Sparkassen and local cooperative banks expanded their loan books between 2014 and 2017, achieving well-above-average growth. Both segments also saw lower net loan loss provisions, resulting in below-average risk costs. Net loan loss provisions to total assets among local cooperative banks averaged 1 basis point per year, while among Sparkassen they were -3 basis points per year, reflecting the release of provisions. This was a significant improvement on previous years. Between 2004 and 2007, Sparkassen and local cooperative banks posted net loan loss provisions to total assets of more than 50 basis points, compared with a national average of 20 basis points.

If macro conditions change, we are not certain Sparkassen and local cooperative banks will be able to maintain current levels of profitability. In a rising interest rate environment, the cost of borrowing could increase faster than interest income, which is derived mostly from long-term assets locked in at low rates. Moreover, higher corporate refinancing costs may lead to a spike in defaults. Also, the strong focus on low-margin mortgage products and heavy exposure to a property market that is potentially overheated in some regions adds risk.

The income pool continued to shrink

Weak income generation has been a structural problem for German banks for several years (see Chapter 2 for a detailed country-by-country comparison). The pool has continued to shrink recently, falling by 3 percent to EUR 119 billion between 2010 to 2013 and 2014 to 2017. The German banking sector's total assets fell by more than 10 percent to EUR 7.3 trillion from 2014 to 2017, from an average of EUR 8.3 trillion from 2010 to 2013. Following this decrease, average asset productivity (income to total assets) improved slightly to 1.6 percent, compared with 1.5 percent previously. This reflected a rise in off-balance-sheet revenue.

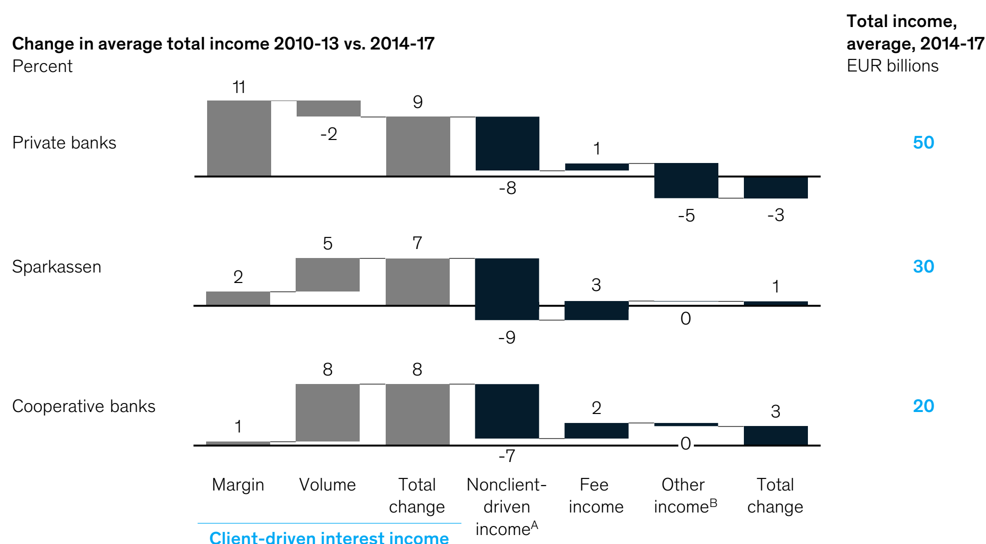
The driving force behind income declines has been an overbanked and consequently underpriced market – with the low interest rate environment adding to the challenge. Significant competitive pressure drove down prices, and retail customers in particular continued to be generally averse to fees, leading to income challenges. In the corporate banking segment, the competitive situation has become more acute, with foreign players pushing hard and many products becoming increasingly commoditized. If the macro situation deteriorates and loan loss provisions rise, there will be even more pressure.

Looking past the macro environment, conservative business models, with a strong dependency on retail deposits and loan financing for German corporations, have created structural limits on growth, in particular because of their capital intensity. This simple – sometimes described as "boring" – approach, has produced reasonable returns for Sparkassen and cooperative banks, but not where interest income has been insufficient to cover costs.

Still, German banks have made efforts to improve income performance (Exhibit 5). They have implemented loan and deposit price adjustments, for example, and in some cases promoted lending. Sometimes they have applied a combination of the two. Private banks cut interest rates on deposits by 50 percent more than they cut rates on loans. In addition, a 2-percent decline in lending and deposit volume was more than offset by an 11-percent rise in net interest margins, resulting in an increase in client-driven interest income. Sparkassen and local cooperative banks bucked the trend in that they tended to cut interest rates for deposits in line with rates for loans. In any event, they saw slight margin increases from client-driven interest income (2 and 1 percent, respectively). Both Sparkassen and cooperatives grew retail and corporate loan volume (by 5 and 8 percent, respectively), resulting in an overall rise in client-driven interest income. In all segments, interest income from nonclients fell, offsetting client-driven rises.

Exhibit 5

German banks made efforts to grow interest and fee income



A Nonclient-driven income: interest income from fixed-income securities and debt register claims; current income from shares, other nonfixed income securities, participating interest, shares in associated companies; income from profit pools, profit transfer, and partial profit transfer agreements
B Other income: extraordinary result and result from financial investment business

Source: Deutsche Bundesbank; McKinsey analysis

German banks also focused on expanding other sources of income, in particular fee income. On average, they achieved fee income of 25 percent of total income from 2014 to 2017, compared with 23 percent from 2010 to 2013. However, the positive impact on total income was marginal compared to the larger swings in client-driven (positive) and nonclient-driven interest income (negative).

Cost-to-income ratios rose

Cost-to-income ratios (CIRs) rose in all segments, with an average CIR of 75 percent from 2014 to 2017, compared with an already high 69 percent from 2010 to 2013 (Exhibit 6).[10] Higher costs and declining income contributed equally to the rise.

Landesbanken and domestic private banks – which both operate also wholesale-focused business models – saw the biggest CIR increases of 10 and 8 percentage points, respectively, from 2014 to 2017, compared with 2010 to 2013. Both domestic and foreign private banks saw costs rise and incomes decline. Sparkassen and cooperative banks posted gains in total costs but slight increases or no increases in income. Landesbanken, in turn, saw stable costs but a 14 percent drop in income from 2014 to 2017, compared with 2010 to 2013.

Operating costs across the industry rose by 6 percent from 2014 to 2017, compared with 2010 to 2013. Personnel expenses and other administrative costs rose by 3 and 9 percent, respectively (Exhibit 7). The trend highlighted a structural increase in the cost base. However, it was offset recently by a fall in nonoperating costs.

Exhibit 6

Cost-to-income ratios deteriorated across all segments

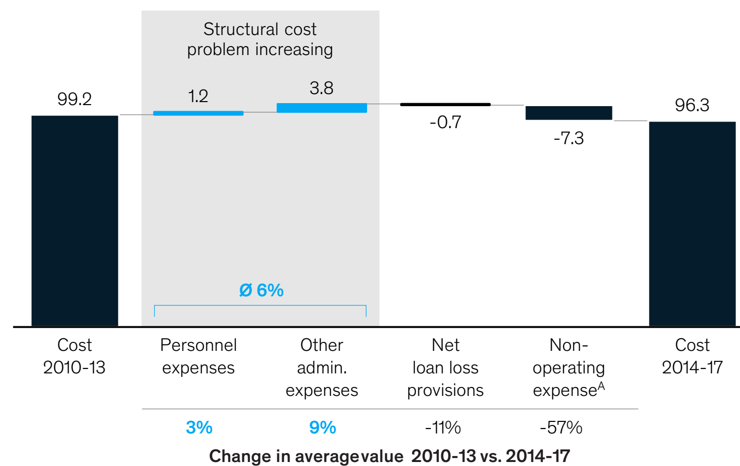
	Average cost-to-income ratio, 2014-17 Percent	Change vs. 2010-13 Percentage points	Change in costs vs. 2010-13 Percent	Change in income vs. 2010-13 Percent
Domestic private banks	88	+8	**+8**	**-2**
Foreign private banks	80	+7	**+5**	**-5**
Landesbanken	71	+10	**+0**	**-14**
Sparkassen	68	+4	**+6**	**+0**
Cooperative banks	67	+3	**+8**	**+3**
Other banks	66	+7	**-4**	**-14**
All German banks	75	+6	**+6**	**-3**

Source: Deutsche Bundesbank; McKinsey analysis

Exhibit 7

Structural cost increases were offset by declines in nonoperating costs – all German banks

Impact of different drivers on change in average cost 2010-13 vs. 2014-17
EUR billions



A Nonoperating expenses include write-offs and write-downs in respect of financial investments (participating interests, shares in affiliated enterprises, and securities treated as fixed assets). In the period 2010-13, this most notably reflects extraordinary write-downs on Greek government bonds. Moreover, nonoperating expenses include charges from losses absorbed and extraordinary charges (e.g., restructuring charges)

Source: Deutsche Bundesbank; McKinsey analysis

Operating costs rose in all banking segments, but with different patterns of cost increases across private banks, Sparkassen, and local cooperative banks:

— Private bank personnel costs changed very little (-1 percent), while other administrative costs increased by 14 percent. [11]

— Sparkassen and local cooperative bank personnel costs increased by 8 and 5 percent, respectively. Other administrative costs rose by 3 and 5 percent, respectively.

There were also differences in net loan loss provisions and nonoperating costs:

— Private bank net loan loss provisions declined by 26 percent, with a particularly sharp drop from 2016 to 2017.

— Local cooperative banks cut net loan loss provisions by 74 percent. Sparkassen have released loan loss provisions since 2011, as reflected in the reporting of negative provisions. However, removal of provisions was stronger from 2010 to 2013 than from 2014 to 2017.

— Among private banks and Sparkassen, nonoperating costs fell sharply from 2014 to 2017. In 2010 to 2013, banks faced high extraordinary expenditures (for example, restructuring charges) and value adjustments (in respect to participating interests, shares in affiliated enterprises, and securities treated as fixed assets). These expenditures fell sharply from 2014 to 2017. Moreover, in individual cases, liquidation of subsidiaries resulted in extraordinary income.

Consolidation lost momentum

Consolidation has led to a decline in the number of banks over the past nearly 20 years, but a slowing pace of consolidation has been a marked trend since 2007. One barrier has been the three-pillar structure of the German banking market, which means that consolidation historically has only taken place horizontally within individual pillars.

Between 2000 and 2017, the total number of banks declined by 43 percent to 1,600 and the number of branches fell by 46 percent to around 30,000. Bank numbers fell 5 percent a year between 2000 and 2006, but after that period the rate of decline slowed (Exhibit 8). Still, the trend from 2014 to 2017 was slightly faster on both counts than from 2010 to 2013; in particuar, recent developments over the last two years point towards a potential uptick in consolidation activity.

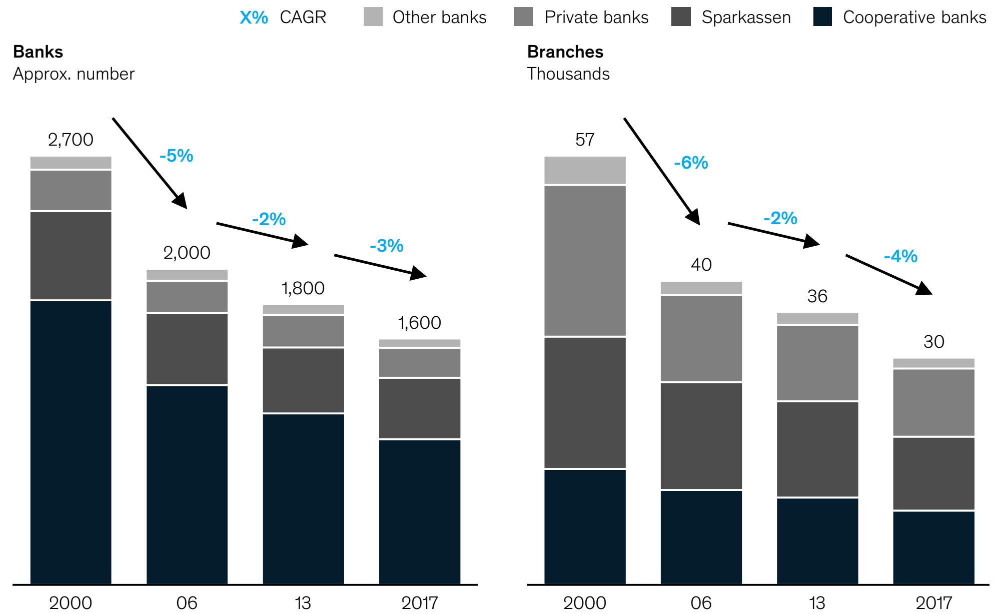
Different segments have seen varying rates of consolidation. Between 2000 and 2017, consolidation was strongest among cooperative banks (the number of banks fell 49 percent), accounting for 76 percent of total consolidation activity. The number of Sparkassen, meanwhile, fell by 31 percent, accounting for 15 percent of activity. The number of private banks fell by 28 percent, accounting for just 6 percent of the decline.

Finally, the number of employees in banking has been declining between 0 and 1 percent annually over the last decade, after falling by 2 percent annually in the previous six years (Exhibit 9).[12] Only very recently do the numbers seem to be on the rise again.

The challenge for the industry is that further consolidation is undoubtedly required. Supply still exceeds demand (ex ante), and that is one of the key drivers of the industry's current tepid performance.

Exhibit 8

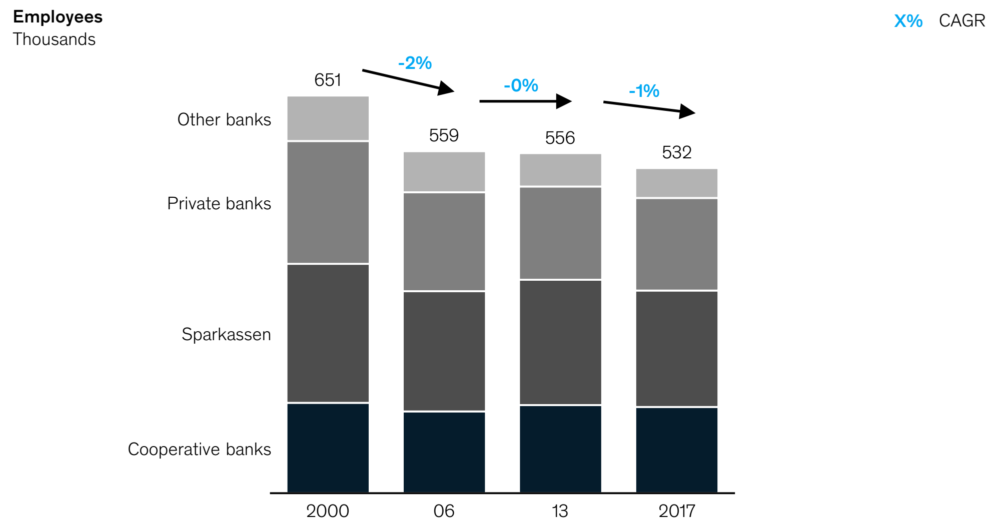
Consolidation was slower than in the pre-crisis period



Source: Deutsche Bundesbank; McKinsey analysis

Exhibit 9

Employee numbers have remained flat in recent years



Note: Number of employees calculated in accordance with § 267, 5 HGB as reported in context of Banking Supervision, Audit Report Regulation (special data). Annual number of employees calculated as average of quarterly numbers. Part-time employees are considered on a pro-rata basis. Apprentices are excluded. Data sources and methodology differ from the Deutsche Bundesbank Monthly Report, which is based on data provided by associations (see Deutsche Bundesbank, September 2018, Monthly Report, p. 40)

Source: Deutsche Bundesbank; McKinsey analysis

Dr. Andreas Dombret, former member of the Executive Board of the Bundesbank (2010-2018) with responsibility in particular for banking and financial supervision

An interview with Dr. Andreas Dombret

Mr. Dombret, our last interview with you was three years ago. In your opinion, to what extent has the German banking market changed? In what areas have German banks improved?

German banks and savings banks have been continuing to do their homework. Commission income has seen further growth compared to interest income. Consolidation has also progressed further. A recent survey revealed that some 50 percent of financial institutions can see themselves entering into a merger. Only a few years ago, the idea of mergers and takeovers was still a taboo subject. In terms of improvements, we have also seen that the equity position has improved, and financial institutions have become more secure. Yet, despite improvements on the commission fee side, business models have not significantly changed. In a drastically changing market environment, this surely remains one of the major challenges.

In our last interview with you, you spoke of "overcapacities". Despite the continuing consolidation of recent years, do you believe these overcapacities persist?

Yes, overcapacities continue to exist. This is clear from the number of branches and branch offices as well as the total number of financial institutions. But it's also reflected in the intensity of competition and the prices of products. However, things aren't likely to change any time soon. In European comparisons, German banking is in a particular constellation. Despite overcapacities, it remains very stable and attractive to customers, but is clearly below average in terms of profitability.
If the situation remains like this, it will have an impact on the equity position in the medium term. During favorable economic times like the ones we are currently experiencing, it's important to build reserves and to take an anti-cyclical approach in order to withstand bad times. In the medium to long term, the below average earning power is a risk. Complete consolidation is not good: The three-pillar structure of German banking should be retained, but at the same time, earning power must be increased. Otherwise it opens the door to foreign providers and FinTechs. In some fields, we are already seeing revenues migrating to foreign providers.

Savings banks and cooperative banks continue to generate the lion's share of profit in the German banking sector. Do you see this primarily volume-driven profitability as sustainable?

The demand of German customers has not yet completely changed, which means the current business model still works. Volume-driven growth is a sensible strategy provided you maintain a conservative credit standard. What is crucial is whether the savings banks and cooperatives can retain their customers if demand changes in the medium term. The prerequisites are good because most customers indicate that they are satisfied. As such, it is vital to develop new products and new business models early in order to be prepared for when the change comes.

So, to stay on the issue of profitability: In scaling back the branch networks, do you see a risk for savings banks and cooperatives, not least because this will result in them losing their proximity to the customer?

No, customer demand has changed such that most customers rarely visit the branch these days. Many products can be purchased without the need for a branch. As such, the number of branches should be adjusted to the change in customer demand. Thinning out the branch network is crucial to the survival of banks. In the past, branches were important in winning new customers, but that's also changed. Only in the rarest of cases does a change of bank have anything to do with the loss of a branch. If a bank really wishes to hold on to its branch network, it needs to find new cost models – something that I see as being virtually impossible in the current competitive situation.

You spoke of changes in customer needs and business models. With regard to the product offering, where do you see this developing?

It is clear that there is a growing demand for wealth management and financial advisory. It's no longer simply a matter of savings deposits. These areas are ones where trust in the bank plays a major role, and it's extremely important to offer that. This is why FinTechs have also entered the market and offer relatively automated products, even for small amounts. In my opinion, I think demand will grow in this area. Customers are prepared to pay money for these products, and if the product is scalable, the potential is clear.

What do you believe will pose the biggest challenges and risks for German banks in the future?

In addition to the points I've already alluded to, I think cyber risks will present a major challenge. We don't yet fully understand how these risks materialize. Whereas in the past, attacks were carried out by individuals, we now know that attackers have become more professional and possess significant financial funds. But what we don't know for sure is what kind of impact a possible attack can have. The risk of contagion from a cyber attack is huge. Even if an attacker only succeeded in clearing out a small savings bank, this would significantly affect trust in the entire financial system. So far in Germany, we have been unable to simulate such an attack. The measures that are available to authorities are far more limited than in other areas. There is no alternative to digitization, but we know very little about the risks and how to manage them. It is very important to understand the responsibilities for this vulnerability as well as the vulnerability itself. Authorities can look at various obvious areas, but there are limits as to what they can do.

Our analyses show that both growth strategies and structural cost optimization programs are critical to success. However, at the individual bank level, we see that growth strategies tend to have a greater probability of success. How do you see it?

The issue of cost must be driven forward with real impetus. At the same time, however, new products also need to be introduced. If a financial institution earns all its profits from interest margins, but wants to target profits from wealth management, then it needs to introduce new products. At the moment, growth is relatively simple. In a phase with rising interest rates – particularly a sharp rise – during which volume growth declines on the credit side, it all depends on whether the bank has taken an anti-cyclical approach to investment to ensure continued revenues.

In one of your speeches last year, you compared the established banks to dinosaurs and noted that a lesson from ancient history continued to apply, that is, that size alone is no guarantee of survival. In your opinion, what could German banks do now to stave off extinction? And what advice would you offer for the future?

What I meant was, is that the idea of being "too big to fail" is no longer as valid as it once was. Size has become less significant as a survival function. To survive today, the most important thing is to retain the trust of the customer. It's important to offer attractive products and services. The banks know this and adapt accordingly. But the question is, how courageous a bank will be, and if it will act ahead of or behind the curve? My recommendation is not just to look at the German banking sector, but the European. The times in which there was a purely German banking sector with German regulators are long gone. The market is a European market now, and that means German banks need to align with foreign banks. Customers now also have the option of responding to international offers. The big plus for German banks is that they are way out in front when it comes to trust. They need to use that to their advantage.

02 Global banking – turning a corner

Most markets remained under pressure

German banks have performed better than international peers by some measures and worse by others (Exhibit 10).[13] However, before analyzing the numbers, it is worth noting that international comparisons have limitations. Different market sizes, market structures, business and client mix, regulatory environments, historical developments and starting positions mean conclusions should be treated with caution. Nonetheless, they can provide an indication of the status quo and industry dynamics.

Exhibit 10

Strengths of the largest banking markets

Operational levers	Germany	Sweden	France	US	UK	Italy	Japan	Spain
Interest income CAGR 2010-17	-2	+7	-1	**+1**	**+1**	-3	-2	-5
Fee income CAGR 2010-17	+1	+8	+2	**+4**	-1	+2	**+3**	0
Bank consolidation Change 2014-17 vs. 2010-13, Percent	-8	+2	-9	-15	-3	-15	-2	**-13**
Branch reductions Change 2014-17 vs. 2010-13, Percent	-11	**-14**	-2	-5	**-16**	-10	-5	-23
Number of employees[A] Change 2014-17 vs. 2010-13, Percent	-3	+2	-1	-2	**-5**	**-6**	n/a	-18
Staff expenses Change 2014-17 vs. 2010-13, Percent	+3	n/a	+2	+10	**-1**	**0**	n/a	-14
Digital adoption[B] Change 2012-18, Percentage points	+27	+3	+24	n/a	**+33**	+39	n/a	**+38**

A UK: stable number of employees from 2015-16 assumed
B Online banking penetration

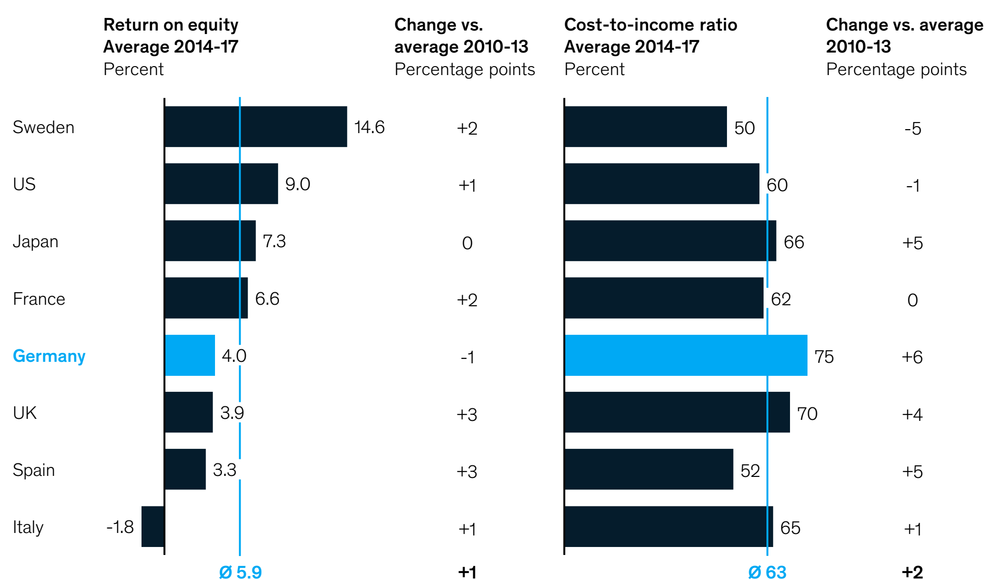
Source: Deutsche Bundesbank; McKinsey World Banking Intelligence; McKinsey Global Banking Pools

Banking markets around the world have seen only limited growth and minor profitability improvements in recent years. Revenue growth in our sample increased slightly to an annual rate of 1.0 percent from 2014 to 2017, compared with 0.4 percent from 2010 to 2013.

Profitability remained low, albeit with a slight increase. The average RoE across the eight countries was 5.9 percent from 2014 to 2017, compared to 4.6 percent from 2010 to 2013. Germany was the only market that saw a decline, with an average RoE of 4.0 percent from 2014 to 2017 compared to 4.7 percent from 2010 to 2013 (Exhibit 11).

Exhibit 11

Banks around the world struggled, with some exceptions



Source: Deutsche Bundesbank; McKinsey World Banking Intelligence; McKinsey Global Banking Pools

Operational productivity improvements through structural changes

German banking's CIR of 75 percent was the highest of the eight-country sample, and Germany saw the biggest increase between 2010 to 2013 and 2014 to 2017.[14] While CIRs also rose in other European markets, including Italy, Spain, and the UK, the increase was smaller and accompanied by improving RoE.

A key reason for Germany's underperformance is the market's three-pillar structure, which creates a highly competitive environment but prevents some of the structural evolutions seen in other markets. Another important factor is the fact that the German market is overbanked and therefore underpriced. Operating costs have also risen in recent years.

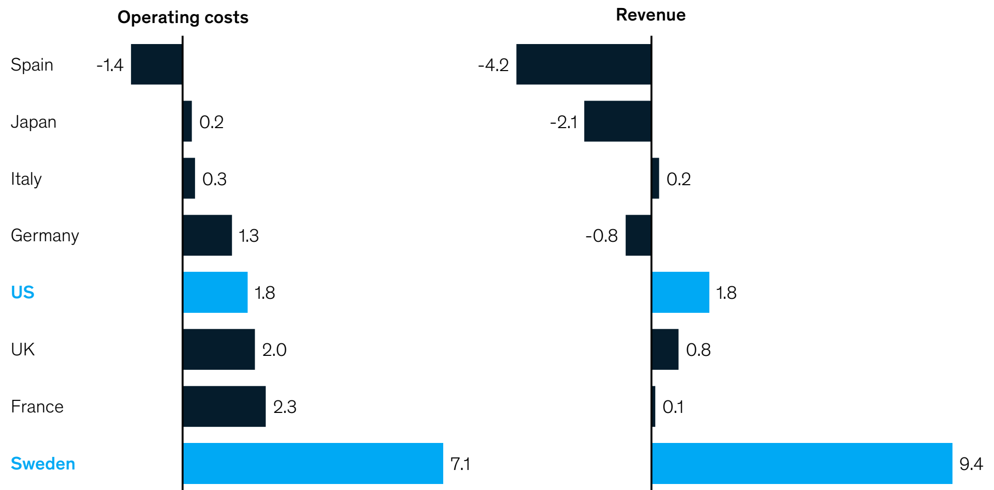
The US and Sweden are very different economies but were the only two in our sample that improved their CIRs between 2010 to 2013 and 2014 to 2017. The US and Sweden also outperformed on revenue generation from 2010 to 2017, albeit against a background of idiosyncratic economic, currency, and regulatory environments. Revenue growth also outstripped cost increases. This was – at least partly – driven by a less fragmented market structure and hence stronger pricing power (Exhibit 12).

Overall, better performing banking markets tended to lead on structural changes, manifested in consolidation, branch closures, and moves towards higher productivity.

Exhibit 12

Revenue growth in the US and Sweden outpaced increases in costs

CAGR 2010-17
Percent



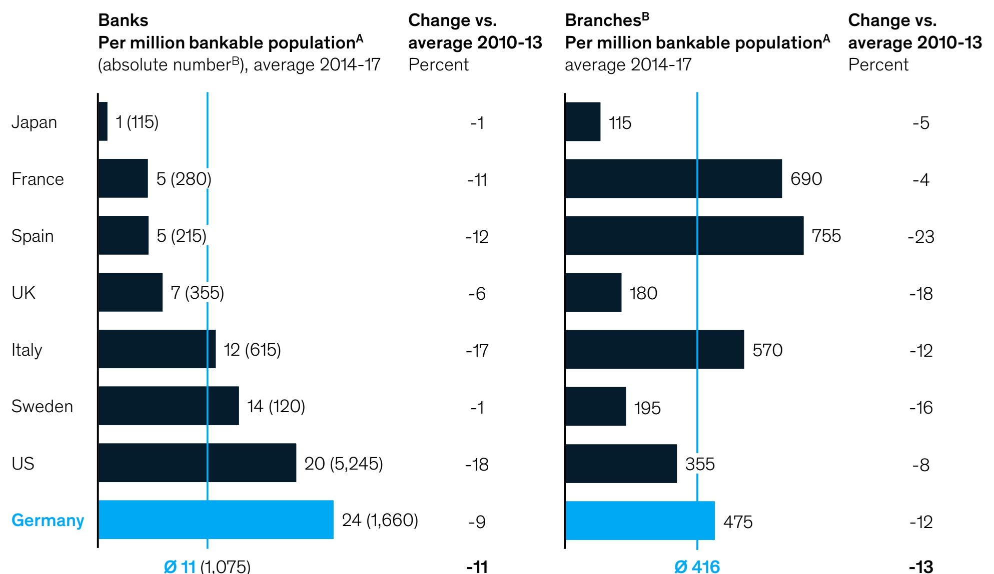
Source: Deutsche Bundesbank; McKinsey World Banking Intelligence; McKinsey Global Banking Pools

Bank consolidation

The number of banks in our sample of eight countries declined on average by 11 percent from 2014 to 2017 (versus 2010 to 2013), leaving an average of 11 banks per million bankable people. Germany, with 24 banks per million bankable people, had more banks than any other country, highlighting the market's fragmented distribution (Exhibit 13).

Exhibit 13

Germany has above-average numbers of banks and branches



A Bankable population defined as population of 15+ years of age
B Values rounded to nearest 5 or 10; Japan: domestically licensed banks, excl. post offices (number of branches incl. post offices: 330 per million bankable population)

Source: Deutsche Bundesbank; McKinsey World Banking Intelligence

Moreover, consolidation progressed more slowly than in most other countries, in particular compared with European markets such as France, Italy, and Spain. In the latter two, consolidation was propelled by regulators following the financial crisis.

Entrenched fragmentation was also evidenced by the relatively low 34 percent market share (by assets) of the top five banks. The top five banks in Sweden had an 83 percent market share. In France, the comparable proportion was 65 percent and in Spain it was 58 percent.[15]

Clearly there is more room for consolidation in German banking. Similar effects within and maybe even across the three pillars, however, may also be achieved by other means – for example, through shared infrastructure, utilities, outsourcing, and strategic partnerships.

We have seen signs of increased use of shared infrastructure, especially in the nonprivate sectors, where the two associations are already providing many back- and middle-office activities for their members, exploiting economies of scale.

Outside Germany, a wide range of nondifferentiating bank activities are already being shared. Participation in utilities has helped banks realize efficiencies and mitigate the impact of a tougher economic and regulatory environment. Sharing is increasingly common across different areas of activity. In sales, for example, ATM infrastructure and network management are often shared. Call center infrastructure and service provision are also more commonly being shared. In regulation and compliance, processes such as client onboarding, monitoring, and product approval are selectively in focus for sharing. Mobile and online payments activities are also often shared, as are payments processing, verification, and acceptance.

In addition, German banks are increasingly turning to outsourcing, although some have been more active than others. IT outsourcing, for example, has gained popularity in recent years, on average accounting for around half the IT budget. Knowledge-intense areas such as accounting and compliance, on the other hand, have seen much lower levels of outsourcing, and certainly low levels compared with international peers.

Another route to efficiency is strategic partnerships between banks and companies from other industries. These are seen in the retail and corporate banking segments. Partnerships in retail range from co-branding credit cards to point-of-sale financing in department stores. In corporate banking, we have seen attempts to build partnerships in areas such as trade finance and credit scoring, with banks aiming to join networks of financial service providers on large technology company platforms.

The number of partnerships between banks and FinTechs is also growing. These can create commercial opportunities that are often mutually beneficial. German banks tend to partner with client-facing FinTechs.

In conclusion, shared infrastructure, utilities, outsourcing, and strategic partnerships offer a variety of opportunities. The industry could certainly do more in these areas.

Branch closures

Branch numbers have fallen in all major banking markets, reflecting not only a drive toward greater efficiency, but what looks like a permanent shift in customer behavior and expectations. It is worth noting that, in some cases, large numbers of smaller, and therefore cheaper, branches may be preferable to low numbers of traditional branches with relatively high personnel costs.

Among the eight countries studied, the number of branches on average declined by 13 percent between 2010 to 2013 and 2014 to 2017, leaving an average 416 branches per million bankable people. The 12-percent decline in Germany was in line with the average. Germany is closing more branches than France and is on a par with Italy. However, it is lagging behind many countries, including Sweden, the UK, and Spain. In addition, from an absolute number perspective, Germany remains more highly branched than the average, with approximately 475 branches per million bankable people from 2014 to 2017.

Among European countries, only Sweden and the UK have less than 200 branches per million bankable people, after seeing branch closures amounting to more than 15 percent of the total from 2010 to 2013. In both countries, banks have replaced branch networks with comprehensive digital offers.

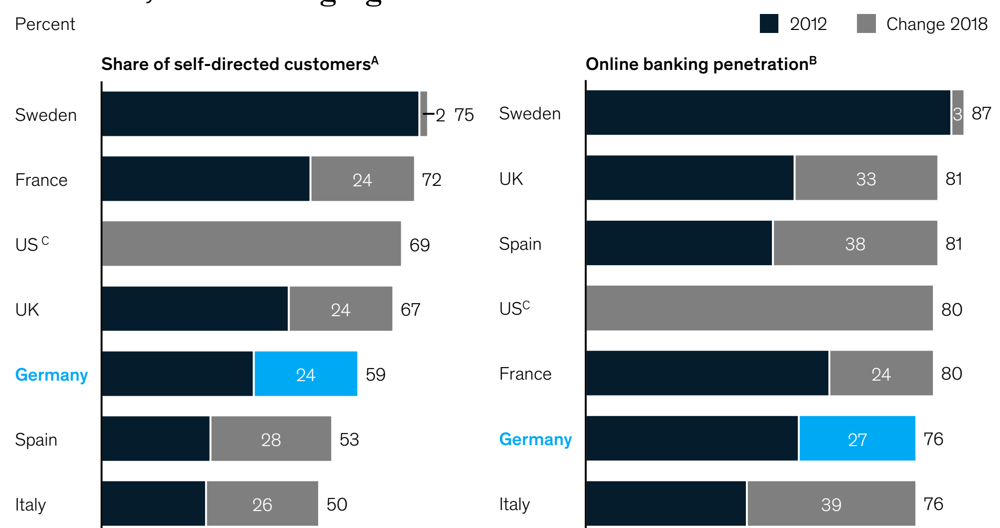
In the US, around half of the top 100 banks have reduced their branch presence by more than 15 percent since 2011. In addition, banks in the US and elsewhere are experimenting with new branch formats. Many are simplifying and digitalizing, adding self-service functionality, open concept design, and tellerless robo-services.

To improve operational productivity and address changing customer expectations, German banks still have significant room to enhance their online and mobile offers, cut branch numbers, and upgrade those that remain. But they need to act fast and go beyond digitalizing the client front end to optimize middle- and back-office processes.

For all markets in scope, online banking penetration and the share of self-directed customers have risen significantly.[16] While Scandinavian countries have traditionally been front-runners, customer behavior in Germany has also changed rapidly. The self-directed segment in Germany rose by 24 percentage points to 59 percent over the past four years, and more growth is expected if Germany is to reach the levels seen in other countries (Exhibit 14).

Exhibit 14

German consumer behavior lags behind shifts in other European countries, but is changing



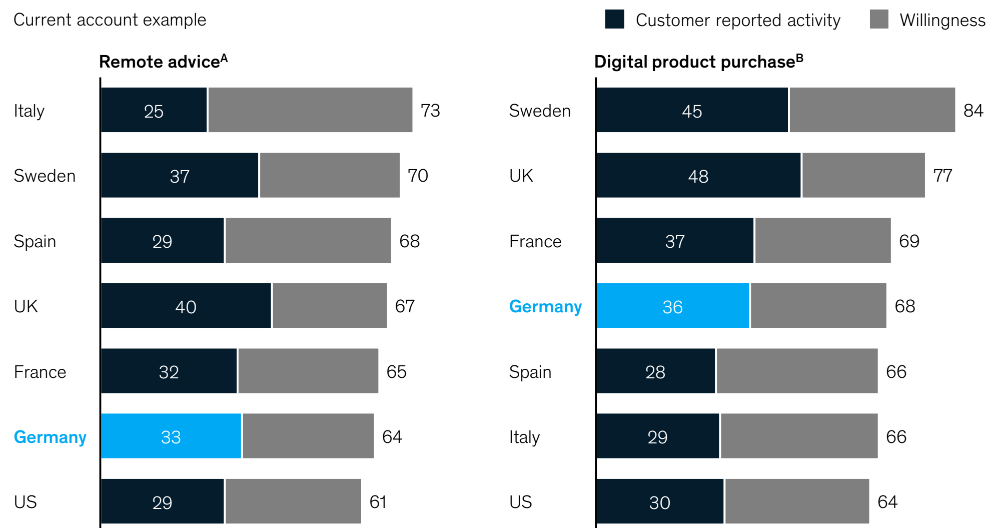
A Self-directed customers are digitally capable customers with a preference for transactions through remote channels
B Share of respondents that use online banking at least once a month
C US: 2012 data not available

Source: McKinsey Retail Banking Consumer Surveys 2012 and 2018

Indeed, German customer willingness to accept remote advice and digital sales is well above actual levels of activity. Uptake among current account holders is around 36 percent, while willingness is at more than 68 percent, indicating a chance for banks to respond to these dynamics more decisively (Exhibit 15).

Exhibit 15

Willingness for remote advice and sales is higher than activity



A Share of people having opened a current account that received advice through digital channels; willingness: share of respondents that would consider receiving "remote digital advice" for current account; includes respondents that answered "yes" or "maybe"
B Current account example

Source: McKinsey Retail Banking Consumer Survey 2018

Productivity increases

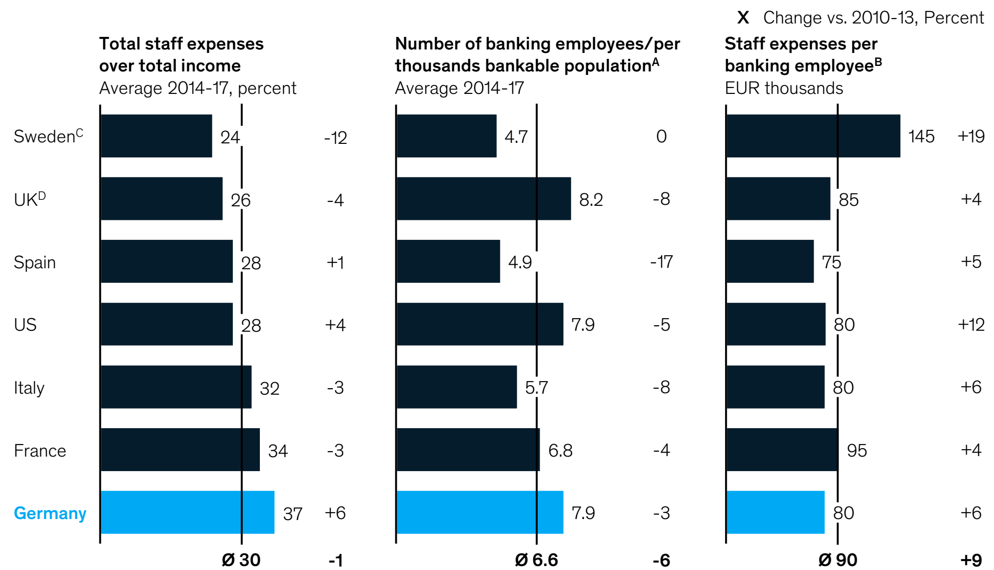
Many international banking markets have seen productivity increases in recent years, evidenced by a lower ratio of staff expenses to income. This was primarily driven by declining numbers of employees (average decline of 6 percent per million bankable people between 2010 to 2013 and 2014 to 2017).

Various factors have contributed to productivity increases, including branch consolidation and process simplification. In addition, banks in countries such as the UK have simplified organizational structures and reduced FTEs through management delayering, optimized legal structures, and cuts to noncore businesses.

Germany had 7.9 banking employees per million bankable people from 2014 to 2017, well above the international average of 6.6. Staff expenses per employee were below average (EUR 80.000 versus EUR 90.000). Nevertheless, the 37-percent ratio of staff expenses to income was higher than in any other country in the sample (Exhibit 16).

Exhibit 16

German personnel costs driven by high number of employees



A Bankable population defined as population of 15+ years of age; values rounded to nearest 100
B Values rounded to nearest 5 or 10
C Sweden: staff expenses estimated as percentage of general operating expenses
D UK: stable number of employees from 2015-16 assumed

Source: Deutsche Bundesbank; McKinsey World Banking Intelligence

To summarize, Germany – with its high and historically increasing CIR ratio – needs to radically tackle costs to compete internationally and meet changing customer expectations. There are three main levers: consolidation, which includes shared infrastructure, utilities, outsourcing, and strategic partnerships; fewer branches (including an enhanced offer for remaining branches and digitalized middle and back office processes); and higher sales productivity. The latter can be achieved through simplification and accelerated digitalization.

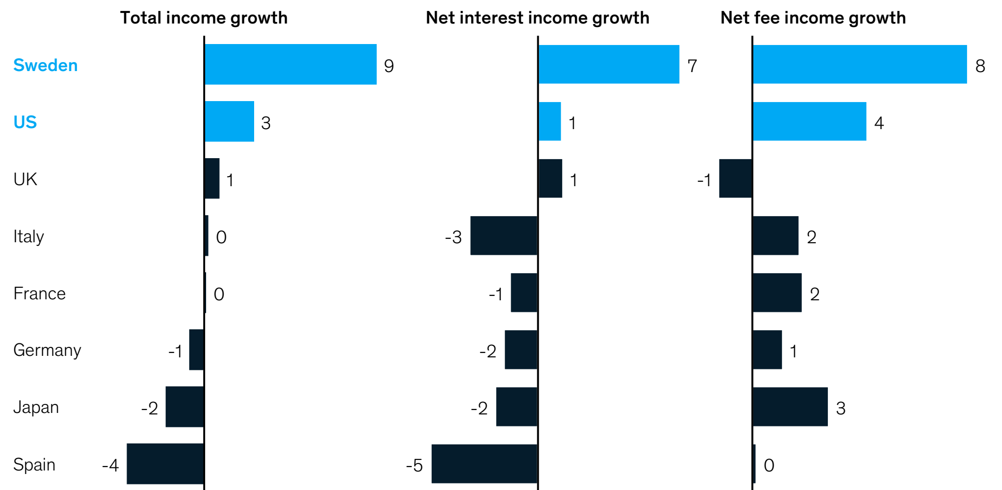
Tapping into new sources of revenue

The US and Sweden outperformed on revenue generation from 2010 to 2017, albeit against a background of idiosyncratic economic, currency, and regulatory environments. Banking sectors in other countries either flatlined or saw revenue decline (Exhibit 17). Swedish and US banks saw annual revenue increases of 9.4 and 2.7 percent, respectively, while the other countries saw average declines of 1.0 percent.

Swedish and US banks increased net interest income and fee income. Swedish bank net interest income rose by 7.2 percent annually from 2010 to 2017. US banks saw net interest income rise by an annual 1.2 percent. Fee income increased by 7.9 percent annually in Sweden and 4.2 percent in the US. By comparison, fee income growth in the other countries amounted to just 1.1 percent per year and interest income declined by 2.1 percent annually. Fee income in Germany increased by 1.1 percent annually. The rise, however, was offset by declines in net interest income.

Exhibit 17

US and Swedish banks outperformed on growth

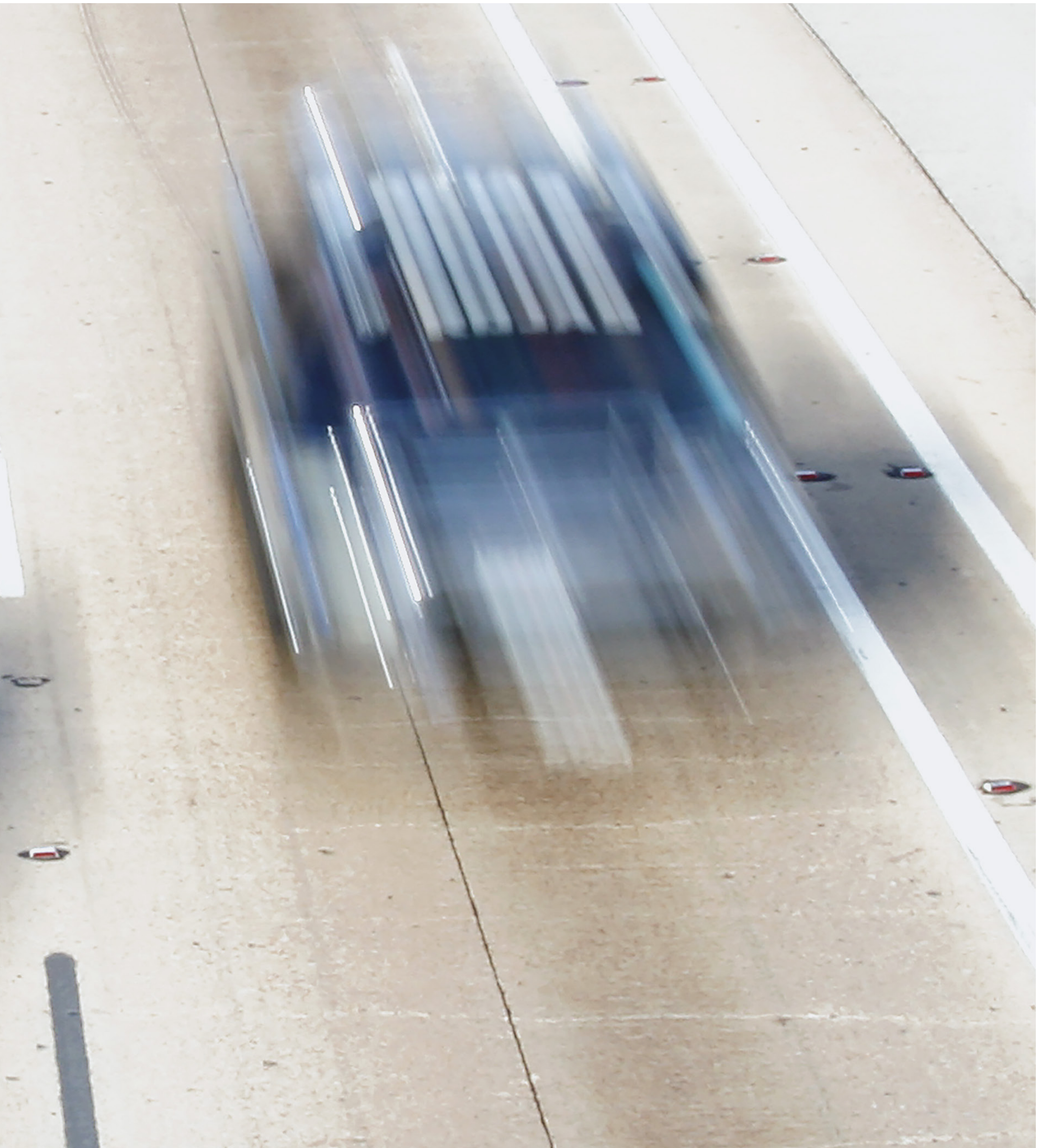


Source: Deutsche Bundesbank; McKinsey World Banking Intelligence; McKinsey Global Banking Pools

In summary, rigorous cost management is necessary to restore profitability, but it is not sufficient. Banks must also find ways to boost revenue. In the US and Sweden, revenue growth that outstripped cost increases was a winning formula. In Germany, however, recent efforts to raise fee revenue have often not been enough to offset declines in interest revenue. Furthermore, especially in corporate and investment banking, the risk associated with increasing fee revenue must be carefully weighed against potential revenue growth.

Real change and innovation in business models is required. We do see some markets and some players acting more decisively and faster than others, successfully monetizing new ways of engaging with their customers. Germany has some catching up to do.

03 A twin speed industry – leaders and laggards

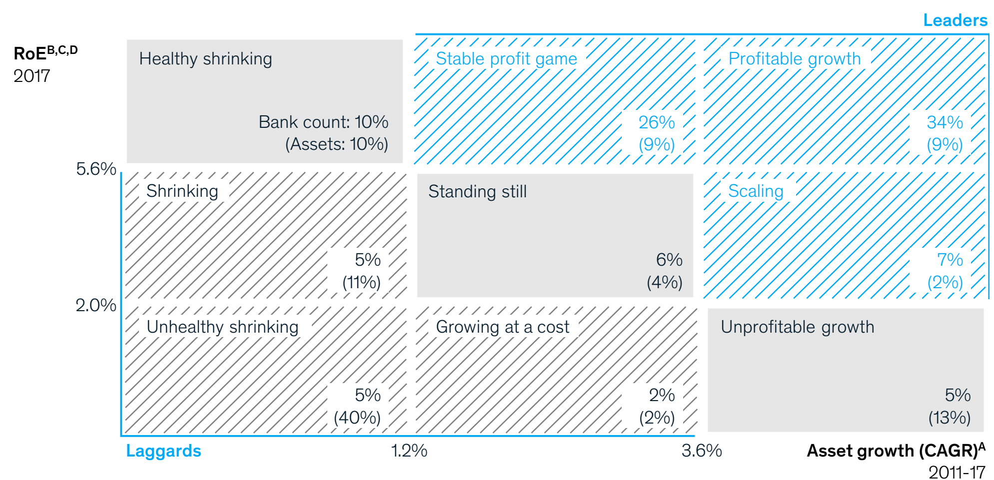


Among Germany's 1,600 banks, there are shades of gray in performance, with some segments consistently performing better than others.[17] An analysis of RoE in 2017 (net profit after tax and before transfers to funds for general banking risks) and growth (measured as the annual increase in balance sheet assets from 2011 to 2017) reveals nine performance segments, of which three represent outperformers (leaders) (Exhibit 18).[18]

In our analysis, the lower boundary for asset growth is set at the average annual inflation rate from 2011 to 2017, while the upper boundary is set at three times the inflation rate. The upper boundary for RoE is set in line with the 30-year average RoE in the German banking market, which is 5.6 percent. This is clearly below a realistic expectation for an average equilibrium RoE of 7 to 10 percent, which would be roughly in line with the minimum required to earn the cost of capital. This, however, is a proxy and highly dependent on the bank's business and, to a smaller extent, its ownership model.[19]

Exhibit 18

9 performance segments of which 3 are leading



A Lower boundary set in accordance with average annual inflation rate between 2011 and 2017 in Germany; upper boundary equals 3 times the inflation rate
B Upper boundary set in accordance with 30-year long-term average RoE in the German banking market
C Individual banks' profitability calculated based on net profit after tax and before transfers to the fund for general banking risks
D Including transfers to the fund for general banking risks (§340g HGB) into the RoE calculation would decrease profitability levels. The share of leaders would decrease to 41% by bank count and 13% by assets. The share of laggards would increase to 25% by bank count and 58% by assets. While this would shift the overall picture, it does not impact our discussion and conclusions on the segments

Source: Deutsche Bundesbank; McKinsey analysis

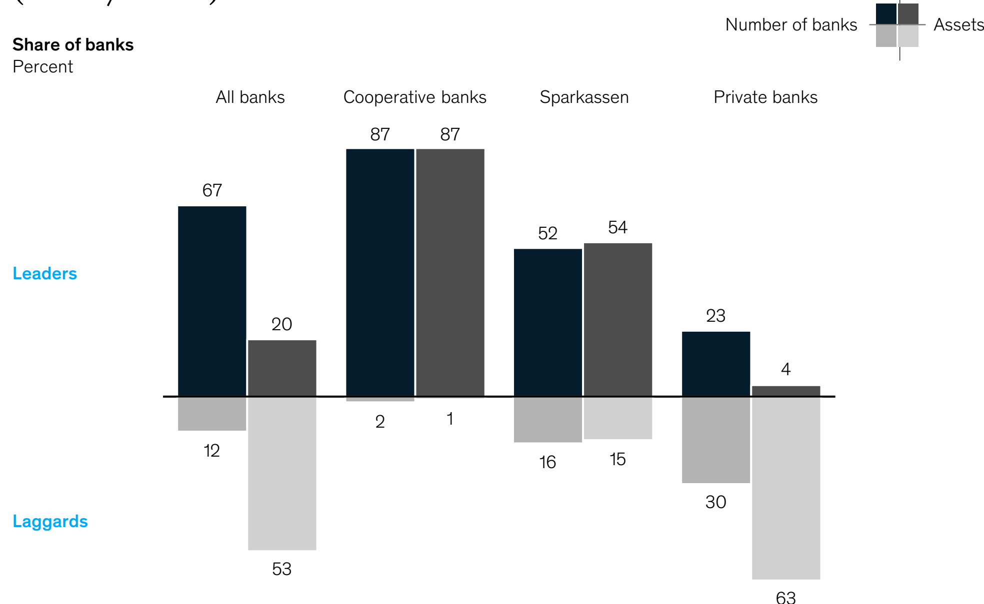
Leaders and laggards

The performance of the German banking market looks very different depending on whether it is viewed from the perspective of the number of banks associated with each of the nine performance segments or the proportion of assets in each. By number, a large proportion of banks (primarily Sparkassen and local cooperative banks) performed relatively well. By balance sheet assets, the picture looks less rosy, explaining the rather conservative RoE thresholds (Exhibit 19).

By number, 67 percent of German banks were leaders. They either saw stable profits (26 percent), grew profitably (34 percent), or scaled up (7 percent). Only around one-tenth were laggards, meaning they either shrank (5 percent), grew at a cost (2 percent), or contracted unhealthily (5 percent). Laggards had a significantly lower RoE than leaders and a higher CIR. While the RoE of laggards was 0 percent on average, the average RoE of leaders was 10 percent. On average, the CIR of laggards was 8 percentage points higher than that of leaders. About a quarter of banks were in the middle of the market. They either grew unprofitably (5 percent), shrank healthily (10 percent), or remained the same (6 percent).

Exhibit 19

Banks are under pressure to act – by assets 53% qualify as laggards (12% by count)



Source: Deutsche Bundesbank; McKinsey analysis

A view by assets paints a radically different picture, revealing that the positive result by number was driven by the high number of small and medium-sized banks, primarily local cooperative banks and Sparkassen. Of course, size per se is not a winning factor (although in many countries economies of scale hold). However, it can be considered a proxy for business model complexity – specifically in Germany. Typically, small and medium-sized banks have less complex and more focused business models, which has helped them perform better than larger banks since the financial crisis.

It is worth noting that the business model is more important than the ownership structure. Landesbanken, which have a more international and wholesale-focused business model (as do large private banks), performed similarly to large private banks, despite completely different ownership structures.

Less than one-third of banking assets beat the long-term average RoE of 5.6 percent in 2017. Just 20 percent were in "leading fields," while more than half were in "lagging fields." Some 40 percent of assets were in a state of unhealthy contraction from the affected bank's point of view, indicating meager RoE and limited growth.

The two very different pictures of the German banking market, depending on whether it is viewed by count of banks or by assets, points to a dichotomy. The majority of banks are under limited pressure to radically innovate or transform their business models, but a large share of assets is owned by a few banks that urgently require change.

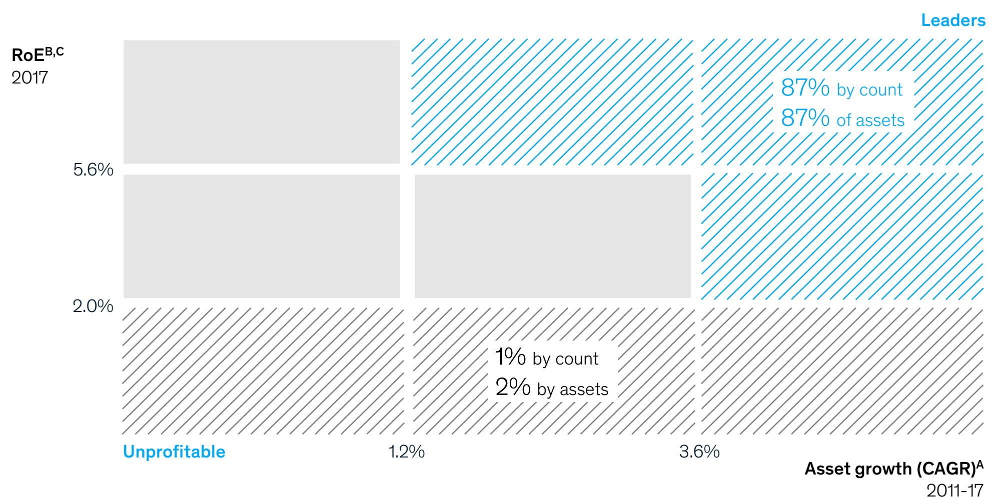
Local cooperative banks and Sparkassen – operational efficiency required to sustain success

Among local cooperative banks, there is a bias towards the right side of the matrix, the result of consolidation, leading to asset growth. Local cooperative banks had the highest share of banks in leading fields (87 percent by count of banks and 87 percent by assets) and the lowest share in laggard fields (2 percent by count of banks and 1 percent by assets). Moreover, only 1 percent of banks by count (2 percent by assets) fell below the RoE threshold of 2 percent (Exhibit 20).

Exhibit 20

Cooperative banks – more than 85% are in leading fields

Cooperative banks' asset growth driven by loan growth and consolidation



A Lower boundary set in accordance with average annual inflation rate between 2011 and 2017 in Germany; upper boundary equals 3 times the inflation rate
B Upper boundary set in accordance with 30-year long-term average RoE in the German banking market
C Individual banks' profitability calculated based on net profit after tax and before transfers to the fund for general banking risks

Source: Deutsche Bundesbank; McKinsey analysis

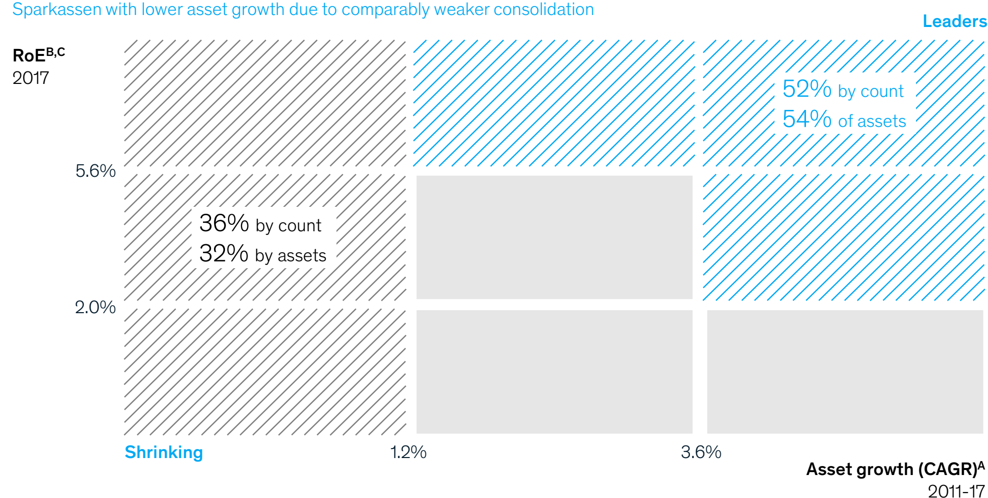
Similarly, Sparkassen generated stronger-than-average RoEs. By count, 71 percent (75 percent by assets) outperformed the long-term average RoE of 5.6 percent. Less than 10 percent (both by count and assets) generated an RoE below 2 percent.

However, Sparkassen did not see strong asset growth. An increase in customer loans in the retail and corporate segments between 2011 and 2017 was offset by a decline in accounts receivables to other banks. Some 36 percent of Sparkassen by count and 32 percent by assets shrank. Only 16 percent by number (15 percent by assets) grew their assets by more than 3.6 percent. This reflects the macroeconomic environment and regulatory changes, which led – among other things – to a healthy reduction in interbank claims (Exhibit 21).

Exhibit 21

Sparkassen – more than half are in leading fields but one-third shrank their asset base

Sparkassen with lower asset growth due to comparably weaker consolidation



A Lower boundary set in accordance with average annual inflation rate between 2011 and 2017 in Germany; upper boundary equals 3 times the inflation rate
B Upper boundary set in accordance with 30-year long-term average RoE in the German banking market
C Individual banks' profitability calculated based on net profit after tax and before transfers to the fund for general banking risks

Source: Deutsche Bundesbank; McKinsey analysis

The favorable position of both segments was explained by their ability to successfully navigate the low interest rate environment and limit negative effects from the financial crisis due to their simpler business models and narrow regional focus. They pursued loan growth and held risk costs low, also benefiting from the favorable economic climate. Low default rates allowed them to keep loss provisions at historically low levels and, in many cases, even release them.

Still, in the medium term, it is likely the credit cycle will turn and risk provisioning will return to normal levels. Rising interest rates may exert pressure before improving net interest margins come into play, suggesting the high-flying performance of Sparkassen and local cooperative banks may not be sustained. This is especially the case given their strong focus on low-margin mortgage products and heavy exposure to a property market that is potentially overheated in some regions. Moreover, higher corporate refinancing costs may lead to a spike in defaults. Sparkassen and cooperative banks have transferred substantial parts of their annual net profits to the fund for general banking risks (§340 g HGB), building reserves and augmenting core capital.

One notable trend among this group is that medium-sized and large banks (assets of over EUR 1 billion) have been more successful than smaller banks (assets less than EUR 1 billion). The proportion of leaders among large and medium-sized Sparkassen was 1.7 times that of small Sparkassen. Medium-sized banks were the most successful.[20] Moreover, the CIR of medium-sized and larger Sparkassen was, on average, 3 to 5 percentage points lower than those of smaller counterparts. This corroborates the theory that scale matters to achieve operational efficiency. However, economies of scale are contingent on proper control of business model complexity. Local cooperative banks, meanwhile, should take action to boost operational efficiency and unlock new sources of growth. By continuing to consolidate, use shared infrastructure, and reduce branch networks, they can cut costs. This, in combination with an enhanced online offer and development of new products and services – especially in retail and partially in corporate banking – can establish a base for further growth.

Of course, good governance is critical. Cooperative banks and Sparkassen must implement centralized and top-down decision making. In addition, they should make joint large-scale investments and use their local presence and customer proximity to gain an edge in customer understanding, tailored advice, and the customer experience.

Private banks – universal banks must reinvent their business models

Private banks saw higher levels of performance variability than other segments. By count, 13 percent of private banks were in the superstar field (profitable growth), while 20 percent were in the "unhealthy shrinking" category. Only 23 percent of private banks were leaders, while 30 percent were laggards.

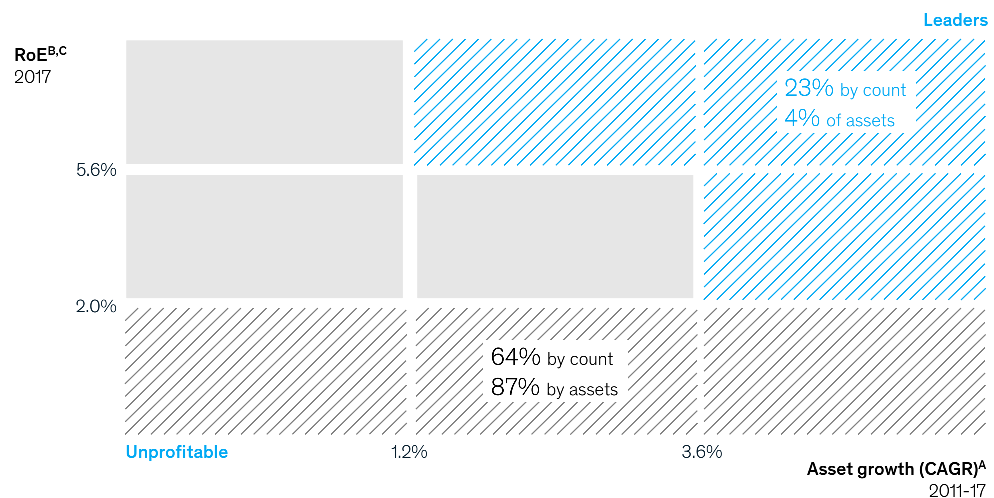
The picture, when viewed from the perspective of assets, was less positive. The majority of assets were in laggard fields and had an RoE below 2 percent. A mere 13 percent of private bank assets generated an RoE of more than 2 percent and 61 percent were "unhealthily shrinking." In many cases, low profitability was the result of past ventures into promising but risky businesses. And private banks are still processing the aftermath of the financial crisis. Just 4 percent of private bank assets were in leading positions (Exhibit 22).

Banks with the highest growth and profitability were operators of new, focused, and cost-efficient business models. This group included direct banks, foreign private banks and banks specializing in consumer finance and automotive loans.

Exhibit 22

Private banks – 64% with RoE below 2% (87% by assets)

Small, focused players were among leaders – large banks struggled



A Lower boundary set in accordance with average annual inflation rate between 2011 and 2017 in Germany; upper boundary equals 3 times the inflation rate
B Upper boundary set in accordance with 30-year long-term average RoE in the German banking market
C Individual banks' profitability calculated based on net profit after tax and before transfers to the fund for general banking risks

Source: Deutsche Bundesbank; McKinsey analysis

Banks with innovative business models — especially direct banks, consumer finance banks, and automotive banks – have been profitability leaders in recent years. Strong growth rates confirm that German consumers have started to embrace the fully digital business model. In addition, direct banks have achieved high levels of cost efficiency through lean operations, especially in IT, and simpler, more standardized products.

Large universal banks have struggled. Once acclaimed as world beaters that could exploit economies of scale and operate diversified portfolios, most have failed to deliver. Of course, economies of scale can be a benefit, as seen at some successful universal banks in Europe. However, size above a certain threshold has been a proxy for complexity in Germany. In fact, large private universal banks with assets over EUR 10 billion were overrepresented in the "unhealthily shrinking" segment. One reason is that most scale has been achieved through international and more complex wholesale businesses, which particularly suffered during and after the financial crisis. Many banks in the large universal segment struggled to manage the complexity of their operations and organizations. Still, while size did not play to their advantage, it might be an asset in the future, for example, when it comes to technology investment.

With regulatory requirements continuing to exert pressure, universal players have restructured and are shifting away from their traditional business models. Many have refocused on core activities and scaled back high-risk and complex businesses, reducing organizational complexity and cutting costs. For most, the new strategic alignment is a work in progress and has yet to translate into higher profitability.

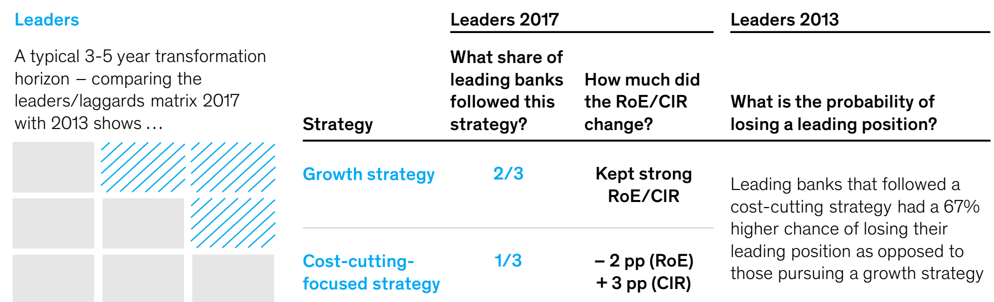
04 Accelerating reinvention of business models

Cost cutting is a must, but not a panacea

Most German banks have a structural cost problem. Despite numerous attempts to reduce costs, the cost base remains out of line with revenue generation. Further efforts are therefore a must. However, a narrow focus on cost reduction alone is unlikely to be sufficient. The performance of leading banks suggests that focusing on growth while managing the cost base is a better strategy (Exhibit 23).

Exhibit 23

Growth is a more productive strategy than cost cutting



Strategy	Leaders 2017: What share of leading banks followed this strategy?	Leaders 2017: How much did the RoE/CIR change?	Leaders 2013: What is the probability of losing a leading position?
Growth strategy	2/3	Kept strong RoE/CIR	Leading banks that followed a cost-cutting strategy had a 67% higher chance of losing their leading position as opposed to those pursuing a growth strategy
Cost-cutting-focused strategy	1/3	– 2 pp (RoE) + 3 pp (CIR)	

To become a leader, pursuing a growth strategy is more promising

Source: Deutsche Bundesbank; McKinsey analysis

We found that two-thirds of leading banks have successfully pursued a growth strategy, meaning they have either increased income and managed costs successfully or seen a proportionally stronger rise in income than costs. The other third focused primarily on cost cutting and saw no growth or the impact of cost cutting outweighed the impact of growth. Furthermore, leading banks delivering a growth strategy have been substantially more successful, maintaining an average RoE of 10 percent in recent years. Banks focused on cutting costs, meanwhile, have lost 2 percentage points of RoE on average while seeing an average 3 percentage point increase in CIRs.

Furthermore, an excessive focus on cost cutting is risky. It can kill growth momentum, negatively impact service quality, and damage customer satisfaction. In our sample, we found that the probability of dropping out of the leading group is 67 percent higher for those only delivering a cost-focused strategy.

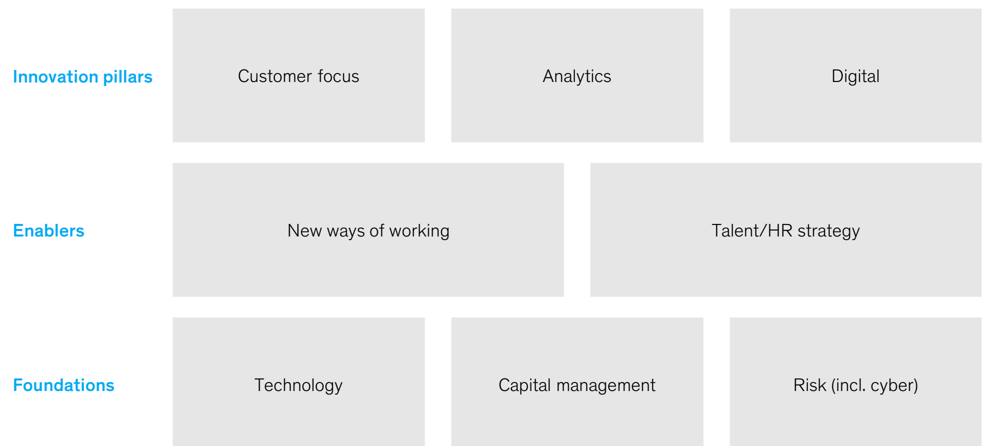
Three innovation pillars, two enablers, and essential foundations

The lesson of our analysis is that banks must work on costs and revenue in parallel. This is a significant management challenge but is certainly possible. In our view, this requires action in three innovation pillars: a laser-sharp customer focus, excellent analytics, and a full commitment to digital. This should be supported by two enablers: a complete change in how banks operate and the right talent and HR strategies. Essential foundations for these comprise enhanced capabilities in technology, capital management, and risk (Exhibit 24).

Still, we expect the success achieved by some banks in implementing these changes will likely come at the expense of others.

Exhibit 24

3 innovation pillars, 2 enablers, and strong foundations



Developing a laser-sharp customer focus

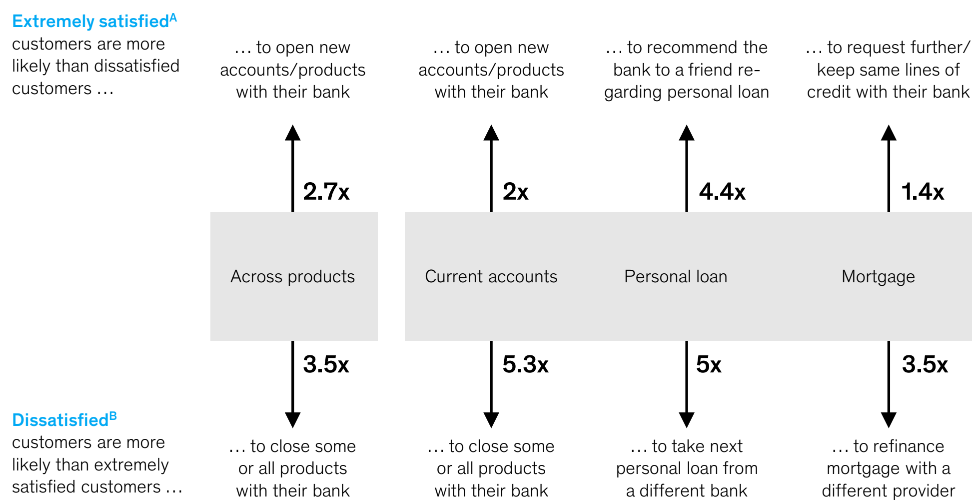
There is strong evidence that retail banks delivering a superior customer experience achieve higher levels of customer loyalty and stronger growth. Also, in corporate banking, it is important to win the fight for the customer, particularly in an era of new technology and rising threat of disintermediation. The imperative is reflected in the efforts we have already seen among corporate banks to join or create networks.

Retail customer satisfaction in respect to German banks is highly variable. However, customers who are "extremely satisfied" are far more likely to become valuable and engaged than those who are merely "satisfied," according to a recent McKinsey survey.[21] Extremely satisfied customers are 2.7 times more likely than dissatisfied customers to open new accounts or buy additional products, 4.4 times more inclined to recommend the bank to friends for personal loans, and 3.5 times less likely to refinance their mortgage with a competitor (Exhibit 25).

Exhibit 25

Banks can capture significant value by optimizing the customer experience

Stated intention to change behavior



A Customers whose CSAT rating overall for the bank or for particular product was 9 or 10
B Customers whose CSAT rating overall for the bank or for the product was b/w 1 to 6

Source: 2018 Retail Banking Customer Experience Benchmark Survey (Germany; N = 4,768)

The centerpiece of strategy should therefore be customer-centric sales and advisory across retail and corporate businesses. That means moving away from product-focused strategies to put the customer at the center of everything the bank does. This requires a transformation of sales tools and processes, expert steering, cutting-edge performance management systems and streamlined customer journeys. An important lever is relationship-based pricing, which increases customer satisfaction and can help protect margins and grow volume.

Some customer-focused banks have adopted a platform approach, augmenting their proposition with third-party offers that can serve customers across a much broader range of needs. Some banks, for example, have formed partnerships with firms in the housing market. Others have collaborated with vendors to offer a range of services around the car buying and selling process –including finding a vehicle, financing, insuring, maintaining, and ultimately selling it. These kinds of initiatives show an understanding that owning the customer relationship is key.

Finally, banks should more selectively define their target segments and markets and focus their business models accordingly. This will enable them to develop a much more focused offer than, say, an undifferentiated push into consumer finance or SME lending. At the same time, they should reduce commitments to noncore businesses, helping cut organizational complexity and costs. Without a differentiated value proposition, banks will largely compete on interest rates, potentially attracting unprofitable or excessively risky business.

FinTechs – blessing or curse?

Tamaz Georgadze (TG)
founder and CEO, WeltSparen / Raisin
Matthias Knecht (MK)
founder and CEO, Billie
Matthias Lange (ML)
managing director, FinLeap

Fintechs have long been seen as potential disruptors to the financial services industry. However, while they have significantly impacted the competitive landscape, true disruption has yet to materialize. In fact, collaboration is more common. Partnerships between banks and FinTechs have become more common, with 2017's 12 agreements comprising the most on record. We spoke with three leading Fintech CEOs to gain an understanding of where the industry stands and what banks can learn:

Tamaz Georgadze (TG)
founder and CEO, WeltSparen / Raisin

Matthias Knecht (MK)
founder and CEO, Billie

Matthias Lange (ML)
managing director, FinLeap

McKinsey: Do FinTechs represent a threat to banks, or is it more of an opportunity where these new offerings will help them to innovate?

MK: We see FinTechs as a cooperation opportunity for banks. Take the example of working capital financing: many established factoring players don't see our business model as their core competency and come to us with work-sharing proposals. They assume responsibility for sales and refinancing. They would very much like to purchase the complete engine at the center from us including API-based customer onboarding, risk scoring, and payment processing. One bank said to us it sees itself in the future as predominantly a brand. It's a banking brand where the customer feels at home. Where do the brakes, steering wheel, or tires of a car come from? Suppliers. You don't have to develop all the parts of the car yourself.

McKinsey: Just as in the automotive market, a strong OEM brand is supported by suppliers, who master their margins with complex, ambitious solutions or through efficiency. Do you think banks will be able to maintain the superiority of their brands and the trust of customers as new, untested brands appear on the market with no legacy problems?

ML: One key change that we are seeing is that many customers expect more banking services at the point of sale for higher convenience. Retailers like Amazon, for example, already offer direct financing for SMEs. Apple and Google have started their own payment solutions. This is toppling the traditional customer relationship of banks. We have therefore a stringent focus on B2B2X solutions. These trends will only grow in future.

TG: Many bank managers sense their margins collapsing in their core businesses. Many are even asking how they can continue to survive in the area. As a result, there is a clear motivation to become a platform. Those in the best position are the ones who can start fresh with their IT systems or transform their legacy systems. What is not advisable is to integrate digital interim modules in between that are supported by manual processes. Those that simply make their customer interface sleek and shiny but don't overhaul the back-end systems will remain inefficient in the long run.

McKinsey: What are the most important success factors for cooperation between banks and FintTechs?

TG: As I see it, there are two key factors. Firstly, the cooperation must be measurable, and above all offer satisfying results for both parties. Secondly, the more streamlined the decision structures, the better. If a dedicated business unit is in place for FinTech cooperation, or even with open banking structures that covers all the relevant functions (Legal, Compliance, etc.), the likelihood of success is far higher. What performs particularly badly is a combination of large bank, small cooperation project, and implementing it in test mode.

MK: Once the deal has been closed, implementation is crucial—it's vital to turn words into action. Many cooperation efforts look great on paper. If the project involves a sales cooperation between a bank and a FinTech, the sales force must be actively involved. Cooperation initiatives can only succeed with the corresponding training and financial incentives. If it remains purely the brainchild of a CEO, it won't work.

McKinsey: What can and must banks learn from you?

TG: Many banks lack the customer mindset—banks must have the courage to offer customers the best solution that is available on the market. Since banking services and products are relatively transparent today, thanks to digitization, the customer soon notices if a better offer becomes available. This is an area where many banks need to develop further. Another problem that we frequently see among banks is a lack of strategic cohesion and commitment. In other words, there must be a clear direction, freedom of decision, and responsibility at all levels in a bank to drive forward innovation.

ML: No one can predict digitization or look into the future and say what a fully digital bank will look like in 10 years. In today's fast-moving world, banks must take bold steps to learn quickly and develop the agility to respond to change. That's what essentially defines the FinTechs. Banks needs to ensure that they don't define a strategy on a five-year horizon that is stringently executed, but rather define a strategic direction that is regularly evaluated with a customer-centric approach — else newly developed products bypass the market as the world evolves in the meantime.

Using data and analytics to boost performance
Banks have access to vast pools of data about their customers' transactions and behaviors. They are therefore optimally positioned to use data to make better decisions and offer more tailored services.

Leading banks have started to put this into practice to drive revenue growth and reduce customer churn. Numerous use cases have been implemented. These have led, for example, to improvements in conversion rates through next-product-to-buy campaigns, detection of "hidden affluents," analysis of corporate cash flow and working capital, and improved customer retention through earlier detection of potential churn.

Other leading banks have implemented advanced analytics to reduce operational expenditure and risk, fraud, and compliance costs. One example is branch network optimization, which can result in 15 to 20 percent higher revenue and 5 to 30 percent lower network costs. Another useful innovation is early warning systems, which combine customer data input from multiple sources and apply machine learning techniques to proactively monitor loans and predict delinquency. This has allowed some banks to reduce NPL losses and more importantly, realize efficiency gains.

Finally, an emphasis on data and analytics encourages banks to implement a more efficient data governance and reporting infrastructure. Some banks have been able to significantly reduce IT costs through internal database consolidation and improved self-service functionalities for reporting.

Reaping the benefits of digital
Digitalization is the catalyst that can enable banks to continue moving away from a pure bricks-and-mortar distribution model and increase productivity. The result should be stronger growth and lower costs. Digital fuels growth by allowing banks to create and test new products and solutions much faster. It is also the key to optimizing the sales process. It enables an integrated multichannel offer and supports "smart relationship managers" who can take advantage of a range of advanced tools and processes.

On the cost side, digital allows banks to innovate on how they interact with their customers. Throughout the bank, the top 20 to 30 end-to-end processes usually account for 40 to 50 percent of the total cost base. Digitalizing and automating has the potential to reduce the cost base by 25 to 35 percent if radically pursued, in addition to completely transforming customer service. In the back office alone, automation can replace many time-consuming manual tasks. Automation of aspects of the mortgage process, for example, has delivered 30- to 60-percent cost savings in some cases.

Two transformation enablers and strong foundations

The three innovation pillars should be supported by two enablers in the form of new ways of working and a dedicated talent strategy. These must be accompanied by continued work on reinforcing foundations in technology, finance, and risk.

New ways of working
Leading banks across Europe have implemented new agile ways of working to unlock growth and cut costs. Many have established cross-functional, self-organized teams to work on transforming key processes through a customer-centric, end-to-end lens. In the process, they have simplified organizational models, aiming to optimize ways of working.

This has helped leading banks transition from a static, siloed operational structure to a networked approach focused on rapid learning and fast decision cycles. A culture of failing fast and empowering cross-functional teams has, in many cases, boosted efficiency and increased operational effectiveness. Furthermore, some banks have implemented flexible budgeting processes, enabling fast adaption to changing business needs. Many have introduced "management by transparency," meaning that decision making is much more open than in traditional organizations.

A dedicated talent strategy

Successful banks have reinvented their talent strategies to manage the transition to a digital- and data-driven era. They have attracted new digital talent from universities and industries such as telecommunications. In addition, they have improved digital readiness through training, new career paths, and changes in performance assessment. Some banks have successfully implemented a zero-based HR strategy focused on skills rather than tenure or hierarchy.

Still, in a tight labor market, banks will continue to struggle to hire and train employees on essential technological and digital skills. Germany will be short of 700,000 employees with "future skills" by 2023, according to a McKinsey report.[22]

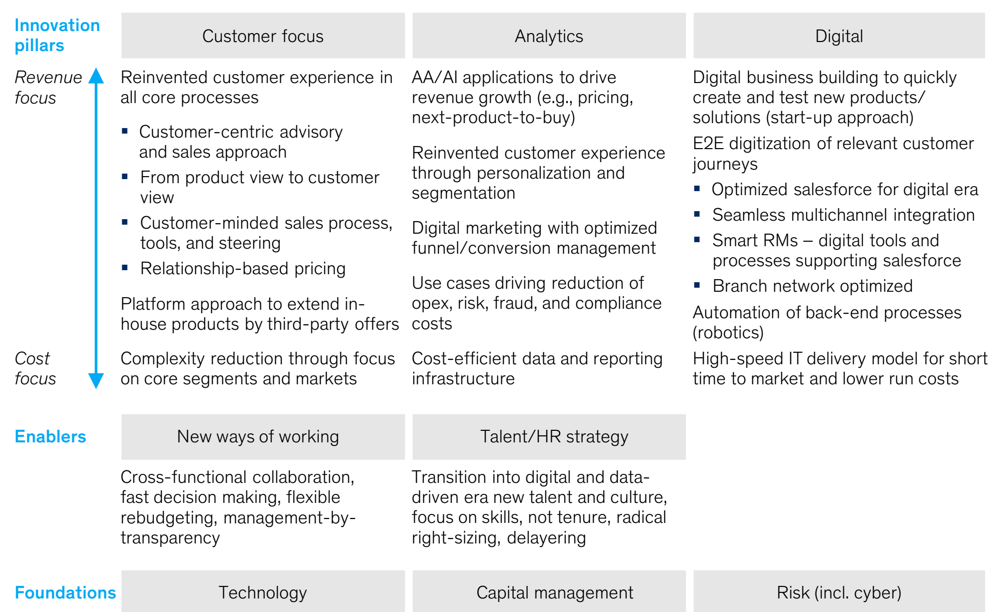
Some leading banks have successfully dismantled complex, multilayered hierarchies and functional silos and introduced delayered, flat structures. Active delayering and rightsizing have led to lower personnel costs and increased productivity. Removal of middle management layers has helped some institutions reduce staff expenses by up to 30 percent without sacrificing productivity.

Efficient technology, robust capital management, and optimized risk management

Change must be built on firm foundations in technology, capital management, and risk management (Exhibit 26).

Exhibit 26

3 innovation pillars, 2 enablers, and strong foundations



Source: McKinsey

Many banks suffer from limited technological flexibility and face escalating costs associated with legacy IT systems. Some have adopted a two-speed approach to technology renewal, allowing them to develop their customer-facing capabilities faster, control costs, and increase speed and flexibility in creating new solutions.

In the current low-interest-rate environment, many banks have pursued aggressive loan growth, which has added to risk-weighted assets and constrained other growth opportunities. Effective capital management is required to anticipate changes and adapt business practices early.

Finally, banks must hone their ability to manage risk, and new risks in particular, such as those emanating from cyberthreats. Trust is one of the industry's key assets. Once lost, it can be very difficult to regain.

German banking needs to think in terms of transformation rather than tactical measures. That means focusing on a sustainable model for the future and moving on from the effects of the financial crisis. Consolidation may be part of the answer. However, banks must also pay attention to their own business models, embrace a stronger customer focus, and invest in analytics and digital to sustainably boost top-line growth and strengthen the bottom line. Each bank must identify its priorities and commit to following through, even in the face of challenges. Difficult macro conditions, meanwhile, should not be an excuse to change direction or refocus on short-term measures.

Finally, time is of the essence; in an era of increasing competition and accelerating change, only those willing to be decisive are likely to emerge as winners of the future.

Endnotes

1 The road ahead – Perspectives on German banking, March 2016.

2 Four Eurozone markets (France, Germany, Spain, Italy), two European non-Eurozone markets (Sweden, the UK) and two non-European markets (the US and Japan).

3 Based on net profit after tax and before transfers to the fund for general banking risks (HGB 340g).

4 As in our 2016 report, we distinguish the following bank segments: private banks (domestic and foreign), savings banks, cooperative banks (local and central), other specialized banks (Bausparkassen, real estate banks, and development banks).

5 Includes all banks that are both monetary financial institutions (MFIs) and credit institutions as defined in the German Banking Act (Kreditwesengesetz – KWG) and are domiciled in Germany. Foreign business activities of German banks are only reflected to the extent that they are conducted by a legally dependent foreign subsidiary or branch. With regards to foreign banks operating in Germany, their legally dependent branches (in accordance with § 53 KWG) are considered. The definition of local banking market follows the reporting convention of the respective central banks in each country.

6 Includes write-offs and write-downs in respect to financial investments (participating interests, shares in affiliated enterprises, and securities treated as fixed assets). 2010 to 2013 most notably reflected extraordinary write-downs on Greek government bonds. Moreover, nonoperating expenses include charges from losses absorbed and extraordinary charges (e.g., restructuring charges).

7 As in our 2016 report, we distinguish the following bank segments: private banks (domestic and foreign), savings banks, Landesbanken, cooperative banks, other specialized banks (Bausparkassen, real estate banks, and development banks).

8 We calculate the return on equity based on net profit after tax and before transfers to the “Fonds für allgemeine Bankenrisiken” (Fund for General Banking Risks) (§340g HGB). This follows the approach of Deutsche Bundesbank’s monthly statistics of the banks' profit and loss accounts and views transfers to the fund for general bank risks in the context of profit appropriation without an effect on net profit in the income statement. Other approaches recognize transfers to the fund for general bank risks as an expense in the income statement with a diminishing effect on profitability. Sparkassen and local cooperative banks in particular have used profits to augment special reserves, providing for future losses. German law allows for the transfer of profits into the “Fonds für allgemeine Bankenrisiken” (Fund for General Banking Risks) for this purpose. As a result of building equity reserves and tier 1 capital, RoE after transfers or withdrawals from the fund remained relatively stable at 3 to 5 percent.

9 Numbers do not include legally independent foreign subsidiaries or branches.

10 The cost-to-income ratio measures general operating costs as a percentage of operating income.

11 Other administrative costs include, among other items, IT costs, rent and equipment expenses, professional service fees as well as amortizations and value adjustments on intangible and tangible fixed assets.

12 Number of employees calculated in accordance with § 267 Abs. 5 HGB as reported in context of banking supervision, audit report regulation (special data). Annual number of employees calculated as average of quarterly numbers. Part-time employees are considered on a pro rata basis. Apprentices are excluded. Data sources and methodology differ from Deutsche Bundesbank Monthly Report, which is based on data provided by associations (see Deutsche Bundesbank, September 2018, Monthly Report, p. 40).

13 Thereof four European Eurozone markets (France, Germany, Spain, Italy), two European non-Eurozone markets (Sweden, UK), and two non-European markets (US and Japan); China excluded.

14 A bank’s CIR has limitations as a measure of performance. First, the CIR is not a perfect measure for cost efficiency but rather profitability since it is also driven by a bank’s income. Second, income is largely dependent on net interest margins and thus the market structure in which a bank operates.

15 A different perspective on Germany is possible if the savings and cooperative pillars are viewed as a single bank. This would imply a top five share of 78 percent. Despite all efforts to foster cooperation, the assumption is not easy to justify given the competition (even if only limited) in the Sparkassen and cooperative segments.

16 Digitally capable customers who prefer transacting through remote channels.

17 There are 1,531 banks included in this analysis based on data availability: 912 local cooperative banks, 389 Sparkassen, 167 private banks, and 63 other types of banks.

18 Of course, asset growth alone is not the goal. This is only desirable if it leads to additional profit for the business and can be handled within the bank’s risk appetite.

19 Following the hypothesis that 7 percent might be a minimum required RoE for a bank, only 56 percent of banks (and 25 percent of banking assets) show this profitability. The asset growth dimension in the analysis is not corrected for inflation and not adjusted for mergers.

20 Not adjusted for mergers.

21 McKinsey’s 2018 Retail Banking Customer Experience Benchmark in Germany – a detailed survey of 5,000 customers of 19 banking institutions.

22 Future Skills: Welche Kompetenzen in Deutschland fehlen, Deutscher Stifterverband in cooperation with McKinsey & Company, 2018.

Final remarks

Data sources
This report is based on data from the Deutsche Bundesbank, McKinsey Panorama and World Banking Intelligence, and other public sources.

Moreover, we draw on the thinking of leading McKinsey clients and our own experts as well as practitioners in Germany and around the world.

In this report, we use data from the McKinsey World Banking Intelligence, a comprehensive database that compiles data on local banking markets based on the reporting of the respective national central banks.

Sample
With regards to the German banking market, the sample includes all banks that are both monetary financial institutions (MFIs) and credit institutions as defined in the German Banking Act (Kreditwesengesetz – KWG) and are domiciled in Germany. Foreign business activities of German banks are only reflected to the extent that they are conducted by a legally dependent foreign subsidiary or branch. With regards to foreign banks operating in Germany, their legally dependent branches (in accordance with § 53 KWG) are considered. Please note that this sample definition differs from Deutsche Bundesbank's monthly publication "Performance of German credit institutions."

With regards to foreign banking markets, definitions follow the reporting convention of the respective central banks in each country.

Complementary resources
For further input, please see complementary McKinsey reports, e.g.:

— Global banking annual review: "New Rules for an Old Game: Banks in the Changing World of Financial Intermediation," November 2018

— Corporate banking: "Building the corporate bank of the future," May 2017

— Retail banking: "Retail Banking Customer Experience Benchmark in Germany," January 2019.

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