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German Retail Banking Practice

COVID-19: The next normal for German retail banks

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A human tragedy and a moment of truth for retail banks

COVID-19 has changed lives drastically. Daily reports of the immense human impact across the world are harrowing. Meanwhile, thousands of health professionals are heroically battling the virus, putting their own lives at risk. There is uncertainty about tomorrow: about the health and safety of loved ones, and about the potential for returning to the lives we once knew. In addition, there is fear about the severe economic downturn that may result from a prolonged battle with the novel coronavirus.[1] It is not only a health crisis of immense proportions we are facing, but also an imminent restructuring of the global economic order.[2]

In the same vein, the challenges for banks are immense. They include both commercial and operational challenges, such as the shift to digital interactions and introduction of remote working.

There are also considerable challenges for the lending book, as households increasingly struggle to repay their mortgages and other loans while small and medium-sized businesses (SMEs) are hit by liquidity shortages in the face of both demand- and supply-side shocks. As they seek to respond to the immediate crisis, in the short term, banks and fintechs face the pressing challenge of continuing to serve their customers and getting the best out of their operating model. Taking a longer-term perspective, many banks are now considering how to position their organizations for the post-crisis era. Yet the first question they need to ask is: “What will the new normal look like?”

We don’t know how long the crisis will last, but it is likely that when we do eventually emerge from it we will find a world that bears little resemblance to the “normal” we had grown accustomed to.

How banks respond to the coronavirus pandemic will have an impact on customers, employees, and, indeed, the economy at large. As deposit gatherers, credit guarantors, and payment facilitators, banks are among the financial institutions most closely connected to the public. While the near-term humanitarian challenge looms large, the crisis is also likely to add fuel to the fundamental evolution of customer behavior already in progress. As people shelter in place, they are rapidly accelerating their adoption of digital technologies, among them videoconferencing, peer-to-peer payments, and online banking. This increasing familiarity with digital technologies and decreased reliance on physical branches could add speed to the transformation of the banking landscape, giving banks with stronger digital capabilities an advantage. In China, for example, digital engagement increased sustainably as the coronavirus began to spread, even among the older generation. The share of consumers older than 45 using e-commerce increased by 27 percent from January to February 2020, according to Chinese market-research firm QuestMobile. Those customers who find the experience positive might well change their behavior permanently.[3]

1 McKinsey Insights: Safeguarding our lives and our livelihoods: The imperative of our time
2 McKinsey Insights: Beyond coronavirus: The path to the next normal
3 McKinsey: Adapting customer experience in the time of coronavirus

Changes today will become the "next normal"

The financial crisis of 2008-2009 had a huge impact on the financial industry, businesses, and consumers around the globe. After sustaining considerable losses, several German banks had to tap government rescue funds in order to stabilize their capital base. A critical consequence was a massive erosion of the banking industry's reputation, as banks were generally seen as the culprits. In particular, the credibility of bank executives was comprehensively shredded on account of the vast bailouts that followed Lehman's collapse.

The situation today is different. In the current crisis, customers appear to be moving closer to their banks as they puzzle over the future of the economy and struggle to repay their loans. Other sectors—for example, the automotive and travel industries—will likely be hit harder by a downturn. Financial services firms, on the other hand, seem better poised to weather the storm, thanks in part to their strengthened capital positions as a result of regulation introduced in the wake of the financial crisis.

However, many banking customers will face financial distress due to job losses or shifts to part-time work, which could increase demand for new loans and erode their ability to pay back existing loans. More than half of German retail banking customers view their personal financial situation as weak, with some expecting it to worsen in the next three months, according to our McKinsey research. One third of German retail banking customers are concerned about job security, with most reporting savings of eight months or less to live off.[4] At the same time, governments are accumulating debt to support local economies and fight rising unemployment rates.

Looking to the future, many of the changes brought on by the crisis are likely to prevail. If German retail banks act boldly today, they can emerge from this deeply challenging time with renewed strength and maneuver into a position from which they can support a return to stability for the people and businesses they serve.

Backed by the regained customer trust, they can overcome legacy structural problems and optimize their business model in multiple dimensions, i.a. digitization and agility, the branch network, and as well as profitability and efficiency (Exhibit 1, page 4).

Digitization and agility

Usage of digital offerings has increased dramatically since the spread of the coronavirus pandemic (one example: finance app downloads jumped 25 percent in the United States from January to mid-March 2020).[5] Before the crisis, German consumers were less inclined to use online and mobile banking compared with their European peers. Indeed, around 81 percent of Swedish consumers used mobile banking at least once a month in 2018, compared with only 45 percent of German citizens, according to the McKinsey Retail

4 McKinsey Financial Insights Pulse Survey
5 Giuseppe Rondinella, "Corona-Krise lässt App-Downloads in die Höhe schießen," March 25, 2020, www.horizont.net.

Exhibit 1

If German retail banks address changes, they can overcome structural problems, optimize their business model, and regain trust within society.

	Digitalization and agility	+	Branch network	=	Profitability and efficiency
Short term (COVID-19 + 6 months)	Growth in contactless, card-based and online payments Need for emergency measures such as repayment suspensions		Remote work and branches closed, customers need to get used to self-servicing via online functionality or lobby terminals		Reduced account openings, more difficult risk modeling of new and existing lending activity
Longer term (>6 months)	Lasting change of customer behavior towards digital Demand for extensive digital offerings/digital customer journeys		Lasting change towards self-servicing Demand for hybrid advice models and new branch formats		Economic downturn with decrease in loan volumes and increased demand for safe products Efficiency gains through digitization and new branch setup

TRUST

Source: McKinsey analysis

Banking Consumer Survey.[6] While the most common reasons German respondents cited for not using digital banking solutions were security and trust concerns, it is also true that online banking has not been seen as a necessity in a market with a bank branch around every other corner. However, the survey also showed that while only few German consumers use remote solutions, their willingness to do so is much higher. While 64 percent of respondents reported they were willing to obtain remote advice, only 33 percent did so. Survey responses regarding the purchase of digital products reveal a similar dynamic: 68 percent of consumers were willing to purchase digital products, but only 36 percent did so.

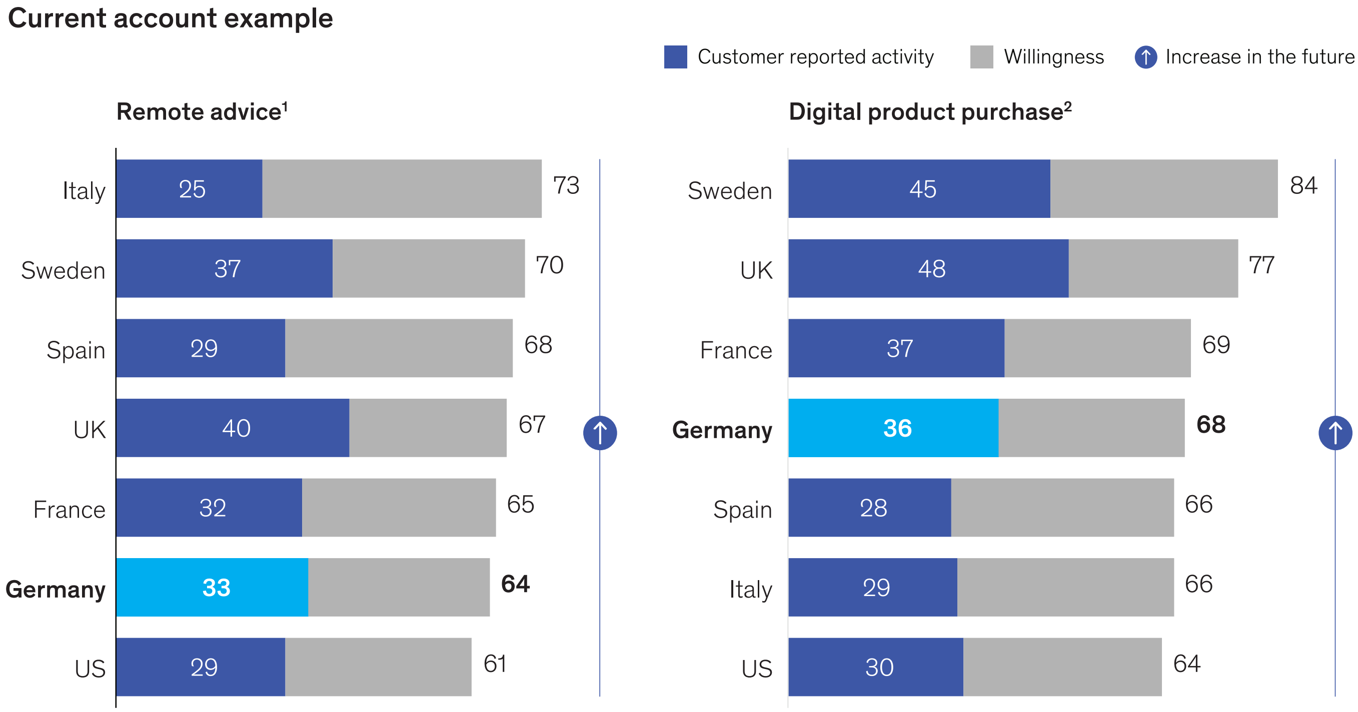
Now that even the bank around the corner is out of reach for millions of customers sheltering at home, many more consumers in Germany are using online banking services, despite their concerns. If banks provide a superior digital experience for these new digital users, and improve their digital products and services, the recent gains in digital share may consolidate into a lasting movement (Exhibit 2).

Physical Point-of-Sale (POS) business can be expected to drop significantly due to the lockdown, leading to a decrease in total card payments by as much as 50 to 60 percent in the short term. Even though online sales are expected to grow during the coronavirus pandemic, they will not be able to offset the decrease in POS payments. Moreover, since online payments are dominated by international players such as PayPal (market share of more than 20 percent in Germany), German banks are unlikely to benefit much from this increase. Yet, the move toward digital can also be seen in offline payments. To avoid physical contact in stores and the use of hard currency, otherwise cash-loving German consumers are increasingly using cashless and contactless payments: more than 50 percent of all card payments are now contactless, compared

6 McKinsey Retail Banking Consumer Survey 2018

Exhibit 2

Willingness to accept remote advice and digital sales in Germany is well above actual levels of activity – banks need to respond more decisively.



[1] 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'
[2] Current account example
Source: McKinsey Retail Banking Consumer Survey 2018

with 25 percent before the crisis.[7] Moreover, card operators have announced their intention to increase the maximum amount allowed for contactless payments from EUR 25 to EUR 50 in response to the crisis, thus eliminating the need to enter a PIN for small purchases.

In the longer run, once the "next normal" has set in, the retail banking segment (both banks and fintechs) will see increased demand for digital offerings due to a lasting change of customer behavior toward digital. Retail banks should act now to set the stage for a rapid expansion of digital offerings and enhanced digital customer journeys. This could require a reprioritization of the existing project portfolio and increasing efforts to build new remote-fulfillment capabilities.

This effort can be supported by digital marketing (e.g., search engine optimization and digital marketing capabilities as well as digital marketing platforms) targeting new customer segments, as well as campaigns that promote online banking services. By reaching out to customer segments largely new to online banking, such as the elderly, banks can make digital channels an attractive alternative for customers who might otherwise quickly return to branches once the crisis is over.

Banks' ability to respond to the current crisis is a manifestation of their level of agility. Customers need help navigating through these challenging times. Many banks have already reacted with emergency measures such as repayment suspensions for loans and mortgages, or waived merchant fees for card payments, resulting in increasing acceptance of card payments in shops. Moreover, German banks have worked with the government and KfW Bank to ensure support for the self-employed and SMEs. Fintechs are offering SMEs quick digital access to KfW funds. Cooperative banks have quickly developed promotional loans for SMEs, a solution that allows credit decisions to be made within minutes. Moreover, many cooperative banks have even enabled online application for these loans.

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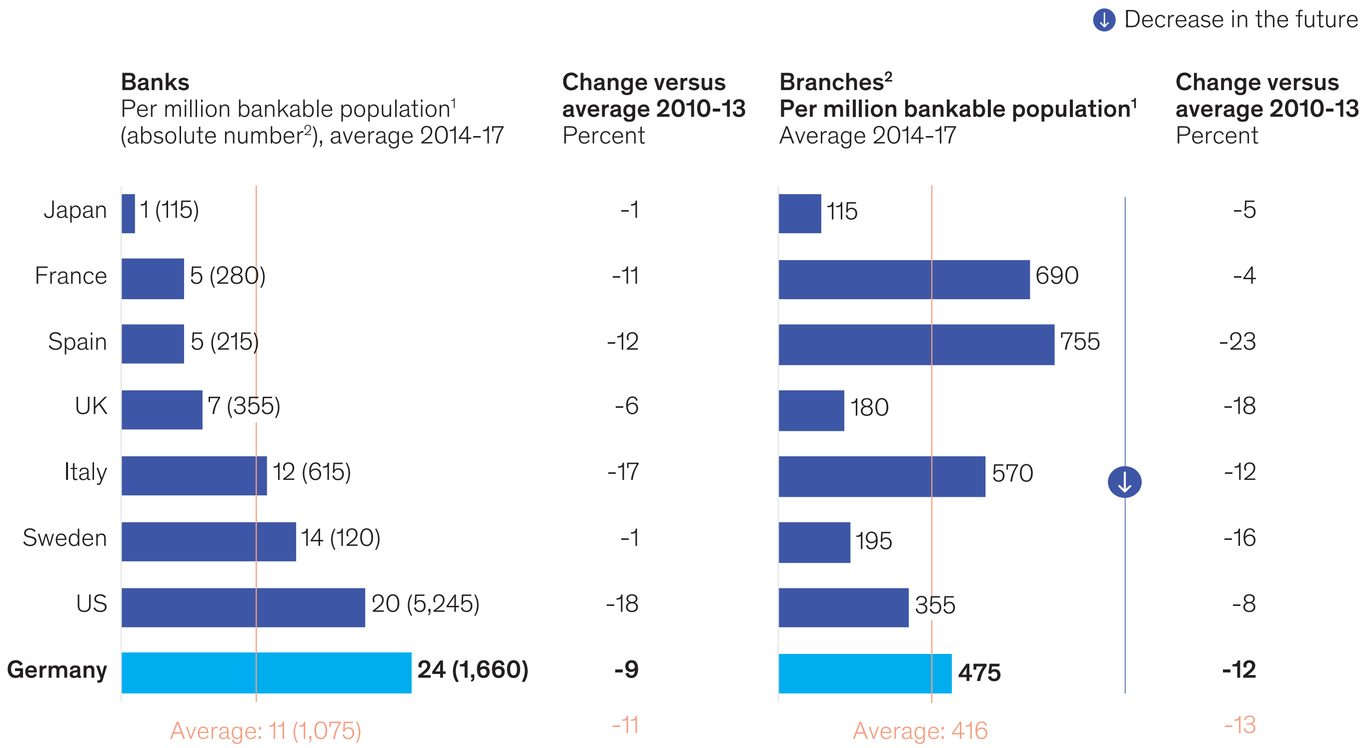
Exhibit 3

Germany has an above-average number of banks and branches, highlighting the market's fragmented distribution.



1 Bankable population defined as population of 15+ years of age
2 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

Branch networks

Today, most non-branch staff of German retail banks are working remotely or in split teams, but branches are also being impacted heavily by the pandemic. Savings and cooperative banks as well as private banks have closed many branches, and it is unclear when they will open again. Some German retail banks closed around 70 percent of their branch networks to help prevent the spread of the virus. Many retail banks opened branches to the public in an alternating manner in order to secure Germany-wide access to banking services. Some banks closed their entire branch network, leaving only self-service zones open while actively promoting their digital banking services. The volume of business transacted through call centers skyrocketed, an indication of their acceptance by customers as a new channel for obtaining advice.

Will digital channels completely replace branch offices in Germany? Probably not: historically, Germany has always been a market with a large number of branch offices. Branch density, at 475 branches per million bankable population, is well above the international average of 416 branches[8] (Exhibit 3). The process of consolidation that has been taking place over the last 15 to 20 years will likely be accelerated by the crisis.

It is probable that some banks will completely switch from a branch-based distribution model to a digital, largely remote business model.

Yet, even if the openness of German customers to digital solutions is increasing overall, a substantial share probably still need—or prefer—to buy products at a branch office. Hence, retail banks should pave the way for lasting change in customer behavior by rethinking the branch footprint, but also enhance digitization and modernization at those branches they do keep open. Hybrid advice models and new branch formats such as flagship stores have been shown to increase both customer satisfaction and bank

8 McKinsey World Banking Intelligence

profitability. Excess capacity due to a reduced and more digitized branch network can be redeployed to sales support or other support functions.

Profitability and efficiency

The coronavirus crisis is already having an impact on the profitability and efficiency of some banks and fintechs. One German neobank reported a 10 percent drop in account openings in certain markets. Moreover, their revenues from payments in Italy went down by as much as 30 percent as of March 2020. Lending in particular will play a critical role. Demand will grow in the short term, given the importance of securing liquidity for companies and the self-employed. However, risk modeling for new and existing lending activity is getting extremely difficult in the current environment and risk costs are expected to increase. Overall, the slowdown in economic activity and growing unemployment will result in an increase in non-performing loans and, in turn, the deterioration of asset quality in loan portfolios.

In the long term, banks are likely to see efficiency gains through digitization and new branch formats. Moreover, the relevance of “trust” may increase after the crisis. There is already a greater appreciation of system-critical professions. As critical services, banks (along with supermarkets, pharmacies, and a few other business categories) have been permitted to stay open during the lockdown. Provided they use this privilege to primarily focus on supporting their customers, banks should benefit from increased trust. (This is in sharp contrast to the impact the 2008 financial crisis had on the industry's reputation.) Many banks have already implemented corresponding measures, such as offering additional liquidity and repayment suspensions for retail customers, or charitable actions and support of the local community through the promotion of vouchers for local restaurants and stores. Additionally, timely and accurate client communication with updates on recent developments and impacts can contribute to the growth of trust. Banks can also offer educational services such as webinars on investing in turbulent markets or online courses for remote banking services. The importance of trust in the banking context is highlighted by McKinsey’s retail banking customer survey: customers with a high level of trust in their bank have a significantly higher number of products with their bank and are less likely to switch to other providers. Banks can build on this trust to strengthen relationships with their customers.

The full scale—the duration, shape, and severity—of the economic downturn brought about by the impact of the coronavirus crisis remains to be seen. The economic climate has a strong impact on the overall business activity of banks. In the longer term, loan volumes are expected to decrease as economic activity slows and uncertainty encumbers the investment plans of SMEs active in affected sectors. Investment products are likely to be affected as well.

Increased uncertainty and fears of job losses will drive many retail investors to shy away from investment products and turn to low-risk products such as deposits or insurance. In a bid to offset the resulting decline in commission income and grow their fee-based business, banks can focus on new and adapted investment products and non-interest products such as health and life insurance.

How retail banks can become true partners in difficult times, while strengthening their business models

The key for banks at this moment of truth for the industry is to take the measures required today to emerge stronger in the post-crisis "new normal." We believe the following measures are critical:

Adopt digital channels at speed, which requires the fast improvement of digital offerings and digital infrastructure.

— Enhance digital, agile, and remote capabilities. Introduce new and enhanced digital customer journeys and ensure that all products are available online.

— Review and reprioritize the existing project portfolio. Increase the number of digital teams for building new remote fulfillment capabilities and reprioritize backlogs (e.g., key ATM/CC/ online mobile functionalities), leveraging existing solutions.

— Introduce incentives and campaigns for migration to alternative channels and allow customers to connect with bank service employees remotely. For example, allow customers to book online meetings through the website.

— Enhance digital marketing. Review and update digital marketing investments and capabilities (e.g., digital marketing platforms), and target new customer segments (e.g., elderly).

Develop the branch network of the future, to address lasting changes in customer behavior.

— Reevaluate branch footprint. Redesign the post-crisis branch network, considering long-term changes in customer behavior.

— Redesign remaining branches. Modernize the remaining branches (e.g., innovative self-service solutions, fast-track digitization of paper-based applications), offer hybrid advice models, and digitize branch processes.

— Strengthen the most critical branches and position them as flagship stores.

— Identify and redeploy excess capacity. Assess sustainably reduced branch capacity and redeploy it to sales support and other roles.

Become a true partner for customers moving back to an open society.

— Position the bank as a supplier of basic needs, available at all times, and build trust.

— Engage clients through proximity and support, and help translate government interventions into day-to-day solutions.

— Ensure regular client communication, including educational and awareness campaigns (e.g., webinars).

— Help clients navigate through the crisis; suspend loan repayments, increase offering of liquidity products, and potentially adjust credit decision rules and prices.

The rapid and, in many cases, impressive response of German retail banks to the coronavirus crisis shows how quickly and nimbly incumbents can react. Bold changes are possible in the face of tough and pressing challenges. The current situation should serve as a wakeup call to all players across the German industry today: make the necessary changes to the operating model now—building on the changing customer behavior—to emerge from the crisis transformed and in shape for the future.

In short, until the more immediate effects of the coronavirus crisis are behind us, it is imperative to support clients with short-term emergency measures.

Looking ahead, banks face the crucial task of responding to the lasting change in customer behavior toward digital and reasserting their positive role in the next normal once the crisis has passed.

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