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Remaking the bank for an ecosystem world

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Global banking-industry performance has been lackluster. Now comes the hard part: the rise of nonbanking platform companies targeting the most profitable parts of the banking value chain.

The global banking industry shows many signs of renewed health. The recovery from the financial crisis is—at long last—complete, capital stocks have been replenished, and banks have taken an ax to costs. Yet profits remain elusive. For the seventh consecutive year, the industry’s return on equity (ROE) is stuck in a narrow range, between 8 percent and the 10 percent figure that most consider the industry’s cost of equity. At 8.6 percent for 2016, ROE was down a full percentage point from 2015. Further, banks’ shares are trading at low multiples, suggesting that investors have concerns about future profitability. Several regions and business lines have done better, and some institutions are outperforming due to strategic clarity and relentless execution on both their core businesses and their efforts to improve.

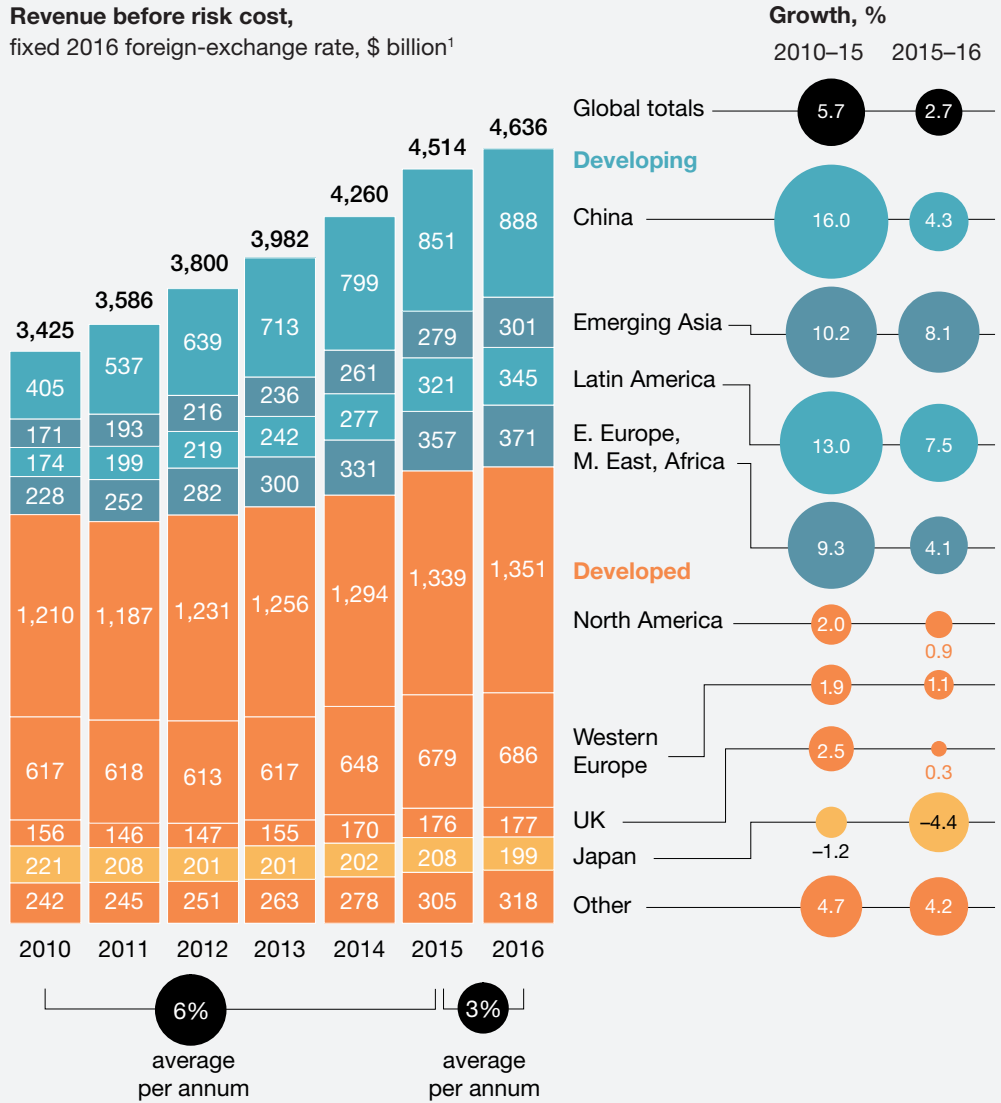
In short, the recovery from the crisis has been tepid, rather like the broader economy to which banking is closely tied. In fact, as our colleagues first mentioned in the 2015 edition of this report, the industry is bogged down in a flat and uninspiring performance rut. At the time, we called this a “new reality”; a few years later, with a string of lackluster performances under the industry’s belt, we have to conclude that the reality is here to stay.

Why is performance proving so hard to budge? Several factors are responsible, starting with a slowdown in revenue growth (Exhibit 1). While the trend line shows a nicely upward slant, the fact is that revenue growth has slowed dramatically: between 2015 and 2016 the rate was 3 percent, half that of the previous five years.

New digital entrants are also having an impact on bank performance, particularly by threatening the customer relationship and margin erosion across retail segments. We see new evidence of those trends—and they are happening faster than we expected. Margins continue to fall worldwide (Exhibit 2). In China, for example, they dropped 35 basis points in the past two years, shaving 6.7 percentage points off ROE. In North America, margins tightened by 46 basis points, lowering ROE by 4.1 percentage points. Banks are also losing share in some products, especially in emerging markets.

Exhibit 1

Global banking-revenue growth slowed to 3 percent in 2016.



¹Figures may not sum, because of rounding.

McKinsey&Company | Source: Global Banking Pools by McKinsey; Panorama by McKinsey

And there is a new heavyweight competitor in town. “Platform” companies such as Alibaba, Amazon, and Tencent—about which we’ll have more to say later—are staking a claim to banks’ customers and the revenues and profits they represent.

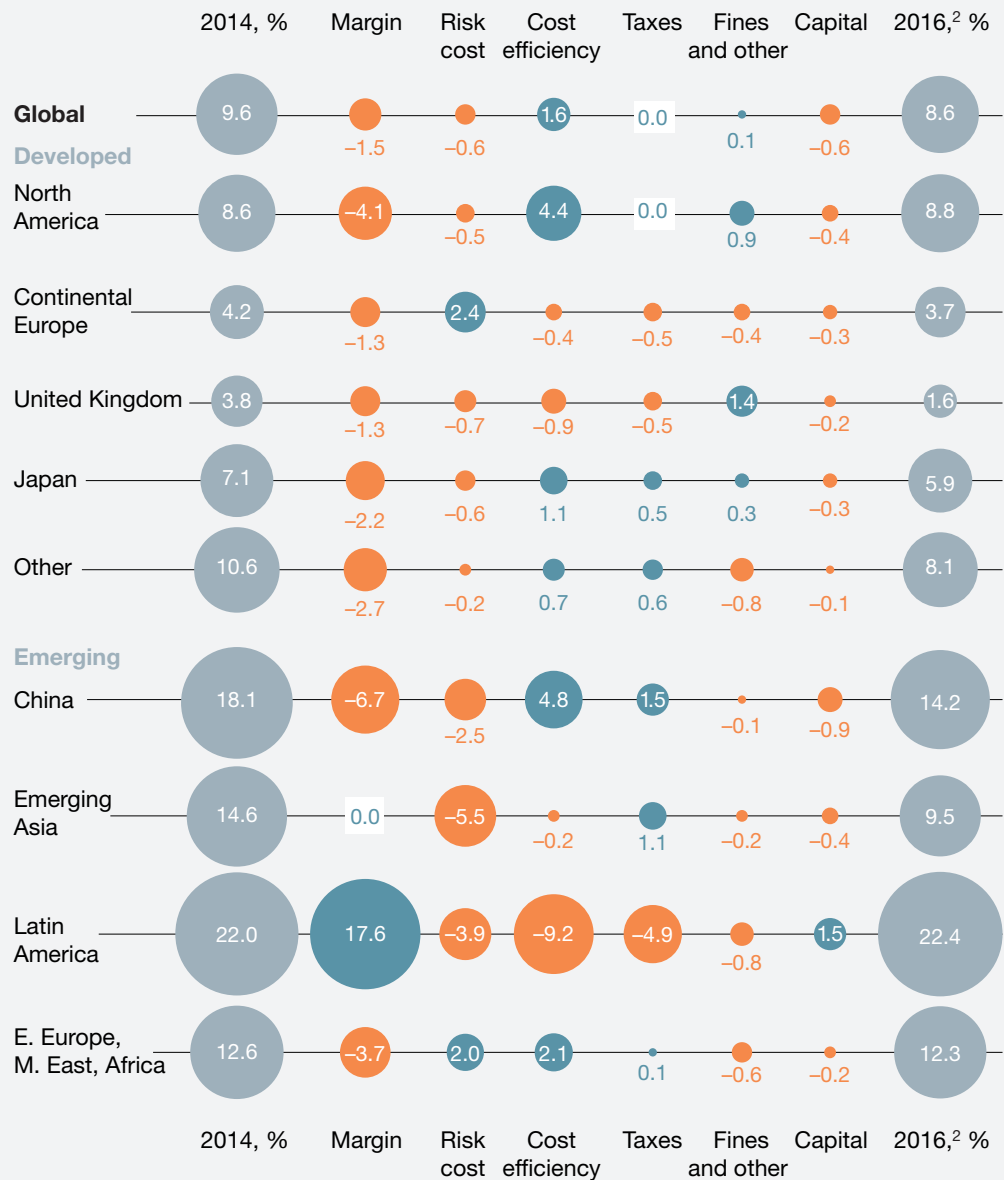
McKinsey’s latest research on the global banking industry leads to a number of additional key findings:

- The variations in banks’ valuations continue to be substantial, but the reasons have shifted dramatically. In 2010, 74 percent of the difference in valuations was due to geography: banks with operations in hot markets were valued more highly. Geography, however, is no longer destiny. In 2017, the location of a banks’ operations accounts for just 39 percent of the difference (Exhibit 3). The rest—more than 60 percent—is due to the business model and its execution, strategy, well-aligned initiatives, and the other levers that banks command.

Exhibit 2

Margins are falling in most regions, while costs have improved.

Banking return on equity (ROE),¹ percentage points, 2014–16



¹Based on a sample of ~1,000 largest banks in regard to assets.

²Figures may not sum, because of rounding.

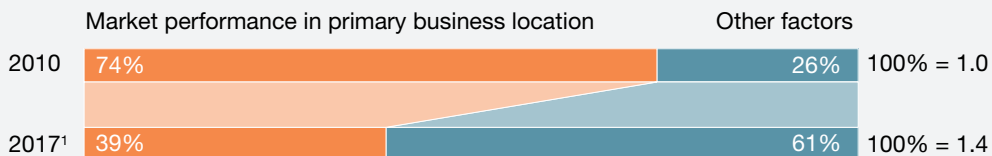
McKinsey&Company | Source: SNL; Global Banking Pools by McKinsey; Panorama by McKinsey

- In the 2015 global banking annual review, we estimated the impact of the digital threat. Today, we update the estimate to account for a faster pace than anticipated. As interest rates recover and other tailwinds come into play, the banking industry's ROE could reach 9.3 percent in 2025. But if retail and corporate customers switch their banking to digital companies at the same rate that people have adopted new technologies in the past, the industry's ROE, absent any mitigating actions, could fall by roughly 4.0 points, to an unsustainable 5.2 percent by 2025 (Exhibit 4).

Exhibit 3

Geography no longer has an overriding impact on a bank's valuation.

Drivers of standard deviation of price/book



¹First quarter 2017.

Source: Capital IQ; SNL; Global Banking Pools by McKinsey; Panorama by McKinsey
McKinsey&Company

- Banks cannot afford to wait any longer to extract the potential of digital to industrialize their operations. As an essential first step, those that have not yet fully digitized must explore the new tools at their disposal and build the skills in digital marketing and analytics that they need in order to compete effectively. If most of the industry were to do this, and not compete too much of it away, we estimate that banks would add about \$350 billion to their collective bottom line. This gain from digitization would lift the average bank's ROE by about 2.5 percentage points—not enough to fully offset the 4.1-point drop forecasted in our unmitigated scenario. But no bank can afford to forgo the benefits of digitization, and individual banks can do much better than the average. A full-scale digital transformation is essential, not only for the economic benefits but also because it will earn banks the right to participate in the next phase of digital banking.

The rise of platform companies

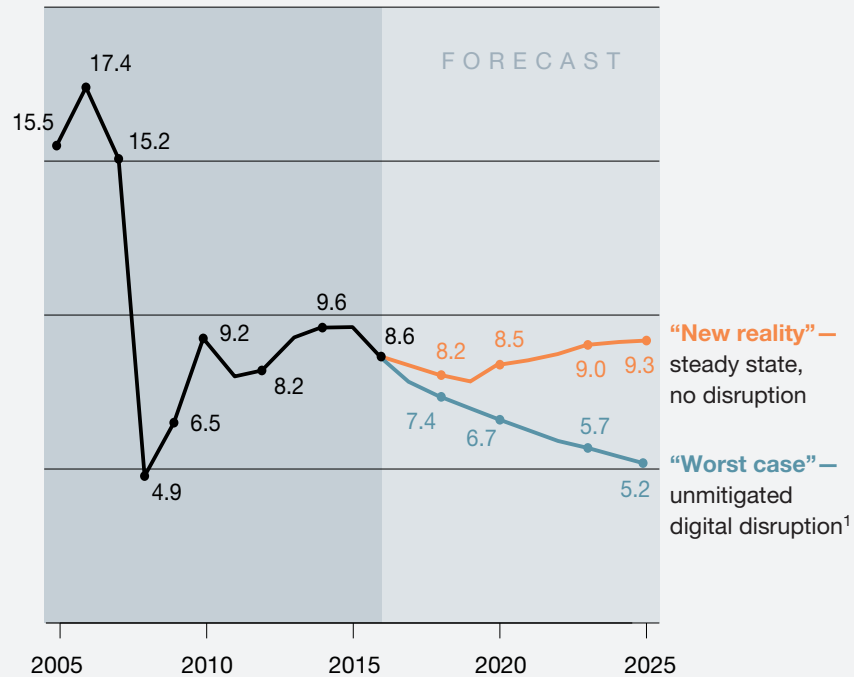
With most retail businesses (except investing) already fully explored, at least for now, fintechs are moving into commercial and corporate banking. McKinsey's Panorama fintech database, which tracks more than 1,000 financial start-ups, shows that one of the fastest-growing segments is payments solutions for large companies. The spate of alliances and acquisitions between retail banks and fintechs has helped to solidify the notion that the land grab is over. Now it is corporate banking's turn, with collaborations between Standard Chartered and GlobalTrade, Royal Bank of Scotland and Taulia, and Barclays and Wave showing that when innovation meets scale, good things can happen. Fintechs are also making strides in capital markets and investment banking, especially advisory—although here, the emphasis is more on enabling traditional business processes, rather than disrupting them.

The idea of fintechs as a threat to retail banking might be receding. But the new strategies adopted by the aforementioned platform companies are even more challenging for incumbent banks. By creating a customer-centric, unified value proposition that extends beyond what users could previously obtain, digital pioneers are bridging the value chains of various industries to create "ecosystems" that reduce customers' costs, increase convenience, provide them with new experiences, and whet their appetites for more. Not only do they have exceptional data that they exploit with remarkable effectiveness but also, more worrisome for banks, they are often more central in the customer journeys that include big financial decisions.

Exhibit 4

Two scenarios are possible for banking return on equity by 2025.

Global banking return on equity, %



¹ Margin decline of 11.6%—average results across sectors and geographies, generally more severe in consumer-finance, payments, and asset-management and wealth-management sectors (up to 20%+ in Japan and the UK).

McKinsey&Company | Source: SNL; Global Banking Pools by McKinsey; Panorama by McKinsey

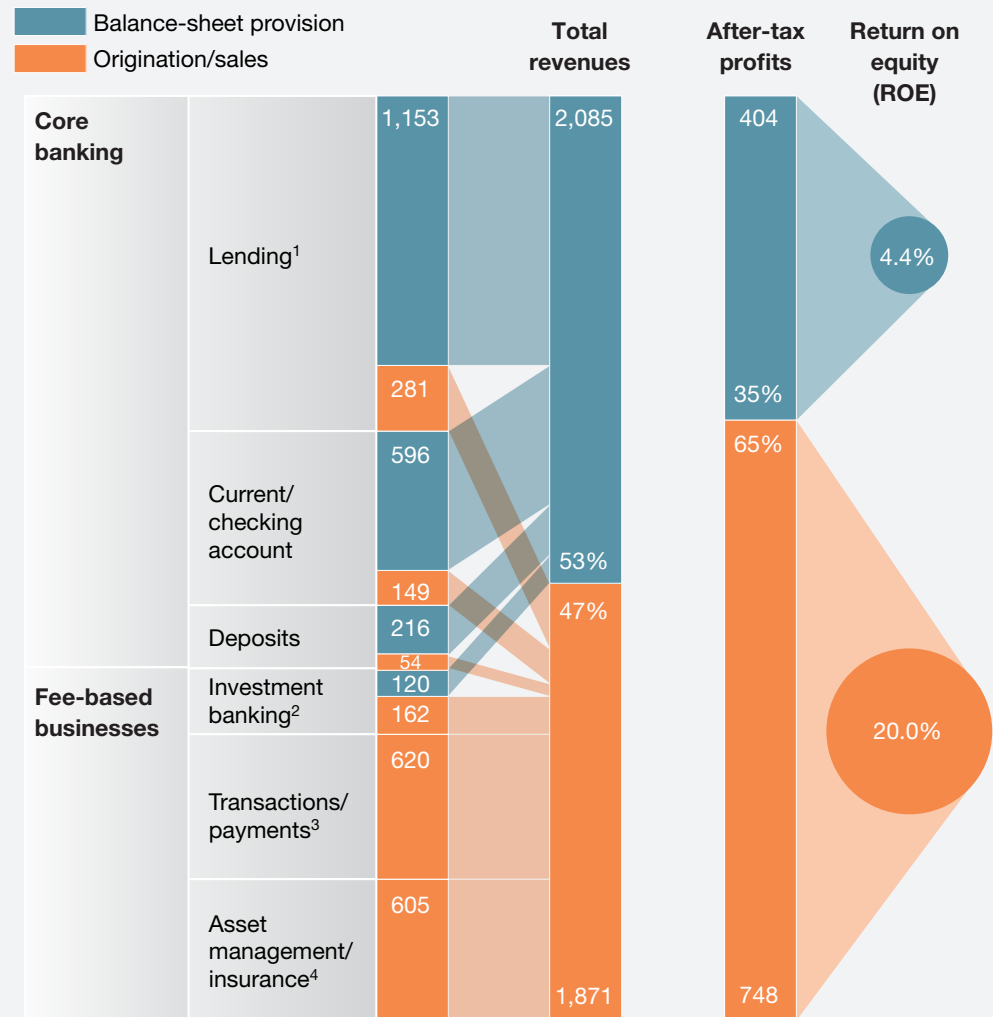
Consider Rakuten Ichiba, Japan's single largest online retail marketplace. It provides loyalty points and e-money usable at hundreds of thousands of stores, virtual and real. It issues credit cards to tens of millions of members. It offers financial products and services that range from mortgages to securities brokerage. And the company runs one of Japan's largest online travel portals—plus an instant-messaging app, Viber, which has some 800 million users worldwide. Likewise, Alibaba is not just an enormous e-commerce company; it is also a large asset manager, lender, payments company, B2B service, and ride-hailing provider. Tencent is making similar advances, from a chat-service base. And Amazon continues to confound rivals with moves into the cloud, logistics, media, consumer electronics, and even old-fashioned brick-and-mortar retailing—and lending and factoring for small and medium-size enterprises. Such companies are blurring traditional industry boundaries. With their superior customer experience, they can sell an ever-wider range of products to their loyal customers. The manufacturing end of many businesses is fading from view, as the platform companies increasingly dominate the distribution end of multiple businesses, providing a wide range of products and services from a single platform.

To put some hard numbers against what may seem like a distant threat to some banking leaders, we calculated the value at stake for global banking should platform companies successfully split banking in two (Exhibit 5). We found that "manufacturing"—the core businesses of financing and lending that pivot off the bank's balance sheet—generated

Exhibit 5

Nonbank attackers are focusing on origination and sales, accounting for 65 percent of profit and delivering 20 percent ROE.

Global banking revenues and profits by activity, 2016, \$ billion



¹ Loans to retail and corporate clients (overdrafts, specialized finance, credit cards, trade loans).

² Corporate finance, capital markets, securities services.

³ Retail and wholesale payment transactions, including cross-border payments and remittances.

⁴ Asset management includes investment and pension products. Insurance includes bank-sold insurance only.

McKinsey&Company | Source: Global Banking Pools by McKinsey; Panorama by McKinsey

53.0 percent of industry revenues, but only 35.0 percent of profits, with an ROE of 4.4 percent. “Distribution,” on the other hand—the origination and sales side of banking—produced 47 percent of revenues and 65 percent of profits, with an ROE of 20 percent. As platform companies extend their tentacles into banking, it is the rich returns of the distribution business they are targeting. And in many cases, they are better positioned for distribution than banks are.

Beat them? Or join them?

It is early days, but much of the global economy may eventually be reshaped by ecosystems. Naturally, mileage may vary: ecosystems will not spring up at the same pace, or to the same degree, in every market. But where they do, banks will be in the platform companies’ crosshairs.

This will place banks at the next strategic crossroads: As ecosystems emerge, should banks beat them or join them? The odds are seemingly against banks' ability to get the jump on the world's most advanced tech companies. But they have some things going for them. When it comes to customers' decisions about where to place their money, research shows that banks enjoy greater trust than tech companies. And they have exclusive access—for now—to mountains of incredibly valuable customer data. Already we are seeing early success stories from around the world, as banks start to develop platform capabilities. It is not too far-fetched to imagine a day when banks will offer a range of services, reach a vastly larger customer base, and succeed at their digital rivals' game.

To do so, banks will have to fully deploy the vast digital tool kit that is now available—something most have failed to do thus far. Harnessing the new powers of data-driven marketing, a digital workbench for sellers, robotic process automation, the cloud, application programming interfaces and apps, and all the other tools now available is an essential step for banks.

If the integrated economy begins to emerge in a bank's market, it could be an opportunity for banks that have built these digital skills and rapid reflexes. Banks that successfully orchestrate a basic ecosystem strategy, by building partnerships and monetizing data, could raise their ROE to about 9 to 10 percent. Banks that can go further and create their own platforms might capture a small share of some nonbanking markets, which would elevate their ROE to about 14 percent—far above the current industry average.

The ecosystem strategy is not open to every bank; nor is it the only option. Banks could also find success, though less profit, with two other business models: a white-label balance-sheet operator, or a focused or specialized bank. But should the integrated economy develop in the way that many expect, a successful ecosystem strategy could be the key to a bright digital future for a number of banks.



Regardless of a bank's views on the ecosystem economy, a comprehensive digital transformation is a clear “no regrets” move to prepare for a digital and data-driven world. As banks move from their traditional focus on products and sales to customer-centric marketing, they should reconfirm that their source of distinctiveness is still potent, design and deliver an extraordinary customer experience, and build the digital capabilities needed not just for the next few years but also for the longer term. With those assets in hand, banks will be ready when the ecosystem economy arrives. □

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