McKinsey & Company

Attaining Escape Velocity

Global Banking Annual Review 2024 |

October 14, 2024

Key messages in GBAR 2024

The industry

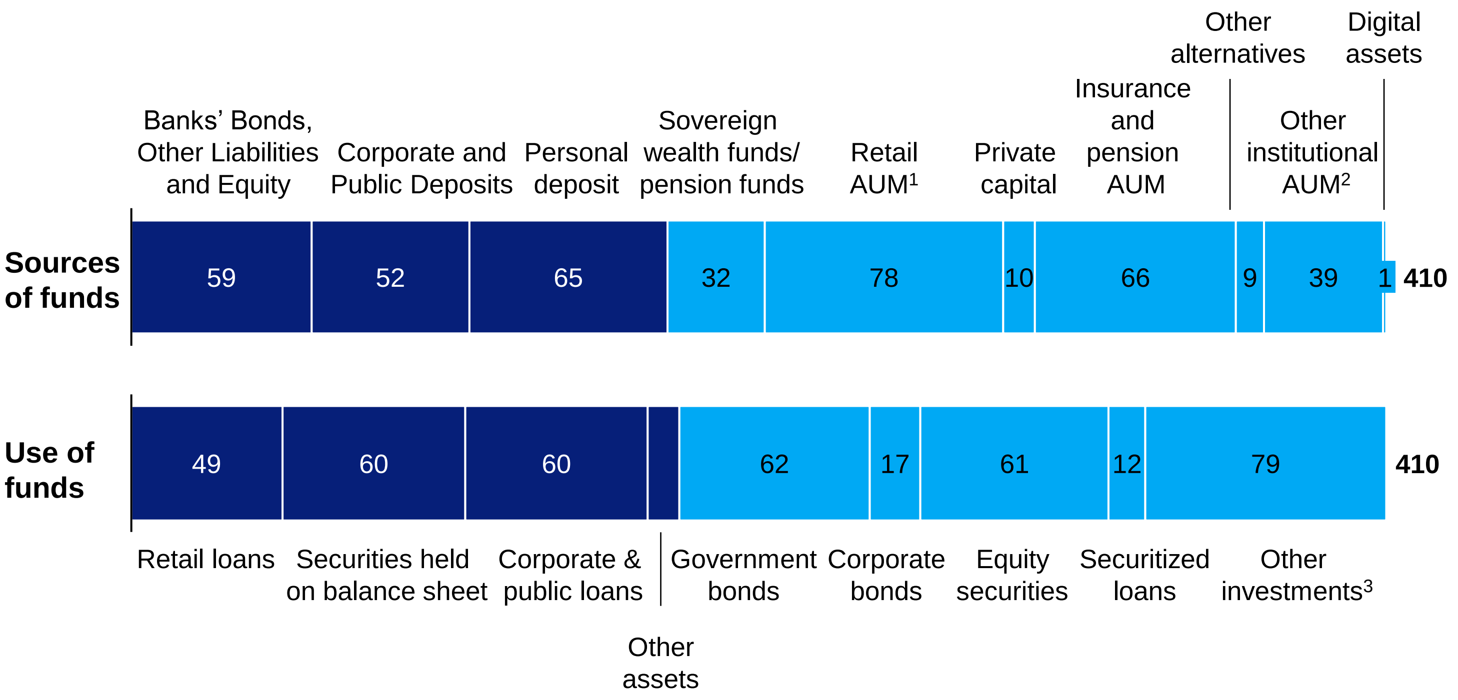
- **Best year** for the banking sector since the Global Financial Crisis: ~$7T in revenue, ~$1.1T in net income, and **11.7% Return on Tangible Equity** (above 10-year average of 10.2%)
- While performance **varies by geography and sector** (and individual institution), the banking sector remains the **lowest-valued among peers (0.9 price-to-book)** – markets remain skeptical about the long-term value creation of the industry
- Possible reasons include: (a) **labor productivity growth mixed**, despite the highest proportion of spend on tech across industries; (b) **regulatory changes** requiring continued investment; (c) **profit pools under attack** and (d) recent lift in performance largely **driven by interest rate increases**, which are already starting to moderate

Learning from the winners

- Identified outperformers over the past decade to understand how to reach “escape velocity”: **14% of institutions** have a P/B above 1 and P/E of more than 15 (vs. 56% of institutions in other industries)
- Winners outperform based on **3 structural dimensions** (selecting segments, finding scale where it matters, and strategically locating themselves – geography or client value chain) and **rigorous operational execution** (across a range of capabilities – analytics, marketing, op model, tech). The combination of these factors is what we call the **“management quotient”** of banks
- **Outperformance is possible** – about 10% of banks moved at least 5 deciles in ROTE over the past decade
- We believe that this is the moment for the leadership of banks to **drive their management quotient** to escape gravity

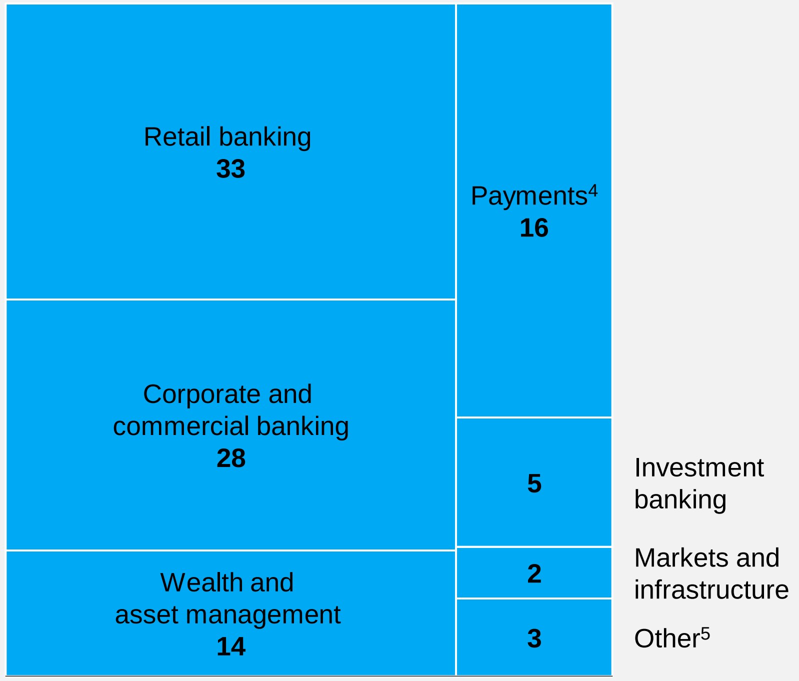
In 2023, the global financial system intermediated $410 trillion in assets, generating about $7 trillion in revenue

Global financial intermediation, 2023, $ trillion



Share of total annual revenue from global financial intermediation by type, 2023, %

$6.8 trillion total

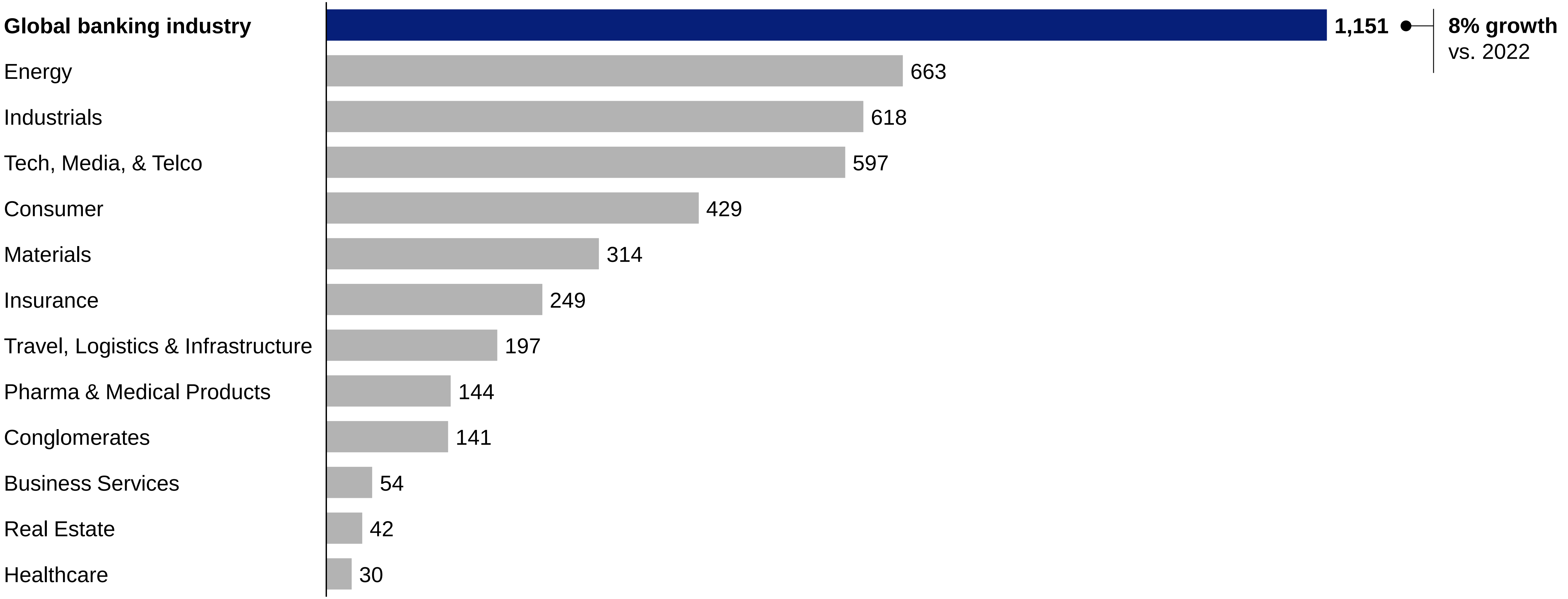


1. Assets under management; 2. Endowments and foundations, corporate investments; 3. Includes real estate; commodities; derivatives; 4. Net interest income from deposits considered in retail and corporate banking; 5. Includes revenues from real estate funds, infrastructure funds, hedge funds, commodities funds, absolute return, liquid alternatives and from mining, buying and selling of digital assets via exchanges, custody, payments, and liquidity providers

Source: McKinsey Panorama

The global banking industry generated $1.15 trillion in net income, roughly equal to the combined next two largest industries

Net income of publicly-traded companies by industry[1],
2023, $ billion



1. Based on ~35k publicly traded companies

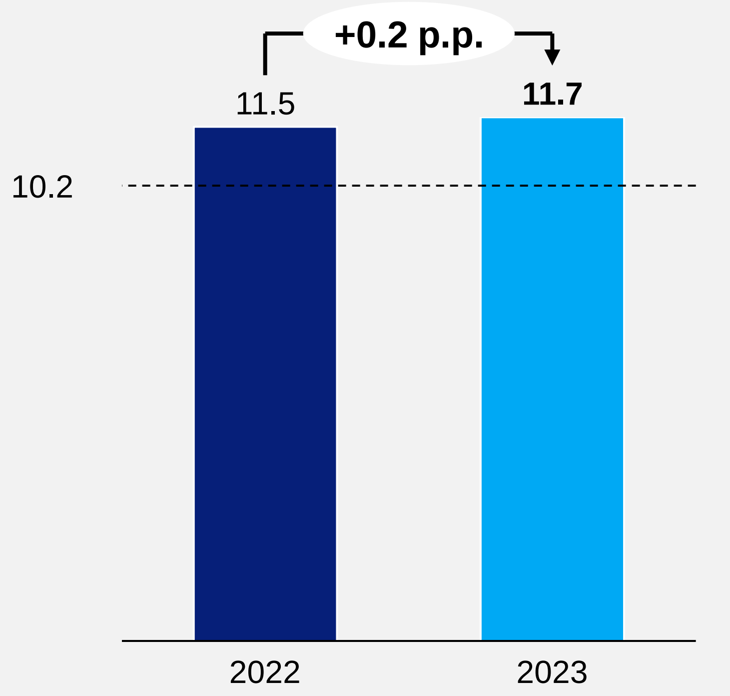
Source: McKinsey Value Intelligence, McKinsey Panorama

Banking revenues, return on tangible equity, and liquidity all grew in 2023, maintaining healthy levels across the board

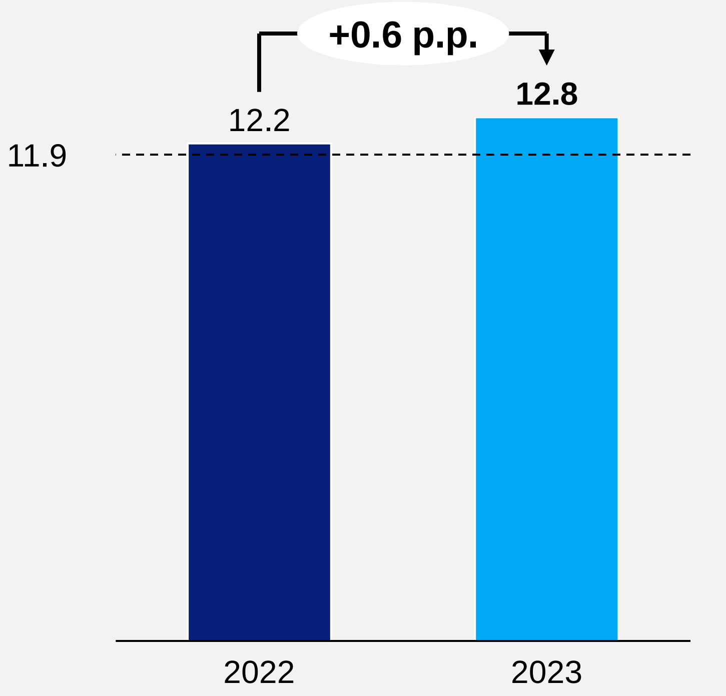
Key industry measures

------ 2011-21 average

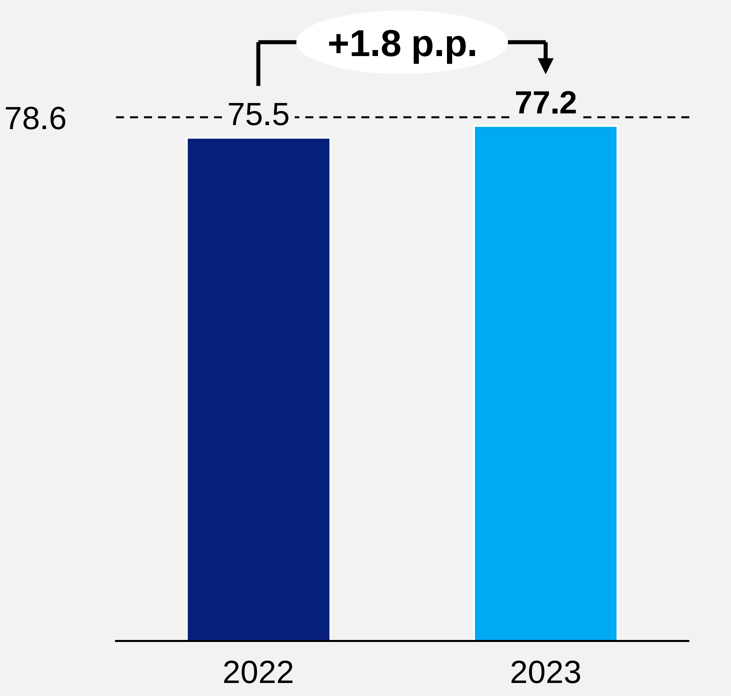
Strong profitability,
return on tangible equity, %



Healthy capital,
common equity tier 1 as a ratio of risk-weighted assets, %



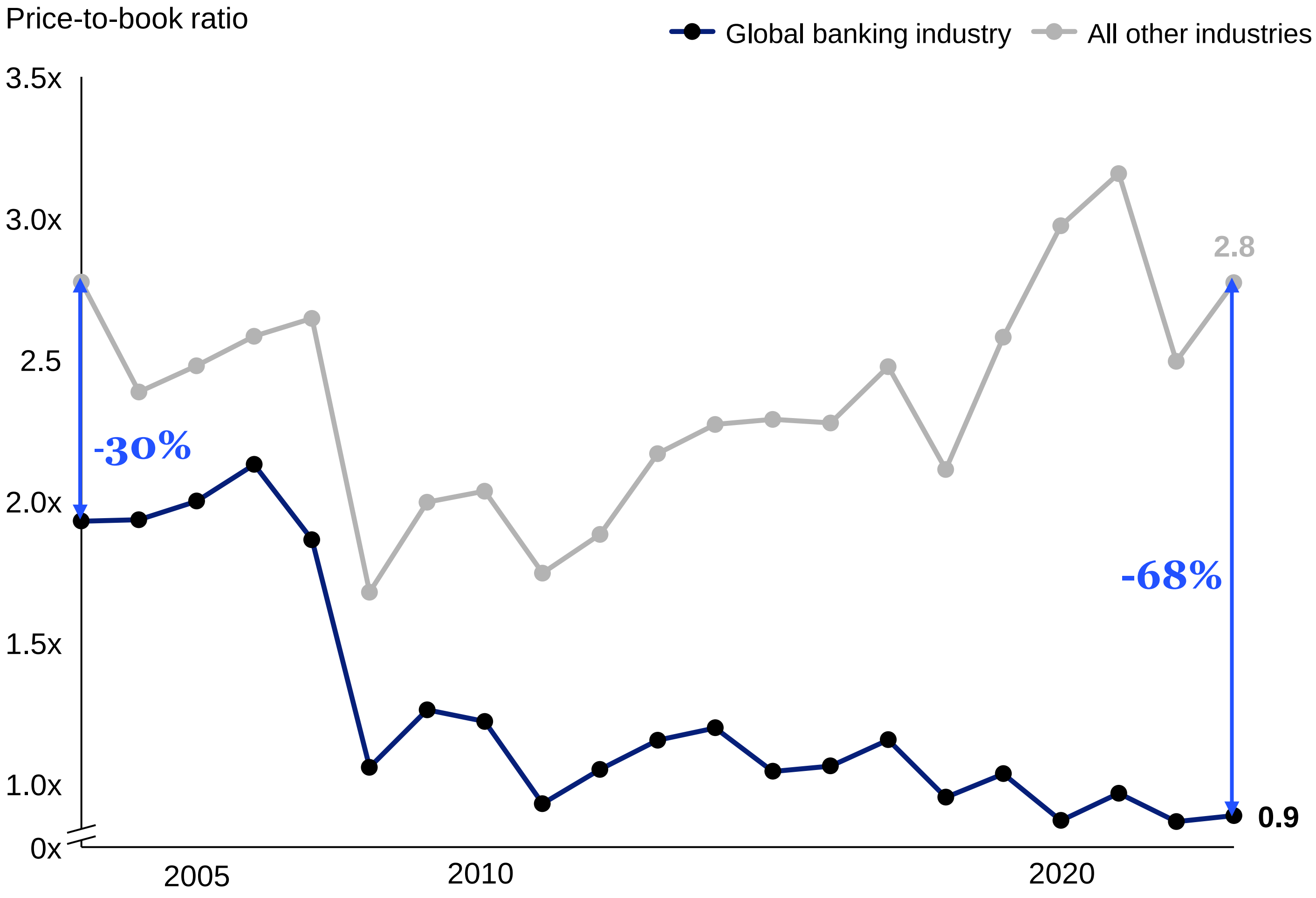
Sustainable liquidity,
Total loans as a ratio of deposits, %



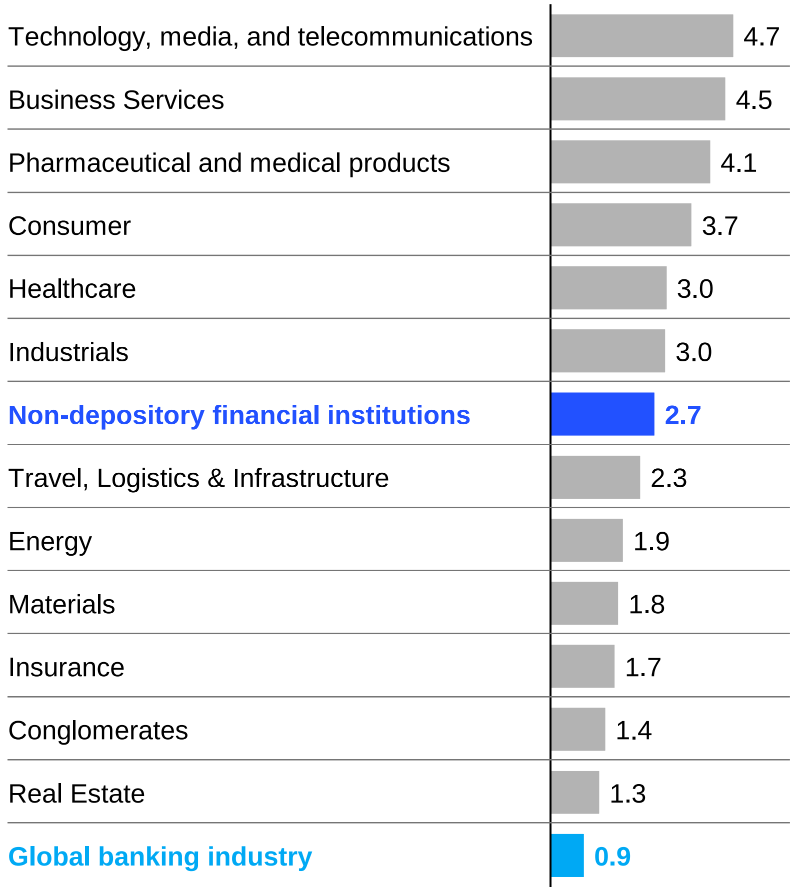
Source: McKinsey Value Intelligence, Capital IQ, McKinsey Panorama

Despite strong performance, the banking sector is valued lowest among industries, indicating market skepticism about long-term value creation

Price-to-book ratio[1],
2003-23



Price-to-book ratio by industry[1],
2023



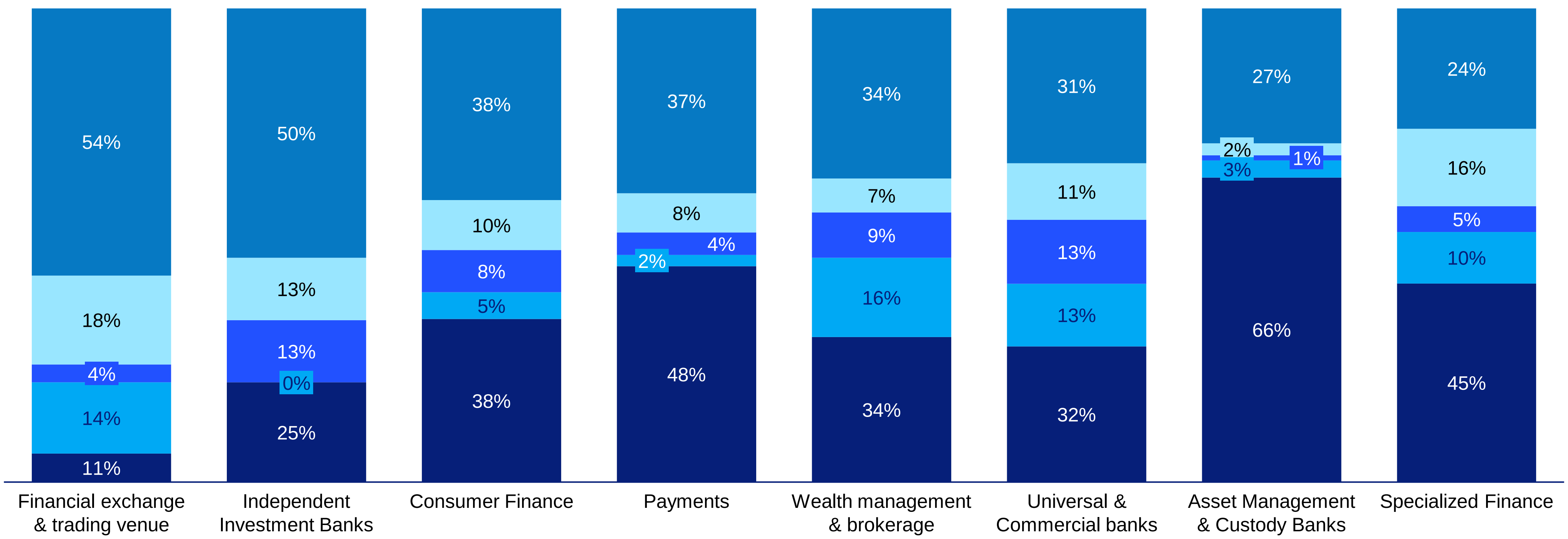
1. Average excluding outliers and firms with a negative price-to-book ratio. Based on ~15,000 publicly traded companies

Source: McKinsey Value Intelligence, McKinsey Panorama

Performance varies across and within sub-sectors, but “gravity” impacts every sector

Distribution of return on tangible equity (ROTE) [1]**,**
2023, % of total institutions

<=0.08 <0.1 <.12 <.14 >=.14



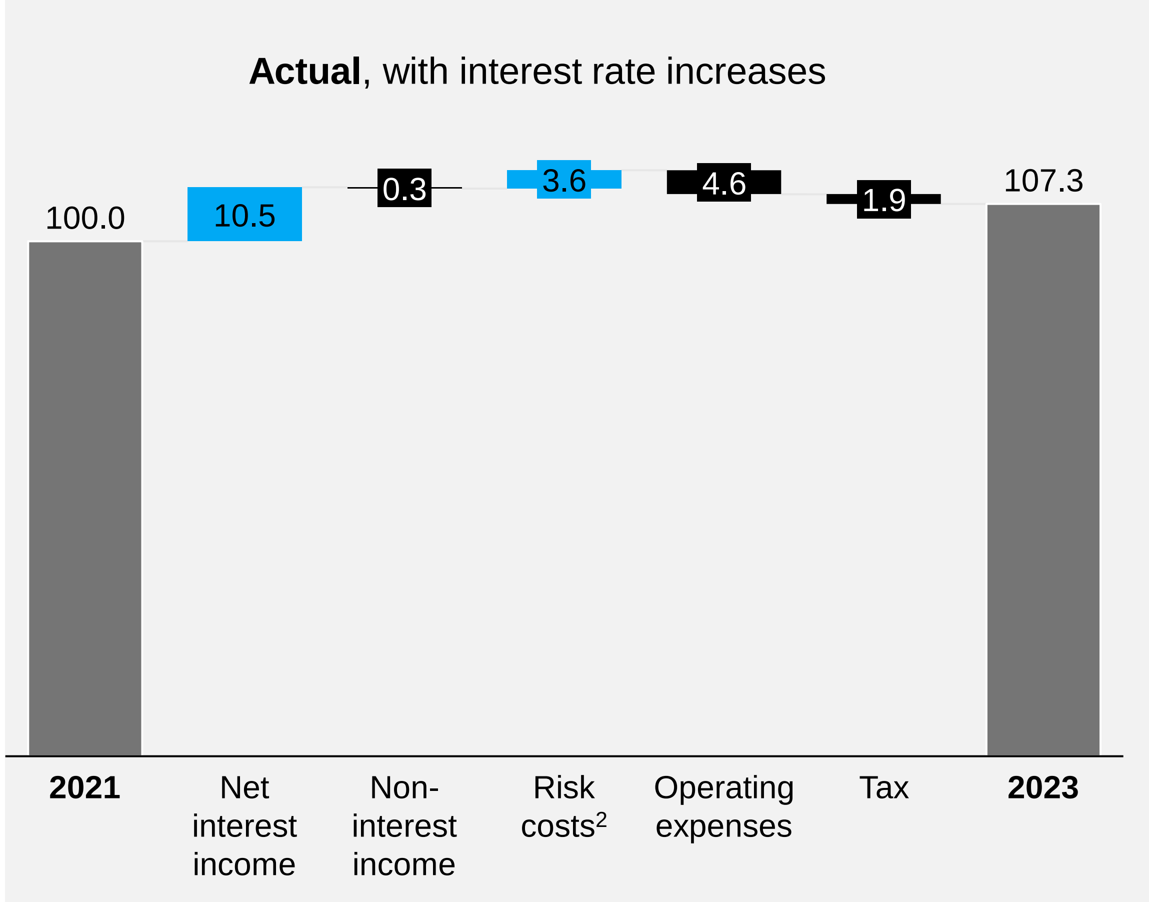
	Financial exchange & trading venue	Independent Investment Banks	Consumer Finance	Payments	Wealth management & brokerage	Universal & Commercial banks	Asset Management & Custody Banks	Specialized Finance
Average ROTE, %	11x	22	16	14	17	12	19	11
Price-to-book ratio	3.1x	3.3x	1.6x	6.0x	1.9x	0.8x	1.5x	1.0x

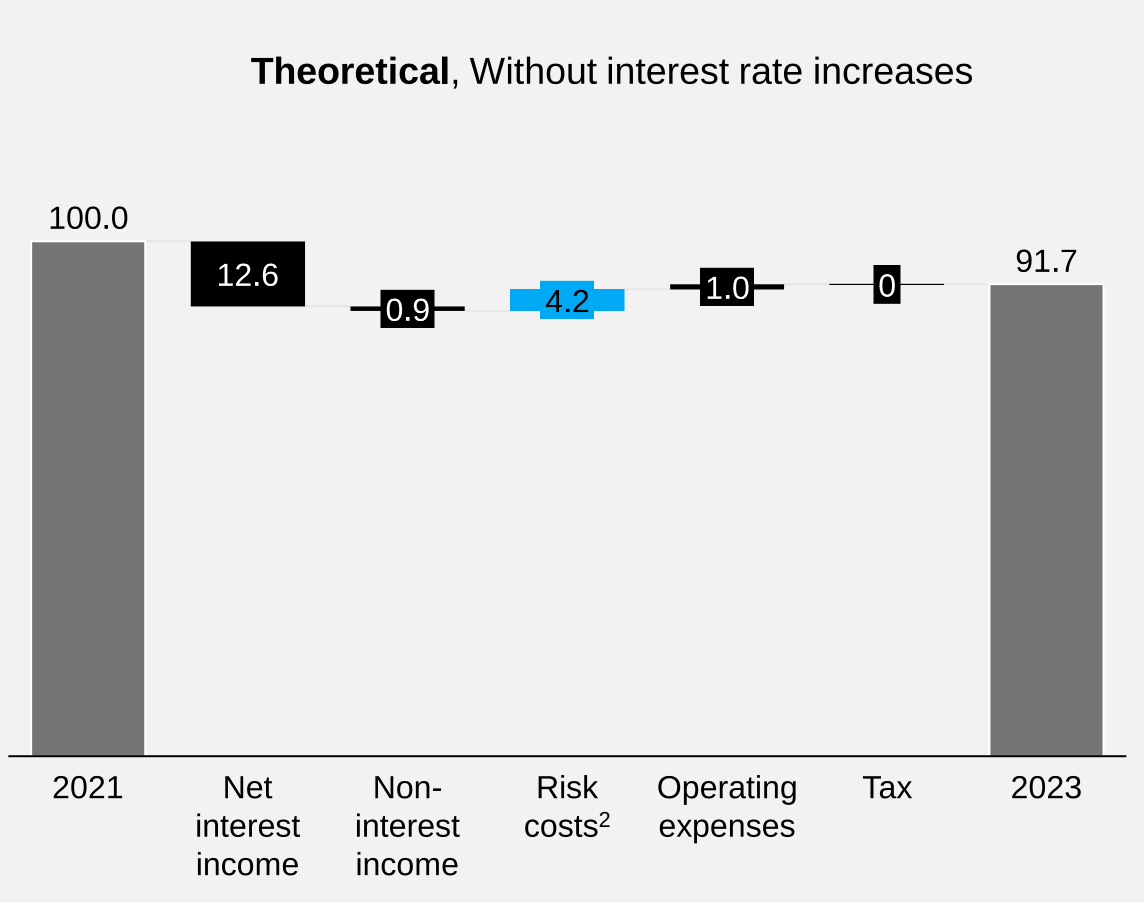
1. Based on ~2,000 financial institutions; 2. Indicates ROE, considering that substantial goodwill in the segment results in negative tangible equity

Source: McKinsey Value Intelligence, McKinsey Panorama

Net interest margin (NIM) improvement has been the key driver of improved returns of tangible equity (ROTE) in recent years

Comparison of return on tangible equity (ROTE) impact with actual and without interest rate increase
2021-23, index 2021 = 100



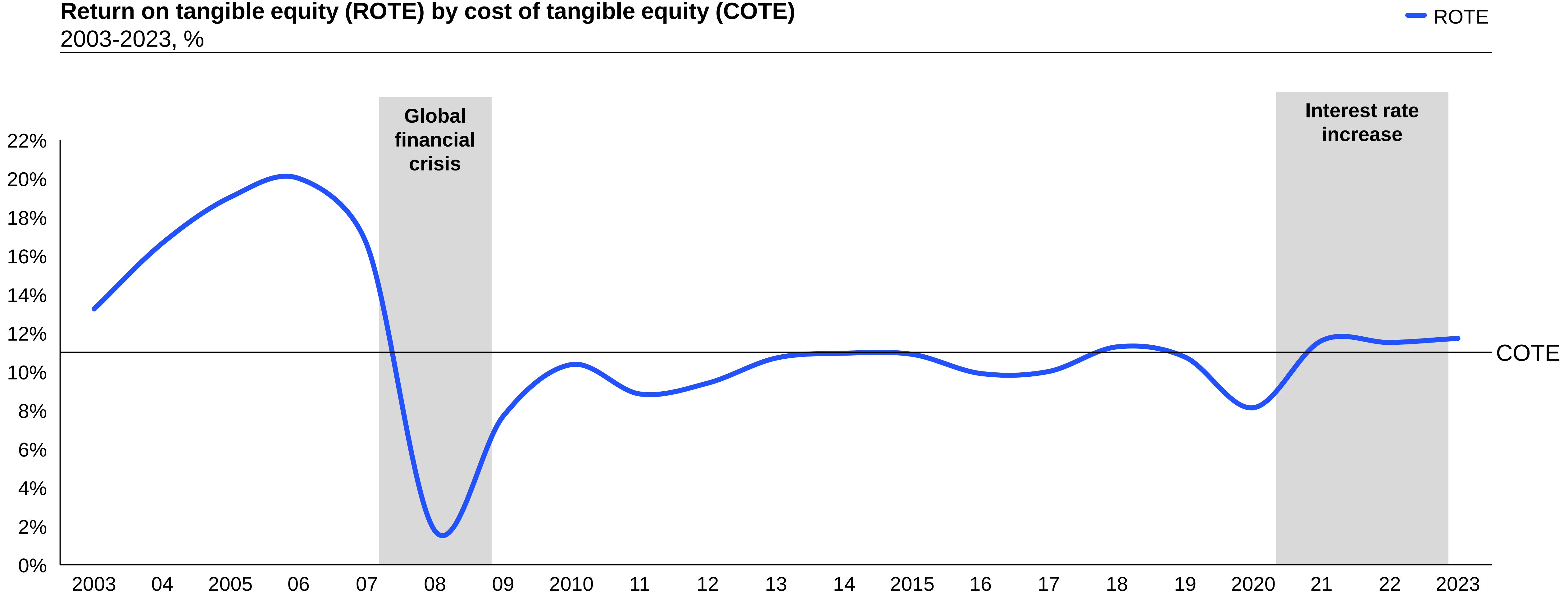


1.Greater China is excluded given different interest rate environment
2.includes loan loss provisions, other financial impairments and write-downs

Source: McKinsey Global Banking Pools, McKinsey Panorama

Higher interest rates have supported recent economic profitability across banking, but can this be sustained if rates moderate?

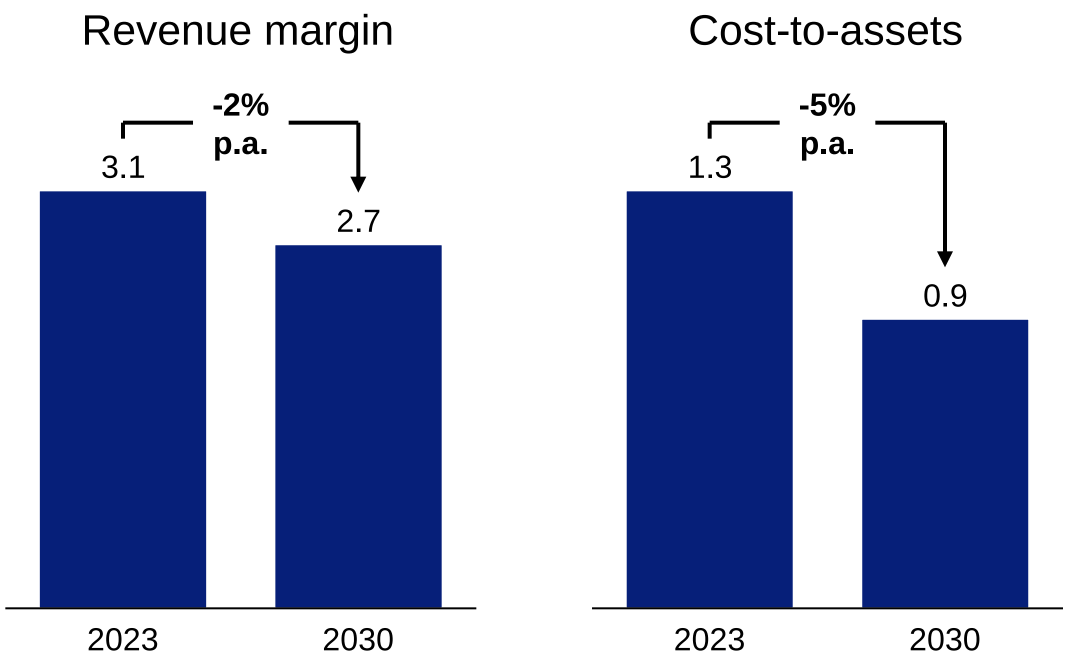
Return on tangible equity (ROTE) by cost of tangible equity (COTE)
2003-2023, %



Source: McKinsey Panorama, S&P Global Market Intelligence

Banking has a leveraged business model …

Change in C/A needed to maintain current levels of ROTE, given revenue margin compression[1], %



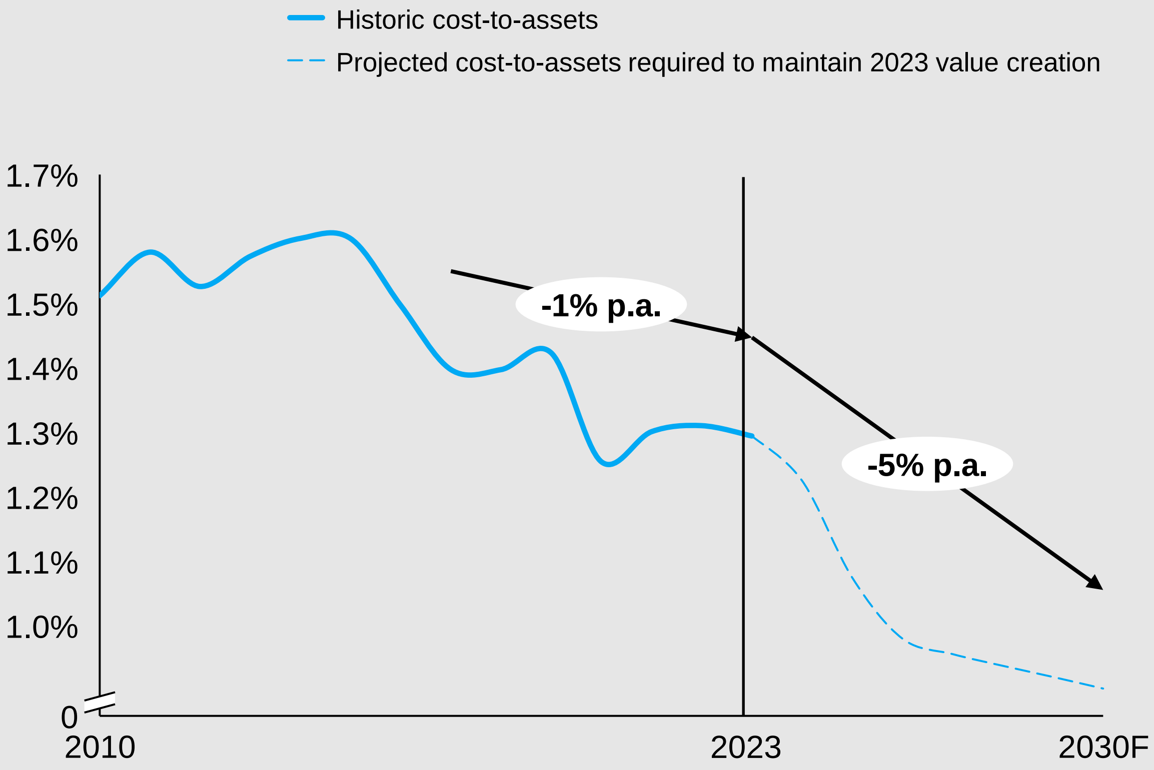
To maintain current ROTE margins, banks will need to cut costs ~2.5x as fast as revenues decline

1. For an average bank

Source: Economic Intelligence Unit, Oxford Economics, McKinsey Panorama

… and therefore, cannot simply cut costs to escape gravity

Cost to assets required to maintain 2023 value creation, %

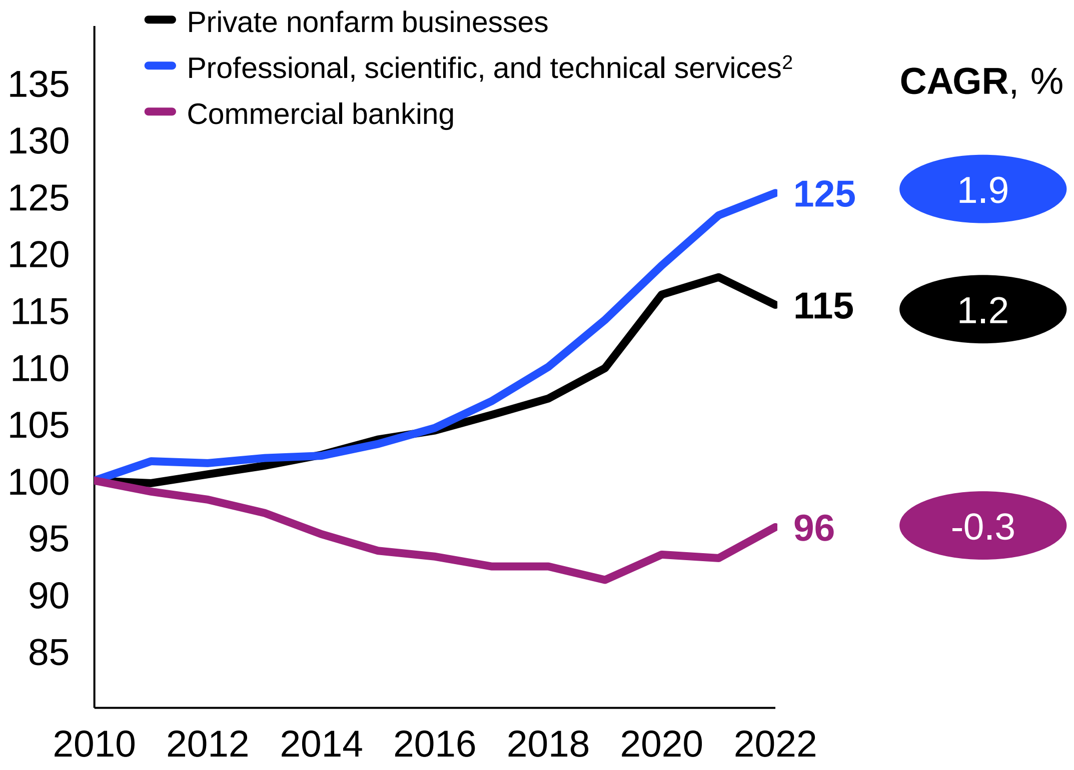


This implies a reduction over the next five years which is 5x as rapid as the previous five

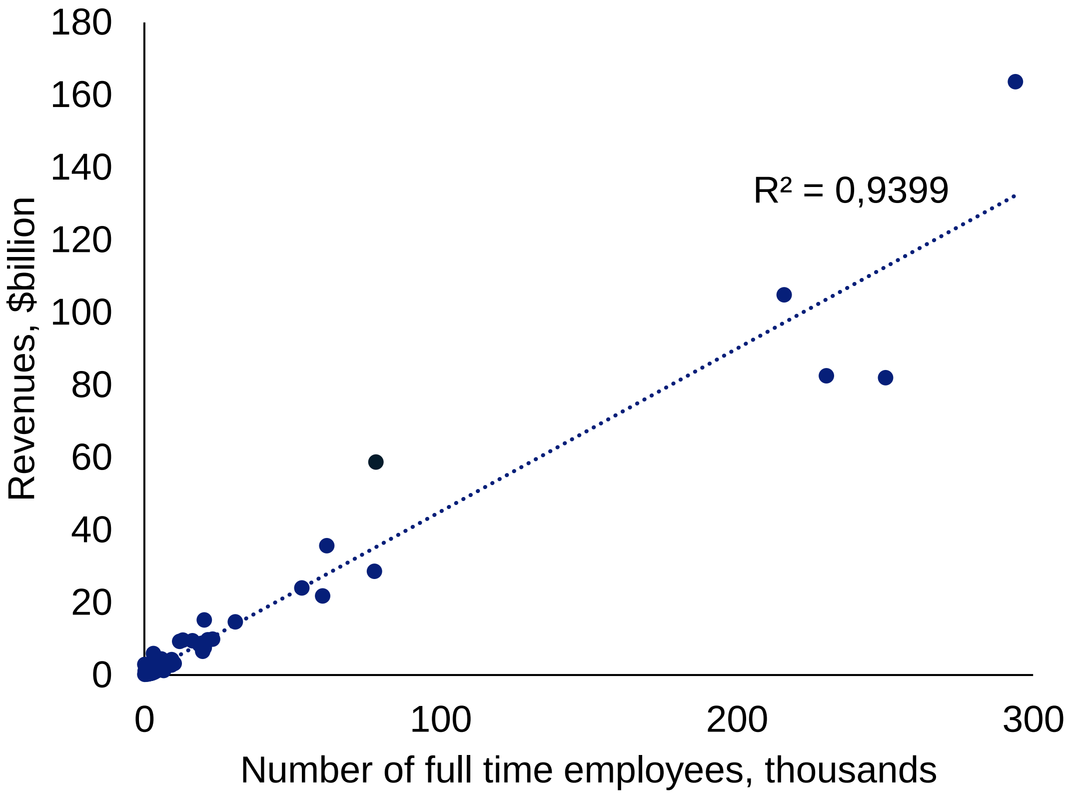
Scale and Productivity: Despite tech spending, productivity has been falling and economies of scale have been elusive

US market example

US labor productivity by sector[1], 2010-22, indexed to 2010



Correlation between revenues and number of employees at US banks, 2023

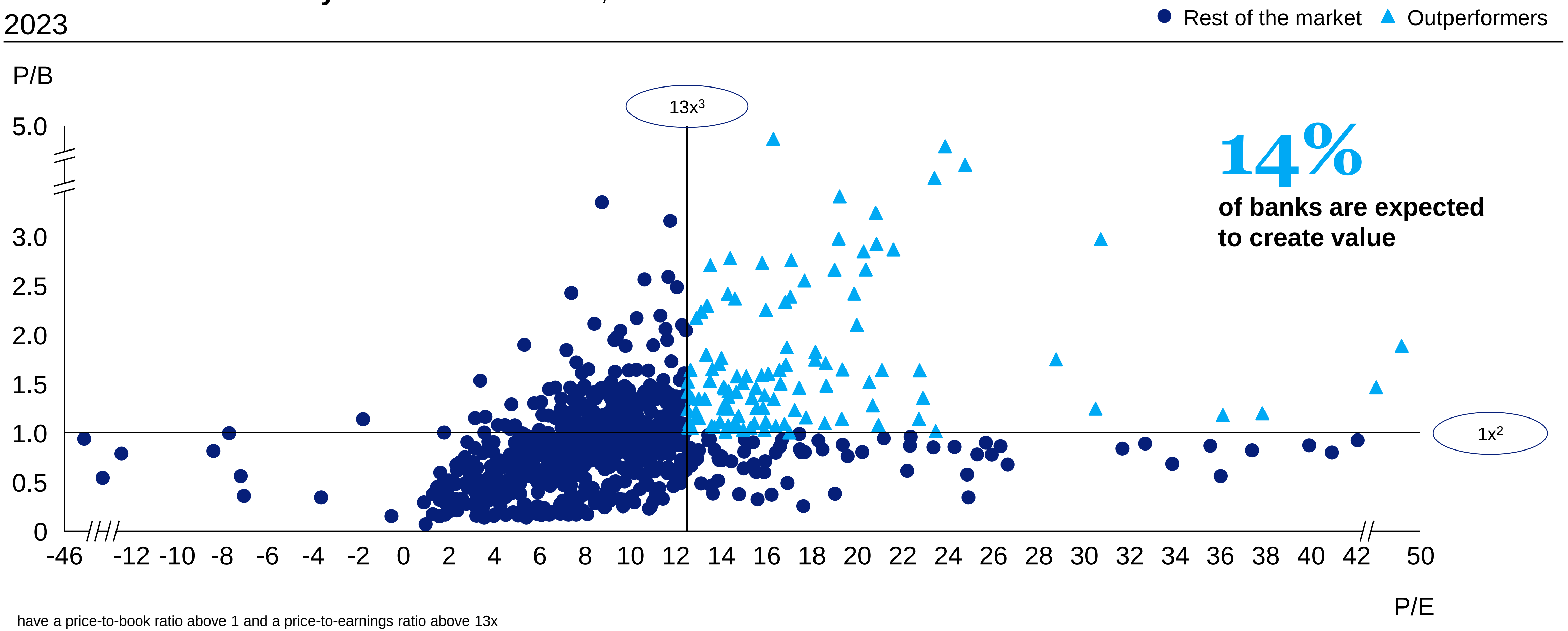


1. Three-year moving averages are used for the professional, scientific, and technical services and commercial banking.
2. Includes subsectors such as legal services, accounting, consulting services, computer systems design, and scientific research.

Source: US Bureau of Labor Statistics data as of September 2024; S&P Capital IQ

14% of banks are expected to create value[1] and perform at high levels, demonstrating that escaping velocity is possible

Distribution of banks by P/B[1] and P/E[2] ratio, 2023

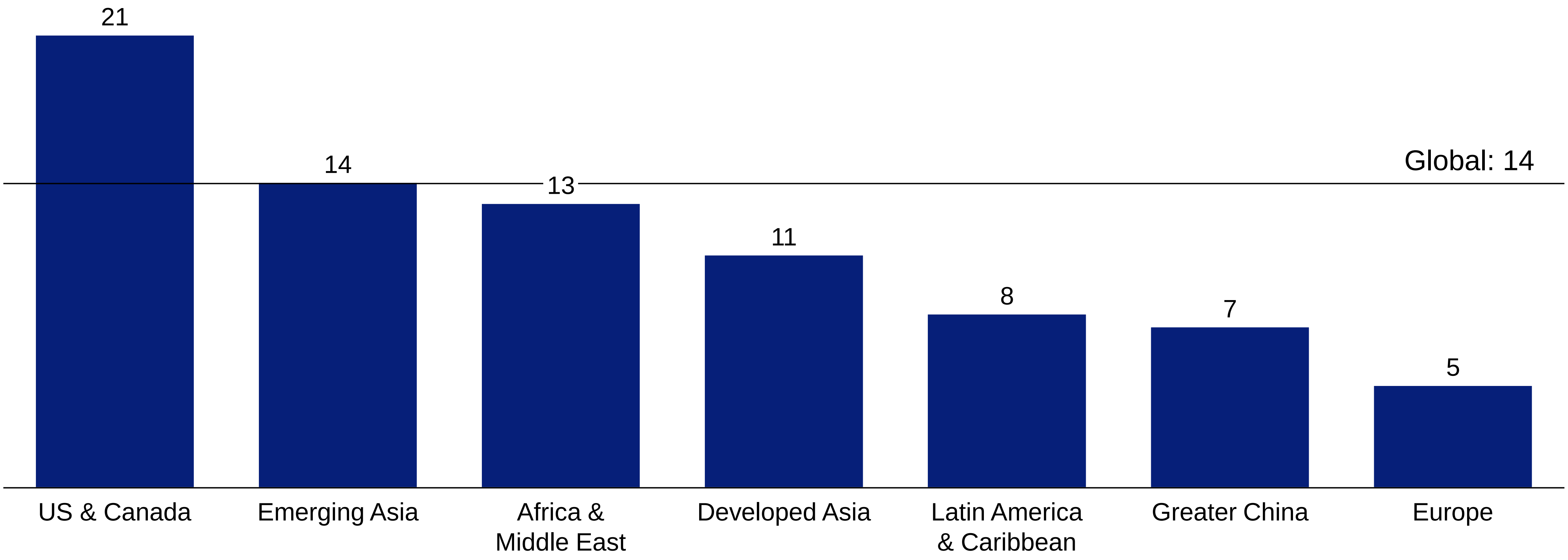


1. have a price-to-book ratio above 1 and a price-to-earnings ratio above 13x
2. Price-to-book
3. price-to-earnings
4. Note: P/B and P/E values are for the year 2023 per tier 1 and 2 banks. N= 786 and 112 values fall as outperformers

Source: Panorama McKinsey Value Intelligence

Value creation is uneven across the world

Share of public banks that outperform the 1.0+ P/B and 13+ P/E ratios,
By region, 2023, %



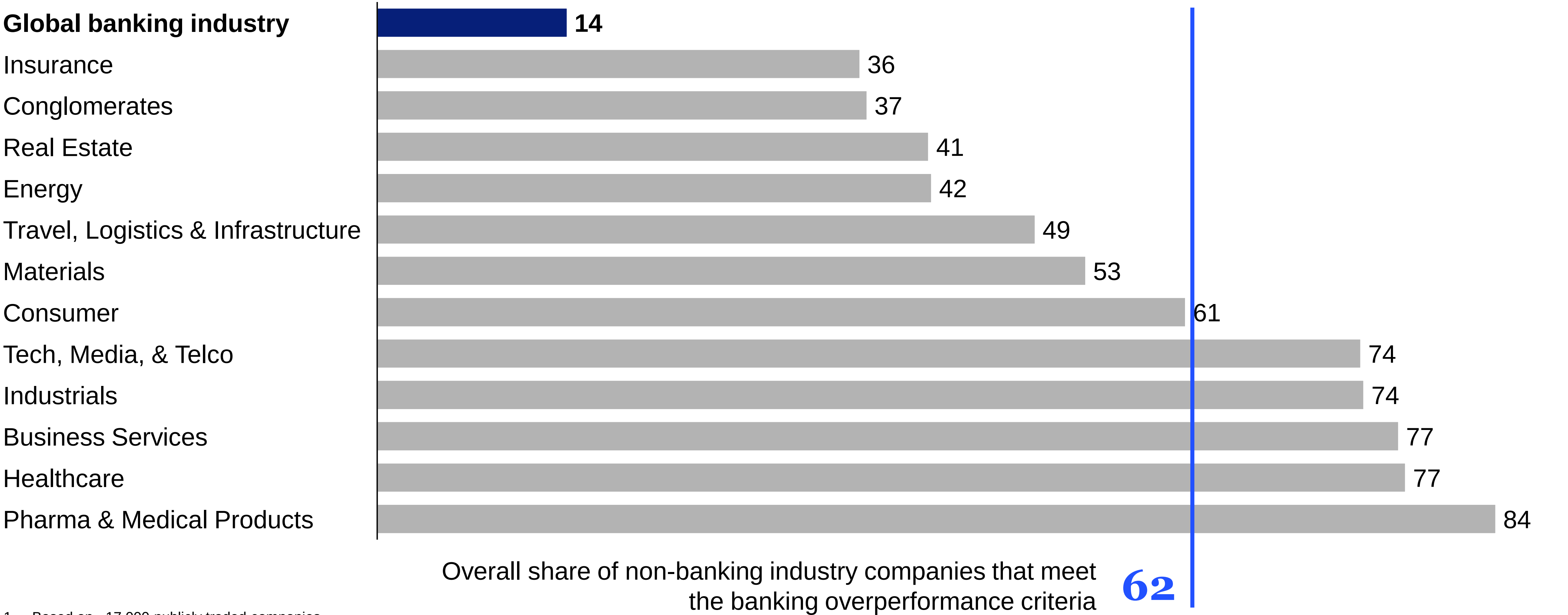
Note: N = 786 and 112 are outperformers

Source: McKinsey Value Intelligence, McKinsey Panorama

Across all other industries, 62% of companies have a price-to-book ratio above 1 and a price-to-earnings ratio of mare than 13x

Share of companies with P/B ratio >1 and P/E ratio >13[1]

%, 2023



1. Based on ~17,000 publicly traded companies

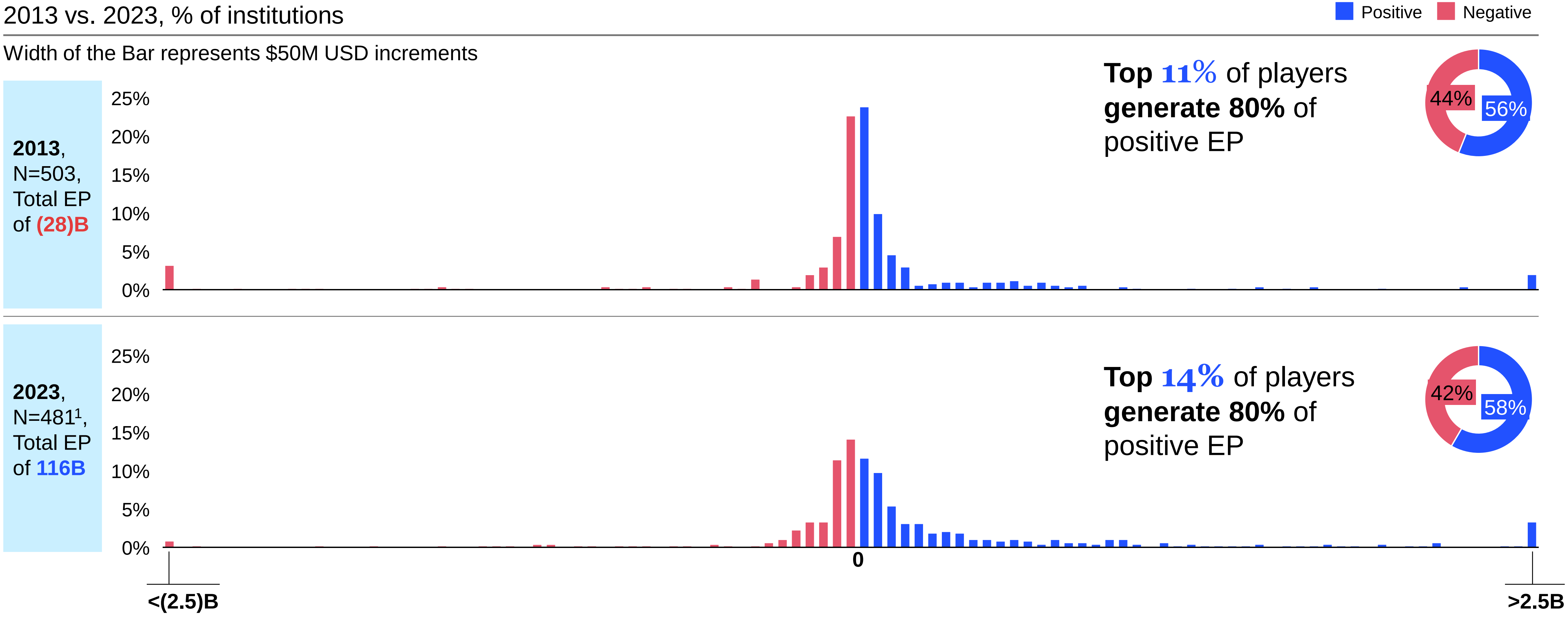
Source: McKinsey Value Intelligence

Distribution of economic profit in banking has broadened

Economic Profit distribution

2013 vs. 2023, % of institutions

Width of the Bar represents $50M USD increments



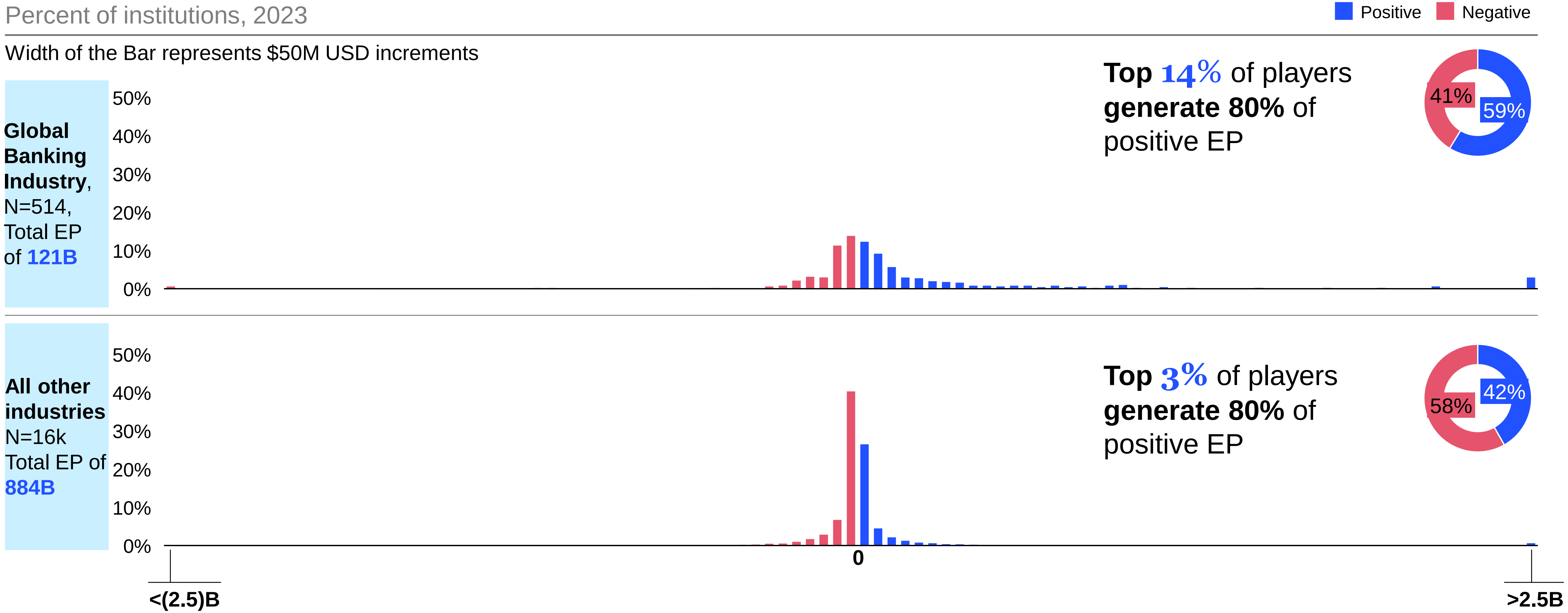
1. Excludes institutions that merged or ceased operations since 2013

Source: McKinsey Value Intelligence, McKinsey Strategy & Corporate Finance

Economic profit is more distributed in banking than elsewhere

Economic Profit distribution for the Global Banking industry and all other industries

Percent of institutions, 2023

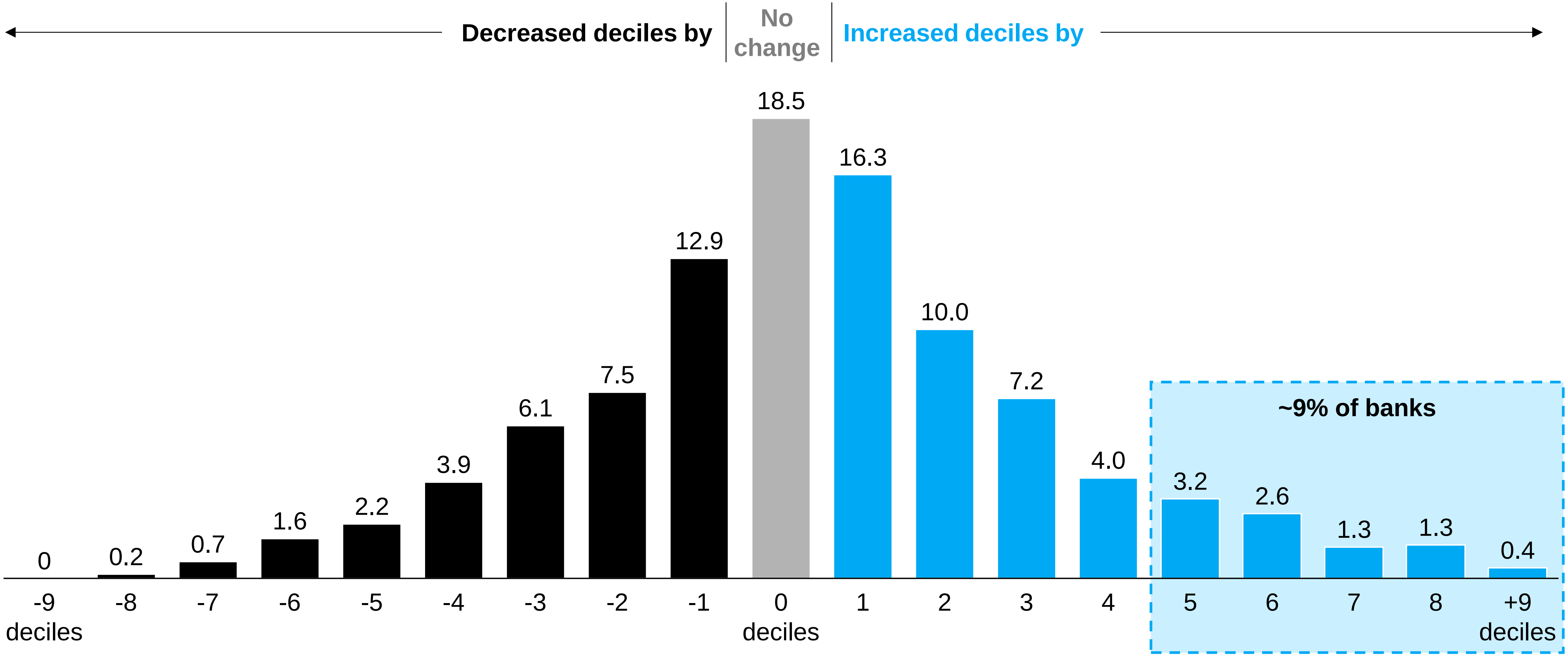


Note: difference in N between ‘EP analysis between two time frames’ and ‘EP::banking vs other industries’ is due to data availability

Source: McKinsey Value Intelligence, McKinsey Strategy & Corporate Finance

It is possible to move up in the ladder - about 10% of banks have moved up 5 or more deciles in ROTE over the past 10 years

Distribution of banks that changed return on tangible equity deciles,
2013-2023, %



Source: McKinsey Value Intelligence, McKinsey Panorama

How to compete

Execution excellence – Five strategic themes for differentiation

A. Primacy in retail

Achieve primacy with retail customers to capture stickiness in deposits and higher fee income relative to the market to win in everyday banking

B. Lending

Create a sustainable premium in lending RAROC to differentiate with complex financing

C. Personalized advice

Generate higher fee growth and income through differentiated talent delivering personalized advice to drive capital-light revenues

D. Unbundle BS

Unbundle balance sheet to focus on fee driven servicing models for traditional and non-traditional customers

E. Cost efficiency

Deliver top-decile cost efficiency and risk management by providing world-class middle and back-office services

Winners need to bet on selected **differentiating factors and execute them**

Management Quotient

Combination of **structure** and **execution**

A. Segments

Picking and decisively committing to the right segments for growth while avoiding the trap of over-rotating into them

B. Scale (selective)

Finding scale where it matters to drive productivity and acquisition

C. Location

Optimizing location—either geographically or in the customer value chain

Rigorous operational execution

Across a range of capabilities (e.g., marketing, op model, analytics, technology)

Examples of winning moves globally

Transformation recipe	Description of transformation
1 **Deepening relationships (one customer-centric bank and ecosystems)**	Delivering the right mix of mutually reinforcing businesses across balance-sheet-intensive and fee-generating activities to spread the cost of acquisition of an expensive customer across more of the bank
2 **Achieving retail or small and medium-size business (SMB) customer primacy through a personalized funnel.**	Create a more personalized experience for customers, all the way from marketing to service. Thrive for low cost of acquisition and customer attrition levels by creating rapid cycle propositions, connected to segmentation that drives who answers the phone, the script used, and ultimately what kinds of ongoing servicing support the customer experiences
3 **Leveraging granular pricing and risk selection**	Develop a holistic approach to mitigate data risk, resulting in improved business decision-making, operational efficiency and digital infrastructure resiliency
4 **Building world-class lead generation in wealth management**	Have the right offer, the right time, and delivery through the right channel; build analytical model that combines client data with these kinds of triggers, along with a rigorous A/B-testing program
5 **Achieving retail or SMB customer primacy through mobile-orchestrated distribution**	Develop a truly mobile orchestrated channel strategy; standardize all other channel operations, turning these channels into interfaces of the same process; move many services that require specialized expertise into a remote advisory model to improve revenues by simplifying customer acquisition and deepening relationships and reduce costs
6 **Using strategic talent management to win with clients and unlock productivity**	Leverage AA models and salesforce excellence components to unlock 100-150M top-line growth for every $15-20B of commercial assets
7 **Picking the right spots in wholesale banking to win**	Build specialized sector offerings to become the destination institution for clients in those spaces; invest deliberately in talent, footprint, marketing and thought leadership to build its brand in these areas
8 **Building an AI-enabled bank**	Apply AI at scale by building into their cultural fabric (e.g., analytics to bee embedded in every cell) and operating models (e.g., best in class data structure, strategic ecosystem investments
9 **Using proven operating models to unleash speed at scale, safely**	Reimagine delivery of capabilities that can operate under the same umbrella with more independence while automating a large portion of common services

5 Key questions for CEOs

1. **The hand you have been dealt**
   What is your thesis about how the **fundamental economics in your specific market** will play out, and what are the **empirical drivers of your and your competitors' market value** that could realistically be influenced to drive relative competitive advantage?

2. **The hand you play**
   How much extra value can **extra value can be generated from endowments your bank** enjoys (e.g., brand, community loyalty, etc.) and **how much would need to rely on execution factors** (moves you make, businesses you grow into)?

3. **Tilting the scales**
   Where are the points of disproportionate structural leverage (e.g., via scale, portfolio mix, relationship depth) **and where are the points of disproportionate executional leverage** (e.g., from better risk selection, talent selection, pricing, marketing)? How much of this leverage is capturable organically?

4. **Friction or frictionless**
   Is your operating model set up to translate ideas to actions fluidly, or does it sometimes feel like you're "wading in mud" when trying to get things done internally? What exactly is getting in your way and what can be learned and adapted from more nimble executors?

5. **Improvise, adapt, and overcome**
   How fast do you tack to changing trends and competitors' moves? Who are the "beacons" you have set yourself and your management team to emulate, so you can leap ahead?