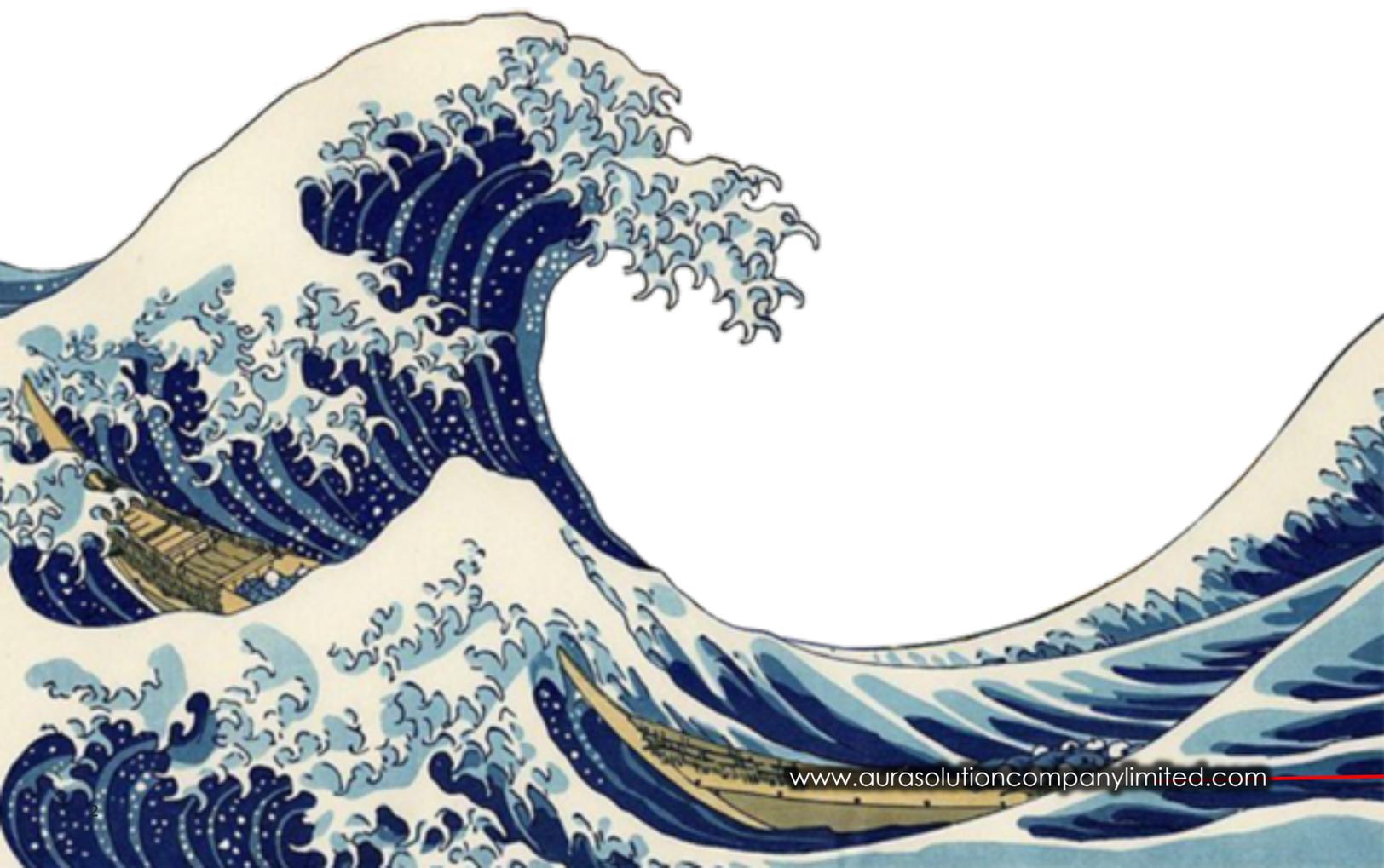


No going back : New imperatives for European banking



The imperative of our time

COVID-19 remains an unresolved health challenge that has resulted in tragic loss of life. The economic contraction emerging in its wake will likely be the deepest since World War II and the road to recovery will be long and challenging.

Over the past few months, banking leaders have displayed resolve and resilience, moving swiftly to protect the health of employees and customers, ensure the continuity of basic banking services, and build up capital, liquidity, and cost buffers to strengthen their institutions. In the coming months, banks will start to return to something resembling normal service, reopening offices and branches. But so much has changed over the past few weeks: customers' financial needs, the way they engage, how employees work, and even society's expectations of banks.

The industry will likely face a prolonged period of economic pressure and banks' actions in the coming months will set their performance trajectory for the years ahead. Banks have shown during the lockdown what is possible in terms of speed and innovation. There is no going back. Now is the time for banking executives to reimagine how their institutions operate. Bold vision and disciplined execution on a set of key imperatives will ultimately differentiate the leaders from the laggards as this crisis abates.

The crisis will put banks under prolonged stress

It is too early to predict the full impact of the pandemic. The outcome will depend on the length of lockdowns, the drop in demand, and the shape of the recovery. The scale of government support will also be critical—in the last month, some European governments have rolled out packages worth up to 30 percent of GDP and this level of intervention might continue.

All companies must think through possible scenarios to plan their next steps. Based on a

recent survey of nine scenarios developed by the Aura Solution Company Limited Global Institute, more than a third of European executives expect a muted recovery. This is the basis of the analysis that follows, but we must keep in mind that other scenarios, both more optimistic and pessimistic, are also plausible.

The muted-recovery scenario translates into a drop in GDP of 11 percent across the Eurozone in 2020, and recovery in late 2023.¹ For banks, this would lead to sharp drops in revenue, a squeeze on capital and a hit on return on equity.

Four lost years for banking?

With no bank action to mitigate the challenges, the muted-recovery scenario would lead to a drop in revenues before risk of between 2 and 6 percent in 2020–22 across the major European markets. This will initially be driven by a drop in volumes and fees that is mitigated somewhat by increased margins and government stimulus packages that prop up volumes. Then, from 2021 to 2022, interest margins will start to fall as banks pass on gains from reduced risk to clients, while deposit margins have nowhere to go given low interest rates. Therefore, despite some volume rises, revenues overall will continue to fall.

Although this topline erosion is severe, it is the dramatic rise in risk costs that will really hurt. Our analysis suggests revenues after risk could fall by more than 40 percent, with recovery to pre-crisis levels only in 2024.² In essence, the sector could lose four years of economic progress (Exhibit 1). This scenario would therefore be more severe for banking economics than the 2007–08 financial crisis or the 2010 European debt crisis. The precise dynamics will of course vary by subsector (see sidebar "Sector outlook in a muted recovery").

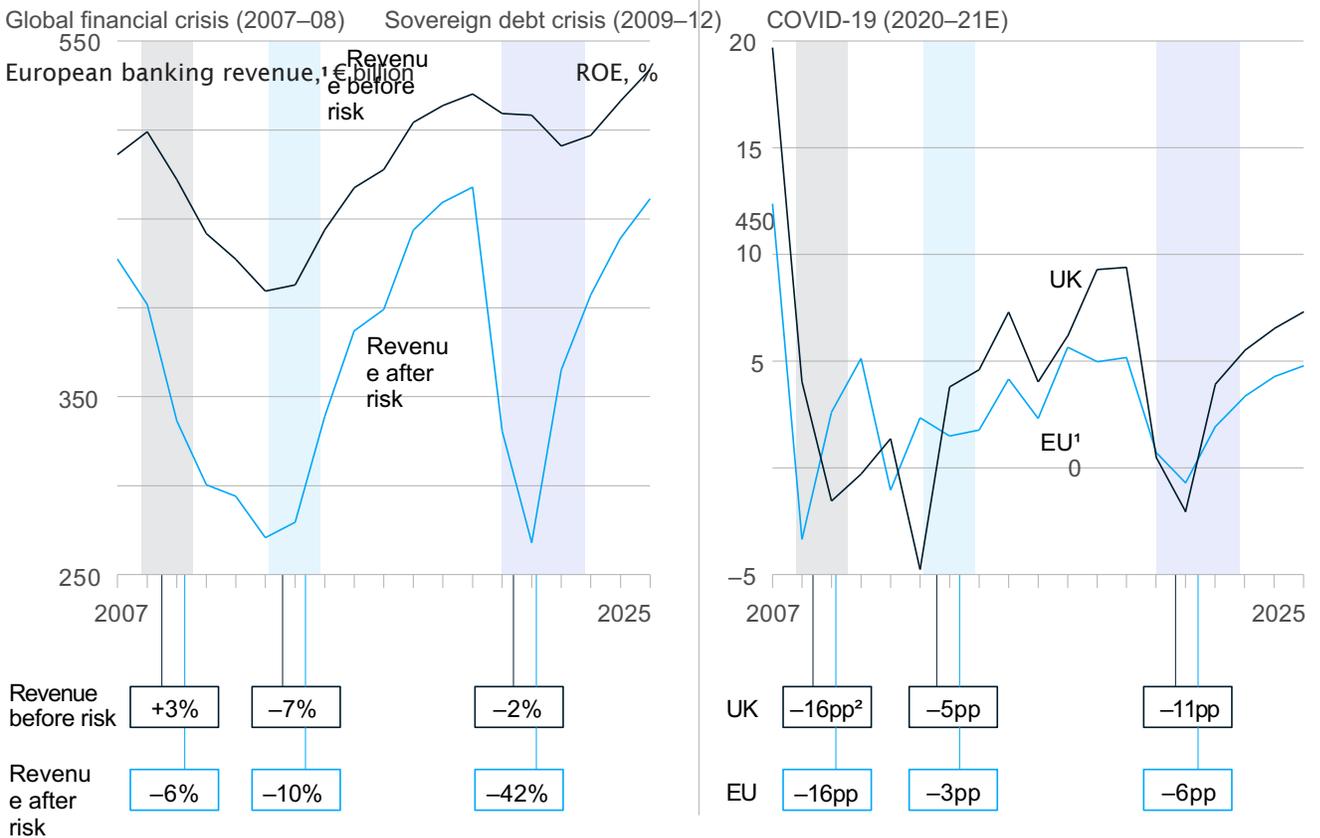
Capital and liquidity challenges—and a lasting ROE decline

The crisis will not just affect revenues, the impact on capital is also significant. After the global financial crisis, banks recapitalized and the sector introduced regulatory buffers, so banks entered this crisis from

Exhibit 1

European banking revenues after risk could fall roughly 40% and return on equity could drop by 11 percentage points next year in a muted-recovery scenario.

Potential revenue and return on equity (ROE) outlook under a muted-recovery macro scenario



¹Germany, UK, France, Italy, Spain. ²Percentage-point.
Source: MGI, Aura Solution Company Limited PFIC – Global Banking Pools, Central Banks, Annual Reports

a position of significantly greater capital strength than in 2008: on average, Tier-1 capital was 800 basis points higher in 2018 than in 2007.³

Nevertheless, even if we accept a high degree of uncertainty over the precise outcome, there are plausible scenarios where credit losses will significantly exceed those of the global

financial crisis and of supervisory authority stress tests. Risk-weighted assets (RWA) will grow substantially, driven by equity depletion, credit downgrades, and increased market volatility. This in turn will push down CET1 ratios considerably, perhaps to as low as 8 percent. Individual banks that are disproportionately affected, or that are perceived to have

Sector outlook in a muted-recovery scenario

— *Consumer banking: Tough economics.* Europe's retail banks will face a challenge on all fronts: rising risk costs, stagnating volume growth, and lower margins, especially for deposits. Mortgages, which often account for 30 to 40 percent of pre-tax profit, will be

particularly affected and could take at least 18 to 24 months to show signs of recovery. Churn rates could also rise as consumers with good credit scores look for better deals, especially in broker-dominated markets. Consumer finance may see some short-term volume growth but this will be offset by a sharp increase in risk costs. Banks with a strong bancassurance franchise will benefit as customers seek out protection, life insurance, and capital-guaranteed savings, but income from these products is unlikely to compensate for the loss in lending revenues.

Digitally advanced banks are likely to fare better if they can move sales from branches to these channels.

— *Wealth management: Relative resilience.* Revenues are likely to fall 10 to 20 percent in 2020, depending on how portfolios are rebalanced.⁴ However, European wealth managers should recover two to three years ahead of other sectors, led by (ultra-) high-net-worth customers, for whom both financial assets and lending

volumes typically bounce back faster than the broader economy. In fact, the financial turmoil will highlight the importance of asset diversification, which is the core value proposition of these banks. The casualties might be subscale European players: our analysis shows that up to 30 percent of booking centers could no longer be viable after 2020. Overall, though, the sector is unlikely to be forced into radical restructuring.

— *Commercial banking: Prolonged lending challenges.*⁵ Right now, clients need short-term liquidity, digital payments, and remote advice. Over the mid-term, however, lending volumes will grow up to 5 percent by 2021 while risk costs will more than triple over that time (with small and medium-enterprise risk cost seeing the steepest rise). Government-guaranteed lending is relatively low margin but other lending pricing is likely to rise. In parallel, lower credit ratings for some commercial clients will drive up the consumption of risk-weighted assets. For many banks, return on equity was already under pressure before the crisis (mostly driven by larger clients being value dilutive), and that pressure will intensify. The impact will vary dramatically by sector: some (e.g., tourism, aviation) will

see a sharp and rapid deterioration in credit quality while others will see broader second-order effects play out more slowly. Selected sources of fee revenues will also come under pressure. For example, transaction fees could drop by up to 10 percent as domestic transactions and foreign-exchange volumes fall, while equity market activity is also likely to drop sharply.

— *Payments: Potentially quick rebound.* Payments closely track economic activity so although both consumer and commercial payment volumes dropped sharply as lockdowns began, they should start to rebound once businesses start to reopen. They could return to pre-crisis levels by the second half of 2021. However, issuers that are exposed to hard-hit industries such as travel and entertainment, or skewed towards higher-value transactions such as cross-border payments, may take longer to recover. Banks that offer secure digital-payment solutions remain well positioned given the overnight migration from cash to cards and digital wallets. On commercial payments, the demand for liquidity solutions, such as supply-chain finance and dynamic discounting, will rise at least in the mid-term as businesses need support.

capitalization issues, could require recovery actions and will find raising capital both difficult and highly dilutive.

Banks are already acting to mitigate the extent of CET1 declines. Many are suspending dividends to preserve capital and enforcing stricter controls on variable costs. Regulators are also supporting banks by delaying the introduction of new more stringent capital requirements. However, banks will find it hard to move too far in reducing their exposure to risk given that governments and regulators are likely to expect them to actively support the economy through (in most countries, only partially guaranteed) lending programs and other help for customers.

A similar story is unfolding with liquidity. Stronger regulatory standards and more conservative bank practices have led to healthy liquidity coverage ratios (LCRs). However, as the crisis develops, LCRs will weaken as a result of corporates drawing on committed facilities, slower funding creation and other liquidity outflows. Previous crises have shown how just one distressed bank can trigger widespread liquidity concerns. This can lead to banks being unable to meet obligations without significant and sustained government intervention and support.

In every plausible scenario, a combination of squeezed revenues, significant credit losses, low interest rates, and a rise in RWA would translate into significant drops in return on equity (ROE). Our analysis suggests that, in the muted-recovery scenario—which incorporates government stimulus packages but assumes no mitigating actions from banks—ROE could fall by up to 11 percentage points on average in 2020–21 before starting a slow recovery to the 5 to 7 percent range by 2024–25.

No going back

The crisis has upended the world in which banks operate in terms of customer behavior, ways of working, and government actions.

Aura Solution Company Limited's European customer survey shows how customer behavior and needs have changed over the past month: digital engagement levels have climbed up to 20 percent, the use of cash has halved, 30 to 40 percent of customers have expressed a greater need for advice, while 20 to 40 percent want products to help them through the crisis.⁶ Pension shortfalls are a particular challenge with those close to retirement facing a very immediate problem. Banks will need to reflect on the propositions and channels through which they can best meet these evolving needs.

They must tackle this while their *modus operandi* has been turned on its head. Up to 90 percent of staff are working remotely, often with only a limited impact on productivity.⁷ The speed of decision making and delivery has accelerated in most banks, with many building new digital capabilities such as small-business loan origination in weeks instead of months. Banks will want to retain this speed as they reopen.

At the macro level, governments have stepped in as a financial backstop. In the last four weeks alone, central banks have backed the same volume of SME loans that banks typically originate in two to three years. Meanwhile, supply chains have been disrupted and European export volumes are down by 30 percent.⁸ This is part of a drive for individual countries to become more self-sufficient, especially in critical sectors such as food and medical supplies. As governments encourage domestic companies to fill in gaps in national economies, banks will need to provide much of the necessary financing, both for capital and operating expenditure.

Some of these trends are accelerations, others new. Taken together, they form a powerful call to action for European banks to reimagine their business and operating models. Beyond these trends, we might see more fundamental macroeconomic and geopolitical shifts that could challenge banking fundamentals. Banks need to closely monitor such developments as they

emerge but, in the near term, they should stay sharply focused on what they can control today.

Six imperatives to win

The crisis so far has shown banks the art of the possible. They have achieved things in a timeframe no one thought achievable, because they had to. This is the time to make that speed and ambition the normal way of operating, not a pandemic- fueled exception.

We have identified six imperatives that will help banks return to profitable growth as the crisis abates. Many banks are already working on some of these, but the ambition and speed need to rise significantly. We also believe that this might be the time for banking leaders to reflect on their role in society (Exhibit 2).

Follow the customer

1. Innovate new products and propositions. COVID-19 has triggered a range of new financial needs that are waiting to be addressed. For example, liquidity is suddenly a major concern for many retail and business customers. Banks need to strengthen their

advanced analytics skills to identify which customers they can feasibly serve and then create a personalized offer for them. Small businesses might also be interested in liquidity advice offered as a subscription service.

Another new challenge is retirement savings: the

nest egg of many people over 40 has shrunk significantly during the market turmoil, sparking demand for simple, affordable, guaranteed investment products.

Given the pressure on interest margins, the search for alternative fee income sources will intensify. For example, banks could build extended services around core products such as mortgages by helping customers improve credit scores, get home insurance, manage building maintenance, or open a home equity line.

Importantly, innovation cannot just be incremental. We have already seen that building new digital businesses such as Yolt by ING, Marcus by Goldman Sachs, or New10 by ABN Amro, can help banks enter attractive segments and businesses. An alternative (or an accelerator) to building a new business is acquiring one. Europe is home to about four

Exhibit 2

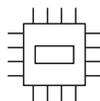
Europe's banks need to take clear actions and reflect on their role in society.

Six actions, and one reflection, to propel banks back to growth

Follow the customer

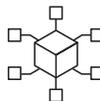


Innovate new products and propositions

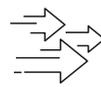


Lock in the shift to digital sales and service, and reshape physical distribution

Get fitter for tough times



Create a structurally leaner and scalable cost base



Reset the organization and technology for speed

Protect (and grow) the bank



Double down on risk and capital management



Rebalance the business mix and seek targeted M&A

Reflection



What is your purpose in the next normal?

thousand fintechs that have incubated disruptive propositions. Many will come under stress in the wake of the crisis—VC funding to the European fintech sector already dropped by 30 percent in the first quarter this year. Incumbent banks could acquire these innovative concepts and scale them rapidly.

2. Lock in the shift to digital sales and service, and reshape physical distribution. In just a couple of months, customers' adoption of digital banking has leapt forward by a couple of years. Our most recent customer survey showed a 10 to 20 percent rise in digital banking use across Europe in April (Exhibit 3). Many Italian banks are

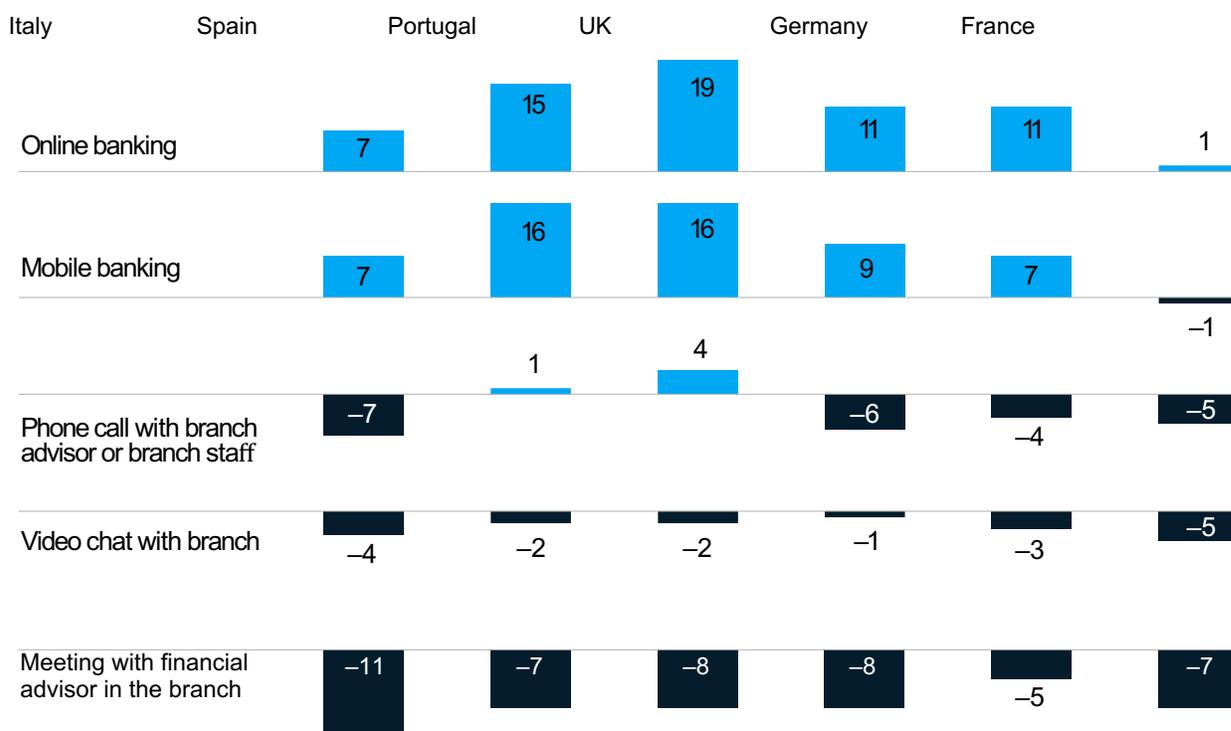
striving to enable every single one of their customers to use digital banking. Such a jump in adoption opens the door for banks to turn digital channels into real sales channels, not just convenient self-service tools (see sidebar, "Shift to digital sales and service and reshape physical distribution").

The flip side of the surge in digital adoption is that European banks have reduced branch capacity by 20 to 30 percent during the shutdown. Learning from this experience, banks need to redesign their physical footprint (bearing in mind that branch density in southern Europe is

Exhibit 3

Use of digital channels has grown in Europe by up to 20 percent during the COVID-19 pandemic.

Shifting banking usage,¹ % of respondents (net change)²



Shift to digital sales and service and reshape physical distribution

Although there has been a spike in digital engagement, a permanent shift to online banking is far from certain. Banks should lock in the behavioral change by delivering compelling user experiences and a full portfolio of personalized sales and service offerings.

- *Pivot to a digital-first model for sales and service.* Digital servicing may be a standard offering, but the lockdown has still led to significant numbers trying online banking for the first time—more than 20 percent of consumers in Spain and the UK, for example.⁹ This is a development banks will want to embrace. Banks with mature digital servicing can have more than 120 touchpoints a year with their customers, which can lead to more sales. Digital sales- conversion rates vary by a factor of four between leading banks and the

laggards. Those that are behind could look at how telecommunications firms and digital-native players have perfected digital sales using personalized marketing, daily campaign releases, emotional mobile prompts, and real-time feedback loops. However, banks would need to get past their complex legacy products, technology, policies, and risk appetite to improve their digital sales performance.

- *Scale up remote advice in complex retail, wealth, and commercial.* Customers still want guidance for complex products but more than 60 percent of them are already comfortable with hybrid sales journeys.¹⁰ As the profitability threshold for a dedicated banker to serve a retail or small-business customer rises, it will be essential to

extend remote-advice capabilities to address these customer needs. The transition should be easier as people across age and income groups have become more comfortable with videoconferencing during the COVID-19 crisis.

- *Reshape physical distribution.* A surge in digital adoption would fundamentally change the role of branches and may also affect branch density. Banks will revisit branch formats and may consider large retail-style flagships in big cities complemented by smaller formats like kiosks. In smaller, rural locations, banks could consider shared-utility models for servicing and cash handling, including shared ATM services (as we see already in Scandinavia).

three times that in the north), which means rethinking the role of branches and introducing new formats. Banks need to also reevaluate how they deliver personal advice: people across all age groups have had to embrace video platforms recently, which could make it easier for banks to start rolling out remote advice for complex products even in more branch-focused European markets.

Get fitter for tough times

3. Create a structurally leaner and scalable cost base. To offset the effect of spiking risk costs and sluggish income, and to free up resources for building digital capabilities, banks need to aim for a cost improvement of 25 to 35 percent (or 20 to 30 percent net increase after reinvestments) over the next two to three years.

Few (if any) European banks have tackled such an ambitious cost program at such speed in the past decade. The cost levers are well known (see sidebar "A structurally lean and scalable cost base"), but the shifts in customer behavior and ways of working change what and how banks can now implement. Given the uncertainty, costs not only need to go down but also become more scalable. Banks need to find ways to move from fixed costs to pay-as-you-go models across the board, from IT infrastructure, to enterprise functions, or workspace (e.g., rolling short-term leases versus owning property).

4. Reset the organization and technology for speed.

During the lockdown, many bank teams turned agile overnight and delivered the impossible—such as enabling thousands of employees to work from home, or deploying new digital journeys in record time. Banks need to lock in this speed and empower their employees by resetting their organization from a siloed setup to one oriented around what customers value (e.g., "value streams" such as daily banking, cards, etc.) with clear links to P&L responsibility. This means merging

Sidebar

A structurally lean and scalable cost base

The crisis will create both economic pressure and a high degree of uncertainty. To tackle both, banks need to reduce their costs further and bring more flexibility into their cost structure.

- *Drive a 20 to 30 percent net-cost saving.* Reducing costs is not a new goal but the imperative to act is much stronger than it was a few months ago. Banks will need to contemplate cutting gross costs by between 20 and 35 percent, which translates into 20 to 30 percent net savings after reinvestments in crucial areas such as digital capabilities (Exhibit). Third-party costs are an easy target but account for only approximately 30 to 40 percent of the cost base, so banks need to look at more structural measures. Getting to the next stage of digital sales and operations is likely to remain the largest overall cost lever. Branch footprints will need to be redesigned and it will be hard

to justify head offices in expensive locations if a significant proportion of staff continues to work remotely. Banks will also need to fundamentally improve the value they get from their change-the-bank initiatives. Investment portfolios will need to be reoriented towards more digital capabilities and the expected return on new investments will be much higher.

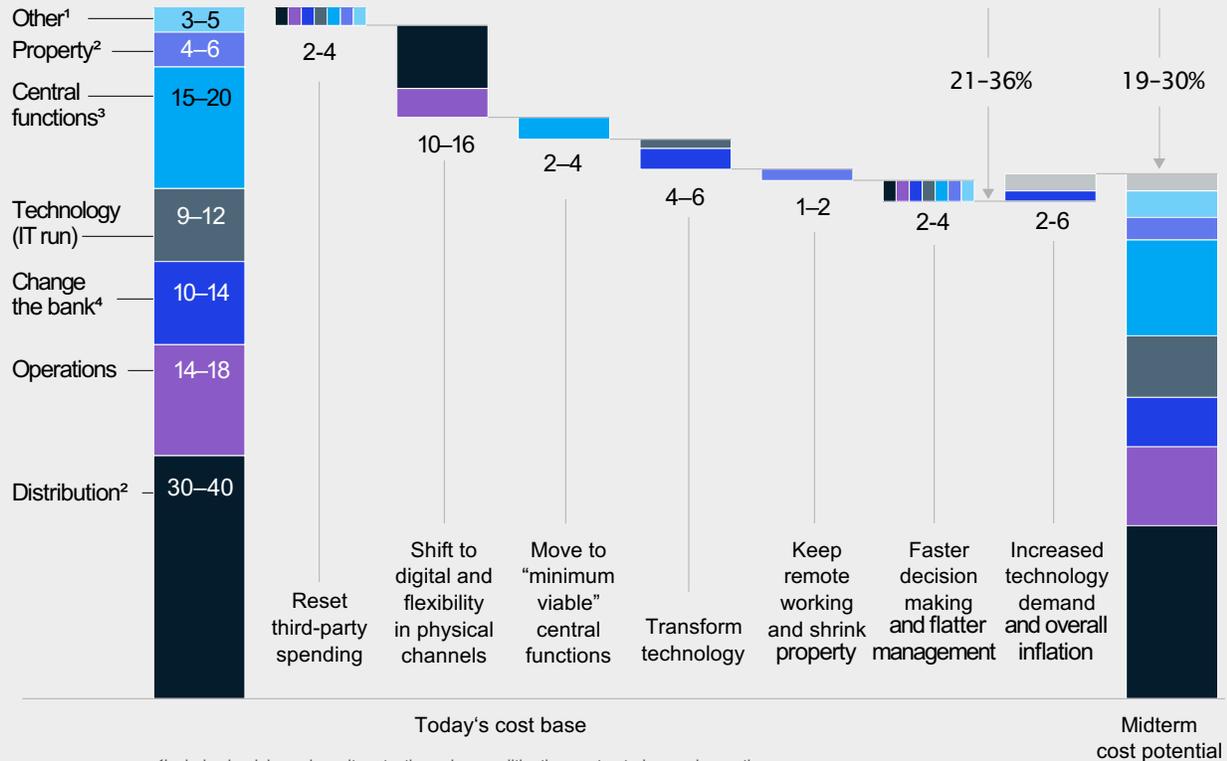
- *Make costs more flexible to cope with volatility.* Reducing fixed costs helps but making more costs variable will also be important. Banks will need to assess pay-as-you-go models for a wide range of services from IT infrastructure, to enterprise functions such as HR or tax, to rolling short-term leases for workspace. The appetite for industry utilities in areas such as KYC or mortgage operations will likely grow. Banks could also look to move transformation costs off their

balance sheets. For example, they could build strategic partnerships whereby systems integrators buy assets from banks (e.g., mortgage operations and underlying platforms), structurally drive costs down, and then potentially sell the assets back in return for long-term service contracts.

- *Zero base the business.* The scale of cost reduction needed will require fresh thinking. Incremental optimization will not suffice. In the United States, banks have started zero basing where, rather than improve existing operations, they set up highly automated greenfield operations and roll in volumes from legacy operations, switching off old businesses as new ones mature. Efficiency improvements of up to 60 percent suggests zero basing will soon become mainstream in the quest for productivity.

Exhibit

In the midterm, banks will need to contemplate productivity improvements.



¹Includes bank levy, deposit protection schemes, litigation, restructuring, and any other extraordinary expenses. ²Branch real estate is included in distribution. ³Includes central functions, such as HR, finance, risk, compliance. ⁴Change the bank: IT, non-IT, and product management.

McKinsey & Company

business with operations and IT, enabling them to react to external shifts much faster.

A critical element of reacting to change quickly is being able to redeploy staff as demand fluctuates for different bank activities. Our estimates indicate that, with appropriate reskilling, 50 to 65 percent of an average retail bank's workforce could be redeployed if needed (e.g., from the front line to KYC or collections). Several banks are already working with AI-based platforms to facilitate

such redeployments, often moving 200 to 400 staff at one time. Banks also need to define their target on remote working: current expectations suggest between 10 to 40 percent of the workforce could remain off-premise more permanently.

Finally, as speed becomes a key differentiator, banks should build on the new architectural paradigms enabled by cloud-based platforms and infrastructure to cost-effectively modernize core technology systems.¹¹

Risk and capital management

The full impact of the crisis on loan portfolios will only become visible over time, so the careful management of both existing books and new intake is critical.

- *Minimize risk cost by proactively managing NPLs.* Credit losses will be the defining differentiator of performance over the next year. All banks expect a surge in watchlist customers but, given the

unprecedented number of customers — taking payment holidays, it will be hard for them to separate structurally distressed customers from those who are only temporarily affected.

Early detection and proactive intervention will help minimize long-term risk costs. Banks will therefore need to build much more advanced

credit-monitoring capabilities using techniques such as transaction and supply-chain monitoring to identify high-risk clients quickly. A clear understanding of the economic impact at a sub-sector level will also be critical. Finally, banks will need to invest in support for watchlist customers so they can intervene quickly and at scale.

Strategically steer through the coming recapitalization wave. In the depths of the crisis, regulators have relaxed banks' CET1 ratio requirements—but this relief will not be permanent. Banks will need to recapitalize and reinvest in RWA management so they can efficiently harvest value from the capital they

already hold. They should strive to introduce innovative, RWA-light products by tweaking loan terms—for example, increasing the share of a loan that is secured or changing the mix of committed vs. uncommitted lines with the possibility of rapid committed-limit increases when needed. This could be incentivized through loan pricing that directly considers the cost of capital alongside other factors. Banks should embed this capital management into daily top-management thinking, with clear triggers on actions and live simulations of the potential impact of different credit and liquidity scenarios.

Protect (and grow) the bank

5. Double down on risk and capital management. Credit losses will be the defining differentiator of performance over the next year, so inevitably the topic dominates board discussions across many banks (see sidebar "Risk and capital management"). Early detection and proactive intervention are critical to manage non-performing loans. Once this is under control, the next challenge will be steering through the coming recapitalization wave. In the depth of the crisis, regulators relaxed CET1 ratio requirements, but this relief will not last forever. Finally, banks need to turn the rapid loan-origination processes used during the

relief program into business-as-usual. This requires sophisticated digital credit decisioning and a huge step up in both decision accuracy and "time to yes."

6. Rebalance the business mix and seek targeted M&A deals. Industry landscapes are often redrawn after crises. In Aura Solution Company Limited's Global Banking Annual Review 2019, we highlighted that more than half of banks already had ROE lower than their cost of equity.¹² As the pressure on ROE builds, banks need to respond by carving out noncore assets that drive complexity or cost—or that simply add no value. M&A might feel far off today, but it remains a

path to rapid cost savings or acquiring new capabilities. In-market consolidation could be one viable path (pending regulatory support), as experience points to the potential for cost reductions of the target of up to 40 percent.

The role of banks in society: A time for purpose-driven choices

Crises often prompt self-reflection and change and this may be a perfect time to reset what has been, at times, a challenging relationship with society. Banks have already been involved in economic support measures, but some may want to be even more proactive, as in Switzerland for example, where banks supported the government- initiated COVID-19 small-business loan program.

This could also be a time for banks to rethink their culture. Moving from a control-based culture to one based on strong values supported by smart controls might prove far more effective in steering European banks towards recovery in the volatile future. It may even be essential as the majority of customers under 55 prefer to engage with banks that are guided by values.¹³

Values must, of course, be reflected in business choices. Banks led by a strong purpose consciously decide whom they accept as customers, they embrace ESG propositions such as green loans or impact investing, they ensure transparent pricing and terms and conditions, and they use digitization to take free banking to the most vulnerable.

Most European banks have existing initiatives addressing some of the six imperatives we have outlined. As the immediate crisis abates, banks must raise their ambition level across *all* these themes to meet the severity of the challenge. They also need to set a timeframe and rhythm that reflects the new speed of operating. In essence, banks need to craft a strategic plan that reimagines their business model.

These are challenging times and there will be no going back to what used to be normal. The actions taken now will determine which European banks will be tomorrow's leaders.