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Banks that want to avoid becoming laggards have a brief post-recovery window to exploit, McKinsey says

Article

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The news: Banks have **a window of just 18 to 24 months** to position themselves for the post-recovery years—or else risk being left in the dust when it comes to delivering shareholder value, per McKinsey's Global Banking Annual Review.

How we got here: The consulting giant warns in its international report that the sector faces a "great divergence," and says that a short window set the trajectory for shareholder returns following the 2008 crisis:

- Top-decile banks delivered returns for investors **approximately five times higher** than those in the bottom decile, and **three times greater** than an average bank.
- However, the top performers **generated around 60% of their divergence in only about two years following the crisis (2009-2011)**, and approximately 40% during subsequent years.

At the same time, McKinsey predicts that the next five years will differ from the previous recovery:

- McKinsey dubbed the years after the immediate crisis recovery (2011-2020) as the era of **"convergent resilience,"** which was marked by banks rebuilding their regulatory capital and making digital investments. Top 10 banks and their average peers had a narrower gap in their return on equity (ROE).
- During this era, banks' offerings generated off their balance sheets were overtaken by those derived from origination distribution, such as mutual funds distribution and payments.
- McKinsey expects the next five years to usher in **"divergent growth"** among financial institutions (FIs). Evidence is already emerging: The price-to-book ratios (an indicator of how capital markets value FIs) of top performers, which rely more on sales and origination, **have a premium of 518%** over those FIs that rely more on balance-sheet-sourced income.

The consulting firm notes that higher-performing FIs—digital insurgents and large banks are included—are doing well because of their scale, geography, and business segments.

Suggestions: McKinsey lays out three steps that banks can take to "**future proof"** their business models:

- **Emulate tech giants** by making products that are embedded in their users' daily lives. For example, banks could do this by drawing customers into their broader ecosystems and creating personalized insights.

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- **Cut reliance on balance-sheet-driven revenue**, which entails focusing on "value-added services that generate greater customer involvement and sustainable fees."
- **Being innovative and agile** in making new products and quickling deploying them.

The big takeaway: Implementing McKinsey's suggestions will not come cheap for smaller banks due to IT and tech talent costs:

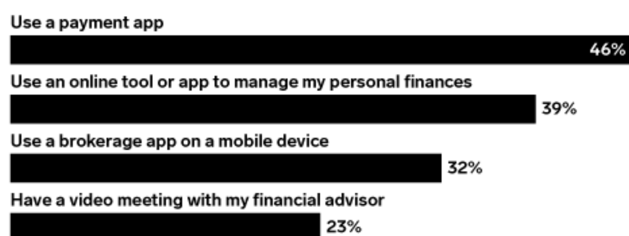
- JPMorgan Chase has **a $12 billion annual tech budget** behind its offerings.
- At the same time, even JPMorgan faces difficulty in landing talent, and is now looking at more locations for recruitment.

However, banks with smaller resources for in-house development have other options for keeping pace with competitors, per our 2021 Innovation Strategies at Small and Midsize FIs report:

- They can **merge with other FIs** to pool resources and improve capabilities, including in customer experience and agility.
- They can take a faster approach by **striking partnerships** with outside fintechs or software vendors. McKinsey states that the top 10 performers among specialist FIs and fintechs, such as wealth management companies, are **averaging price-to-book ratios north of 15% versus low single digits for the older FIs.** As one example, partnerships within the wealth management sector could help FIs cater to US consumers' interest in digital solutions for personal financial management and wealth management.

Activities that US Investors Plan to Do Digitally After the Coronavirus Pandemic Subsides, June 2021

% of respondents



Note: n=1,000
Source: Charles Schwab, "Charles Schwab Investing & Technology Survey 2021" conducted by Logica Research, Sep 28, 2021

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