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Why US banks need a new business model

Investors want radical plans to boost ROE above the cost of capital.

Toos Daruvala, Hasan Malik, and Fritz Nauck



This autumn, many US banks reported a respectable improvement in earnings for the third quarter: more than 80 percent of the largest beat the market's consensus forecasts, and a similar proportion showed year-on-year increases. The second quarter was equally impressive. So why have the stocks of large banks declined by more than 20 percent since the beginning of the third quarter—nearly three times more than the broader stock market—to the point where four out of five now trade below book value?

Many commentators blame Europe's sovereign-debt crisis and fears of a double-dip recession. But three additional factors also weigh heavily on investors: the new bank capital requirements introduced under the Basel III international-banking regulations, the impact of new US banking regulations responding to the financial crisis, the Dodd–Frank Act, and the unwinding of consumer debt. All three undermine banking's traditional business model.

By business model, we mean how banks actually operate—how work is done, the degree of automation, the pricing and design of products, and underlying compensation systems. In the market's view, the threats are so strong that it won't be enough to trim the sails, refocus investment, or cut costs a bit here and there. Our estimates show that if banks maintain their existing business models, their average return on equity (ROE) would fall to 7 percent by 2015, from its current level of 11 percent, against a cost of equity projected to be more than 9 percent.

Investors want to see the management teams of banks propose credible, far-reaching plans to close this gap. The message that investors are now sending—shares of banks will be valued at levels implying that they will not earn their cost of equity—has profound implications for a US economy dependent on a healthy banking system to support recovery and fuel growth.

Of the three threats, the most significant comes from the Basel III requirements, proposed by the Basel Committee on Banking Supervision. Without mitigating actions, they could reduce the ROE of some banks by as much as five percentage points. While the details are still being determined, we estimate that the US banking system will need an additional \$500 billion in retained earnings or new equity to meet the new capital adequacy standards (assuming the current asset level and mix).

The second threat is the continuing deleveraging of consumers. The history of the past 100 years suggests that when excessive borrowing is a principal cause of a recession, consumers and businesses spend the next seven to eight years rebuilding their balance sheets. On that basis, we are in only year three of a much longer journey. There is

little prospect of a quick return to the heady consumer-borrowing levels of the years immediately preceding the crisis—and some of that business may never return. In 2006, after all, bank revenues related to consumer credit exceeded their longer-term average by 25 percent.

Third, new US bank regulations resulting from the Dodd–Frank Act are also taking their toll on bank profits.¹ The reasons include an amendment that caps fees on payments, as well as a requirement to move many over-the-counter (OTC) businesses to clearing houses and to divest proprietary activities. The costs implicit in a new consumer oversight agency will probably make day-to-day operations more expensive and complex.

These forces of change will compel banks to reinvent four of their core banking businesses: retail branch banking, payments, mortgages, and fixed-income OTC trading.

Take the business model of core retail banking. Over the past decade, banks continued to invest in branches as a response to free checking and to the rapid growth in consumer borrowing. But regulations undermining the assumptions behind free checking and a significant reduction in consumer borrowing have called into question the entire retail model. In five years, branch banking will probably look fundamentally different as branch layouts, formats, and employee capabilities change. The use of the Internet and mobile devices will grow exponentially. Overall, the cost of serving each customer in a branch is likely to fall by one-third.

What's more, until investors see evidence of a similar transformation in cards, mortgages, and OTC trading operations, they will continue to lack confidence in the ability of banks to earn attractive rates of return. Banks must therefore squeeze the most out of every dollar of capital—something they largely neglected to do over the past decade, when it (and leverage) were widely available. They will come under increasing pressure from investors who want to know how capital is deployed, how effectively banks are using it, and how well compensation systems support the new objectives. Banks that historically geared rewards to the results of the income statement must now link them to risk-adjusted capital usage.

Accepted wisdom on the businesses banks should own is also being turned on its head. While most have started to think about which of their activities are noncore, this evaluation will have to be stricter in coming years. Many more businesses will be tagged as peripheral, speeding up divestitures and sales, as investors demand greater transparency on this issue, a rigorous review process, and evidence of solid execution in divestitures.

¹ The Dodd–Frank Wall Street Reform and Consumer Protection Act, signed into law in July 2010, represents the most significant reform of banks and financial-services providers in the United States since the Great Depression. It establishes, among other regulations, new rules for how banks and insurers can invest capital, how hedge funds are regulated, and how financial-services firms report information.

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We estimate that by remaking all four key banking businesses, the industry could boost overall ROE by five to six percentage points. At this level, banks would be earning an ROE of 12 to 13 percent, comfortably above their cost of equity and right in line with their 50-year average. But valuations won't improve until investors have a clear understanding of the banks' plans to embrace the new business model implicit in this transformation. ○

Toos Daruvala is a director in McKinsey's New York office, where **Hasan Malik** is a principal; **Fritz Nauck** is a director in the Charlotte office. Copyright © 2012 McKinsey & Company. All rights reserved.