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A NEW MAP FOR STRATEGIC GROWTH IN BANKING

Portfolio strategists need to look beyond economic development when eyeing new investment.

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When bank strategists seek new growth or reevaluate their portfolios, the odds of success often look stronger in places where banking penetration is low and opportunities relatively abundant. But not always.

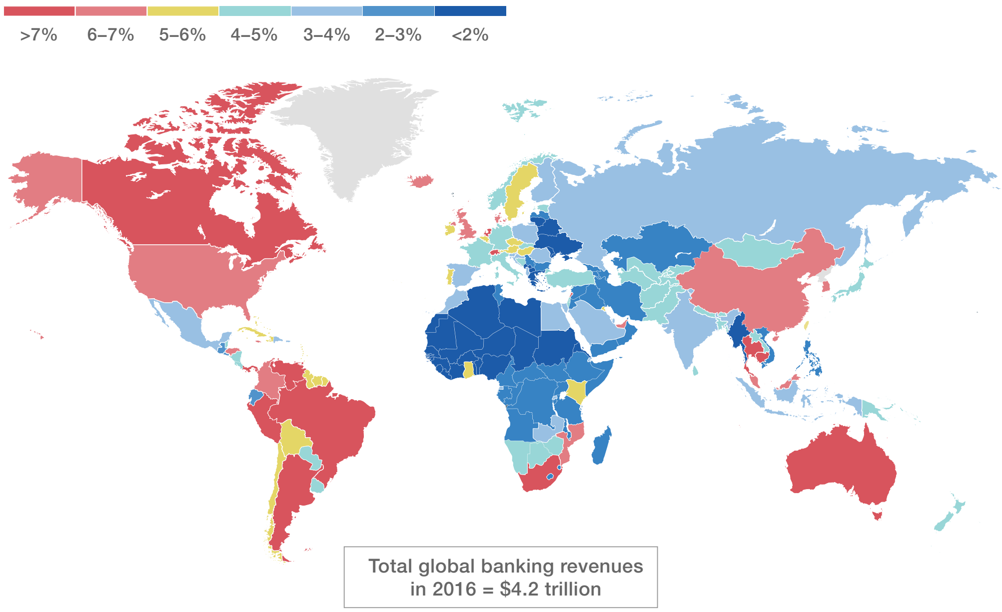
To get a better understanding, we looked at the ratio of banking revenues as a share of GDP across global markets, deducting banks' costs of risk.[1] As the exhibit shows, the old pattern of banking activity that is more entrenched in developed than developing markets no longer holds: penetration in China last year reached the same levels as in the United States; Brazil's ratio is higher than the United Kingdom; and some Eastern European nations are more "banked" than Western Europe. Economic development should be just the starting point for a growth discussion, as multiple factors—including capital-market depth, the growth outlook, asset mixes, margin trends, regulation, and risk—should all be taken into account. Margins in some developed markets, for example, are elevated as a result of market consolidation. That may be a signal that banks in these markets are more vulnerable to margin erosion, among other challenges to the continued success of established business models. Digital attackers—fintechs and even incumbents with new, lower-cost models—will find these markets increasingly attractive. Emerging markets with high margins such as those in Latin America and China may be susceptible to abrupt turns in the credit cycle. In China, corporate lending is vulnerable to an economic slowdown.

Elsewhere in developing markets, Northern and sub-Saharan Africa are conspicuous for their low volumes in retail and small-business lending. That suggests potential for growth, but volatile commodity prices and structural challenges, such as income inequality and political instability, complicate short-term investment bets. In India, where only half the population has access to banking services, a new currency and government reforms are spurring growth in the number of bank accounts.

It is noteworthy that Western Europe's penetration rates are substantially lower than those in the United States (and many have recently slipped behind those of Eastern Europe). That reflects the high-risk costs of corporate debt, in contrast to the United States where banks benefit from a strong base in retail and in wealth and asset management, Exhibit

High banking penetration is no longer limited to developed markets.

Global banking penetration: Ratio of revenues (after risk costs) to country's GDP, 2016



Source: Panorama by McKinsey

which are performing well. Assuming low interest rates persist as Western Europe's economies struggle, banks will remain under pressure to improve efficiency, by cutting operating costs and cleaning up and selling off bad loans to bolster their capital base. Q

[1] We deducted write-downs and loss reserves to arrive at the ratio of revenues after risk costs to GDP.

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