

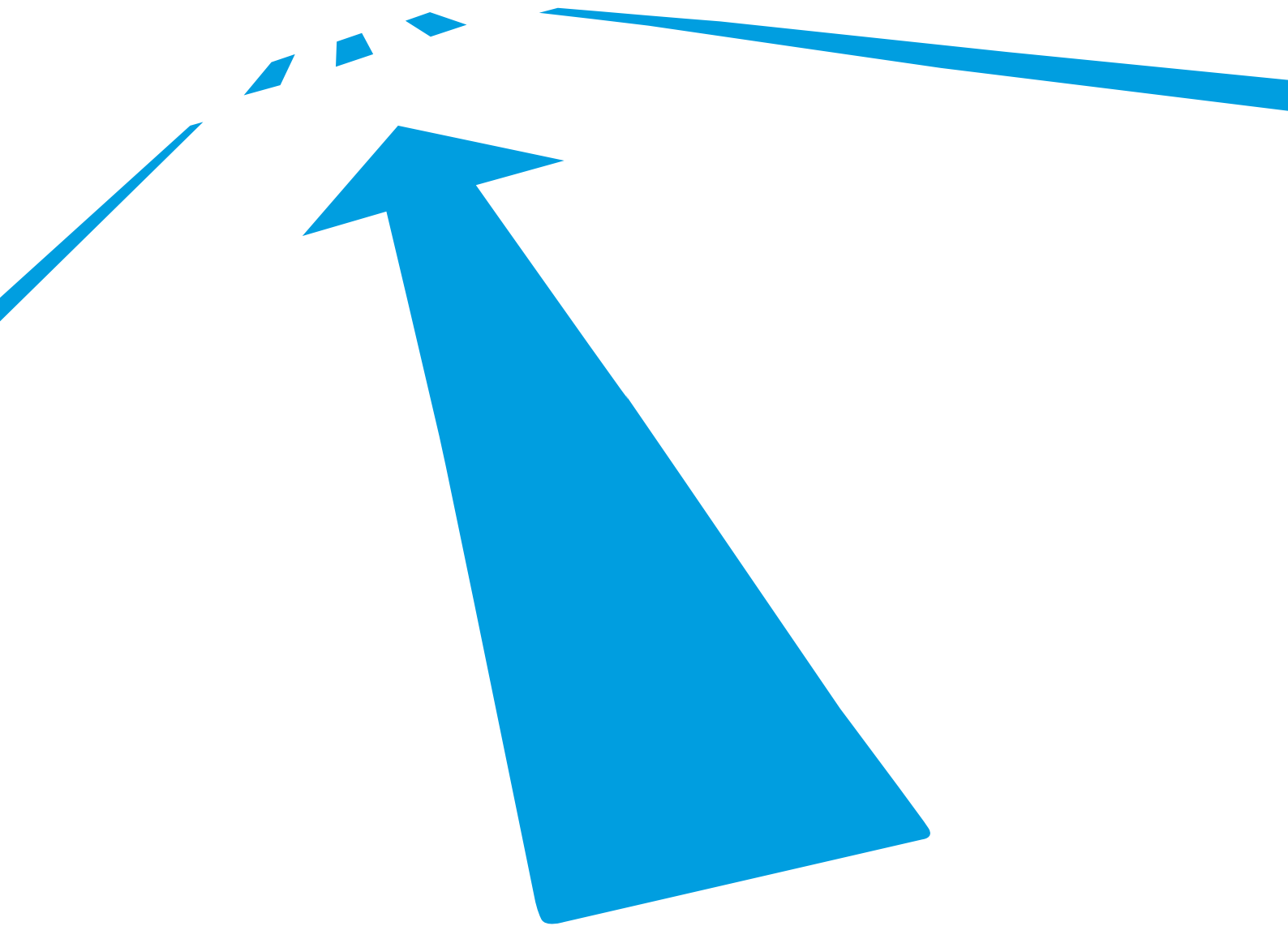
The road ahead Perspectives on German banking

German Banking Practice March 2016

Authored by:
Philipp Koch
Max Flötotto
Ursula Weigl
Gerhard Schröck

Contents

EXECUTIVE SUMMARY	5
INTRODUCTION	9
1 DRIVING CONDITIONS – CHARACTERISTICS OF THE GERMAN BANKING MARKET	10
2 HARD TRAVELING – SIGNIFICANT SHIFTS SINCE THE FINANCIAL CRISIS	18
AN INTERVIEW WITH DR. ANDREAS DOMBRET (DEUTSCHE BUNDESBANK)	26
3 NEW TRAFFIC PATTERNS – THREE TRENDS THAT ARE CHANGING GERMAN BANKING	33
4 STEERING CLEAR – RETURNING PROFITABILITY TO GERMAN BANKING	46
FACTS AND FIGURES	54
APPENDIX	64



Executive summary

The German banking market faced a rough ride during the financial crisis. Some banks almost drove off the road, while others managed to stay on track, allowing them to overtake their competitors. However, the road ahead is still not clear. Massive trends are shaping new traffic patterns, putting additional pressure on all types of banks, even those that seem to be in good shape today. If left unmitigated, these trends will put three out of four banks in real trouble. The next three years will be critical for the industry in order to find the right set of mitigating levers. German banks will have to decide which turn to take to avoid a dead end.

Driving conditions – characteristics of the German banking market

The German banking market's unique three-pillar structure of private, savings, and cooperative banks distinguishes it substantially from banking markets elsewhere. German banking is further characterized by its strong dependency on net interest income, an extensive branch network, and a prudent risk profile. Compared to global peer markets, long-term profitability is low, and German banks have difficulty earning their cost of capital. Several factors induce this low profitability:

- High competition in lending and deposit taking – the bread-and-butter business of German banks
- Low prices for banking products and services
- Little customer experience with fee-based pricing models
- A relatively rigid cost base (with high branch density and a large staff base).

Hard traveling – major shifts since the financial crisis

As in all global markets, German banking experienced a major shock to profitability during the financial crisis. Since then, the industry has been in transition to a new reality. It has recently returned to precrisis return on equity levels (averaging 5 percent from 2010 to 2013), but profit distribution across the pillars has changed radically. Sparkassen and cooperative banks are now substantially outperforming private banks, earning double-digit returns compared to returns of around zero for domestic private banks. Two factors have supported the postcrisis success of Sparkassen and cooperative banks:

- They have achieved considerable growth in loans, well above the German average, and consequently improved their ratio of net interest income to operating costs.
- With their prudent business model, they have been able to navigate through the crisis-induced turbulence in the financial markets with so far hardly any increase in risk cost.

Industrywide, however, German banking made no downward cost adjustments in response to the crisis-induced decline in profitability; the cost base has even increased nominally by a total of 4 percent.

New traffic patterns – three trends that are changing German banking

The German banking market is now moving to a new reality with further pressure from three trends:

1. **Low-interest-rate environment.** Interest rates are expected to remain low at least through 2016 and 2017, and so interest margins will continue to be squeezed. Even if interest rates rise gradually thereafter, net interest margins might not recover for another two or three years. The low-interest-rate environment will presumably cause client-driven interest income to decline. If the falloff is 20 percent over the next five years, pretax profits could be half of what they were in 2013. Most affected will be the banks that significantly engage in lending and deposit taking, including the average Sparkasse, local cooperative banks, foreign private banks, and Bausparkassen.
2. **Regulatory tightening.** New regulations will become effective in the near future and will have an impact on sector profitability. Expanded consumer protection rules and information disclosure requirements might further limit fee income. Capital regulation and restrictions on trading activities will make generating income from trading more challenging. To comply with forthcoming regulations, German banks will incur higher fixed costs. Smaller banks will be more affected by the cost increases; banks that are highly dependent on fee and trading income, including the average private bank and the central cooperative banks, will be most affected by the loss in income.
3. **Digitization.** The preferences of both retail and corporate customers are shifting towards online and mobile channels, presenting challenges for banks in serving and retaining them. Nonbank attackers, especially financial technology firms, are making inroads into the banking market, capturing business and pushing down prices. Left unchecked, the digital movers could cause banks to forfeit between 5 and 15 percent of interest and fee income over the next five years. Banks that have a high share of simple and therefore attackable products on their balance sheets (including simple retail savings and lending products) will be most affected – such as the average Sparkasse, local cooperative banks, foreign private banks, or Bausparkassen.

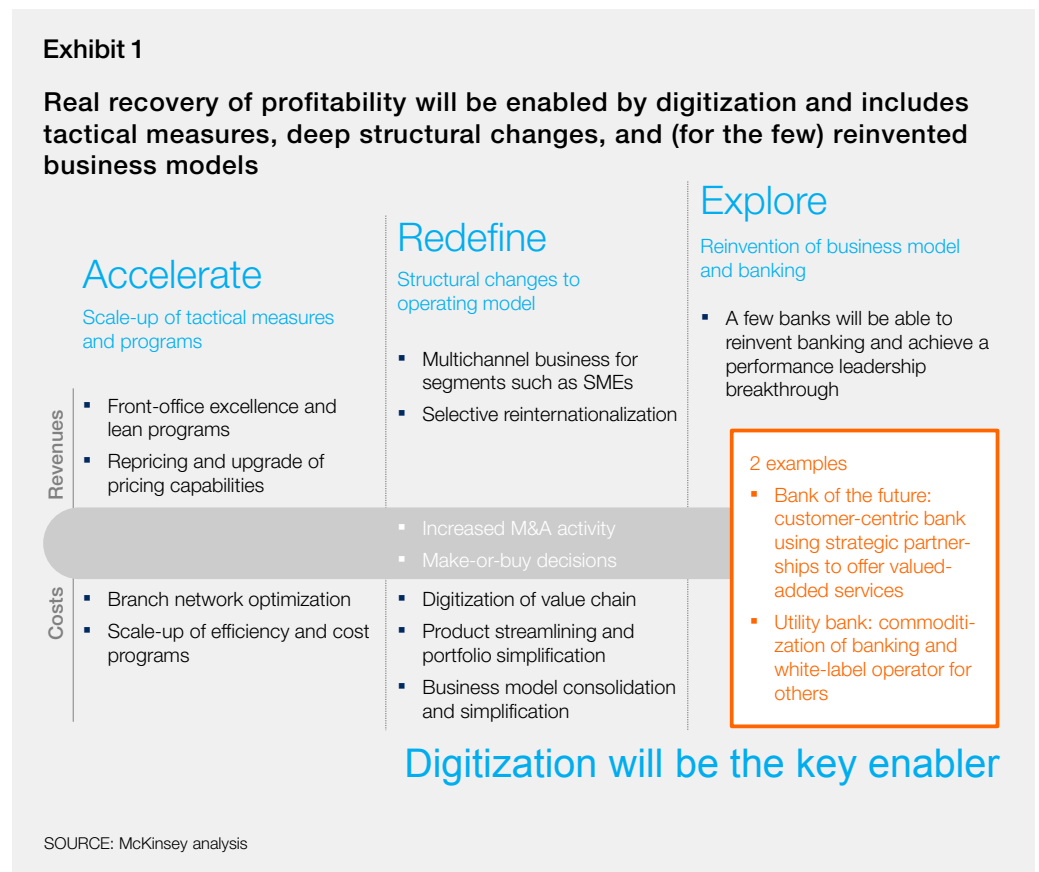
If left unmitigated, the combined effect of these three trends could be strong enough to push the banking industry's return on equity down by 6 percentage points, from currently +4 to -2 percent. Should this scenario materialize, it would put the profitability of three out of four banks in Germany at risk. Banks thus need to take significant mitigating action, responding strategically, by invigorating their business models. In the short run, the adverse impact of the trends can be alleviated with tactical measures. However, to restore profitability and succeed permanently in a radically changing financial services landscape, German banks will need to make transformational changes.

Steering clear – returning profitability to German banking

The German banking sector as a whole would have to either reduce costs or increase revenues – either by nearly 30 percent or through a combination of cost and revenue measures – to return to average long-term profitability levels. Each of these goals is highly challenging.

The next three years will be critical for the industry. German banks will have to decide which turn to take to avoid a dead end.

In order to build a stable future, German banks need to respond strategically, with holistic cost-savings and revenue-generating programs. Incremental measures such as withdrawals from rainy-day reserves and other stop-gap measures might temporarily help alleviate the adverse impact. However, to permanently restore profitability, German banks need to make structural changes. The severity of the trends that will shake up the industry offers a real opportunity for these vital changes.



Accelerate. The first step on the path to sustained profitability is the acceleration and expansion of tactical measures. The potential for efficiency improvements has not yet been fully exploited. Traditional transformation programs, ranging from front-office excellence and lean programs to branch footprint optimization, can help banks attain a higher level of efficiency. Revenue can be lifted, especially in the area of pricing capabilities, with innovative measures such as loyalty programs and relationship pricing.

Redefine. For most banks, tactical measures alone will not be enough to recover sustainable profitability. As second step, banks will need to structurally change their operating model. Here, digitization can be a key enabler. Banks can thereby:

- Reinforce their connection to the customer, revitalize their brand appeal, and push customer satisfaction to a more satisfying level
- Offer multichannel connectivity and an appealing digital banking experience
- Build strategic partnerships or joint ventures for shared platforms and services with other banks
- Automate processes and digitize parts or the entire banking value chain
- Standardize plain banking products and streamline the product portfolio.


By tapping into the far-reaching potential of digitization, banks can improve the cost base, defend existing revenue pools, and even find new revenue sources.

Explore. Only a few banks will be able to aspire to true performance leadership. To attain these heights, they will have to take a third step of exploring opportunities beyond traditional business models. Commoditization of the balance sheet and mastery of customer relationships are two promising, but opposing strategies for a future transformed bank business model:

- *Commoditizing today's banking.* Banks can extend their balance sheet capacity to financial technology companies, platforms, and competitors. While achieving operational excellence and scale, they can radically cut costs.
- *Mastering the customer relationship.* Banks can deliver a superior customer experience by creating customer ecosystems that comprise novel and innovative services. By leveraging their customer data trove and establishing B2B business models, banks can capture attractive new revenue pools.

Between commoditization and customer centricity, there are many other different strategies that German banks can pursue. Above all, banks must recognize the urgency to develop a viable and sustainable business model for the future.

Finally, beyond the three dimensions for transformation, the German banking market could benefit from further consolidation, recognizing that some banks will not be able to achieve the required cost savings or revenue enhancements. In these situations, an efficient and reasonable consolidation strategy can generate cost synergies and improve bank resilience.



Philipp Koch



Max Flötotto



Ursula Weigl

Introduction

German banking is unique and differs substantially from other banking markets around the globe. Analysts and foreign experts often underestimate the size and reach of the German banking sector due to its fragmented structure, comprised of numerous small institutions. Its profitability drivers and characteristics differ from other leading banking markets. Many stakeholders even pursue objectives other than pure profit maximization. Reports surveying global banking with a cross-country perspective, based as they often are on listed (publicly traded) banks, do not accurately reflect the German market because they exclude the majority of assets and customers.

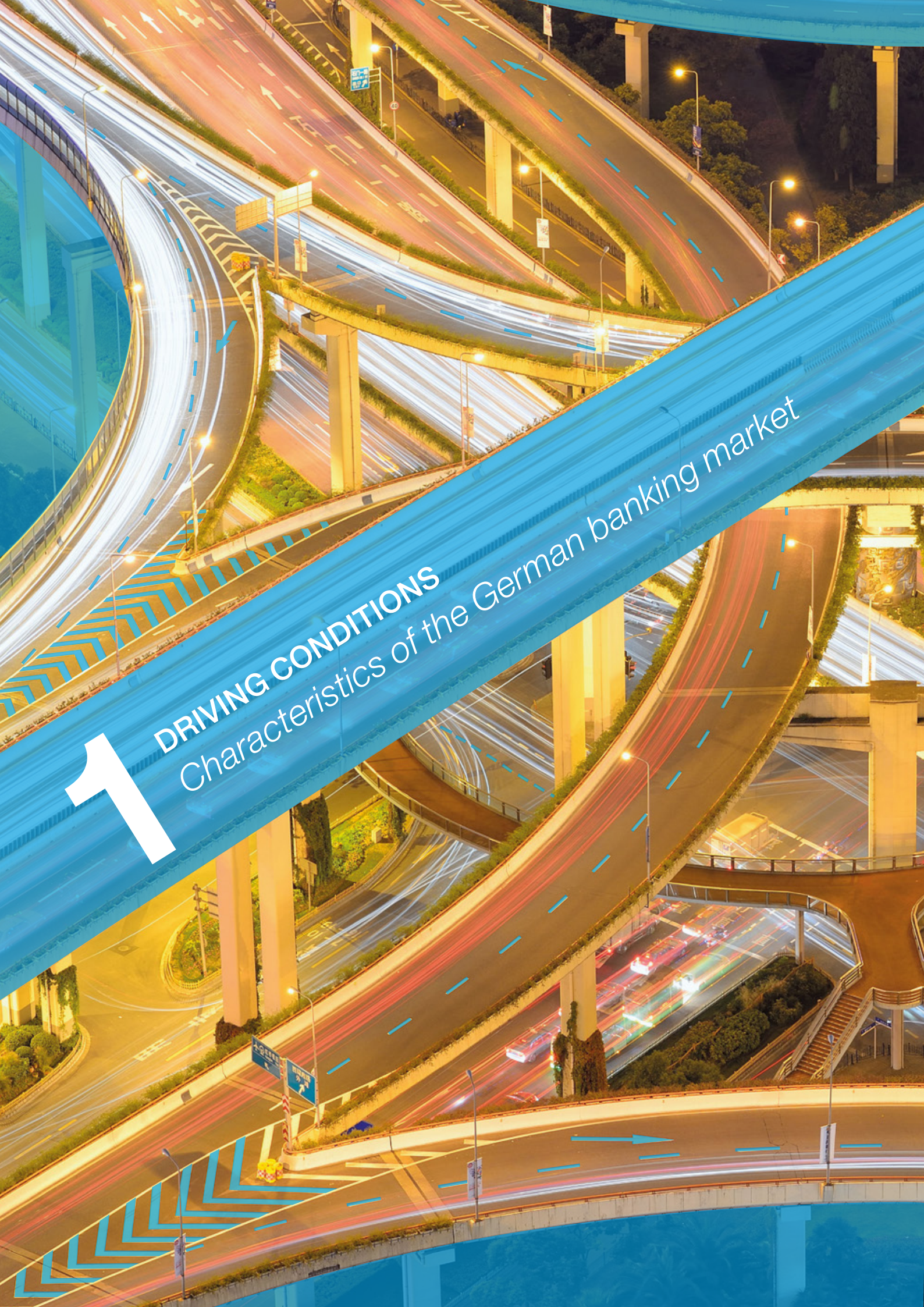
McKinsey's "The road ahead – Perspectives on German banking" is based on the research and analysis done to better understand this sector. The authors have combined McKinsey's analytical skills, data, and industry expertise with granular data on the German banking market from Deutsche Bundesbank and other public sources, including data on different bank segments and size classes. Taking full account of German banking's unique three-pillar structure, the report explores the market from different perspectives.

Sparkassen and cooperative banks have come through the crisis in good shape and are now performing better than ever before. The three key trends that are fundamentally reshaping the industry are herein examined, and an outline is provided for how German banks could surmount the challenges these trends present. A persistently low-interest-rate environment, tightening regulations, and digitization will put enormous pressure on the profitability of the entire German banking sector.

Based on scenario calculations, the report reveals that these trends could cause significant negative effects within the next five years if no mitigating actions are taken. Average return on equity may decline by 6 percentage points across the German banking sector. Average cost-to-income ratios could increase by as much as 20 percentage points. Possibly three out of four banks will need to undertake significant mitigating actions in order to prepare their business model for the future. Fortunately, in developing their strategic response to these threats, banks will be able to use the far-reaching potential of digitization to increase cost efficiency and create new business opportunities.



This report gives an overview of the state of the German banking market, including a review of the characteristics that distinguish this market from banking elsewhere. We also analyzed the considerable changes in the industry's structures and dynamics that have taken place since the start of the global financial crisis. Three important trends are examined that are putting German banks under pressure: the continuing low-interest-rate environment, regulatory tightening, and increasing digitization in banking. The impact of each of these trends on different segments in the German banking market is then assessed, and the report concludes with an outline of a potential path forward for German banks, enabled by digital initiatives, to reset the cost structure and generate new revenue. An interview with Andreas Dombret, member of the Board of the Deutsche Bundesbank, supplements this report and provides further perspective on German banking. Finally, an appendix with graphic exhibits provides key figures and further details about each segment of the German banking landscape.



1

DRIVING CONDITIONS

Characteristics of the German banking market

The German banking market is different from its international peer markets.¹ It has a unique three-pillar structure comprised of private banks, public savings banks, and cooperative banks. Each of these pillars has distinct characteristics and a historical role in the German economy.

Across the three pillars and within an additional category of specialized banks, overall nine banking segments can be identified.²

- **Private or commercial banks.** Private banks control more than 40 percent of domestic banking assets. They are privately owned and operate mainly according to a profit-maximizing mandate. In this report, we differentiate between domestic (Segment 1) and foreign (Segment 2) private banks.
- **Savings banks.** This segment holds 30 percent of domestic banking assets. Sparkassen (Segment 3) are small to medium-sized institutions with regional focus and have traditionally centered their business on supporting local communities, municipalities, and businesses. They are geographically organized and owned by municipalities; the Sparkassen in turn are owners of the larger Landesbanken (Segment 4), which act as central banks for the Sparkassen.
- **Cooperative banks.** The cooperative banks are the most numerous, with approximately 1,100 institutions, but these collectively hold only about 15 percent of total domestic banking assets. Local cooperative banks (Segment 5) are small institutions with rather local focus that operate for the benefit of their 18 million members, mainly small businesses and individuals. The local cooperatives own most of the two central cooperative banks (Segment 6).³
- **Other specialized banks.** In addition to the three pillars, the German banking market comprises banks serving specialized purposes: Bausparkassen (building societies, Segment 7), Hypothekenbanken (real estate banks, Segment 8), and mostly state-owned development banks (Segment 9).

The German banking terrain is unusually fragmented, with nearly 1,800 institutions overall. More than 1,100 institutions possess under EUR 1 billion in assets each and collectively account for a small fraction of the total domestic banking assets. A large majority of all assets – around 70 percent of the total – is owned by 40 institutions: each has more than EUR 25 billion in assets (Exhibit 2).

Asset concentration in the German banking market is still lower than in peer markets: the top five banks account for only 44 percent of total domestic banking assets. In the US, the concentration is 56 percent, in the UK it is 84 percent, and the average for Western European countries is 76 percent. The Herfindahl index⁴ for the German banking market generally confirms a low to moderate level of concentration and a moderate to high level of competition, respectively.

Exhibit 2

The German banking market is highly fragmented with 1,800 banks – but 69% of total assets are held by 40 banks

Composition of the German banking landscape, 2013

Number of banks by class according to total assets



SOURCE: Deutsche Bundesbank

The savings banks and cooperative banks possess a significant degree of autonomy. However, were each of these pillars counted as a single bank, the asset concentration of the top five German banks would rise to 78 percent.

Low price levels and fee-averse customers

Competition in the German banking market is high, and therefore banking products are competitively priced. As a result, retail banking revenues in Germany equated to 3.8 percent of total disposable household income (average for 2010 to 2013), below the level in the UK (4.0 percent) and the average for Western European countries (4.1 percent). Banks find it especially difficult to generate fee income in Germany. Compared to global peer markets, noninterest income is particularly low, accounting for only 0.5 percent of total assets, relative to 1.2 percent in the UK and 1.3 percent of the Western European average for 2010 to 2013.

An average German retail banking customer prefers savings products over investment products and has little experience with a fee-based pricing approach. There are two reasons for this: traditional risk aversion among German bank customers and the relatively broad range of products and solutions they can choose from.⁵ Despite a continuously low interest rate environment, retail deposits grew at 3.8 percent in Germany (CAGR for 2008 to 2014), at a rate above overall personal financial asset growth (3.4 percent). A survey of EU retail banking customers conducted by the European Commission in September 2011 revealed that only 10 percent of German customers hold mutual funds, compared to 13 percent in the UK, and only 35 percent use credit cards, compared to 50 percent in the UK.⁶

High dependence on net interest income

German banks are reliable providers of credit to the economy (retail mortgages and corporate loans). Bank loans make up more than 50 percent of the total debt of nonfinancial firms in Germany. This is a higher share than that of banking in any other major European country (40 to 45 percent), the US (35 percent), or Japan (47 percent). The global financial crisis did not disrupt credit provision by German banks. Mortgages and corporate loans continued to grow steadily, with Sparkassen and cooperative banks in particular ensuring provision of corporate loans.

Given the high penetration of bank loans and deposit products as well as the low fee income, German banks are highly dependent on net interest income. Net interest income constantly accounts for 70 percent of total operating income in the German banking market (long-term average for 2000 to 2013). Lending and deposit taking, the bread-and-butter business of German banking, remains highly competitive.

Reasonable cost structure but low profitability

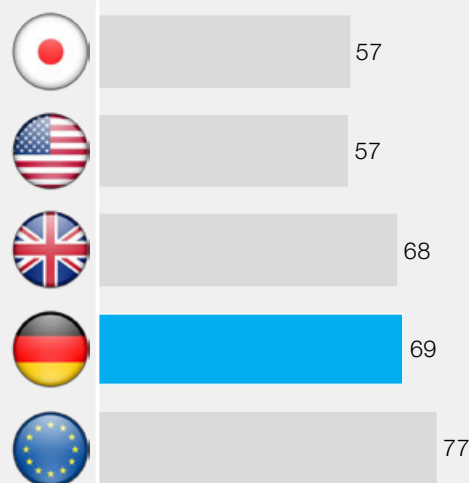
Cost-to-asset and cost-to-income ratios for German banks show very different patterns compared to peer markets. The cost-to-income ratio, which most directly relates to profitability, is relatively worse at 69 percent (average for 2010 to 2013), in particular compared to markets like Japan or the US. The cost-to-asset ratio, a more suitable measure for cost efficiency, is low compared to other markets at 1 percent. The disparity confirms some basic characteristics of the German banking market: its large asset base, relatively cost-

Exhibit 3

German banking market vs. peers – poorer cost-to-income ratios, but better cost-to-asset ratios

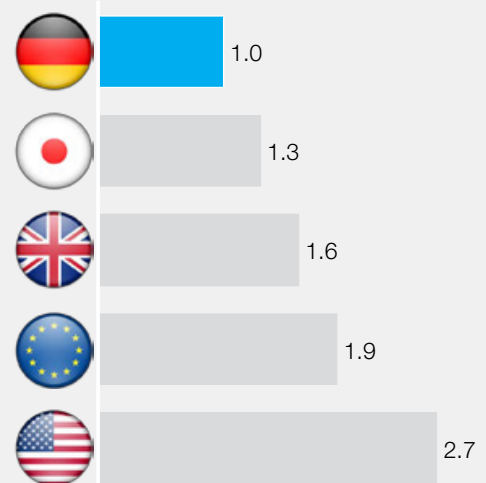
Cost-to-income ratio

Average 2010 - 13, percent



Cost-to-asset ratio

Average 2010 - 13, percent



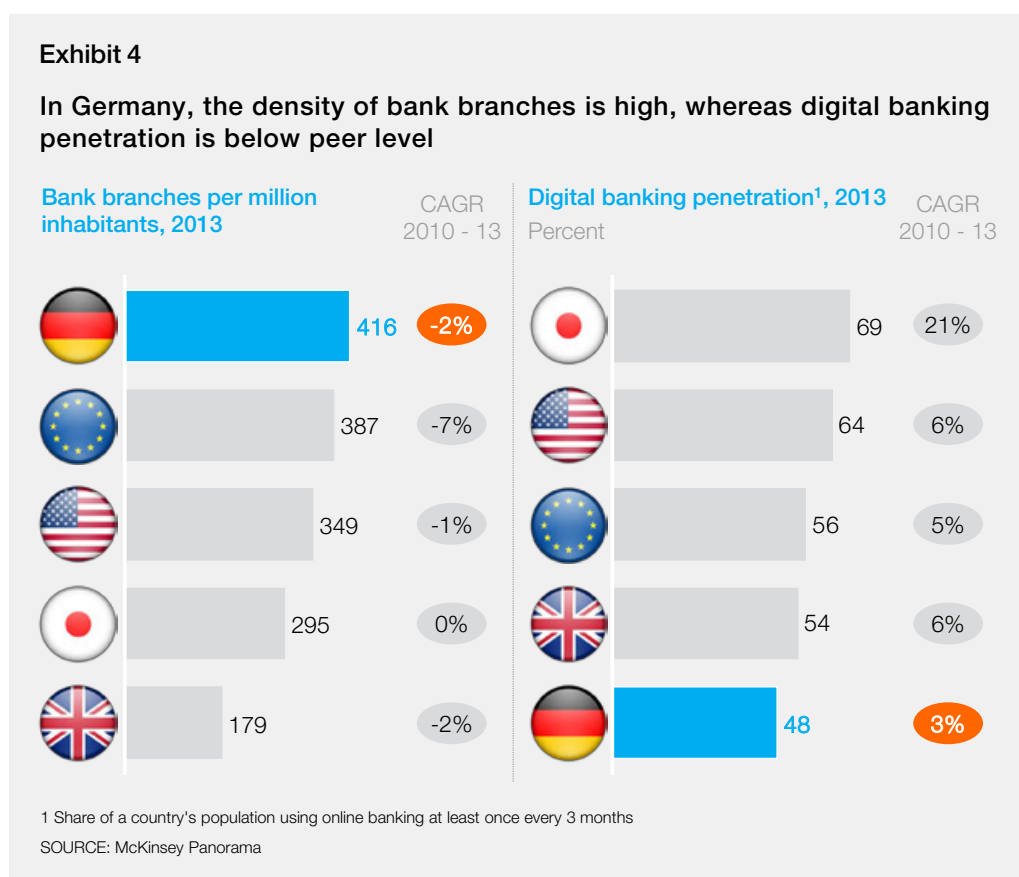
Note: International peer market data based on sample of listed banks with more than USD 10 billion in assets

SOURCE: Thomson Reuters

efficient operations (partly due to an efficient payment system), but low profitability due to the revenue structure discussed in previous paragraphs (Exhibit 3).

Looking deeper into the cost base of the German banking market, we find significant differences across bank segments. The net interest income of German banks overall exceeds total operating cost. However, the cost-to-income structure varies from segment to segment. While Sparkassen and cooperative banks can easily cover operating cost with net interest income, this income source is insufficient for private banks.

Economies of scale can be observed in most German bank segments; cost-to-income and cost-to-asset ratios decline with increasing balance sheet size. The economies of scale are greater, and the cost-to-income and cost-to-asset ratios vary more in the private bank segment. Among the Sparkassen and cooperative banks, performance is rather uniform, as they efficiently spread costs throughout their sector with joint platforms and shared services.



Branch-based banking model Despite efforts in the early 2000s to reduce their branch network, German banks still maintain high branch density and about 36,000 branches in total. Germany's 416 branches per million people compare to the Western European average of 387 and the UK level of 179. German bank customers thus enjoy a dense branch network that may play a role in their relatively lower use of online banking (Exhibit 4). Only 48 percent of German bank customers use online and mobile banking sites as opposed to 54 to 69 percent in peer countries.

Conservative profile

German banking has a low risk profile compared to peer markets, predominantly driven by its business mix. The mix is determined by the role of banking in the German economy, as the main financing source for corporations. Loan loss provisions in Germany have traditionally been lower than in other markets and have lately hit rock bottom. In the period of 2010 to 2013, the average ratio of loan loss provisions to total assets was lower than 10 basis points in Germany, whereas this ratio was higher than 40 basis points in Western Europe, the UK, and the US. German banking furthermore had seen lower loan loss provisions in the postcrisis years (2010 to 2013) than in the expansion period before the crisis (2004 to 2007).

Since 2008, German banks managed to deleverage their balance sheet and increase their capital base. On average, German banks reduced their risk-weighted assets by more than 20 percent. At the same time, they raised their tier 1 capital by more than 25 percent during the postcrisis period. The tier 1 capital ratio peaked at 15 percent in 2013, far exceeding the required minimum of 6 percent and higher than levels in Western Europe (13 percent), the UK (14 percent), and the US (13 percent).

Considerable economic relevance

The German banking system has been a reliable employer in recent years. Since 2007, its personnel base has been stable and, at 1.3 percent of the total labor force, in line with peer markets (1.4 percent in the US and UK, 0.5 percent in Japan). Within Germany, banking represents a substantial employment sector, with a smaller share in total employment than only the mechanical construction (2.3 percent) and automotive sectors (1.8 percent). The savings banks segment is the largest employer within banking, with more than 40 percent of total employees.

The banking system also offers attractive salaries. The average salary in German banking in 2013 was more than EUR 60,000, well above the German average of around EUR 30,000. By segment, Sparkassen and local cooperative banks pay the lowest salaries, with the average of just under EUR 50,000.

However, the contribution of German banking to GDP is lower than in peer markets, a partial reflection of the low price levels of German banking products and services. Banking accounts for 4 percent of German GDP, compared to 5 percent in the US and 6 percent in the UK. Consistent with other global markets, in Germany, the GDP contribution of banking has declined slightly in the last decade.



While German banking has provided stability for economic development, it has not always generated adequate returns despite a reasonable cost structure. Over the past 30 years (1984 to 2013), the average return on equity (after tax) has amounted to only 6 percent. This has made it difficult for German banks to earn their cost of capital. Several structural characteristics described above have contributed to low profitability. Strong competition among a multitude of institutions depresses price levels and hampers revenue generation. The cost base of German banks is somewhat rigid, as reflected in the extensive branch network.

In the next chapter, we examine the changes in profitability and levels of return that have occurred since the global financial crisis, both within the pillars and segments of German banking as well as from the perspective of global peer markets. With this understanding of the shifts, let us turn to the recent dynamics of the industry.

An aerial photograph of a busy pedestrian crossing with white stripes on a grey asphalt surface. A large, semi-transparent blue shape is overlaid on the top right portion of the image, containing the text. The scene is filled with many people walking in various directions. Some people are carrying umbrellas, suggesting a sunny or slightly rainy day. The overall atmosphere is one of a busy, modern urban environment.

2

HARD TRAVELING

*Significant shifts since
the financial crisis*

The financial crisis caused a major shock in German banking. Like all global banking markets at that time, German banking incurred significant losses and endured socially costly bailouts. In the aftermath of the crisis, unexpected shifts and dynamics were reflected in profitability and returns. Bank segments that once earned double-digit returns began to fall back while others have benefited from an updraft. As the market has moved into a new reality and is already facing new challenges, a retrospective glance at the recent shifts will be worthwhile.

We start with a global survey of crisis-induced performance shifts, contrasting German banking to its peer markets. We then move on to an analysis within German banking and compare profitability across different bank segments. The following analyses comprise three discrete time periods. In retrospect, the first period, 2004 to 2007, can be seen as one of unsustainable expansion; the second period comprises the crisis years of 2008 and 2009; the third period, 2010 to 2013, is defined by the transition to the new reality.

Assimilation of profitability and revenue growth

In comparison to global peers, the precrisis German banking market lagged behind in profitability (6 percent average return on equity) and revenue growth (2 percent annually) (Exhibit 5). During the crisis, German banks lost 11 percentage points in profitability, yielding -5 percent return on equity. Revenues kept growing at 2 percent annually, mainly because loan demand remained stable. At the same time, peer banking markets were hit hard due to high write-downs and risk costs. While the return on equity of global peers did not quite turn negative, they suffered large losses in both profitability and growth.

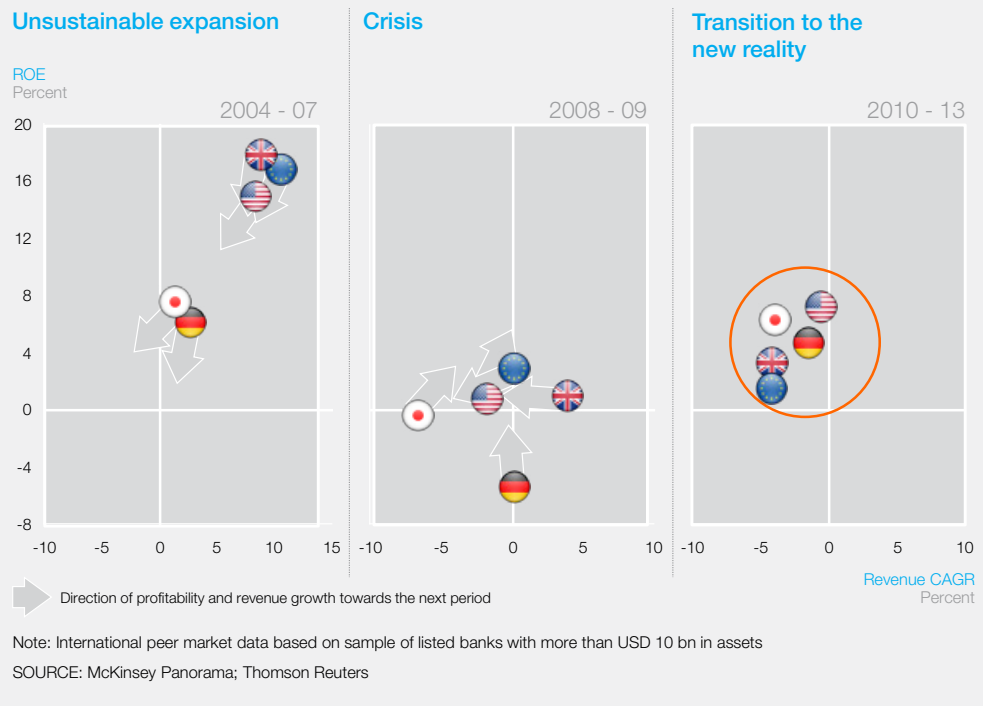
In the transition period, profitability and revenue growth of German and global peer banking markets have become more alike. Germany experienced the largest absolute rise in profitability after the crisis (+10 percent) and almost returned to its precrisis level at 5 percent average return on equity. As in Japan, the UK, and Western Europe, German banking revenues are also shrinking (at -1 percent annually).

German banking upside down

A closer look at the German banking market reveals the remarkable shifts that have occurred since the beginning of the financial crisis (Exhibit 6). During the precrisis period of unsustainable expansion (2004 to 2007), private banks saw a return on equity of 10 to 12 percent on average. Sparkassen and cooperative banks were reasonably profitable as well, at around 6 percent. During the crisis, private banks, Landesbanken, and development banks, given their risky investments, suffered the most, with returns falling below -10 percent. The Sparkassen and cooperative banks were more stable through the crisis, able to achieve positive (if low) returns of 3 to 5 percent.

Exhibit 5

Since the financial crisis, profitability and revenue growth of German and peer banking markets have converged



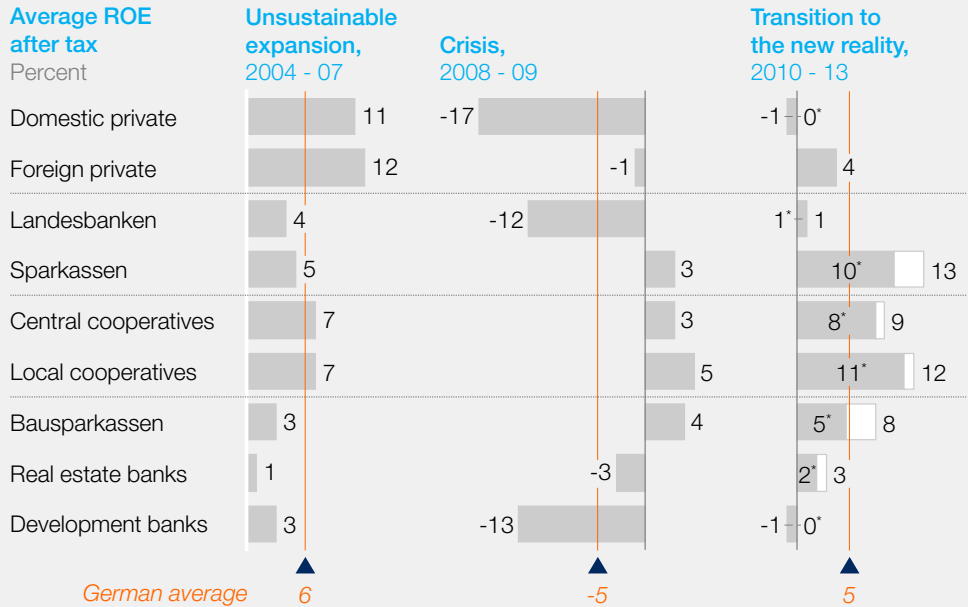
It might have been expected that private banks would recover their former strength and precrisis profitability in the postcrisis period. This has not happened.

Private banks are being substantially outperformed by Sparkassen and cooperative banks, which on average are earning 10 to 11 percent return on equity compared to the average returns of zero for domestic private banks and around 4 percent for foreign private banks. Clearly, private banks are still struggling with the aftermath of the financial crisis, including losses and fines.

Thus, while asset distribution in German banking has hardly changed since the crisis and average return on equity has returned to precrisis level, profit distribution is very different. The savings and cooperative bank sectors have managed to double their combined share of total profits, from 41 percent (2004 to 2007) to 85 percent (2010 to 2013), despite owning only 40 percent of total banking assets. Private banks, meanwhile, have seen their share of banking profits plummet by more than 80 percent (Exhibit 7).⁷

Exhibit 6

Business mix of Sparkassen, cooperative banks, and Bausparkassen has helped them lead in the postcrisis market



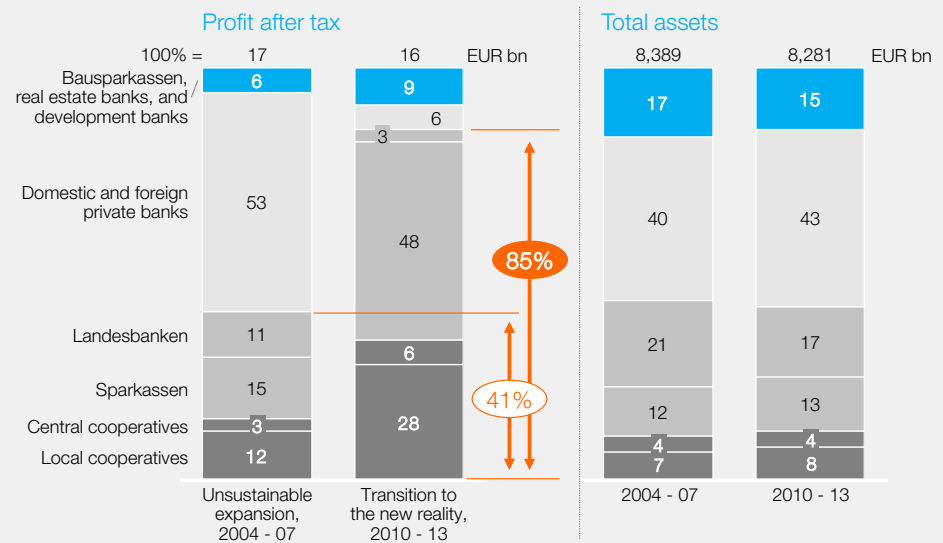
Note: ROE numbers marked with an asterisk (*) indicate that 2011 has been excluded to avoid the distorting effect of an unusually high reallocation of undisclosed reserves (§ 340 f HGB) as disclosed reserves (§ 340 g HGB)
 SOURCE: Deutsche Bundesbank

Exhibit 7

Sparkassen and cooperative banks have doubled their share of banking profits since the crisis

Total assets and profit after tax in the German banking market by bank segment

Annual average, percent



SOURCE: Deutsche Bundesbank

Drivers of postcrisis success of Sparkassen and cooperative banks

When looking into the postcrisis profit composition of German banks, we found three outstanding factors that contribute to the higher profitability of Sparkassen and cooperative banks: high loan volume growth, improved cost coverage, and low risk cost (Exhibit 8):

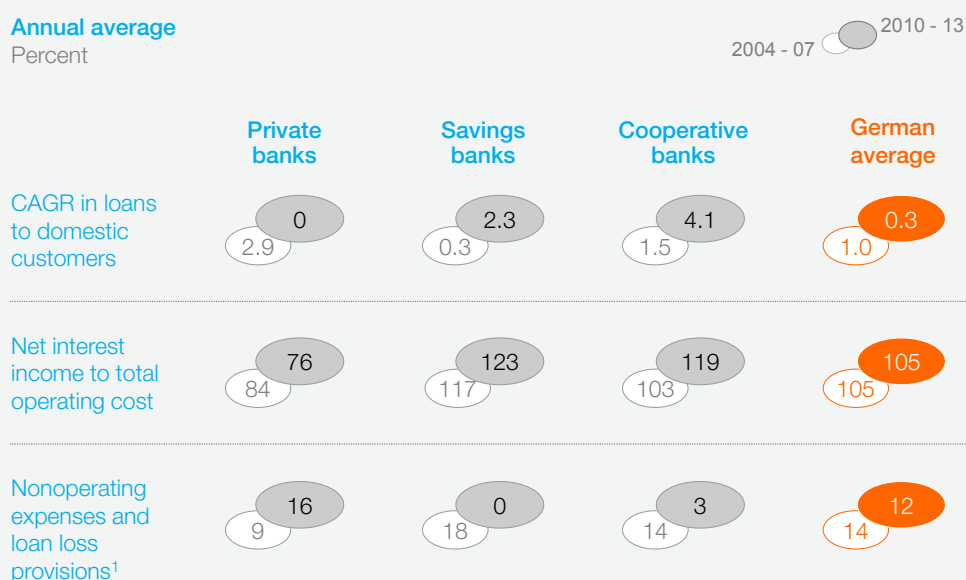
- **High loan volume growth.** In the aftermath of the financial crisis, Sparkassen and cooperative banks pushed loan growth well above the German average. This happened for several reasons. First, in the retail business, where Sparkassen and cooperative banks traditionally have a strong footprint, they benefited from higher demand for mortgage loans in the low-interest-rate environment. In the corporate business, furthermore, Sparkassen and cooperative banks have benefited from the more restrictive lending practices of the other banks on the one hand, and from the steadier loan demand of their core customers on the other hand – the small and medium-sized enterprises of the Mittelstand, which were less affected by the global financial crisis.
- **Improved cost coverage.** The composition of income and costs in Sparkassen and cooperative banks is structurally different from that of other bank segments in Germany. Sparkassen and cooperative banks can cover operating costs with net interest income. Fueled by strong loan growth, these banks even managed to improve their ratio of net interest income to operating costs during the recent transition period (2010 to 2013) while the German average remained constant.
- **Low risk cost.** Due to a rather prudent business model, Sparkassen and cooperative banks hardly experienced risk costs in the aftermath of the crisis. Nonoperating expenses (including write-downs and legal charges) and loan loss provisions at Sparkassen and cooperative banks are currently far below the German average. This is a change from the precrisis expansion period, when risk costs of these banks were in line with the German average.

The ownership and business models of Sparkassen and cooperative banks are moreover strikingly distinct from those of private banks. Traditionally, Sparkassen are owned by local municipalities and the cooperatives collectively by its members. The business operations of both of these types of banks are regionally focussed, in support of local communities. The following further attributes distinguish Sparkassen and cooperative banks from private banks:

- **Deposit taking and lending as backbone.** In line with their mandate, Sparkassen and cooperative banks are focused on deposit taking and lending and therefore intensively engaging in maturity transformation. Their average net interest income, furthermore, accounts for 70 to 80 percent of their total income; these banks are thus able to cover their operating cost entirely by net interest income.
- **High asset productivity.** Sparkassen and cooperative banks have been able to deploy their relatively small asset base effectively to generate income. They earn net interest income of 3.0 to 3.5 percent on loans, above the overall average for German banking of 1.5 to 2.0 percent, and net fee income of 0.6 or 0.7 percent on total assets, exceeding

Exhibit 8

High postcrisis profitability of Sparkassen and cooperative banks is supported by lending growth and low risk cost



¹ Percent of total income

SOURCE: Deutsche Bundesbank

the German average of 0.3 to 0.4 percent. One reason for the high asset productivity of Sparkassen and cooperative banks could be their local and even rural presence, which reduces their exposure to strong competition and price pressure.

- Sectorwide economies of scale.** Despite their localized operations, Sparkassen and cooperative banks manage fixed costs relatively well, utilizing joint platforms and shared services across their respective sector. Small banks within the sector can thus operate at low cost. The cost-to-asset ratio of Sparkassen and cooperative banks with total assets under EUR 1 billion has been around 2 percent while that of private banks in the same asset class is above 5 percent (averages for 2010 to 2013).

The above-average postcrisis performance of Sparkassen and cooperative banks has been fueled by growing loan volumes and corresponding net interest income. A question arises, however, about whether this success can be sustained. A high dependency on net interest income makes both segments vulnerable to persistently low interest rates in general. But should those banks have recently issued more long-term loans to boost returns, they might be additionally exposed to a significant interest rate risk.

Little progress on costs

Despite considerable efforts to reduce costs, German banks taken as a sector have achieved little (Exhibit 9). Since 2006, there has been very little bank consolidation, branch closure, and personnel downsizing. Total operating costs for German banking have risen by 4 percent, only slightly below inflation. Among banking types, private banks and central cooperative banks experienced the greatest rise in operating costs, of between 1 and 2 points annually.⁸ The cost base for Sparkassen and local cooperative banks remained stable.

Exhibit 9

Despite cost reduction efforts, German banking as a sector has seen its cost base rising since 2006

	General operating cost CAGR 2006 - 13, percent	Cost-to-income ratio Average 2010 - 13, percent
Domestic private	1	80
Foreign private	1	73
Landesbanken	-2	61
Sparkassen	0	65
Central cooperatives	2	54
Local cooperatives	0	66
Bausparkassen	-2	73
Real estate banks	-3	70
Development banks ¹	5	44
Average annual increase (nominal)	0.4	69

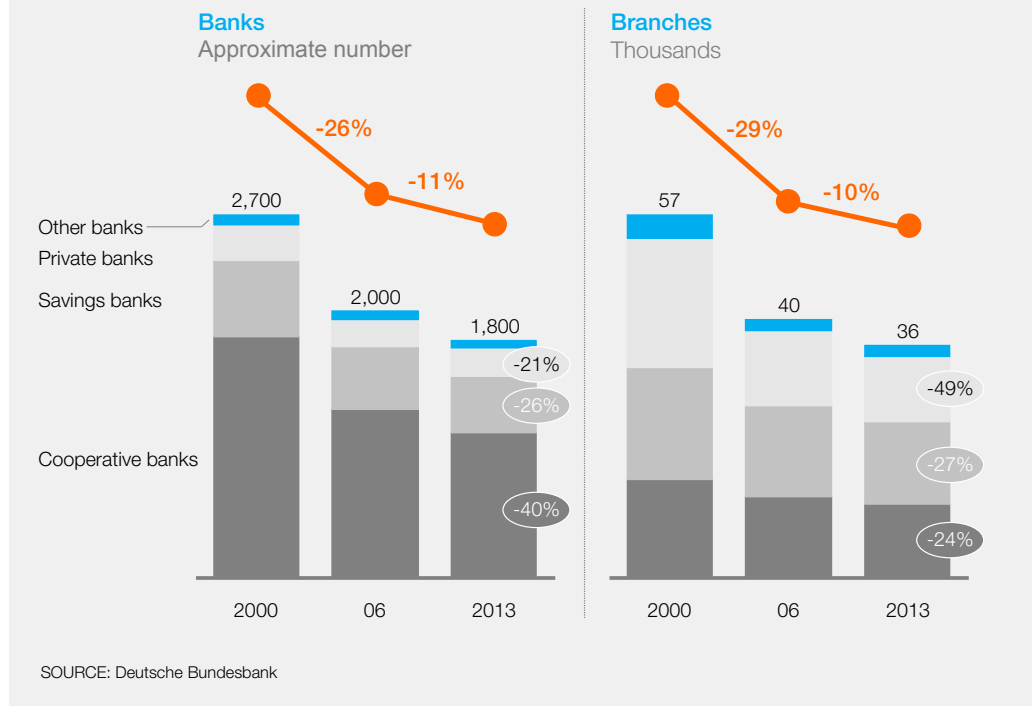
In total, +4% nominal increase in cost base 2006 - 13

¹ The increase for development banks was triggered by the reclassification of Portigon (formerly WestLB) from a Landesbank to a development bank
SOURCE: Deutsche Bundesbank

In the early 2000s, German banks began to consolidate (Exhibit 10). From 2000 to 2006, the number of banks and branches dropped by almost 30 percent. Since 2006, however, the consolidation dynamics have slowed – evidently the easier opportunities (“low-hanging fruits”) had already been captured and management attention was drawn to crisis management. The number of banks and branches has declined very slowly since then, only by around 10 percent from 2006 to 2013. 40 percent of the consolidation total from 2000 to 2013 was captured by the cooperative segment. As for branch reduction, private banks led, cutting their branch density by 40 percent between 2000 and 2006 and by 50 percent in all since 2000. Cooperative banks and Sparkassen reduced their branch density by around 25 percent, mostly before 2006.

Exhibit 10

Consolidation and branch reduction has slowed down since 2006



The personnel base is largely linked to the branch network; therefore, whatever reduction already took place, occurred before 2006. The FTE base for German banking has remained more or less constant since 2006, with only small shifts between segments. Private banks decreased their total FTE number (by 1 percent annually) while Sparkassen and cooperative banks increased their personnel base (also by 1 percent).



Sparkassen and cooperative banks have come through the crisis in good health and are now performing better than before. Private banks, on the other hand, are struggling, still in search of a sustainable business model. Surprisingly, the cost base of German banks remains unchanged and is to a certain extent rigid, determined by a branch network that is still extensive.

With these factors in mind, we turn now to the trends that will shape the banking industry in the future. Three of them promise to shift the patterns observed so far. Continued low interest rates are expected to put further pressure on margins and could severely impair revenue opportunities for banks, a stricter regulatory environment will incur higher costs for banks negatively affecting profitability, and digitization will present banks with additional competitive challenges. Each trend is examined in detail in Chapter 3, along with its potential implications for all bank segments. If left unmitigated, the combined effect of these three trends could be strong enough to put the profitability of a majority of German banks at risk.





An interview with Dr. Andreas Dombret

Member of the Executive Board of the Deutsche Bundesbank

Mr. Dombret, in your opinion, what is unique about the German banking market?

Dombret: The German banking market has several distinctive features – first and foremost, its hetero- geneous structure. Germany is home to major globally active banks as well as to regional banks that only operate domestically. There are also many smaller local institutions. German banks are also different in terms of their business models. From universal banks to specialized financial institutions, from “brick and mortar” to online banks – to name but a few variants – basically every business model you can think of is represented.

This diversity is obviously one of the strengths of the German financial system. Moreover, the majority of German banks are well capitalized and have extensive reserves.

We also cannot ignore the fact that these banks benefit from Germany’s positive economic situation. German companies are beating competitors to the punch, and private households enjoy decent employment levels and low interest rates. Though there are a few downside risks to the economy, in terms of foreign trade, for example, any shadow they cast over what is currently an overwhelmingly positive picture is minimal at most.

At the same time, the profitability of German banks is comparatively low, mostly due to the high competitive pressure and overcapacity. Low interest rates are certainly not helping in these challenging circumstances.

In addition to these most likely temporary factors, there are other longer-term challenges that German

banks need to face and that we must not underestimate. I am referring in particular to the demographic shift, which will put pressure not only on the banking system, but also on the entire German economy in the medium to long term. Therefore, German financial institutions will have to tackle these issues at an early stage.

It has been eight years since the financial crisis began. Looking back, how have banks in Germany coped with the fallout? Why did the crisis have such different effects on the various banking segments?

Dombret: Overall, Germany's banks managed to get through the financial crisis extremely well, although a few banks were hit particularly hard by the crisis. Several banks exited the market; others that called for public funding were forced to radically alter their business models.

Banking is an inherently risky business, and some banks simply managed those risks better than others in the past. The ones that failed did so, for example, because their business model was not sufficiently sustainable or incentive systems were flawed. During the crisis, it was evident that institutions that obtained most of their funding through deposits rather than the interbank market were less affected by the upheavals than those that relied heavily on the money market. Not only that, but when the crisis began, people believed that the government would rescue banks of a certain size if they got into difficulties. This meant that risks were often ignored and there was too much focus on potential earnings from certain deals.

Even when the crisis was ongoing, efforts were being launched by regulators – including us here at the Deutsche Bundesbank – to make banks safer in the future and to protect the taxpayer. Hence, these institutions are now being required to maintain more and higher-quality capital than before the crisis. They have to build up extra capital buffers if they are considered integral to the overall financial system. And they also have to comply with liquidity regulations and put recovery plans

in place. Today, there is very little hope of intervention by the government – and thus the taxpayer.

Banks in Germany currently face a challenging environment: low interest rates, regulation, and digitization are key issues. What are the risks, especially for smaller financial institutions?

Dombret: The main risk is the banks' weak earnings. As I mentioned before, this is partly related to intense competition and overcapacity in the market as a whole. Nevertheless, today's low interest rates are putting considerable pressure on profitability. Small and medium-sized banks in particular regularly earn the bulk of their income through lending and deposits. For them, a flat yield curve can be especially problematic since it depresses their interest margin.

Any further flattening of the yield curve could aggravate the situation for German banks. I think that one of the dangers is that financial institutions could take greater risks in order to obtain what they see as an acceptable return.

According to our research, financial institutions are still coping well with low interest rates. This is partly due to the extensive capital reserves that the banks have recently built up, as well as restructuring on the liabilities side. At present, depositors are focusing on sight deposits that only pay low or even no interest at all and are, in some cases, unloading their longer-term deposits. But there are limits to this. Currently, however, there are few signs that banks are systematically taking greater credit or market risks so as to stabilize their earnings. From a regulatory point of view, we will be watching closely to see how the banks tackle the challenges arising from this low interest rate environment in the future.

We are also keeping a critical eye on the Basel interest rate coefficient and its steady rise. This is a clear indicator that the banks are exposed to ever greater

interest rate risks, since in the current circumstances borrowers are of course trying to secure the longest possible periods of fixed interest rates. Given that banks often choose relatively short-term funding, their interest margins could very quickly come under pressure were interest rates to rise.

We learned a lot from our experience during the financial crisis; stricter regulation was unavoidable.

Small and medium-sized banks in particular are complaining about the additional workload this involves. And they have a fair point there. That is why I believe it is important to take a measured approach to applying the rules, and to maintain a sense of proportionality.

The new rules of the Basel III reform package are due to be finalized this year. We are making every effort to ensure that the work is indeed completed by the end of the year. This is important because the banks need certainty about the regulatory framework under which they operate. At this point I would like to emphasize that we are not working on “Basel IV.” Any rumors to that effect have no basis in fact.

However, there is one element of the Basel rules that, from my point of view, needs to be reworked completely: the rules for government debt. These are not risk-free securities, as the past few years have very clearly demonstrated. I therefore think it is important that, now and in the future, sufficient capital is held against government bonds in a risk-based manner and, as with all other types of credit, a large exposure limit is introduced.

You often speak with members of the boards at various banks. What do you feel are the most important issues? What would be your advice to bankers in Germany at this time?

Dombret: Even though I do not act as a consultant – that would not be compatible with my role – it is important to me to make people aware that here in Germany, we have largely overcome the latest financial crisis, but are in no position to rest on our laurels. Banks are still facing major challenges.

Especially given the current low interest rate environment, every institution should be constantly reviewing and testing its business model. In this context, I also highlight the issues that will come under particular scrutiny by regulators in the next few months. These include risks related to the business model, earning power, and especially operational risks. Given the banking industry’s steady march towards digitization and the growing threat of cyberattacks, I am convinced that this will be one of the key topics of discussion for the next few years, if not decades. German banks need to take digitization very seriously and leverage it to secure their future.

We should also mention legal and reputational risks relating to misconduct – and I am not just referring here to spectacular cases such as the Libor scandal. The consequences of unethical or illegal behavior can be critical to a bank’s continued survival. Reputation is ephemeral; it takes time to build, but none to lose. And in the end, a bank’s reputational risk is the result of the behavior and expertise of each individual employee. In this respect, I can only advise banks to take preventive measures. Costly in the short term, yes, but in the long term there is enormous potential for cost savings, in my opinion.

At the end of the day, financial institutions must look for opportunities to maintain adequate and sustainable profitability – nothing should be off-limits.

Of course, it is vital to keep an eye on costs, to strive to become more independent of lending business, and to earn more through commissions. Consolidation should not be entirely ruled out either, even if it is truly only advisable for healthy institutions that complement one another. At the same time, financial institutions must respond to changing customer behavior by consolidating their branch networks.

What positive developments and signs have you observed in the market?

Dombret: Although the ongoing low interest rates are extremely demanding for German financial institutions, the resilience of the vast majority of banks is assured, now and in the future, by way of their extensive reserves and good capitalization. Germany's economic outlook also remains positive. This year we expect to see 1.7% economic growth, and also predict above-average capacity utilization by the German economy for the next two years.

Banks will benefit from the increasing demand for loans, among other factors. This was indicated by the results of the latest euro-area Bank Lending Survey. According to this survey, the demand for loans by German companies increased significantly at the end of 2015, which points to a greater willingness to invest. The demand has been driven by large companies as well as a need for long-term funding, especially for asset investments.

The net demand for loans across the entire euro-zone rose steadily in all credit categories. Growth in demand for corporate loans was especially significant. This is mainly a result of the very low interest rates. In terms of corporate loans, demand for financing for equipment and asset investments also played a role, while demand for housing loans was supported by consumer confidence and prospects for the housing market. I expect this positive development in Germany to continue. Advantageous financing conditions, companies in solid financial situations, and easier access to credit all favor spending on additional investments. Given the planned growth in infrastructure investment, we can expect a considerable increase in government construction investment next year and the year after.

How do you see the future of the German banking sector? Do you think there will be structural changes, e.g., a market shakeout/consolidation or structural increase in prices for banking services?

Dombret: I still believe there is room for further consolidation in the German banking market. The longer the low interest rate environment persists, the more likely we are to see mergers, in my opinion.

If interest income drops, commission income increases minimally (if at all) and major investment in areas such as digitization needs to be shouldered, then financial institutions will be forced to consider additional cost-cutting measures.

In these circumstances, German banks may have no choice but to reevaluate their branch networks and possibly close certain locations. From my point of view, they also need to boost non-interest-based income, meaning fees and commissions. Raising the price of banking services might be an unpopular move, but it is a potentially vital one. One thing is certain: interest income alone will barely suffice in the future if interest rates remain low.

Customer focus and retention is, and will remain, of primary importance to banks. They have to offer the services that customers are asking for and for which they are willing to pay. Strategically speaking, the industry must maintain control over customer retention. In this respect, I believe that the German banking system is generally in a good position already.

Dr. Andreas Dombret

Member of the Executive Board of the Deutsche Bundesbank

Dr. Andreas Dombret was born on January 16, 1960 in the US to German parents. He studied business management at the Westfälische Wilhelms-Universität Münster and was awarded a PhD by the Friedrich-Alexander-Universität Erlangen-Nürnberg

Since May 2010, Andreas Dombret has been a member of the Executive Board of the Deutsche Bundesbank. Before joining the Deutsche Bundesbank, he worked at the Deutsche Bank's Frankfurt headquarters, as Co-Head of Rothschild Germany, and as Vice-Chairman for Europe and Head for Germany, Austria, and Switzerland at Bank of America. His current responsibilities at the Deutsche Bundesbank include Banking and Financial Supervision and Risk Control as well as IMF- related duties. Andreas Dombret is a member of the Supervisory Board of the Single Supervisory Mechanism (ssm) and the Basel Committee on Banking Supervision (BCBS). Furthermore, he sits on the Board of Directors of the Bank for International Settlements (BIS).

Andreas Dombret was awarded an honorary professorship from the European Business School in Oestrich-Winkel in 2009 and holds several other positions outside the Deutsche Bundesbank. He serves on the Board of Trustees of the Center for Financial Studies in Frankfurt, the Österreichische Bankwissenschaftliche Gesellschaft (Austrian Society for Bank Research) in Vienna, the Westfälische Wilhelms-Universität Münster, and the Schirn Kunsthalle art exhibition center and the Städel Museum, both in Frankfurt. In addition, he is a member of the Board of the International Center for Monetary and Banking Studies in Geneva and a member of the Exchange Experts Commission (BSK) as well as treasurer of the Atlantik-Brücke. He is also co-editor of the Zeitschrift für das gesamte Kreditwesen in Frankfurt and the International Economy in Washington, DC.

Andreas Dombret was awarded the Bundesverdienstkreuz (Federal Cross of Merit), the Hessischer Verdienstorden (Hessian Cross of Merit), and the Österreichisches Ehrenkreuz für Wissenschaft und Kunst (Austrian Cross of Honor for Science and Art). He has also been granted the Ehrenplakette (Badge of Honor) of Frankfurt am Main and Baden (near Vienna).

An aerial, high-angle photograph of a massive freight train yard. The yard is filled with hundreds of railcars of various colors, including red, blue, yellow, and white, arranged in long, parallel rows. The perspective is from above, looking down at the tracks and the cars. The lighting is bright, creating strong shadows and highlights on the surfaces of the railcars. The overall scene conveys a sense of industrial scale and organized activity.

3 NEW TRAFFIC PATTERNS

Three trends that are changing German banking

The German banking market will come under further pressure, resulting from three trends: a macroeconomic environment of continued low interest rates, tightening regulatory requirements, and the challenge of nontraditional competitors and digital banking. In the crowded German market, these trends will affect banks differently, according to segment and size. Without countervailing actions, the combined effects of the trends will be highly disruptive and could pose serious problems for many banks.

In this chapter, each trend is discussed in detail, including its implications and impact on German banks. The isolated and unmitigated impact of the trends on profitability and sustainability has been estimated for each bank segment within a five-year time frame.⁹ These calculations are emphatically not forecasts, but rather scenarios of stress or worst cases. Banks will not allow these scenarios to develop without taking countervailing measures; in fact, they have already begun developing such strategies.

TREND 1: LOW-INTEREST-RATE ENVIRONMENT

Financial institutions in Germany have been struggling with low interest rates and narrowing margins for a long while. In the 1980s, net interest margins averaged 2 percent. They have steadily declined since, and now stand at 1 percent. The current monetary policy of the European Central Bank has reinforced this trend, keeping interest rates low and further compressing net interest margins. As new loans are less profitable than outstanding loans when interest rates decline, net interest margins are squeezed and interest income is depressed. Forecasting institutions expect that the low interest rates will persist at least until 2017.

The impact of low interest rates on net interest income is felt more acutely by German banks for two reasons. First, German banks are highly dependent on net interest income. Approximately 70 percent of the top line is driven by the interest margin. Second, German banks traditionally hold a high share of assets with very long maturities. That is, approximately 80 percent of all loans to domestic households and corporates have maturities of longer than five years. Hence, interest earned on assets is locked in for a long time. This has provided a cushion for banks so far but will put sustained pressure on interest margins in the near future. Low interest rates also have indirect effects on bank income. For example, as many bank pension plans are built on defined benefit systems, banks are having to make higher expenditures for pension provisions while generating less return on the associated funds.

The impact that an interest rate increase will have on banking will also depend on how fast the rate rises after 2017 and the maturity composition of each bank's assets and liabilities. If interest rates rise gradually, the interest margin might well continue to contract for two or three years before returning to healthier levels over time. Profitability can improve as margins gradually increase, but banks should not rely too much on rising interest rates. If interest rates rise, presently high deposit levels may quickly recede, as depositors with-

A savings glut and an investment dilemma

Apart from the persistently low interest rate environment, the income of German banks is also constrained by a savings glut. Very high deposit levels have already provoked debate in Germany over whether or not Germans are saving efficiently. Depositors have in fact increased their savings ratio despite the decline in interest rates. Deposits and other short-term liabilities often exceed the level of outstanding loans, implying that the surplus has to be invested. Since the early 2000s, the amount of short-term liabilities exceeding total loans has risen steadily, reaching EUR 370 billion in 2013, or about 5 percent of total assets in the German banking sector. The disparity has been caused by an aging German population and a lack of attractive alternative investment options for savers (Exhibit 11).

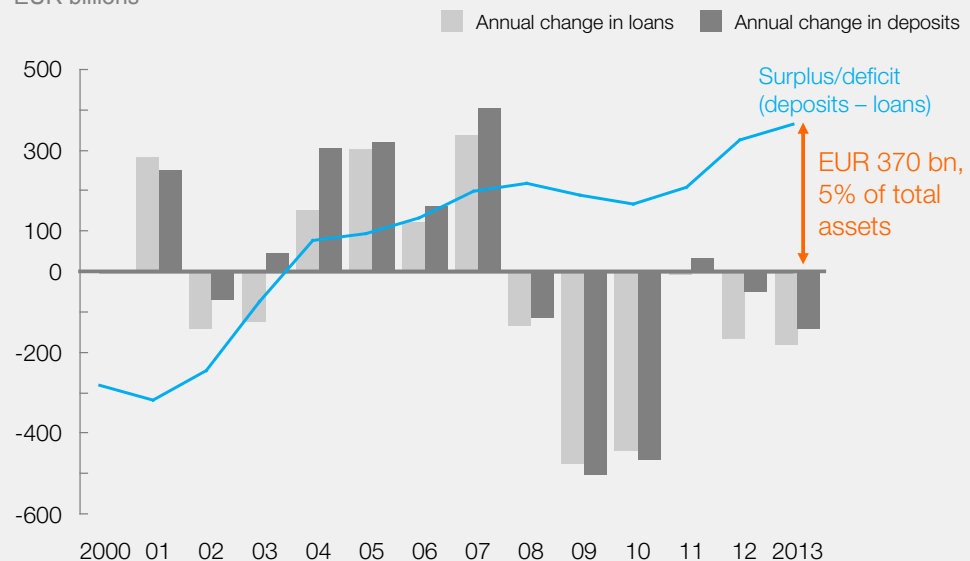
German banks, and especially Sparkassen and local cooperative banks, are subject to massive pressure to invest their surplus of short-term liabilities. The problem is that traditional investment opportunities, including German Bunds and corporate bonds, have yielded low returns in recent years; furthermore, the size of small banks can inhibit effective investment and risk management. Moreover, investment opportunities are increasingly restricted by regulation. The investment dilemma facing many German banks is that they need to invest and generate decent returns but can find few suitable investment opportunities in the low-risk space. The Sparkassen and local cooperative banks have been able to mitigate the effects of this dilemma somewhat, by distributing excess liquidity within their sector and particularly to their central institutions.

Exhibit 11

A savings glut with an investment dilemma – German banks under pressure to invest surplus find few opportunities without significant risk

Surplus/deficit of liabilities, Germany, 2000 - 13

EUR billions



SOURCE: Deutsche Bundesbank

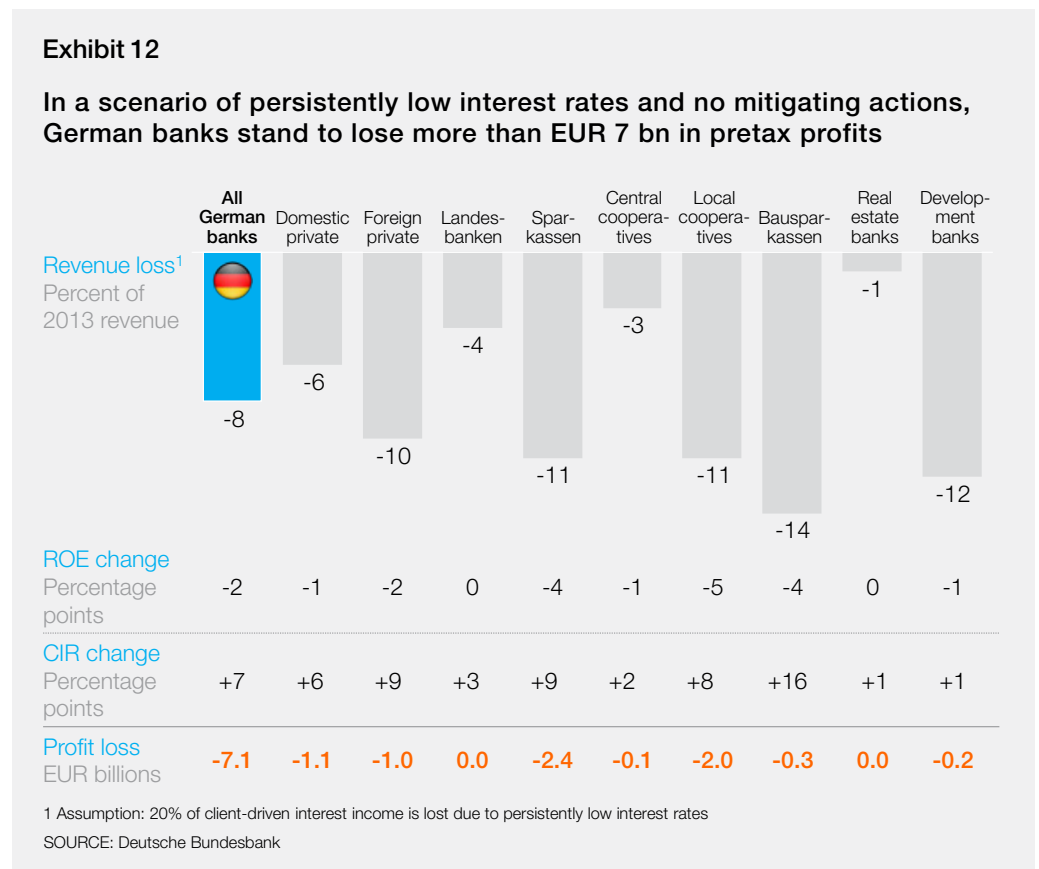
draw funds in search of more attractive investment returns. Banks will need to protect their competitive position by passing the new rates on to savings customers as fast as they can, to keep them from withdrawing. Banks that are not able to adjust deposit rates fast enough might lose market share to banks that offer higher rates (such as foreign direct banks without any long-term assets).

Should interest rates rise rapidly, however, the cost of funding will increase a lot faster than interest income from long-term assets with locked-in rates. The disjuncture could seriously jeopardize net interest income and disrupt maturity transformation while the risk of borrower defaults might spike due to quickly increasing funding costs for households and corporates.

The trend in low interest rates affects Sparkassen, cooperative banks, and Bausparkassen the most

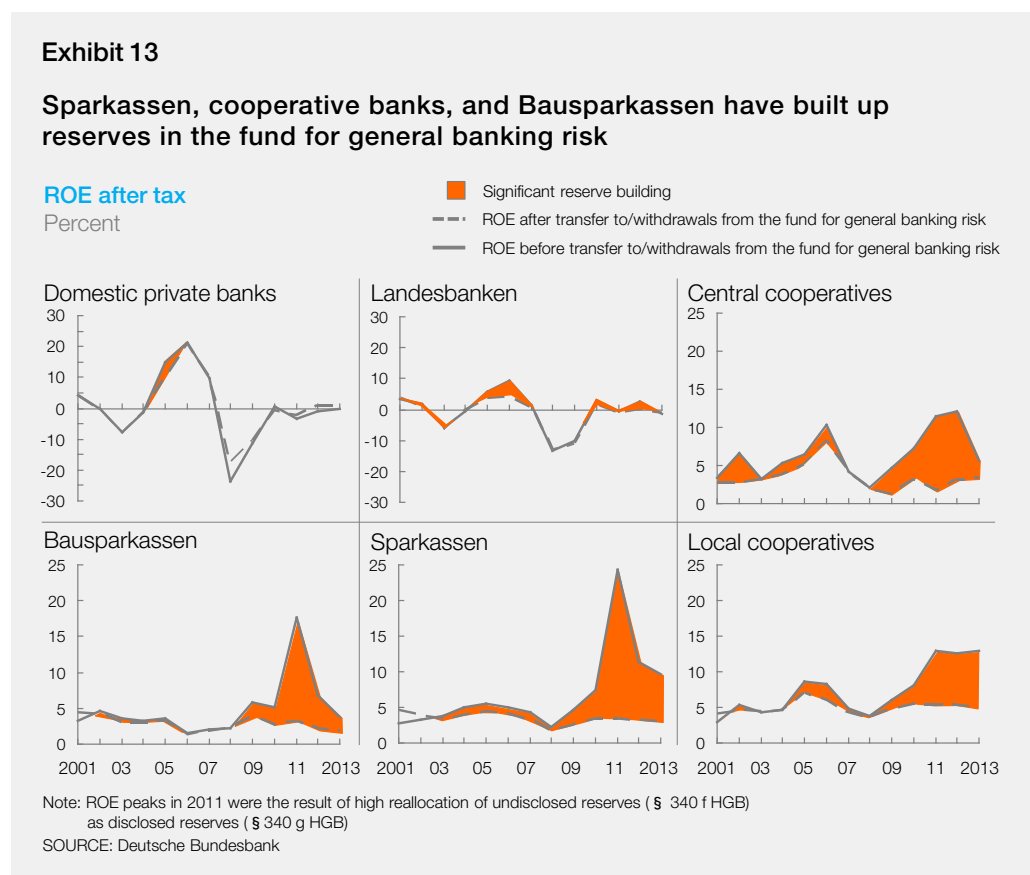
The recent interest rate dynamics suggest that interest income will decline in the coming years. It is reasonable to assume a loss of 20 percent of net interest income from lending and deposit taking over the coming five years, leading to a loss of roughly 50 percent of overall pretax profit for the banking market as a whole, assuming mitigating actions are not taken.¹⁰

All bank segments are generally exposed to adverse interest rate developments, but the loss of profits may be particularly damaging for Sparkassen, local cooperative banks, and Bausparkassen (Exhibit 12). These segments are more vulnerable due to their strong dependency on net interest income, their high share of deposits and loans, and the particularly



long-term maturity profile of their loan books. In the postcrisis low-interest-rate environment, Sparkassen, cooperative banks, and Bausparkassen increased loan origination. The interest rates on these loans being low and locked in expose these banks to potential serious hardship, should interest rates start rising. The high surplus of short-term liabilities of Sparkassen and cooperative banks will become especially burdensome in this context and will increase the pressure on these segments.

Under German accounting rules, Sparkassen, cooperative banks, and Bausparkassen have been able to mitigate some of this risk by stockpiling capital. German banks are allowed to build up special disclosed reserves to provide for future losses (“Fonds für allgemeine Bankrisiken”) according to § 340 of the German Commercial Code (HGB). After the crisis, Sparkassen, cooperative banks, and Bausparkassen thus began building up equity reserves and tier 1 capital, thus smoothing their return on equity to 3 to 5 percent (Exhibit 13). However, new and more rigorous capital requirements restrict their freedom to withdraw from these reserves, as earnings and reserves sufficient to meet the requirements must be retained. While these reserves offer some relief in the short term, they are neither sufficient nor useful for solving the profitability problem of German banks; rather, they may postpone a solution.



TREND 2: REGULATORY TIGHTENING

As the regulatory environment continues to tighten, noninterest income and costs also come under greater pressure. The regulatory environment for banks has become more rigorous since the beginning of the financial crisis, and further new requirements will shortly become effective (see the text box “New regulation – an (incomprehensive) glance”). The stricter crisis-inspired regimen is intended to reduce risk taking in German banking and make the market more resilient overall. Although new crisis-induced regulation has already had an impact on German banks, the German banking sector overall has generally responded well to the trade-off between profitability and derisking. Overall return on equity has recovered, nearly reaching precrisis level, while capitalization and loan loss provisions have also improved since precrisis times: for the period of 2010 to 2013, the average tier 1 capitalization ratio is 13 percent, and the average loan loss provision ratio is 13 basis points (Exhibit 14).

Additional new regulations are set to take hold in the near future, and have the potential to severely affect the sector’s profitability. Overall, banks can expect reduced return on equity in the new and tighter regulatory environment.

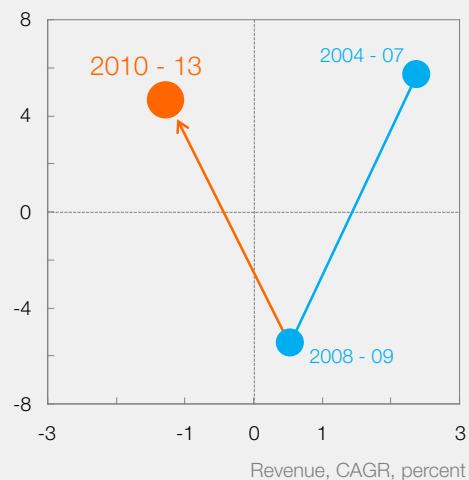
Exhibit 14

German banks responded well to the postcrisis regulatory trade-off between profitability and derisking – profitability is recovering

Annual average

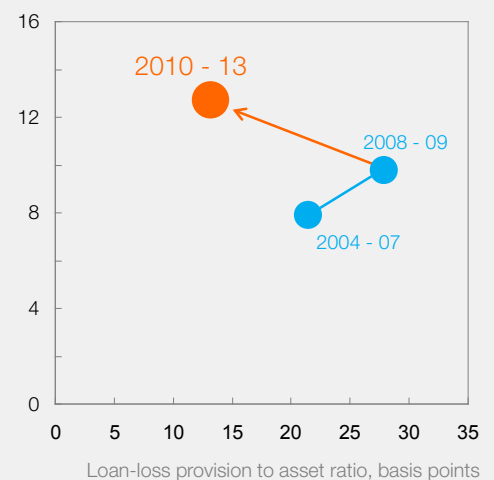
Steadily declining revenues but recovery of ROE ...

ROE, percent



... while significant derisking and increased capitalization

Tier-1 ratio, percent



SOURCE: Deutsche Bundesbank

Additional new regulations are set to take hold in the near future, however, and have the potential to severely affect the sector's profitability. Overall, banks can expect reduced return on equity in the new and tighter regulatory environment.

New and significantly higher levels for capital quantity are being introduced, and the criteria for qualifying capital are becoming more restrictive. To increase the quality and quantity of their capital, banks will either have to retain more of the profits or seek additional shareholder funding. These steps might raise their cost of capital at the margin. In addition, new requirements for the quantity and quality of liquidity buffers will urge shifts in the liability structure towards more expensive longer-term funding.

Expanded consumer protection rules and information disclosure requirements could constrain fees and increase price transparency, with the result of limiting fee income further. Capital regulation and restrictions on trading activities will tend to make high-return investments less attractive, and elaborate proprietary trading activities might be further curtailed. The generation of trading income could thereby become more challenging.

Overall, banks will encounter higher fixed costs, as more financial resources will be needed and additional capabilities need to be built for improved risk and capital management, regulatory compliance, and internal controls. Moreover, to meet higher data and reporting requirements, banks will have to invest in IT infrastructure, processes, and governance.

New regulation – an (incomprehensive) glance

New regulations include measures addressing capital and liquidity requirements, resolvability and recovery, transparency and disclosure, governance and controls, consumer protection, and market functions:

- **Capital requirements.** New and significantly higher levels for capital quantity and quality are being introduced through Basel III and IV. Higher minimum capital ratios plus additional countercyclical capital buffers need to be in place. Additional surcharges have been added for systemically relevant institutions. Higher risk weights have been imposed for specific assets (such as securitizations, some trading activities through the Fundamental Review of the Trading Book). There is a trend in the Basel regulation to supplement the internal model approaches (IMA) with standardized approaches and to install a floor that will increase capital requirements and reduce benefits from IMA. The criteria for qualifying capital are more restrictive. Further loss-absorbing components, including a minimum for total loss-absorbing capacity (TLAC), are in place, and the leverage ratio is being used as an additional curb on the size of the balance sheet.
- **Liquidity requirements.** New requirements for the quantity and quality of liquidity buffers have been imposed: the liquidity coverage ratio (LCR) for short-term funds and the net stable funding ratio (NSFR) for the long term.
- **Resolvability and recovery.** The EU Bank Recovery and Resolution Directive (BRRD) requires banks to establish plans for recovery and to enable the resolution of their institutions. "Bail-in" structures are also required, such as "contingent convertible"

capital instruments (CoCos). A minimum requirement of own funds and eligible liabilities (MREL) is set by the resolution authority, bank by bank on the basis of the resolution plan. Banks should separate risk-trading activities from retail activities – as recommended in the Liikanen Report on structural reform in banking, and adopted by the German government in the German Bank Separation Act.

- **Transparency and disclosure.** The requirements on information disclosure and risk reporting have been strengthened. A directive of the Basel Committee on Banking Supervision (BCBS 239) aims at empowering banks to identify bankwide risks promptly. The European Central Bank's analytical credit data set (AnaCredit) allows for more institutional transparency and peer benchmarking. Further requirements include the common and financial reporting guidelines (COREP and FINREP) of the European Banking Authority (EBA).
- **Governance and controls.** Governance rules are stricter, with a requirement for senior management involvement and appropriate controls, including the EBA's Supervisory Review and Evaluation Process (SREP). Effective communication and exchange with supervisors and contribution to regulatory exercises, such as the Asset Quality Review (AQR) and Comprehensive Assessment, need to be ensured. Regular stress testing exercises will assess the ability of banks to deal with the economic crisis. EBA will conduct the next stress test of the EU's largest banks in 2016.
- **Consumer protection.** The European Commission's Markets in Financial Instruments Directive II (MiFID II) includes requirements for greater conformity of exchange and trade platforms, more market data and burden of proof in trade execution, and more transparency in reporting before and after trades. To ensure appropriate levels of consumer and investor financial services protections across Europe, MiFID II requires bans on inducements of investor advice and will limit the use of commissions.
- **Market functions.** To reduce systemic risk, the European Securities and Markets Authority (ESMA) has introduced the obligation to clear certain classes of over-the-counter (OTC) derivatives through designated central counterparties (European Market Infrastructure Regulation (EMIR)).
- **Other regulations.** Additional regulations now in effect include new requirements on the compensation and remuneration of key bank employees, limits on bank levies, resolution fees, and deposit insurance premiums, as well as significant changes in the accounting treatment of provisions and fair values according to the International Financial Reporting Standards (IFRS 9).

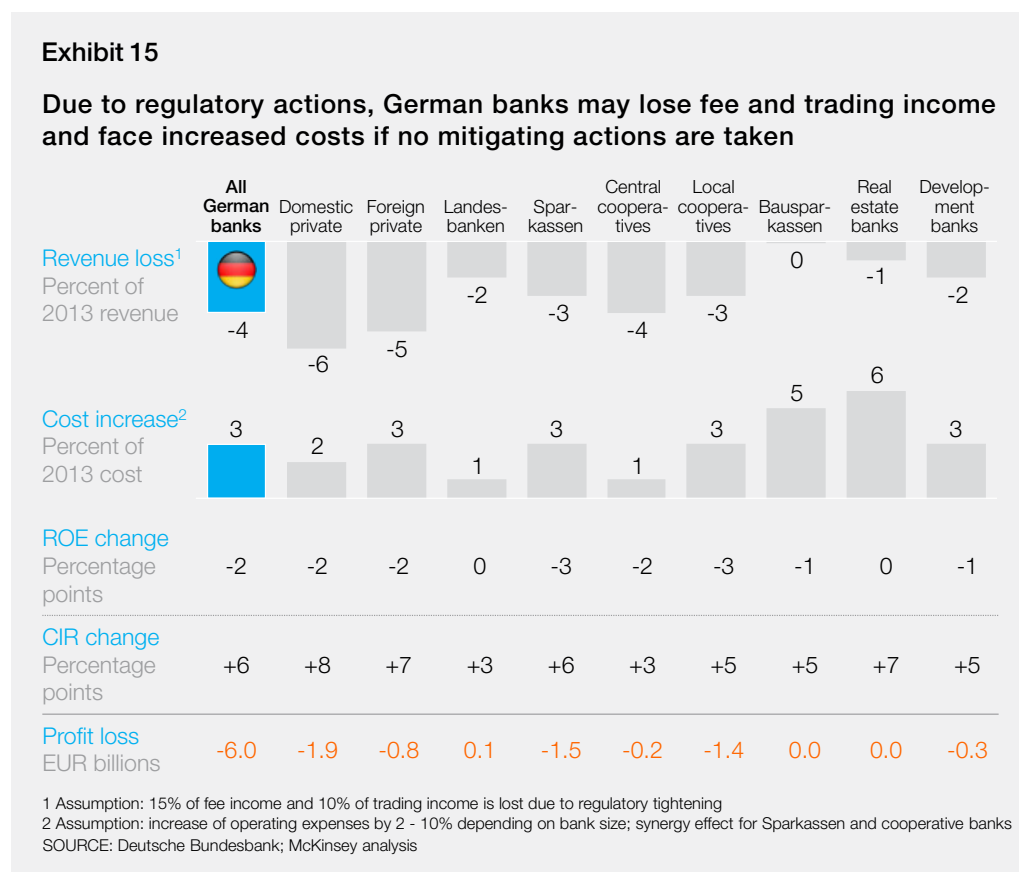
Regulatory tightening will likely affect private banks and small banks across all segments the most

The level of effort required for banks to comply with the new regulatory rules will differ across bank segments and regulatory areas. Large, systemically important banks across all segments will have to fulfill higher minimum capital ratios, hold up additional capital charges, and meet new requirements for the quantity and quality of liquidity. Sparkassen will have to

cope with more restricted core capital definitions. So far, a large part of their equity has been funded by silent participations from municipalities and other owners. Silent participations resemble debt instruments and only absorb potential losses up to the nominal value. Under Basel III, these participations will no longer be accepted as core capital, and Sparkassen will need to replenish their equity base. Cooperative banks are not affected by this as their equity base does not comprise silent participations.

The forthcoming regulatory changes will reduce noninterest income across all German banking segments unless banks take countervailing measures. The reduction would affect domestic and foreign private banks in Germany the most, which now rely on noninterest income for 30 to 40 percent of revenue (average for 2010 to 2013). Under the assumption that all banking segments will see fee income reduced 15 percent and trading income 10 percent over the next five years, the profitability of private banks would be most affected.

The cost base for all bank segments is also expected to rise as a result of the new regulation. Since a significant share of the regulatory cost is fixed, the relative increase will be most pronounced for small banks. Assuming an increase in operating expenses varies by bank size, from a 2 percent increase for large banks to a 10 percent rise for small banks, the total cost base of the banking sector would increase by 3 percent overall in five years.¹¹ Sparkassen and cooperative banks might be able to manage fixed-cost investments more efficiently by spreading expenditures across the entire segment (Exhibit 15). We therefore estimated a more even spread increase in operating expenses of 5 percent across both segments.



TREND 3: DIGITIZATION

The process of digitization in financial services is moving forward at speed. Digital banking is of course not new, but the increased pace and widespread customer adoption are creating opportunities and posing challenges as well. It is changing the landscape of German banking and putting competitive pressure on revenue pools. Momentous shifts are still to come, and sooner than most people think.

The value chain of banking is likely to be disrupted. Customer preferences are shifting, expectations towards financial service providers are changing, and there is growing competition from banks and nonbanks alike putting pressure on margins.

As it relates to banking, digitization has a number of essential components. In the first place, customers have become more digitally savvy. They are increasingly connected and well informed. Over half of German banking customers are using online banking services, up from one-fifth in 2001.¹² Nearly half of mobile device users, furthermore, conduct banking transactions with mobile applications.¹³ These shifting preferences are exhibited by both retail and corporate customers and make it more difficult for banks to serve and retain them with traditional service models.

Retail customers are also more aware of the choices available to them. Their financial decisions are increasingly guided by the customer experience and convenience of digital channels. Although retail customers often stick with their main checking account, they feel no strong bond with their bank. They increasingly engage in comparative shopping for financial products, and in the process encounter innovative offerings of nonbanks. Corporate customers, meanwhile, are raising the bar for tailored offerings and more transparent pricing while expecting banks to work closely with them through multiple touch points. They demand quick and direct access to standardized products (such as cash or foreign-exchange management) and do not hesitate to shop around for lower prices, greater convenience, and better functionality.

Given these new digitally created parameters, bank and nonbank competitors offering a superior digital customer experience are poised to attract a significant share of customers. Nonbanking attackers, especially financial technology companies, have already made significant inroads into the banking market. Their potential to exploit changes in technology and shifting customer preferences will only increase.

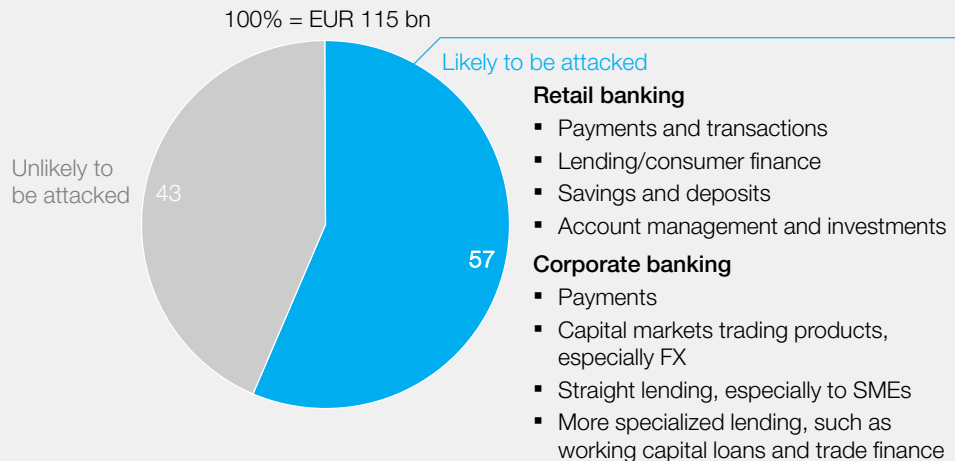
Simple retail and corporate banking products, especially savings and lending products, are the businesses most vulnerable to the new competitors. The complex and more customized products and services, such as asset-backed lending and investment banking, are in less immediate jeopardy (Exhibit 16).

Exhibit 16

Existing revenue pools are at risk of being attacked by traditional competitors and new "nonbank banks"

Total revenue pool in the German banking market, 2013

Percent



Small loss in volume but high margin pressure expected due to increasing competition, price transparency, and customer disintermediation

SOURCE: McKinsey Panorama; McKinsey analysis

Highly specialized financial technology companies are zeroing in on particular banking functions: payments, savings, lending, and investments. Most often they work with banks that serve as white-label operators in the background. While the banking product often stays on the balance sheets of these banks, the financial technology attackers are likely to take over the customer relationship, with its opportunities for origination and sales, in a process known as "customer disintermediation" (as opposed to real "credit disintermediation").

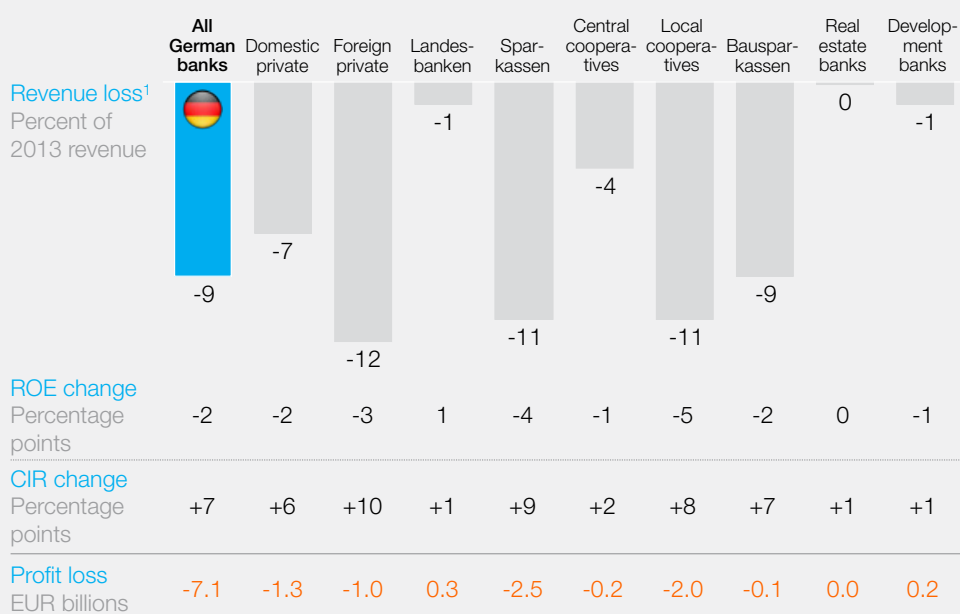
The risk is high that the financial technology firms will trigger a disruption in the banking value chain. McKinsey's "Global Banking Annual Review 2015" makes it clear that, at the moment, customer-facing activity, namely origination and sales, account for around 60 percent of global banking profits. Even without the credit disintermediation affect (the loss of customer assets on their balance sheet), the impact of nonbank attackers could be detrimental for banks. Only small parts of the banking balance sheet are at risk of being captured, but this would push down prices in a market that is already highly competitive. Price transparency created by heightened customer awareness and comparison shopping will undoubtedly put additional pressure on margins. In these ways, most of the negative impact on profitability will come from margin compression rather than volume loss.

Digitally enabled competition threatens local cooperative banks, Sparkassen, and foreign private banks the most

Assuming the progress of digitization in banking proceeds at its current pace, client-driven income could decline by 5 to 15 percent in the next five years. The relative impact on profit and loss would depend on the share in the bank's balance sheet of simple banking products, such as retail deposits or consumer loans. Sparkassen, local cooperative banks, and foreign private banks rely most heavily on these products and are therefore potentially more vulnerable to the effects of digitization (Exhibit 17). The local footprint of Sparkassen and cooperative banks could deflect some of the potential decline, but all banks will need to take dedicated countervailing actions.

Exhibit 17

Digitization, while creating opportunities, may also result in revenue losses of up to 12 percent if no countervailing actions are taken



¹ Assumption: losses due to digitization of 5 - 15% of client-driven interest income and 5 - 15% of fee income depending on the balance sheet composition of the different bank segments
SOURCE: Deutsche Bundesbank; McKinsey analysis

OVERALL ADVERSE IMPACT ON GERMAN BANKING

If left unmitigated, the combined effect of the examined three trends – low-interest-rate environment, regulatory tightening, and digitization – could be strong enough to push the German banking industry's return on equity down by 6 percentage points, from currently +4 to -2 percent (Exhibit 18).

The return on equity of Sparkassen, local cooperative banks, Bausparkassen, and private banks will be the most challenged. Given their relatively favorable starting position, however, Sparkassen and local cooperative banks would end up with better ratios than private banks.

Exhibit 18

Without mitigating action, the combined effect of the 3 trends could reduce ROE by up to 10 percentage points

ROE after tax

Percent

	2013 actual	Change	5-year horizon
Domestic private	0	-7	-7
Foreign private	4	-7	-3
Landesbanken	-1	-1	-2
Sparkassen	10	-9	1
Central cooperatives	5	-2	3
Local cooperatives	13	-10	3
Bausparkassen	4	-8	-4
Real estate banks	0	0	0
Development banks	2	-1	1
	<i>German average 4</i>		<i>German average -2</i>

SOURCE: Deutsche Bundesbank; McKinsey analysis

Most vulnerable are domestic and foreign private banks and Bausparkassen. These banks all had low profitability in 2013 and thus would end up with the most unfavorable return on equity after taking into account the combined impact of the trends. Overall, the unmitigated scenario effects would put at risk the profitability of 74 percent of all banks in Germany while leaving only 15 percent with returns of 6 percent or above (Exhibit 19).

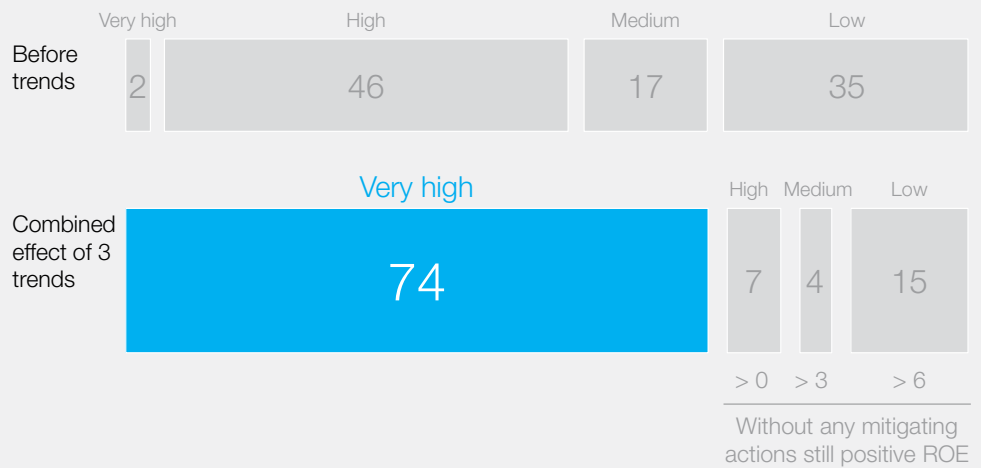
Generating significant economic pressure, the combined effect of the trends has the potential to push many banks with low profitability over the line. Today, nearly half of all banks already have a return on equity of less than 3 percent.

While many institutions have so far managed to hang on despite their dismal profitability, the expected changes make decisive actions imperative.

Exhibit 19

The profitability of nearly 3/4 of all German banks is at serious risk unless mitigating actions are taken

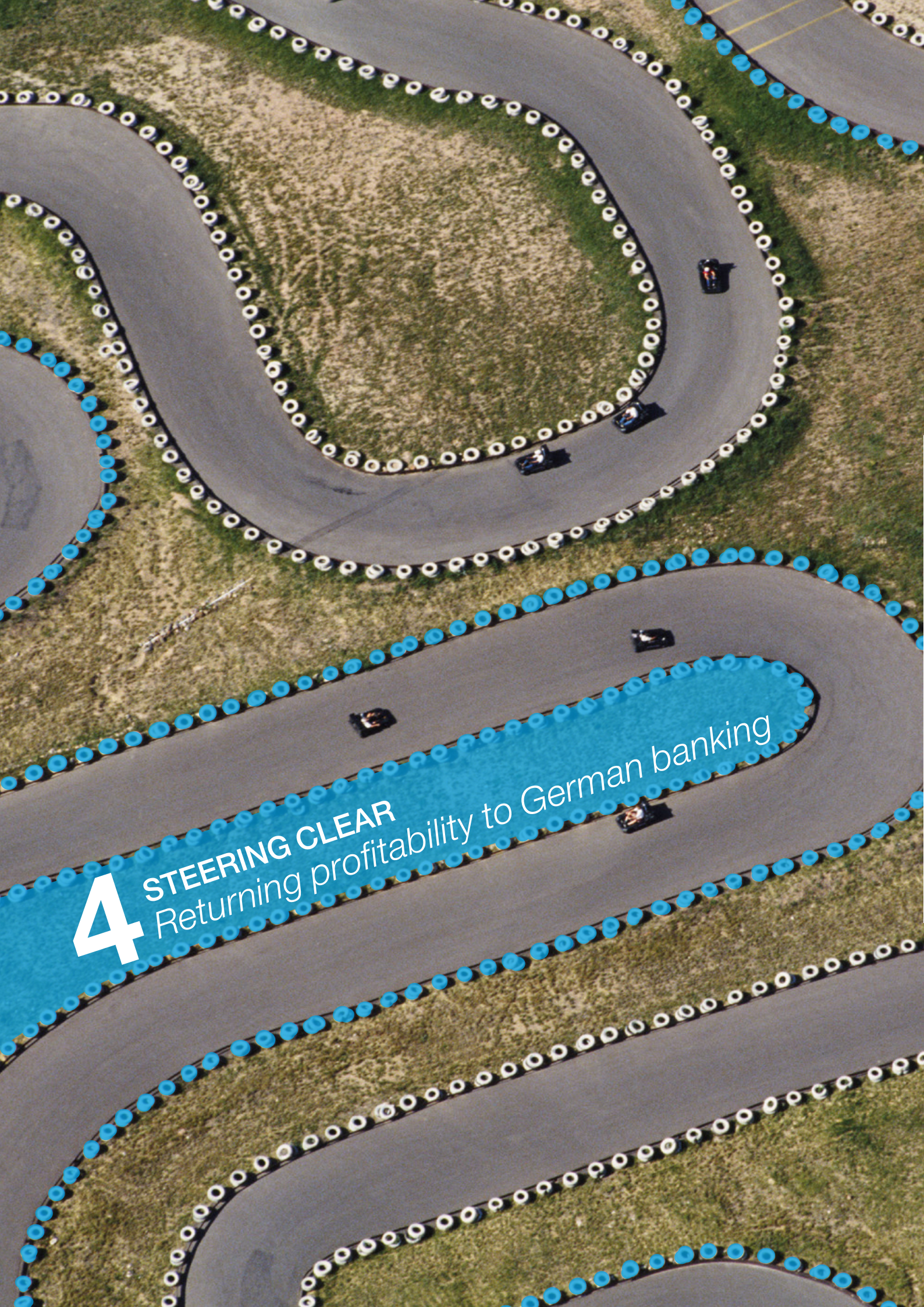
Need for mitigating actions
Distribution of banks, percent



SOURCE: Deutsche Bundesbank; McKinsey analysis



The three key trends described in this chapter will put significant pressure on the entire German banking market. To push back, banks need to take substantive action. The market will be unable to return to healthy profits and sustainable growth paths by relying only on tactical efforts. Only through profound structural changes and substantially transformed business models will German banks be able to bolster profitability. Not surprisingly, one of the trends causing the disruption, digitization, also holds the key for unlocking successful transformations. In the next chapter, we outline the measures that banks can take to tackle the challenges.



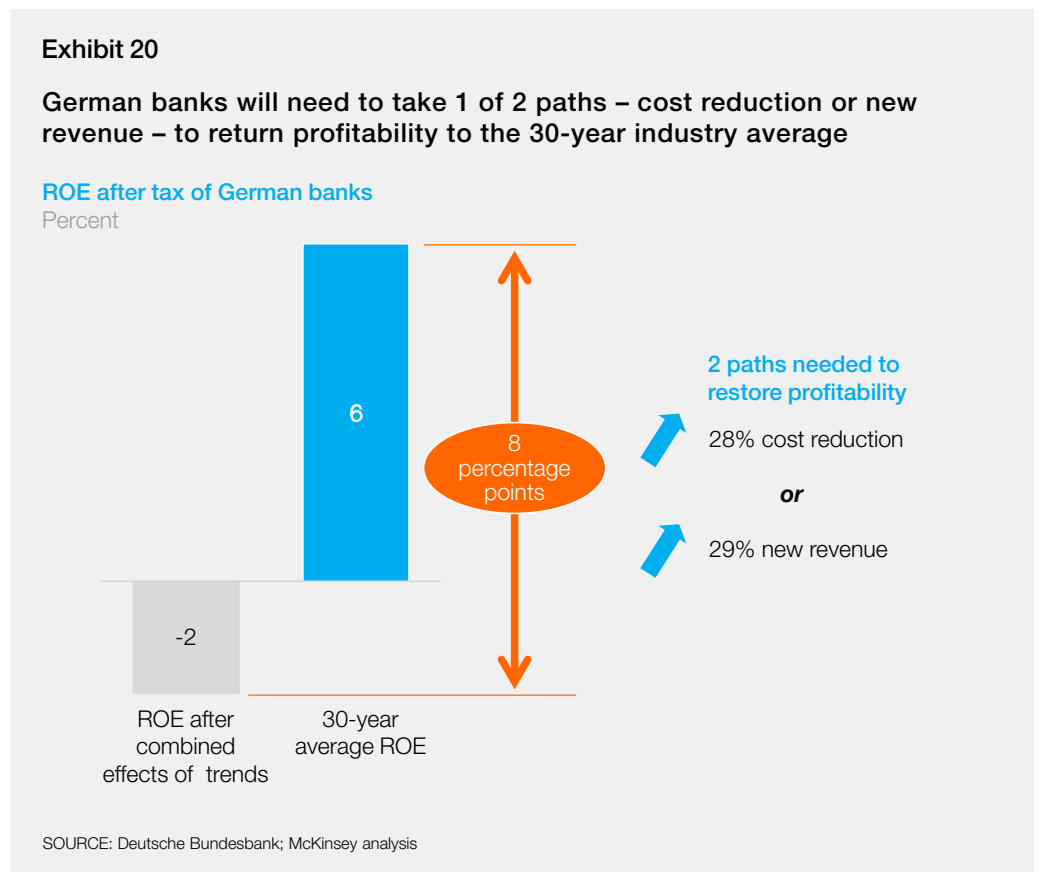
4

STEERING CLEAR

Returning profitability to German banking

The German banking market faces downward pressure on profits and upward pressure on costs from the trends we have been discussing: the low-interest-rate environment, regulatory tightening, and digitization which could lead to a further deterioration of profitability. Without countervailing actions, these trends could have a severe negative impact on the industry, pushing return on equity down to -2 percent overall.

To keep pace with the banking market changes and regain positions of reliable profitability, there is no alternative to taking drastic actions as banks must become more cost-efficient and find new revenue streams. Restoring the industry to the 30 year average return on equity of 6 percent will take considerable effort in both these areas.¹⁴ Should cost savings or new revenues alone be pursued, banks would need to attain unfeasible improvements – of nearly 30 percent (Exhibit 20).



The magnitude of the improvements that will be needed over the next five years means that banks will have both to reduce costs and open new revenue streams – sustainable profitability will be little attainable if only one improvement path is pursued. The industry itself is headed for transformation, posing a serious challenge for many banks. While for some the efforts to restore profitability may prove to be unobtainable, for others the period of transformation presents an opportunity to become a performance leader.

Given the potential severity of the trend effects on the banking market, one responsive measure to be considered is consolidation. That there is room for further consolidation in the market is highlighted by the significantly different starting positions from bank to bank as the industry faces the coming changes. With a reasonable and efficient consolidation strategy, German banking could generate considerable cost savings throughout the market. The banks that emerge from this process would be more financially resilient. Furthermore, when the number of banks (and branches) matches the demand for banking services more closely there is less of a danger of harmful competitive behavior and industry cannibalization.

A note on consolidation

Considerable effort was exerted to consolidate the German banking market in the early 2000s. Since then, banking leaders focused less on consolidation and more on other concerns, such as regulatory compliance. The German banking market is still highly fragmented, however, with many small institutions, some independent, some belonging to overarching networks (Sparkassen and cooperative banks). Increased M&A activity of banks leading to reasonable consolidation could generate considerable cost savings throughout German banking while improving the resiliency of the banks that emerge from the process. When the number of banks (and branches) are more commensurate with the demand for banking services, the equation will reduce harmful competitive behavior including industry cannibalization and will help to find a more reasonable price level for the whole industry. This problem is particularly severe among Landesbanken who are competing fiercely.

The German banking sector is in fact already undergoing additional consolidation, and so serious reconsideration of this market phenomenon should be undertaken by banks as soon as possible. The first signs of a shakeout are already visible. More than 30 local cooperative banks have consolidated in 2014, and HSH Nordbank, a crisis-ridden Landesbank, must be consolidated until 2018, according to the EU Commission, as a condition for further state aid.

Even if the sector as a whole does not return to historic profitability levels, all individual banks should try to find their path to long-term financial health. This requires a combination of actions: an acceleration of tactical measures, driving structural changes to their operating model and exploring opportunities beyond the traditional banking business models.

RESIST TAKING ACTIONS THAT DO NOT CONTRIBUTE TO THE REAL SOLUTION

The pressures the three trends are creating cannot be decisively alleviated through short-term efforts alone. While tactical and partial measures must be a part of banks' overall response to the challenges, the ultimate and necessary goal is the achievement of real and lasting change in the banking sector. Measures that bring only temporary or incremental relief, furthermore, may actually create opportunity costs without contributing to long-term recovery.

Withdrawing from the rainy-day fund and other delaying actions

Certain actions are therefore not recommended. German banks overall have accumulated more than EUR 70 billion in rainy-day reserves (Fonds für allgemeine Bankrisiken), with Sparkassen, cooperative banks, and Bausparkassen leading the way. By halting new allocations to the fund and leveraging the stockpiled reserves, German banks could make some improvement in net profits. By this route, however, banks would need to withdraw ten times their aggregate contribution made in 2013 to move their return on equity to long-term average levels over the next five years. Even if these funds were large enough to permit withdrawals of this magnitude, most banks would still be prevented from doing this by capitalization requirements. For most banks, that is, reserves in the fund are included in their tier 1 capital holdings, so large withdrawals would quickly bring bank capitalization to a critical level without structural changes.

In addition to making withdrawals from the fund for general banking risks, banks could be tempted to take other short-term initiatives to improve profitability and lower costs. Familiar but inadvisable measures include hiring or investment freezes, higher sales targets, and fee adjustments. Some of these measures are routinely applied when banks incur sizeable losses. While they sometimes result in short-term performance improvement, the relief they might bring would in any case be insufficient for meeting the challenges banks are facing.

A PROGRAM FOR REAL CHANGE – TACTICAL MEASURES, STRUCTURAL CHANGES, AND THE REINVENTION OF THE BUSINESS MODEL

To recover sustainable profitability under the combined effect of the three trends, banks will need to achieve changes of a structural character. The transformative period banks enter will require responses at every possible level: tactical change programs to begin with and deeper changes to the operating model to make real gains. For a select few, an even higher level of change can be explored in reinvented business models aided by digitization. The path to a successful and sustainable future business model will combine approaches of different depth, each contributing different combinations of cost savings and new revenues and having different operational and strategic implications. The responses of each bank will differ in the specifics, but the overall strategic transformation can be envisioned along three horizons of increasing strategic scope.

Expand tactical measures and programs

Banks will most likely first want to reduce the size of the profitability gap with efficiency-enhancing change programs. The industry as a whole and many banks in particular must establish higher levels of efficiency. A fair amount of this needed improvement can be achieved through traditional transformation programs. If implemented with the necessary diligence and commitment, these programs can offer banks substantial relief. A number of tactical measures are used to enhance revenues and cost efficiency, including lean programs and programs to address pricing, costs, and the branch footprint. Each bank will have to decide measures that best fit their overall strategy and capabilities:

- **Front-office excellence and lean programs.** Lean programs aimed at achieving front-office excellence have been used by banks for over a decade. Success can be elusive without leadership commitment and rigorous implementation. For those banks that have succeeded, lean programs have reduced delivery times and errors by up to 80 percent, and brought sustained productivity improvement of 3 to 5 percent.
- **Repricing and upgrading pricing capabilities.** A comprehensive pricing transformation typically includes tactical measures like leakage reduction, list price optimization, and selective repricing with a potential revenue increase of 4 to 5 percent. Pricing programs can also include innovative elements for strategically optimizing share of wallet, including loyalty programs and relationship pricing. By these measures, some banks have been able to achieve revenue increases in their retail business of more than 10 percent. While the three trends will expose margins to further pressure, excellent pricing capabilities are in any case important assets for banks and can be a decisive competence for lifting revenues. Some banks have already started to build “pricing labs” similar to retailers.
- **Optimizing the branch footprint.** Branch density is particularly high in Germany compared to peer markets and represents a large and rigid layer of costs. Many banks have recently launched footprint optimization programs, closing large numbers of branches; others have announced their intentions to do so. The trend is expected to accelerate, with banks in all segments taking part. Banks are recognizing redundancy in their branch networks, which may not adequately reflect customer willingness to travel or shifting customer preferences towards digital channels. German banks that already offer a broad range of banking products and services through online and mobile applications are in an excellent position to consider far-reaching reductions in their branch network. To substantially improve the cost base, German banks will have to rethink their branch footprint in terms of number, scale, and location of branches. In doing so, they have to carefully weigh potential drawbacks such as customer churn and unemployment.
- **Scale up of efficiency and cost programs.** Many banks have already implemented a series of cost reduction and efficiency programs. Not every program results in what was hoped for, especially if it does not reach far enough. While many banks have failed to reduce their overall cost levels, about one in five European banks have managed to realize cost savings of over 20 percent of the pre-crisis cost base. Given the spotty success of cost programs, we believe there is still room for improvement and the coming squeeze cannot be endured on today’s cost base. Many banks will need to revisit their entire operating model and set up a multiyear transformation journey, hopefully creating a sound cost culture for the banking sector.

Change the structure of the operating model

For most banks, the foregoing tactical measures can only be one part of a successful response to the adverse impact of the three trends. To return to sustainable profitability, banks will need to change the structure of their operating models. To defend existing revenue pools and, where possible, meet the cost base or lift revenues, banks will have to assemble their own strategic approach from a number of possible initiatives, some of which are described below. The enabler of many of these changes will be digitization.

- **Multichannel excellence.** Both retail and corporate customers increasingly demand convenience and an appealing digital banking experience. A truly customer-centric bank meets these demands with full multichannel functionality, so customers can move easily between branch, online banking, and mobile app. The multichannel offerings must be tailored to the needs of different banking segments. In this respect, offerings for small and medium-sized enterprises are currently often underdeveloped. An initiative for multichannel excellence can be an opportunity for banks to develop a distinct value proposition and gain market share in this important customer segment.
- **Selective reinternationalization.** The process of reinternationalization has quieted among German banks. Since the financial crisis, banks have even preferred exiting foreign business and markets. Still, many banks have the scale and skills to diversify their business abroad. Although this kind of expansion might not align with the current zeitgeist, selective reinternationalization could be a winning move for some banks.
- **Increased M&A activity.** The mergers completed in the German banking sector have not always been strategically reasonable in the past. Now, however, it seems clear that further consolidation in the sector is unavoidable along the path to sustainable cost levels. Mergers and acquisitions allow banks to improve their revenue base, which leads to scale improvement, and to realize cost synergies over time. Banks having the required capital resources should keep their eyes open and screen the market for potential partners.
- **Make-or-buy decisions.** Given the pace of digitization in banking, banks will increasingly face make-or-buy decisions. Digitization is an occasion for the strategic reevaluation of a bank's strengths along the value chain. Many banks will gain advantage by a) sourcing out certain of their own processes or services, b) building strategic partnerships or joint ventures for shared platforms and services with other banks, and/or c) offering certain services and operations to others. For most banks and therefore the industry as a whole, reasonable make-or-buy decisions will help to increase efficiency and find a better cost level. For some, furthermore, providing services to others can be an attractive new source of revenue.
- **Digitization of the value chain.** The automation of standard processes, back-office integration, and transaction processing is a powerful cost lever, bringing significant savings. Digitization of the whole value chain is also an essential part of the initiative to improve customer experience and help meet customer preferences.
- **Consolidating the business model and simplifying the product portfolio.** Make-or-buy decisions will help simplify business models. Banks can make further progress, capturing cost advantages in IT and operations, by adopting standardized plain banking products and by streamlining the product portfolio. Some banks have managed to reduce the number of core banking products by more than 90 percent, mainly by standardizing features and limiting customization. By focusing on products with heavy mid- and back-office support, banks have realized up to 30 percent reductions in IT and processing costs.

- **Customer experience – satisfaction and brand appeal.** In this initiative, banks use big data to reinforce their connection to the customer, revitalize their brand appeal, and push the customer experience to more satisfying levels. The process enhances the attraction and retention of customers and the opportunities to cross-sell. Customer data, massively compiled by banks through myriad transactions, are mined for potential new revenue sources. New product offerings tailored for customer needs (the “next product to buy”) are shaped from the insights drawn from this data. Data analysis can also help optimize and simplify the customer journey, improve lead generation, and forecast churn and defaults.

Reinvent the business model and banking

A select few banks will be able to explore opportunities beyond the traditional banking business models and be part of the reinvention of banking in Germany. Overall, banking is a commoditizing industry, and achieving higher returns will become more difficult in the next few years. To achieve a performance breakthrough, capable banks will need to reinvent banking by exploring revenue pools beyond today’s traditional business model. Only a few banks will accomplish this third step, since it involves a complete transformation of the business model. As with the tactical and structural changes, digitization will be the key enabler for banks undertaking more radical change.

Banking innovation has accelerated in the past decade and no one knows exactly the direction it will take in the next decade. Two promising and quite different strategies for banking innovators are the commoditization of the balance sheet and the mastery of customer relationships.¹⁵

- **The commoditized balance sheet and the utility bank.** By commoditizing their balance sheets, banks can radically cut costs and focus more narrowly on basic business activities such as lending and deposit taking. They can also partner with platforms and financial technology companies, creating an extended balance sheet – understanding that they might lose the direct customer relationship in the process. Some banks go as far as becoming a banking utility, acting as a white-label operator to deliver balance sheet capacity and operational banking excellence to intermediary companies such as other banks and financial technology companies.
- **Mastering the customer relationship and the consumer ecosystem.** Banks choosing to master customer relationships will face a different set of challenges from those faced by the commoditizing bank. To increase revenues, these banks will need, above all, to create an emotional connection with customers. A superior customer experience can be created partly by drawing on the bank’s treasury of customer data. Innovative, nontraditional revenue-generating products and services can be developed, including accounting, tax, and legal services. From customer spending data, banks can even offer advice on cheaper electricity or telephone services, or provide customers with coupons and vouchers tailored to their buying preferences. B2B business models can be explored – such as between the bank and the telephone provider – that add new revenue streams. From these initiatives, the bank begins to develop a consumer ecosystem, supported by novel but sustainable revenue pools, enabled through the digital bank and the multifaceted customer relationship.

The commoditized balance sheet and the consumer ecosystem are only two possible business models of the bank of the future. Between these opposite poles lie many potential strategies to be developed and pursued. The parameters for individual banks capable of undertaking this more radical step are the bank's position in the market (bank type, size, and business mix) and the efficacy of each strategy given the situation. Banks must all recognize the urgency of developing a competitive business model for the future and proceed accordingly, under the leadership of top management.



The challenges the German banking market faces are serious and require immediate action. Within five years, the market will have gone through transformative changes with or without strategic responses from German banks. The savviest strategies will be designed to secure both significant cost savings and new revenues. By pursuing only one or the other, banks would be overwhelmed by the magnitude of the improvement required: to reach sustainable profitability through only savings or new revenue, an improvement of nearly 30 percent would be needed. There is also room for consolidation in the market, since the starting position differs significantly from bank to bank – and some will be unable to achieve the needed improvement even if both paths are pursued.

Successful and sustainable future business models will be the result of a number of strategies, each comprising a different winning combination of revenue-enhancing and cost-saving measures. Each model will have its own operational and strategic implications. Banks will need to base their approach on achieving sustainable profitability, and focus all their tactical and strategic efforts on this. Time and resources should not be wasted on stop-gap measures that incur opportunity costs and do not contribute to long-term recovery.

To develop their competitive strategy, banks should, first of all, improve their starting point. Existing transformation and cost efficiency programs will be helpful in increasing profitability in the short run. Tactical measures alone, however, will not be enough to reach long-term sustainable profitability. The second step moves the required transformation into strategic territory, as banks define their new and sustainable operating models. Their paths could lead to radically simplified business models, digitization of the whole value chain, or, potentially, increased M&A activity and selective reinternationalization. A few leading banks will be able to undertake a third step, progressing to the bank of the future. These few will explore new worlds, beyond traditional banking, to find novel revenue pools and make performance breakthroughs. For these and all banks undertaking strategic transformations, however, digitization will be the enabler. Change is coming. Get on top of it by acting deliberately and without delay.

DOMESTIC PRIVATE BANKS

SIZE AND SCALE (AS OF 2013)

2,500 EUR bn
TOTAL ASSETS

110
TOTAL # OF BANKS

8,000
TOTAL # OF BRANCHES

110,000
TOTAL # OF EMPLOYEES

Since 2000,
total # of
private banks'
branches
declined by nearly
50%

AVERAGE SIZE

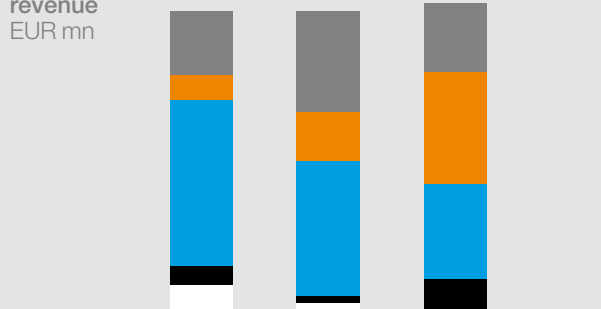


23 EUR bn

REVENUE MIX AND COST (2010-13 AVERAGE)

Average
revenue
EUR mn

1,200 **2,150** **34,250**



Size class <1 bn 1-10 bn >10 bn

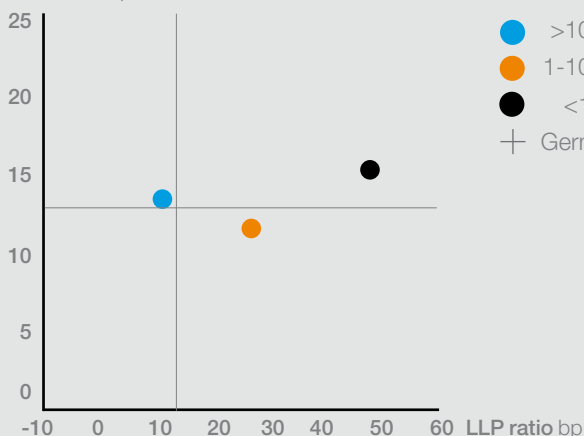
Cost-income ratio percent **81** **86** **79**

- Client-driven interest income
- Non-client-driven interest income
- Commission income
- Trading income
- Other operating income

Particularly **high share of trading income** at large domestic private banks

RISK PROFILE (2010-13 AVERAGE)

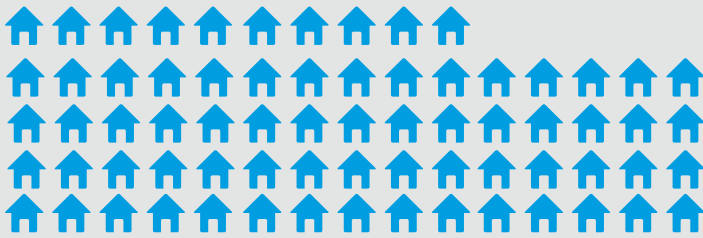
Tier-1 ratio percent



- Size class
- >10 bn
 - 1-10 bn
 - <1 bn
 - + German average

Both **strong deleveraging** and **capital increase** to improve Tier 1 ratio

AVERAGE # OF BRANCHES



70

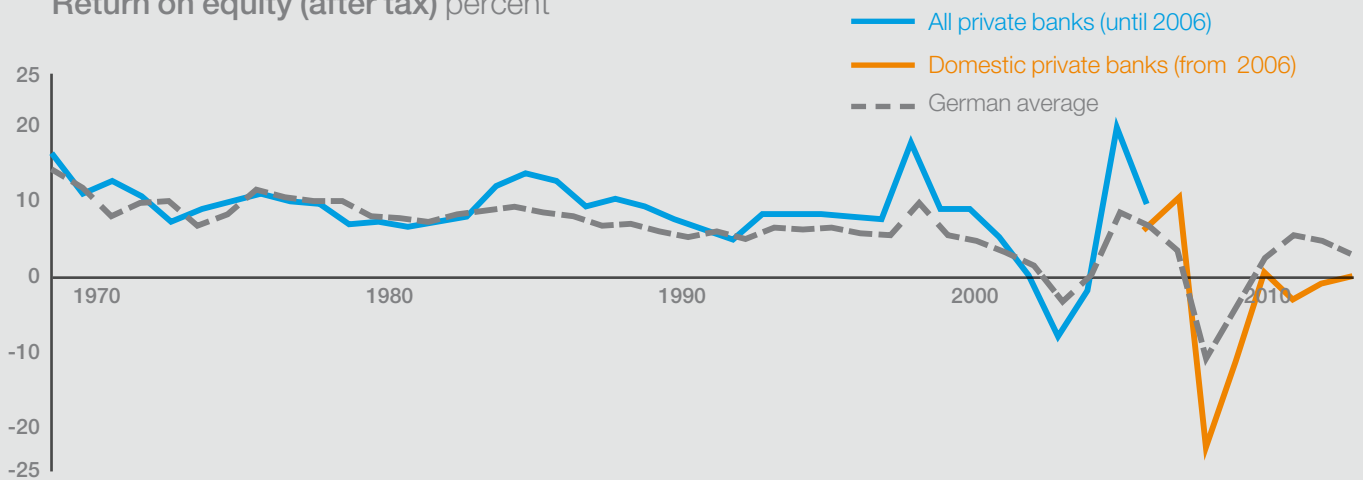
AVERAGE # OF EMPLOYEES



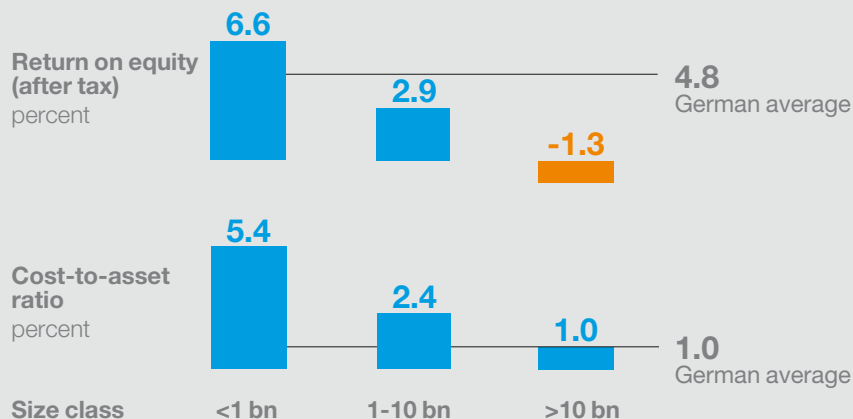
1,000

LONG-TERM PERFORMANCE

Return on equity (after tax) percent



PROFITABILITY AND COST EFFICIENCY (2010-13 AVERAGE)



Since 2008, large domestic private banks are generating mostly negative ROE

FOREIGN PRIVATE BANKS

SIZE AND SCALE (AS OF 2013)

650 EUR bn
TOTAL ASSETS

AVERAGE SIZE

100
TOTAL # OF BANKS

Since 2008, total assets declined by 6% p.a.

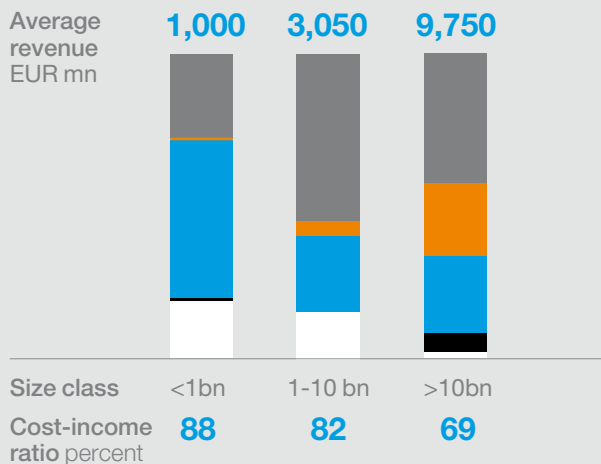
2,000
TOTAL # OF BRANCHES



7 EUR bn

42,000
TOTAL # OF EMPLOYEES

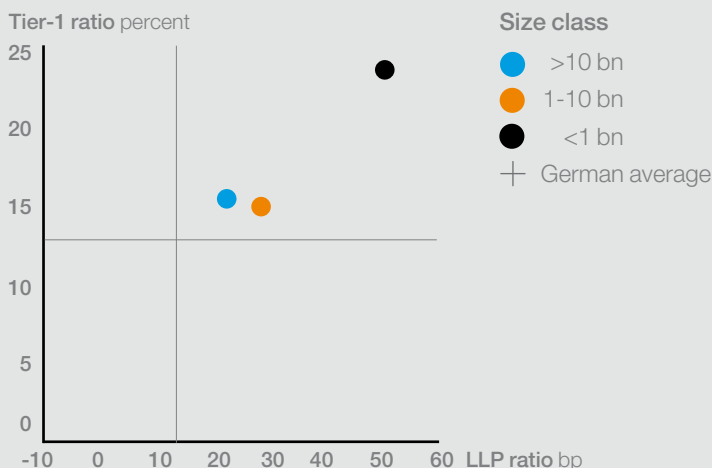
REVENUE MIX AND COST (2010-13 AVERAGE)



- Client-driven interest income
- Non-client-driven interest income
- Commission income
- Trading income
- Other operating income

Strong deposit gathering – retail deposits grew at 12% p.a. in 2008-13

RISK PROFILE (2010-13 AVERAGE)



Foreign private banks are particularly well capitalized – improvements in capital ratios driven by deleveraging

AVERAGE # OF BRANCHES



20

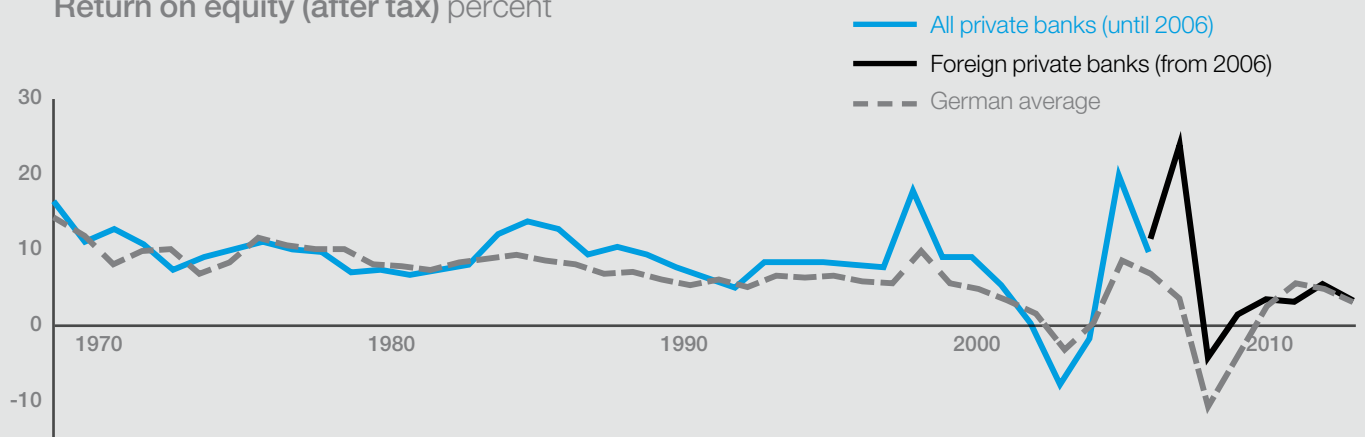
AVERAGE # OF EMPLOYEES



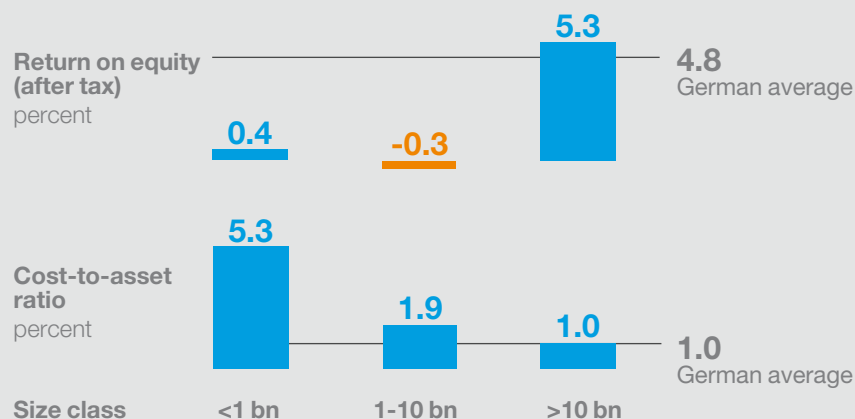
430

LONG-TERM PERFORMANCE

Return on equity (after tax) percent



PROFITABILITY AND COST EFFICIENCY (2010-13 AVERAGE)



Large foreign banks are consistently more profitable than small ones

SAVINGS BANKS

SIZE AND SCALE (AS OF 2013)

2,200 EUR bn
TOTAL ASSETS

425
TOTAL # OF BANKS

13,000
TOTAL # OF BRANCHES

235,000
TOTAL # OF EMPLOYEES

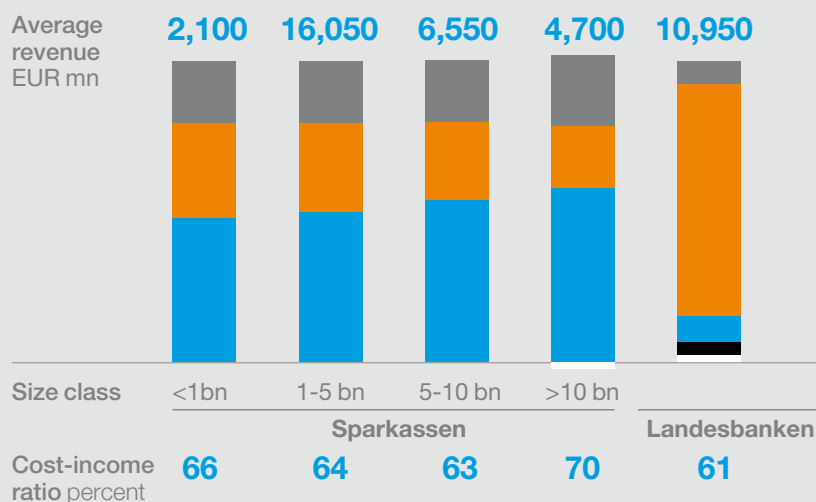
Since early 2000s, the # of **Landesbanken** declined by **30%** and further consolidation is expected

AVERAGE SIZE

2.5 EUR bn
SPARKASSEN

125 EUR bn
LANDESBANKEN

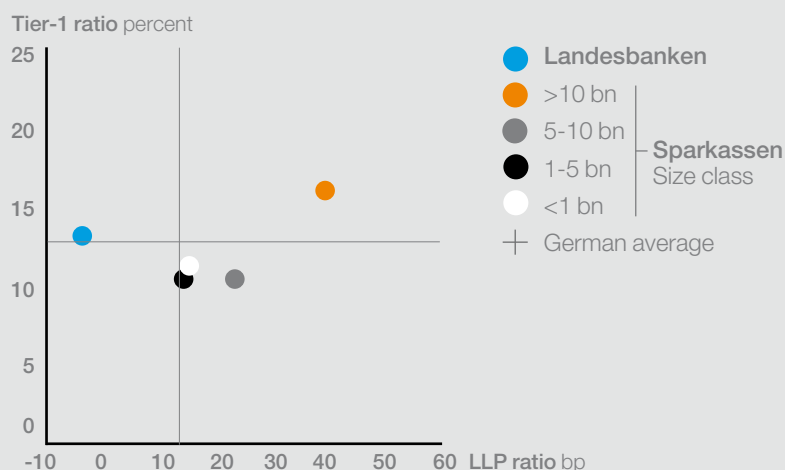
REVENUE MIX AND COST (2010-13 AVERAGE)



- Client-driven interest income
- Non-client-driven interest income
- Commission income
- Trading income
- Other operating income

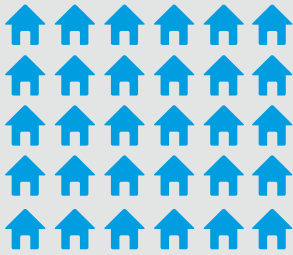
More than **85%** of loans are long-term, more than **50%** of customer deposits are short-term

RISK PROFILE (2010-13 AVERAGE)



Regulatory capital of Sparkassen consists mostly of instruments **other than** shareholder capital

AVERAGE # OF BRANCHES



30
SPARKASSEN

AVERAGE # OF EMPLOYEES

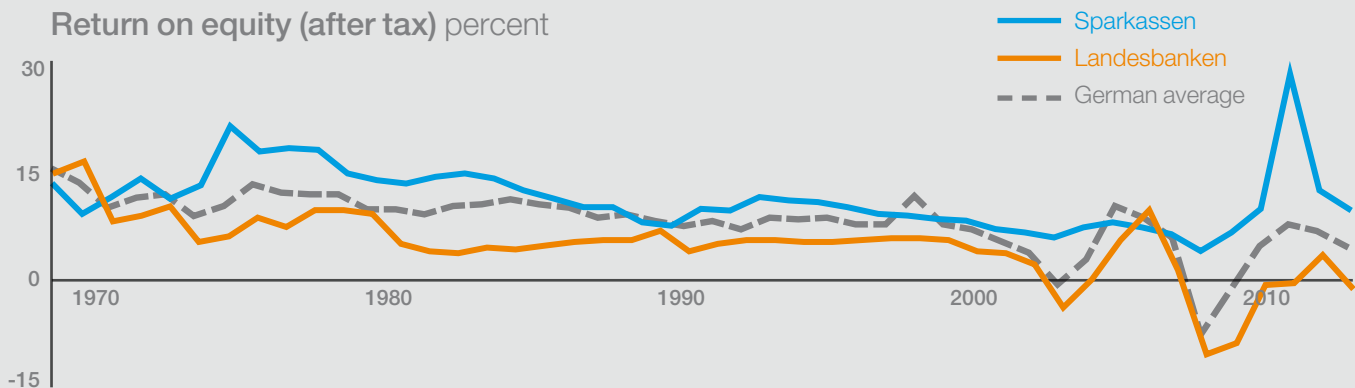


490
SPARKASSEN

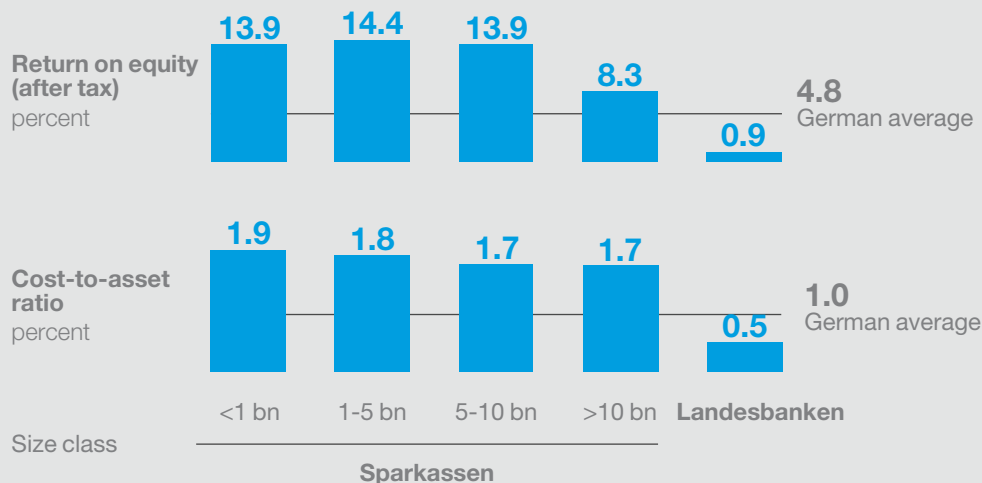
3,400
LANDESBANKEN

Sparkassen employ more than **40%** of German banking's workforce, but pay the **lowest** average salaries

LONG-TERM PERFORMANCE



PROFITABILITY AND COST EFFICIENCY (2010-13 AVERAGE)



Uniform cost structure through shared services and joint platforms

COOPERATIVE BANKS

SIZE AND SCALE (AS OF 2013)

1,000 EUR bn
TOTAL ASSETS

1,080
TOTAL # OF BANKS

11,500
TOTAL # OF BRANCHES

144,000
TOTAL # OF EMPLOYEES

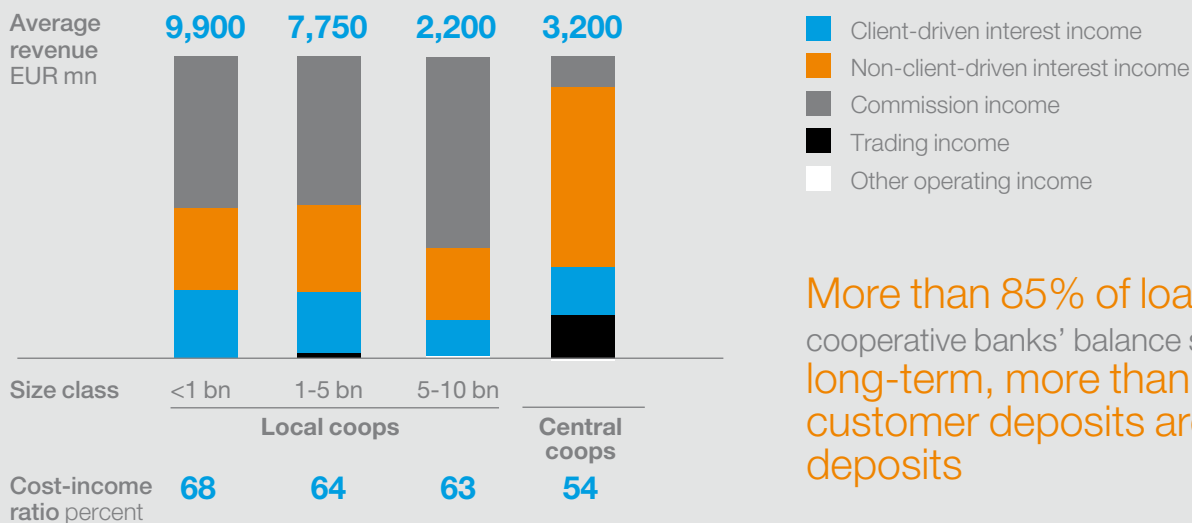
Total # of banks declined by 40% since 2000

AVERAGE SIZE

0.6 EUR bn
LOCAL COOPS

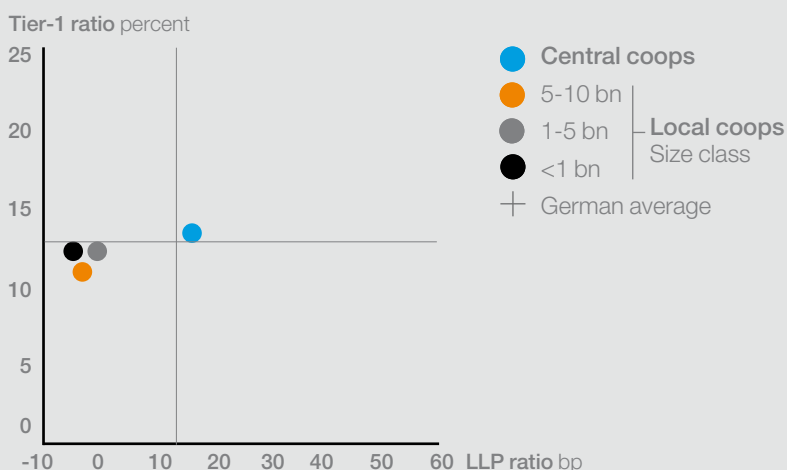
65 EUR bn
CENTRAL COOPS

REVENUE MIX AND COST (2010-13 AVERAGE)



More than 85% of loans on local cooperative banks' balance sheet are long-term, more than 50% of customer deposits are sight deposits

RISK PROFILE (2010-13 AVERAGE)



Before 2010, the cooperative banks sector had higher tier-1 ratios than the savings banks sector

Despite consolidation, cooperative banks among the smallest institutions in Germany

AVERAGE # OF BRANCHES

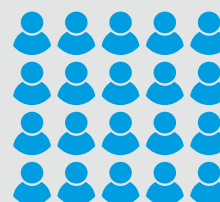


10

AVERAGE # OF EMPLOYEES



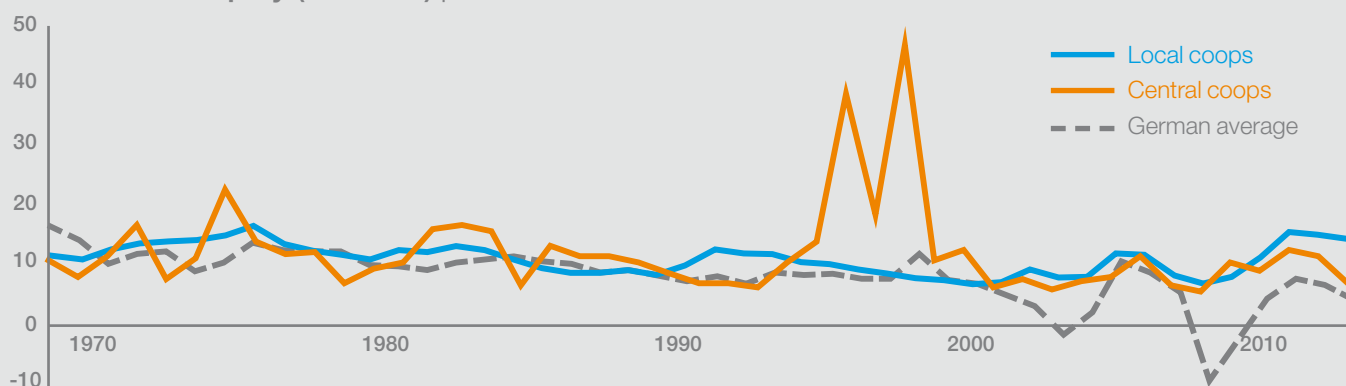
125
LOCAL COOPS



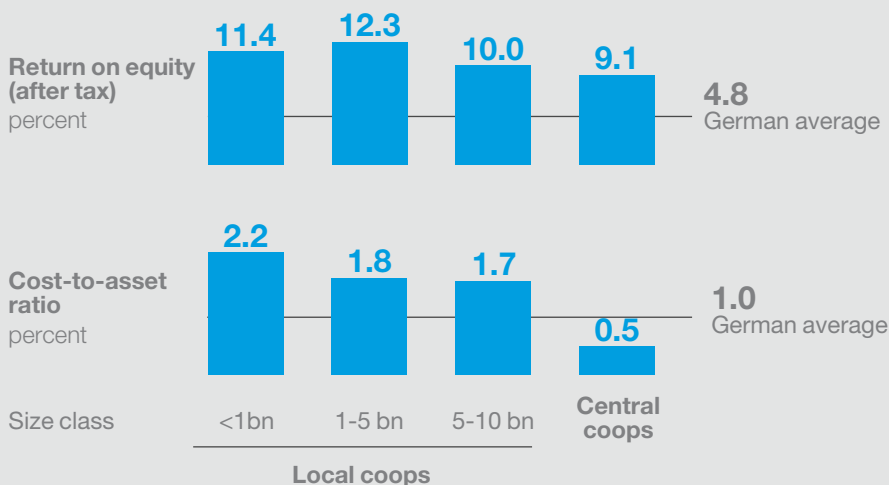
2,000
CENTRAL COOPS

LONG-TERM PERFORMANCE

Return on equity (after tax) percent



PROFITABILITY AND COST EFFICIENCY (2010-13 AVERAGE)

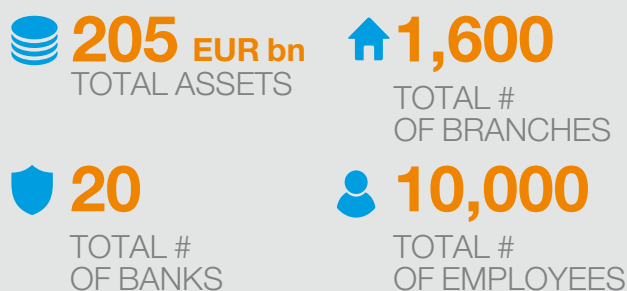


Central cooperative banks are significantly more profitable than Landesbanken

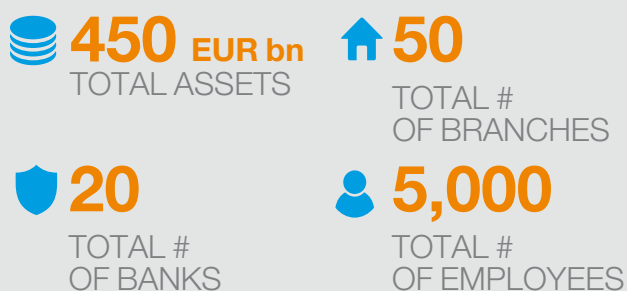
OTHER BANKS

SIZE AND SCALE (AS OF 2013)

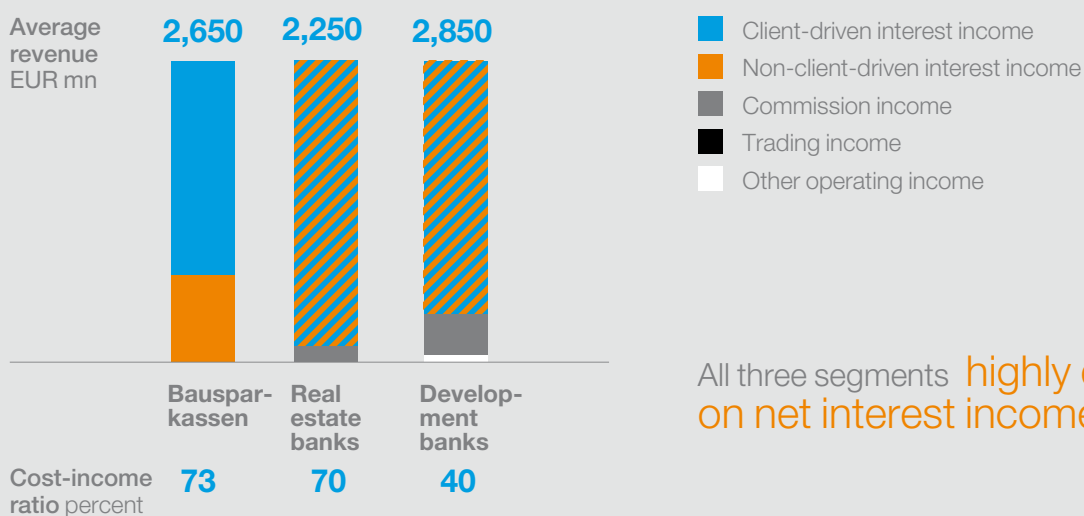
BAUSPARKASSEN



REAL ESTATE BANKS

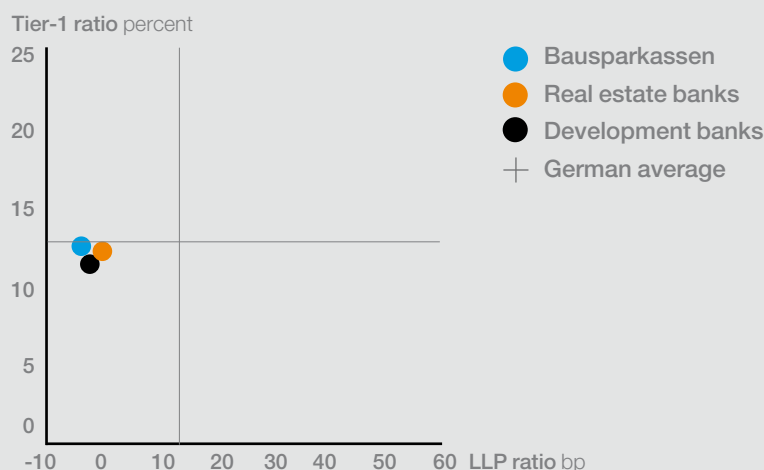


REVENUE MIX AND COST (2010-13 AVERAGE)



All three segments highly depend on net interest income

RISK PROFILE (2010-13 AVERAGE)



DEVELOPMENT BANKS

475 EUR bn
TOTAL ASSETS

30
TOTAL # OF BRANCHES

20
TOTAL # OF BANKS

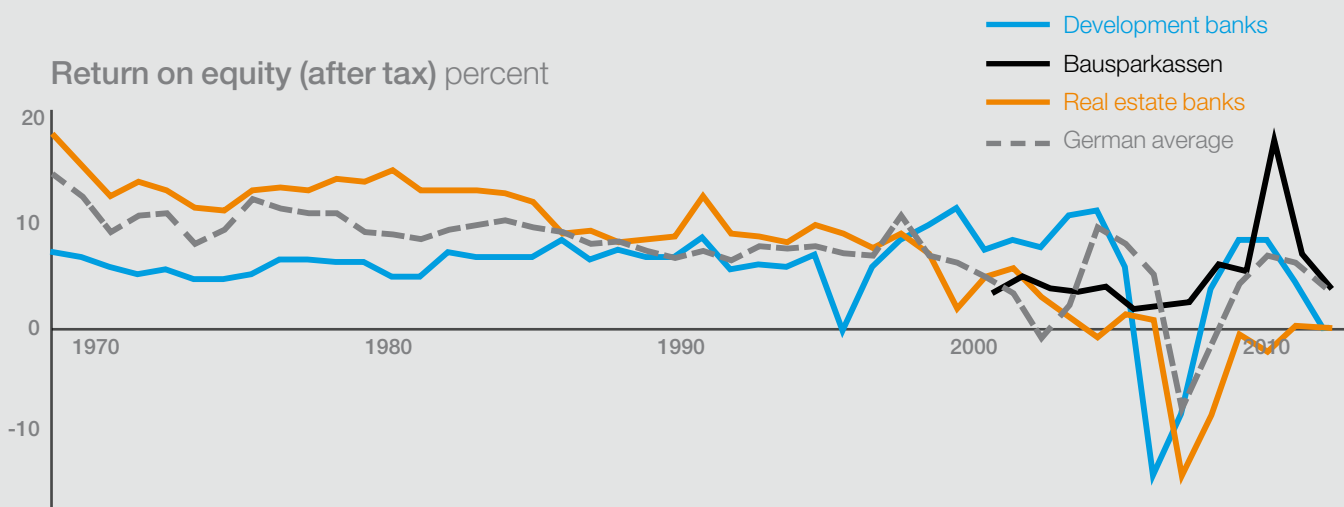
9,000
TOTAL # OF EMPLOYEES

Total # of branches declined for Bausparkassen by 56% since 2000

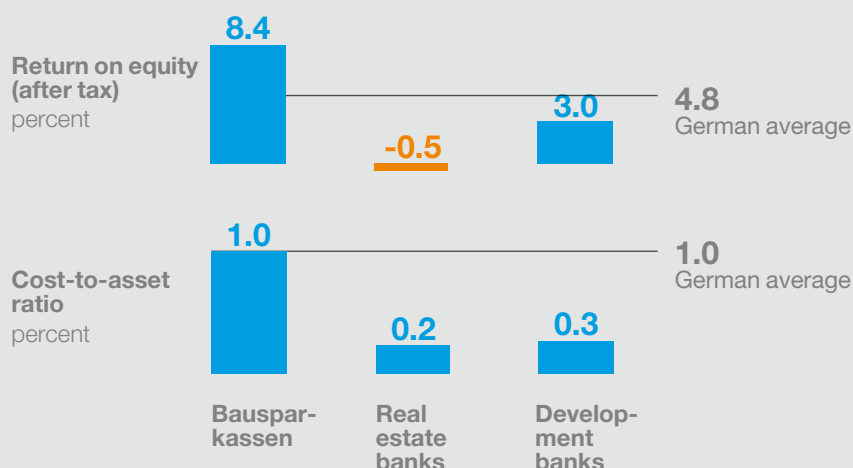
Total # of banks decreased for real estate bank by 45% since 2000

Development banks is the only segment without any consolidation in 2000-13

LONG-TERM PERFORMANCE



PROFITABILITY AND COST EFFICIENCY (2010-13 AVERAGE)



Real estate banks with hardly any positive profits since the crisis

Endnotes

- 1 This report draws on the thinking of leading McKinsey clients and our own experts and practitioners in Germany and around the world, as well as on granular data from the Deutsche Bundesbank, McKinsey Panorama, and other public sources.
- 2 Each of the nine segments can be further split into two to four size classes for more detailed analyses. For key figures and facts about each segment, please see the appendix.
- 3 For reasons of confidentiality, our data set for the central cooperatives includes the three largest local cooperative banks; however, the two central cooperative banks account for approximately 85 percent of total assets in the category.
- 4 The Herfindahl index is a measure of the size of firms in relation to the total market and an indicator of the amount of competition among them. It is calculated as the squared sum of the market shares of each individual player in the market.
- 5 For example, German banking customers can use an efficient payment system as an alternative to credit cards and have also used guaranteed life insurance products as their retirement fund (rather than mutual funds).
- 6 European Commission Special Eurobarometer 373 Retail Financial Services; http://ec.europa.eu/internal_market/finances-retail/docs/policy/eb_special_373-report_en.pdf
- 7 We consider the profit distribution based on net profits after nonoperating expenses (for example, amortization and value adjustments, absorbed losses, and other extraordinary expenses). When calculating net profit before nonoperating expenses, we find a higher profit share of the private bank segment. Yet, even when considering profits before nonoperating expenses, Sparkassen and cooperative banks have significantly increased their share of banking profits since the crisis.
- 8 The higher increase in costs within the development banks (5 percent annually from 2010 to 2013) was triggered by the reclassification of Portigon (formerly West LB) from a Landesbank to a development bank.
- 9 Note on the methodology: to estimate the impact of the three trends, simple scenario calculations have been used, depicting the effects of the trends without mitigating actions or consequences (such as cost reductions due to income loss). Where sensible, assumptions for the effect of each trend vary by size class. Effects have been assumed only for profits and losses, with no implications on the balance sheet, which is assumed to remain stable. The effects have been applied to 2013 status quo and estimated over a time horizon of five years. Where pretax profit is nonnegative, taxes are taken into account at the 2013 rate. The three trends are expected to have different effects on profits and losses. The combined impact is the sum of all three trend effects. To determine the effort needed to mitigate the detrimental impact of the trends, long-term average profitability (average return on equity for 1984 to 2013) has been used as a benchmark for a sustainable profit level.
- 10 Our estimate is in line with a recent study by the Deutsche Bundesbank and BaFin. Pretax profit is expected to decline between 25 percent in a moderate scenario and 75 percent in the worst case scenario. https://www.bundesbank.de/Redaktion/DE/Downloads/Presse/Pressenotizen/2015/2015_09_18_bafin_bbk.pdf?_bob=publicationFile
- 11 A study made in December 2013 on behalf of the Bundesverband deutscher Banken and the Bundesverband Öffentlicher Banken Deutschlands also estimated that additional direct and indirect costs incurred through regulatory requirements from 2010 to 2015 would average EUR 9 billion annually.
- 12 Bundesverband deutscher Banken: Online-Banking 2014; <https://bankenverband.de/newsroom/meinungsumfragen/online-banking-2014-weiter-auf-dem-vormarsch/>
- 13 Survey conducted in 2015 on behalf of ING-DiBa; <https://www.ing-diba.de/pdf/ueber-uns/presse/pressemitteilungen/mobile-king/pm-mobile-banking-nutzung.pdf>
- 14 The nominal average return on equity over the last 30 years is around 6 percent. Adjusting for inflation gives a real average return of around 4 percent; assuming a 2 percent inflation rate for the next five years leads again to 6 percent nominal return on equity.
- 15 For other ideas, please see also: The Bank of the Future (McKinsey & Company, 2015) and The Fight for the Customer: McKinsey Global Banking Annual Review 2015 (McKinsey & Company, 2015).

Thank you

The authors would like to acknowledge the contributions of Philip Bacher, Jay Datesh, Daniel Härtl, Darko Jus, Philipp Kalveram, Anke Raufuß, and Valentin Ulrici to this report.

The authors would also like to thank their many colleagues in McKinsey's Banking Practice, and in particular Philipp Härle, Holger Harreis, Helmut Heidegger, Matthias Heuser, Hans-Helmut Kotz, Frank Mattern, Sebastian Schneider, Uwe Stegemann, and Eckart Windhagen for their contributions to this report.

The authors are grateful to the Deutsche Bundesbank for providing aggregated balance sheet and P&L data on the German banking market.

Finally many thanks to Robert Götzfried for the visual conception and layout of this report.

Authors



Philipp Koch

is a Director in McKinsey's Munich office



Max Flötto

is a Principal in McKinsey's Munich office



Ursula Weigl

is an Associate Principal in McKinsey's Munich office



Magdalena Ignatowski

is a Senior Associate in McKinsey's Frankfurt office



Jakob Berndt

is a Fellow Associate in McKinsey's Hamburg office



Gerhard Schröck

is an Expert Principal in McKinsey's Frankfurt office

Contact

Marina Mentrup-Schmid

Telephone: +49 89 5594-8248

E-mail: Marina_Mentrup-Schmid@mckinsey.com

