

# To Seize a \$7 Trillion Opportunity, Banks Need Bolder Strategies for Serving Customers and Society

January 2024

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*Amid a multifaceted disruption, they also need supportive governments and collaborative regulators*

**BCG**

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# Executive Summary

**Banks must redefine where to compete, who to partner with, and how to deliver value amid multifaceted disruption in the global financial ecosystem. They cannot succeed without active support from governments and cooperative partnerships with regulators.**

## The So What

**Banks are not likely to return to the profitability levels and valuations that existed prior to the global financial crisis.** Yet they have the opportunity to earn more than their cost of equity on a sustainable basis and increase valuations.

**We estimate that at least \$7 trillion in value can be created.** This corresponds to roughly doubling current valuations in the coming five years by taking a fair share of expected growth and improving price-to-book ratios.

**It is critical for banks to set their sights on this target.** The goal is not only to create shareholder value but also to meet their obligations to drive economic growth and finance the climate transition. These aspirations can be reached if banks take a step back, get to the bottom of their performance issues, and set a bold agenda. This agenda needs to promote growth, significantly improve productivity, and make them more appealing to investors to enable additional capital infusion.

**Banks' share of total financial assets in almost all economies has been steadily declining.** The trend is accentuated in markets where many banks have unsustainable financial returns—bank valuations remaining below book value for sustained periods—and in high-growth economies where demand for production credit is rising at a rapid pace. A cross-market review of banks suggests that those with business models anchored in primary customer relationships have high valuations.

**Now is the time to act and truly embrace radical change rather than incremental improvements.**

Currently, many banks benefit from income tailwinds due to rising rates that creates headroom for change. At the same time, many newer competitors (such as payments players, fintechs, and even big tech companies) are facing challenges—in particular, increased attention from regulators (which is expected to slow their growth) and rising scrutiny from investors (potentially complicating their access to funding for growth).

**Governments will place high expectations on banks to be role models and catalysts for change on climate transition and corporate social responsibility.** The climate transition will create new business opportunities for banks but will place additional pressure on profitability in the short term.

**Regulators are expected to place additional capital and liquidity requirements in anticipation of higher risks.** These demands will mandate significant loan-portfolio optimization and further investments in data infrastructure for tracking and reporting.

**Regulators and governments across the world can embrace complementary ideas.** Such cooperation can reinforce banking profitability without compromising systemic stability. They should adopt new agile approaches to rules like the test-and-learn paradigm, push for consolidation, and encourage industry utilities and digital assets, among other things.

## Now What

**If banks want to win competitively, they must drive toward far-higher productivity and radically reduce the cost of complexity.** Starting with a digital-first delivery concept and a detailed cost-driver understanding, it is possible to design a zero-based business model that will allow a step change in productivity that is 40% higher than what is considered normal today.

**Banks need to make portfolio decisions that enhance value.** Banks should exit business lines or, at a minimum, reduce capital exposure to low-return asset classes and invest in new areas of strategic growth with more favorable levels of return on equity.

**Banks need to design a drastically simplified business model.** It must be supported by an actively managed balance sheet, a modern platform operating model, a bold deployment of front-to-back digitization, and a comprehensive re-imagining of functions leveraging AI and generative AI. The new operating model should help deliver vastly more impact from data and technology as well as help build strategic partnerships and capabilities for competitive advantage.

**Banks need to embrace the paradigm of a “tech product company” and not just a “tech company” as a foundation for a new organization model and talent framework.** This paradigm places emphasis on business teams to upskill themselves as “product owners” with expectations of rapid customer centric feature iterations and prioritizations, continuous test and learn, and collaborative working with technical teams.

**It is no longer viable for banks to approach transformation incrementally.** They cannot continue to build, bit by bit, on legacy setups that can actually do more to hold them back than to propel them forward. Banks need to holistically examine their entire organization and blaze a clear strategic path that enables them to meet their obligations—not only to customers but also to society as a whole—by driving economic growth, helping to finance the climate transition, and creating lasting shareholder value.





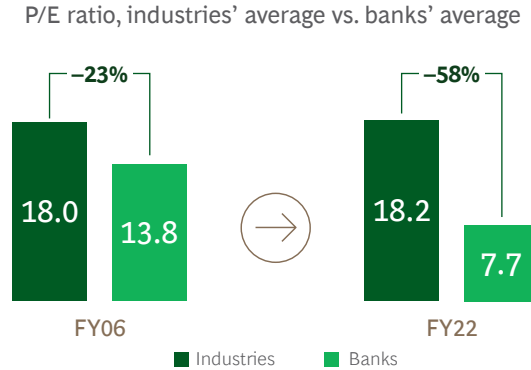
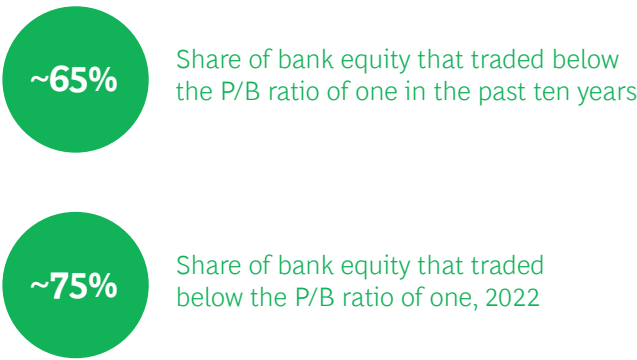
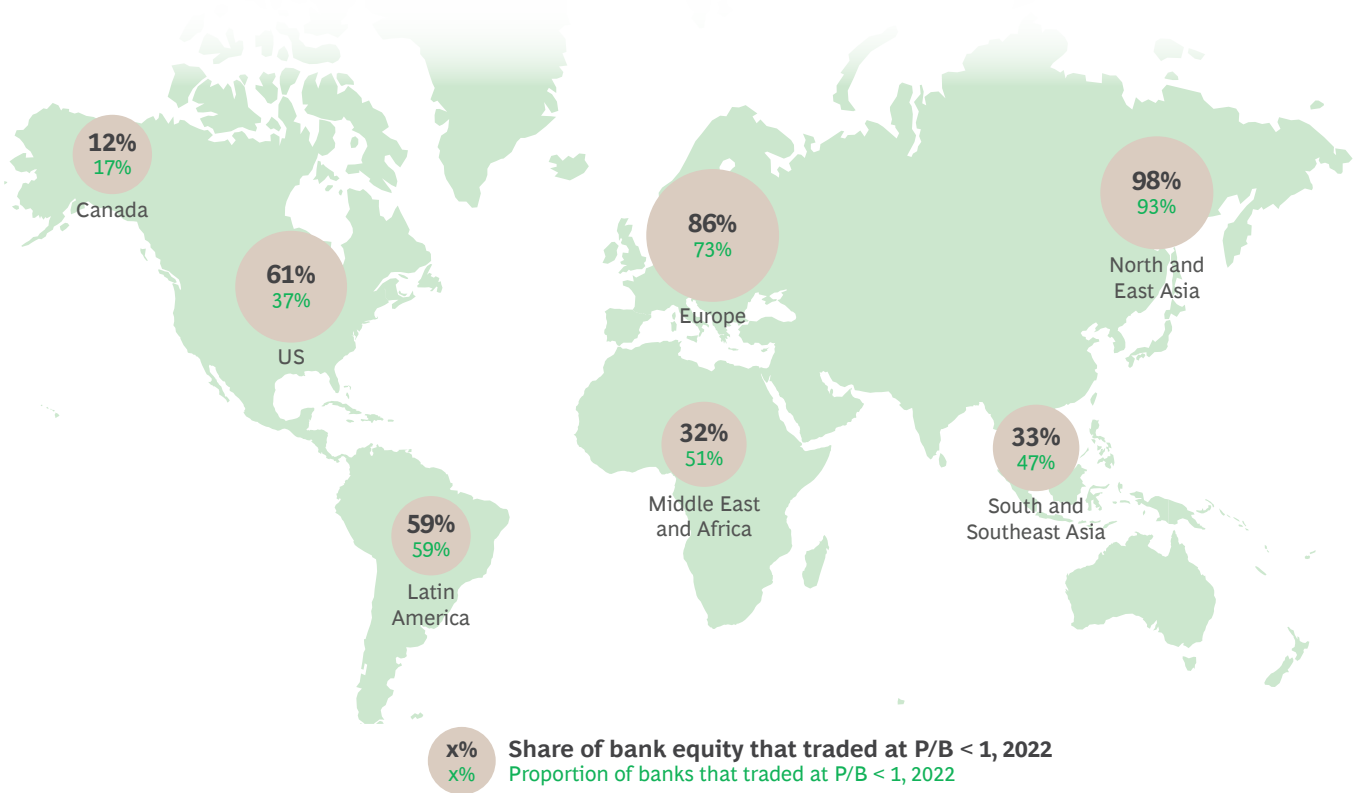
# To Meet Today's Expectations, Banks Need a Bold Agenda

The global financial crisis (GFC) marked a turning point for the banking industry. Major systemic risks were revealed and a massive government intervention was required to restore a measure of stability.

Not surprisingly, bank valuations across the globe took a severe hit, and large parts of the sector have never recovered. In 2022, roughly 75% of bank equity traded below a price-to-book ratio of 1.0. (See Exhibit 1.) On a price-to-earnings basis, multiples were almost cut in half by the GFC. The discount for bank stocks shows an increase from about 20% in 2006 to nearly 60% in 2022, compared with the stocks of other industries. Consequently, the total shareholder return of the banking sector has lagged behind major market indices since the GFC—a gap that is increasing. (See Exhibit 2.)

The largest driver of pessimism about the banking sector has been the significant drop in profitability. The average return on equity has declined by more than 450 basis points since the GFC, and many banks do not earn their cost of equity. Although bank valuations and profitability have been under duress across the globe, the situation has varied strongly across markets. For example, in emerging markets such as Southeast Asia and India, banks have benefited from high economic growth expectations. In relatively smaller markets that are often more consolidated and partly shielded by their own currencies (such as Australia, Canada, and Sweden), banks have tended to perform better. Unique market structures (such as Germany's three-pillar system) affect the competitive situation and tend to negatively impact banking returns.

# Exhibit 1 - Seventy-Five Percent of Bank Equity Traded Below a Price-to-Book Ratio of One



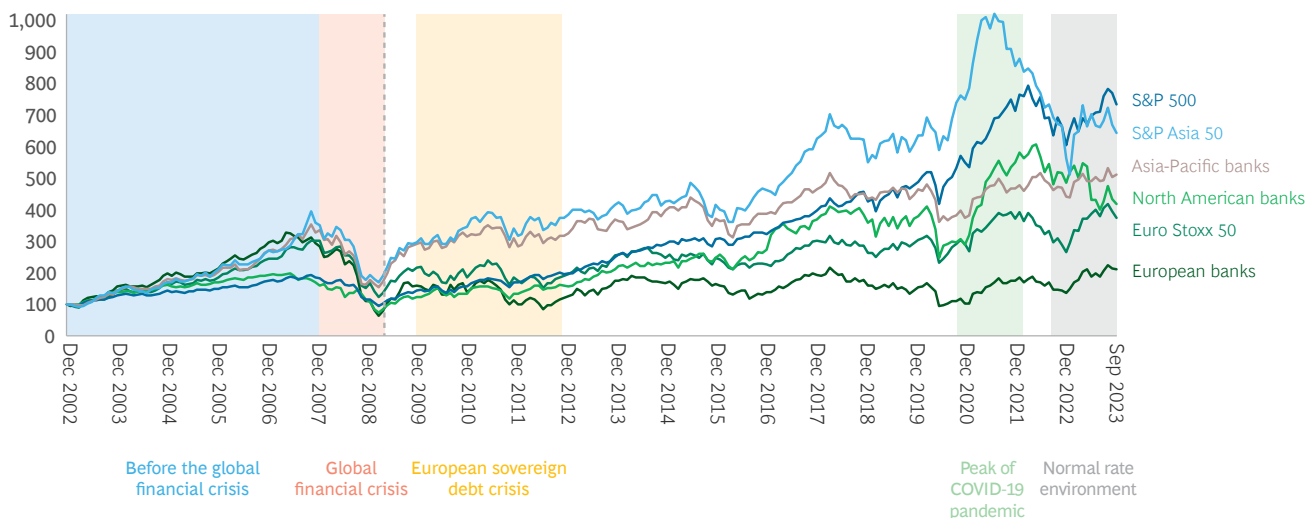
Banking's P/E ratio has dramatically fallen, while that of other industries has remained steady

Sources: S&P Capital IQ; BCG analysis.

Note: P/B = price to book; P/E = price to earnings. Europe excludes Russia. North and East Asia is Mainland China, Japan, South Korea, Taiwan, and Hong Kong. South and Southeast Asia is India, Singapore, Indonesia, Malaysia, Thailand, Vietnam, and the Philippines. The Middle East and Africa is Israel, Saudi Arabia, United Arab Emirates, Qatar, Kuwait, Bahrain, Egypt, South Africa, and Nigeria. Latin America is Mexico, Colombia, Brazil, Argentina, Chile, and Peru. Values are derived from the equity and the market capitalization of the largest listed banks (representing at least 80% of assets in the respective regions).

## Exhibit 2 - Since the Global Financial Crisis, Banks' TSR Has Lagged Behind Major Market Indices

Banks' TSR (December 2002, index = 100)



Sources: S&P Capital IQ; BCG's ValueScience Center.

**Note:** TSR = total shareholder return. Market data is as of September 2023. TSRs were calculated in US dollars using historical conversion rates. Regional banks' TSR represents the median TSR. Banks include the 35 largest banks in Europe, the 45 largest banks in North America, and the 60 largest banks in Asia-Pacific based on market capitalization as of September 30, 2023.

Of course, variation in valuations *within* markets can also be significant. Some banks have benefited from their specific business models (especially those with capital-light income streams). But more generally, the outperformers have been the banks that adjusted their business models to the new reality after the GFC. Such banks have embraced the impact of new regulations and reduced income volatility—as well as demonstrated execution discipline via strict capital management and stronger operating leverage.

Since bank valuations are built on future expectations, current levels point to a cautious outlook among investors. Investors are concerned that net income and profitability metrics are “capped.” They expect that net interest income likely has peaked and are instead concerned about future risks (e.g., higher default rates).

### Banks Now Have a Window of Opportunity

To be sure, we do not believe that banks can return to the profitability levels and valuations that existed prior to the GFC. Nonetheless, banks have the opportunity to earn more than their cost of equity on a sustainable basis and increase valuations. There are multiple ways to gauge the ambition for an upside—closing the gap in price-to-earnings multiples to other industries, capturing a fair share of expected growth, or improving price to book. We estimate that at least \$7 trillion in value can be created. This corresponds to roughly doubling current valuations in the coming five years—an exemplary derivation would correspond to growth at rates comparable to past years and improving price-to-book ratios to 1.25, on average.

It is critical for banks to set their sights on this target not only to create shareholder value but also to meet their obligations to drive economic growth and finance the climate transition. The goal can be reached if banks take a step back, get to the bottom of their performance issues, and sketch out a bold strategic agenda that enables growth, higher productivity, and adequate shareholder returns.

**Many newer competitors, such as payments players, fintechs, and even big tech companies, are facing challenges.**

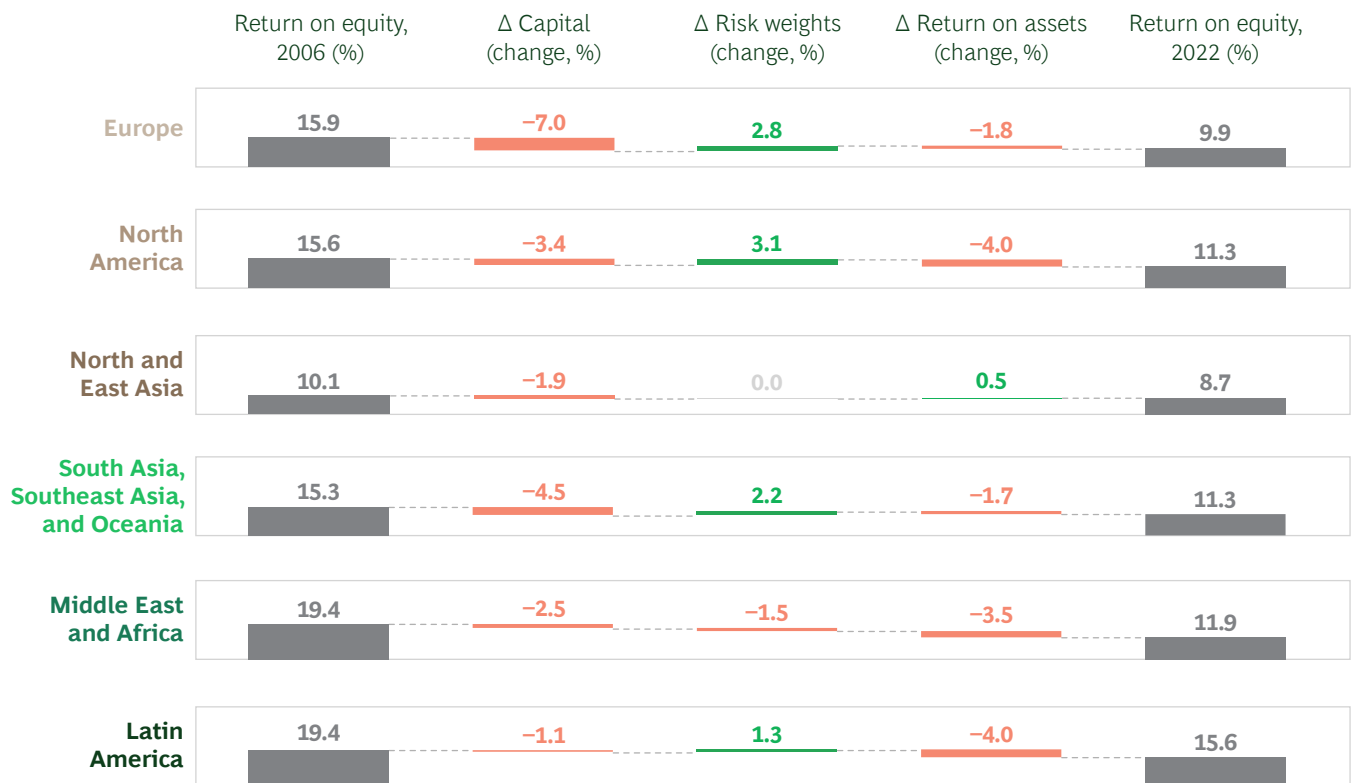
Now is the time to act and truly embrace radical change rather than incremental improvements. Many banks still benefit from income tailwinds due to rising rates that create headroom for change. At the same time, many newer competitors (such as payments players, fintechs, and even big tech companies) are facing challenges—in particular, increased attention from regulators (which is expected to slow their growth) and rising scrutiny from investors (potentially complicating their access to funding for growth).

### The Rules of the Game Will Continue to Change

Following the enormous public investment required to rescue the banking sector from the GFC, governments and regulators focused on establishing systemic stability—the most significant measure being an increase in the amount of capital banks must hold given their balance sheet risk. Ever since, banks have worked to optimize their risk-weighted assets, but this remedy has only partly offset the requirements. (See Exhibit 3.)



## Exhibit 3 - Higher Capital Requirements Have Not Been Fully Offset by Higher Returns on Assets



Sources: S&P Capital IQ; BCG analysis.

**Note:** Europe excludes Russia. North and East Asia is Mainland China, Japan, South Korea, Taiwan, and Hong Kong. South and Southeast Asia is India, Singapore, Indonesia, Malaysia, Thailand, Vietnam, and the Philippines. Oceania is Australia and New Zealand. The Middle East and Africa is Israel, Saudi Arabia, United Arab Emirates, Qatar, Kuwait, Bahrain, Egypt, South Africa, and Nigeria. Latin America is Mexico, Colombia, Brazil, Argentina, Chile, and Peru. Values are derived from equity and the market capitalization of the largest listed banks (representing at least 80% of assets in the respective regions).

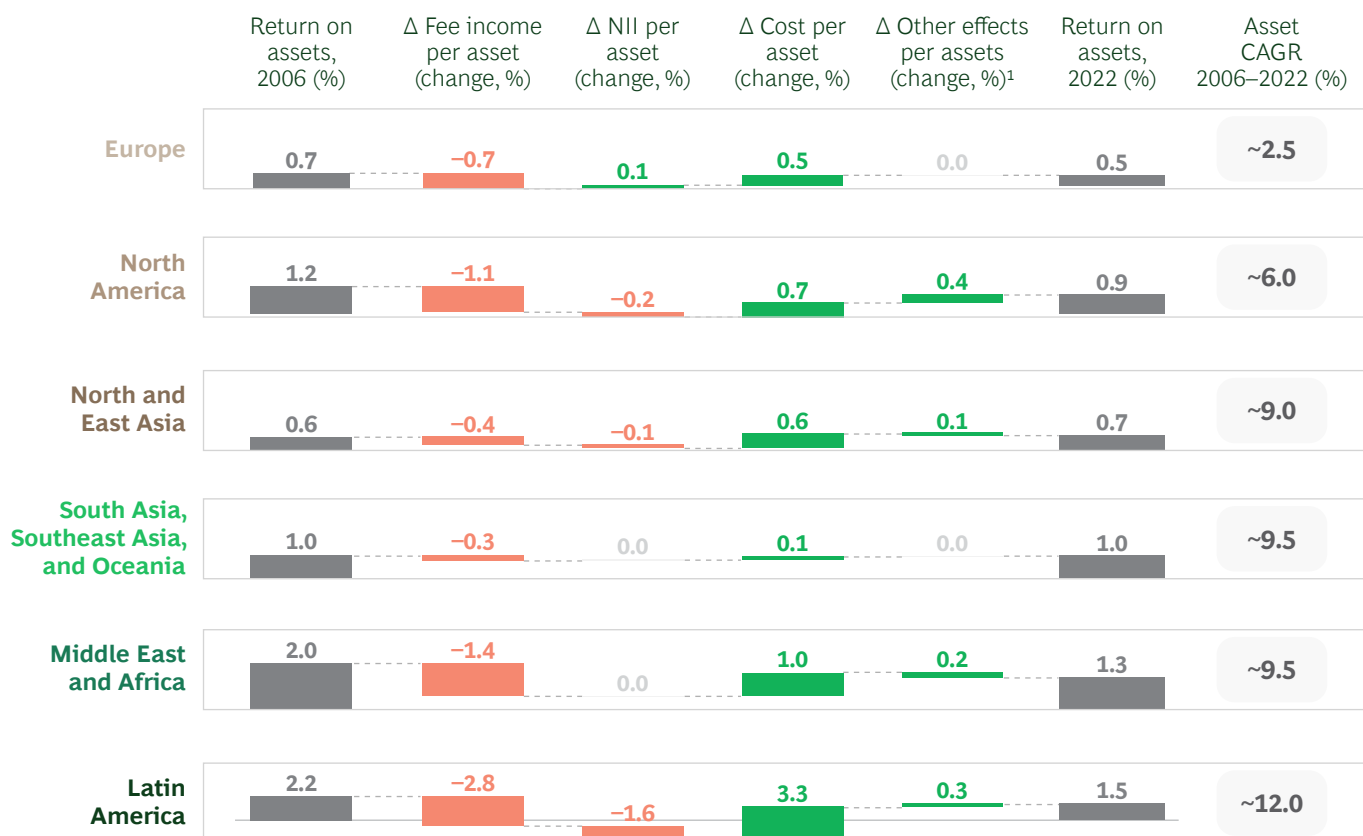
Indeed, banks were not able to pass on the implied costs of the higher net-resource needs to their customers in the form of higher prices. Only very few adapted to the new reality by taking fundamental portfolio choices. In fact, the return on assets declined in almost all markets, with lower fee income being the key contributor. (See Exhibit 4.) Looking ahead, regulations that are already in effect (such as Basel IV in Europe and Basel III Endgame in the US) are expected to have a significant impact on banks. Two main principles are driving this dynamic:

The first is more stringent caps on the maximum capital savings that internal models can generate and less discretion in their application (for example, low-default portfolios, operational risk) and on methodological choices (for example, discount rates for LGD models).

The second is a more risk-sensitive standardized approach (for example, through more granular segmentations and risk drivers) that does not disincentivize the use of good risk management practices (for example, adequate collateralization levels) and robust risk-based decision making.

This shift aims to level the playing field among institutions, ensuring greater comparability in performance and promoting fairer competition. There will, however, be notable differences in the impact of implementation, owing to different starting points and specific application rules (such as variations between the US and Europe). Inconsistencies across regions will likely lead to increased complexity and higher operational costs for cross-border banks. Since the effects differ across asset classes, a careful evaluation of balance sheet structure and resource allocation is more relevant today than ever before.

## Exhibit 4 - Lower Fee Income Was a Key Contributor to the Drop in Return on Assets in Most Markets, Despite Improvement in the Cost per Asset



Sources: S&P Capital IQ; BCG analysis.

**Note:** NII = net interest income. Europe excludes Russia. North and East Asia is Mainland China, Japan, South Korea, Taiwan, and Hong Kong. South and Southeast Asia is India, Singapore, Indonesia, Malaysia, Thailand, Vietnam, and the Philippines. Oceania is Australia and New Zealand. The Middle East and Africa is Israel, Saudi Arabia, United Arab Emirates, Qatar, Kuwait, Bahrain, Egypt, South Africa, and Nigeria. Latin America is Mexico, Colombia, Brazil, Argentina, Chile, and Peru. Values are derived from equity and the market capitalization of the largest listed banks (representing at least 80% of assets in the respective regions).

<sup>1</sup>Other effects include loan loss provisions, taxes, and miscellaneous items.

### Banks Are Stuck Between Income Pressures and Non-scalable Cost Structures

Across most markets and business lines, two main factors are responsible for the persistent decline in fee and commission income relative to asset volumes: regulatory action (such as the outright banning, reduction by fiat, or capping of fees), and more-intense competition spurred by the rise of new, digital competitors.

To address such challenges, over the past decade, banks across the globe have run major cost-reduction programs and have invested heavily in digitization and automation. At the same time, banks have had to develop capabilities and resources to handle increasingly complex regulatory guardrails, especially for areas such as cybersecurity, financial crime, and climate risk—a buildup often carried out reac-

tively, without focus on process design or cost efficiency. While banks' operating expenses have declined relative to assets, cost-to-income ratios have not materially improved, and the industry has not seen real progress in operating leverage. The increased complexity affects midsize players in particular, because they must deal with requirements similar to those mandated for large players.

Consolidation can be a natural way to deal with rising fixed costs in many industrial sectors, but this solution is not always applicable to the banking business. There was indeed consolidation in several markets after the GFC, notably in the US. However, large-scale consolidation would not be a panacea because, among other reasons, it can hinder access to financing for specific segments (such as small and medium-sized enterprises, or SMEs). In addition, consolidation can create players that are too big to fail.

## IT Legacies Constrain the Headroom for Bold Modernization

Technology is at the core of banks’ operating models. Consequently, the share of income that banks spend on IT is higher than the share spent in most other industries—a gap that is still increasing. (See Exhibit 5.)

Yet banks have struggled both to reap the benefits of their tech spending and to achieve a step change in their cost bases. Many institutions are trapped in a vicious cycle, particularly in developed economies where large players tend to have a complex tech setup of legacy systems that feature an intricate web of point-to-point connections. New functionalities can be delivered only via patch solutions that further increase complexity. The main challenge with such an infrastructure is that it complicates change, such as adopting to new regulatory requirements, due to factors like regression testing and integration issues. It also makes this change more expensive. These banks are therefore not able to redirect enough funding to holistic modernization that allows for true innovation.

A cross-industry survey conducted by BCG found that despite huge investments, banks are running behind in embracing continuous improvement and building new capabilities at scale. (See Exhibit 6.) This problem will escalate further in the medium term, given the disruptive technological advancements made in AI (such as generative AI).

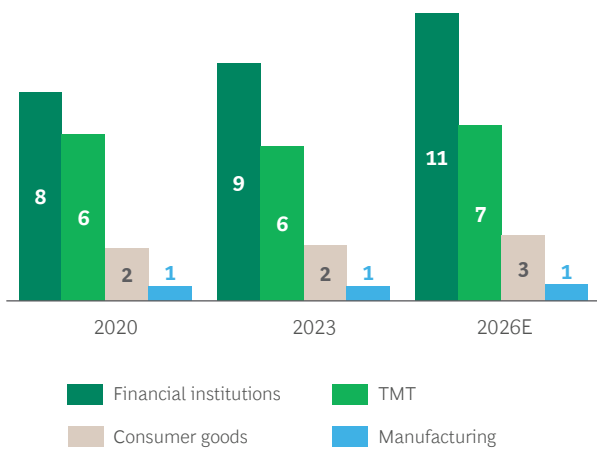
Some large banks have the scale to invest out of the vicious cycle, and some small banks with simpler business models can turn to extensive outsourcing of applications using software-as-a-service vendors. Still, many midsize banks are stuck carrying a level of complexity similar to that of large banks but lacking the sufficient budget, high-quality tech talent, and resources to embrace outsourcing at scale (owing partly to data-migration challenges).

## Macro Trends and the Climate Transition Will Increase Demands on Banks

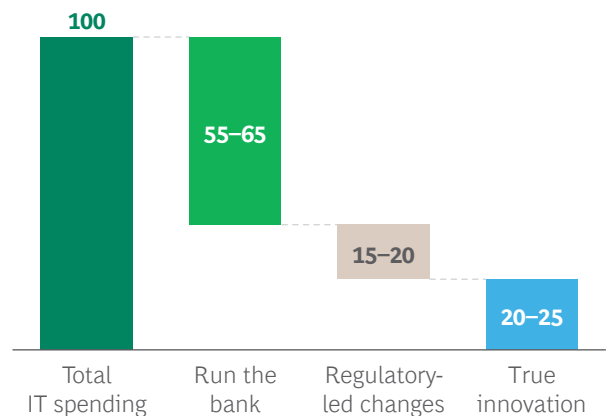
With interest rates apparently returning to higher-for-longer norms, most banks—especially those with strong deposit bases—have experienced a strong income tailwind. Yet this effect has already reached its peak or is expected to do so soon. If rates stay at current levels, credit and liquidity risks that are already emerging will intensify. Accordingly, regulators are exploring a further rise of capital requirements and ways of applying more scrutiny on liquidity risks. Anticipation over how best to manage the balance sheet, along with the inherent, related risks, will only heighten.

## Exhibit 5 - Banks Are Spending More on IT, but Only a Small Share of the Total Spending Is on Innovation and Modernization

IT spending across industries as a share of revenue (%)



IT spending in banking (%)



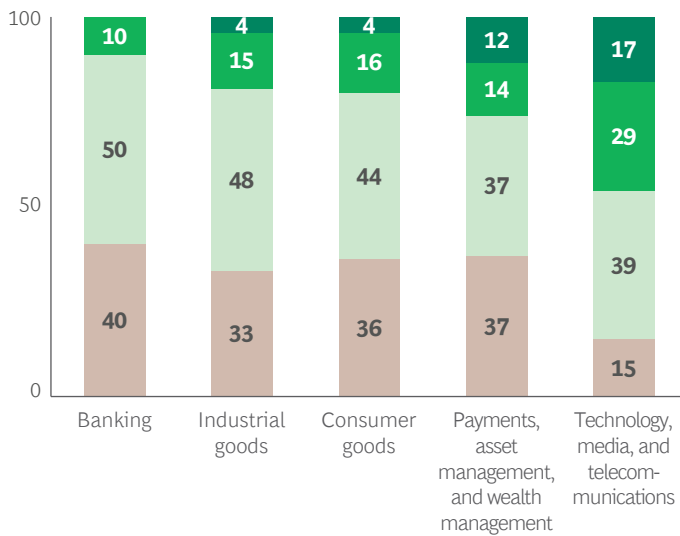
Sources: Gartner; Oxford Economics; BCG’s Expand Research.

Note: TMT = technology, media, and telecommunications.



# Exhibit 6 - Despite Huge Tech Spending, Banks Are Running Behind Other Industries in the Systemic Building of New Capabilities at Scale

Companies (%)



### Future built

Continuous innovation by systematically building capabilities at scale



### Scaling

Successful digital transformation by pivoting to innovation-led growth



### Emerging

Executed digital transformation, but facing challenges in effective scaling



### Stagnating

Yet to create value

Source: BCG’s Build for the Future Survey 2022.

Note: Sample size varies for each industry. Specifically, n = 30 for banking, n = 84 for industrial goods, n = 25 for consumer goods, and n = 78 for technology, media, and telecommunications.

Moreover, a majority of central banks globally are exploring the launch of central bank digital currencies (CBDCs). According to the Bank for International Settlements, there could be up to 15 retail and 9 wholesale CBDCs in circulation by 2030. Such a possibility is capable of shaking up the fundamental building blocks of finance for banks, which would lose fees to new entrants if nonbanks are permitted to distribute CBDCs. And some balances could shift away from banks’ books to central banks’ books. Ultimately, the outcome will depend on the approach across markets. Europe is likely to pursue a digital euro as a pan-European digital payment instrument, and emerging markets are likely to leverage the programmability feature of CBDCs for social payouts and other purposes.

Banks will play a crucial role in the climate transition and more broadly in the overall environmental, social, and governance (ESG) agenda. Governments see them as key in steering financial flows to support change. Climate is probably the biggest risk the world will face in the next decades. Transition and physical risks may also impact financial stability, being drivers of risks (for example, credit, market, operational, litigation) for banks. Regulators are placing a very important emphasis on how banks are managing these risks. In particular, the focus has so far been on disclosure and embedding of climate in the overall risk management framework. Going forward, we expect an increased focus also on capital (and accounting) requirements. Managing climate risks requires the ability to “measure,” which will require structured end-to-end ESG data platforms and increased data availability.

## Will Open Banking Intensify the Push of Big Tech Companies into Banking?

After a long gestation period with underwhelming impact, open banking is reaching a tipping point in most markets that includes standards, infrastructure, broad-based adoption, and global reach. The US, with arguably the most widespread adoption, is set to embrace rules mandating open application programming interfaces (APIs) for banks and a central body to ensure standardization. The European Commission’s proposed guidelines for the Third Payment Services Directive recognize the success of the UK in enforcing standards across the industry. Emerging markets—for example, India and Brazil—have advanced frameworks to promote financial inclusion using services such as cashflow-based credit for small businesses.

Over the next three to five years, we expect that governments and regulators will press ahead with a concerted effort to safely push open banking. Their aim will be to trigger higher levels of consumer-facing innovation and digitization, as well as to enhance customer journeys. This trend could pose a serious medium- to long-term risk to banks that are not fully prepared to leverage their infrastructure as a data user, rather than being just a data provider.

Apple’s recent announcement that it will use open banking protocols in the UK to offer customers access to their bank accounts through the Apple wallet could well signal an upcoming complex interplay between the tech players and banks that are active in open banking. The integration of wallets with bank accounts could take away rich transaction information from banks and push them gradually toward the status of utilities. At the same time, we expect regulators to extend their oversight of big tech companies in payments domains in order to level the playing field with banks.

**The trend of banks losing share in assets to nonbanks has continued over the past decade, going beyond the intended risk-reduction goal and impacting core areas of their businesses.**

### Nonbanks Are Threatening to Unseat Banks as the Primary Commercial Credit Providers

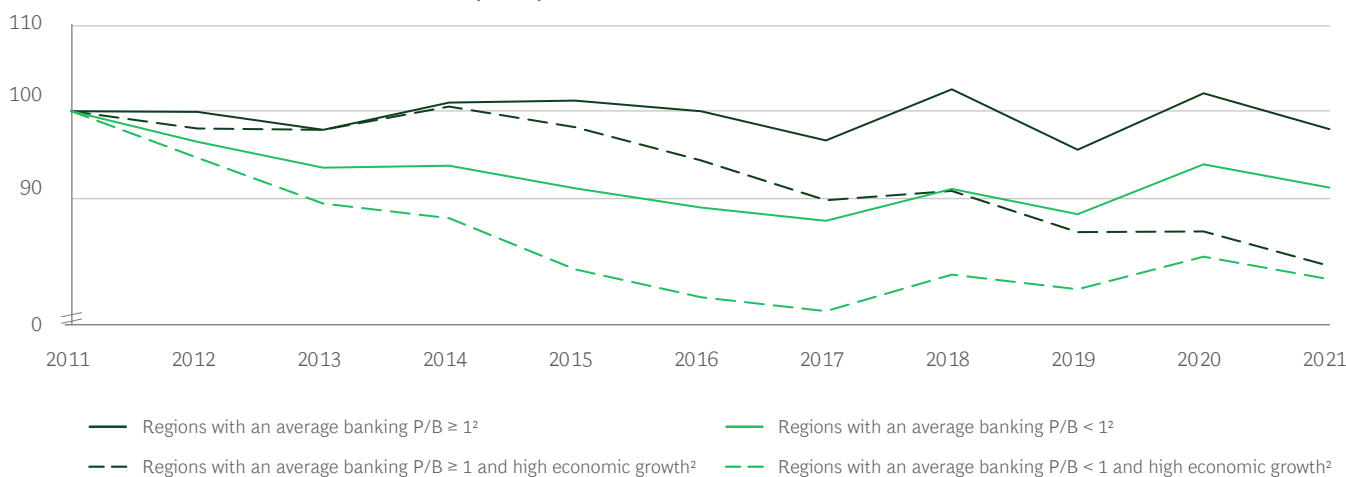
The crucial role of banks in channeling productive credit into the economy is historically well established. In nearly all markets, small businesses disproportionately depend on banks for funds. Most markets, the US being a notable exception, do not have sufficiently deep capital markets for them to be a credible alternative. However, we find that banks’ share of total financial assets in almost all economies has been steadily declining. (See Exhibit 7.) The trend is accentuated in markets where many banks have unsustainable financial returns—bank valuations remaining below book value for sustained periods—and in high-growth economies where demand for production credit is rising at rapid pace.

In the aftermath of the GFC, certain high-risk businesses (such as proprietary trading and long-tenor financing) were forced out of banks’ books by regulation. The trend of banks losing share in assets to nonbanks has continued over the past decade, going beyond the intended risk-reduction goal and impacting core areas of their businesses. The rapid rise of private credit is a case in point: at a 20% compound annual growth rate (CAGR) from 2017 through 2022, private credit is the fastest-growing segment of the asset management industry. Direct lending, representing roughly a third of the \$2.1 trillion in outstanding private credit globally, has grown at an even faster rate of about 30%. In recent years, the focus of private credit has been on leveraged or long-term financing, but recent announcements by the largest players underscore their ambitions to cover the credit market even more broadly, building their own origination platforms and leveraging their access to funding.

To be sure, the diversification of financing sources for the real economy is a good thing. However, the regulatory arbitrage with the nonbank world—which has no capital requirements, price transparency, or price controls—creates a systemic risk. Regulated bank credit comes, of course, with higher transparency and prudent safeguards that no other type of financial institution can match, and banks have sharp capabilities in assessing commercial creditworthiness and working out nonperforming assets. Driving economic growth and innovation, as well as supporting structural transitions such as climate change, will likely require high levels of bank financing. The ability of banks to generate sustainable returns and attract capital is therefore critical for the broader global economy.

## Exhibit 7 - Banks Are Ceding Ground to Nonbanks in Funding the Real Economy

Ratio of bank assets to total financial assets (index)<sup>1</sup>



Sources: Financial Stability Board report, 2022; BCG analysis.

Note: P/B = price to book.

<sup>1</sup>Total financial assets includes those of banks, insurance companies, pension funds, nonbank financial institutions, and private capital firms.

<sup>2</sup>The average is over 2011–2021.



## Seven Strategic Imperatives Can Unlock \$7 Trillion in Value

Traditionally, most banking-related products and services have been integrated into the universal bank model. They are now being gradually deconstructed as modern technology permits, allowing for the emergence of new business models that focus on specific services. In this context, guardrails have evolved to regulate the services according to their risks, a trend that should intensify as the fintech industry continues to mature. One way to think about a potential new landscape is the concept of a banking stack. (See the sidebar “The Banking Stack.”)

The banking stack both enables and challenges banks to think about their future business models. It also unlocks complex dynamics between banks and nonbanks: they can be partners and competitors at the same time. Banks can choose the elements in the stack that they will own and outsource the rest to the extent permitted by regulators. Overall, what’s required is a rejuvenation of the banking value proposition, making choices and leveraging opportunities to remain relevant to customers and operate more efficiently. A number of different strategies can be activated with the resources and models available to banks. Here, we highlight seven key imperatives.



# The Banking Stack

The framework that we refer to as the banking stack is a representation of possibilities, not realities. (See the exhibit “The Banking Stack Is a Techno-Regulatory Framework of Businesses Linked with APIs and Subject to Varying Levels of Regulatory Scrutiny.”) It is a techno-regulatory architecture based on application programming interfaces (APIs), and it allows a breakdown of banking into distinct services that can be offered on banks’ own digital platforms or on external ones. Conversely, banks can offer third-party financial (or nonfinancial) services on their own digital platforms or outsource certain processes to external providers. Technology has thus converted the banking ecosystem into a stack of products and services that are seamlessly interconnected through APIs and subject to varying degrees of regulatory scrutiny.

At a glance, the stack may look like a threat to banks because they lose traditional ties to their customers. Moreover, they will be required to reposition themselves in the financial services ecosystem. But it’s a two-way street, with services migrating both out of and into banks’ orbits. (See the exhibit “Banks Will Need to Navigate Complex Strategic Choices on Embedded Finance and Embedded Commerce.”)

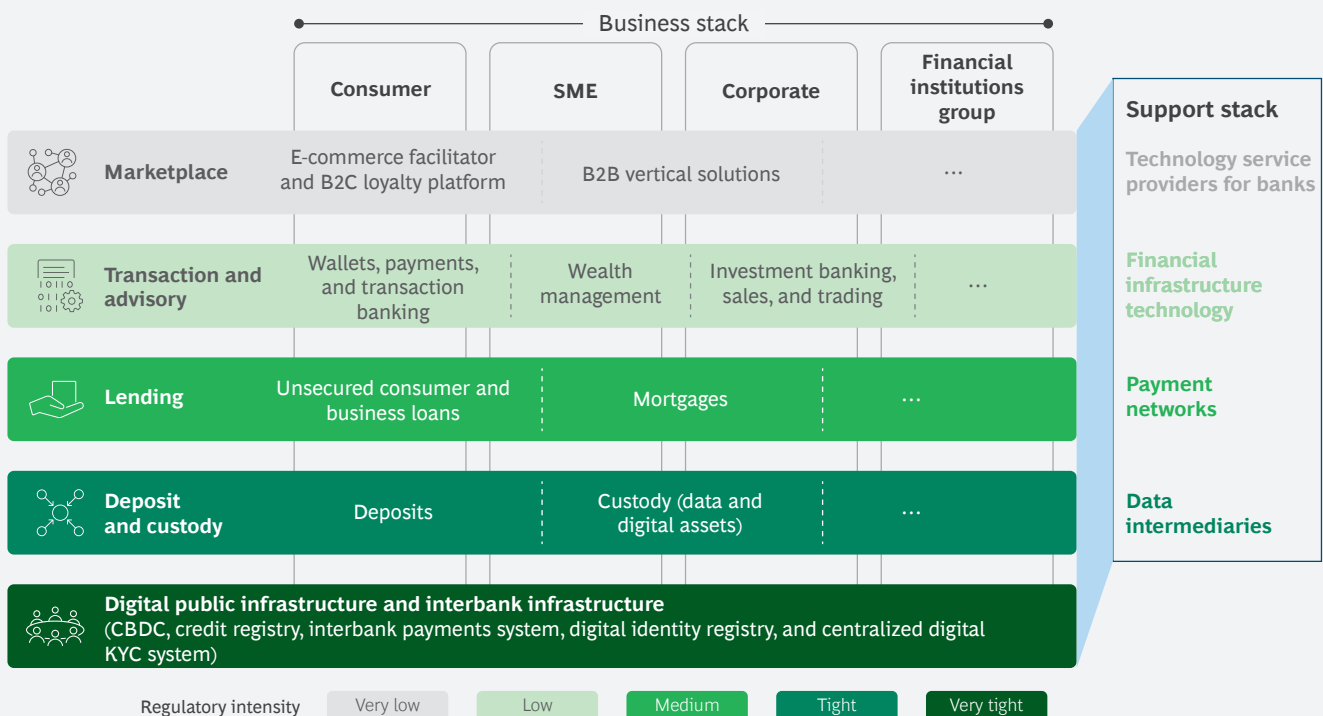
For example, the following can result from outward migrations:

- Bank products can be originated and distributed on third-party platforms.
- Transactions in bank accounts can be initiated on third-party platforms.
- Credit can be originated by banks and sold to third-party investors.

At the same time, banks can benefit from inward migrations:

- They can offer third-party financial services (such as cross-border remittances) on their platforms.
- They can provide third-party nonfinancial services (such as travel-booking services).
- They can offer fee-based services (such as wallets for digital asset custody and secure storage for health data).

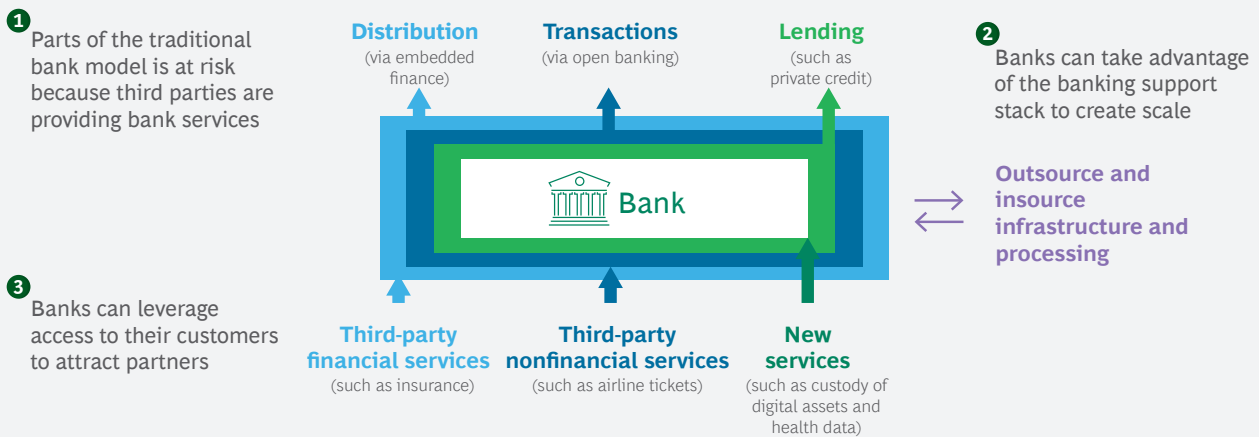
## The Banking Stack Is a Techno-Regulatory Framework of Businesses Linked with APIs and Subject to Varying Levels of Regulatory Scrutiny



Source: BCG analysis.

Note: API = application programming interface; SME = small and medium-sized enterprise; CBDC = central bank digital currency; KYC = know your customer.

# Banks Will Need to Navigate Complex Strategic Choices on Embedded Finance and Embedded Commerce



Moreover, a rich set of operational activities can be in-sourced or outsourced:

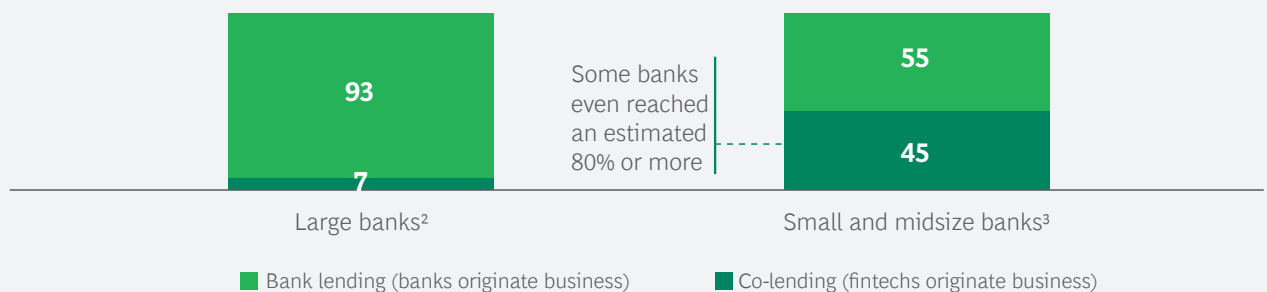
- Business processes (such as the mortgage application process) or services (such as know-your-customer systems) can be outsourced to a tech vendor to help banks access scale benefits.
- Technically, banks can insource back-office processes for other players.

A market where the dynamics of the banking stack has been most pronounced is China. The rapid consumer adoption of fintechs, such as Ant Group and WeBank, has allowed disintermediation of banks for consumer lending.

The economics of business origination on fintech platforms was so compelling for small and midsize banks that by 2019, we estimate that up to 45% of unsecured consumer loans (other than mortgages) that were on the books of such banks in China were sourced through fintechs. (See the exhibit “Unsecured Consumer Loans in China Sourced Through Fintechs.”) This number has come down to about 30% with regulatory intervention and the recognition by banks of the hazards of turning into a utility. Still, Ant Group and WeBank are by far the largest players in the unsecured consumer lending market.

## Unsecured Consumer Loans in China Sourced Through Fintechs

Banks’ consumer loans (2019 estimates, %)<sup>1</sup>



Sources: Expert interviews; BCG analysis.

<sup>1</sup>Excludes mortgages.

<sup>2</sup>Large banks refer to large state-owned banks, joint-stock banks, and large-city commercial banks (more than RMB 1,500 billion in assets).

<sup>3</sup>Small banks refer to small-city commercial banks and rural commercial banks (RMB 50 billion to RMB 100 billion in assets). Midsize banks refer to midsize-city commercial banks and rural commercial banks (RMB 100 billion to RMB 1,500 billion in assets).

## Defend Primary Banking Relationships with a Holistic, Digital Offering

A cross-market review of banks suggests that those with business models anchored in primary customer relationships have high valuations. Such banks are able to sell multiple products across all aspects of banking (for example, deposits, lending, transactions, and investments), providing access to rich transaction data for risk management and marketing, as well as for attracting external partners—enabling banks to sell third-party products on their own platforms. This holy grail of value is true for banks across all segments—including retail, SME, and corporate—and has long withstood the test of time. Competition for deposits is currently increasing amid rising rates, and studies show that diversifying deposit wallets increases the risk of attrition in primary relationships.

Moreover, we have seen a step change in the complexity of primary relationships because transactions have increasingly been conducted on nonbank platforms. Especially for retail and SME customers, in order to maintain relationships across varying products and services, offering a high-quality, 360-degree digital experience delivered through multiple channels has become table stakes. Banking leaders are embedding third-party financial and nonfinancial products into their platforms to consolidate primacy.

**Banking leaders are embedding third-party financial and nonfinancial products into their platforms to consolidate primacy.**

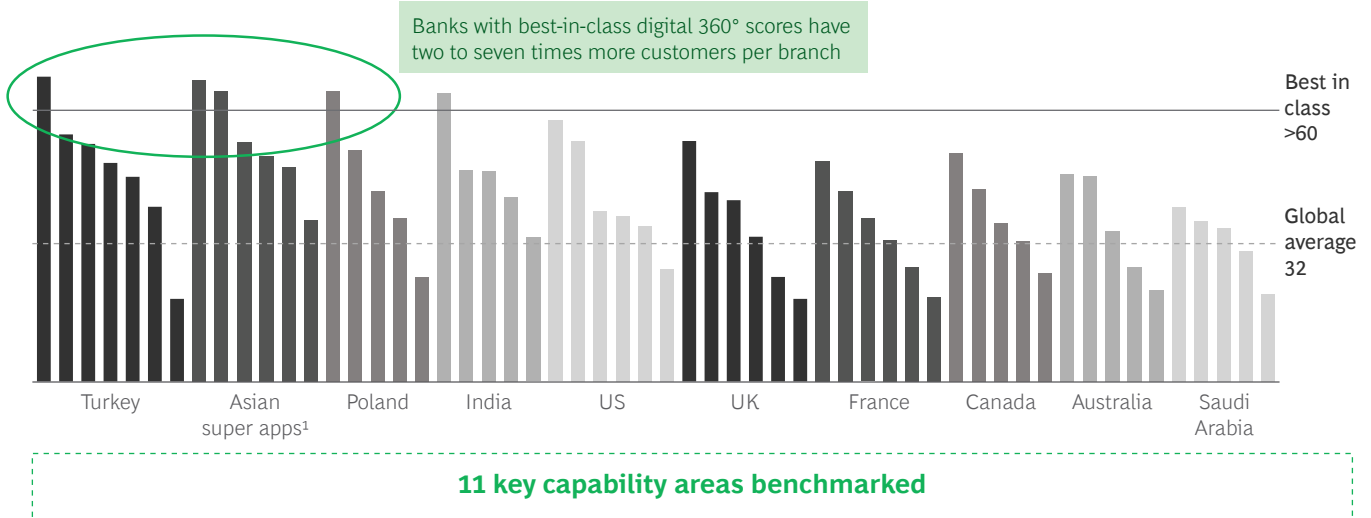
There are strong differences in the digital maturity of retail banks. Typically, only a few players in each market have upgraded their propositions holistically, and the others are lagging behind. (See Exhibit 8.)

A similar trend applies to corporate and investment banking. Players will need to build digital self-service platforms that give institutional investors multichannel access to trading solutions and offer corporate treasurers a full spectrum of offerings to manage cash and liquidity.

Overall, providing a superior experience will permit banks both to defend existing relationships and to win over customers from nontraditional competitors—recapturing business across the stack from digitally savvy customers who have branched out to different platforms.

## Exhibit 8 - Only a Few Banks in Each Market Have Pushed the Frontiers of Digital Distribution Excellence

Digital capabilities (maximum score = 100)



### Daily banking and servicing

- Money insights and liquidity
- Product application and fulfillment
- Transfer and payments
- Self-service features
- SME-specific features

### Engage

- Product research
- Login and security
- Usability and customer delight

### Offer and sell

- Marketing and engagement capabilities
- Assisted sales and support
- Third-party products

Source: BCG's 360° Diagnostic, September 2023.

Note: More than 300 mobile banking applications were assessed in more than 40 markets; not all banks and markets are shown. SME = small and medium-sized enterprise.

<sup>1</sup>Asian super apps include select players from Mainland China, Indonesia, Japan, Singapore, and South Korea.



## Reinforce the Role as Trusted Custodian of Customers' Financial Well-Being

There are limits to a purely digital experience in a trust-based product such as banking. Using high-quality engagement on the basis of expertise, reliability, and integrity must be a key differentiator for banks when competing against more tech-driven players. Indeed, since selling products and administering processes can now be easily carried out digitally, the role of bankers must shift toward trust-enhancing touch points and advice. Such touch points can be created by embedding the option of human interaction at any point in a customer's digital journey—especially the high-anxiety moments. Traditional branches serving individual and business customers should give way to the availability of meeting rooms for consultations and complex problem solving. Contact centers, augmented by video calling and agent-enablement tools, need to manage digital channels to provide the critical human assurance on demand.

### **The role of bankers must shift toward trust-enhancing touch points and advice.**

Banks also need to build strong internal design capabilities to ensure that messages regarding safety and transparency are as prominent as convenience in the customer experience. Moreover, banks' brand association must be unambiguously linked to trust and further reinforced by regulatory association.

Advisory, for its part, will include nudges on financial well-being for the mass market, personalized investment advisory for high-net-worth individuals, and tailored solutions for the advanced needs of corporate and institutional clients. Such clients can include insurance companies and pension funds that look for market diversity, regulatory expertise, and structuring capabilities. They can also include large corporations that seek solutions to challenges related to changes in their business models. Such challenges can include financing a takeover; executing a large, cross-currency hedge; or customizing global cash management or equity issuance. Advisory must always focus on deepening relationships with clients and creating additional revenue streams—ideally, recurring ones that generate fees.

## Turn Risk and Compliance and Social Responsibility into a Competitive Advantage

Banking, at its core, is a risk-taking business, and excellence in managing risk and compliance is central to value creation. Banks can consolidate their advantage by leveraging their risk and compliance capabilities as reusable digital services that are embedded in customer journeys at scale.

A related capability is to understand the spirit of regulation and anticipate its direction, foresee likely adjustments, and embed options in strategy, technology, and process design—rather than simply react (often with manual interventions) after new rules are enforced.

Risk management becomes a particular advantage when it is introduced at the mouth of the funnel in the strategic and operational processes of a bank. Considerations of risk, compliance, and social responsibility need to be on the table when a new strategy is articulated, a new product is designed, and new customer journeys are being envisaged. Banks must embrace the mantra of compliance by design and aim to future-proof their processes.

It's important to note that most banks do not sufficiently leverage the regulated nature of the business as part of their value propositions—as is more common in other industries. This is especially true when competing against nonbank rivals from the technology world. For example, in a situation where a bank is embedded in a third-party platform, it should insist—with support from regulators, if needed—both on full transparency regarding the underlying service provider and on its right to own the customer relationship.

### **Banks must embrace the mantra of compliance by design and aim to future-proof their processes.**

## Boldly Embrace the Climate Transition Challenge

As we approach the monumental task of transitioning to a net zero future, we foresee a staggering investment requirement of \$100 trillion to \$150 trillion—or a yearly investment of \$3 trillion to \$5 trillion—from now until 2050. Moreover, safeguarding nature and biodiversity will likely contribute to an additional annual financial need of \$1 trillion for the global economy. Banks are poised to assume a pivotal role in this capital mobilization, acting as intermediaries between issuers and investors and serving as lenders, investors, asset managers, and providers of risk management solutions. Winning banks will need to excel in three dimensions. (See [Exhibit 9](#).)

**Managing Climate Risks and Requirements.** Identify sources of physical and transition risks emanating from climate change, and integrate those considerations into credit, finance, risk management, and business planning.

**Delivering on Net Zero Commitments.** Establish a robust mechanism to track financed emissions, set targets, and monitor commitments. The entire organization—including sales, credit underwriting, risk management, finance, and technology—needs to be mobilized. A data platform is critical.

## Exhibit 9 - The Capabilities Required to Support the Climate Transition Have Three Key Objectives

- Upskill and equip the workforce, primarily employees in the front office and on risk teams
- Build the capability to assess the robustness of clients' transition pathways and plans
- Align incentive schemes and governance

**Enabling clients to accelerate their own transition**

**Building advanced climate risk management capabilities**

- Assess the transition, physical, and nature risks of clients
- Embed climate risk within the bank's policies and models (including credit, market, liquidity, and litigation)
- Adapt the bank's risk appetite framework

**Core capabilities required to embrace the climate transition challenge**

**Leveraging accurate data to inform strategic decisions**

- Integrate climate data into the bank's overall data setup
- Partner with relevant data providers across sectors and regions in an open ecosystem
- Consider cross-industry partnerships within the financial services ecosystem and beyond

**Accelerating Clients' Transition.** Act as an advisor to accelerate the climate transition of clients' businesses and supply chains, using technical inputs, financial product innovation, and risk management solutions. Sustainable finance is to become a core element of banking strategies. Projections indicate that leading global banks could generate more than 10% of their total revenues from sustainable finance in the medium term.

### Capture Network Effects and Increase Scale Through Partnerships

Banks can create jointly owned entities to gain network effects and scale in a number of areas. These areas include payments (for example, interbank real-time payments), credit and risk (which could have online fraud and credit registries), climate change (which could have a data utility), and commerce (which could have shared e-commerce platforms). Such entities can help banks capture network effects and scale benefits.

Notably, some small, regional bank networks have demonstrated that they can be cost competitive, more so than large incumbents, by creating a shared, back-office utility for technology and operations. Cooperative or savings banks in Germany are a prime example of such collaboration. Moreover, several technology service providers in the banking stack can be tapped to secure scale benefits, reducing operations and technology costs related to complex processes (such as mortgage and KYC processes) that can be outsourced.

We expect a **rapid rise in so-called enabling fintechs**, which provide services to banks to enhance customer value propositions or improve operational excellence. By proactively partnering with these companies, banks can benefit from the scale created by multiple players sharing services globally.

## Navigate Strategic Choices in Embedded Finance and Embedded Commerce

Digital platforms with significant customer traffic often embed banking in their customer journeys—a practice known as embedded finance. Conversely, banks with significant customer bases and quality digital assets embed third-party services (such as e-commerce and travel booking services) on their digital properties, enhancing the end-to-end value proposition for customers—a practice known as embedded commerce. A complex set of choices must be navigated using a strategic and value-focused compass.

**Single-product lending relationships that are acquired through embedded finance are difficult to convert to full banking relationships unless the bank has a truly distinctive cross-selling engine.**

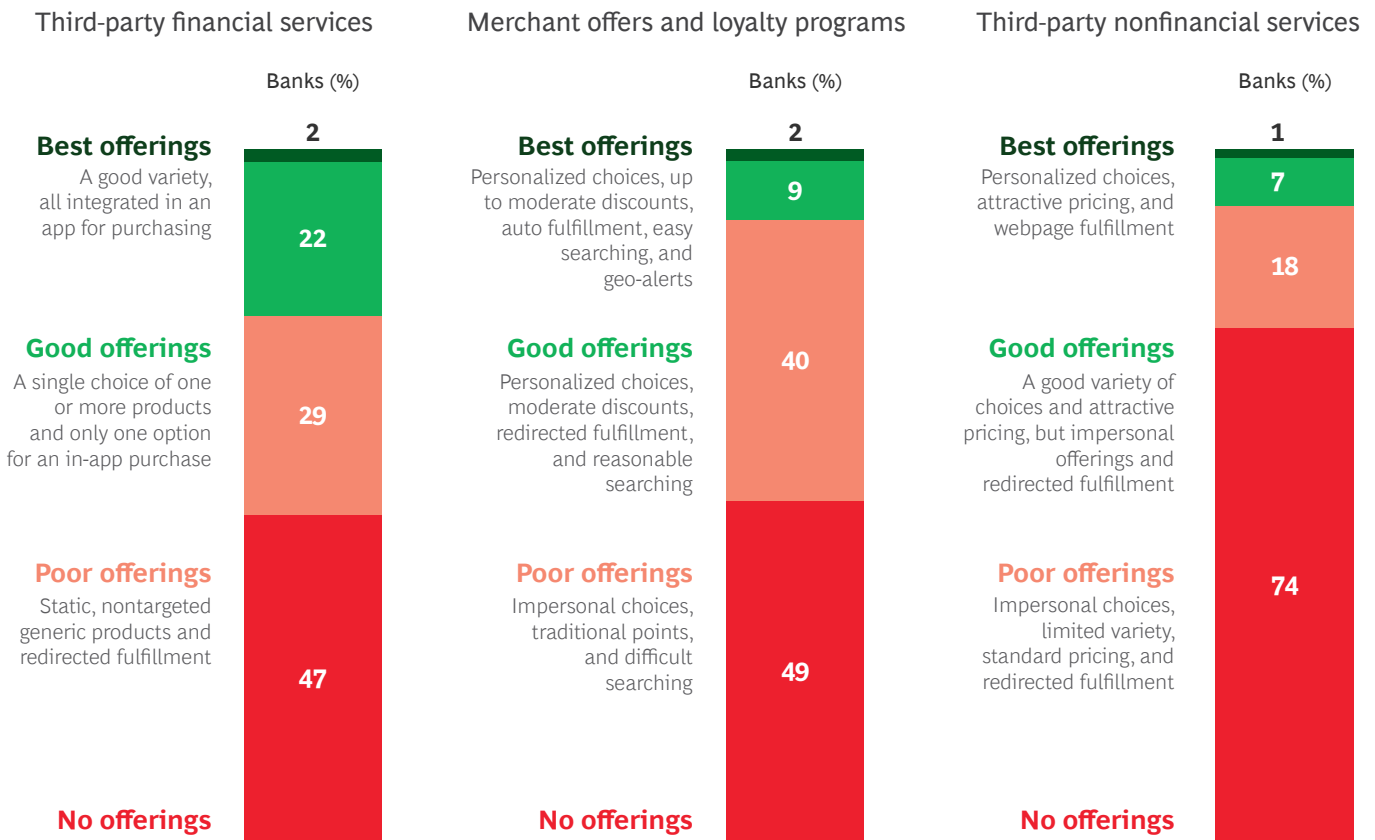
It's key to note that embedded finance options are not always strategically beneficial for a bank. If the third-party platform has ambitions to eventually build financial services relationships with customers, the bank is relegated to the role of a utility. An estimated 45% of SME banking revenue pools in the US and Europe will be addressable through finance embedded in industry vertical software

platforms by 2030. Banks, therefore, need to carefully evaluate where they decide to embed their offerings. Some banks that have embraced embedded finance for consumer lending on e-commerce portals have acquired huge numbers of digitally savvy customers rapidly. But such single-product lending relationships that are acquired through embedded finance are difficult to convert to full banking relationships unless the bank has a truly distinctive cross-selling engine.

Only a few banks have been able to take significant advantage of embedded commerce so far. (See Exhibit 10.) A prerequisite is for the bank to have its own strong digital proposition. Further, banks with large customer bases have an advantage in negotiating customer offers on their own platforms—thus deepening client relationships. The simplest form of embedded commerce is the distribution of third-party financial products such as insurance, and 25% of banks in a BCG study had a solid offering in this area.

Banks have both consumers and merchants on their platforms, positioning themselves to create two-sided marketplaces with merchant-funded offers that enhance banks' value propositions. BCG's study showed that only about 10% of banks have taken steps forward in this area.

## Exhibit 10 - A Small Number of Banks Have Taken Significant Advantage of Embedded Commerce



Source: BCG's 360° Diagnostic, September 2023.

Note: n = 233 across 35 markets.

## Retain a Hold on Highly Profitable Areas of the Banking Stack

The disaggregated businesses in the banking stack demonstrate different economics, operating at different valuations that reflect varying profitability and growth prospects. So-called disruptive fintechs (which create services that compete with banks), enabling fintechs (which provide services to banks), payments players, and standalone wealth managers often have significantly higher multiples than banks. (See Exhibit 11.) These are some of the high-profitability elements in the banking stack, notably in payments and wealth management, that generate fee income (and valuable data) with little or no capital. Fintech competitors and big tech companies are actively pursuing a weightier presence in these spaces.

It is important for banks to be aware of such models and invest to retain their positions. While volumes will be small, compared with those in the overall banking revenue pool, they can boost banks' profitability and recapture lost fee income.

## Exhibit 11 - Businesses with Higher Fee and Lower Capital Requirements Receive Higher Multiples Than Banks Do

P/E ratio, FY 2022



Sources: S&P Capital IQ; BCG analysis.

Note: P/E = price to earnings. The analysis is based on only publicly listed companies. Disruptive fintechs are customer-facing fintechs, while enabling fintechs are fintech players that provide services to other financial institutions and act in the back end.





# Regulators Should Collaborate with Banks

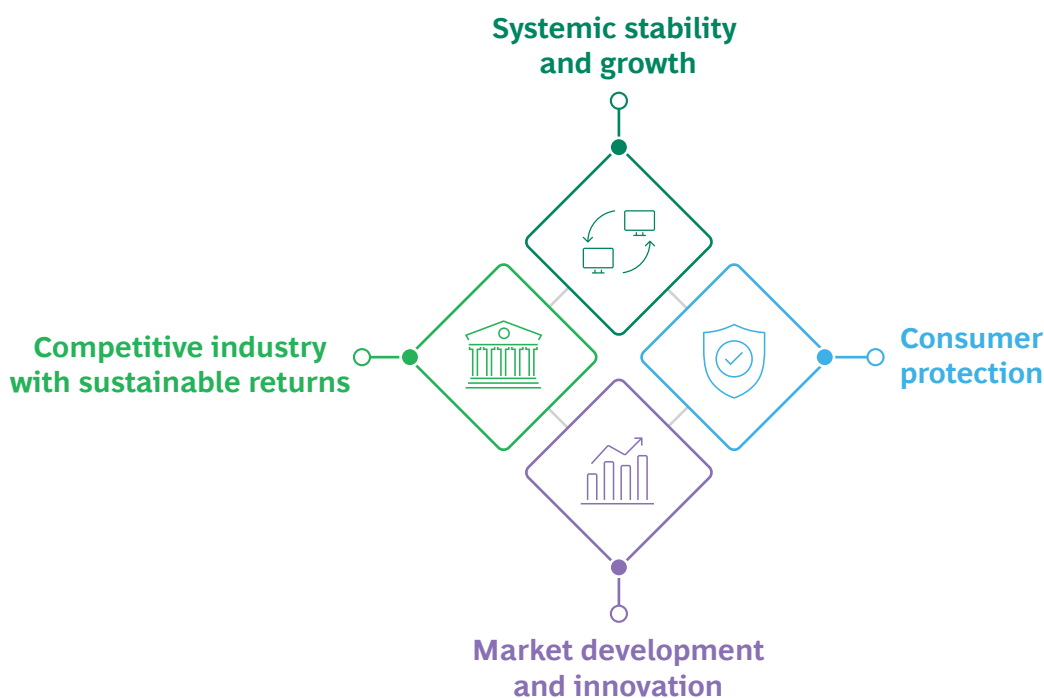
**G**overnments and regulators try to strike a balance among systemic stability, consumer protection, market development and innovation, and the maintenance of a competitive industry with sustainable returns. (See Exhibit 12.) There will always be tradeoffs, but a balance can be achieved.

Given the challenges to macroeconomic stability that are on the horizon, there is reason for the stricter capital and reserve requirements that have been proposed. However, regulators and governments across the world can also embrace complementary ideas to reinforce banking profitability without compromising systemic stability.

**Regulators and governments can embrace complementary ideas to reinforce banking profitability without compromising systemic stability.**

In the fifteen years since the GFC called the resilience of the banking industry into question, regulators in much of the Western world have focused on bolstering systemic stability, reducing bank risk, and protecting consumers. Although much progress has been achieved, issues—such as insufficient liquidity for some regional US banks and weak financial performance for some eurozone institutions—remain.

## Exhibit 12 - An Optimal State Is Possible Among the Four Key Priorities That Governments and Regulators Try to Balance



### New Regulatory Approaches and Capabilities Are Needed

There is a clear need for a sharper focus on banks' risk culture to improve resilience. Risk management should be embedded even more forcefully into day-to-day decision making and live at the core of business models.

Regulators should further embrace market development by taking a strong hands-on role in steering the direction of the industry. Technology-driven disruption and the resulting changes in consumer preferences and habits call for this new approach. Regulators should adopt a mindset of partnering with banks on certain initiatives, including the following ones, to keep the industry on a positive trajectory:

- Strengthen platforms that facilitate a dialogue among banks, regulators, and other related industry participants to ensure collaboration and enable banks to proactively align their business models and practices with regulatory guidelines.
- Build capabilities for rapidly adopting new regulations (such as pricing guidelines that can have indirect and unintended effects on consumer behavior), taking a test-and-learn approach.

- Adopt a regulatory portfolio-management approach, since regulation may suddenly become outdated owing to advancements in technology or rapid changes in consumer behavior, or both.
- Apply stronger metrics to measure and foster competitiveness and growth in the banking industry and in the economy.

Regulatory stances can vary widely, given the unique contexts and priorities in different jurisdictions. And as we've seen, some regulators, notably those in Europe and the UK, have emphasized the primacy of overall stability and consumer protection. Others (for example, those in Canada) have also focused on sustainable bank profitability as a high priority. Yet another set of regulators in certain financial hubs—such as Singapore, Hong Kong, and Dubai, as well as in emerging markets such as India and Brazil—have embraced a proactive and hands-on role in market development. Many have achieved positive results in fostering innovation and ensuring adoption at scale.

## Ensure a Level Playing Field Across the Entire Stack

Regulators need to secure a level playing field by creating a framework of consistent guardrails that progressively lighten as one moves up the stack, layer by layer. Across the banking stack, institutions need to connect seamlessly with a multitude of partners for distribution (through embedded finance, for example), for data services (such as personal financial management), for product collaborations (such as co-lending arrangements using private debt), and for tech services (including cloud-based services). Regulators must find a way to provide sufficient accreditation to all participants from a risk and compliance perspective, so that integrations are quick and that the onboarding of new fintech services does not become an onerous, bank-by-bank, due diligence process. This implies that big tech companies in financial services need to be suitably and proportionally regulated.

Moreover, given the trends in consumer behavior, banks need to offer customers a more end-to-end proposition in order to stay relevant and competitive. For example, daily banking should be integrated with e-commerce, mortgages connected with property searches, and SME lending available on industry vertical platforms. Regulators need to acknowledge an enhanced definition of banking that includes transaction and trade facilitation.

## Foster Consolidation, Directly and Indirectly

Considering all the current industry challenges, it will be critical for regulators to help banks create scale that allows for sustainable returns. Further consolidation is an obvious and important consideration, especially in the US and Europe, but regulators must also consider the tradeoffs between the level of competition and banking stability. In some cases, market consolidation is helpful to stability because weak players in a fragmented market are more susceptible to a sector-wide crisis. Yet consolidation is only beneficial up to a certain point; too much can lead to a decrease in the amount of lending overall and create institutions that are too big to fail.

During the coming years, regulators should carefully evaluate third-party service providers that could manage significant end-to-end processes to help multiple banks collectively achieve scale. Such providers should be regulated to ensure easy onboarding and to permit careful oversight on operations risk and resiliency in the system. While regulators must increase oversight on critical third parties, a framework for partner accreditation could be helpful for lower-risk service providers to foster wider collaboration. Such a framework should not create antitrust implications by benefiting a few dominant, accredited suppliers in particular markets. Yet such a model can permit small regional banks—often crucial to small business credit—to stay competitive and provide diversity in the banking landscape.

## Stimulate Digital Public Infrastructure and Industry Utilities

Digital public infrastructure can contribute significantly to the banking system's profitability by creating platforms that enable strong network effects. Such platforms are most often utilities, jointly owned by a consortium of banks. The utilities either own assets (such as digital or infrastructure banking assets) or enforce standard protocols for interaction between industry participants. Examples of utilities include an interbank real-time payments system, a shared credit registry, a shared fraud registry, shared transaction-monitoring platforms, and shared merchant-loyalty platforms. In the future, a shared utility for climate and ESG-related data could enable banks to cost-effectively manage climate risks and support the disclosure and management of carbon footprints.

Such utilities can benefit banks by reducing costs and enhancing value propositions—partly countering the network effects that favor the platforms of big tech companies. For instance, real-time interbank payments systems in India and Brazil have led to widespread adoption of digital payments by consumers. Similarly, in the UK, open banking has demonstrated that implementation backed by a shared industry body with a hands-on role in setting standards can accelerate adoption. It is imperative that such infrastructure is managed along commercial lines with strong incentives for adoption and economically viable pricing.

## Sharpen Regulatory Clarity on Digital Assets

BCG, the Global Financial Markets Association, the law firm Clifford Chance and others outlined in a [report](#) how the adoption of distributed ledger technology (DLT) and digital assets ecosystem could enhance the efficiency, resilience, and effectiveness of money flows and capital markets. But regulators need to accelerate internationally consistent regulatory clarity in digital assets to unlock this value. Combined with central bank digital currencies (CBDCs), the tokenization of real assets (such as property) as digital assets can trigger a phase of radical digitization in secured credit. CBDCs, currently in active design phases with a majority of regulators, will capture immediate value in payments in advanced economies and open up use cases for purpose-bound money in emerging markets.

## Should Regulators Reinforce Banks' Role in Financial Advisory?

It is crucial that financial advice, especially for the mass market, is rendered by a well-regulated industry. The framework needs to encourage, enable, and incentivize banks to be trusted financial advisors, and regulation on the pricing of advice needs to be carefully structured by the observed impact on consumer behavior. With the soaring relevance of data today, new business opportunities are emerging for banks that build on this principle and emphasize the need to provide secure custody of their customers' sensitive data, digital assets, health records, and digital identities.





# Banks Can Make Productivity Leaps of 40% with a Radical Redesign

Local market structures, the degree of adoption of innovative business models, and regulatory direction are fundamental, contextual parameters of any bank's strategic options. Any selected portfolio needs to anticipate regulatory evolution and competitive disruption—and must remain robust in order to deliver attractive shareholder returns. Banks, therefore, need to make portfolio decisions that enhance value: exit business lines or, at a minimum, reduce capital exposure to low-return asset classes and invest in new areas of strategic growth with more favorable levels of return on equity.

However, given the expected intensity of competition and future regulatory demands, growth alone will not suffice as a path to delivering adequate returns. While scale in banking is indeed alive, many banks have allowed the benefits to dissipate into a nonproductive variety of offers and services, all across a growing array of channels that have often been seen as a mere cost of doing business. Banks cannot afford such business complexity any longer. If they want to win competitively, they must drive toward far-higher productivity and radically reduce the cost of complexity. Starting with a digital-first delivery concept and a detailed cost-driver understanding, it is possible to design a zero-based business model that will allow a step change in productivity that is 40% higher than what is considered normal today.

Overall, banks need to design a drastically simplified business model that is supported by an efficiently managed balance sheet and a modern platform operating model. The business and operating models should transform the bank from front to back, deliver vastly more impact from data and technology, and help build strategic partnerships and capabilities for competitive advantage. Banks should take these steps regardless of the archetype of their business model. (See the sidebar “Six Banking Archetypes.”) Here, we detail some key initiatives.

## Take Decisive Action on Business Portfolio Choices

Transformation efforts are often limited to the incremental optimization of the existing business model along the individual value chain, rather than a full analysis of the business portfolio aimed at identifying where a bank lacks a competitive edge and at trimming historically grown complexities. With capital, funding, and investment resources remaining challenged, an objective review of current allocations along with bold decisions on future ones is mandatory. Such a review may trigger decisions to exit entire businesses or markets, or conversely, to invest in creating scale or amending current capabilities, or both.

Strategic discussions are all too often anchored along historically grown business lines. Yet, the discussions should focus on building blocks—which may be specific products, client segments, or markets—that represent, in a sense, interchangeable parts of the business model. While the split will differ within the context of each bank, the questions to be answered in deciding where to compete should be uniform:

- Is the overall market outlook attractive, considering the growth prospects and the impact of future regulation (including ESG considerations)?
- Can the bank achieve sufficient scale to operate at competitive cost levels and to keep up with investment demands?
- Is the building block core to the strategic goals of winning customers’ primary banking relationships and positioning the bank as a trusted advisor?

Only the building blocks that meet all criteria should be pursued, while others should be scaled back or exited. To be sure, many banks have held onto some businesses for too long, such as subscale markets activities that were significantly challenged by regulations after the GFC. And simply identifying the building blocks for focus is not enough; establishing a right to win will require creating a competitive value proposition. Critical to these decisions is full transparency on the status quo, such as capital allocations (considering the full capital base of the bank), cost allocations (across the entire value chain), and contributions to the funding base (considering the full implications for the funding model, including costs and stability).

The regulatory intensity and the valuations for certain financial services differ quite strongly from the traditional banking business. Given this, banks may investigate options to leverage a holding company framework—the “banking business” being a ring-fenced entity and subsidiary—to reveal the true value of the franchise. (See the sidebar “Could a Holding Company Structure Help Unlock Value?”)

## Optimize the Balance Sheet for Value, and Excel in Deposits

Any business portfolio must settle on a clearly articulated balance sheet structure, which must define where capital is allocated, how the bank is funded, and the level of returns that are expected. While capital must obviously be allocated to businesses that possess the tools needed to succeed, the funding mix must be carefully steered toward cost-competitive and low-volatility sources.

**A new wave of regulation can be expected that will increase scrutiny over the stability of the balance sheet—the liability side in particular.**

Given recent events, a new wave of regulation can be expected that will increase scrutiny over the stability of the balance sheet—the liability side in particular. In most business models, access to sticky deposits will be a critical competitive advantage. The impact of higher rates on the liability side, therefore, needs to be carefully evaluated to identify the potential need for action. Many banks should consider pursuing a dedicated deposit strategy.



# Six Banking Archetypes

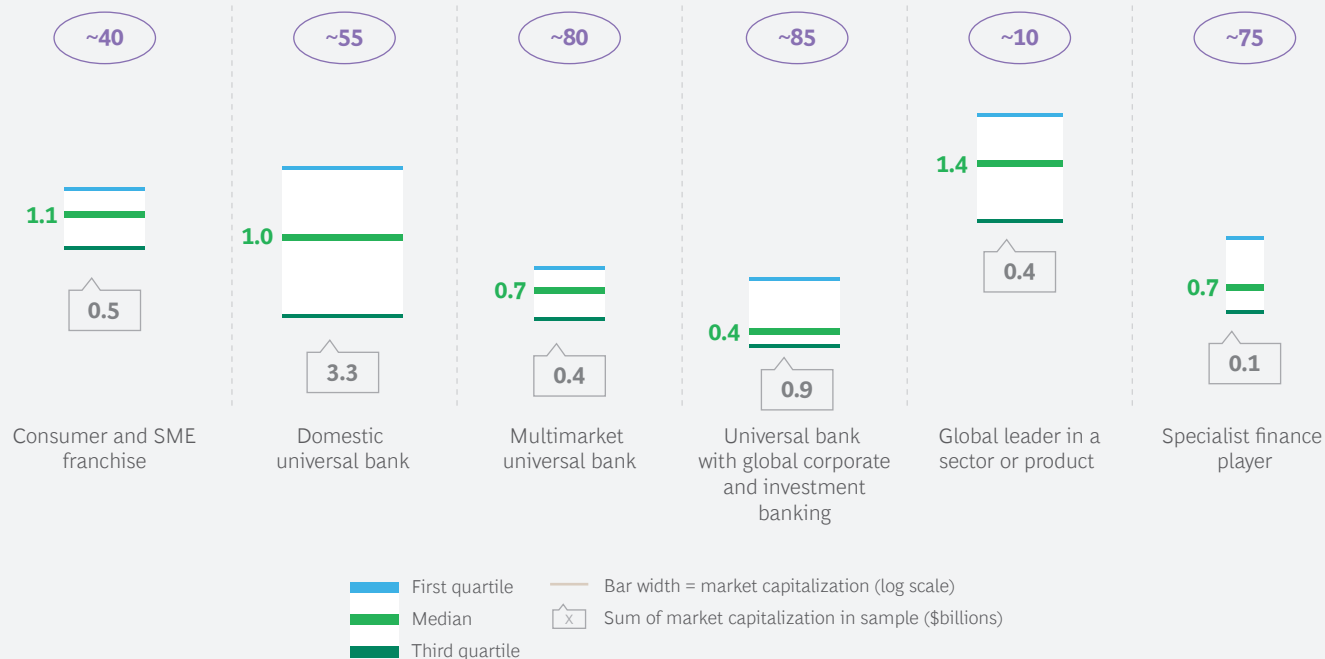
We have identified six banking archetypes: the consumer and small and medium-sized enterprise (SME) franchise, domestic universal bank, multimarket universal bank, universal bank with a global corporate and investment banking arm, global leader in a specific sector or product, and finance specialist. (See the exhibit “Six Banking Archetypes Have Strong Differences in Complexity and Valuations.”)

**Consumer and SME franchises** historically operated on a regional level, with proximity to their clients as a key differentiator. More recently, with branches becoming less relevant in step with digitization, it has become easier to cover entire markets. Today, winning consumer and SME banks typically feature front-to-back digitization of value streams (including extensions to relevant nonbank services) and extensive leveraging of customer transaction data to create high levels of personalization. In terms of valuation, this is clearly among the preferred archetypes of investors.

**Domestic universal banks** stand out as the largest in terms of total assets, given the historical predominance of this model in banking. Having a strong consumer and SME franchise is a prerequisite. The technology stack for corporate business is typically very different from a consumer and SME franchise, offering few synergies. However, winning models demonstrate synergies in the cross-selling of retail and SME products to the ecosystem of corporate clients. Winning corporate bank franchises require aspects such as sector-specific solutions (with risk management embedded at the mouth of the business funnel), a transaction-banking offering that generates strong fees and float, relationship manager enablement with advanced analytics (including generative AI applications), and light balance sheets with strong capabilities to originate and distribute to capital markets or private capital.

## Six Banking Archetypes Have Strong Differences in Complexity and Valuations

Players with P/B < 1 (%)



Sources: S&P Capital IQ; BCG analysis.

Note: P/B = price to book; SME = small and medium-sized enterprise.

**Multimarket universal banks** need to take a hard look at their business models, since the banking stack and regulations differ in subtle ways by jurisdiction. These differences impede international cross-border standardization that global banks traditionally aimed for to achieve scale. The successful multimarket universal bank archetype of the future must either be at scale in a few chosen markets (with select horizontal capabilities leveraged for scale across jurisdictions) or operate with a disproportionate share in select business lines and customer segments with distinct positioning, compared with the share for local market leaders.

**Universal banks with a global corporate and investment banking arm** will likely attract the most scrutiny from investors. Most players lack the scale to be globally competitive in corporate and investment banking after the global financial crisis, and players must be among the top three to five in a certain product category to be profitable. This is particularly true for certain markets businesses (especially flow equities) and for areas of origination and advisory.

Those banks that have achieved scale are performing very well, while there is a long tail of subscale players that is falling behind. One reason is that the cost of constantly keeping pace with technological developments is often too high for subscale players. Nonetheless, several thoughtful banks have recognized the challenges in scaling high-frequency businesses by entering partnerships with stronger players or by finding profitable ways to exit the risk side of the equation (while continuing to serve clients). The successful players build on a strong domestic franchise in their home market that provides access to cheap funding while aiming for leadership in corporate and investment banking. Newly proposed capital regulations, particularly the Basel III Endgame measures introduced by US regulators, possess the potential to again significantly alter the financial dynamics of the business. Banks need to carefully evaluate the impact on their portfolio and review their strategies accordingly.

**Global leaders in a specific sector or product** are active in areas that allow for global synergies across markets, such as ultra-high-net-worth wealth management and custody. They focus on asset-light and fee-heavy products that do not require broad access to deposits and primary-customer transaction accounts beyond their own concrete offering. The businesses are fee-based and offer high return on equity, and given the low capital requirements, they often lead to robust valuations. To be successful, a market-leading product capability and a trusted brand is needed. In the long run, we expect still more consolidation in this archetype.

**Specialist finance players** focus on a niche that has a specific product (such as credit cards, mortgages, or commercial real estate). Focusing on such niches can provide a competitive advantage owing to specialization, but they can also carry higher risks because of less diversification and limits to size. Such a position can subdue valuations of the group as a whole. The winners in this archetype demonstrate extraordinary skills in managing risks in their financing category. Many players are collaborating with investors and private credit firms because funding their businesses at scale is difficult, owing to the lack of customer primacy and access to deposits.

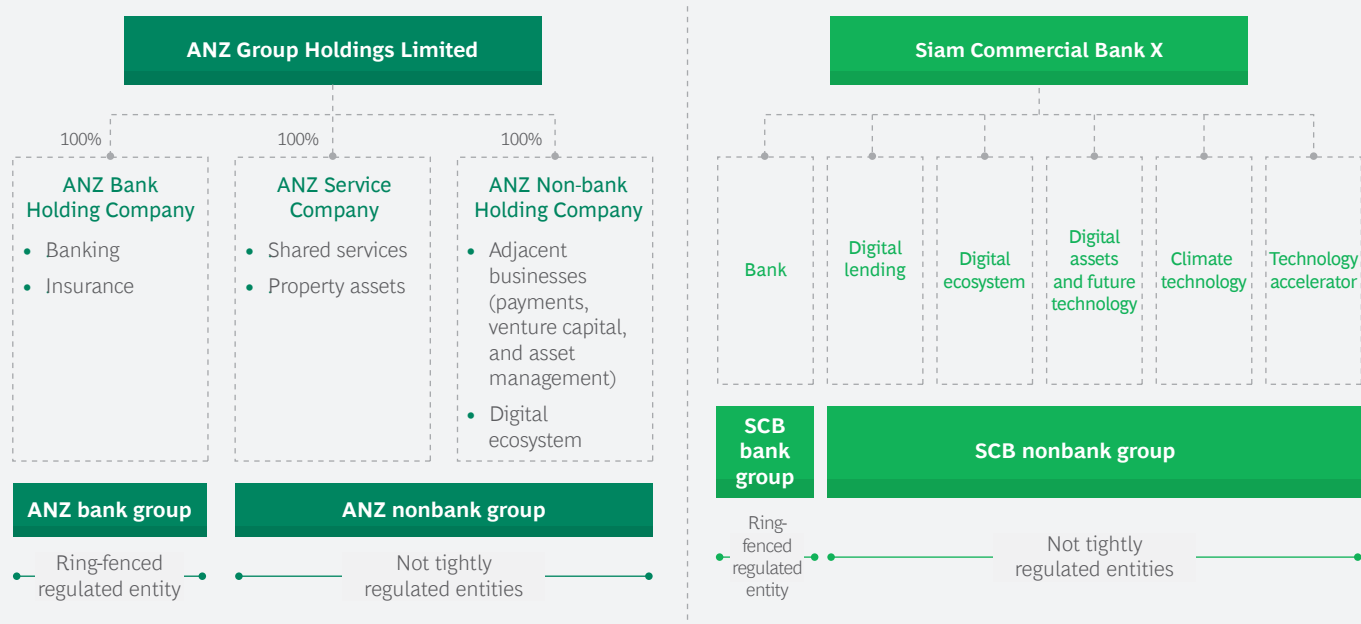
# Could a Holding Company Structure Help Unlock Value?

To stay competitive and offer an end-to-end experience to customers, banks need to amend their value propositions by offering services that go beyond traditional definitions of banking. But the human resources policies and financial resources that are needed to deliver on innovative, tech-heavy services are not always suitable for regulated banking entities, given their risk profiles, compensation structures, and the need for third-party partnerships.

To overcome this challenge, banks can consider applying a holding-company framework in which their regulated businesses are housed in a ring-fenced entity, along with other entities engaged in developing and offering adjacent nonbank services. The holding structure should be leveraged to reveal the true value of the businesses and to provide full financial transparency to investors.

Holding company structures have already been used in many markets, and more banks are embracing them to incubate technology-based businesses in their portfolios. (See the exhibit “Some Banks Are Experimenting with a Holding Company Structure for Greater Strategic and Operational Flexibility.”)

## Some Banks Are Experimenting with a Holding Company Structure for Greater Strategic and Operational Flexibility



Sources: Investor presentations; BCG analysis.

Financial planning, budgeting, and daily steering are very often focused on volume and the income developments of individual segments. To further push the productivity of the balance sheet, a forward-looking and action-oriented approach should be applied. Specific initiatives include:

- Steer governance and processes (for example, real-time positioning and dynamic scenario-based forecasting) to enable a forward-looking perspective on the resilience of day-to-day business beyond regulatory requirements—thus permitting better-informed, fully risk-aware decision making.
- Ensure full transparency on the performance of both sides of the balance sheet. Assess the profitability of assets, accounting for true capital consumption and using an effective funds transfer pricing model to enable the efficient allocation of resources and to set the appropriate hurdle rates for different asset classes. In addition, assess the attractiveness of funding sources, taking into account their impact on regulatory ratios (for example, the liquidity coverage ratio and net stable funding ratio) as well as their pricing. Reinforce a strategic approach toward long-term funding resilience, including measures to support deposit growth and to optimize the treasury setup.
- Provide a toolkit that enables active management of the credit portfolio—divesting assets, for example, by collaborating with private credit players and establishing effective governance to support execution.

## Raise Operating Leverage and Delivery Excellence

On the heels of the large cost programs carried out over the past decade, most banks are still confronted with poor cost efficiency, and most activities do not scale. The elimination of subscale or nonstrategic activities, identified as part of a portfolio review, will typically enable a major cost reduction if the associated complexity reduction is carried through front to back.

For the core to successfully achieve operating leverage, banks will need to more fundamentally question the way they operate. Significant efficiency improvements are possible. For example, we observe productivity gaps of up to 65% among retail banks of the same size (5 million to 10 million customers), comparing the full-time equivalents scaled to the respective bank's customer base. (See Exhibit 13.) Banks need to simplify and replace variable operational costs with scalable platforms, using technology to achieve a leap in productivity. To address this, banks must re-evaluate change delivery, particularly technology-driven transformational change, through a platform-enabled, front-to-back product delivery structure. The required elements include the following ones.

**A Platform-Based Operating Model for Front-to-Back Redesign.** The pursuit of innovation in banking is as much an organizational challenge as a technological one. Banks can learn from the way tech product companies are organized. The key is to leave behind traditional setups related both to businesses and functions and move to what is called a platform operating model.

In this model, the organization is structured along the following lines: business value streams for channels and products (for example, checking accounts and mortgages), shared platforms that jointly develop services (such as KYC processes) that can be reused in designing multiple customer-value streams, and enterprise-wide platforms (for instance, finance and tech platforms) that enable universal, shared capabilities. (See Exhibit 14.)

This way of organizing enables the rapid buildup of technology assets, leveraging reusable components. It also forces deep collaboration among business, functional, and technology groups to jointly manage the buildup—finding the right tradeoffs between meeting business needs and avoiding a burdensome level of customization. Moreover, since the platforms are horizontal, they cut across the silos of business lines and functions.

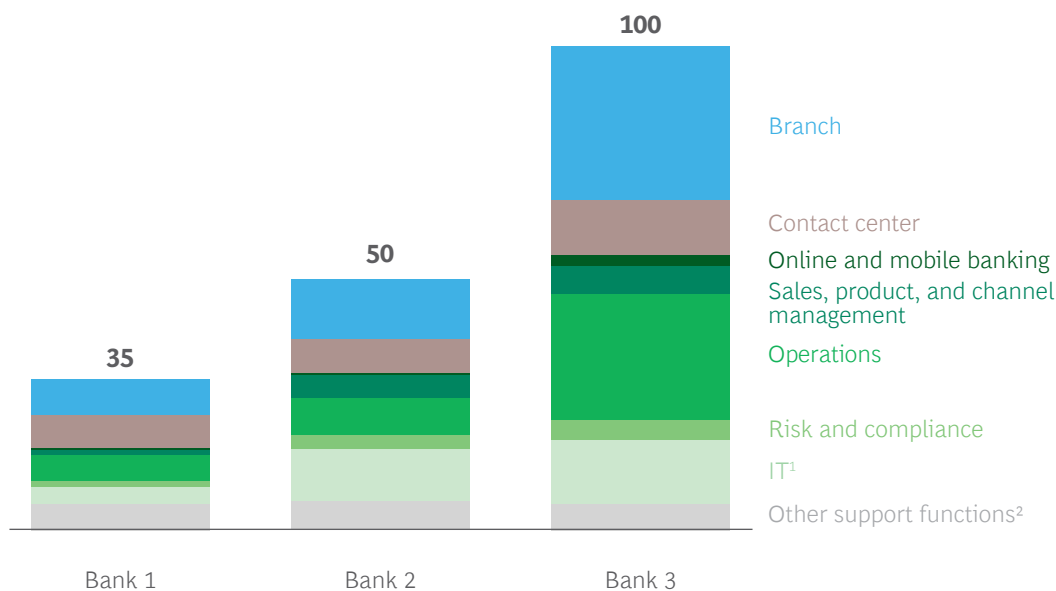
The key to unlocking a step change in efficiency has been and will always be the optimization of processes. This requires vigilance and persistence and must be carried out across all parts of the platform operating model—all with full transparency from the front to the back office. In the past, many banks have digitized their processes or near-shored/offshored activities, but they often failed to achieve the efficiency increases they targeted. The reason? They did not follow a front-to-back approach that enhances efficiency and value creation across the entire spectrum of a product's or service's life cycle, all the way from inception (the front) to delivery and beyond (the back). To truly excel in delivery, existing processes must be transformed with data, AI, and technological possibilities (and limitations) in mind. To be successful, the change delivery teams must be organized along the platforms, transitioning from a traditional project-delivery mindset to a product-delivery mindset. By forming persistent cross-functional teams of business, risk, and technology talent, banks can achieve superior results. This approach transcends organizational silos and delivers holistic solutions that are more closely aligned with banks' priorities.



# Exhibit 13 - Efficient Retail Banks Have Demonstrated the Ability to Operate at Significantly Lower Cost Levels

## Three comparable retail banks of similar size (5M–10M customers)

Full-time equivalents, scaled to bank 3's retail customer base (indexed to 100 for bank 3)



	Bank 1	Bank 2	Bank 3
Branches (number)	~100	~150	600
Digital sales (%)	~75	>50	~30

**Source:** BCG's Retail Banking Excellence Benchmark.

**Note:** Data is for the retail banking units of global, market-leading banks.

<sup>1</sup>IT includes internal and external full-time equivalents.

<sup>2</sup>Other support functions include HR, finance, and legal.

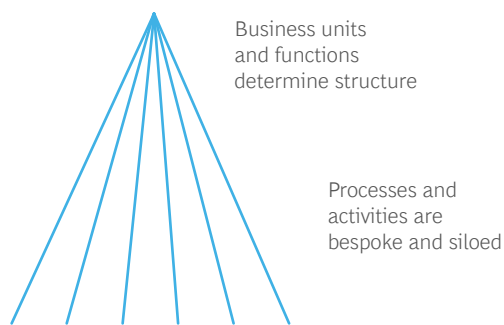
A successful implementation hinges on having a robust and agile technology infrastructure and purpose-built data platforms in place. Banks should consider a shift from monolithic core systems that house ledger, account, and transaction data and have complex interconnections to decoupled systems that separate transaction processing, ledger management, customer accounts, and channel capabilities. Adopting technology infrastructure hosted on private or public cloud environments allows for scalable solutions with an optimal expense profile, enabling quicker sharing of capabilities with delivery teams.

**Leveraging AI and GenAI Together for Reimagining Functions.** Applications and process transformations that combine predictive AI and generative AI can enable significant efficiency gains. At the same time, these solutions will allow for an individual client and employee experience, thereby supporting personalization, customer primacy, and improved decision making.

AI is particularly well suited for working with large amounts of data—and banking is a particularly data-heavy industry. The granular transactional data of a bank's customer base can provide precise insights in ways that few other companies' data sets can.

# Exhibit 14 - Platform Operating Models Can Unlock Far-Higher Efficiency and Growth

## Traditional organization

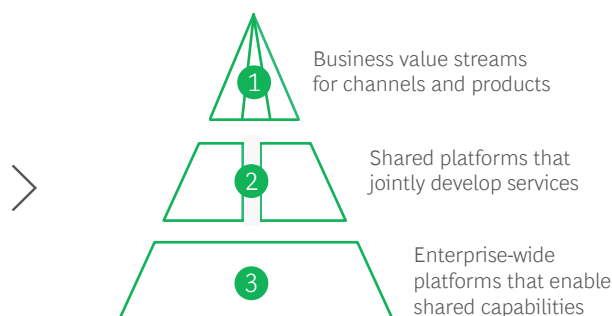


Change is prioritized along reporting lines

Change is delivered in projects and capabilities are partly shared

There is limited reusability of assets

## Platform operating model



Horizontal prioritization cuts across business units

Platforms, shared capabilities across multiple business units, are permanent project teams

Reusability is the primary requirement of new assets

Source: BCG analysis.

AI is set to change the banking sector. Banks have already been leveraging AI for a decade, but generative AI opens up a new opportunity to truly transform the industry. This is not about small tweaks to existing processes; it's about fundamental reimagination. We are seeing the largest impact in use cases where predictive AI and generative AI are used together—for example, when replying to a customer inquiry. Generative AI can analyze and classify the customer's question, and predictive AI can then select a mode and route to reply. On the basis of that decision, generative AI can formulate a response. Such scenarios have the potential to substantially increase productivity across all parts of the banking value chain if deployed proactively and boldly. (See Exhibit 15.) They can also help deliver better outcomes for customers—such as deeper, personalized communications across all channels, faster and more effective responses from customer service teams, and better product offerings at the right time.

Banks with large investment appetites and the ability to attract solid talent will have an advantage in the short term. However, the possibility of off-the-shelf solutions available on software-as-a-service platforms could reverse this dynamic in the medium term.

Banks will never be run by AI, but the roles of bank employees are likely to evolve over time to increasingly leverage the technology. Moreover, there are clearly roles for the skills that only human beings have. We foresee employees interacting with AI in four ways: building, shaping, using, and governing AI.

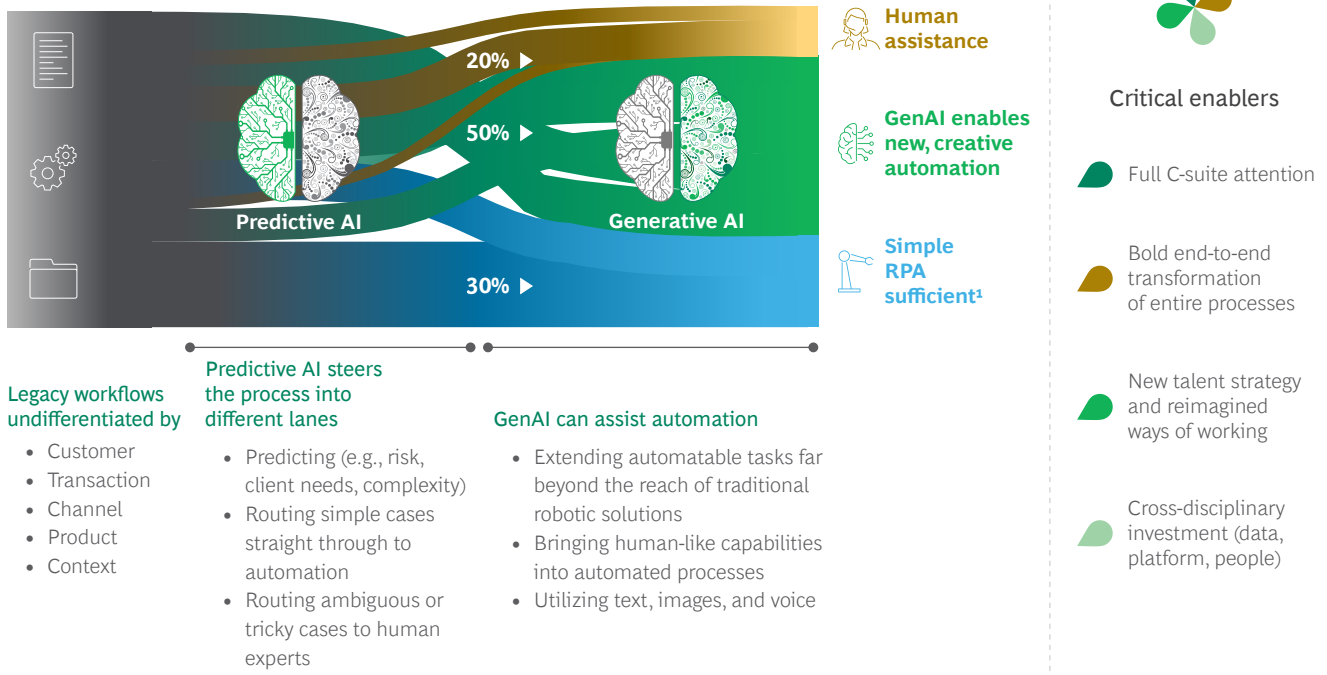
**Capability Hubs in Strategic Roles.** Global capability centers in offshore locations have evolved over the past decade from being a source of low-cost talent for back-office activities to being strategic centers to house advanced capabilities as well. Capability and innovation hubs (CIHs) are centers with access to high-quality talent at scale, typically at offshore locations. CIHs host four distinct capability areas: operations, technology, support functions, and advanced skill sets (such as expertise in data, blockchain, and, more recently, generative AI). CIH's have been delivering 30% to 40% in cost efficiencies by transforming processes through an end-to-end lens. Access to advanced talent pools is accelerating the digitization agenda for the banks, with annual benefits of about 20% being seen in many operational processes.

Mature CIHs have an expanded portfolio of services that include front-end, customer-facing business operations and capabilities in emerging technologies, led by centers of excellence. More than 30% of talent across large CIHs focus on advanced digital capabilities. Most CIHs also house global process and product owners who have shared business goals and outcome metrics. (See Exhibit 16.)

In the past 24 months, 88% of CIHs have added AI and machine language capabilities and have set up centers of excellence. A strategic deployment of the CIH model can not only enhance a bank's cost productivity but also be a catalyst for bold front-to-back digitization of functions.

# Exhibit 15 - Together, AI and Generative AI Can Increase Productivity, but Realizing the Full Potential Requires a Coordinated Focus

Legacy workflows can be transformed end to end...



Source: BCG analysis.

Note: Numbers are indicative.

<sup>1</sup>RPA = robotic process automation.

## Become a Tech Product Company, Not Just a Tech Company

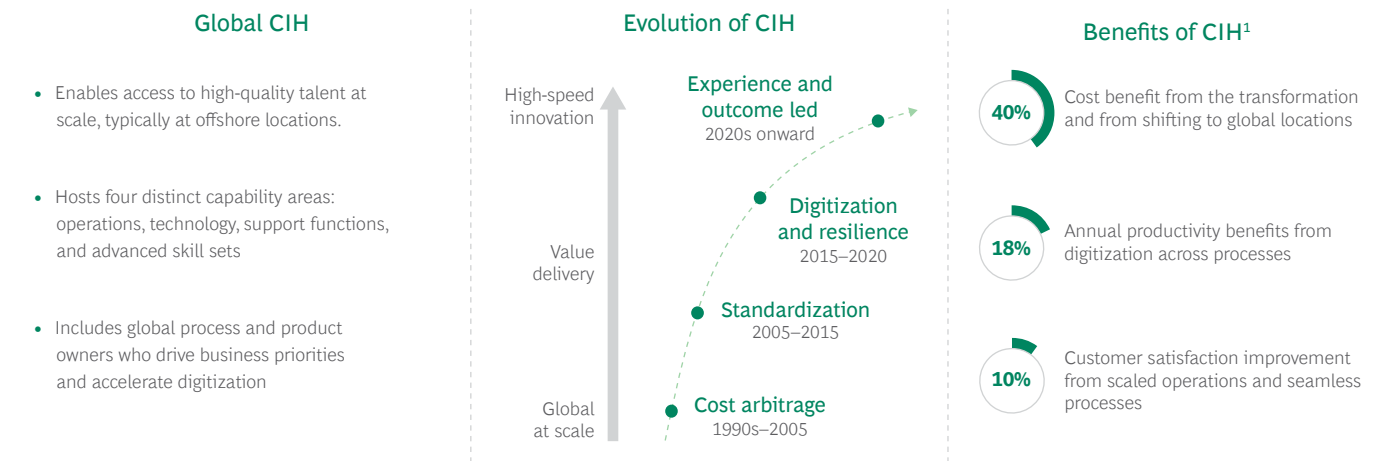
Legacy tech setups continue to impede business transformations. Capabilities developed presently will be crucial in the future, because today's cutting-edge technology will be tomorrow's legacy.

Modernizing legacy setups requires reimagining the architecture, creating a clear transition pathway to connect current and future states. This pathway should incorporate staggered modernization strategies, such as hollowing out the core, decoupling product processors from process automation, and extracting data to develop separate data platforms. Such approaches help replace critical components while isolating parts of the legacy setup for future transitions, preventing modernization efforts from becoming unwieldy and lacking clear impact.

An often-overlooked pitfall of such transformations is a tendency to focus solely on pure technology, missing the opportunity to transform the tech organization structure that is aligned to the legacy setup. It's important that the new organization structure supports, rather than hinders, modernization efforts. Potential options include adopting the DevOps model, restructuring data organizations, and establishing data domain-based delivery teams. A reimagined technology organization and human resources function are key enablers, along with redesigned processes. In-house engineering talent will also prove to be critical in this journey.

Only a portion of the required technology talent can be provided by strategic partners. Core engineering needs to be housed within the enterprise, presenting a challenge for many banks because financial institutions have not typically been able to attract top engineering talent. It's critical for banks to pursue innovation, and this will require new incentive models and talent development processes.

# Exhibit 16 - Banks Have to Leverage Global Capability and Innovation Hubs as Strategic Units with the End-to-End Scope of a Function



**Sources:** BCG’s survey of capability and innovation hub leaders, 2023; World Economic Forum; BCG analysis.

**Note:** CIH = capability and innovation hub; AI = artificial intelligence; ML = machine learning; CoE = center of excellence. Number of survey respondents was 50, with a 50-50 split across Indian and global leaders.

<sup>1</sup>Benefits are based on the performance of advanced hubs.

We further believe that the idea of banks having to become tech companies hinders identifying the right priorities and, eventually, leads to disappointments. Banking is a risk-taking business, with customer trust at its center. A key requirement is to embrace tech as a core capability that can help create customer propositions and journeys that support deep, long-lasting relationships. The tech capability should also balance cutting-edge digital capabilities with a highly personalized human touch that is offered on demand at the right moments of truth in customer journeys.

**The tech capability should balance cutting-edge digital capabilities with a highly personalized human touch that is offered on demand at the right moment in customer journeys.**

In order to bring this experience to life, the business staff has to act as so-called product owners and partner with the tech function to build the right customer experience iteratively. The lack of product owner capabilities is an equally large, if not larger, legacy to address. Banks need to create reskilling programs and talent frameworks to attract and train personnel in diverse job categories, such as product owners, full-stack engineers, data scientists, and data engineers.

## Strengthen the Foundations of Data

Compared with most other industries, banking has better quality data and better systems to manage it. Yet despite heavy investments, most banks have not been able to realize their data’s full potential, owing partly to legacy processes and technologies, as well as to data privacy concerns. Next-generation data capabilities remain elusive, a gap that has become ever-more critical with the advent of AI and generative AI initiatives.

To unlock data’s potential, banks should focus on four areas:

- Data Ownership.** Implement a domain-centric framework for data product ownership to centralize accountability and drive both business and technical transformations. This framework should establish an end-to-end mechanism for creating reliable data assets that are usable for commercial, analytical, and regulatory purposes. It also should enable banks to take a risk-reward approach to governing data: establish strict standards for activities such as financial crime management and credit decisions, and create looser guardrails for commercialization use cases, such as customer analytics and cross-selling.



- **Data Management.** Most banks have data deeply embedded in multiple applications and distributed across different systems and locations. Banks need a systematic process to retrieve data and to consolidate it onto specific data platforms. Data must be organized according to domains and ensure easy access through a user-friendly data catalog. While large banks may employ multiple data platforms with purpose-built solutions, a well-defined data strategy that guides these platforms remains difficult to implement—but it is of utmost importance to capture the full value of data and leverage breakthroughs in AI.
- **Data Governance.** Many large banks lack a true leader for data, or if they do have a dedicated role, it does not have the right level of empowerment and organizational support. In our view, a chief data officer (CDO) should be fully authorized and have the budget to set the data standards for the bank, execute the required data transformation, and unlock the value of data. The CDO must formulate clear policies, roles, accountabilities, and robust data governance processes for enterprise data to derive value from AI breakthroughs. Adopting advanced analytics and generative AI to rapidly scale key data governance processes (such as metadata management, data quality measurement, and data lineage) is essential to creating data products in weeks, as opposed to years. Given the burgeoning significance of data governance, banks should adopt a cross-functional outlook (that is, one created by the risk, finance, and business functions) when addressing regulatory initiatives, as well as increase the level of coordination driven by the CDO.
- **Data Risk Management.** The increase in the importance of data, especially given game-changing technologies such as generative AI, is introducing significant associated risks related to managing sensitive data, cybersecurity threats, and regulatory issues (in areas such as privacy and bias). As banks think about data assets, organization structure, and leadership for supporting data assets, they need to keep risk management front and center. Banks should adopt a clear framework for managing data risk to enable the sound steering of their data-risk appetite. In parallel, they should create an effective responsible AI framework and continue to partner and engage vendors to ensure that the highest standards are met.

## Build New Muscle in Partnerships

To complement their offerings, banks will need to broaden their partnerships with other players in the financial ecosystem, such as fintechs. There is a wide spectrum of opportunities, reflected in the following action steps:

- Seek innovative software services to be embedded on the bank's platform, or outsource entire processes to access scale and capabilities.
- Gain access to external balance sheets to conserve capital (for example, through co-lending arrangements with third-party lenders that can provide private debt).
- Take advantage of embedded finance by distributing bank products on digital platforms that have heavy customer traffic.
- Embrace embedded commerce by distributing synergistic third-party products on the bank's platform.

The traditional partnership models of banks have been geared toward large-vendor relationships that involve complex and sometimes frictional onboarding processes. Winning banks need to create a new organization unit to scout, integrate, and manage partnerships in an agile manner—one that rapidly escalates and resolves problems, uses joint teams, adopts value-sharing-based terms and flexible commercial terms, and simplifies onboarding.

Banks should also act with confidence. Owning access to a strong franchise of primary customer relationships makes banks attractive partners for other types of players that focus on select areas of the banking stack—players that are often confronted with high costs to win customers. Many new players have competitive offerings but struggle to reach scale. Banks can offer them an easy pathway to scale—in return for fair compensation.

Ultimately, now 15 years after the GFC, the world is facing a myriad of new challenges, and banks are at center stage. It's simply no longer viable for banks to approach transformation incrementally, building bit by bit on legacy setups that can actually do more to hold them back than to propel them forward. Banks need to take a deep breath, holistically examine their entire organization, and blaze a clear strategic path that enables them to meet their obligations not only to customers but also to society as a whole—driving economic growth, helping to finance the climate transition, and creating lasting shareholder value. In order to reach these goals, banks must dramatically reduce the complexity of their business and operating models and sharply raise overall productivity. Fortunately, there are ways to get such things done.

We believe that banks, along with the entire financial industry, are up to the task. But each day spent lingering, without taking real action, can represent significant lost opportunity.

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## Acknowledgments

The authors are grateful for the contributions of Tushar Agarwal, Inderpreet Batra, Amine Benayad, Andrea Castoldi, Jungkiu Choi, Roy Choudhury, Matteo Coppola, Tijsbert Creemers-Chaturvedi, Stefan Dab, Florian Dahl, Cristina Espinosa, Dean Frankle, Sreysha George, Norbert Gittfried, Joe Grundy, Kshitij Gupta, Max Hauser, Kunal Jhanji, Justine Kerriou, Oliver Kude, Gwenhaël Le Boulay, Bingbing Liu, Akanksha Maheshwari, Federico Muxí, Alexander Paddington, Michal Panowicz, Ella Rabener, Benjamin Rehberg, Jürgen Rogg, James Sattler, Sebastian Schloissnik, Mark Schofield, Yann Sénant, Juliana Sguerra, Yagya Sharma, Tjun Tang, Steve Thogmartin, Juan Uribe, and Leonhard Vollmer.

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