A&M'S EUROPEAN FINANCIAL SERVICES INDUSTRY VIEW

July 2015

ALVAREZ & MARSAL

Return to "some" economic growth

Although the European economy has started to get back on its feet, economic growth is still moderate at 1.8% (2014: 1.4%). Concern remains as to whether this growth will actually result in new jobs. In some countries unemployment is still a very real concern, for example Spain has unemployment rates of +20%.

Concurrently, the relationship between Greece and its funding providers is becoming increasingly difficult and the future of Greece as a member of the Eurozone is still at stake.

The EU average Government Debt/GDP ratio is still well above 80%, with none of the larger EU countries meeting the 70% Stability and Growth Pact requirement. It is therefore logical for the ECB to keep interest rates at their current low levels in order to make debt servicing manageable and to fuel economic growth.

Following the Asset Quality Review ('AQR'), there has been improved trust in banks and they are increasingly able to fund themselves on the interbank market. Only a few European countries remain reliant on national banks and the ECB to provide liquidity, most notably Greece where liquidity has dried up completely. However, trust in banks still needs to be improved, particularly as levels of longer term funding continue to decline.

A&M VIEW

"Major change in monetary policy in short-term is unlikely"

The stability of short-term and long-term interest rates in Q4 2014 and Q1 2015 has been severely impacted by both the initiation of the ECB's Quantitative Easing ('QE') program and the situation in Greece. The ECB continues to hold interest rates at an all-time low to strengthen economic growth by attractively pricing Eurozone products for overseas purchasers.

Banks still need to strengthen buffers and adjust their business models to comply with continuing regulatory pressures. In the short term, low funding costs and ample liquidity will enable the banks to stabilise their current book, while at the same time introduce a new business model.

The ECB is highly unlikely to prematurely terminate their largest ever QE program given the Greek crisis and the negative impact such a decision would have on the ECBs credibility.

QE and the ECB's interest rate policy are therefore likely to remain unchanged, with interest rates remaining low until well after the Federal Reserve has made a move. This in turn means it may take longer before banks and insurers get the tailwind they anticipated from higher interest rate rises and steepening yield curves. Given the market circumstances, both banks and insurers are focusing their efforts on fee businesses and generating customer loyalty.

Operational improvement in focus

The current low interest environment and flat yield curve is putting banks' net interest income under pressure. Regulation requiring that they hold significantly higher stocks of low yielding liquid assets, whilst also capping maturity transformation is causing significant strain.

To cope with this shift, banks need to explore all opportunities to reprice their current book and find higher yielding assets, without unduly increasing risk. Diversification by increasing fees may be a solution, but only for those who really have an edge to play in specific niche markets.

The average C/I ratio shows a clear downward trend, and in Q1 2015 is at a median of 56% for a large group of European banks (industry research views 45% as a long-term target for European retail banks). Based on industry research, regulatory pressures could cause a further 4% reduction of RoE to 6% for retail banking in Germany, France, Italy and the UK combined.

However, reported RoEs of the largest European banks increased in Q1 2015 to between 5 – 11%, supported by fairly low loan losses as banks had replenished their provisions in advance of the AQR.

A&M VIEW

"Considerable operational improvement still required"

Banks are currently being pushed to make tough decisions on multiple fronts. Increased capital, liquidity and ring fencing requirements are increasing the costs of doing business. New regulations regarding "Know Your Client" and client centricity are also forcing banks to reconsider their operating models.

Significant technological enhancements are enabling new players to enter the market, which is putting additional pressure on banks to clearly differentiate themselves against competition, as well as assess how they operate internally with regards to legacy systems and efficient deployment of their workforce.

Shareholders are now demanding banks start to post returns that are commensurate with the investment risks they offer. As a result, the banking industry is being forced to adapt quickly and reduce its cost base, whilst at the same time transform their business and operating models.

EUROPEAN FINANCIAL INSTITUTIONS OBSERVATIONS

Deleveraging still to start

Regulatory pressure on the banking sector is significant with the IIF estimating the impact of new regulations on economic growth in the Eurozone to amount to 0.9% GDP p/a. Still, new regulatory initiatives have started to force the industry to implement change.

As trust in risk models has waned, regulators have taken the step to put more emphasis on (simple) leverage ratios to reduce the potential systemic impact of a bank failure. The U.S. has increased the leverage ratio to 6% and the ECB has confirmed it sees merit in the leverage ratio as a tool to increase the stability of the banking sector.

Actual leverage ratios continue to hover around 5% for the sector and total assets have even increased by roughly €2trn since Q4 2013 (source: ECB). At the same time, the RWA/TA ratio is increasing (source: EBA KRI) which means new assets are generally higher risk weighted.

A&M VIEW

"Impact from leverage caps and limits to risk models"

Through the increased focus of regulators on limiting leverage, banks are placing more scrutiny on the actual risk adjusted return of their assets. This could lead to the reallocation of capital to higher revenue generating (and potentially more risky) assets, with banks shedding lower yielding but generally better collateralised assets.

The outcome of the AQR has put some comfort around the quality of the bank balance sheets; the EBA and ECB have refocused their attention on internal models. This will most likely result in higher risk weights applied to asset classes, which will force banks to yet again assess the risk/reward profile of their assets.

Increased interest from private equity / infrastructure funds

Increased regulatory requirements are forcing banks and insurance companies to refine the definition of their core activities. Regulation for example, impacts banks' ability to compete in the market for longer maturity lending. This poses opportunities for specialist funds that focus on offering longer term asset based, big ticket (infrastructure) lending.

Under the new regulations, activities that no longer have the right risk/reward profile are being considered for divestment. This has led to a significant uptick in transactions of both loan portfolios (a particularly hot market right now) and servicing capabilities for specific loan types, such as small/medium-sized enterprises and Commercial Real Estate.

Now that private equity funds have replenished their reserves through raising new funds (industry research indicates globally funds raised $499bn in 2014), they have started to explore financial industry opportunities where further consolidation particularly amongst service providers may occur and potential for operational improvement exists.

A&M VIEW

"M&A market fuelled by changes in business models"

The long awaited development of a capital market providing financing to businesses has arrived. Due to higher capital requirements imposed on banks and insurers, some types of financing (particularly longer-term) are now more efficiently provided by funds.

Operational improvements that can be achieved in some areas (particularly retail, commercial banking and life insurance) due to recent technological developments offer attractive opportunities to private equity firms.

Various financial supervisors have confirmed that the sector needs change and acknowledge that private equity can facilitate the necessary transformation.

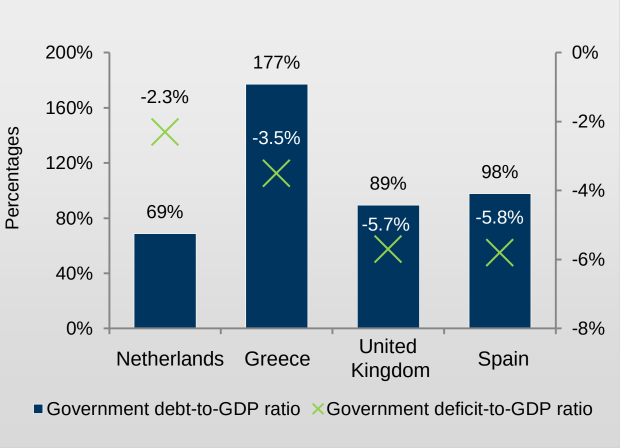
A&M is well positioned to support funds and private equity to better understand the investment opportunities that are arising across Europe and can help clients on opportunities to create value from specific investment situations.

In the current financial sector environment, many companies need the support of experienced professionals, who can work alongside management to develop and deliver solutions to complex problems. Founded in 1983, Alvarez & Marsal is known for its distinctive restructuring heritage, hands-on approach and relentless focus on execution and results. With clients across the financial sector, A&M can:

- Support management teams in realising change and adapt to the significant regulatory and technological developments
- Work with management to optimise cost and capex
- Analyse asset performance and portfolio prioritisation to identify divestiture opportunities
- Improve internal planning and financial control processes and systems
- Assist companies pursuing acquisitions, mergers or divestitures with financial and operational due diligence, valuation, tax structuring and acquisition/carve-out integration planning and execution.

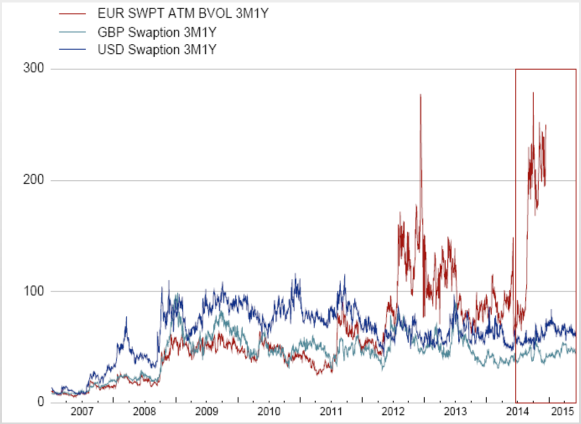
KEY MARKET SIGNALS

Government debt & deficit-to-GDP ratio



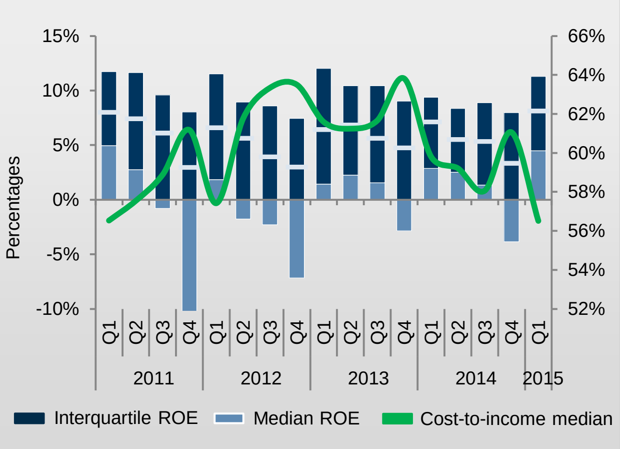
Source: ESRB Risk Dashboard June 2015

Short-term interest rates - volatility



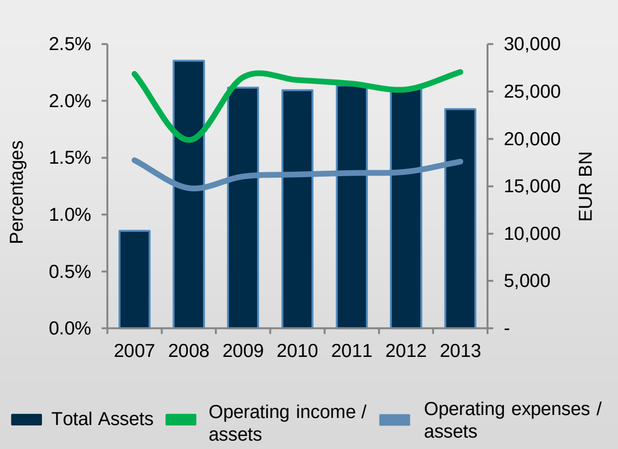
Source: ESRB Risk Dashboard June 2015

ROE and Cost-to-Income



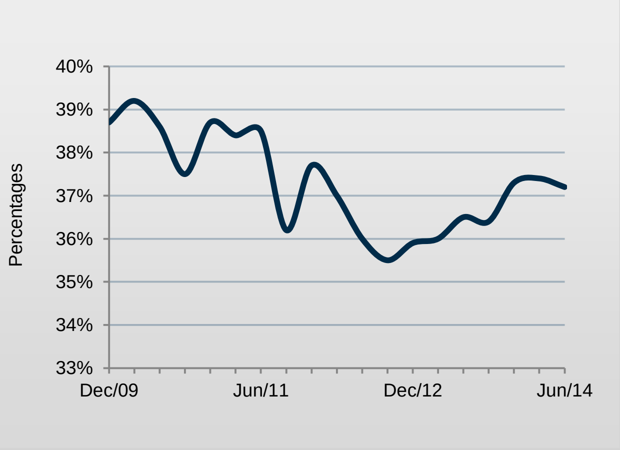
Source: ESRB Risk Dashboard June 2015

Operating income - expenses / Total assets



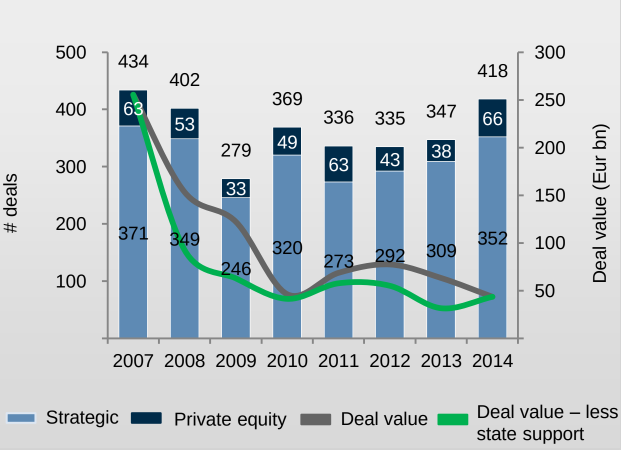
Source: ECB consolidating banking data (excluding central banks)

RWA / Total assets



Source: EBA Risk assessment of the European banking system December 2014 (KRI)

Deal activity Financial Services EU



Source: Mergermarket, A&M analysis

CONTACT US

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Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) when conventional approaches are not enough to activate change and achieve results.

Privately-held since 1983, A&M is a leading global professional services firm that delivers performance improvement, turnaround management and business advisory services to organizations seeking to transform operations, catapult growth and accelerate results through decisive action. Our senior professionals are experienced operators, world-class consultants and industry veterans who draw upon the firm's restructuring heritage to help leaders turn change into a strategic business asset, manage risk and unlock value at every stage.

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