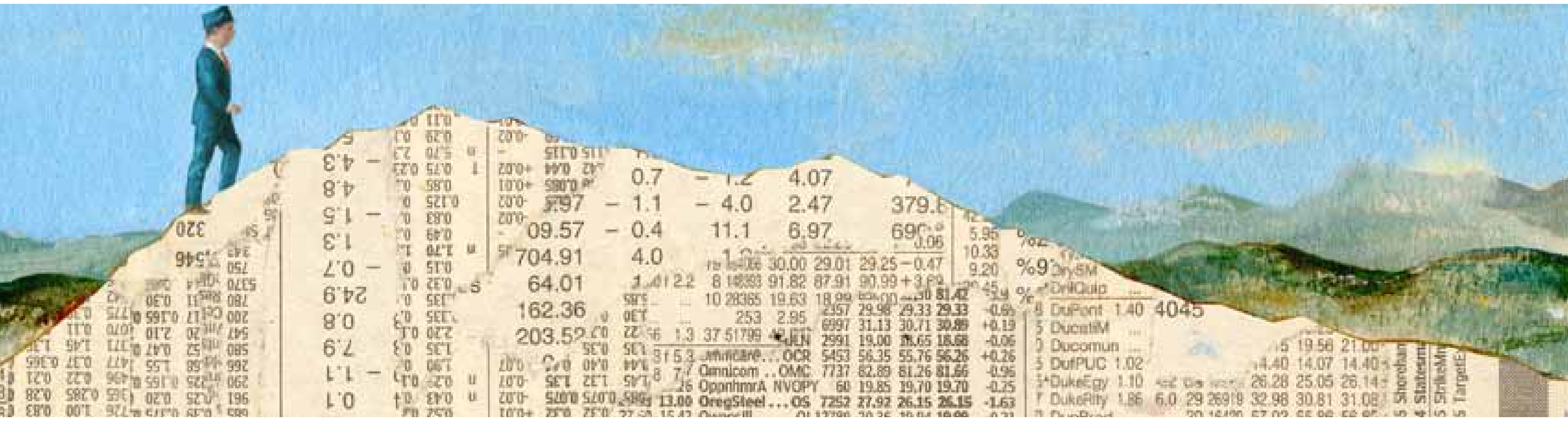


How European corporate banking survived the crisis: An analysis

McKinsey's Corporate Banking Profit Pools, an annual research effort, looks at the industry's varied dynamics.

Helmut Heidegger, Ralph Heidrich, and Bernhard Klement

The news on corporate banking in Europe is mixed. On one hand, profits in 2009 sharply declined for the second year in a row. Net profits (before cost of capital) were down roughly two-thirds from 2007 levels (Exhibit 1), translating into an average return on equity (ROE) in the low single digits. Increased risk costs have been a major challenge. Nor does the future look much brighter: new regulations are on the horizon, such as Basel III, liquidity regulation, and bank-specific taxes, all of which will likely affect profits.

On the other hand, industry revenues (which we define as the complete customer revenues from all products sold to midsize and large corporations, before risk cost) remained fairly stable in 2009. The decline was a modest 3 percent (Exhibit 2). The pattern was similar in all major Western European markets, including the United Kindom, Germany, Italy, France, and Spain. Even in Central and Eastern Europe, with their very different banking economics, revenues stayed on course, continuing along a slow and steady growth trajectory.

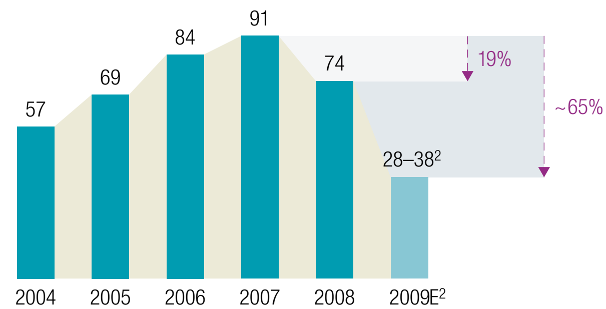
What exactly were the forces at work? In this article we will illustrate how risk costs turned a stable top line into falling product profitability. This remains an important topic, as risk pressure is unlikely to subside any time soon. Banks may now have a better understanding of their bad loan portfolios, but in some markets risk cost may rise still further.

Exhibit 1

Collapsed profits

European corporate banking net profits in 2009 declined for the second year in a row, down roughly two-thirds from 2007 levels.

Profit pool,[1] € billion



[1] Before cost of capital; Western Europe and Central and Eastern Europe.
[2] Upper end of range: annualized Q1–Q3 data; lower end: discounted for potential Q4 charges.

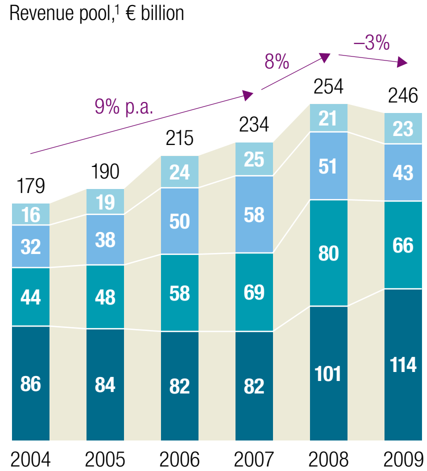
Source: Annual/quarterly reports; McKinsey Corporate Banking Profit Pools

Exhibit 2

Revenues stable before risk costs

Industry revenues remained fairly stable in 2009, declining only 3%.

Revenue pool,[1] € billion



	Annual growth, % 2004–07	2007–08	2008–09
Capital markets/corporate finance	15	–14 ▼	7 ▲
Specialized finance[2]	22	–11 ▼	–16 ▼
Cash management	16	15 ▲	–18 ▼
Straight loans	–2	23 ▲	13 ▲
Eastern Europe's share of revenue pool, %	28	32 ▲	11 ▲

2004	2005	2006	2007	2008	2009
8	10	11	13	16	18

[1] Before risk cost, after liquidity premium; Western Europe and Central and Eastern Europe.
[2] Leasing, factoring, trade finance, structured loans, and arrangement and underwriting for syndicated loans.

Source: McKinsey Corporate Banking Profit Pools

Beyond the risk current that is shifting the industry, liquidity and funding costs are also making waves in this lending-heavy—but not lending-only—business. Our research shows that these costs have generated some surprising shifts in the performance of products and segments. For many observers these shifts have been more obscure than usual. And yet they were significant overlays to sales performance in 2009—indeed, in many cases the effects on the P&L were bigger than the results from sales efforts.

Bear in mind that in this article, we share only high-level and aggregate views; the picture varies considerably by region. Nor do the industry's results hold true for every institution. Nonetheless, while several leading banks bucked the trends we describe here, for the average corporate bank, 2009 was a truly challenging year.

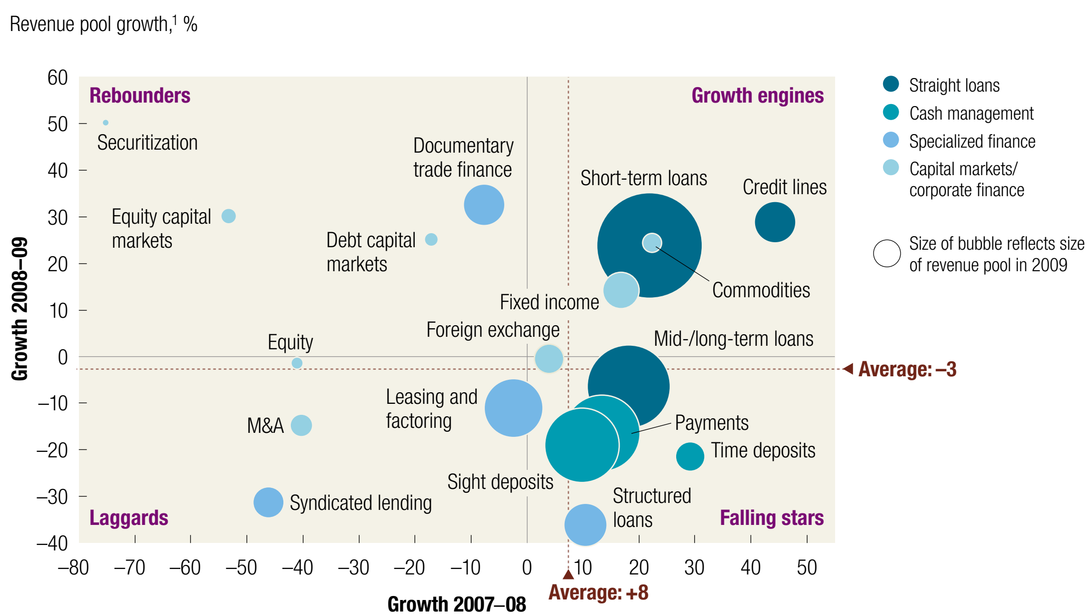
A study in diversity

The relative stability of corporate banking during the crisis was somewhat predictable—after all, corporate business activities are fairly stable, and even distressed companies continue to need banking services. But the products that make up corporate banking took many different roads during the crisis (Exhibit 3). (See box on p. 59 for McKinsey's Corporate Banking Profit Pools methodology.) Four of these products are particularly noteworthy and should provide food for thought as corporate bank leaders plot their strategies for a post-crisis world.

Exhibit 3

Radical differences across products

The products that make up corporate banking took many different roads during the crisis.



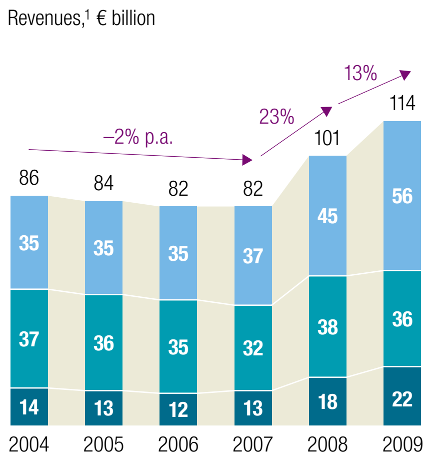
[1]Before risk cost, after liquidity premium; Western Europe and Central and Eastern Europe.

Source: McKinsey Corporate Banking Profit Pools

Exhibit 4

Straight loans continued to grow

Total outstanding loan volumes were up 13% in 2009.



Annual growth, 2007–09	Revenues,[1] %		Volumes, %		Margin,[1] basis points	
	2007–08	2008–09	2007–08	2008–09	2007–08	2008–09
Short-term loans	22	24	12	–1	20	60
Mid-/long-term loans	18	–7	13	14	6	–24
Other[2]	35	28				

[1]Before risk cost, after liquidity premium; Western Europe and Central and Eastern Europe.
[2]Includes credit lines and off-balance-sheet guarantees.

Source: McKinsey Corporate Banking Profit Pools

Lending

Many expected that during the crisis, with all banks under capital pressure, lending would be limited. Exhibit 4 reveals that, in fact, total outstanding loan volumes were up 13 percent in 2009 after an earlier increase in 2008 (23 percent). Growing volumes were the net result of several factors. To be sure, many banks were clearly more selective in new lending. But in straight loans, the constraining capital pressure on new lending activities was more than made up for by other forces: public pressure to finance small and midsize enterprises, the effects of closed securitization markets, straight loan substitutions for syndicated loans, clients' higher utilization of existing credit lines, and shifts to shorter maturities at the beginning of the crisis (which rebalanced toward mid- and long-term loans in 2009).

With repricing initiatives across the industry, many also thought that margins would be up. This turned out to be true only in a superficial sense. Lending margins before risk costs (but including liquidity costs) expanded strongly in 2009 (by about 20 basis points across the entire book; new-business margins increased even more). This came on top of a similar increase in 2008 (about 15 basis points). Price increases for short-term loans were the primary driver; margins on these loans were on average up 60 basis points in 2009, on top of a 20 basis points gain in 2008. The repricing of mid- and long-term loan books had been slower, and the hit from liquidity costs was heftier than for short-term loans. We found that for mid- and long-term loans, margins before risk costs increased only slightly in 2008 and actually started to fall over the course of 2009.

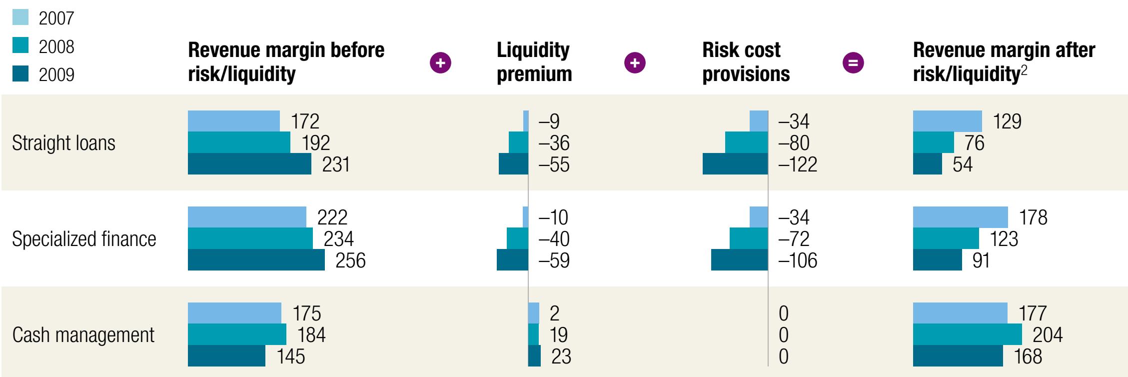
When we take into account the costs of risk (that is, loss provisions), we get a very different view of margins, and of products. After factoring in risk costs (on top of liquidity premiums,

Exhibit 5

Risk and liquidity charges eviscerate margins

After factoring in risk and liquidity costs, average straight lending margins fell to less than half their pre-crisis levels.

European margins,[1] basis points



[1] Includes Western Europe and Central and Eastern Europe; specialized finance includes only structured loans, leasing, and factoring; cash management includes only sight and term deposits.
[2] Some figures may not sum precisely, because of rounding.

Source: McKinsey Corporate Banking Profit Pools

as mentioned), average straight lending margins fell to less than half their pre-crisis levels (Exhibit 5). Risk costs more than tripled, adding roughly 90 basis points. Most corporate banks have repriced their straight loan books but have clearly not been able to pass these higher costs along in full to their clients. Straight lending margins settled in 2009, net of risk costs, at about 50 basis points, well down from approximately 130 basis points in 2007. Pricing variances remain large and suggest opportunities to capture value. Similarly, repricing of specialized finance margins seems neither complete nor yet fully coherent.

These problems are likely to persist. While liquidity spreads have been easing since their peak immediately after the collapse of Lehman and seem set to further normalize, in the future three new factors are likely to boost costs and weigh on lending profitability. First, emerging new regulatory liquidity requirements (for example, the ILAS[1] regime to be phased in by the UK's Financial Services Authority in 2010–11) will require larger and higher-quality liquidity buffers at banks, bringing potentially sizable new liquidity cost burdens. Second, new regulatory capital requirements seem certain to call for banks to put larger capital cushions behind their activities. New populist pressures may well reinforce this regulatory tightening, through the imposition of new banking taxes, for example. Third, in some markets, risk costs are likely to continue their rise. Especially in the mid-corporate segment and in CEE markets, it seems that delinquency rates have not yet peaked. These dynamics will make adequate pricing of straight loans and specialized finance products a particular challenge in 2010.

Cash management

With wholesale funding scarce, cash management was widely expected to perform well in the crisis. This turned out to be true only in a limited

[1] Individual liquidity adequacy standards.

sense. Banks did develop a newfound appreciation of deposits as a comparatively accessible and cheap source of funding. As a result, deposit stocks grew slightly at the start of the crisis.

But margins dropped precipitously; depending on their loan/deposit ratio and their access to other refinancing sources, many banks priced aggressively in their pursuit of deposits. This was particularly true for sight deposits, where margins dropped by an average 45 basis points in 2009. Term deposits were less sought after and remained relatively stable. To be sure, this drop came after the softening effect of the rolling hedging protections that many banks use as part of their asset-liability management. Nonetheless, the fall in margins was substantial, particularly affecting the United Kingdom, France, and Spain. The only exceptions to the trend were those Central and Eastern European countries that saw big interest-rate increases.

At these margins, total European cash-management revenues were down by 18 percent in 2009 after 15 percent growth in 2008. Even worse, in 2009—despite this cutthroat pricing approach—the industry in aggregate could no longer attract additional net new money (though some banks succeeded at this).

It should be noted, however, that despite its problems, cash management still did better than lending products. It benefited from additional liquidity value, an average increase of some 20 basis points through treasurers' transfer prices (on a behavioralized basis). And of course it had no risk-cost problems. Relatively speaking, then, cash management was indeed the star, muted but still twinkling, of 2008 and 2009.

In 2010 corporate banks will find it difficult to maintain deposit stocks. The "hot" money expensively collected early in the crisis may be at risk of melting away as corporate clients reinvest their cash in a more benign macroeconomic setting. Banks will also face continued pressure on deposit margins, as the hedging programs many use are creating an inertial drag. To tackle the challenge, banks will have to restore their focus on the product itself. For example, the development of truly value-added cash-management solutions and pricing approaches that avoid handing over the entire surplus to the customer could do much to restore profits.

McKinsey's Corporate Banking Profit Pools

Data, analyses, and conclusions in this article are derived from our extensive proprietary database. It includes revenues, volumes, and a simplified P&L of all global corporate banking activities broken down by countries, detailed products, customer segments, fee versus interest income, and year. Its content is built from three sources:

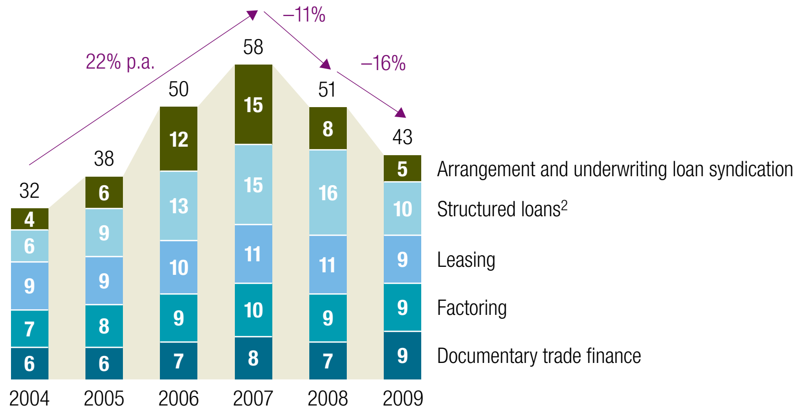
- As a starting point, we use publicly available data, such as national central bank statistics on outstanding lending volumes
- In areas with limited or opaque public data, we use aggregated information from our annual surveys (for example, the Global Corporate Banking Survey and the Global Capital Markets Survey), which cover a large proportion of European corporate banks, including most of the leading institutions
- To validate results and fill remaining gaps, we use systematic expert interviews and dedicated research efforts

Exhibit 6

Specialized finance had a mixed picture

Specialized finance was highly varied, and not as negative as many thought.

Revenues,[1] € billion



[1] Before risk cost, after liquidity premium; Western Europe and Central and Eastern Europe.
[2] Includes corporate leveraged and acquisition finance, project finance, and structured trade/commodity/asset finance.

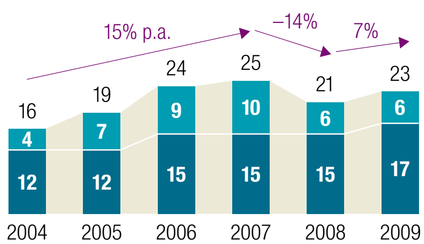
Source: McKinsey Corporate Banking Profit Pools

Exhibit 7

Investment banking products were resilient

Many predicted that corporate finance activities would collapse in the crisis, but the reality was more nuanced.

Revenues,[1] € billion



Annual growth, 2007–09 (▲ 2007–08, ▲ 2008–09)

	Revenues,[1] %		**Volumes,** %		**Margin,**[1] basis points	
	2007–08	2008–09	2007–08	2008–09	2007–08	2008–09
Corporate finance[2]	–41	2	–54	9	27	–8
Capital markets[3]	3	8				

[1] Before risk cost, after liquidity premium; Western Europe and Central and Eastern Europe.
[2] Includes equity capital markets, debt capital markets, M&A, securitization, and other advisory.
[3] Includes fixed income, foreign exchange, commodities, equity, and securities services.

Source: McKinsey Corporate Banking Profit Pools

Specialized finance

Specialized finance was not as comprehensively negative as many thought. Exhibit 6 summarizes the highly varied picture for specialized finance. Some activities were hit hard. Volumes of syndicated loans (which generate arrangement and underwriting fees) declined to half their 2007 level in 2008 and stagnated throughout 2009; relatively small margin improvements could hardly compensate. Structured loans were also a clear victim of the crisis, even with corporate clients: although the product managed to keep momentum in 2008 (when volumes were up by 6 percent and revenues by 11 percent), in 2009 structured loans experienced the expected drop (revenues fell by 36 percent) as volumes finally gave in (falling 18 percent). Leasing revenues also suffered, largely driven by the difficulties of independent leasing companies in gaining access to wholesale funding.

On the other hand, those specialized finance products that are closely linked to the underlying flow of corporate business activities, such as documentary trade finance and factoring, fared much better. In 2009, documentary trade finance revenues were some 20 percent higher than in 2007, with repricing more than compensating for volume losses. In factoring, not much repricing was seen, leaving revenues fairly flat.

Corporate finance and capital market products

Many predicted that corporate finance activities would collapse and risk-management products would boom in the crisis. Exhibit 7 shows that the reality was much more nuanced. In early 2009, corporate finance activities (bond and equity issuances, M&A, securitization) had already begun to recover, driven by a fresh run of bond and equity issuances by large corporations. Over the year, revenues started to grow again modestly, after a sharp 40 percent drop in 2008.

Indeed, for corporate clients, capital market products (that is, derivatives and cash securities) did better than corporate finance. While it wasn't exactly a boom, they generated modest but stable growth in revenues due to fairly robust underlying corporate business activities and an increased demand for risk-management products such as interest-rate and foreign-exchange protections.

Overall, corporate finance and capital market products grew by 7 percent in 2009, after a 14 percent decline in 2008. This was better than many expected and, surely, much better than the headline-making losses investment banks accumulated in both institutional sales and trading and proprietary trading.

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In sum, 2009 was a challenging year for the average corporate bank, and 2010 will probably not be much better. Loan businesses are unlikely to boost 2010 P&Ls, given the sustained risk pressure and reemerging threats to contribution margins. Cash management remains an interesting opportunity, but only in a very difficult market context. Successful corporate banks will need to forcefully think through pricing, cross-selling, and cost efficiency to bolster profitability.

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