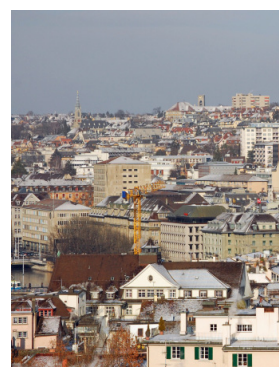


McKinsey Working Papers on Risk, Number 36



Day of reckoning for European retail banking

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Day of reckoning for European retail banking

Executive summary

Europe's retail banks are now entering a period of regulatory reform that looks certain to substantially affect revenues, profits, and margins, and perhaps alter the time-honored ways that these institutions conduct their business. New McKinsey research has estimated these effects. Key findings include:

- As a result of new global, regional, and national regulations, and absent any mitigating action by banks or material changes in the economic and competitive environment, return on equity (ROE) for retail banking in Europe's four largest markets is expected to fall on average from about 10 percent to 6 percent, a decline of 41 percent. This analysis is based on 2010 financial-year data and assumes that the cumulative regulatory impact expected over the next several years is realized immediately.
- These four markets will see the following drops in ROE:
 - France from 14 to 10 percent (a 29 percent decline)
 - Germany from 7 to 4 percent (47 percent)
 - Italy, from 5 to 3 percent (40 percent)
 - The United Kingdom from 14 to 7 percent (48 percent)
- The retail-banking activities of banks that qualify as global systemically important financial institutions (G-SIFIs) will be subject to a further ROE decline of between 0.4 and 1.2 percentage points.
- While Basel III is the single most important source of these effects, it is the cumulative impact of many regulatory initiatives that drives the decline in ROE.
- Among asset-based products, mortgages are particularly hard hit. Among liability products, investment products and debit cards are hit hardest, especially in the United Kingdom.
- It is unlikely in the short-to-medium term that the industry will come back to the returns it achieved prior to regulatory reform. But individual banks can rebuild ROE to preregulation levels by pulling all of the four levers available to them:
 - Reduction of capital and funding wastage through technical optimization can rebuild between 30 and 160 basis points.
 - Capital- and funding-light operating models can improve ROE by 10 to 80 basis points.
 - Some selective repricing may be possible.
 - Substantial business-model realignment is the single most important lever.
- Banks should develop a regulatory mitigation road map, which can be embedded into a comprehensive strategic review, to rebuild ROE step by step.

Given the breadth of regulatory reform and of its implications for the future of the retail-banking business, and the wide range of actions we believe retail banks must embrace in response, this paper can provide only an overview. We refer the reader to more detailed research we have published on several related topics.¹

¹ For more on reducing capital and funding wastage and capital- and funding-light operating models, see "Hidden in plain sight: The hunt for banking capital," *McKinsey on Corporate and Investment Banking*, January 2010 (mckinsey-quarterly.com). For more on repricing and business-model realignment, see a forthcoming companion white paper on future retail-banking models, to be published in Summer 2012 on mckinsey.com. For more on regulatory reform and its effects on banks, see our series *McKinsey Working Papers on Risk* (mckinsey.com).

The coming wave of regulation

Some four years after the turmoil in financial markets began, a comprehensive reform of banking regulation is now arriving in Europe. To many observers, both within the industry and outside it, the new rules are arriving at an opportune moment, as the industry is embroiled in yet another crisis. Regulation will have to catch up to the evolving problems, but it is clear that this may be a once-in-a-generation opportunity to put the industry on a firm regulatory foundation and restore it to its essential and vital role in the financial system.

Capital-markets businesses come in for the most critical treatment in the new crop of regulations.² Consequently, most universal banks have rightly focused their time and investments on coping with the effects of new regulation on those businesses. Retail banking has received less attention. On the face of it, the regulatory impact on retail banking appears to be moderate. Basel II.5 and Basel III increase, in some cases dramatically, risk weightings for wholesale-banking products, while risk weights for retail products are largely unaffected. Basel III affects retail-banking capital needs mostly through higher capital ratios that affect all businesses. At first sight, retail banking even appears to be the beneficiary of funding rules under Basel III because retail deposits are critical for the future funding of universal banks.

However, a closer look reveals that European retail banking will be severely challenged. First, the impact of Basel III on retail banking, while less than on wholesale banking, is not small. Second, there are many other regulatory initiatives on the European and national levels. While each of them appears manageable individually, their aggregate impact is severe. Third, retail banking's ROE starts from a much lower base than ROEs in capital-markets businesses, and even a small impact from regulatory reform might push ROE below the cost of equity. Finally, mitigating the regulatory impact in retail banking is quite difficult (though not impossible), as adjustment of business models (branch networks, long-duration portfolios, and so on) takes much longer than in capital-markets businesses, where trading desks and positions can typically be shifted more quickly.

This paper is devoted to helping European retail bankers understand the changes to come, and the actions they can take to rebuild ROEs step by step. To some, this may not appear to be the first priority in light of the continued euro crisis. Some of them are rightly focusing on their own survival, rather than on their long-term business model. However, one big reason why they and other less challenged banks currently suffer from low valuations and have difficulty raising capital is investors' legitimate concern about their profitability. We would argue that because of that concern, even those banks focused on short-term issues must also think about how they can rebuild their ROEs and ensure the long-term sustainability of the bank.

Totting up the costs of regulation

Higher capital requirements have received lots of headlines lately. At the time of this writing (July 2012), new requirements based on the stress tests of the European Banking Authority (EBA) have come into force, requiring European banks (of all kinds, including retail-oriented institutions) to raise €114 billion. New capital requirements that will kick in during the transition to Basel III will require banks to close a further capital gap of another €200 billion by 2015. And when the new Basel III rules come into full force in Europe, by January 2021, banks will have to find yet more capital. All told, based on their 2010 balance sheets, European banks will need to raise about €1.1 trillion before 2021.

This comes at a time when European retail banks are already challenged. In our analysis, the vast majority of European retail banks failed to cover their cost of equity (which we estimate at about 10 percent) in 2010; and a good many actually had negative returns on equity.

² *McKinsey Working Paper on Risk, Number 29: "Day of Reckoning? New regulation and its impact on capital-markets businesses"* (mckinsey.com).

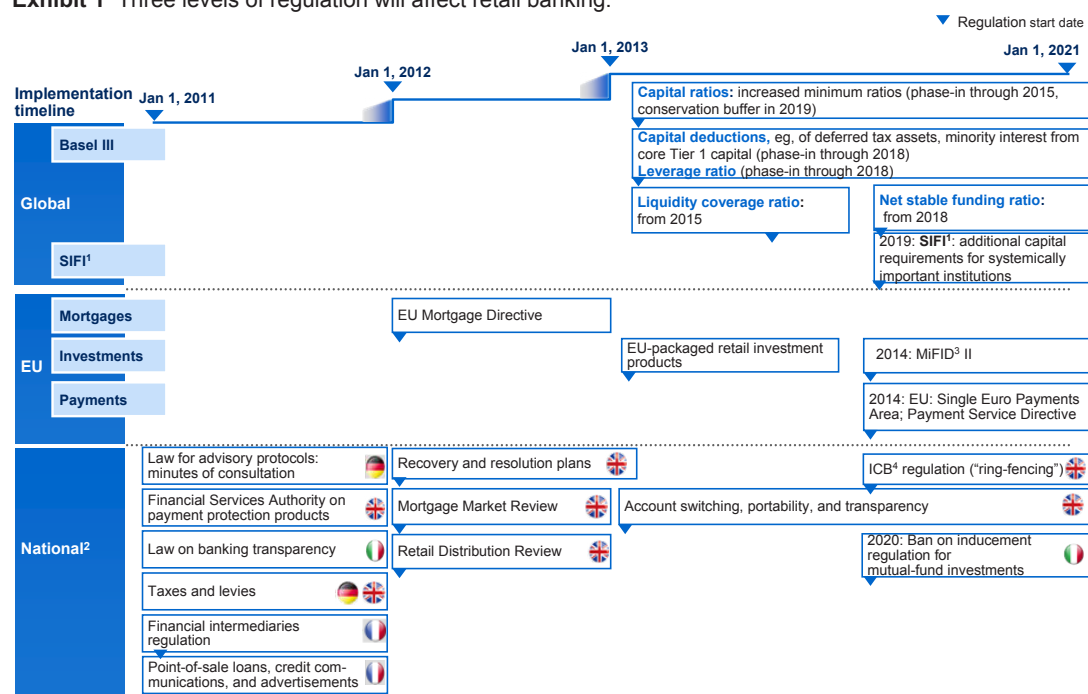
But higher capital charges are only the beginning. Three categories of rules (global, EU-wide, and national), arriving in several batches between 2011 and 2021, will also raise costs for liquidity, funding, compliance, and other activities (Exhibit 1). To understand the full range of effects, we have analyzed the impact of each of 39 new sets of rules, on each of the main retail-banking products, in each of the four largest European markets. (The approach is similar to that used by our colleagues in analyzing the effect of new rules on the capital-markets businesses.³)

Scope of our research

More specifically, we set the following as the scope of our research:

- **Regulations.** The full list of regulations we studied can be found in Appendix 1, on page 18. In addition to the 22 national regulations assessed, key European and global regulations include:
 - Basel III, a regulatory framework issued by The Basel Committee on Banking Supervision (BCBS). Basel III builds on earlier frameworks Basel II and Basel II.5, which were implemented in the EU through the Capital Requirements Directive (CRD) and its successors CRD II and CRD III. Basel III is a package of long-term changes due to commence on January 1, 2013 and expected to be complete by 2021. Basel III will be implemented through CRD IV, which will include both directly applicable EU regulations, in the form of a “single rulebook,” and a directive for other regulations, which will require implementation through national law. CRD IV will subsume and replace all the previous CRDs. We assume that the current proposal will be implemented as

Exhibit 1 Three levels of regulation will affect retail banking.



¹ Systemically important financial institutions.

² France, United Kingdom, Germany, and Italy.

³ Markets in Financial Instruments Directive.

⁴ Independent Commission on Banking (United Kingdom).

Source: Basel Committee on Banking Supervision; current regulatory discussions

³ “McKinsey Working Paper on Risk, Number 29: “Day of Reckoning? New regulation and its impact on capital-markets businesses” (mckinsey.com).

written, despite ongoing discussions about potential adjustments. We also include the potential impact from two key provisions of Basel III, the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR), while acknowledging that neither has been finalized by the BCBS and the EBA and both are likely subject to change.

- European Union directives on mortgages, Markets in Financial Instruments Directive II (MiFID II), Packaged Retail Investment Products, and Single Euro Payments Area (SEPA).

We have not included some non-European regulations that also affect European banks (for example the Foreign Account Tax Compliance Act, a US law that requires all banks, US and foreign, to provide information about the investments of American customers). Also, the estimates of impact in this paper do not take into account the capital surcharge for G-SIFIs, as this surcharge does not affect all banks and is not the same for each G-SIFI. (We have however estimated the additional impact of a G-SIFI capital surcharge on retail banks; and we have analyzed the requirement that G-SIFIs establish recovery and resolution plans; see “G-SIFI rules and retail banks” on page 9)

Products (Exhibit 2). These include asset-based products (personal loans, mortgages and small-business loans, credit cards, and overdrafts,) and liability-based products (current-account deposits; non-current-account deposits; investment distribution, including securities, derivatives, and mutual funds; debit cards; insurance and pension distribution; and transactions, including transfers, direct debits, checks, and standing orders).

Markets. We studied the four largest European markets—France, Germany, Italy, and the United Kingdom—comprising 66 percent of all European Union (EU-27) retail-banking volumes. To understand the impact for the entire European Union, we calculated a weighted average of the ROEs of the four countries, and used this as a proxy.⁴

Exhibit 2 We analyzed the full range of retail-banking products.

Description, how we measure		
Asset-based products	Credit cards	<ul style="list-style-type: none"> Traditional credit cards, private label and shopping cards, charge cards Outstanding volume (revolving balance, including cash advance)
	Small-business loans	<ul style="list-style-type: none"> Professional loans (self-employed, sole proprietors); other companies too small to be included in traditional SME² category (total volume outstanding)
	Mortgages	<ul style="list-style-type: none"> Housing loans and home-equity loans granted to individuals Volume on the balance sheet plus volume securitized and sold
	Overdrafts	<ul style="list-style-type: none"> Total outstanding overdrafts on current accounts as well as outstanding balances of non-card-related revolving credit
	Personal loans	<ul style="list-style-type: none"> Auto loans, unsecured cash loans, point-of-sale loans Total volume outstanding
Liability-based products	C/A ¹ deposits	<ul style="list-style-type: none"> Current-account deposit volumes (excluding flow-type transaction volumes)
	Non-C/A ¹ deposits	<ul style="list-style-type: none"> Savings deposits, redeemable at notice but held in a separate savings account and usually cannot be used for payments or ATM withdrawal (total volume) Term deposits with agreed-on maturity (total volume)
	Investments	<ul style="list-style-type: none"> Total volume of managed and nonmanaged distribution of securities (shares, bonds, and certificates) and of mutual funds
	Debit cards	<ul style="list-style-type: none"> Debit-card payments, total transaction amount
	Insurance	<ul style="list-style-type: none"> Gross premiums of life and residential nonlife insurance distributed Gross inflow of private and corporate pension funds distributed
	Transactions	<ul style="list-style-type: none"> All means of transactions, eg, transfers, direct debits, checks, and standing orders, including cash remittances from abroad

¹ Current account.

² Small and medium-size enterprise.

Our methodology

We estimated the impact on capital, revenues, costs, and profit margins of all relevant regulations on each product in each of the four markets, using return on equity as our standard metric. ROE, which is widely used in wholesale banking but less so in retail banking, at least at the product and segment levels, reflects the impact of regulation on both the P&L and on capital. Importantly, we estimated impact using 2010 as the reference year; in other words, we modeled all the impact from 2010 through 2021 as if it had happened all at once, in 2010. The logic for doing so is to show the cumulative effect while avoiding the inevitable error that comes with projecting revenues and profits several years into the future.

We assume pre-reform Tier 1 capital ratios of 9 percent in Italy, 10.5 percent in Germany and France, and 11 percent in the United Kingdom, in line with the Tier 1 ratios of representative banks in each market in 2010. Based on the capital requirements entailed in Basel III, the EBA's current 9 percent requirement, and the United Kingdom's recommendation, via the Independent Commission on Banking, of a 10 percent capital ratio for retail banks, we assume that across all four countries, postreform Tier 1 ratios will converge toward 11 percent. This includes a capital cushion of two percentage points that we expect continental banks to hold on top of a regulatory minimum of 9 percent, and a one percentage point cushion on top of the 10 percent regulatory minimum for UK retail banks. In addition, we have applied a 20 percent buffer (that is, about another two percentage points) necessary to meet higher capital-quality standards under Basel III, and to make the capital definitions of Basel II and III comparable.

We modeled the impact on both the numerator and denominator of ROE—that is, the effects of higher costs and lower revenues on returns and the effect of higher capital requirements on equity. For asset-based products, we calculated the effect of new regulatory costs as a reduction in profit margins, or returns, and the new levels of Tier 1 capital, or equity, required to support each product. For liability-based products, only the effect on returns matters. For a full explanation of our methodology, see Appendix 2.

Our data are taken primarily from McKinsey's long-standing research into banking revenues and profits, Global Banking Pools (GBP).⁵ GBP uses publicly available data and the expertise of our consultants based in all the leading banking markets worldwide. The GBP model includes 68 countries, in which 98 percent of total banking assets are covered; in each country, 56 products are analyzed. The methodology used for GBP is explained in Appendix 3. We also drew on McKinsey's Global Payments Map, another proprietary database that covers 43 countries comprising roughly 95 percent of worldwide payment revenues.

Our calculations are not risk adjusted, which means that we do not fully distinguish between regulations that reduce both ROE and risk (for example, Basel III) and those that only lower ROE (but may also have other positive benefits, such as increasing customer rights; the EU mortgage directive is an example). We have not assigned a value to potential risk-reducing effects of the regulation; for example, we have not assessed a potential reduction in investors' required returns due to lower leverage and more conservative funding. Moreover, we modeled the first-order impact of regulation only and did not include second-order effects from changes to the competitive landscape and to market prices.

Severe pressure on ROE

Consider first the impact at the highest level, on national and continent-wide retail-banking markets.

We estimate that for the four largest markets as a whole, retail ROE will fall from about 10 percent to 6 percent, a drop of 41 percent. (Again, we calculate the cumulative effect of regulation as if the rules took effect immediately.) The impact on the broader European market will also be material, as the four markets analyzed represent 66 percent of the EU-27 retail-banking market and are quite similar to the remaining smaller markets with respect to profitability, capitalization, and funding, and their regulatory approaches are similarly heterogeneous. (Countries that have been particularly hard hit by the European sovereign and banking crisis, such as Greece, may be exceptions.)

5 solutions.mckinsey.com/globalbankingpools.

Each of the four national markets studied in detail will come under severe pressure:

- In France, ROE will fall from 14 percent to 10 percent (a drop of 29 percent), driven by changes affecting mortgages, debit cards, and investments. Many of the country-specific changes were already implemented in 2010. Because we used 2010 as our reference year, these effects are already in the baseline.
- In Germany, ROE will fall from 7 percent to 4 percent (a drop of 47 percent). All asset-based products will see returns fall well below the cost of capital. Of the liability products, investments and debit cards will be affected the most, because of MiFID II and new payments regulations.
- In Italy, ROE will drop from 5 percent to 3 percent (a decrease of 40 percent). Even before new regulation, returns had fallen from historically high levels because of a rise in the cost of funding, shrinking volumes in investment products, and a significant increase in nonperforming loans. Regulation will add to the burden, mainly because the current Tier 1 ratio is lower in Italy (9 percent) than elsewhere. As in France, many of the new national rules with the bigger impact have already come into force.
- In the United Kingdom, returns will fall from 14 percent to 7 percent. The impact here, 48 percent, is high because of extensive country-specific regulation. The most affected products will be mortgages and loans on the asset side, and investments, debit cards, and non-current-account deposits on the liability side.

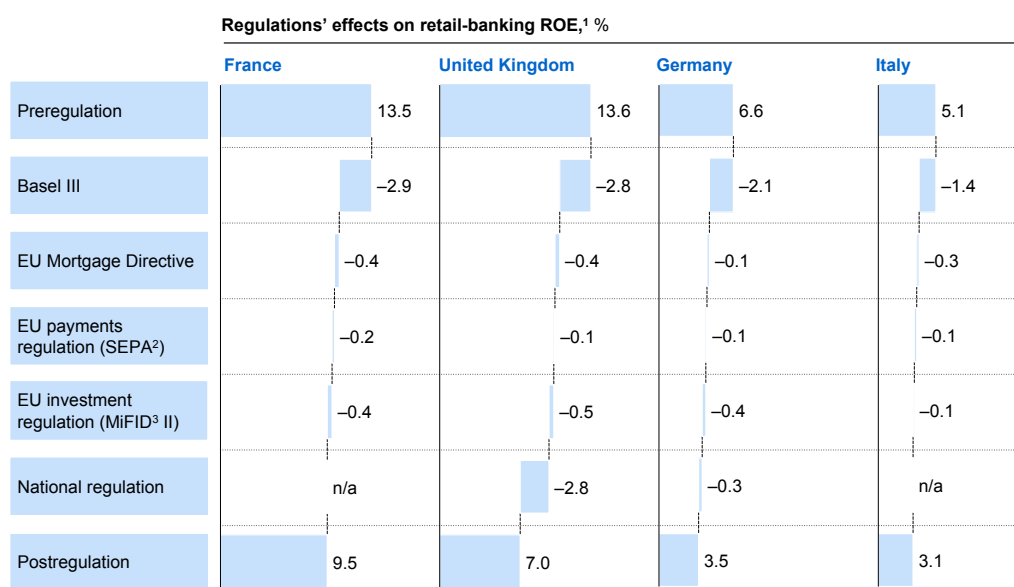
While all the regulations we studied will have some effect, the range is from significant to trivial (Exhibit 3). By far the biggest impact will come from Basel III, with its higher capital requirements and new emphasis on adequate funding and liquidity. Taken together, three EU directives (mortgages, SEPA, and MiFID II) will also take a significant bite out of ROE. And as mentioned, national regulations will have dramatic impact in the United Kingdom, a smaller effect on Germany's retail banks, and negligible impact in France and Italy, where some significant rules with material impact were already implemented by 2010. Broadly speaking, new national regulation has been produced more or less in proportion to the damage that the crisis produced, and is targeted at the perceived causes of the problem. Thus in Germany new national rules focus on investment products, in response to the risky investments, such as Lehman Brothers certificates, that were pitched to unsophisticated investors there, sometimes using aggressive tactics. And in the United Kingdom, the emphasis is on insulating retail banks from their wholesale cousins, as the connections between them were seen to be at the root of the failure of some big universal banks there.

Importantly, the impact may vary significantly within countries. As one example, take the NSFR, Basel III's rule on funding. In Germany, some institutions such as the savings banks are "funding long" with their NSFR already comfortably above 100 percent. Other retail banks with NSFRs below 100 percent, however, will see negative impact on their profitability.

The effects on products

Which products will be most affected? At the most detailed level, we calculate the cumulative effect of new regulation on each product in each market. Consider first the asset-based products (Exhibit 4). In the United Kingdom and France, mortgages, and especially small-business loans, are most adversely affected. Indeed, these products are hard hit in all four markets. In Germany, mortgages, personal loans, and small-business loans also stand to lose ground; and in Italy, every asset-based product will be hard hit. Across the board, the ROE for most asset-based products will drop below 10 percent, which is our estimated cost of equity for retail banks.

For example, ROE for mortgages will drop from 14 to 9 percent in the United Kingdom (a drop of 35 percent), from 11 to 6 percent in Italy (42 percent), from 6 to 4 percent in France (36 percent), and from 1 to almost 0 percent in Germany (64 percent). The impact on mortgages stems mainly from lower revenue margins. Renegotiation of mortgages and the loss of switching revenues (as customers will now be allowed to switch banks without paying penalty fees) will lower revenues. Greater transparency into costs and a better bargaining position for customers will also hurt margins, as will higher operating costs for mortgage-application processing.

Exhibit 3 Basel III will affect return on equity the most; UK regulations will also have substantial impact.

1 Return on equity.

2 Single Euro Payments Area.

3 Markets in Financial Instruments Directive.

Exhibit 4 A range of effects on the return on equity of retail-banking asset-based products can be expected.

Product ROE, ¹ FY 2010 and after regulation												
Relative change, %												
The numbers underlined are below cost of capital 10%												
Products	France			Germany			Italy			United Kingdom		
	Pre-	Post-	Delta	Pre-	Post-	Delta	Pre-	Post-	Delta	Pre-	Post-	Delta
Credit cards	41	32	-22	6	<u>4</u>	-28	77	52	-32	19	14	-27
Small-business loans	<u>1</u>	<u>0</u>	-86	8	<u>6</u>	-31	<u>8</u>	<u>5</u>	-40	15	10	-33
Mortgages	<u>6</u>	<u>4</u>	-36	1	<u>0</u>	-64	11	<u>6</u>	-42	14	<u>9</u>	-35
Overdrafts	32	26	-20	11	<u>8</u>	-28	<u>8</u>	<u>5</u>	-35	30	21	-29
Personal loans	<u>6</u>	<u>4</u>	-28	2	<u>1</u>	-39	12	<u>8</u>	-34	13	<u>8</u>	-38

1 Return on equity.

Liability-based products will fare better (Exhibit 5). Indeed, deposits will become more valuable to retail banks (and others), as they are an advantaged form of funding and liquidity under the new rules. In France and Germany, only investment products and debit cards will be adversely affected. In the United Kingdom, with its tough new set of national rules, all liability products (including deposits, and especially investments and debit cards) will be affected. In Italy, most liability products will be unscathed.

As for investment distribution, as a result of MiFID II regulation, profit margins (calculated as pretax profit/volume) will drop from 15 to 10 basis points (bps) in the United Kingdom (a drop of 32 percent⁶), from 17 to 14 bps in Germany (16 percent), from 31 to 26 bps in France (15 percent), and from 24 to 22 bps in Italy (8 percent). The impact stems mainly from the prohibition of inducement revenues for independent advisers, a loss of similar revenues for discretionary mandates, new limits on telephone orders for complex products that will trim some high-margin revenues, as well as higher compliance costs (such as the requirement to maintain a record of telephone conversations). The difference in impact by country is explained mainly by the difference in volumes to which these mostly fixed costs are applied.

Where could we be wrong?

As noted earlier, it appears quite likely that the LCR and NSFR will be diluted. If that happens, their impact would be lower than estimated in this paper; we have assumed that all regulations will be implemented as currently drafted.

Another source of uncertainty is the level at which capital ratios will settle; in the end, they could of course be lower or higher than estimated for this paper.

A third source of uncertainty is the speed at which customers react to new regulations and the ways their switching behavior changes. If customers switch from one product to another in greater numbers than we estimated, for example, actual impact might be greater than our estimate.

Exhibit 5 Margins of retail-banking liability-based products will be lightly affected.

Products	Product margins, FY 2010 and after regulation Basis points											
	France			Germany			Italy			United Kingdom		
	Pre-	Post-	Delta	Pre-	Post-	Delta	Pre-	Post-	Delta	Pre-	Post-	Delta
C/A ¹ deposits	61	61	1	75	72	-4	113	115	2	-21	-25	-22
Non-C/A ¹ deposits	24	29	18	20	20	-1	-100	-69	31	4	3	-26
Investments	31	26	-15	17	14	-16	24	22	-8	15	10	-32
Debit cards	173	164	-6	14	13	-11	56	53	-6	-3	-4	-25
Insurance	14	14	0	10	10	-5	10	10	0	1	1	-17
Transactions	-11	-11	-2	-13	-14	-6	-8	-9	-4	-11	-12	-13

¹ Current account.

⁶ In the United Kingdom, the investment products' impact also includes the impact from a UK-specific regulation, the Retail Distribution Review.

G-SIFI rules and retail banks

As is becoming well-known, the Financial Stability Board, a group of regulators from the G20 nations and the Basel Committee on Banking Supervision (BCBS), have proposed additional capital charges for global systemically important financial institutions (G-SIFIs). They assess systemic importance primarily through size but also by gauging an institution's degree of connectedness in the global financial system, its uniqueness, the extent of its global activity, and its complexity. Because of these additional criteria, even very large retail banks are typically not judged to be globally systemically important unless they have a very significant international retail presence. Almost all the banks identified as G-SIFIs were so designated, in our view, because of their wholesale activities. (The obvious exception we see is Santander, which has a large international retail franchise but slightly less weighty investment-banking activities.)

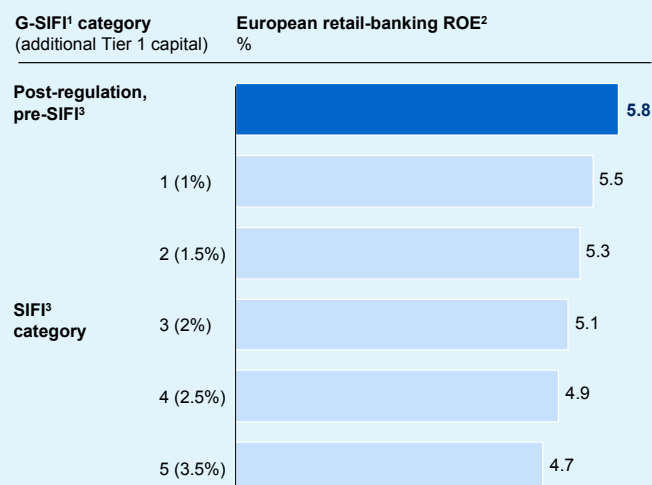
The initial list of G-SIFIs from November 2011 includes 29 banks, of which 17 are based in Europe and comprise five categories of G-SIFIs. The list will be updated each year in November.

The G-SIFI capital surcharge of 1 to 3.5 percent Tier 1 capital will apply across the entire banking group, including retail divisions, where the impact is material (exhibit). The surcharge ranges from a further reduction in return on equity (ROE) of about 0.4 percentage points for the least affected to 1.3 percentage points for those banks facing the highest G-SIFI-related capital charges. This impact is in addition to the estimated reductions in ROE discussed in this paper.

In addition to the capital surcharge, G-SIFI status carries other burdens:

- All G-SIFIs are required to have in place by the end of 2012 a recovery and resolution plan (RRP) that will provide a strategic road map for authorities to unwind the bank. Each G-SIFI will need to establish a crisis-management group (CMG) comprising the home regulatory authority and key host authorities. A board-level representative of the bank must keep the RRP up-to-date and coordinate its annual review and resolvability assessment by the bank's CMG. To govern this assessment, each G-SIFI must establish a cross-border cooperation agreement by the end of 2012.¹ These are costly undertakings; moreover, discussions with regulators about RRP could lead to further requirements, for example, regarding group legal structures, the degree of and approach for outsourcing and offshoring, or group funding and liquidity-management approaches.
- Another responsibility for G-SIFIs comes in risk IT. The BCBS is currently developing new global rules on risk IT for G-SIFIs, which are expected to be issued before the end of this year.² They will need to be implemented before the beginning of 2016 and may require significant investments.³

Exhibit G-SIFI capital charges will further lower retail banking ROE.



¹ Global systemically important financial institutions.

² Return on equity.

³ Systemically important financial institutions.

¹ Global Financial Markets Association, "Briefing Note: Global Systemically Important Banks – Overview," March 5, 2012

² Basel Committee on Banking Supervision consultative document, "Principles for effective risk data aggregation and risk reporting," June 2012 (bis.org).

³ International Institute of Finance and McKinsey & Company, *Risk IT and Operations: Strengthening capabilities*, July 17, 2011 (iif.com and mckinsey.com).

- Finally, G-SIFIs are increasingly subject to intensive supervision with many ad hoc requests, which raise costs and occupy management resources.

In addition to the RRP requirements for G-SIFIs mentioned above, the EU and several countries have also issued proposals for RRP.⁴ Those proposals are not restricted to G-SIFIs but apply to a larger set of banks, defined differently in each country. The United Kingdom has one of the widest definitions, requiring almost every deposit-taking bank to establish an RRP. Because they differ significantly, we refrained from estimating the impact from the national and Europe-wide requirements on G-SIFIs—with one exception, the United Kingdom. There, the rules are clear, fully developed, and most importantly apply to almost all retail banks.

One final, related note: following a request by the G20, the BCBS published in June 2012 the consultative document “A framework for dealing with domestic systemically important banks.”⁵ The proposed framework aims to complement G-SIFI regulation by addressing the banks that may not be systemically relevant from a global perspective but otherwise meet certain criteria for domestic systemic importance, and to ensure a consistent approach across jurisdictions. While the current version is likely subject to revision, and the principles stated leave significant leeway for discretion by national legislatures, we expect the framework to lead to higher core Tier 1 capital requirements for affected banks (domestic systemically important financial institutions, or D-SIFIs). Banks that do not qualify as G-SIFIs should not rest easy, as their turn may be coming.

Finally, it is possible that retail-banking ROEs in 2010 (our reference year) may turn out to have been rather low in a historical context, perhaps as a function of the on-again, off-again European recession, and that some natural or cyclical improvement over the next few years is likely.

With these caveats, we should also note that our overall approach has been rather conservative; if anything, we may have underestimated impact. For instance, there are several regulations whose impact we did not quantify, because of various technical constraints, even though it is clear that these regulations will lower profitability. For example, we have quantified recovery and resolution plans (RRPs) only for the UK market, even though they will clearly affect banks elsewhere. In the United Kingdom, banks have substantial experience with similar concepts following the Turner Review in 2009; the ideas are now sufficiently clear, and the guidance from the Financial Services Authority sufficiently detailed, to allow us to form an estimate of impact. Elsewhere the concepts are too new and the implementation too uncertain to design an accurate calculation.

Retail banks' response

The effects on ROE discussed above assume no action on the part of banks. But of course, banks have already begun to implement the new rules, to plan for compliance with future rules, to make changes to their businesses that will lower the impact of new regulation on their profitability, and to capture potential opportunities arising from the new regulations. While we think it is unlikely that the industry will return to preregulation ROE levels in the short to midterm, individual banks can rebuild ROE to preregulation levels, but most will succeed only if they pull all levers.

- **Technical mitigation.** By improving the efficiency of capital and funding (through improved data quality, better risk processes, and refined risk models) banks can increase ROE by between 30 and 160 basis points. As the regulation on LCR and NSFR is not finalized, and therefore the potential for mitigation uncertain, our estimate for technical optimization consists mainly of risk-weighted asset (RWA) optimization levers.
- **Capital- and funding-light operating models.** Banks can further improve funding efficiency and reduce RWAs by, for example, changing their product mix and characteristics, pursuing collateral more vigorously, and improving their ability to outpace risks (by issuing covered bonds for mortgage portfolios, for instance). These changes can

also help boost revenues, and improve ROEs by between 10 and 80 basis points. Retail banks can further improve their profitability by adopting tools such as economic value-added models to increase the capital and funding/liquidity efficiency of their business.

- **Repricing.** If they do nothing else and wish to fully compensate for the costs of regulatory reform, banks would have to raise some product prices by as much as 400 basis points. Obviously, their ability to do that will be severely limited by competitive dynamics; and they would certainly run afoul of the intent of many consumer regulations. Nevertheless, we expect to see some limited repricing; the order of magnitude will depend heavily on the competitive environment (that is, the degree of consolidation of the market and the capital-markets orientation of the largest players). In markets with a highly fragmented landscape, in which a lot of market share is controlled by nonlisted players (for example, Germany), repricing is less likely to happen than in more concentrated markets with a large market share in the hands of listed players (such as the United Kingdom).
- **Business-model alignment.** Over the longer term, in response to regulation but also to the other forces shaping the industry, retail banks might make ROE (or profitability measures like risk-adjusted return on capital (RAROC)) their steering metric; address industry-wide cost challenges with moves that take advantage of changes in technology and consumer preferences, resulting in a net reduction in costs of 20 to 30 percent; and pursue some focused M&As, including divestitures.

Business-model alignment is the single most important mitigation lever, in our view. Such actions can boost ROE significantly, but the potential positive ROE impact will be very different from bank to bank and will require longer lead time to achieve. Considering the longer durations of their liabilities, their stable portfolios with limited customer attrition, and their large sales forces and branch networks, the old adage about turning around a supersize oil tanker comes to mind.

On average, European retail banks that take advantage of technical mitigation and capital-light operating models can restore a significant portion of the ROE that will be lost to regulatory reform. Note that the picture varies considerably among and even within the four markets studied (Exhibit 6). In France, banks may be able to rebuild ROE to within a percentage point or so of pre-reform levels with technical mitigation and capital-light operating models—and, importantly, may be able to once again boost ROE over the cost of equity. UK banks will be challenged to accomplish that feat, and German and Italian banks are confronting a distinctly unfavorable outlook for profitability, as their markets were already structurally unprofitable even before the wave of new regulation. They will not only need to recover the ROE lost to regulation but also set their ambition much higher to reach a return above the cost of equity, which we estimate to be 10 percent.

Within countries we see considerable differences in potential, especially through technical optimization and capital-light business levers. Some leading banks in Europe have already run stringent optimization programs leading to RWA savings of over 20 percent; these programs have been so successful that additional optimizations in retail can yield only another 5 to 10 percent. Banks that have not yet run stringent programs can achieve RWA savings of up to 25 percent.

The situation is similar with respect to mitigation of higher liquidity and funding costs. Moreover, given that LCR and NSFR requirements are newer, and banks have less experience with liquidity and funding hunts under Basel III, banks' own estimates vary significantly. Some say they can mitigate over 50 percent of the additional costs from the LCR and NSFR; others are much less optimistic. To be conservative, we focused almost exclusively on RWA optimization levers in our assessment of mitigation potential.

Pulling all four levers will require time, investment, discipline, and rigor. While some banks will certainly succeed, many others will not. Therefore, we do not expect the industry as a whole to fully recover from the regulatory impact in the short to medium term.

Exhibit 6 A range of mitigation levers can help restore return on equity.

		Mitigation potential for retail-banking ROE, ¹ %			
		France	United Kingdom	Germany	Italy
Type of impact	Description				
	Preregulation ROE¹	13.5	13.6	6.6	5.1
	Regulatory impact				
	Basel III, European and country-specific regulation	-4.0	-6.6	-3.1	2.0
	1 Technical optimization				
	Technical optimization of capital, liquidity/funding	1.0–1.6	0.8–1.3	0.4–0.6	0.3–0.5
	2 Capital-light business models				
	Capital-light, sustainable steering approach	0.5–0.8	0.5–0.7	0.2–0.3	0.1–0.2
	3 Repricing opportunities				
		Tbd	Tbd	Tbd	Tbd
	4 Long-term alignment				
		Tbd	Tbd	Tbd	Tbd
ROE¹ after mitigation		11.0–11.9	8.3–9.0	4.1–4.4	3.5–3.8

¹ Return on equity.

Improving efficiency of capital, funding, and liquidity use

The ways that retail banks use their capital, funding, and liquidity are ripe for change. Regulatory reform has a lot to do with that, of course, especially Basel III's new capital ratios, the NSFR and the LCR, and the deleveraging process that most banks are undertaking in response to higher capital charges. But even without these new regulations, banks' use of these resources has long been inefficient. Remedying those inefficiencies can make a very significant contribution to restoring profit.⁷

Leading banks are attacking the problem in three ways. First, they are improving *data quality* throughout the enterprise, and especially in capital-intensive businesses such as small-business lending and businesses prone to data-quality issues such as mortgage lending. Data quality can be improved by extending the effort to collect more detailed information on heavy RWAs; for example, banks can collect missing information on turnover (that is, sales) of clients to ensure that retail clients are appropriately identified. Many banks assume that, in the absence of this information, customers are corporates, which receive heavier risk weights under Basel II. Banks can also scrub their databases to remove errors that affect RWA calculation, such as missing or incomplete data on collateral, and can clean up the historical time series that they use to estimate risk parameters such as probability of default (PD), exposure at default (EAD), and loss given default (LGD).

The data that underlie liquidity and funding calculations are less tested than capital data; banks have long collected these data, but mostly for internal purposes. Now they must also establish that their liquidity and funding meet Basel III's guidelines. To boost the accuracy of their calculations, leading banks are checking to ensure that they have correctly classified their funds. Key steps here are to ensure that "stable and reliable" IT processes are in place, as called for by Basel III, and that the necessary account and customer information is available.

The treatment of the LCR and NSFR is further complicated for banks as the rules are not yet final and leave significant room for interpretation. This is particularly true for the NSFR, which is not included in the CRD IV. A key step to work

⁷ McKinsey maintains a permanent, regularly updated, and growing database of levers that retail and other banks can use to improve capital and liquidity and funding efficiency. See "Hidden in plain sight: The hunt for banking capital," *McKinsey on Corporate and Investment Banking*, January 2010 (mckinseyquarterly.com). As of June 2012, the database covers more than 260 levers on capital efficiency and over 60 levers to increase liquidity and funding efficiency.

around this uncertainty is to define clear internal criteria and discuss these with the regulator; if alignment can be gained, the final changes requested by the regulator may be small. For example, the “established relationship,” an important concept in the LCR, can be defined internally and discussed with regulators; systems can then be programmed to ensure that all eligible funds receive this classification.

A second way to boost efficient use of scarce resources is to upgrade *related processes*. Increasing the level of automation and avoiding manual adjustments in the calculation process significantly reduces errors and reduces the end-to-end calculation time. In turn that reduces uncertainty and allows for lower buffers and more accurate steering. Effective early-warning systems, a pivotal element of an effective monitoring process, raise a flag when customers’ creditworthiness deteriorates. Early warning lets banks reduce their uncollateralized exposure to delinquent customers and ensure an appropriate treatment of troubled exposures. Again, this will lead to lower losses, which for A-IRB banks also translates into lower PD, EAD, and LGD estimates.

Finally, leading banks are exploring *methodological improvements*. These include refinements to risk models, to better estimate risk parameters. Many banks don’t use sufficiently granular risk models; instead they treat customers and products that have very different characteristics with one model. For example they do not differentiate sufficiently among retail, small, and medium-size businesses in their models. Separate and fine-tuned models for each segment can reduce overall RWAs. Even within retail segments, banks will find that further subsegmenting by exposure and customer characteristics can improve the risk assessment and reduce RWAs.

Models can be designed and calibrated better for their specific purpose. Banks need a highly accurate view of a point in time (PIT), which is good for underwriting, short-term portfolio steering, estimating loan-loss provisions, and providing information to pricing tools. But they also want to gauge creditworthiness over a period of time, such as an economic cycle; such a through-the-cycle (TTC) view is good for steering the bank in the long run, managing capital requirements, and modulating exposure to the broader economic environment. Some leading banks have now begun to use two calibrations, one for PIT and one for TTC. The TTC calibrations are then used for capital-management purposes, allowing the bank a less cyclical and hence more efficient capital-allocation approach.⁸

Making the business capital- and funding-light

Leading banks are changing some of the ways they operate, especially in collateral management, credit-line management, and the product mix they offer in an effort to reduce RWAs and liquidity and funding requirements; cut operating expenses; and even boost revenues.

Start with collateral. Banks should provide commercial guidelines and tools to help the front line boost the amount and quality of collateral they collect. These tools should help staff by pointing out opportunities to lower loan-to-value ratios in mortgages, find acceptable collateral for some consumer loans, increase the level of cross-collateralization (that is, if a piece of collateral has more value than is needed, use the surplus to collateralize something else), and, in some circumstances, ensure assets are eligible for risk transfer (for example, securitization) and funding purposes (for instance, covered bond eligibility).

The management of credit lines (for example, overdraft and credit-card facilities) can often be optimized. Many banks have intensified their review of the size of granted facilities, avoiding excessive credit lines that consume RWA, liquidity, and funding.

Frontline staff must also be given transparency into RWA and liquidity and funding costs of the products they sell, and these costs must be reflected in products’ prices (which in retail is often highly automated and standardized). Again, tools and guidelines can help frontline staff steer the bank’s business to a less capital-, liquidity-, and funding-intensive position.

8 “Ratings revisited: New frontiers in risk rating: Part 1: Tackling the problem of the economic cycle,” July 2012 (mckinsey.com).

Many banks have already begun to explore these technical RWA and liquidity- and funding-optimization opportunities as well as capital- and funding-light opportunities. But few have comprehensively explored all the available levers.

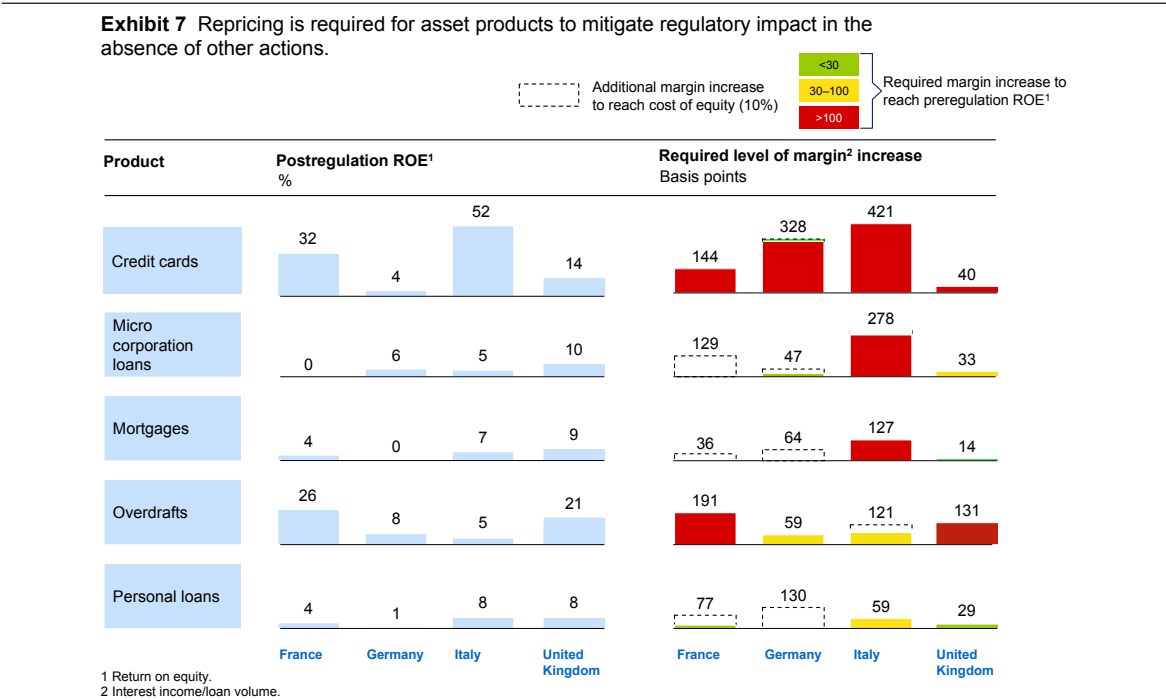
Repricing

After the costs of production (labor, say, or energy) rise substantially, every business will seek to pass on some of those costs to customers. Retail banking is no different. But if these banks expect to cover fully the newly higher costs of regulation, they face an uphill struggle (Exhibit 7). We estimate that in credit cards, for example, German banks would have to raise prices by 328 basis points to recover costs; Italian banks would have to boost prices by 441 basis points. In other products and markets, the challenge is not quite as severe but still imposing.

Most banks will find their ability to recover even part of these costs limited by several factors. Start with the obvious: regulators will be watching closely and may intercede if it appears that customers are being asked to bear the brunt of regulatory costs that were intended for banks. Moreover, in some markets the prices of some retail products, such as France’s Livret A savings accounts, are set by regulation and cannot be easily shifted. Regulatory pressure for transparency is also being felt; in the new world, customers must be given more information than before about costs.

The most important limiting factor may be market dynamics. Fragmented markets and those with a lot of players that are subject to less pressure to make profits (for example, mutual or state-owned entities with privileged access to capital) will see very limited repricing in the short to midterm. In more consolidated markets, banks may have some limited opportunity to raise prices for the most vulnerable credit products.

Despite the many obstacles, some form of repricing will be necessary for products in which some economic contributions (such as inducement fees) have now been explicitly forbidden by regulation. We see a general trend to more fee-based pricing of services and modular product features instead of one-size-fits-all schemes and “hidden” pricing components (interest margin on balances or compensation from product providers). Banks can explore several options, including these four:



- **New fee-based pricing.** At present many banks view a component of interest income as their revenue for some services, such as investment advice, and some products, such as savings. Some also receive compensation from insurers and asset managers for the sale of their products. New regulation will ban these arrangements and will make it difficult to continue business as usual. Banks should find ways to price their advisory service as a stand-alone offering; to do that they must secure an impartial view on client needs.
- **Modular pricing.** Instead of one-size-fits-all offerings (for example, a current account for €5 a month), which include many features that some customers find unnecessary, banks can create a basic, free-of-charge offering, to which additional charged features can be added, such as worldwide cash withdrawal, small interest on accounts, and so on.
- **Partial performance remuneration.** The bank might participate in the performance of client investments (especially individual wealth-management accounts and funds-of-funds), sharing in the gains when these do well and absorbing some of the loss when they do not.
- **Value-added packages.** Banks can create meaningful combinations of products and services that will help them escape the threat of commoditization. One example is a consumer loan with a flexible down payment, giving the customer an option to postpone a payment. Such a product might cost more than a “no-frills” consumer credit.

Long-term business-model adjustments

Finally, leading banks are exploring two big changes to adapt their business to the new regulatory landscape. Traditionally, most retail-banking executives have built performance-management approaches that use incentives based on volumes and revenues; some have extended these to include some notion of profitability. But in the new world, while these ideas continue to be meaningful, we argue that the emphasis should shift to ROE or risk-adjusted profitability measures such as RAROC. Retail banks have not often paid sufficient attention to ROE in the past, in part because the 25-year boom in banking meant that revenues were more important than costs, and in part because ROEs were difficult or impossible to understand at the product level, as the data on costs were hard to come by.

Given the severe pressure banks are facing to return their cost of equity, banks now must understand the impact of every business decision on ROE. They should also adapt the steering of the bank, including the front office, in a way that enables it to optimize ROE. This will be a hard piece of work for many banks, but we strongly believe that a rigorous ROE focus, the first of the two business-model shifts, could form a strong competitive advantage for some time to come, before it becomes the industry standard over the midterm. To establish a rigorous ROE focus, banks will need to invest in management information systems to achieve greater granularity and accuracy in their data. ROE will have to factor into pricing models also. And of course, ROE will need to move to the top of front-office performance criteria. Finally, banks should move quickly to strengthen the discipline of their processes for resource allocation (of capital, investments, and people). Too many banks today take an opportunistic market approach, moving only when forced to, thus making changes in resource allocation a process that takes particularly long with retail banks.

The second big shift is toward what we call sustainable retail banking. While this is a big topic and beyond the scope of this paper,⁹ for now we see four key elements to this shift:

- **Expand into new revenue sources.** Retail banks can move beyond their traditional structures and experiment with new ones. Bankinter and KPN teamed up for an innovative mobile/banking proposition that more closely ties the two companies in a way that builds their customer base and delivers value for them and for their customers.
- **Create advice for which customers will pay.** Umpqua Bank of Portland, Oregon has developed a uniquely personal advisory service with a powerful focus on the customer experience.

⁹ McKinsey will publish a white paper on this topic in Summer 2012 on mckinsey.com.

- **Reconfigure and focus the distribution system.** Customers demand a much leaner and simple distribution. Leading banks are pushing their channels toward full digitalization, but with the appropriate personal touch. In the new world, each channel (branch, call center, ATM, Web, mobile) has a unique role, and together they make for a strong and seamless experience as the customer moves among them.
- **Rebase the absolute cost levels by 20 to 30 percent.** The opportunity offered by new technology to cut costs is much greater than even the successful cost-trimming efforts of recent years. Technology advances allow banks to rebase their costs across the whole value chain (especially in direct sales, straight-through processing in operations, “big data”-based credit-risk management, and customer life-cycle management) while increasing customer-service quality and convenience. Banks should aspire to recalibrate their cost base at levels that are 20 to 30 percent lower—a transformative change instead of the more commonly achieved marginal net reduction.

One other business-model shift should be mentioned—the unpleasant but in some cases unavoidable step of exiting certain businesses or products completely in light of regulatory change. For example, in an effort to address upcoming Retail Distribution Review (RDR) regulation in the United Kingdom, HSBC is closing down its tied-advice service and parting ways with its 650 tied advisers. The bank believes that “the tied business was not generating sufficient volumes of business and the advisers would not be able to charge a high enough fee to make it worthwhile continuing the proposition after the retail distribution review.”¹⁰ Similar steps are being taken by the Royal Bank of Scotland. It announced recently that it will trim over 600 financial-planning roles as a result of RDR.¹¹

A regulatory mitigation road map

Most banks have launched some early measures to respond to regulatory challenges of the kind discussed above. However, the extent of these programs and their impact differ significantly. They range from some decentralized working groups that monitor the current regulatory environment and provide guidance to the businesses to fully fledged programs with staffing, tight management, and keen attention from senior leaders.

Not all the approaches and techniques described in this paper will be relevant for all banks—but many will. To capture the full mitigation potential, the retail division needs to join forces with the risk and finance functions. A tightly managed, cross-functional project with strong senior leadership is often the best approach. Typically, this cross-functional team begins with an assessment of regulatory impact for its own unique circumstances, including a scan of coming regulations and reviews of the product portfolio, its cost structure, and its capital-allocation approach. Armed with these analyses, it can then evaluate the available remedies and develop a program that will capture the most powerful opportunities.

From there, banks can move forward with two mitigation workstreams. Often, it makes sense to bundle the technical optimization and the capital- and funding-light business-model levers in one workstream. The goal here is to develop an action plan of very specific mitigation actions with clear responsibilities and deadlines. The granularity and stringency of this plan along with tight execution are key distinguishing factors of more successful mitigation projects. To get there, we have found an intensive initial period of expert workshops and detailed data-sample analyses most helpful. Depending on the institution this can be done in about two months, during which a long list of levers is generated and then prioritized to about 15 to 20 core initiatives. Typically 60 to 70 percent of the levers can then be implemented and the value captured within one year.

¹⁰ FT Adviser, April 26, 2012.

¹¹ FT Adviser, June 19, 2012.

A second workstream should focus on a review of the pricing strategy as well as potential changes to the business model. Both are highly bank- and market-specific and cannot be developed in isolation from other important trends such as technology or changing customer behavior. Often, such a review might not even be triggered by regulatory changes but by other trends, which is fine as long as it has a sufficient focus on ROE and includes a detailed assessment of regulatory impact on the bank's products.

Over time, a thoughtful program may even help banks once again achieve returns on par with those in the years leading up to the crisis, a period that increasingly seems to have been the golden age of retail banking.

Regulations in our assessment include two sets of global rules, several European regulations, and country-specific regulations in the United Kingdom, Germany, Italy, and France. In this appendix, we briefly list the rules and provide a description. In Appendix 2, we explain how we modeled the impact of each of these regulations.

Appendix 1: Summary of new regulations

Global rules

Basel III

Basel III comprises the regulations introduced in the Basel Committee on Banking Supervision papers *Basel III: A global regulatory framework for more resilient banks and banking systems* (December 2010; revised June 2011) and *Basel III: International framework for liquidity risk measurement, standards and monitoring* (December 2010) as well as numerous shorter consultation papers. In Europe, these rules are implemented through the Capital Requirements Directives (CRD II, CRD III, and CRD IV, each an amendment of the previous version). Main requirements relevant for retail banks are:

- CRD II has been in force since December 31, 2010; it focuses on the treatment of hybrid capital instruments.
- CRD III (often called “Basel II.5”) has been in force since December 31, 2011; the rules in this directive are less important for retail banks and include higher capital requirements for securitizations and trading-book assets.
- CRD IV is currently under consultation. It will become effective on January 1, 2013, and its rules will be fully phased in by January 1, 2021. It will consist of a regulation for all European countries (“single rule book”) as well as a directive, which will be implemented through national laws. Below are some key features of CRD IV of which banks should take note.
 - **Capital-quality** rules now disallow a number of forms of capital, such as capital held by insurance subsidiaries, defined-benefit pension-fund assets, investments in unconsolidated financial institutions, and deferred-tax assets.
 - New **capital ratios** will begin with a core Tier 1 requirement of 4.5 percent, a Tier 1 requirement of 6 percent, and a total capital requirement of 8 percent. The directive also specifies an additional capital conservation buffer of 2.5 percent core Tier 1 capital and a countercyclical capital buffer ranging from 0 to 2.5 percent. All capital ratios will be introduced gradually from 2013 through 2021. A **leverage ratio** will be included as a supplement to the Basel II risk-based framework. At first the leverage ratio will only be introduced as a Pillar 2 measure; banks will need to monitor and report their leverage to their regulator beginning in 2013 and disclose their leverage ratios to the market beginning in 2015. It will become a binding Pillar I requirement in 2018.
 - A **liquidity coverage requirement** will be introduced only in 2015, due to uncertainty about unintended consequences. The current proposal outlines a **liquidity coverage ratio (LCR)** to be calculated as the stock of highly liquid assets (for example, cash, central-bank reserves, government bonds), divided by net cash outflow over a 30-day period. The cash net outflow is determined by the difference of cash outflows (for example, deposit runoff, committed credit facilities) minus the cash inflows (for example, retail/wholesale inflows). The LCR must be greater than 100 percent. The LCR is designed to ensure that sufficient high-quality liquid assets are available to meet short-term needs.
- Not yet a part of CRD IV, but part of the Basel III package, is a new funding requirement, subject to an observation period through 2018, when a legislative proposal will be made. As currently contemplated, the **net stable funding ratio (NSFR)** is the available amount of stable funding (capital, long-term debt, some deposits, and so on, all assigned various weights) divided by the requirements (receivables, loans, bonds, and other assets, again variously weighted). The NSFR must also be greater than 100 percent. The NSFR is designed to promote more medium- and long-term funding of assets.

G-SIFIs

Another set of rules relates to **global systemically important financial institutions (G-SIFIs)**. Capital surcharges for G-SIFIs are about to be introduced in major markets around the world. In November 2010 the Financial Stability Board

(FSB) issued its report *Reducing the moral hazard posed by systemically important financial institutions*; and in July 2011 the FSB produced a consultative document, “Effective resolution of systemically important financial institutions,” which presents a framework for identifying systematically important financial institutions.

In November 2011 the FSB published a list of 29 G-SIFIs, in five categories, and announced its intention to update the list every year. Beginning in 2016, G-SIFIs will be subject to Tier 1 capital requirements ranging from 1 to 3.5 percent of risk-weighted assets (RWAs) (depending on the category) in addition to the regulatory minimum.

Some countries may enact even higher capital requirements for G-SIFIs. Switzerland now requires SIFIs to hold a capital conservation buffer of 8.5 percent (in addition to the Basel III core Tier 1 minimum of 4.5 percent), and a 6 percent progressive systemic surcharge, resulting in total capital requirements for these institutions of 19 percent of RWAs.

The FSB proposals also call for G-SIFIs to define recovery and resolution plans (RRPs) for a potential wind-down in crisis situations; these must be written by the end of 2012. (All licensed deposit-taking institutions, not just G-SIFIs, are subject to the proposal; smaller banks in the United Kingdom, and likely elsewhere, will have more time to create their RRP).

How we treated global regulations

We included the requirements of CRD IV as outlined above (higher capital charges and capital quality as well as the LCR ratio) and the NSFR.

Given that the G-SIFI capital surcharge does not affect all banks, we have not included it in our impact assessment. (We have, however, estimated how G-SIFIs would be affected. See Appendix 2.)

The increased costs associated with defining and updating RRP have been quantified only for the United Kingdom. Following the Turner Review in 2009, UK banks have gained sufficient experience with the concepts, and the Financial Services Authority (FSA) has provided sufficient guidance to calculate reasonable estimates. In other countries the RRP is too new, and regulatory guidance is not yet promulgated, making calculation too difficult to attempt.

European regulations

In addition to the CRDs (see above), we included four other EU directives in our study. We also looked at several other rules but did not include them in our assessment either because they were already in force in 2010 (our preregulation base), they had no material impact, or because technical constraints (for example, where regulations have not yet been sufficiently detailed) made it difficult to reliably calculate the impact on profits.

Regulations included in our assessment

- **EU Directive on Credit Agreements Relating to Residential Property.** This directive was issued in March 2011 with the goal of harmonizing mortgage lending across European member states and to foster competition. It requires a new, precontractual “European Standardized Information Sheet” to provide the borrower with comparable information on the mortgage market. Additionally, transparency will be provided by a standardized calculation of the annual percentage rate of charge. Finally, an early repayment right for borrowers will be introduced, and customers will be allowed to switch banks without paying penalty fees.
- **MiFID II.** A revised version of the Markets in Financial Instruments Directive (MiFID) was released in October 2011. Major changes affecting retail banking relate to the strengthening of investor protection with respect to advisory services in addition to execution services, providing transparency on independent versus restricted advisers, banning inducements to independent advisers, the limitation of telephone orders for complex products, and a requirement to maintain a record of telephone conversations.

- **Single Euro Payments Area (SEPA).** In March 2012, new harmonized rules for processing cross-border payments were issued by the EU. The **Payment Services Directive** represents the legal platform for the SEPA.

Additional regulations not included in our assessment

- **“EU framework for bank recovery and resolution.”** In addition to the G-SIFI regulation issued by the FSB, the European Commission also released its proposal “EU framework for bank recovery and resolution,” detailing its requirements for RRP in June 2012. National legislation is expected to be in place by 2013. In the United Kingdom, however, national regulation is already in place, and applies to almost all retail banks. Therefore, as discussed in “G-SIFI rules and retail banks” on page 8, we included the UK requirements established to enforce this EU framework in our impact assessment for the United Kingdom.
- **Unfair Commercial Practices Directive.** This directive—in force since 2007—reinforces existing EU standards on misleading advertising and sets new EU standards against aggressive commercial practices including harassment, coercion, and undue influence. In the case of noncompliance, fines are applied.
- **Credit Agreements for Consumers.** This consumer-credit directive—in force since 2007—aims to increase and standardize the information rights of customers. This includes a mandatory standardized method for calculating the cost of the credit (that is, the annual percentage rate of charge, or APR). Customers also received two new rights: to withdraw from the credit contract within 14 days after conclusion and to repay a loan early, for which lenders would receive a justifiable compensation.
- **Packaged Retail Investment Products (PRIIPs).** This ongoing consultation of the European Commission aims to increase investor protection by improving information transparency for packaged products that are not subject to the MiFID regulations. This would include the introduction of a standard information leaflet for all investment products (including insurance products) to improve precontractual disclosure. Our analysis showed that PRIIPs regulation would not lead to material impact on ROE beyond what has already been caused by MiFID II.
- **Deposit Guarantee Schemes Directive.** The existing deposit guarantee schemes were amended in 2010 to extend guaranteed deposits to €100,000 and to accelerate payouts to account holders within a maximum of seven days. Financing of guarantee schemes is made more sound by a 75 percent ex-ante financing by banks. The remaining 25 percent will be collected from banks ex post, or borrowed from other schemes or from the market.
- **Investor Compensation Schemes Directive.** This regulation from July 2010 aims to protect investors against the risk of losses in the event that an investment firm (including credit institutions) is unable to repay its clients. It mainly foresees that the level of compensation payable to investors if an investment firm fails to return the investor’s assets due to fraud, administrative malpractice, or operational error is increased from a maximum of €20,000 to €50,000; that claims are paid out without delays; and that all investment services and activities covered under MiFID shall be subject to this regulation.

National regulations

In the following, we summarize national regulations that were analyzed in the United Kingdom, Germany, France, and Italy. We have ordered the countries by the size of regulatory impact expected through national regulation.

United Kingdom

We included the following regulations in our assessment:

- **Independent Commission on Banking (ICB) recommendations on ring-fencing.** The ICB issued a report in September 2011 aiming to make the UK banking system safer and to boost competition; the vast majority of its

recommendations have been adopted in a white paper published by HM Treasury in June 2012.¹ Legislation will likely be completed by May 2015 and banks must comply with all measures by 2019. The report has two parts:

- **Financial stability.** The first part of the report deals with the Commission's two main recommendations for financial stability: proposals for a "ring fence" around UK retail-banking operations and measures to improve the loss absorbercy of UK banks. The ring-fence recommendations include:
 - A threshold of £25 billion of mandated deposits below which banks are not required to ring-fence their deposits from individuals and small-to-medium-size enterprises (SMEs)
 - Introduction of a ring fence around larger retail-banking units such that they are "legally, economically, and operationally" independent from the rest of banking groups' activities
 - Requirement that only ring-fenced entities can provide UK retail-banking activities to European Economic Area (EEA) individuals and SMEs; strict prohibitions on customer type (such as non-EEAs, financial institutions) and activity (underwriting; most derivatives, except some simple ones for hedging purposes)
 - An independent board to oversee the interface between the ring-fenced division and the group; ensure a commercial, arm's-length relationship (for example, the group should have the same exposure limits for the retail bank as it has for comparable third parties), and ensure adherence to ring-fence principles
- **Account switching/portability.** The second part of the ICB document deals with competition issues affecting UK banking markets. The proposal suggests among other things that it should be easier for both individuals and SMEs to switch current accounts, and calls for the establishment of a robust and risk-free redirection service by September 2013.
- **Recovery and resolution plans (RRPs).** In 2012, the FSA published a consultative statement on RRP; the final rules are expected to be published in autumn of this year. An RRP is a requirement for a number of financial institutions in the United Kingdom, including all deposit takers. We have assumed that it is therefore relevant for all retail banks.
- **Bank levy.** The UK government introduced a bank levy in October 2010; it was first assessed in January 2011. Beginning in 2012, the levy is set at 0.078 percent annually on a bank's short-term chargeable liabilities, and 0.039 percent annually for long-term chargeable equity and liabilities. Banks with chargeable equity and liabilities of more than £20 billion are subject to the levy.
- **Payment Protection Insurance (PPI).** In November 2011, the FSA and the Office of Fair Trading published a guidance consultation on payment-protection insurance products. It aims to avoid the "mis-selling" of PPIs to customers and especially prohibits the sale of PPIs alongside credit products, a practice that led to extensive damage claims by customers.
- **Limit on loan-to-value and stricter affordability criteria.** The FSA published a consultation paper ("Mortgage market review," or MMR) in July 2010, in which it called for, among other things, stricter assessment of affordability. The Institute for Public Policy Research responded by publishing a report in May 2011 proposing to introduce a cap on loan-to-value ratios of 90 percent, and to limit mortgages to three-and-a-half times household income. The FSA has not ruled out loan-to-income or loan-to-value caps in the future, and has also said it is open to a debate on restrictions on equity withdrawal. Some other parts of the MMR were not material, in our opinion; see below.

1 HM Treasury, "Banking reform: Delivering stability and supporting a sustainable economy," June 2012.

- **Retail Distribution Review.** The Retail Distribution Review (RDR) is a key part of the FSA's consumer-protection strategy. It is proposing that from the end of 2012 advisory firms explicitly disclose and separately charge clients for their services and clearly describe their services as either independent or restricted; additionally, a code of ethics shall be adhered to. Essentially, RDR means that banks can no longer fold the cost of relationship managers into their product pricing but have to instead charge a separate advisory fee.

We also studied two other rules but did not include them in our assessment. We concluded that their impact on retail-banking profits would either not be material or was similar to but did not exceed the impact of other regulations that we did include:

- **Liquidity regime.** New requirements from the FSA for liquidity systems and controls began to take effect in December 2009; staggered implementation of qualitative measures and reporting requirements took place between May and November 2010. Banks are now required to produce an Internal Liquidity Adequacy Assessment and comply with the overall liquidity-adequacy rule, which requires banks to assess for themselves what constitutes sufficient quantity and quality of liquidity resources. However, the implementation of quantitative standards (that is, an increase in liquidity requirements) was postponed in November 2010, when the FSA decided not to impose a standard different from Basel III's LCR.
- **Project Merlin.** Following a period of discussion between the Government and the major UK banks, the banks stated in February 2011 a capacity and willingness to lend £190 billion of new credit to business in 2011, with £76 billion of this lending capacity allocated to small and medium-size enterprises. If demand exceeds this, the banks committed to lend more.

Germany

We included two regulations in our assessment:

- **Levy and taxes.** The "Bankenabgabe" foresees an annual payment by banks of at least 2 basis points and as much as 6 basis points of their qualified liabilities (adjusted to reflect the size, risk, and systemic importance of the financial institution). The maximum amount is capped at 20 percent of the bank's net income. The government plans to collect €1 billion from the system annually and has a target size of €70 billion for the resulting protection fund.
- **Fee-based advice.** The "Eckpunkte für eine gesetzliche Regelung des Berufsbildes der Honorarberatung" prohibits financial advisers that consult customers independently from receiving fees from banks.

Other regulations that we studied but did not include:

- **Credit scoring** (Gesetz zur Änderung des Bundesdatenschutzgesetzes, July 2009). This law requires banks to provide detailed information to customers, including six months of credit history, about the input variables and functionality of the scoring models they use. Restrictions on the use of customer information without prior consent are extended, and exchange of customer information with credit-reference agencies (for example, Schufa) is restricted.
- **Advisory protocol** (Gesetz zur Neuregelung der Rechtsverhältnisse bei Schuldverschreibungen aus Gesamtemissionen und zur verbesserten Durchsetzbarkeit von Ansprüchen von Anlegern aus Falschberatung, August 2009). This law details the content of advisory protocols that have to be generated for every investment-advisory service, according to the Wertpapierhandelsgesetzes and the Wertpapierdienstleistungs-, Verhaltens-, und Organisationsverordnung.

- **Product information, adviser database** (Anlegerschutz u. Funktionsverbesserungsgesetz, April 2011). Relevant aspects of this law for retail banks include requirements that investment advisers employed in banks be registered in a central database hosted by the regulator and that investment products be made more transparent to customers through a detailed leaflet.

Italy

We assessed the following regulations but did not include them in our assessment, as they were either implemented before 2010 or will not have a material impact on retail-banking profitability:

- **Banking transparency.** The Bank of Italy issued new rules in its report *The protection of the transparency of contractual conditions and of the correctness of relations with customers* in March 2011. The rules will be implemented starting in July of this year and require banks to:
 - Inform customers of the characteristics and costs of services
 - Ensure that the conditions applied correspond in every respect with those advertised
 - Send periodic communications on contractual relationships and in particular on the actual amounts available under lines of credit
- **Usury.** A new usury law has introduced a cap on interest rates beyond which rates are deemed usurious. The cap will be determined through a calculation of a global average rate; the usury rate will be equal to 125 percent of the global rate, plus 4 percent.
- **Mortgages.** New rules call for a cap of 4 percent on floating-rate mortgages issued before 2008. For mortgages after 2008, the floating rate depends on the EU reference rate.
- **Simplified current accounts.** A simplified current-account type has been introduced to meet basic needs of customers (for example, a fixed annual fee with six cash withdrawals annually)

France

We assessed the following regulations but did not include them in our assessment, as they were either implemented before 2010 or will not have a material impact on retail-banking profitability:

- **Consumer rights.** The limit for consumer credit will be extended from €21,000 to €75,000 and the withdrawal period will be extended.
- **Point-of-sale loans.** For point-of-sale (POS) loans greater than €1,000, customers will be able to choose between redeemable and revolving credit; for POS loans greater than €3,000, the lender will need to compile an information sheet on the customer.
- **Credit communication and advertisement.** Stricter rules on marketing of loans will apply and information rights of customers will be strengthened (for example, more information on credit costs will be made available before the loan).
- **Mortgage insurance.** Mortgage insurance rules will be liberalized.
- **Financial intermediaries.** Information rights on the risk level for each investment product will be improved and an official registry for intermediaries will be created.

Appendix 2: Methodology

In the following, we summarize the methodology and assumptions we used for modeling the impact of regulation on European retail banking.

Baseline ROE

We define baseline return on equity (ROE) for the four countries as:

$$\frac{(\text{Revenues} - \text{Operating expenses} - \text{Taxes})}{\text{Allocated Tier 1 capital}}$$

- Revenues and operating expenses are for 2010, as determined by McKinsey's Global Banking Pools, which draw on publicly available information (see Appendix 3 for more details).
- The tax rate is set as follows: 28 percent in the United Kingdom, 29.4 percent in Germany, 32 percent in Italy, and 33.3 percent in France.
- To determine the Tier 1 capital allocated to each business, we used typical revenues to risk-weighted asset (RWA) ratios of between 30 and 75 percent for retail-asset products (mortgages, personal loans, small-business loans, overdrafts, and credit cards). We have also added additional RWAs for operational risk.
- For the preregulation Tier 1 ratios in 2010 we analyzed the average Tier 1 ratios of the major banks in each country as well as (separately) the retail-focused banks (for example, the savings banks in Germany). We excluded banks with no material retail businesses as well as banks whose business was mainly outside the country (for example, Standard Chartered in the United Kingdom) from the analysis. For the universal banks included in the sample we did not estimate a retail-division-specific capital ratio but took the overall bank capital ratio. Based on this analysis we assumed for our impact estimations preregulatory Tier 1 ratios of 9 percent in Italy, 10.5 percent in Germany and France, and 11 percent in the United Kingdom.

Impact from global regulations

Basel III

To estimate the impact of Basel III, we considered three main effects:

- **Increase in capital costs**, driven by higher capital ratios. We assume that post-regulation banks will converge to a Tier 1 capital ratio of 11 percent. Our thinking is based on recent developments. The European Banking Authority's de facto requirement is now 9 percent core Tier 1, which many take as an indication of the future requirement, implying a 2 percent cyclical buffer. Similarly the Independent Commission on Banking (ICB) requires a 10 percent core Tier 1 ratio for retail banks in the United Kingdom. In addition to this 9 or 10 percent core Tier 1 minimum ratio, we assume that banks will hold a capital cushion of one percentage point (in the United Kingdom) or two percentage points (in the rest of Europe).

To account for the new rules on capital quality in Basel III, we assume that banks will need an additional 20 percent of their Tier 1 capital (that is, about two percentage points on top of the 11 percent). In other words, we assume that banks will need to meet an 11 percent Tier 1 ratio, but we have used 13 percent for our calculation to reflect the higher quality of capital that will be needed in future. Thus impact in Germany and France is derived from an increase from 10.5 percent to 13 percent, in the United Kingdom from 11 percent to 13 percent, and in Italy from 9 percent to 13 percent.

- **Increase in liquidity costs**, driven by the LCR, which will require banks to hold additional liquidity for some long-term funded products. We assumed a target LCR of 105 percent.
- **Increase in funding costs**, driven by the NSFR. We assumed a target NSFR of 105 percent; long-term funding is treated as 100 percent available stable funding (ASF); short-term funding is treated as 40 percent ASF; funding costs are deemed to be 70 basis points for long-term funding and 10 basis points for short-term funding; capital benefit is accounted for as long-term funding.

G-SIFIs

As noted earlier, we estimated the impact of G-SIFI capital charges but did not include it in our product or country profitability assessment. To estimate the impact, we have used the five categories outlined by the FSB (one category for which 1 percent additional capital will be required, and four others with 1.5 percent, 2.0 percent, 2.5 percent, and 3.5 percent additional capital required). For each, we have modeled regulatory impact as discussed above, under Basel III.

In the paper, we have done a sensitivity analysis of SIFI impact depending on the respective category. Overall European impact is calculated as the average of the impact in four analyzed markets.

Impact from European regulations

Directive on Credit Agreements Relating to Residential Property

We have evaluated the impact of four main implications of this EU directive on mortgages:

- **Lower revenue margins** due to renegotiation of mortgages. We assume that banks will become more willing to renegotiate terms as customers will be able to easily switch banks without penalty fees. Average revenue margin decrease is assumed to be 20 percent across the countries in scope.
- **Loss of switching revenues** as customers will be allowed to switch banks without paying penalty fees. The average penalty fee is assumed to be 3 percent of volume.
- **Lower revenues from new mortgages** due to increased market transparency and customers' improved bargaining position. The average margin decrease is assumed to be 20 percent.
- **Higher operating costs** for mortgage-application processing due to the increased transparency requirements of the mortgage application. For example, banks will have to verify net disposable income in all cases and provide explanations when they reject mortgage applications. We assumed these costs will add €50 per new application.

Markets in Financial Instruments Directive (MiFID II)

We have evaluated the impact of five main implications of MiFID II:

- **Loss of inducement revenues from independent advisers.** We anticipate a decrease in sales of independent advisers of 20 to 30 percent (or 25 percent on average), as the ban of inducements reduces sales incentives for independent advisers.
- **Loss of inducement revenues from discretionary mandates.** We anticipate a decline in discretionary mandates, another result of the ban on inducements. We assumed a 15 percent decline in the kickback rate.

- **Loss of revenues from telephone orders of complex products.** New rules restrict phone instructions to execution-only orders of complex products. We assumed a reduction in these orders of between 15 and 20 percent (or 17 percent on average).
- **Loss of revenues for online-banking execution-only orders.** Similar to the above, new rules restrict online instructions of complex products to execution-only, resulting in lower revenues.
- **Higher costs to maintain mandatory record of telephone conversations.** The new requirement to record orders from customers over the telephone will double the expected related costs, we assume.

Single Euro Payments Area Initiative (SEPA)

The new rule will result in lower profit margins on payment products such as credit- and debit-card transactions and other banking transactions, because of higher transparency requirements, higher costs for IT requirements, and the costs needed to provide necessary information. We assumed a decline in margins at 5 to 10 percent.

Country-level regulations

United Kingdom

We used the following assumptions:

- **ICB regulation** will reduce profits because of higher operating costs. Ring-fenced retail banks will require their own governance structure and disclosure procedures, which would generate additional overhead and IT costs. We have assumed a profit decrease in the UK retail-banking sector of 5 percent.
- **Recovery and resolution plans** will require banks to incur new costs related to their setup and implementation. We have assumed ongoing compliance costs of £100 million to €150 million annually (equivalent to 1 percent of UK retail-banking sector profits).
- **Payment-protection products** regulation will require banks to pay damages to clients for misleading them into buying payment-protection insurance in the past. We have assumed one-off damage payments of £8 billion to €10 billion over the period 2011 to 2015 (equivalent to a 10 percent decline in profits for these years).
- **Account switching and portability** regulation will add operating costs to set up non-bank-specific account numbers and enable flexibility to move accounts among banks. We estimate this at £600 million for the period 2011 to 2015, lowering profits for current and noncurrent accounts by about 1 percent.
- **Current-account fees** will rise. Greater transparency into current-account costs will prompt the industry to shift to a fee-based model, resulting in a rise in current account fees. We estimate an increase in fee income of 1.5 percent annually.
- **The Retail Distribution Review** will mean that banks are no longer able to fold the cost of their relationship managers into their product pricing and will instead have to charge a separate advisory fee. A fee that covers actual costs will be too high for the mass/mass-affluent segment, leading these segments to exit advisory services and shift to self-service channels. We assume a 40 to 50 percent decline in revenue margins for investment products.
- **The bank levy** will reduce profits by €700 million to €750 million, in our estimate, equivalent to a profit decrease of about 4 percent.

Germany

- **Taxes and levy** regulation will lower profits by about 5 to 10 percent. We allocated this reduction to products based on their share of pretax profits.
- **Fee-based advice** rules will lower profits, as banks spend money to create a fee- based advisory model and business shifts away from in-house advisers. This results in a loss of investment profits of 1.5 to 3 percent (2.25 percent average).

Estimating the impact for overall European retail banking

We did not estimate the impact of new regulation on retail banking in all European countries. However, we do not expect that overall impact to differ significantly from the impact estimated for the four countries (France, Germany, Italy, and the United Kingdom). First, these four countries represent 66 percent of the EU-27 retail market, measured by gross revenues. Second, the four markets do not differ structurally from the average retail market in Europe with respect to four essential characteristics:

- **Capitalization.** The average Tier 1 ratio in the EU was 11 percent in 2010, a figure on the same order as the Tier 1 ratios we observed for banks with material retail-banking in France (10.5 percent), Germany (10.5 percent), Italy (9 percent) and the United Kingdom (11 percent).
- **Profitability.** The average retail ROE in the EU was 11 percent in 2010, comparable to the average retail ROE of 10 percent we observed in the four countries we analyzed. (Note, however, that there were some significant differences in ROE among these countries, ranging from 14 percent in France and the United Kingdom to 7 percent in Germany and 5 percent in Italy. These figures reflect the very different starting positions of the retail-banking sectors in Europe in 2010.)
- **Funding.** The average loan-to-deposit ratio in the EU was 115 percent in 2010, which is also in line with the four countries France (121 percent), Germany (95 percent), Italy (143 percent) and the United Kingdom (106 percent).
- **Regulatory agenda.** To be sure, the four countries face quite different regulatory agendas, as discussed in the paper (for example, compare new and proposed regulation in Italy with that of the United Kingdom). But this heterogeneity is common across Europe.

Appendix 3: Global Banking Pools

McKinsey Global Banking Pools (GBP), a proprietary McKinsey asset, is a global database that captures volumes, revenues, profits, and other information for banking markets in more than 60 major countries, from Austria to Vietnam. Other smaller markets are covered through five additional regional models. GBP now carries 12 years of data (2000–2011) and includes forecasts for 9 forward years (2012–2020) with multiple scenarios.

Scope

The database covers all key drivers of profitability, including:

- Customer volumes (balances outstanding and transactions)
- Margins (interest and fees/commissions)
- Credit losses (normalized loan-loss provisions)

Institutions and activities. The database encompasses the client-facing activities of both traditional banks and specialist finance players (such as broker dealers, leasing companies, and asset managers). (The database excludes hedge funds and private-equity firms.) The data covered for each country refer to banking businesses conducted within that geography (for example, revenues from all loans extended, deposits raised, trading conducted, or assets managed in the specific country). It does not cover treasury activities such as asset-liability management or proprietary trading, interbank market activity, or insurance activities.

Products. The database includes 56 banking products, in three segments:

- **Retail:** asset gathering and transactions (current accounts, deposits, investment, insurance, and pension distribution) and lending (consumer finance, mortgage, and microlending)
- **Wholesale:** cash management (current accounts and deposits), lending (straight lending and specialized finance), and capital markets and investment banking
- **Asset management** (institutional and retail asset-management production)

Management

The database was developed and is maintained by the McKinsey Global Financial Initiative (MGFI), a banking research center located in Budapest and Delhi, specializing in sectoral analysis and quantitative services. MGFI captures and disseminates the latest McKinsey knowledge and insights from each country covered and tracks global trends with the contribution of more than 150 McKinsey partners, experts, and analysts around the world. The database is regularly updated based on public data as well as the experts' local insights and estimates. In addition, MGFI offers a range of in-depth services:

- Developing customized scenarios based on proprietary models
- Converting market data into strategic thinking (such as portfolio reviews, expansion strategies)
- Sharing the latest trends and analyses via publications (for example, "In search of a sustainable model for global banking," mckinseyquarterly.com)

For more information and details on access to MGFI's data and analyses, visit solutions.mckinsey.com/globalbankingpools.

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