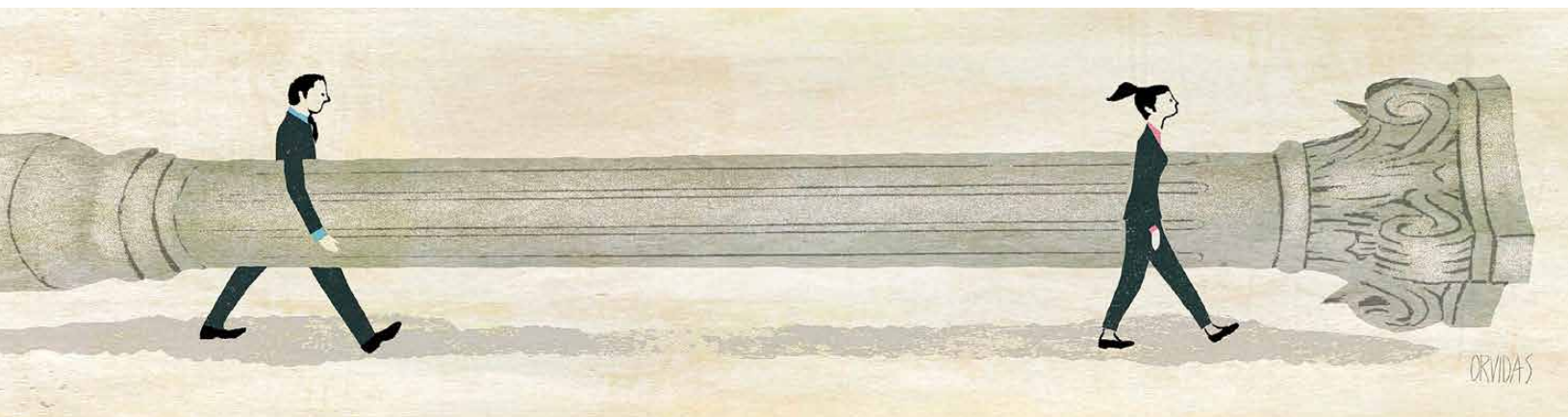


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What's next for the restructuring of Europe's banks?

The long period of stagnation is over, and European banks are increasingly undergoing restructuring.

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European banks are ripe for restructuring—and a lot of it. After five years of relatively stagnant economic conditions, many of them continue to face pressure from difficult funding conditions, a transition to higher costs of capital, changing regulations, and tighter capital requirements. They need to shed capital-intensive operations and simplify businesses to compete more profitably in fewer market segments. All told, Europe's banks are considering the sale of up to 725 business lines across various business segments and geographies (exhibit).

So far, activity remains subdued. Since 2007, when banks struck deals worth €207 billion, the only bump in deal activity came in 2008, as

governments began injecting €322 billion of public capital¹ to save vulnerable financial institutions. Deal volume hit €67 billion in 2012, a modest increase from the low levels of 2010 and 2011, and although 2013 so far has been slow, with around €28 billion in deal value, what activity there has been may offer a glimpse of what's to come and who will be involved.

We expect such activity to continue given the following trends.

Forced restructuring of bailed-out banks.

Aid from national governments often comes with restrictions and conditions. One key feature of the support extended by European and national

authorities is the requirement of banks to divest assets to increase liquidity and pay back the aid. The result is that many CEOs of European banks now face restructuring programs to satisfy the terms of agreements signed with European or national regulators. In extreme cases, the asset base of some banks may be cut in half, and painful measures will be unavoidable.

Government divestiture. Bailouts put billions of euros of financial-services assets into government hands. In general, the authorities do not consider themselves to be a natural owner of banks. There is an expectation that ownership will be returned to the private sector when conditions in capital markets permit it. Growing public deficits, pressure from public opinion,

Exhibit

European financial institutions are considering selling 400 to 725 business lines in various subsegments and geographies.

Opportunities as of Feb 2013: ■ >15 ■ 5–15 ■ <5

Subsegment	Eastern Europe	Mediterranean ¹	United Kingdom	Germany	France	BNL ²	Others ³	Total
Retail banking	50–100	40–50	5–10	5–10	10–15	5–10	0–5	115–200
Corporate and investment banking	10–15	5–10	5–10	0–5	5–10	5–10	0–5	30–65
Asset management	0–5	5–10	10–15	0–5	5–10	5–10	5–10	30–65
Private banking	0–5	5–10	10–15	0–5	20–25	5–10	25–30	65–100
Payments ⁴	0–5	0–5	10–15	15–20	5–10	5–10	5–10	40–75
Others ⁵	15–30	20–35	45–60	0–15	25–35	5–20	10–25	120–220
Total	75–160	75–120	85–125	20–60	70–105	30–70	45–85	400–725

¹Greece, Iberia, Italy, and Turkey.

²Belgium, Netherlands, and Luxembourg.

³Denmark, Finland, Norway, Sweden, and Switzerland.

⁴Including security services and market infrastructure.

⁵Disposal of specific assets (eg, real-estate portfolio, asset leasing), including life and property-and-casualty insurance. Might overlap with other subsegments.

Source: Dealogic; McKinsey analysis

and the desire to promote competition and realize profits will naturally drive governments to divest their holdings. Some divestments are already under way.

Pressure to strengthen the capital base.

Governments across Europe are encouraging banks to rid their balance sheets of toxic assets. For example, in Spain, the European Union required the establishment of a so-called bad bank—the Company for the Management of Assets proceeding from Restructuring of the Banking System, or SAREB—as a pre-condition in exchange for aid of up to €100 billion to the Spanish banking sector. By the end of February 2013, SAREB had acquired €52 billion of property-development loan assets from Spanish institutions.

Moreover, despite efforts to deleverage and improve capital ratios, banks are still hungry for capital. Given its scarcity in the market, banks are being forced to divest assets in order to raise capital—and such sales may be practically necessary before investors will again open their wallets. We estimate that European banks need to raise more than €100 billion of equity to meet their capital needs.

Pressure to improve returns. Industry returns are expected to be substantially (and structurally) lower than before 2008. To boost them, financial institutions must build critical mass in their core businesses and divest subscale, noncore, and capital-consuming operations. Consequently, there will be a shift toward scale and to having business lines run by their best natural owner. This will result in the unraveling of some acquisitions made in the last M&A wave and, perhaps, a spate of mergers among equals looking to create scale in their core business.

Domestic roll-ups are already under way. In 2011, Spain's Bilbao Bizkaia Kutxa acquired fellow Basque bank Kutxabank for €1.64 billion. This was followed by Banco Popular's €1.34 billion acquisition of Banco Pastor and several other roll-ups in Spain during 2012. And in the United Kingdom, there was Virgin Money's opportunistic acquisition of Northern Rock.

In the same vein, many banks will want to divest low-margin, low-growth businesses, such as infrastructure activities like clearing and securities servicing where scale effects and efficiency gains are elusive. Such infrastructure-type services can, instead, be outsourced. Indeed, this is

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already happening. ING sold its local custody and securities-services businesses in Bulgaria, the Czech Republic, Hungary, Romania, Russia, Slovakia, and Ukraine to Citi in April 2013.

When activity does pick up, acquisitions by non-European banks are likely to be an inevitable part of the sector's restructuring. More than 16² of the top 20 global banks are non-European; most of them are better capitalized and trade at higher multiples than their European counterparts—for whom the capital needed to shore up the

sector is likely out of reach. That puts non-European banks in a strong position to snap up some assets that are still priced at book value³ as well as others, such as those in retail banking, which at this writing are trading at very low valuations and could offer potentially outsize returns. ○

¹ Up to the end of 2011—not including guarantees—in the form of asset-relief interventions and other liquidity measures.

² As of June 30, 2013.

³ The Datastream European banking index is currently trading at a price-to-book value of 0.97.

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