



# Implications of Basel III for the European banking sector

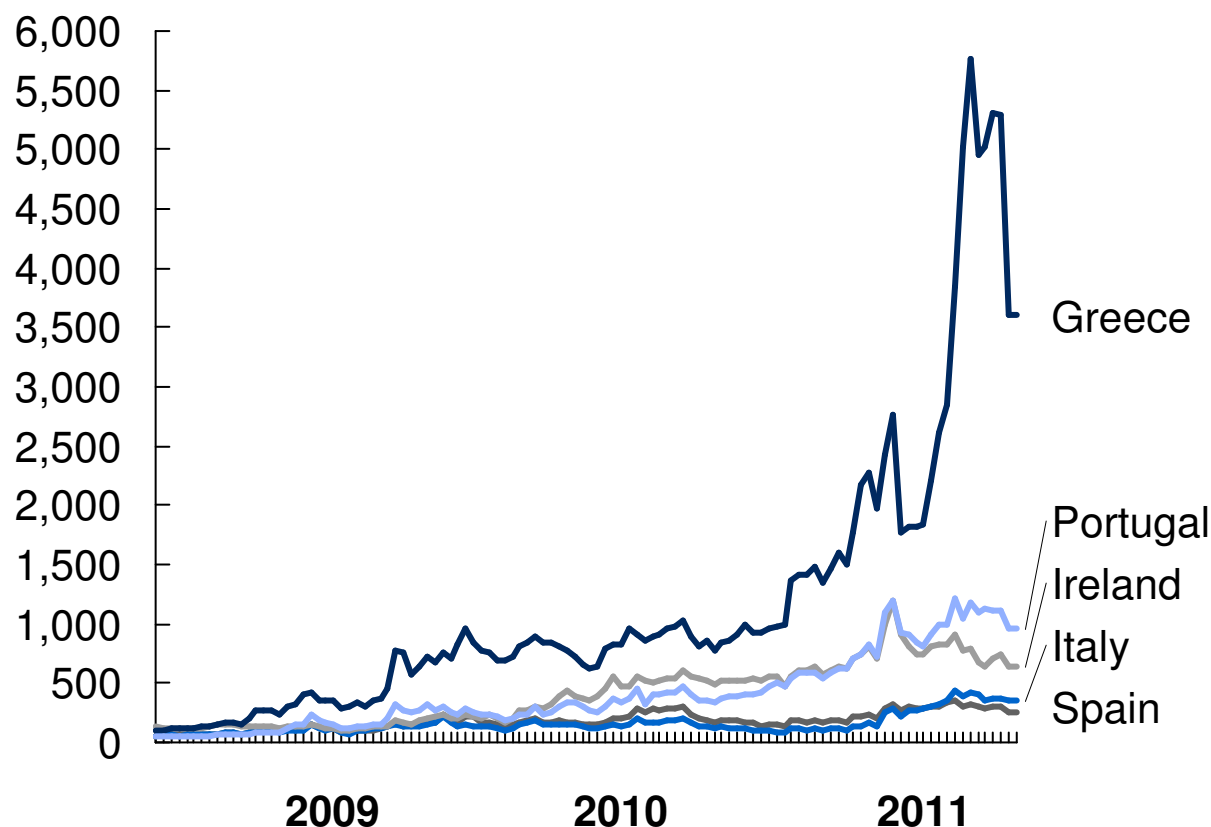
Euro Finance Week 2011

Frankfurt  
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# Current context of financial regulation and risk management in banking

CDS spreads sovereign bonds, bps



- **Significant volatility** in the financial markets; liquidity markets drying up
- **Short-term capitalization requirements** from EBA stress testing vs. **depressed bank equity valuation levels**
- **Significant risks of an economic downturn**
- **Longer-term regulatory reforms and business transformation** in banks and market structure changes overall in the financial services industry

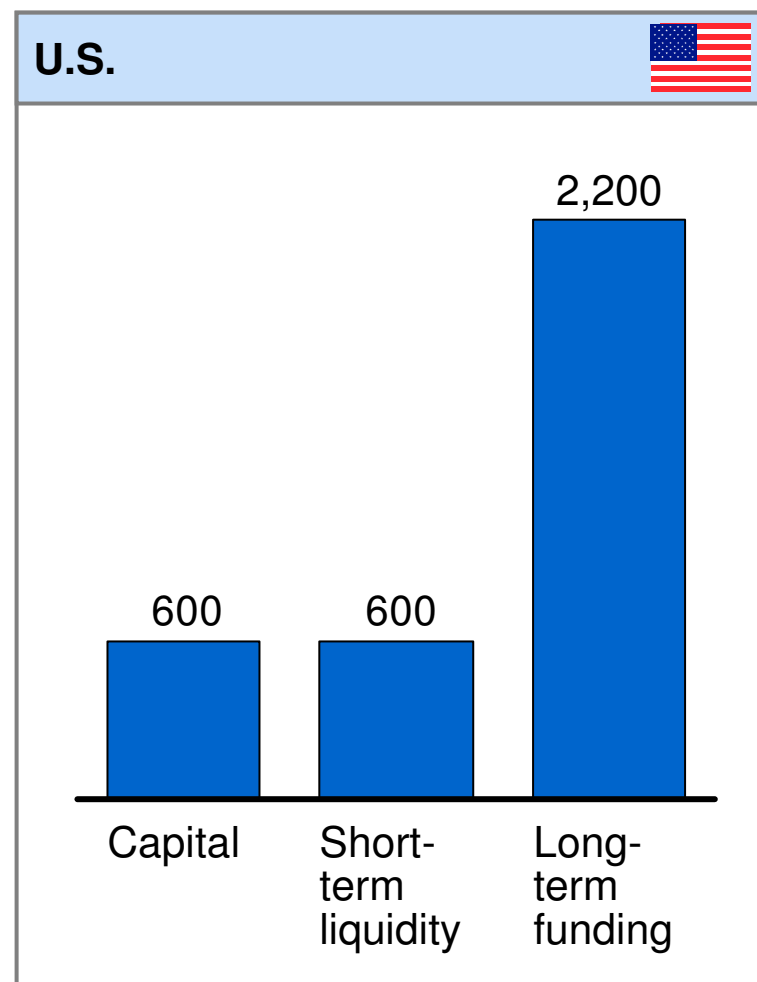
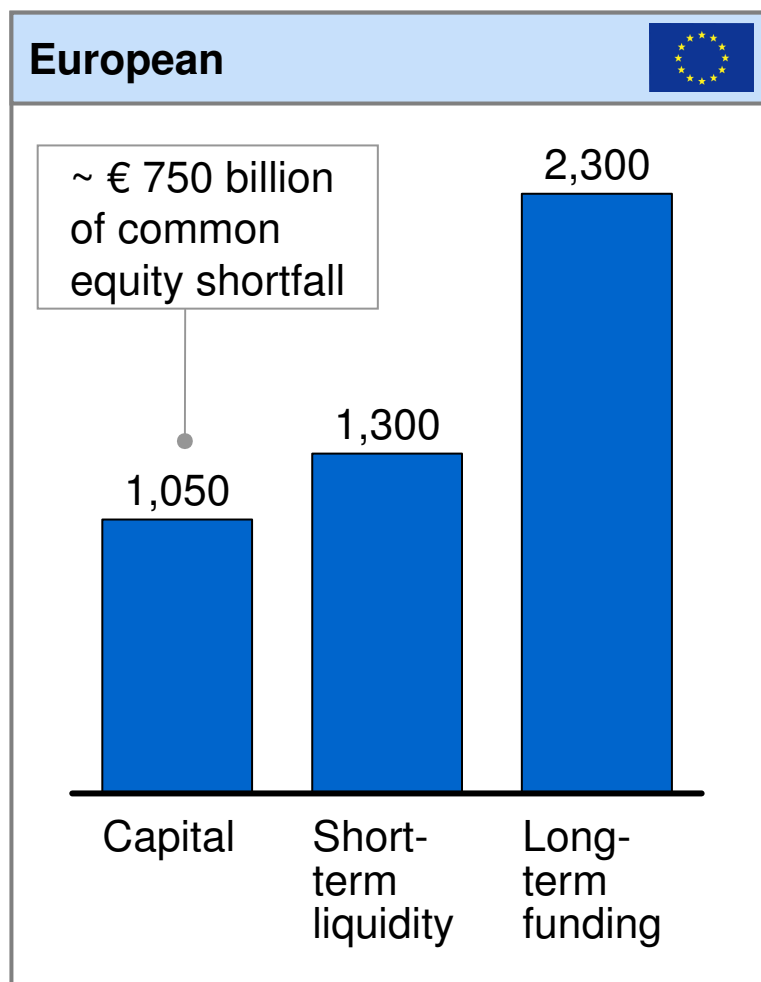
## Europ. Banks

	2009	2010	2011
- MtB	~0.9	~0.7	~0.5
- CDS (bps)	~120	~320	~470

1 European Banks ex UK  
2 5 yr spreads, European banks

# New regulatory regime will force significant capital and liquidity shortfall for Europe and U.S. financial institutions

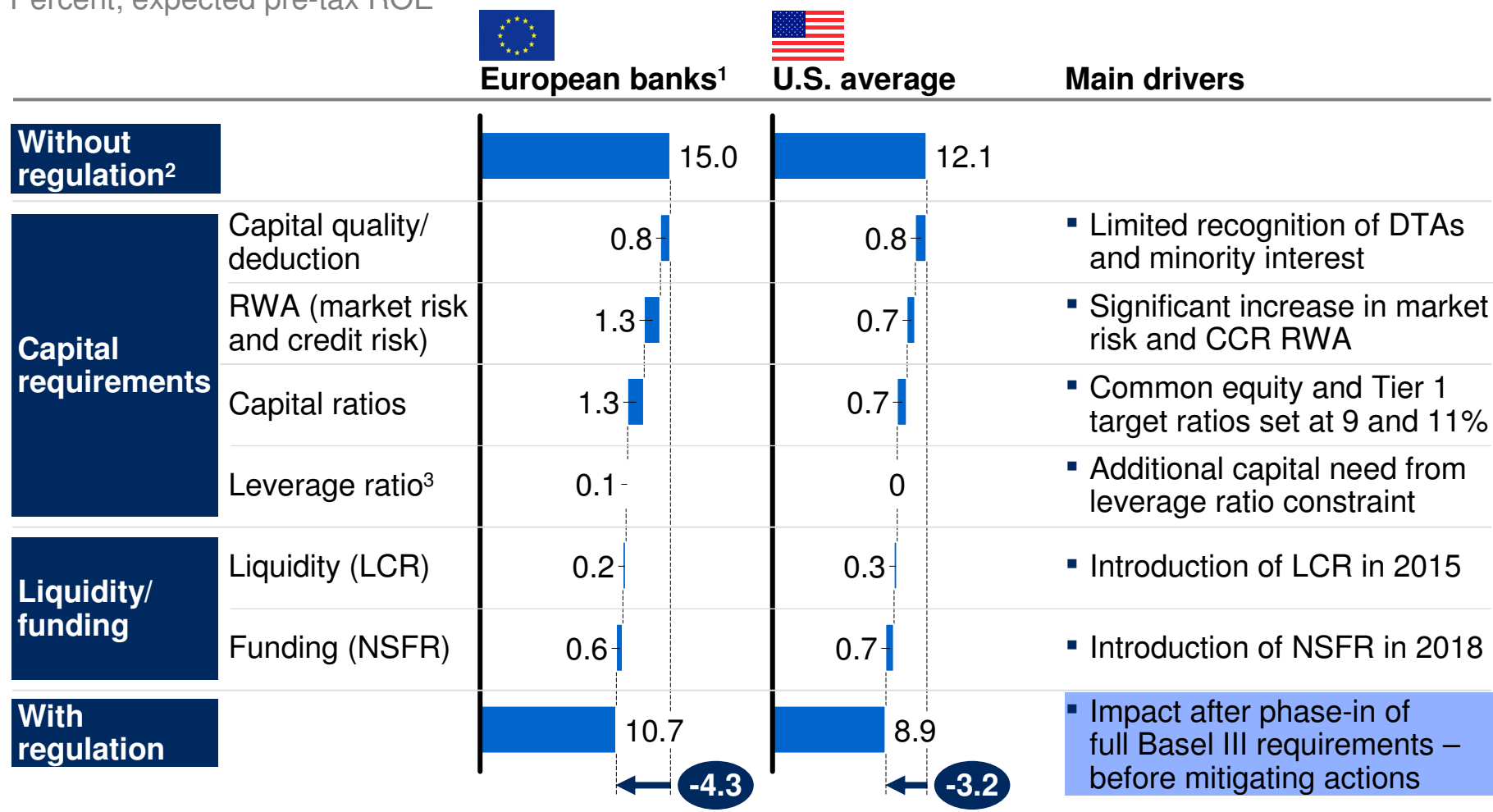
EUR billions; 2019



# After implementation of Basel III regulatory measures, ROE of global banks could decrease by 3-4 pp before mitigation

ESTIMATES  
BEFORE  
MITIGATION

Percent; expected pre-tax ROE



1 Sample includes ~45 banks across Europe

2 EU: based on 2004-07 ROE for individual banks scaled down to average 1980-2008 levels across EU

3 Only additional capital need (after increase of minimum capital ratio and capital deductions) considered

## Resulting impact on the financial and banking market structure: what trends we do expect?

1

**Significant repricing of banking products – though timing given the different competitive positions unclear**



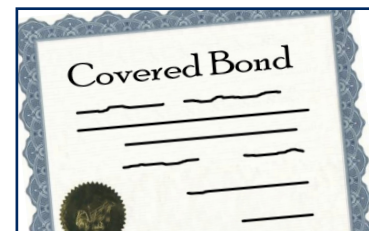
2

**Disintermediation** and more direct capital transfer between Corporates and Investors (insurances, funds etc.)



3

**New structure for banks' capital and funding markets** (secured funding, collateral management)



4

Continued **deleveraging/derisking of banks' balance sheets** and an increase in non-bank/shadow banking activities

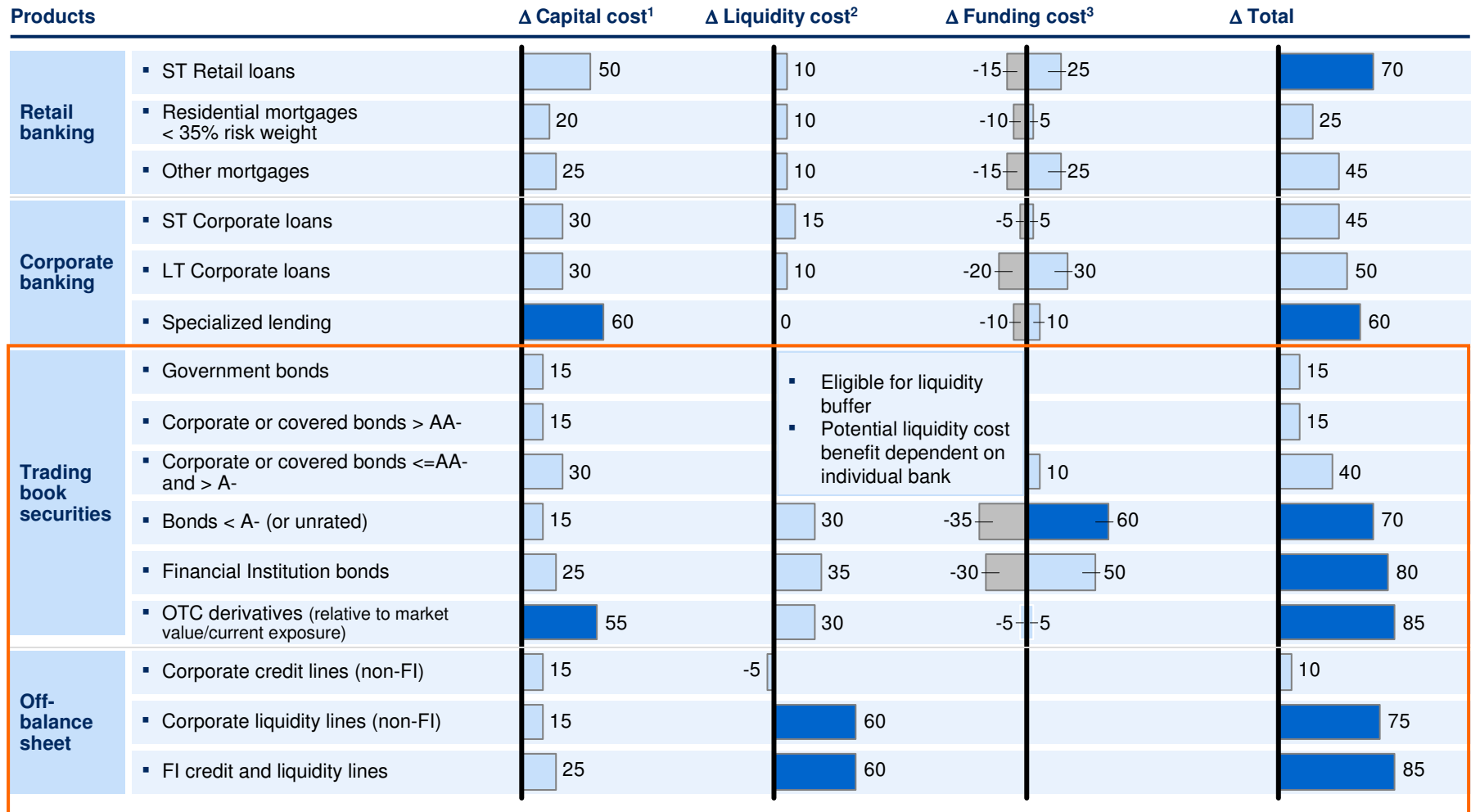


# 1 Basel III will significantly change product costs

bps

ESTIMATES BEFORE MITIGATION

■ Reduced liquidity cost due to increased long-term funding ■ Cost increase over 50bp



1 Assuming target Tier 1 ratio of 8% under Basel II and 11% under Basel III; in addition, 20% increase to account for capital quality and deductions measures

2 Introduction of LCR in 2014; assuming current liability structure and 7% liquidity holding per product under Basel II and 105% LCR target ratio under Basel III

3 Introduction of NSFR in 2019; assuming 105% NSFR target ratio

# 1 Significant re-pricing would be needed to restore ROEs, especially in structured products

ESTIMATES

Percent

Level of margin increase  
>50 20-50 <20

Asset class	RoE post(!) immediate mitigation <sup>2</sup>	Increase in client margin needed <sup>1</sup>	
		Target RoE of 12%	Target RoE of 15%
FX	~19	N/A	N/A
Rates - Flow	11-12	1-5	20-30
Rates - Structured	7-8	30-50	60-80
Credit - Flow	10-11	10-15	30-40
Credit - Structured	7-8	30-50	60-80
Commodities	~11	5-10	30-35
Cash Equities	~18	N/A	N/A
EQD - Flow	~11	1-5	15-20
EQD - Structured	12-13	N/A	15-20
Prime Services	11-12	1-5	25-30
Proprietary Trading	11-12	N/A	N/A

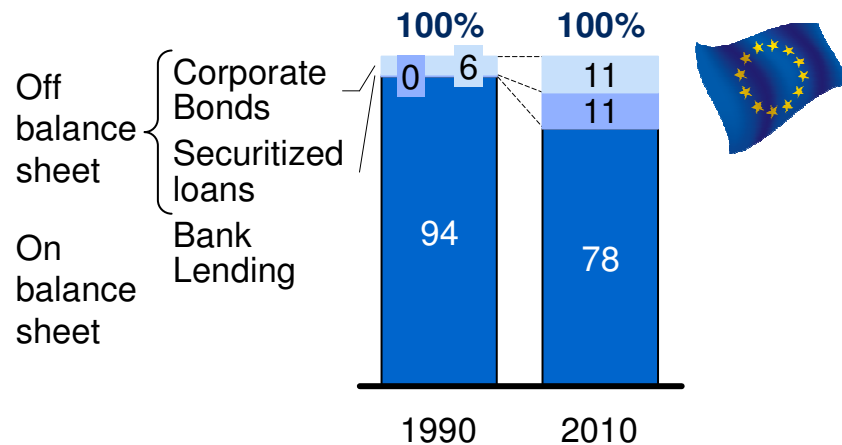
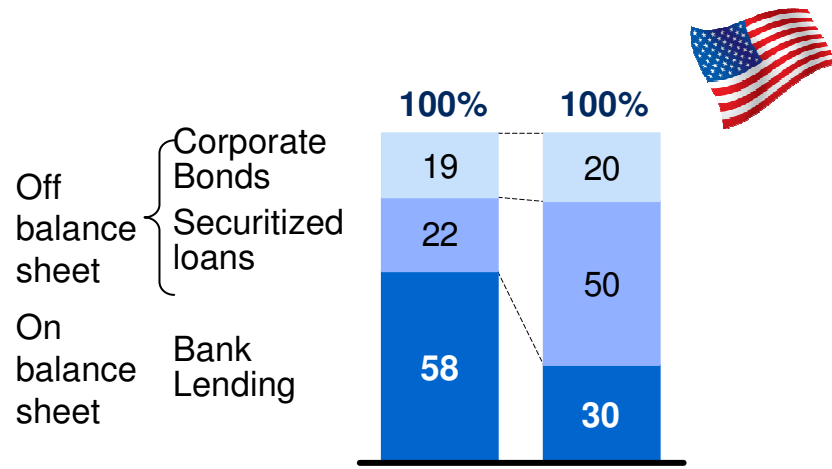
1 Increase in client margin in percent of current margin (to bridge the gap between post mitigation RoE and target RoE)

2 Incl. technical mitigations such as improvements in data systems, collateral management, adjustments to product structure

## 2 Disintermediation of banks' B/S will lead to a more US type/disintermediated debt market structure

ESTIMATES

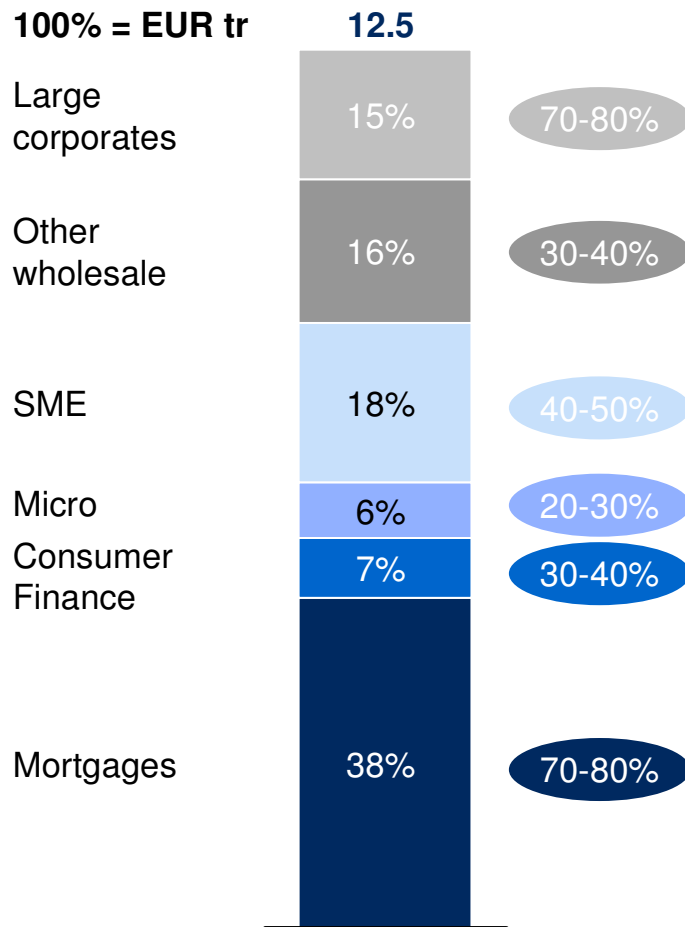
Percent



- **US debt capital markets driven by corporate bonds and securitizations** (in particular MBS)
- However, **current regulation, e.g., on backup liquidity lines, securitization, and trading** will require adjustments to current business model, incl. some reintermediation (see new US proposal on covered bonds)
- **European debt markets very focused on bank lending**
- Disintermediation expected due to
  - **High capital/funding charges** on bank debt (e.g., infrastructure finance)
  - **Reduced appetite for banking exposure** by insurance companies (SolvII) and other inst. investors
  - Countereffects from current regulation as experienced in the US

### 3 Secured funding and collateral management will play a significantly increased role

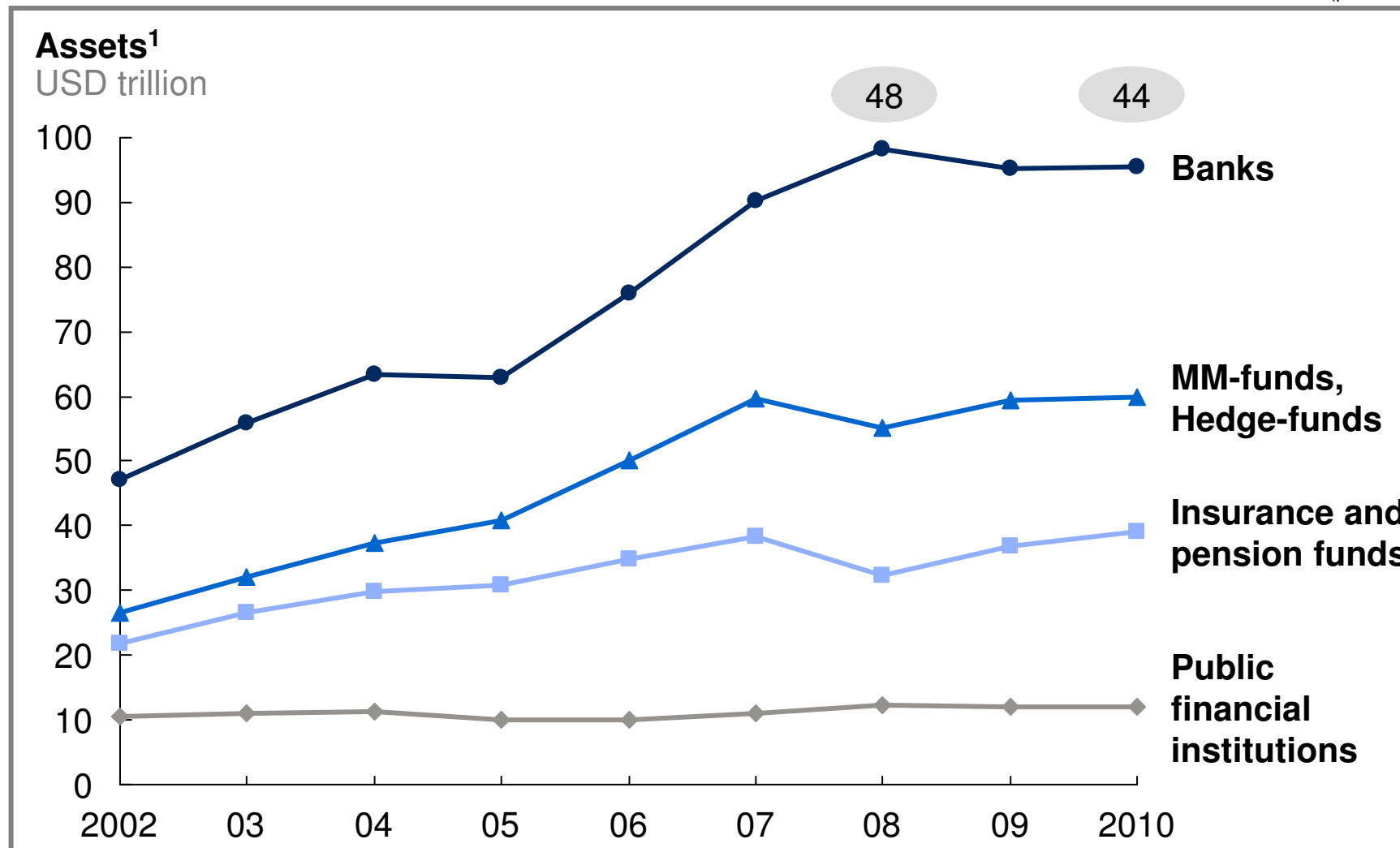
ESTIMATES



- **Long-term funding:** Expansion of secured funding markets (vis-à-vis DCM and other disintermediations)
  - **Covered bonds**
  - Increased and **new forms of securitizations/loan funds**
  - **Government-sponsored programs (SME)**
  - **Funding substitutions:** syndicated lending with direct placements towards institutional investors
  
- **Short-term funding:** further growth in the collateralized short-term/repo funding markets incl. more active collateral trading with corporates and institutional investors
  
- **Important prerequisite: new regulatory liquidity and funding requirements (LCR/NSFR) are appropriately adjusted!**

## 4 Overall, the banking system will be disintermediated at the expense of near-/shadow banking business models

○ Share of total (percent)



<sup>1</sup> Based on flow of Funds data for the Euro area, Australia, Canada, Japan, Korea, UK and US.

## Implications for the banks' risk management

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- Significantly **increased complexity of risk management frameworks** (regulatory capital/liquidity/leverage frameworks, revised accounting standards, rating methodologies, ...)
- **More forward looking discretionary management interventions** to handle increased complexity and market volatility
- **Further industrialization of risk management processes** (given continued cost pressures, but also regulatory information requirements) through increased level of specialization/automation
- Higher relevance for **risk function in managing/guiding bank transformation** (e.g., to ensure sustainable business models, manage regulatory pressures etc.)

