Coping with the credit crunch: Opportunities for corporate banking in Europe

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Although the outlook for corporate banking is less bright than it has been in recent years, appropriate strategies can still deliver solid growth in the short to medium term.

Continuing turmoil in global capital markets after the credit crunch of mid-2007 has clouded the short-term outlook, especially in investment banking. We believe, however, that corporate banking in Europe will benefit from several profitable growth areas over the next 18 months and that shrewd players should position themselves accordingly.

The current financial crisis and higher funding costs will doubtless hit products such as straight loans, asset-backed securities, and leveraged finance. But increased interest rate spreads and a more risk-averse business environment should promote other products and services, including cash management and corporate risk mitigation. By focusing on a clear set of opportunities, European corporate-banking executives can limit the impact of the current malaise and look forward to a period of continued, albeit slower, revenue growth.

In the decade leading up to mid-2007, corporate-banking revenues in Europe grew solidly, at an average rate of around 7 percent a year. Central and Eastern Europe enjoyed a particularly good run, with average annual revenue growth of around 13 percent—and a benign risk environment kept loan losses in check.

But in the wake of the recent credit crunch, borrowing costs in the interbank market have moved higher, along with the cost of capital market funding—for some players, by up to 40 basis points. Economic growth forecasts have been revised downward, and capital adequacy ratios are starting to come under pres-sure. Banks have been forced to take more leveraged-buyout debt onto their balance sheets, and large backlogs remain.

Some institutions now wonder if they should change their medium-term plans. In our view, that would carry unwarranted risks. The economic outlook is by no means universally bad for corporate banking. Granted, lower-than-expected GDP growth will affect all business clients as the overall volume of traded goods and services declines and the amount of money required to finance them falls. But other trends, such as increased funding costs and aversion to risk, will be more positive.

Our assessment reflects the findings of the McKinsey Global Corporate Banking Survey, a detailed comparison of product revenue structures, sales models, incen-tive structures, and credit process efficiency across more than 35 leading European banks. The results not only highlight and quantitatively substantiate key product opportunities but also pinpoint striking differences in the performance of European sales teams and back-office operations—differences that executives shouldn't ignore. Taking action would be desirable at all stages of the economic cycle. Taking action now, when reve-nues are under pressure, will support revenue growth and cushion a potential midterm worsening of the credit cycle (see sidebar, "Operational efficiency").

The product opportunities

How then can banks best exploit the cur-rent opportunities for growth? The results of our corporate-banking survey illustrate several exciting possibilities, such as repric-ing core lending activities, raising the revenues from payment and deposit prod-ucts, and meeting the demand from corporate clients for a more active approach to risk mitigation, as well as a range of specialized opportunities.

Traditional lending

The key anchor product, traditional lending, still tends to be a loss leader for many European banks when they fully factor in capital, risk, and operational costs (Exhibit 1). Given the changes in funding and risk, some corporate banks will come under serious pressure in 2008.

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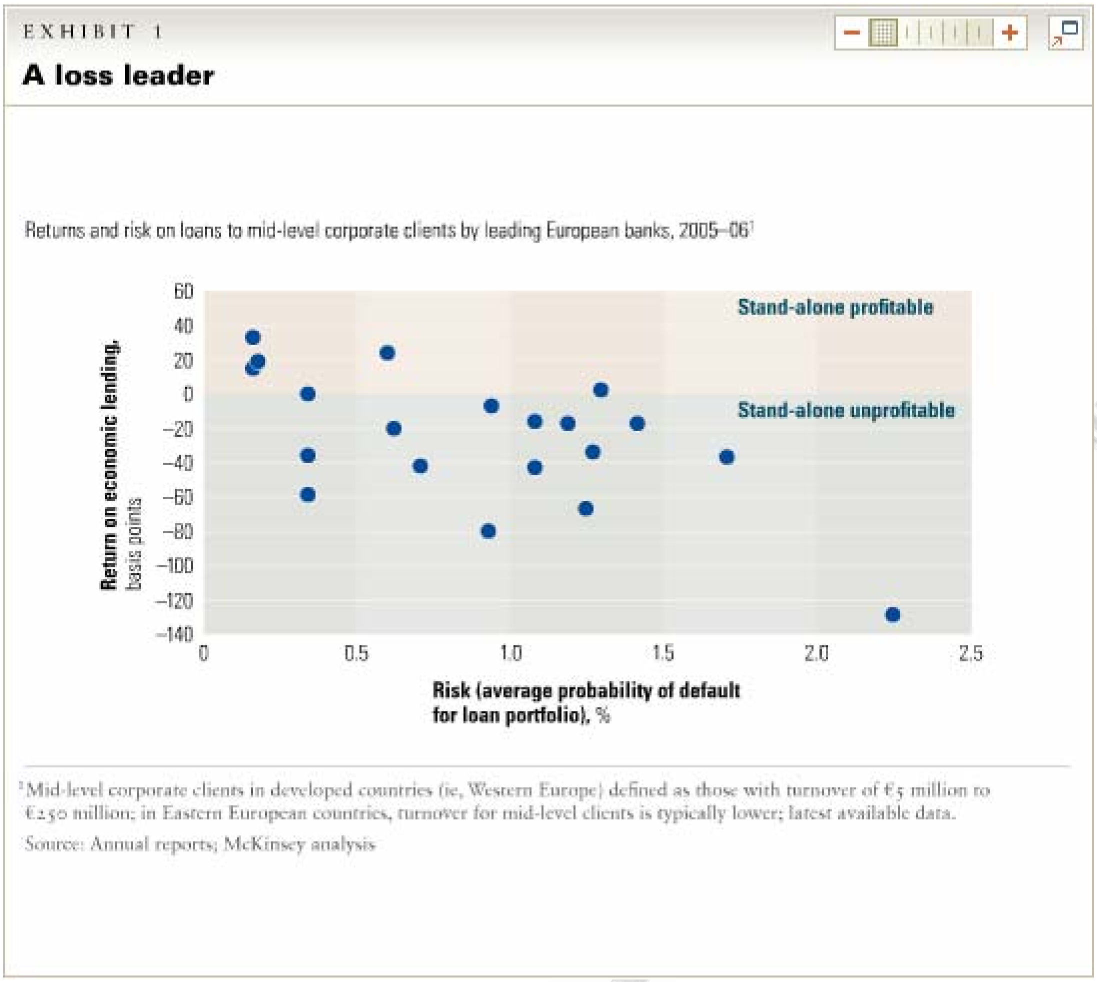

EXHIBIT 1

A loss leader

Returns and risk on loans to mid-level corporate clients by leading European banks, 2005–06[1]

[1] Mid-level corporate clients in developed countries (ie, Western Europe) defined as those with turnover of €5 million to €250 million; in Eastern European countries, turnover for mid-level clients is typically lower; latest available data.

Source: Annual reports; McKinsey analysis

What's most striking, however, is that the five top performers not only achieve far higher margins (plus 50 to 60 basis points) on their cross-selling activities than the average of their competitors but also run their core lending businesses at a profit. The message is clear: banks leave substantial amounts of money on the table if they assume that without the "subsidies" of cross-selling they can't make an economic profit from lending.

Banks should therefore see current market conditions as an opportunity to revisit unsustainably low margins and ensure that their lending is profitable in its own right. Most of them also have a significant potential to boost fees as well as net interest income: our survey shows that the top players achieve higher interest margins and, at the same time, earn higher fees. Contrary to a widespread belief, there does not appear to be a trade-off between the two—banks that do a good job for their corporate clients are rewarded on both counts.

Many players price loans to their midcorp clients carelessly because they don't differentiate sufficiently by risk. In fact, the returns from lending to such clients don't differ markedly across a wide band of different risk portfolios—in contrast to large corporate loans, where the pricing of risk is already more prevalent. Banks should follow the example of the leaders that use a rigorous yet standardized risk assessment to price loans. This approach challenges the notion that lending to midcorps has a specific "market price" and suggests that corporate banks can adjust what they charge in order to reflect the risk in their portfolios.

Payments and deposits

Payments and deposits already account for around 11 percent of total corporate-banking revenues in Western Europe and around 19 percent in Central and Eastern Europe. Exhibit 2 highlights three key drivers of revenue growth: the number of clients using these products, the amount of business banks generate from average clients, and revenue margins. Banks differ remarkably—at one end of the spec-trum, for example, top-quartile banks enjoy close to 100 percent penetration; at the other, a mere 50 percent of a bank's clients use payment and deposit products. "Ticket size" (average revenues per client using these two products) differs by a factor of almost four in the case of midcorp businesses, and revenue margins fluctuate by a still-larger factor from the weakest to the most successful pricing quartile of players. Banks differ as sig-nificantly within countries as among them, indicating that country effects may have been overplayed in the past.

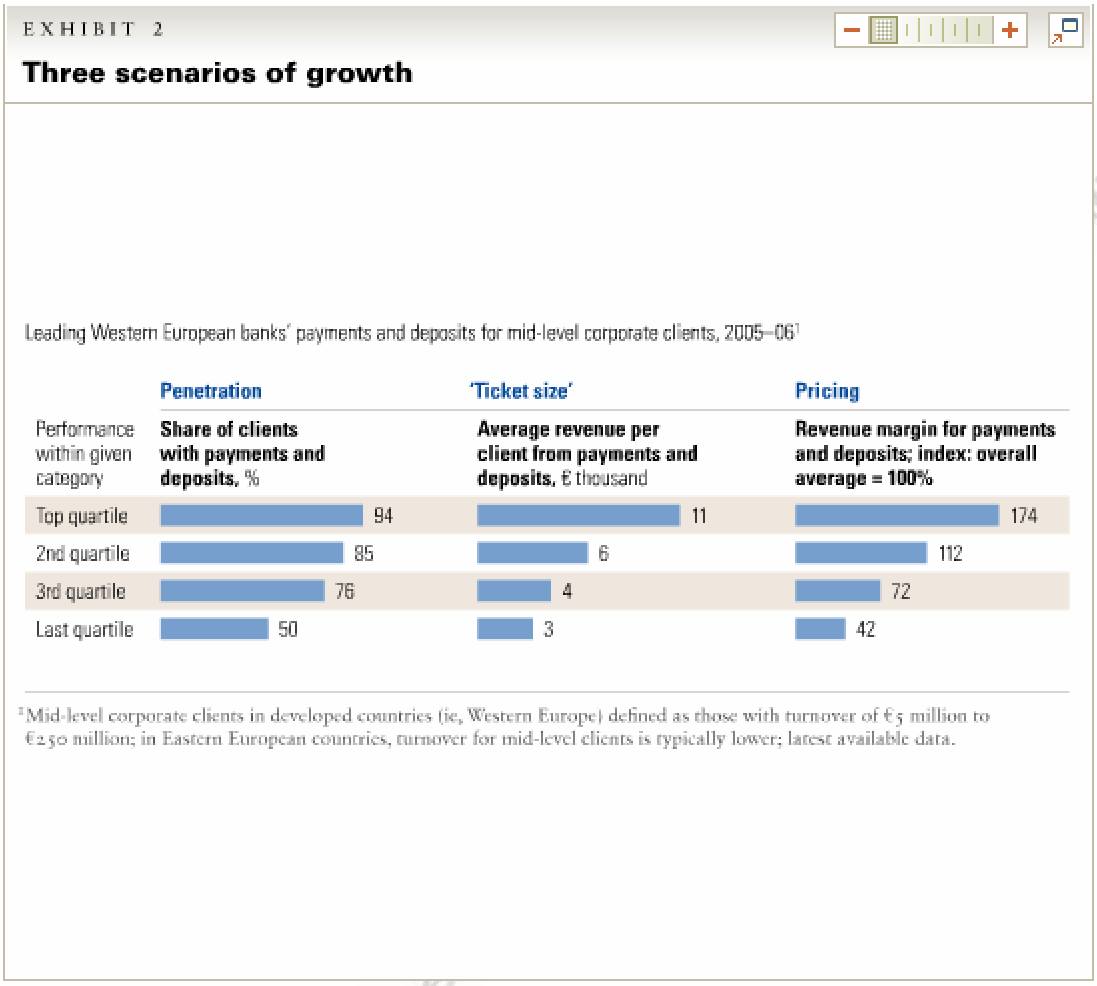

EXHIBIT 2

Three scenarios of growth

Leading Western European banks' payments and deposits for mid-level corporate clients, 2005–06[1]

Performance within given category	Penetration Share of clients with payments and deposits, %	'Ticket size' Average revenue per client from payments and deposits, € thousand	Pricing Revenue margin for payments and deposits; index: overall average = 100%
Top quartile	94	11	174
2nd quartile	85	6	112
3rd quartile	76	4	72
Last quartile	50	3	42

[1] Mid-level corporate clients in developed countries (ie, Western Europe) defined as those with turnover of €5 million to €250 million; in Eastern European countries, turnover for mid-level clients is typically lower; latest available data.

These data strongly suggest that many banks should increase their payment and deposit revenues instead of blaming the margin structures of their respective countries. Banks that already do well segment their corporate clients: they under-stand, among other things, that for large ones, a relationship manager must engage a cash-management product specialist early in the sales process. To encourage seamless interaction between the relationship manager and the prod-uct specialist, they typically use structured and disciplined account-management approaches backed by incentives focusing on total customer value. In the midcorp client segment, the best players adopt a more prestructured approach relying primarily on the corporate relationship manager as a single point of contact for sales of payment and deposit products and the like, involving specialists when necessary.

Capital markets and corporate risk mitigation

Although the investment banks' revenues from capital market activities will probably fall in 2008 as institutional clients pull back from many highly structured products, corporate clients in Europe are stepping up their demand for capital market products. Those clients increasingly look for more sophisticated corporate risk mitigation tools to survive a choppier economic climate. Any expansion of cross-border trade will fuel demand, as well. Interest-rate-volatility, foreign-exchange, and equity-derivative products will probably be of particular benefit to corporate clients.

Corporate banks have two levers for driving capital market revenues: catching up with the best-practice performance of the leaders and focusing on the most attractive product areas. Exhibit 3, which highlights the opportunities, compares the top three players in each capital market subcategory with the aver-age performance of all survey participants, as well as anticipated market trends. The share of equity and fixed-income prod-ucts in the revenues of the top three institutions is nearly three times greater than it is for the average of all banks in the survey—and three and a half times greater in the case of foreign-exchange products,1 including derivatives.

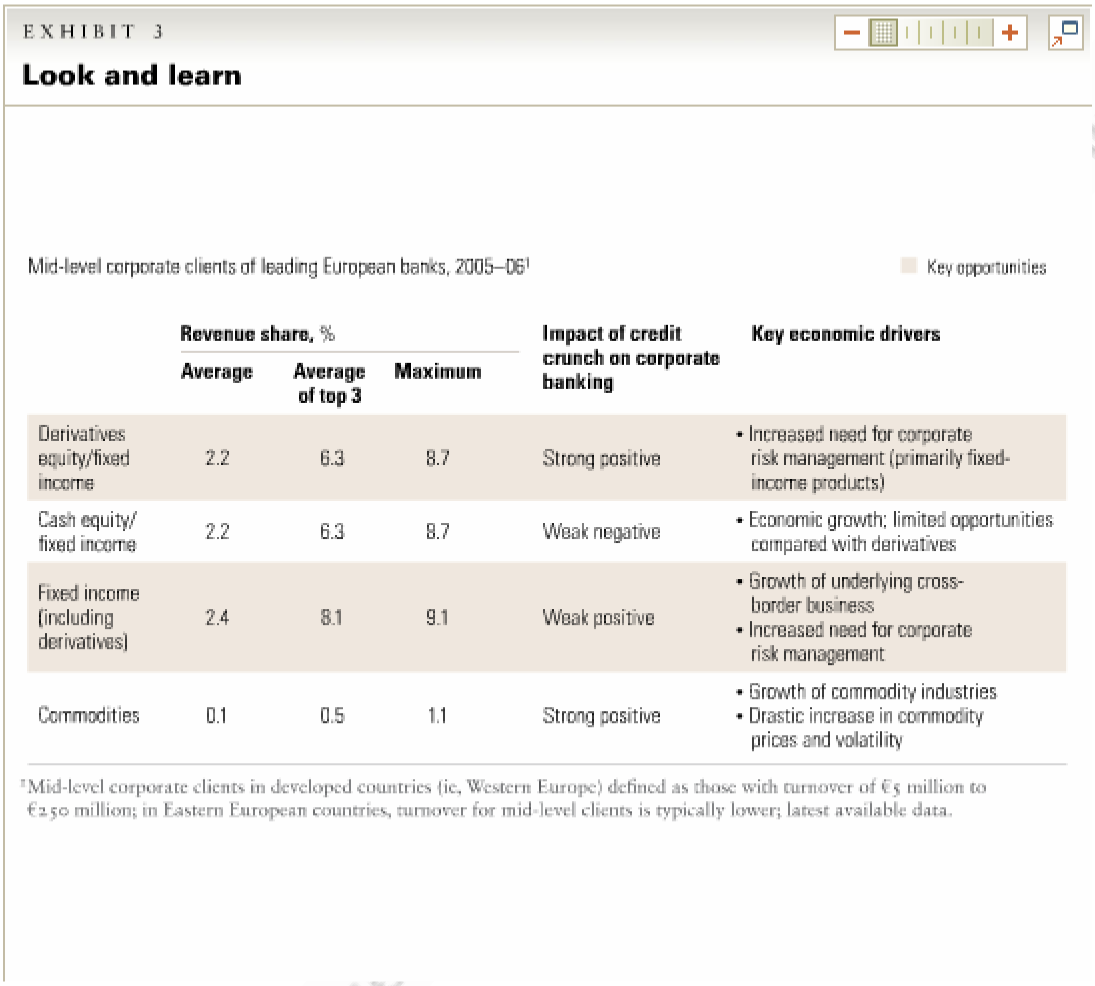

EXHIBIT 3

Look and learn

Mid-level corporate clients of leading European banks, 2005–06[1]

▨ Key opportunities

	Revenue share, %			Impact of credit crunch on corporate banking	Key economic drivers
	Average	Average of top 3	Maximum		
Derivatives equity/fixed income	2.2	6.3	8.7	Strong positive	• Increased need for corporate risk management (primarily fixed-income products)
Cash equity/ fixed income	2.2	6.3	8.7	Weak negative	• Economic growth; limited opportunities compared with derivatives
Fixed income (including derivatives)	2.4	8.1	9.1	Weak positive	• Growth of underlying cross-border business • Increased need for corporate risk management
Commodities	0.1	0.5	1.1	Strong positive	• Growth of commodity industries • Drastic increase in commodity prices and volatility

[1] Mid-level corporate clients in developed countries (ie, Western Europe) defined as those with turnover of €5 million to €250 million; in Eastern European countries, turnover for mid-level clients is typically lower; latest available data.

Commodities, judging by their relative contribution to revenues, have been a peripheral product in European corporate banking over the last couple of years. Yet the volatility of the prices of the underlying commodities will become a growing challenge for many banking clients across sectors, including primary industries, logistics, and manufacturing. Banks should also put a much greater emphasis on fixed-income and other derivatives.

Several European players, including banks in Italy and Germany, have successfully introduced specialized hedging business units for midcorp clients. Typically, three key features of these units support sales. First, systematic tools (for example, a thorough trade flow analysis and vulnerability assessment) make it possible to evaluate the true underlying needs of clients. Ready-made sales documents and simulation tools help relationship man-agers to explain the benefits of corporate risk mitigation. Finally, customizable product structures bring both quality and efficient scale to the hedging of risks in foreign exchange, interest rates, and commodity prices.

More specialized opportunities

Our research demonstrates that corporate finance (M&A, equity capital markets, and debt capital markets) is a small, even negligible, activity for the majority of midcorp banking players. Two-fifths of the banks in our survey reported zero revenues in this category, and for three-quarters of the banks such revenues (if they have any at all) amount to less than €20 million a year. In the current climate, banks that already have an established pres-ence in this business shouldn’t run away from it—deals won’t dry up completely. But this isn’t the time for most banks to enter the arena for the first time or to have highly ambitious expansion plans, especially for big-ticket M&A and equity capital market transactions.

By contrast, specialized finance is a much bigger activity, with broader client penetration for most banks. Products (such as leveraged and project finance) driven by financial sponsors have fueled growth in recent years. Nonetheless, on a short- to medium-term view, demand is more likely to increase for flexible and plain-vanilla corporate products, such as leasing, trade finance, invoice discounting, and factoring. Average performers have considerable scope to match the penetration of the best: for example, top banks sell leasing finance and documentary trade finance to around 30 and 40 percent of their clients, respectively. Such banks, which have integrated these products into a more comprehensive product suite, offer seamless advice and service rather than the isolated products commonly sold elsewhere.

Sales models

Banks can’t limit themselves to targeting specific product areas in response to changed economic and market conditions. To be successful, they must follow up with concerted and effective sales efforts. A comparison of revenues per relation-ship manager in the large-corporate segment reveals a wide gap between the most and least productive companies—at top banks, relationship managers earn €8 million (and more) each by cross-selling products. Less successful banks produce €2 million to €4 million per relationship manager in this segment. In the case of midcorp clients, the multiple between best and worst is six.

Our survey findings suggest that banks can achieve far better results by focusing on a small set of distinctive products rather than offering clients an overly com-plex suite of exotic and niche ones. Exhibit 4 shows a clear correlation between above-average economic-profit margins and banks that focus most of their cross-selling efforts on just a few select product categories.

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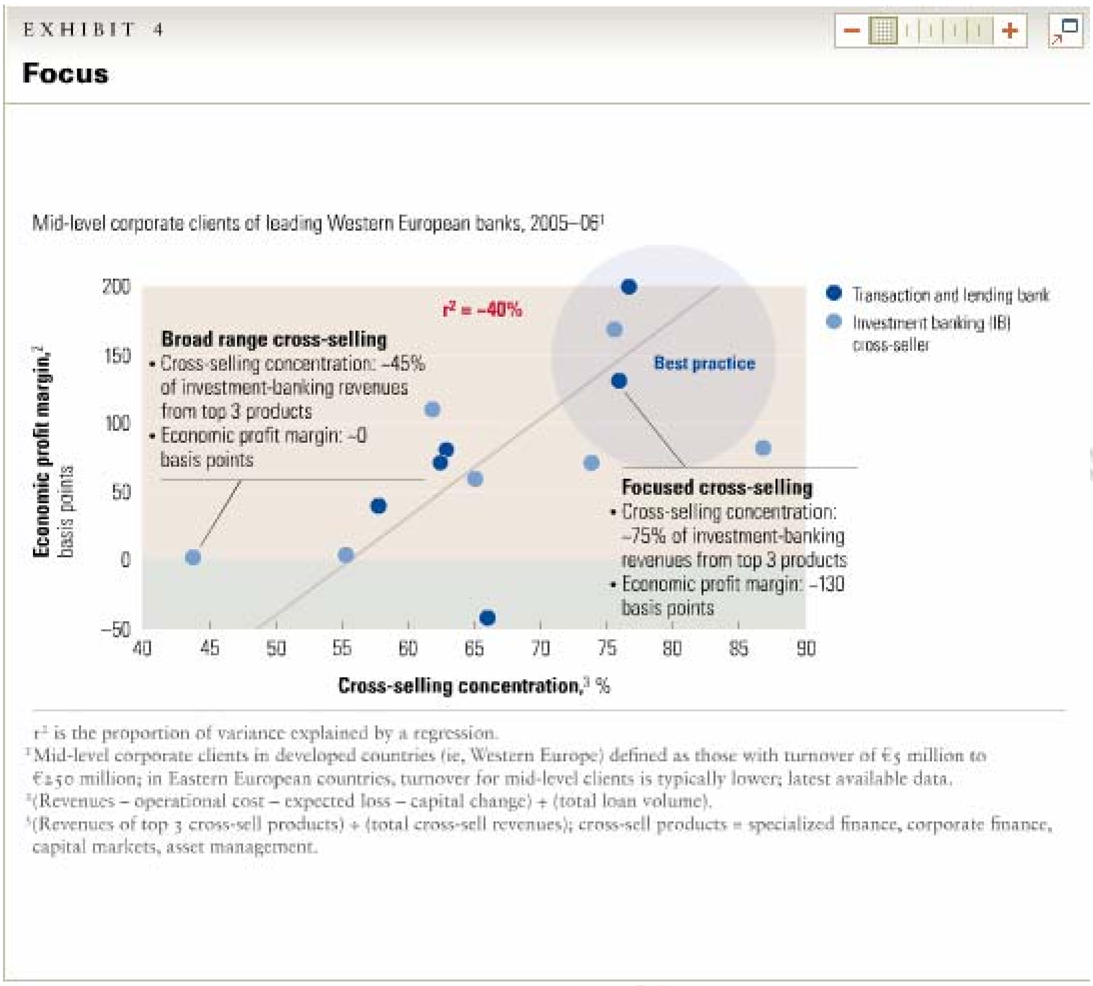

EXHIBIT 4

Focus

Mid-level corporate clients of leading Western European banks, 2005–06[1]

r² = ~40%
Broad range cross-selling
• Cross-selling concentration: ~45% of investment-banking revenues from top 3 products
• Economic profit margin: ~0 basis points
Best practice
Focused cross-selling
• Cross-selling concentration: ~75% of investment-banking revenues from top 3 products
• Economic profit margin: ~130 basis points
● Transaction and lending bank
● Investment banking (IB) cross-seller
Economic profit margin,² basis points
200
150
100
50
0
–50
40
45
50
55
60
65
70
75
80
85
90
Cross-selling concentration,³ %

r² is the proportion of variance explained by a regression.

[1] Mid-level corporate clients in developed countries (ie, Western Europe) defined as those with turnover of €5 million to €250 million; in Eastern European countries, turnover for mid-level clients is typically lower; latest available data.

[2] (Revenues – operational cost – expected loss – capital change) ÷ (total loan volume).

[3] (Revenues of top 3 cross-sell products) ÷ (total cross-sell revenues); cross-sell products = specialized finance, corporate finance, capital markets, asset management.

Banks must therefore build their sales models around a few highly visible products and simplify the interactions between relationship managers and product specialists. We also have evidence that the size of a relationship manager’s portfolio may be significant. The coverage ratio among the banks in our survey varies considerably, but the sweet spot appears to be around 30 to 40 clients per relationship manager in the midcorp segment. Banks with coverage in this range seem to have the best of both worlds: a comparatively efficient selling operation and above-average revenues from cross-selling products (Exhibit 5). For large corporate clients, the sweet spot appears to be around 10 to 25 per relationship manager.

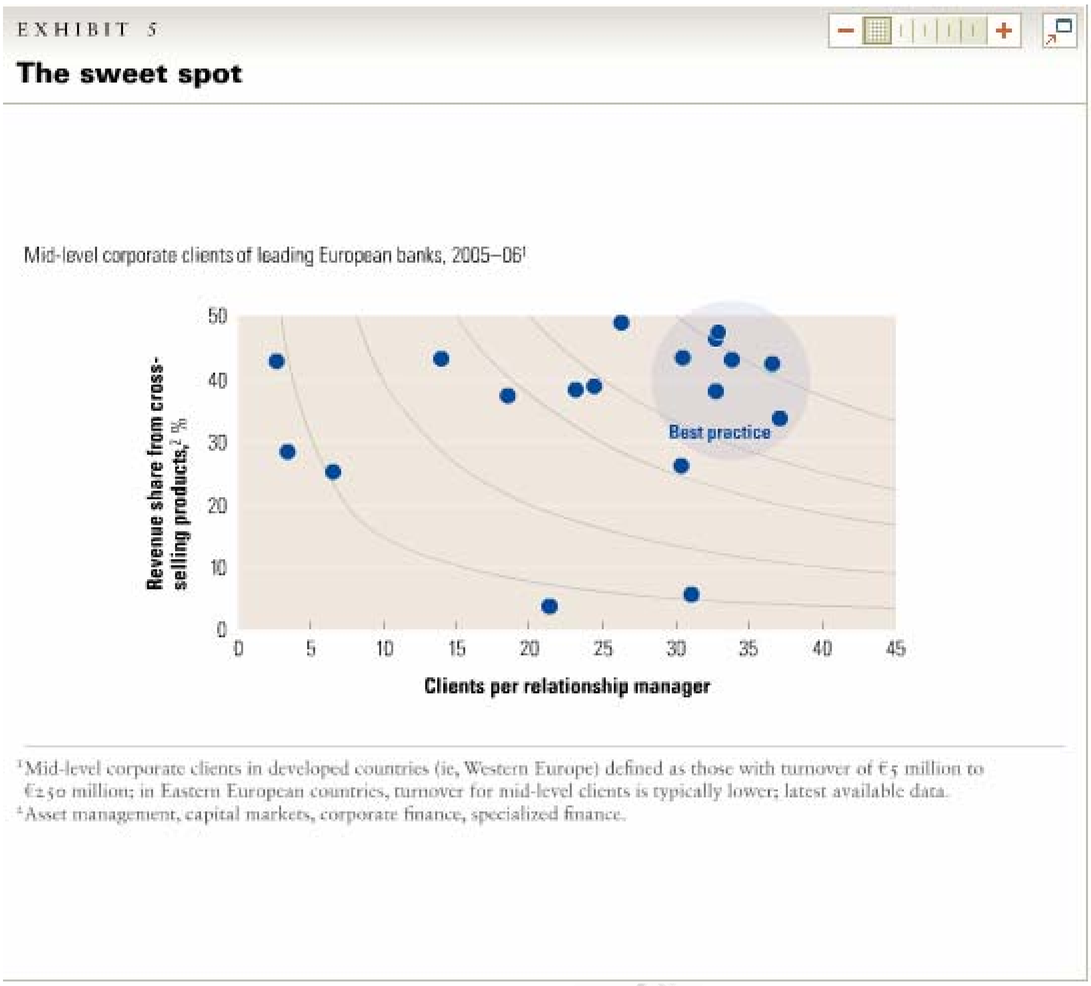

EXHIBIT 5

The sweet spot

Mid-level corporate clients of leading European banks, 2005–06[1]

Revenue share from cross-selling products,[2] %
50
40
30
20
10
0
Best practice
0
5
10
15
20
25
30
35
40
45
Clients per relationship manager

[1] Mid-level corporate clients in developed countries (ie, Western Europe) defined as those with turnover of €5 million to €250 million; in Eastern European countries, turnover for mid-level clients is typically lower; latest available data.

[2] Asset management, capital markets, corporate finance, specialized finance.

Some European banks have a robust account-planning process for large corporate clients. For midcorp ones, however, only a few top banks have a well-structured, semiautomated process that focuses on key products. A well-regarded regional bank, for example, is introducing a model relying on product specialists who systematically identify the potential needs of clients by using carefully crafted decision trees to choose products for them and by following industry-specific triggers, such as share of exports. Simple account tools to plan activities systematically and committed follow-up efforts support these specialists.

Over the next 18 months, the outlook for corporate banking is clearly less bright than it has been in recent years. Other types of banking business will probably encounter greater challenges, however. By exploiting the opportunities we have laid out, corporate-banking executives can expect solid revenue growth in the short to medium term. To what extent, however, depends on how shrewdly banks address specific markets and how efficiently they organize their sales teams and back-office operations. A full-fledged change in midterm strategy is not an appropriate response to the credit crunch. But a sharper approach to markets, combined with greater clarity in selling and greater efficiency in execution, will pay off handsomely at this stage of the cycle.

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