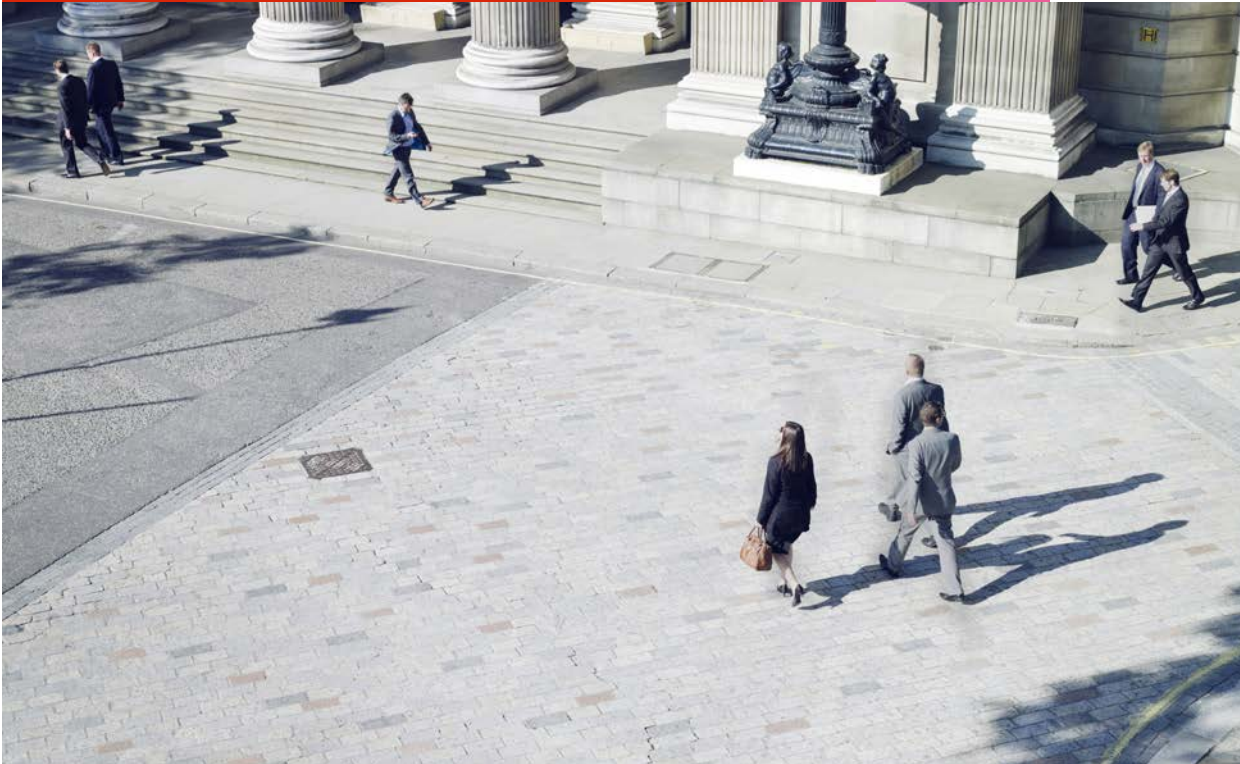


Capitalising on the acceleration in bank restructuring

European Bank Restructuring Conference 2016

This publication has been amended since publication to provide further explanation concerning our estimate of non core lending.







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Introduction



Richard Thompson
Global Leader,
Portfolio Advisory
Group, PwC (UK)

+44 (0)20 7213 1185
richard.c.thompson@
uk.pwc.com

In March 2016, we hosted our seventh European Bank Restructuring Conference. The annual conference explores the investment opportunities opened up by the restructuring in the European banking industry and how sellers, investors and servicing companies can capitalise on them. This year's event attracted around 650 market participants from over 25 countries, representing around 100 different banks and 100 investor groups.

European banks hold €2.3 trillion of loans they no longer want¹. More than half of these assets are performing (€1.3 trillion), but are no longer central to banks' strategies as they look to free up capital and concentrate resources where they can earn the best return. The scale of the opportunity is highlighted by the fact that 74% of conference participants believe that up to €1 trillion of the €2.3 trillion in non-core lending will end up trading as a portfolio transaction. Further opportunities are emerging in Asia, including the €640 billion in identified non-performing loans (NPLs) in China and €125 billion in India. Recent regulatory changes and other factors may open these markets to independent investors and servicers.

The pressure to boost return on capital through the divestment of non-core loans has been heightened by the poor performance of European banks of late. PwC research

suggests that less than 10% of the biggest 40 European banks were able to cover their cost of capital (return on equity higher than cost of equity) in the year to June 2014. The resulting need for restructuring and cost cutting is set to bring a fresh wave of deal opportunities to the market. Regulation will also continue to drive the bank restructuring agenda and hence deal activity. Key developments include possible changes to provisioning under IFRS 9 and the capital requirements directive (CRD IV).

The deal momentum is reflected in the €141 billion in transaction values recorded in 2015, up more than 50% on 2014. The big year-on-year rise in deal activity already seen in 2015 and the pipeline of deals already in the market in 2016 suggests that this year could be another record year. Reforms in Italy are set to assist in the acceleration of NPL sales. In turn, the strong recovery in Ireland and Spain is broadening the focus of buyer interest in areas such as SME debt.

Rather than following a pre-set agenda, the panel discussions were fully interactive by focussing on questions coming from "the floor" (each participant had an iPad to relay questions to be addressed by the panel). What came through strongly from both the questions and the responses is the strong sense of realism within the market; realism that the clean-up of balance sheets and refocusing of resources needed to spur

sustainable returns still has a long way to go on the one side and the importance of credible valuations, effective servicing and continuing legal reform in making deals happen on the other. In an increasingly mature and sophisticated debt portfolio market, buyers and sellers immediately know who is serious and who is just dipping their toe in the water.

I would like to thank all the speakers, panellists and delegates for providing their valuable time and insights, which generated a lively debate throughout the day.

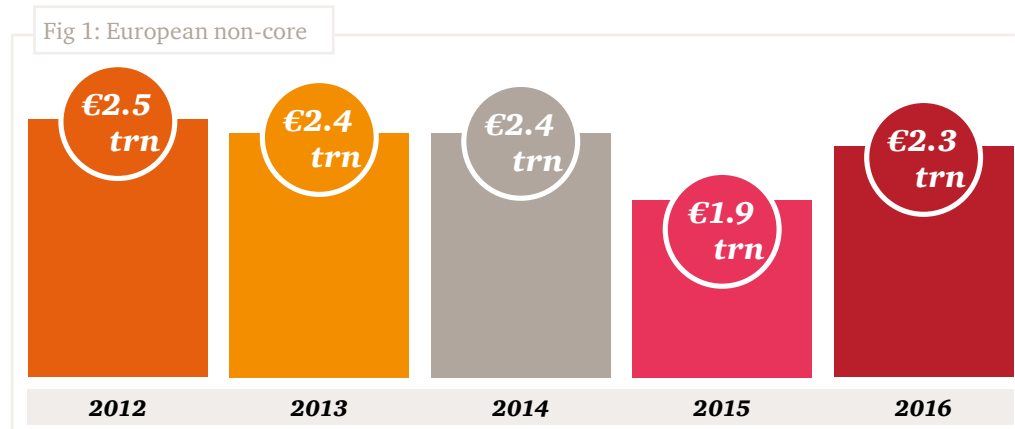
This report provides a brief summary of the main themes discussed during the conference. It also includes findings from the live polling, which gave participants an opportunity to convey their views on the direction of the market.

Planning is already underway for our 2017 conference. If you would like to discuss any aspect of the matters arising in this document please do not hesitate to contact me.

Overview

How big is the potential market?

European banks hold €2.3 trillion of loans they no longer want², of which around €1 trillion are NPLs and the remainder are performing loans. Despite a large number of transactions, the value of non-core assets is rising once again as the continued restructuring of the banking sector results in more assets being designated as non-core.



Source: This is a high level estimate based on public information concerning non core assets held and stated objectives around reductions in assets. There is limited information available as to the underlying nature of such assets. Consequently this estimate should be viewed as illustrative in nature only and the total amount is likely to include assets other lending.

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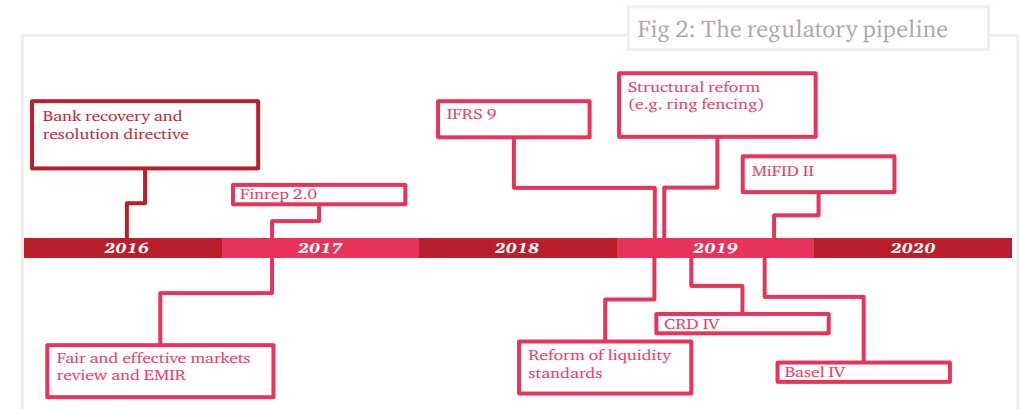
There is limited information concerning the performance status of non core assets. For the purposes of estimating the potential volume of performing assets we have assumed that all reported non performing lending is within non core.

What's driving deal activity?

Poor returns

Less than 10% of the biggest 40 European banks were able to cover their cost of capital (return on equity higher than cost of equity) in the year to June 2014. Bringing the global systemically important banks (G-SIBs) back to economic breakeven would require around a 35% reduction in costs and 25% increase in income. Fundamental restructuring is needed to meet these targets.

Regulatory pressures



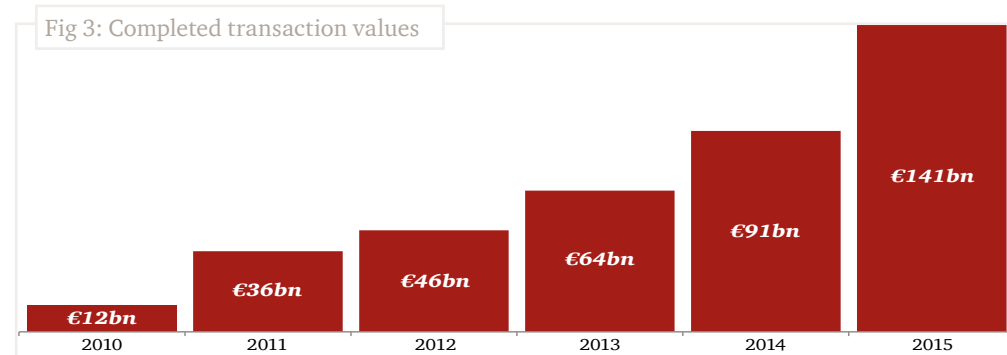
Source: PwC analysis

Over four fifths (87%) of the banking and capital markets CEOs taking part in PwC's Annual Global CEO Survey see over-regulation as a threat to growth³. The rationale for continued restructuring and further asset divestments includes the opportunity to free up capital and refocus resources on core businesses.

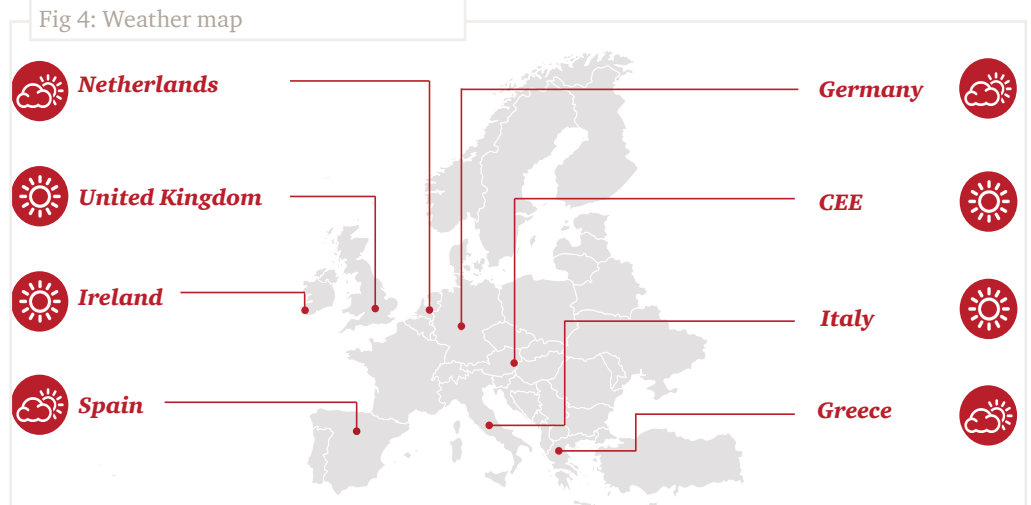
³ Creating a platform for competitive regeneration: Key findings in the banking and capital markets sector, PwC 19th Annual Global CEO Survey (<http://www.pwc.com/gx/en/ceo-survey/2016/industry-focus/banking-and-capital-markets-key-findings-global-ceo-survey-2016.pdf>)

Record year

In 2015 debt portfolio sales reached €141 billion, with much of this rise coming from a big surge in secured retail transactions, which was driven by divestment of a number of non-strategic performing residential mortgage portfolios in the UK. 2016 has already seen a further rise in year-on-year deal values, with Italy, Greece and Central and Eastern Europe set to be at the forefront of growth.



Source: PwC analysis



Source: PwC analysis

Looking ahead, the scale of the opportunity is highlighted by the fact that 74% of conference participants believe that up to €1 trillion of the €2.3 trillion in non-core lending will end up trading as a portfolio transaction.

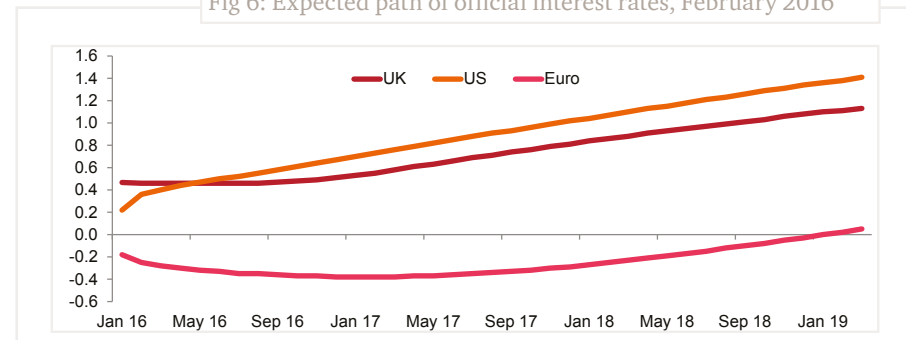
Struggling to sustain returns: Are banks viable?

Investors could eventually run out of patience with the poor returns being delivered by most major European banks. Is the slump likely to be temporary or will it be the catalyst for fundamental restructuring and strategic re-orientation?

Less than 10% of the largest 40 European banks were able to cover their cost of capital (return on equity exceeding the cost of equity) in the year up to June 2014. If banks can't boost shareholder returns, they're going to find it increasingly difficult to compete for capital. This would, in turn, leave them starved of the investment they need to compete in a sector being transformed by technology and changing customer expectations.

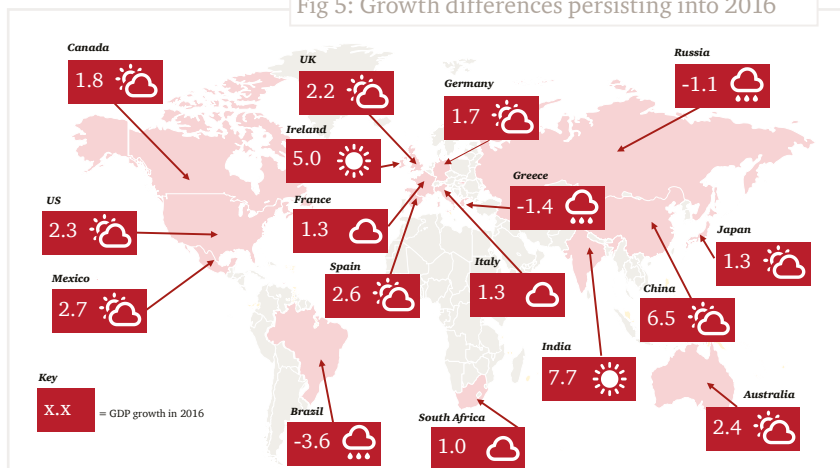
Many banks will be hoping that returns will become more attractive once the EU economy comes back to full health, big regulatory changes are out of the way and interest rates begin the slow climb to historic norms. But none of this looks imminent. In any case, given the extent of change in regulation, technology, competition and customer attitudes, even an optimistic scenario on economic normalisation will be insufficient to restore performance.

Fig 6: Expected path of official interest rates, February 2016



Source: Bank of England Inflation Report

Fig 5: Growth differences persisting into 2016



Source: PwC February 2016 Global Outlook

As several panellists argued, the biggest problems facing banks aren't externally driven, but rooted in weaknesses within the sector itself. They include significant overcapacity, uncompetitive costs and often slow and unwieldy legacy systems. Marginal cost reduction won't be enough when global systemically important banks (G-SIBs) need to reduce expenses by more than 30% to reach economic breakeven (cost of equity equals return on equity)⁴.

Breakeven would alternatively require a boost in income of more than 25%. The pressure on the economics in the sector is heightened by competition from a number of new entrants including the emergence of a significant number of FinTech businesses, all unencumbered by the legacy issues faced by established banks and can hence operate at much lower cost and react much more quickly to changes in the market.

Overhauling business models

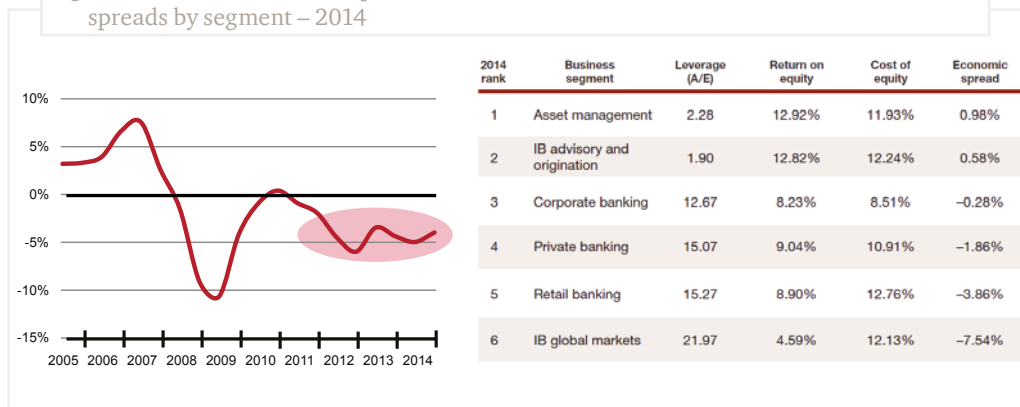
Will the combination of client relationships, infrastructure and the ability to manage complex regulation protect the incumbent banks?

The next conference session explored what the new ecosystem that emerges will look like and the restructuring opportunities that will be opened up.

A panellist warned that many big telecoms companies believed that the same barriers would protect their market share 25 years ago, but have since been disrupted and disintermediated by new entrants and new technology. Many of these established players have ended up as utilities, delivering steady risk-adjusted returns but trading at much lower multiples than before.

As banks look to reinvigorate profitability and growth, the panellists looked ahead to a fundamental overhaul of business models, cost structures and capabilities. "There is going to be a lot of value lost if banks don't take decisive action now. And that means looking aggressively at costs and developing creative solutions for the economic issues they face," said a panellist.

Fig 7: Global bank economic spreads (RoE-CoE) 2005-2014 and Global bank economic spreads by segment – 2014



Source: PwC analysis

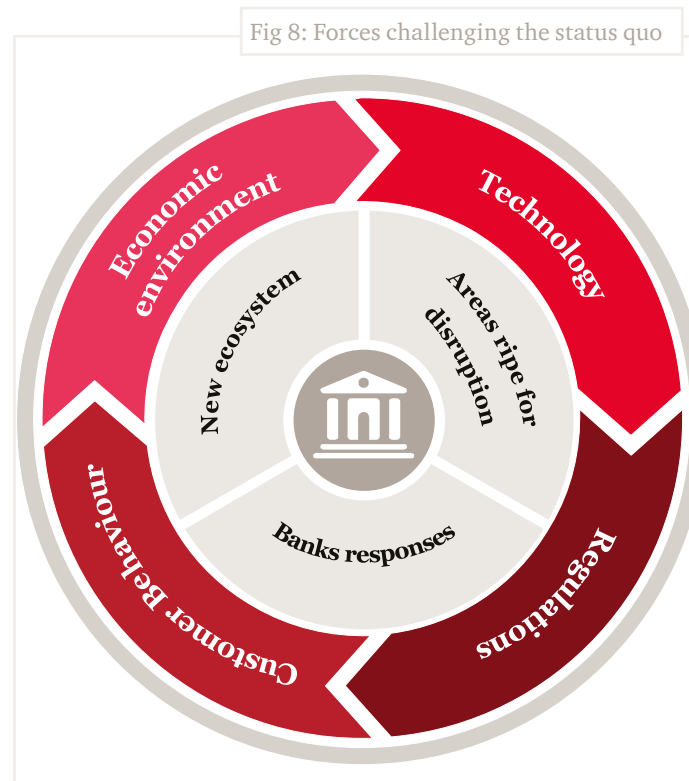
⁴ Strategy & analysis

Challenging the challengers: The future shape of banking

Returns are hard won. Industry boundaries are becoming increasingly blurred. What kind of banking ecosystem will emerge as a result?

We increasingly hear “people need banking, but do they need banks?”. The challenge is highlighted by the fact that 73% of millennials would be more excited about a new financial services offering from Google, Apple, Amazon, Square or PayPal than from their bank⁵.

A panel that included a mix of executives from FinTech, established banks and financial investors agreed that customer-centricity is the key competitive battleground in a fast-changing and increasingly disrupted marketplace. And FinTech has been setting the pace. But established banks are beginning to challenge the challengers.



“If incumbents get their act together, they can do well,” said a participant. A panellist cited the continuing advantages of customer deposits as a stable source of funding. Another noted that established banks have huge data deposits as well as money deposits to draw on. They can therefore compete as customer-centric data sources as well as financial businesses. As traditional revenues recede, the new openings include developing customised solutions based on advanced customer profiling and real-time data, and providing access to peer-to-peer and capital markets finance as well as traditional lending – the “window to financial life” as a panellist described it. To capitalise on the transformational possibilities, banks need “to eradicate the friction and optimise the user experience,” said another.

⁵ The Millennial Disruption Index, Scratch 2014

New phase of regulation

The impact of regulation has certainly made it harder to focus full attention on customer needs. But now that banks are finally moving into what one panellist described as the “implementation phase”, they can step back and ask the crucial questions about ‘how are we going to make money?’. A key part of this is determining what is core and non-core competitively, and then accelerating restructuring and divestment to ensure that capital, financial and human resources can be focused where they can be most efficiently deployed.

Back to front transformation

The other key imperative is developing the technological capabilities needed to drive down operational costs on the one side and deliver the insight, engagement and innovation to meet customer expectations on the other. A lot of the focus so far has been on the direct customer interface in areas such as new apps, while those behind the scenes are left struggling to keep the lights on in the legacy systems. Citing the use of blockchain distributed ledgers as an example of how technology could eliminate a range of needlessly complex and labour intensive processes, a panellist described the next big developments as a “back to front office transformation”.

Performers and producers

The ecosystem that emerges will see FinTech and established banks working much more in collaboration than competition. FinTech will want access to the data and funding of its established counterparts, while they will, in turn, look to FinTech to help them develop the real-time customer profiling and response.

As successful businesses are always partnerships between producers (conceiving new ideas and bringing them to market) and performers (skilled in optimising existing systems and products) there is likely to be considerable interchange of personnel between the producer-orientated FinTech and performance-orientated incumbents.

Many of the challenges of making this new collaborative ecosystem work are cultural. As FinTech businesses move into the mainstream, they will become increasingly regulated, forcing them to develop more structured ways of operating. Hedge funds have faced a similar journey in recent years. In turn, established banks need to ensure that the people and ideas coming in from start-ups and Fintech businesses aren’t smothered by what a panellist described as the “immune systems” of established working practices, HR and IT management.



Evaluating the deal opportunities

A combination of more realistic and attractive pricing and the development of more effective servicing capabilities is deepening and broadening the debt portfolio market.

Focus on Southern Europe

When conference participants were asked “you have €100 million, would you invest in Italy or Greece?”, 65% said Italy and 35% opted for Greece. When we asked the same question two years ago, the split was a much closer 55:45.

Market conditions in Italy are continuing to improve. Key developments include the recent Government guarantee scheme and certain changes to improve the collectability of non-performing debt. Panellists stressed that Italy’s Government guarantee scheme is not a panacea in itself, rather one of a number of reforms designed to stimulate the market and close the bid-ask spread. This includes accelerated provisioning and a shortening of legal proceedings. The impact of these developments can already be seen in the growing focus on unsecured debt portfolios and greater availability of vendor finance. Further development in servicing capabilities would be needed to ensure the full benefit from the legal reforms.

While Greece may have slipped further behind Italy in the eyes of conference participants, the regulatory landscape is improving and in particular providing a stimulus for the continuing development of servicing capabilities, which are helping to attract a broader range of investors into the market. A considerable amount of investment is moving into the creation of platforms for mortgage and unsecured consumer portfolios, and SME debt looks set to follow.

The portfolio market in Spain is benefiting from the gathering economic turnaround. This is reflected in the growing interest in collateralised loans, including land earmarked for development. Investors see an opportunity to acquire good land at a discount.

So what is the key to make deals happen? Many of the easy deals in some of the mature debt portfolio markets have already been done. What’s coming onto the market is more complex. Panellists therefore highlighted the importance of full

transparency over what’s on offer and the basis for valuation. It’s also important to ensure that “everyone is in the same room,” said a panellist. This includes consultants, rating agencies and servicing companies, as well as sellers and investors.

What are the brakes on further activity? The development of servicing capabilities in many markets is still work in progress. The prospect of having to record portfolio losses in the income statement also continues to hold back sales. Recognition over time would help to ease the impact and stimulate further sales.

Focus on long-dated assets

Banks hold a large number of non-core performing long-dated assets on their books. This includes project finance, equity release and infrastructure investments. Many banks would like to divest such illiquid assets to help lower their liquidity ratios. Private equity is coming into the market to carry out structured deals. Other potential investors include life insurers, who can use these assets to match their long-term liabilities however there was some scepticism on the ability of the insurers to have the skills and processes in place to effectively compete in M&A style sales processes. With Solvency II now in place, insurers also have greater certainty over the impact of these investments on their own capital demands. But they will need to develop their expertise in this area, both as knowledgeable investors and in building these investments into their internal model evaluations.

Focus on real estate

The returns on prime real estate continue to be attractive, with yields comparable to non-investment grade assets.

There has been a lot of focus in the media on whether the rapid increases in asset values are creating a potential bubble. Leveraged lending is now more readily available. But panellists noted that similarities with 2007 are otherwise limited. Key differences include a much greater proportion of equity in what is therefore a healthier capital mix.

And the real estate market itself has changed. Tenants are becoming more demanding. Developments in technology and demands on space mean that buildings can quickly slip into obsolescence without regular investment. This creates opportunities for companies that are prepared to take on, renovate and more actively manage property assets.

Many investors are looking at value-added strategies in which development is aligned with infrastructure and regeneration. The panel discussions also highlighted the focus on individual cities rather than countries.



Panel hosts and participants

Thank you to all who took part in the panel discussions and conference delegates who engaged in the discussion by submitting questions.

Market update and the European macro-economic environment

- Richard Thompson (host), Global Leader, Portfolio Advisory Group, PwC (UK)
- Andrew Sentance CBE, Director & Senior Economic Adviser, PwC (UK)

Are banks economically viable?

- Colin Brereton (host), EMEA Financial Services Risk, Regulation and Economic Crisis Leader, PwC (UK)
- Michalis Athanasiou, Group Chief Risk Officer, Bank of Cyprus
- Miles Kennedy, Partner, Strategy& PwC (UK)
- Sascha Klaus, Division Board Member, Non-Core Assets, Commerzbank
- Timo Löyttyniemi, Vice Chair, Single Resolution Board (SRB)

What does the financial institution of tomorrow look like?

- Michael Magee (co-host), Financial Services Restructuring Leader, PwC (UK)

- Alan Gemes (co-host), Financial Services Strategy Leader, Strategy& PwC (UK)
- Giles Andrews OBE, Co-founder and Executive Chairman, Zopa
- Joe Giannamore, Founder and Co-Managing Partner, AnaCap Financial Partners
- John Egan, Director, Anthemis
- Kevin Burrowes, Global Banking & Capital Markets Leader, PwC (UK)
- Richard Kibble, Group Director of Strategy & Corporate Finance, Royal Bank of Scotland
- Vicky del Castillo Marchese, Managing Director, BBVA

Investment in Southern Europe

- Richard Thompson (host), Global Leader, Portfolio Advisory Group, PwC (UK)
- Alberto Vigorelli, Senior Vice President Distressed Asset Management, UniCredit
- Emil Yiannopoulos, Partner PwC (Greece)

- Fabrizio Pagani, Head of the Office of the Minister of Economy & Finance, Italian Ministry of Economy & Finance
- Paul Mylonas, Deputy CEO, National Bank of Greece

Investment opportunities on the horizon

- Richard Thompson (host), Global Leader, Portfolio Advisory Group, PwC (UK)
- Jaime Bergaz, Partner, PwC (Spain)
- John Davison, CEO, Pillarstone Europe
- Richard Roberts, Managing Director, Business Development, GE Capital
- Shazia Azim, Partner, PwC (UK)

Investment opportunities in real estate

- Simon Hampton (host), Head of Real Estate & Hotels, Corporate Finance, PwC (UK)
- Dale Lattanzio, Managing Partner, DRC Capital
- Dennis Lopez, CIO, AXA

- Hans Vrensen, Consultant Director Research & Education, Commercial Real Estate Finance Council
- Lorna Brown, Managing Director, Blackstone

Portfolio Advisory Group contacts

Richard Thompson
+44 20 7213 1185
richard.c.thompson@uk.pwc.com
Jaime Bergaz
+34 915 684 589
jaime.bergaz@es.pwc.com

Austria

Jens Roennberg
+49 699 585 2226
jens.roennberg@de.pwc.com

Bernhard Engel
+43 150 188 1160
bernhard.engel@at.pwc.com

CEE

Jonathan Wheatley
+40 212 253 645
jonathan.wheatley@ro.pwc.com

Cyprus

Stelios Constantinou
+35 725 555 190
stelios.constantinou@cy.pwc.com

Czech Republic and Slovakia

Petr Smutny
+42 025 115 1215
petr.smutny@cz.pwc.com

Denmark

Bent Jørgensen
+45 39 459 259
bent.jorgensen@dk.pwc.com

France

Hervé Demoy
+33 156 577 099
herve.demoy@fr.pwc.com

Finland

Harri Valkonen
+35 840 539 9339
harri.valkonen@fi.pc.com

Germany

Christopher Sur
+49 699 585 2651
christopher.sur@de.pwc.com

Thomas Veith
+49 699 585 5905
thomas.veith@de.pwc.com

Greece

Emil Yiannopoulos
+30 210 687 4640
emil.yiannopoulos@gr.pwc.com

Hungary

Csaba Polacsek
+36 14 619 751
csaba.polacsek@hu.pwc.com

Ireland

Aidan Walsh
+35 317 926 255
aidan.walsh@ie.pwc.com

Italy

Fedele Pascuzzi
+39 028 064 6323
fedele.pascuzzi@it.pwc.com

Pier Paolo Masenza
+39 065 702 52483
pierpaolo.masenza@it.pwc.com

Patrizia Lando
+44 20 7804 4700
patrizia.lando@uk.pwc.com

Vito Ruscigno
+39 028 064 6333
vito.ruscigno@it.pwc.com

The Netherlands

Peter Wolterman
+31 887 925 080
peter.wolterman@nl.pwc.com

Joris van de Kerkhof
+31 887 927 622
joris.van.de.kerkhof@nl.pwc.com

Norway

Lars Johansson
+47 48 161 792
lars.x.johansson@no.pwc.com

Poland

Lukasz Bystrzynski
+48 225 234 228
lukasz.bystrzynski@pl.pwc.com

Portugal

Antonio Rodrigues
+35 121 359 9181
antonio.rodrigues@pt.pwc.com

Romania

Cornelia Bumbacea
+40 212 253 960
cornelia.bumbacea@ro.pwc.com

Spain

Jaime Bergaz
+34 915 684 589
jaime.bergaz@es.pwc.com

Guillermo Barquin
+34 915 685 773
guillermo.barquin.orbea@es.pwc.com

Pablo Martinez-Pina
+34 915 684 370
pablo.martinez-pina@es.pwc.com

Richard Garey
+34 915 684 156
richard.garey@es.pwc.com

Antonio Fernandez
+34 915 684 052
antonio.fernandez.garcia_fraile@es.pwc.com

Sweden

Per Storbacka
+46 855 533 132
per.storbacka@se.pwc.com

Turkey

Husnu Dincsoy
+90 212 376 5302
husnu.dincsoy@tr.pwc.com

Ukraine

Vladimir Demushkin
+38 044 490 6776
vladimir.demushkin@ua.pwc.com

United Kingdom

Richard Thompson
+44 20 7213 1185
richard.c.thompson@uk.pwc.com

Robert Boulding
+44 20 7804 5236
robert.boulding@uk.pwc.com

Ben May
+44 20 7212 3664
benjamin.d.may@uk.pwc.com

Christina Zarifi
+44 20 7213 2045
christina.zarifi@uk.pwc.com

Natasha Firman
+44 20 7212 3453
natasha.firman@uk.pwc.com

Panos Mizios
+44 20 7804 7963
panagiotis.mizios@uk.pwc.com

North America

Mitchell Roschelle
+1 646 471 8070
mitchell.m.roschelle@us.pwc.com

Asia Pacific

Ted Osborn
+85 222 892 299
t.osborn@hk.pwc.com

Chiara Lombardi
+65 623 637 03
chiara.m.lombardi@sg.pwc.com

James Dilley
+85 222 892 497
james.ha.dilley@hk.pwc.com

Australia

Anthony Boswell
+61 82 662 551
anthony.dk.boswell@au.pwc.com

Latin America

Nico Malagamba
+55 119 9976 4250
nicolas.malagamba@br.pwc.com

Japan

Masahiro Komeichi
+81 904 137 5649
masahiro.komeichi@jp.pwc.com

pwc.com

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